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CENTRAL BANK OF MALTA

## INTERIM FINANCIAL STABILITY REPORT 2016

This *Interim Report* covers the first six months of 2016 and evaluates developments which may impact the resilience of the domestic financial system since the publication of the *Financial Stability Report 2015*. It also analyses whether any new risks have emerged.<sup>1</sup> The *Interim Report* is prepared by the Financial Stability Department and is subsequently reviewed and endorsed by the Financial Stability Committee of the Central Bank of Malta.

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### Overview

#### **Risks to financial stability remained on the downside with a positive outlook for 2016.**

International headwinds persisted throughout the first half of 2016, as economic growth in the euro area recovered modestly, whereas debt sustainability concerns stood elevated. Furthermore the uncertainty surrounding the UK's referendum regarding membership in the EU and its outcome led to bouts of market volatility. Amid this environment, the Maltese economy was resilient and continued to perform strongly, outpacing growth in the euro area as a whole. The favourable domestic macroeconomic environment continued to support the financial system in Malta. The core domestic banks reported further growth in profits, while maintaining prudent practices despite the globally-low interest rate environment. This was also mirrored in the credit-to-GDP gap which remained negative and resulted in a 0% countercyclical capital buffer rate for the first half of the year.<sup>2</sup> Furthermore, the resilience of the sector was enhanced further through capital accumulation and the add-ons of specific capital buffers, including the other systemically important institutions (O-SII) and capital conservation buffers.

With regards to credit risk, loan quality has improved mirroring enhanced creditworthiness, whereas the level of non-performing loans (NPL) continued on their downward path, partly driven by the recovery in the property market in Malta. This trend was also supported by low unemployment and strong economic growth. The banks remained prudent in their lending practices, indicating that there is no undue risk accumulation. The NPL ratio for both households and non-financial corporates (NFC) is expected to decline further and therefore overall credit risk is expected to recede further.

Challenges to bank profitability remain relevant, particularly in a context of a prolonged low interest rate environment and weak credit growth, the latter partly reflecting the structural shift in the economy towards services. Although non-services industries, which typically are more capital intensive and rely extensively on bank credit, remain a fundamental element of the Maltese economy, banks will need to identify new lending

<sup>1</sup> The cut-off date for data published in this *Interim Report* is 6 September 2016. GDP data used refer to the NSO's *News Release 142/2016*.

<sup>2</sup> <https://www.centralbankmalta.org/countercyclical-capital-buffer>.

avenues or income sources, or seek to contain further their operating costs to improve profitability. To date, despite the low interest rate environment, returns from financial intermediation remained buoyant.

In the first half of 2016, risks to financial stability remained low with a positive outlook for the second half of the year. This is also evidenced by the systemic stress index of the Central Bank of Malta, which reflects risks below systemic stress thresholds.<sup>3</sup> However, despite the current positive macro-financial environment, financial institutions should not lower their guard to vulnerabilities and should remain prudent so as to ensure no accumulation of undue risks. In this light, the recommendations proposed in the *Financial Stability Report 2015*, namely to mitigate further credit risk and continue to adopt prudent lending practices, remain relevant. Furthermore, a more prudent regulatory framework calls for the preservation or enhancement of capital buffers.

**Table 1  
SUMMARY OF RISKS**

| Main vulnerabilities and risks for the financial system                       | Type of risk             | Nature of risk       | Change in risk level since FSR 2015 | Risk position as at H1 2016 |        |          | Risk outlook for H2 2016 |
|---|--------------------------|----------------------|-------------------------------------|-----------------------------|--------|----------|--------------------------|
|   |                          |                      |                                     | Moderate                    | Medium | Elevated |                          |
| <b>Vulnerabilities within the financial system</b>                            |                          |                      |                                     |                             |        |          |                          |
| The level of non-performing loans   | Credit                   | Cyclical/ Structural | ↓                                   |                             | ●      |          | ↓                        |
| Concentration in bank lending   | Credit                   | Structural           | ↔                                   | ●                           |        |          | ↔                        |
| Subdued credit developments   | Profitability            | Cyclical/ Structural | ↔                                   |                             | ●      |          | ↔                        |
| Reliance on short-term funding  | Liquidity                | Cyclical/ Structural | ↔                                   | ●                           |        |          | ↔                        |
| Interlinkages between banks and the insurance and the investment fund sectors | Contagion                | Structural           | ↔                                   | ●                           |        |          | ↔                        |
| <b>Vulnerabilities outside the financial system</b>                           |                          |                      |                                     |                             |        |          |                          |
| Domestic macroeconomic developments   | Credit, Profitability    | Cyclical             | ↓                                   | ●                           |        |          | ↔                        |
| Performance of key economic sectors reliant on bank credit                    | Credit                   | Cyclical/ Structural | ↓                                   |                             | ●      |          | ↔                        |
| Exposures of the financial sector to domestic sovereign securities            | Profitability            | Structural           | ↔                                   | ●                           |        |          | ↓                        |
| Economic conditions in the euro area  | Credit, Profitability    | Cyclical             | ↔                                   |                             | ●      |          | ↔                        |
| Euro area sovereign debt crisis   | Contagion, Profitability | Cyclical             | ↔                                   |                             | ●      |          | ↔                        |
| Geopolitical uncertainties  | Contagion                | Structural           | ↑                                   |                             | ●      |          | ↔                        |
| Search for yield owing to the low interest rate environment                   | Profitability            | Cyclical             | ↔                                   | ●                           |        |          | ↔                        |

<sup>3</sup> Refer to Central Bank of Malta, *Quarterly Review*, 2016:2.

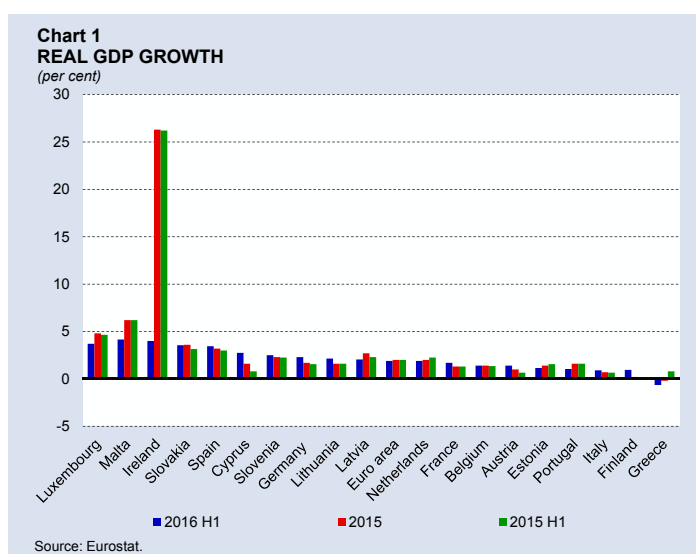
## The Macro-financial environment

**Economic and financial conditions in the euro area were more positive, supported by easier monetary conditions and improving labour market dynamics. In Malta, economic activity continued to expand robustly, and the downward trend in the unemployment rate was sustained.**

Despite persistent headwinds, some positive macroeconomic developments were observed in the euro area. Real gross domestic product (GDP) grew steadily by 1.9% on an annual basis, while unemployment eased to 10.4% in June 2016. HICP inflation fluctuated in the first half of 2016 but turned positive in June 2016 and edged up to an annual 0.4% in September 2016. Economic growth is expected to be sustained in the coming quarters with inflation climbing slowly but still somewhat lower than the ECB's target. Inflation in 2017 and 2018 is expected to reach 1.4%.<sup>4</sup> In this context, the monetary stance was loosened further with the main refinancing rate and the marginal lending facility rate cut by a further 5 basis points to 0% and to 0.25%, respectively, whereas the deposit facility rate was cut by a further 10 basis points to -0.4%. The Asset Purchase Programme was also expanded to €80 billion per month starting from April 2016, while the list of eligible assets was extended to include investment grade euro-denominated bonds issued by non-bank corporations established in the euro area. In June 2016 a new round of targeted longer-term refinancing operations (TLTRO II) was launched, with a maturity of four years and interest rates that could go as low as the overnight deposit facility rate.

Within the context of heightened political uncertainty in a number of EU countries, the UK's referendum result on EU membership in June 2016 impacted adversely on the Pound Sterling and financial markets internationally. Macroeconomic developments in emerging market economies (EME), including China, remained weak, with spill-overs onto advanced economies through declining prices of risky assets and of equities issued in EMEs. Markets were also buffeted by persistently low commodity prices and the low, but volatile, oil prices. Banks in some euro area countries continue to be saddled with high levels of NPLs, which inhibit growth in credit supply and impact negatively profitability. Poor asset quality also led investors to reassess risk in the banking sector, resulting in higher cost of funding, hindering banks in their efforts to raise capital from the markets. Meanwhile, despite an improving fiscal position, government debt in a number of countries remained high. As a result, concerns about debt sustainability in the euro area remained elevated, as economic growth could stall in the short-term should the necessary structural reforms to curtail debt be implemented. This could raise the risk premia of sovereign debt, spilling over to the non-financial private sector.

In the first half of 2016, real GDP continued to grow strongly by 4.1% in Malta, and although it decelerated somewhat compared to the exceptional growth recorded a year earlier, it nevertheless still recorded the second highest economic growth among euro area Member States (see Chart 1). Domestic demand continued to be the driver underpinning economic growth, with both investment and consumption being the main contributors. The services sector continued to spur the domestic economy, with all sub-sectors recording increases in gross value added. Collectively, the non-services sector, which includes manufacturing and construction activities, contributed positively



<sup>4</sup> European Commission Forecast Autumn 2016.

towards economic growth, although gross value added by the construction sector declined slightly during the first half of the year.

The unemployment rate maintained its downward trend and reached a new historic low of 4.9% in the first half of 2016 (see Chart 2),<sup>5</sup> with the number of registered unemployed declining by nearly 34% since June 2015.<sup>6</sup> Tight labour market and favourable economic conditions were reflected in both higher compensation of employees and gross operating surplus. These developments, in conjunction with higher households' net financial wealth, improved the creditworthiness of households and NFCs. Further-

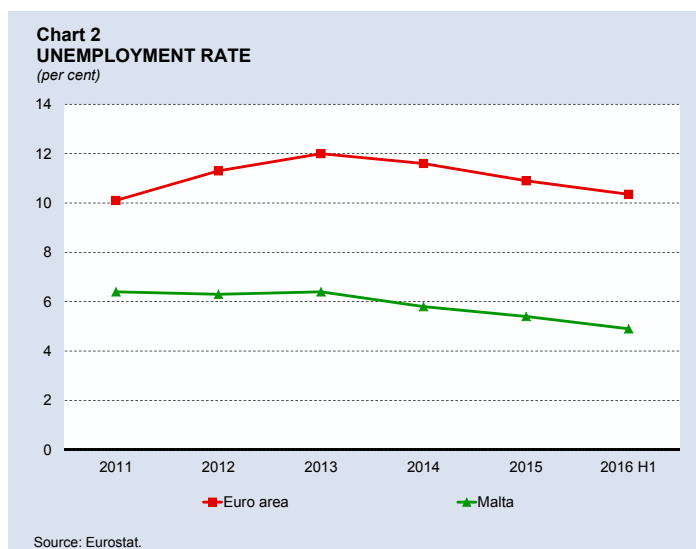
more, household debt-to-GDP declined to 57.6%, below the euro area average of around 59% in June 2016. Similarly, NFC debt-to-GDP fell to 145.8% by June 2016, but remained relatively stable on a consolidated basis, at around 82%, which is also in line with the euro area average. By mid-2016, the inflation rate stood at 0.9%, stabilising up to September 2016 but remaining above the euro area average.<sup>7</sup>

Malta's macroeconomic conditions are expected to continue supporting financial stability on the back of continued robust economic growth and a low unemployment rate. Moreover, fiscal consolidation is projected to proceed with both the debt and fiscal deficit declining further.

### The local financial sector remained robust with risks to financial stability easing in the first half of 2016.

In the first half of 2016 the domestic financial system remained sound with low risks to financial stability. The financial sector was generally unaffected by increasing geopolitical risks and its soundness remained intact on the back of the sector's sustained growth and profitability. The business models of the core domestic banks continued to be mainly oriented at providing financial intermediation funded by retail deposits. Liquidity remained highly abundant as customer deposits continued to flow in. Lending to residents remained subdued, with mortgages continuing to be the main driver of resident credit growth, albeit slowing down, while lending to NFCs contracted further, though showing signs of an incipient recovery. NPLs declined, on the back of a favourable economic environment accompanied by historically-low level of unemployment. Despite the interlinkages between banks and the domestic insurance and investment funds sectors, risks for these financial institutions remain contained with limited systemic implications. Links between the non-core domestic and international banks with the domestic economy remained very limited. Risks emanating from these banks are also contained given their profitability, healthy liquidity levels and relatively high capital buffers.

On balance, risks to financial stability eased during the first half of 2016, while the resilience of the financial system in Malta was enhanced on the back of a positive local macro-financial environment.



<sup>5</sup> Unemployment rate as measured in the Labour Force Survey.

<sup>6</sup> Source: Jobsplus.

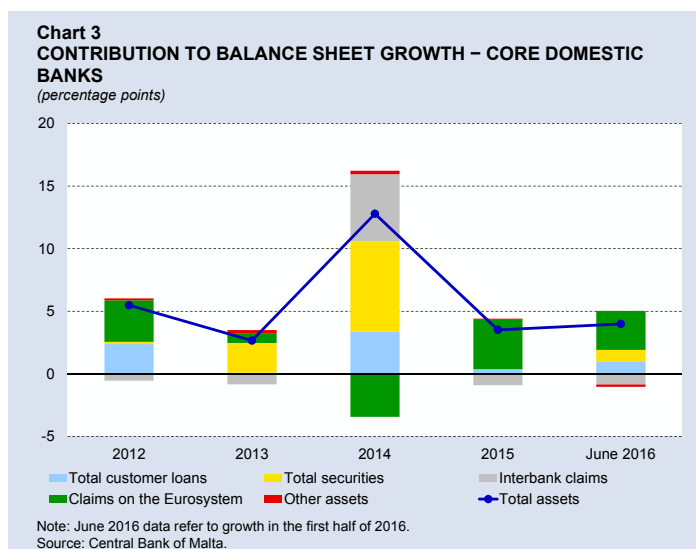
<sup>7</sup> Inflation rates quoted are based on HICP.

**The core domestic banks' balance sheet expanded further, driven by higher placements with the Eurosystem.**

In the first half of 2016, total assets of core domestic banks expanded by 4.0% to €21.5 billion, equivalent to 237.6% of GDP. While growth in total assets was spread across almost all this category of banks, about two thirds of the increase in assets was attributed to one bank.

This growth in assets was largely reflected in higher placements with the Eurosystem, which rose by 52.0% in the first half of 2016 to €1.9 billion (see Chart 3), which accounted for 8.7% of total assets.

The loan portfolio continued to grow, expanding by a further 2.2% to reach €10.0 billion and accounting for 46.7% of total assets. Securities holdings, which accounted for almost a third of total assets, grew by 2.8% to €7.0 billion. By contrast, interbank exposures declined, contracting by 9.4% in the period under review and accounted for 7.8% of total assets.



**Asset quality improved further, supported by lower non-performing loans, higher coverage and a securities portfolio composed of high-rated bonds.**

Despite a marginal increase in resident lending, non-resident lending was the main driver behind the expansion in the loan portfolio, growing by 13.8% and reversing the drop reported in 2015. This change was derived from the cross-border operations of one bank. Resident loans, which accounted for over 90% of total lending, grew by 1.2%, in line with that of the same period a year earlier. As observed in recent years, resident mortgages mostly contributed to the increase in resident lending. Such lending grew by 3.4% in the first six months of 2016, which is slower when compared to growth in the second half of 2015. Notwithstanding, the share of mortgages in total resident loans edged up to 44.4%, as both consumer credit and lending to NFCs contracted further in the first six months of 2016. Lending to resident NFCs fell by 1.4%, despite further declines in the weighted average lending rate. The contraction was attributed to public sector NFCs, as private sector lending increased by 0.4%. This trend contrasts somewhat with the robust economic growth underpinned by higher investment. This is in part explained by the fact that the Maltese economy has diversified towards services, which are less capital-intensive than other sectors, and also because some of the larger firms are resorting to cheaper direct funding from the market given the abundance of liquidity. Credit standards for corporate lending were tightened further in the first quarter of 2016 and are likely to have also contributed to restraining credit growth.

From a sectorial perspective, the drop in resident NFC lending resulted mainly from public administration and to a much lesser extent from transport and storage; and the accommodation and food services activities sectors. This fall was however partly offset by higher lending, particularly towards the construction and real estate sector, halting the downward trend in previous years, and mirroring the recovery in the real estate market.

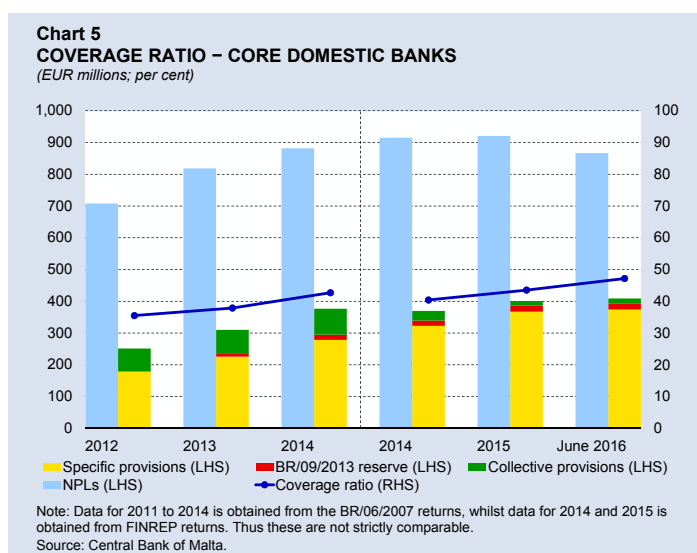
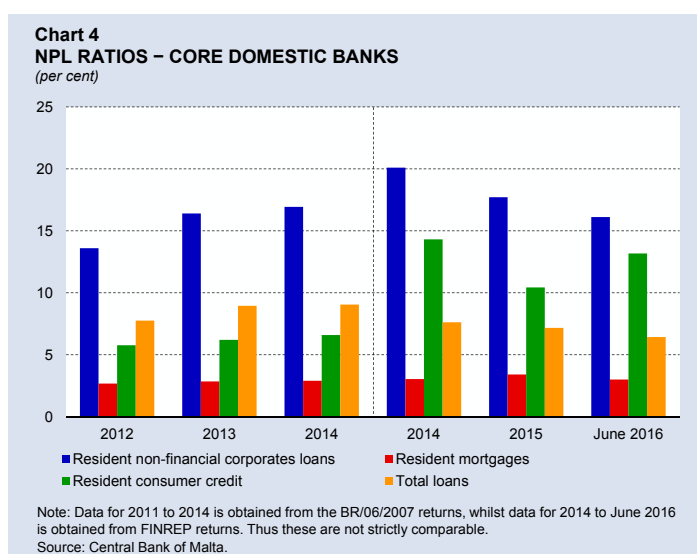
Core domestic banks continued to report an improvement in their loan quality, as the stock of NPLs fell by 5.8% during the first half of 2016. This fall resulted from both resident and non-resident NPLs, with the latter accounting for merely 5.2% of total NPLs. Core domestic banks reported an improvement in the asset quality of NFC lending, with NPLs dropping by 11.8%. These developments were mainly underpinned by the construction and real estate, and the wholesale and retail trade sectors. Meanwhile, household NPLs rose by 8.8%, driven by consumer credit, whereas mortgage NPLs remained relatively stable. The increase in

consumer credit NPLs was however bank-specific, and was in part attributable to a more stringent policy in the classification of NPLs by a particular bank.

As a result of this improvement in asset quality, the NPL ratio declined by a further 0.7 percentage point to 6.4% in June 2016. The NPL ratio of resident NFCs continued to decline, falling by 1.6 percentage points to 16.1% (see Chart 4). Loan performance by both small and medium-sized enterprises (SME), which represent the bulk of NFC lending, and also to large enterprises, improved in the first half of the year. However, the NPL ratio of 15.8% for resident SMEs was lower than that of resident large corporates, reaching 18.5% in June 2016. Meanwhile, the resident household NPL ratio remained relatively stable at 4.8%. This reflected contrasting developments, where the rise in the consumer credit NPL ratio outweighed the improvement in the mortgage NPL ratio. Indeed, the latter declined to 3.0% in June 2016, reversing the rising trend.

Enhanced loan quality was reinforced by higher loan loss provisions, up by 2.2%, as both specific and collective provisions increased. As a result, the specific coverage ratio rose by 3.3 percentage points to 43.1% and when adding the “Reserve for General Banking Risks” as per Banking Rule 09/2013, the coverage ratio rises to 45.4%. Taking into account collective provisions, the total coverage ratio would increase further to 47.2% (see Chart 5). Apart from loan loss provisions, core domestic banks continued to adopt prudent lending practices, such as conservative loan-to-value ratios, which on average hovered around 73% in the first quarter of 2016, and sound valuation haircuts on collateral. More than half of the NPLs are backed by collateral, predominantly in the form of real estate.

The securities portfolio remained of high quality, dominated by debt securities, with equities accounting for merely less than 6% of the total securities portfolio in line with 2015. In the first half of 2016, the bond portfolio expanded by 3.0% to €6.6 billion, mainly reflecting higher holdings of sovereign debt, mainly foreign; as holdings of foreign corporates and monetary financial institutions (MFI) contracted (see Chart 6). While holdings of domestic sovereign paper increased by 4.2% to €1.9 billion, their share remained relatively unchanged at around 28% of the total bond portfolio and only 8.8% of total assets. This may reflect both the interest of Government in placing new issues with private investors searching for yield in very long dated bonds, as well as the core domestic banks’ plans to limit their exposure on their sovereign given prospects



that these may start attracting risk weights in the prospected Basel II regime currently under negotiation. The majority of the bonds remained booked as held-to-maturity, thus limiting possible implications on profitability arising from the effects of market volatility on bond prices.

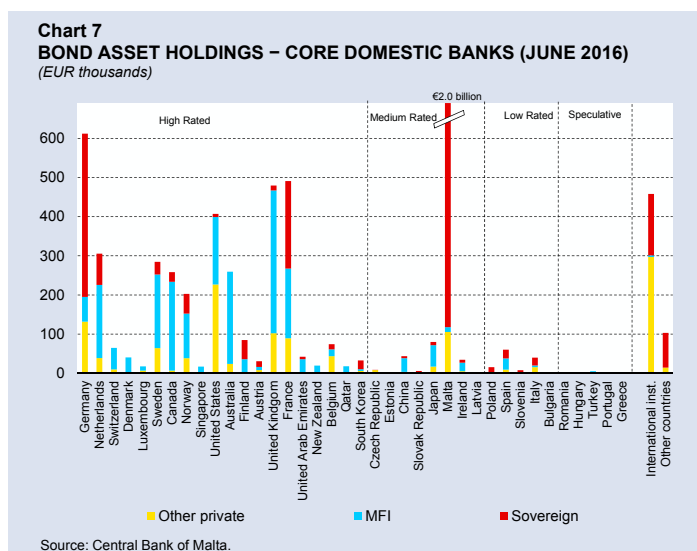
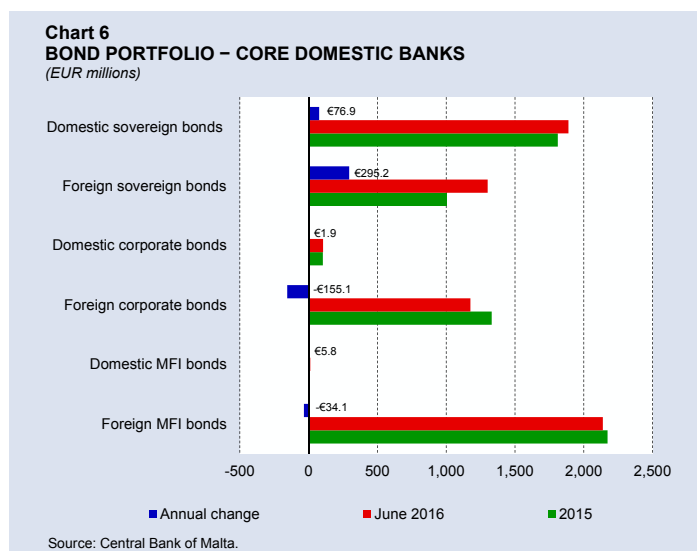
Core domestic banks did not report any non-performing bonds, mirroring the high-quality of the bond portfolio. After excluding domestic sovereign paper, about half of the remaining bonds held by the core domestic banks were rated as AA- or higher, with another 36.4% rated between A- and A+. Furthermore, most of the foreign bond holdings originated from high-rated countries, as more than four-fifths of total foreign bonds were issued in countries with a credit rating of above AA- (see Chart 7). The composition of the bond portfolio indicates that core domestic banks do not seem to be engaging in higher risk taking in searching for better yields, as these continued to invest in high-quality-low-yielding bonds, which matches the prevailing risk-return trade-off of these banks.

The positive developments reported in the first half of 2016, pushed the non-performing exposure (NPE) ratio further down by an estimated 0.4 percentage point to 4.3% as at end June 2016.<sup>8</sup>

**Core domestic banks continued to rely on stable funding sources, predominantly on retail deposits, amplifying further their liquidity levels.**

In the first half of 2016, customer deposits financed nearly 80% of the core domestic banks' total liabilities, remaining the prime funding source for these banks. At 1.5%, growth in customer deposits slowed down compared to a year ago largely due to weaker growth in household deposits. Non-resident customer deposits, however, dropped by 1.0%. The latter however constituted a minor proportion in total customer deposits, with the resident component accounting for almost 85% of total customer deposits and mainly composed of household deposits. As customer lending increased at a faster pace than customer deposits, the declining trend in the loan-to-deposit ratio appears to have bottomed at 58.6% in June 2016; yet remaining markedly lower than the euro area average of about 100%.

The prevailing low interest rate environment continued to provide an incentive for depositors to shift towards the short-term maturity spectrum, allowing them greater flexibility for better investment opportunities. Indeed,



<sup>8</sup> NPE include loans and advances, and securities.

the share of current and savings deposits, withdrawable on demand or at very short notice, increased from 69.7% in December 2015 to 71.7% of total deposits in June 2015, whereas term deposits with maturities of over one year declined, making up just 8.1% of total deposits.<sup>9</sup>

Other sources of funding remained limited, with sale/repurchase agreements and debt securities issued comprising only 4.0% and 2.2% of balance sheet value, respectively. The proportion of interbank and Euro-system funding remained marginal, with each of these two sources of funding accounting for just 0.4% of total liabilities. The core domestic banks' low utilisation of wholesale funding sources reflects their robust liquidity position. This is further reinforced by the fact that less than one quarter of the collateral pool was utilised for monetary policy operations in June 2016, leaving banks with ample room to tap such cheap source of funding should the need arise.

The liquidity ratio (expressed as liquid assets-to-short-term liabilities) improved by 3.9 percentage points in the first half of 2016 to 54.1%.<sup>10</sup> Furthermore the composition of liquid assets includes highly-quality liquid assets (HQLA), such as placements with the Central Bank of Malta (which increased during the period under review), but also marketable debt securities. The latter remained the core component of such assets, representing 54.6% of eligible liquid assets.

Throughout the first six months of 2016, core domestic banks maintained a strong Liquidity Coverage Ratio (LCR) of 164.3% – more than double the regulatory threshold of 70%.<sup>11</sup> As regards the Net Stable Funding Ratio (NSFR), although it is projected to come into force in January 2018, preliminary results indicate that core domestic banks will eventually meet the minimum requirement of 100%.

***Core domestic banks reported better profits, which aided the increase in the capital buffers and further strengthening capital ratios.***

Compared to the same period in 2015, the core domestic banks booked an increase of 15.9% in pre-tax profits in the first half of 2016, amounting to €153.1 million (see Table 2). This improvement was mainly attributable to lower non-interest expenses which dropped by 9.0% in the period under review, owing to lower net impairment losses as other non-interest expenses increased. Non-interest income also rose mainly on account of higher non-trading profits and other non-interest income, which were however partly offset by a fall in trading profits. Despite other sources of income, the profits of core domestic banks continued to derive mainly from interest-earning activities, namely through financial intermediation. Overall net interest income, which accounted for 58.9% of gross income, remained relatively unchanged when compared to the first half of 2015. The stable net-interest income, however, masks offsetting trends within its components. Net income from intermediation activities increased by almost €4 billion reflecting lower interest expenses, in part due to the shift away from fixed-term to current and savings deposits. In turn, lower interest rates coupled with muted credit growth resulted in weaker interest income from lending. The increase in net income from intermediation was however fully offset by a fall in other net interest income.

In June 2016, the return-on-equity (ROE) and return-on-assets (ROA) stood at 12.8% and 1.0% respectively, up from 11.9% and 0.8% in the corresponding period of 2015.<sup>12</sup> These remained substantially above the average ROE and ROA of small institutions in the euro area and augur well that core domestic banks can meet challenges for additional regulatory capital.<sup>13,14</sup> The cost-to-income ratio increased to 47.2% for the first half of 2016, from 46.5% in the corresponding period of 2015.<sup>15</sup> This rise was however attributed

<sup>9</sup> The remaining 20% of total deposits include term-deposits with a term-to-maturity of less than 1 year.

<sup>10</sup> BR/05/2007 Liquidity Requirements of Credit Institutions authorised under the Banking Act 1994 stipulated a minimum threshold of 30%.

<sup>11</sup> The LCR ratio will be progressively implemented in accordance with the CRR as follows: 60% from 1 October 2015, 70% from 1 January 2016, 80% from 1 January 2017, and 100% from 1 January 2018. The LCR implementation will be reached in 2018 – one year earlier than required under Basel requirements.

<sup>12</sup> The ROE and ROA have been annualised, based on the profits after tax for the first half of the year.

<sup>13</sup> Source: SDW, ECB.

<sup>14</sup> Based on SDW data, it is estimated that the annualised ROE and ROA ratios of small institutions in the euro area stood at 2.5% and 0.2%, respectively, in March 2016.

<sup>15</sup> The cost-to-income ratio is defined as operating expenses (net of amortisation but including amortisation of intangible assets other than goodwill) to gross income (net interest income and non-interest income).



**Table 2**  
**MAIN COMPONENTS OF THE PROFIT AND LOSS ACCOUNT – CORE DOMESTIC BANKS**

EUR millions

|                                       | 2014    | 2015    | 2015    |         | 2016    |
|---------------------------------------|---------|---------|---------|---------|---------|
|                                       |         |         | H1      | H2      | H1      |
| <b>Total net-interest income</b>      | 344,570 | 371,786 | 183,758 | 188,028 | 183,704 |
| Net interest income on intermediation | 257,117 | 307,376 | 148,355 | 159,022 | 152,223 |
| Other net interest income             | 87,452  | 64,410  | 35,403  | 29,007  | 31,481  |
| <b>Non-interest income</b>            | 186,812 | 204,960 | 123,047 | 81,914  | 128,240 |
| Trading profits <sup>(1)</sup>        | 5,856   | 20,384  | 13,992  | 6,392   | 10,474  |
| Other non-interest income             | 180,956 | 184,576 | 109,055 | 75,521  | 117,766 |
| <b>Non-interest expense</b>           | 329,338 | 353,633 | 174,678 | 178,954 | 158,871 |
| Of which net impairment charges       | 57,129  | 41,459  | 27,169  | 14,291  | 6,486   |
| <b>Profit before tax</b>              | 202,044 | 223,114 | 132,126 | 90,987  | 153,073 |
| <b>Profit after tax</b>               | 133,985 | 146,603 | 87,502  | 59,102  | 100,803 |

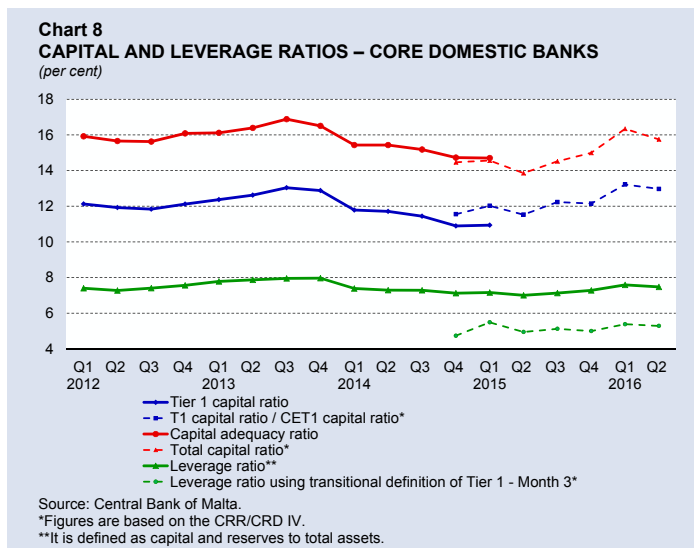
<sup>(1)</sup> Trading profits (fair valuation movements and gains/losses on traded securities).

mainly to one bank, as most core domestic banks reported a decline in their cost-to-income ratios. While core domestic banks continued to perform positively, looking ahead, the challenges of a prolonged low interest rate environment may exert pressure on profitability, particularly if overall credit growth remains below its historical average.

During the first half of 2016, the core domestic banks strengthened further their capital position with the total capital ratio and the Tier 1 capital ratio reaching 15.8% and 13.0%, respectively in June 2016 (see Chart 8).<sup>16</sup> This reflected faster growth in own funds as opposed to the growth in total risk weighted exposures. The core domestic banks' capital ratios are also adequately covering for the additional system-wide and bank-specific capital buffer requirements.<sup>17</sup>

The leverage ratio (based on CRR/CRD IV regulation using the transitional definition of Tier 1-month 3) also improved, up by 0.3 percentage point to 5.3%.<sup>18</sup> A similar pattern was reported for the capital and reserves to total assets ratio, rising to 7.5% by the first half of 2016.

Univariate stress test exercises, comprising: (i) an increase in NPLs



<sup>16</sup> The minimum reserve requirement for the total capital ratio, Tier 1 capital ratio, and Common Equity Tier 1 capital ratio stands at 8%, 6% and 4.5%, respectively. The core domestic banks hold no additional Tier 1 capital, and thus the Tier 1 capital ratio equates the Common Equity Tier 1 capital ratio.

<sup>17</sup> The Countercyclical Capital Buffer remained at 0% since December 2015 whereas the phasing-in of the Capital Conservation Buffer resulted in a transitional provision of 0.625% for 2016. The O-SII capital requirements were set at 2.0%, 1.5% and 0.5% for the three systemically important institutions (Bank of Valletta Group, HSBC Malta Group and Medifin (Mediterranean Bank)), respectively.

<sup>18</sup> The leverage ratio is based on CRR/CRD IV regulation using the transitional definition of Tier 1-month 3. The minimum requirement of this ratio during the phase-in period is 3.0%.

of varying magnitudes owing to adverse macroeconomic conditions; (ii) a drop in property prices; (iii) credit quality deterioration in the securities portfolio; (iv) persistent deposit withdrawals; continue to reaffirm the core domestic banks' overall adequacy in their loss absorption capacity, both in terms of liquidity and solvency. The stress testing exercises were based on the balance sheet data of the core domestic banks for the first half of 2016, following similar methodology and magnitude of shocks to those presented in the 2015 *Financial Stability Report*.

Core domestic banks' solvency and liquidity positions improved further during the first six months of the current year, accompanied with an overall drop in the NPL ratio. In terms of securities exposures, core domestic banks continued to invest in higher rated securities, with around 90% of the banks' securities portfolios rated single A or higher. No significant portfolio rebalances were observed during the period under review. The resulting CET1 ratios for tests (i) to (iii) mentioned above, following the application of significant shocks, continued to exceed the regulatory thresholds. In addition, core domestic banks remained highly liquid during the one month survival period of the liquidity stress test.

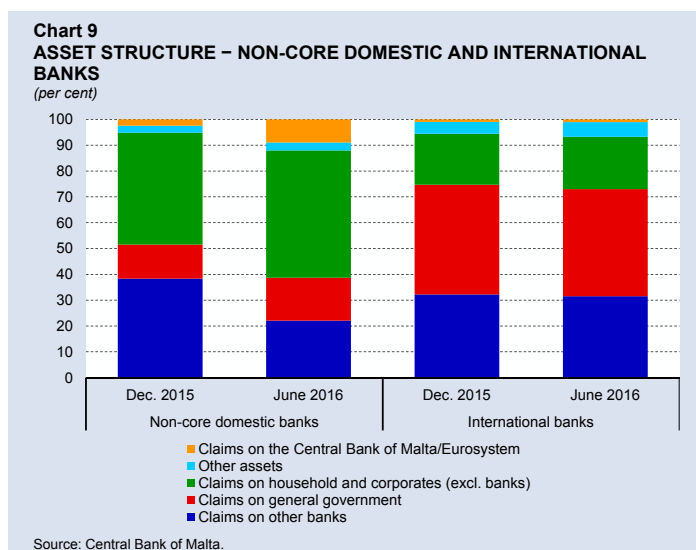
The EBA 2016 EU-wide stress testing exercise was carried out during the first half of 2016 with its results published on the 29th July. Unlike previous exercises, the exercise conducted in 2016 was restricted to credit institutions with a minimum threshold of total assets that was higher than that of any of the core domestic banks so that no domestic bank was included in the EBA's sample.

***The non-core and international banks continued to operate with high capital ratios and ample liquidity, while improving their profit performance. Links with the domestic economy remain very limited.***

#### **Non-core domestic banks**

In the first half of 2016, the assets of the non-core domestic banks contracted by 6.9% to €2.2 billion, equivalent to 24.3% of GDP.<sup>19</sup> This contraction was attributable to one institution which contracted its operations before being sold, with the new shareholders changing the business model of the bank and thus being now classified as an international bank, and another bank which scaled back its operations following its parent's decision to reduce its exposures with its subsidiaries.<sup>20</sup> The latter development resulted in lower claims on banks, which dropped by 46.4% since end-2015 (see Chart 9).<sup>21</sup> By contrast, claims on the Central Bank of Malta/Eurosystem increased by €138.8 million to almost €200 million, pushing their share in total assets to 9.0% in June 2016 from 2.4% as at end 2015.

A non-core domestic bank increased its exposure to households and corporates, particularly towards financial and insurance activities, and to a lesser extent in manufacturing and wholesale and retail trade.<sup>22</sup> Indeed, this bank placed funds in a local non-MMF investment fund. These bank-specific developments pushed the proportion of claims to households and corporates to nearly half of the non-core domestic banks' total balance sheet value, up from 44.3% in



<sup>19</sup> GDP figure for 2016H1 was calculated using the four-quarter moving sum.

<sup>20</sup> Excluding the bank which was sold, total assets would have dropped by 3.3%.

<sup>21</sup> Claims on other banks include also securities holdings.

<sup>22</sup> Claims to households and corporates include non-MMF investment funds and other financial intermediaries.

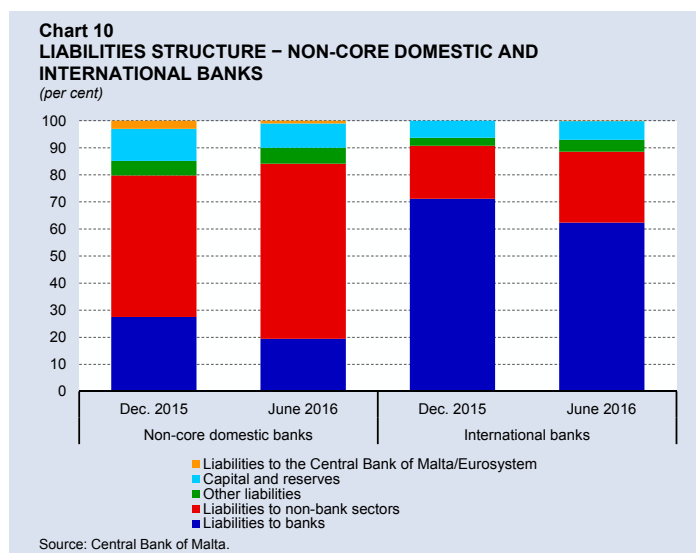
December 2015. Claims on general government increased by 16.8%, predominantly in the form of US Treasury bill holdings. Nevertheless, holdings of domestic government paper contracted during the first six months of the year, as the increase in holdings of Treasury bills was outweighed by the drops in Malta Government Stocks (MGS).

In terms of asset quality, the NPL ratio deteriorated by 0.2 percentage point to 4.3% as total loans dropped at a faster pace than NPLs. During the period under review, all non-core domestic banks reported a drop in NPLs, mostly in the wholesale and retail trade sector. The coverage ratio declined by 2.5 percentage points to 60.6% by mid-2016, as both specific and collective provisions fell at a faster pace than NPLs.

On the funding side, non-core domestic banks increased their reliance on retail funding, financing almost two thirds of their balance sheet. Indeed, customer deposits surged during the first six months of the year at the expense of wholesale funding, with the latter accounting for around 20% of total liabilities, down by eight percentage points from end 2015 (see Chart 10). Higher customer deposits were predominantly derived from non-resident households, as deposits from other financial intermediaries and corporates dropped significantly. Resident customer deposits remained fairly stable accounting for a mere 2.3% of resident customer deposits in the whole banking system. Capital and reserves contracted by almost a third to 9.0% of total liabilities, whereas Eurosystem funding dropped substantially as two banks no longer participated in the regular longer-term refinancing operations (LTRO).<sup>23</sup>

In the first half of 2016, the capital position of this group of banks went down by 6.6 percentage points to 15.9%. The fall was largely driven by the takeover of one bank. Similarly, the leverage ratio (based on CRR/CDR IV transitional definition of Tier 1 capital) fell by 3.1 percentage points to 8.1% owing to a contraction in Tier 1 capital. The proportion of capital and reserves to total assets stood at 9.0% in June 2016, down from almost 12%, six months earlier. Non-core domestic banks continued to be characterised by ample liquidity as evidenced by the high LCR governed under the CRR/CRD IV framework which stood at 200%, well above the 70% threshold.

In the first half of 2016, profitability rebounded following the losses booked (by one bank) during the last quarter of 2014 and in the first half of 2015. Improved profits came about principally from lower net impairment losses derived from one bank. Meanwhile, net interest income almost halved compared to the same period in the previous year, owing to a faster increase in customer deposits compared to customer loans. The fall in net interest income was however more than compensated for by the recovery in loan-loss provisions, which improved profitability. In June 2016, the ROA and ROE (after tax) stood at 0.7% and 7.8% up from 0% and 0.3%, respectively in December 2015.<sup>24</sup>



<sup>23</sup> The fall in capital resulted from the take-over of a non-core domestic bank which was entirely funded by capital and reserves prior to being taken over.

<sup>24</sup> ROA and ROE (after tax) is calculated on annualised net profit after tax.

### **International banks**

The total assets of international banks grew by 0.7% in the first half of 2016 to €24.4 billion, and accounted for around 270% of GDP in June 2016.<sup>25</sup> The increase in total assets is mainly attributed to one bank which started operations in the latter half of 2015 and increased placements with other credit institutions and holdings of government securities. Remaining assets of this group of banks rose by almost a quarter owing to one of the largest branches owned by a foreign bank, which expanded its financial derivatives portfolio. Nevertheless, 'remaining assets' still represented only 5.7% of total assets (see Chart 9). Claims on households and corporates, particularly towards foreign manufacturing firms also contributed to the growth in total assets. Resident lending remained insignificant, maintaining negligible links with the domestic economy. In terms of asset quality, the NPL ratio deteriorated by 0.4 percentage point to 1.3%, owing to higher NPLs on consumer credit reported by two banks which engage in pay-day loan business.

Claims on general government fell by 1.7%, although this asset component still accounted for the largest share in total assets, at 41.5% by the end of June 2016. Concurrently, claims on other banks also fell, reflecting lower placements and debt securities issued by unrelated credit institutions. Most of these developments related to the two largest branches of foreign banks, given their considerably larger size compared to other international banks.

On the liabilities side, wholesale funding remained the prime source of funds for international banks (see Chart 10). Nevertheless, in the first six months of the year, interbank lending declined on account of lower placements from unrelated credit institutions. This drop was partly compensated for by higher non-resident customer deposits, reaching just over a quarter of the balance sheet size. The remaining liabilities are in the form of capital and reserves which increased slightly due to the introduction of a new bank, which has taken over a non-core domestic bank in the first half of the year.

The total capital ratio improved further, up by 10 percentage points to 66.8%, still relatively high despite the impact from one bank which was in the process of winding down. Similarly, the leverage ratio increased from 31.6% as at end 2015 to 38.7% in June 2016.<sup>26</sup> This group of banks continued to operate with abundant liquidity, as reflected in a LCR of around 249%, significantly higher than the 70% regulatory minimum threshold.

In June 2016 the ROA and ROE (after tax) surged to 1.6% and 24.8%, up from 0.7% and 8.7% a year earlier.<sup>27</sup> Higher profits, coupled with lower total assets and shareholders' funds, contributed to improved profitability ratios. The increase in profits stemmed mainly from the performance of one of the largest branches owned by a foreign bank which recovered the trading losses on foreign exchange dealings incurred during the first half of 2015. On the other hand, net interest income declined with the drop emanating mainly from the two largest branches operating in Malta.

### ***The low interest rate environment and market volatility continued to present a challenge for the domestic insurance industry. Nevertheless, insurance companies remained profitable with sustainable capital levels.***

During the first half of 2016, the total assets of the insurance industry operating from Malta approximated €9 billion, down by around €3 billion during the first half of the year. This contraction mainly reflected the maturity of a reinsurance policy ceded by a reinsurance company operating from Malta.<sup>28</sup>

<sup>25</sup> GDP figure for 2016H1 was calculated using the four-quarter moving sum.

<sup>26</sup> As part of the winding down process, several subordinated loans were terminated which carried a one-to-one capital allocation. Excluding this bank, the capital ratio would have decreased by 2.3 percentage points to 48.6% mostly due to a faster increase in total risk exposures than total own funds. The leverage ratio would stand at 29.4% in June 2016, down from 31.7%.

<sup>27</sup> ROE excludes the 3 branches classified as international banks.

<sup>28</sup> These refer to all the insurance entities licensed by the Malta Financial Services Authority (MFSA) and which report periodic data to the Central Bank of Malta and the MFSA.

The domestic insurance companies (which mainly write insurance for the residents of Malta) expanded their assets by €45.6 million during the first half of 2016, to reach the €4.0 billion mark.<sup>29</sup> In terms of assets, these eight companies accounted for 44.1% of GDP. The domestic insurance landscape remained unchanged, comprising three life insurance companies, four non-life insurance principals and one non-life protected cell company.<sup>30</sup> Malta's insurance density (considering only the services offered by these eight domestic insurance companies), approximated €1,178 in June 2016, up from €1,052 in 2015.<sup>31</sup> Insurance penetration (gross premia-to-GDP) stood at 5.6% in June 2016, compared with 5.1% in 2015.

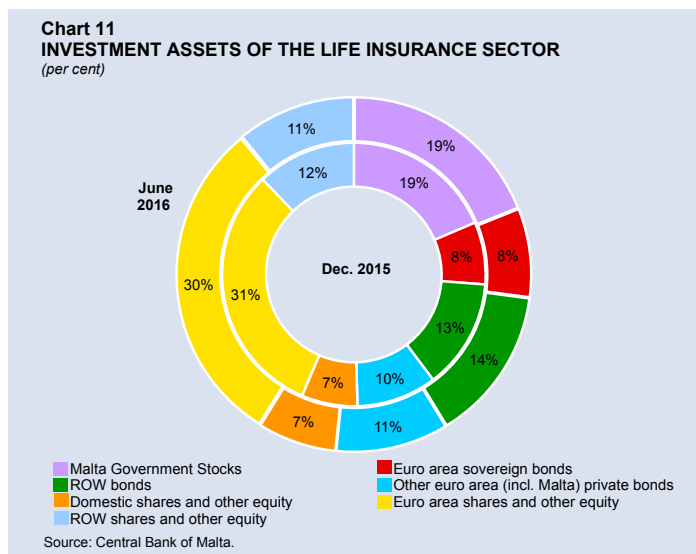
The insurance industry is inherently interconnected with the domestic economy. On the assets side, the insurance industry is mainly exposed to the Government and domestic banks, through holdings of MGS and bank deposits and equity. Furthermore, links with the banks are further reinforced by the fact that one life insurance company is a subsidiary of a core domestic bank; while another core domestic bank has shareholdings in both a life and a non-life insurance company. Insurance companies are also exposed to other economic sectors, with the main exposure being towards real estate activities. However, individual company exposures are limited as a proportion of each insurer's total assets. On the liabilities side, domestic insurers are highly interlinked with resident households, which financed almost 90% of the insurers' balance sheet via policy holdings, reflecting the retail nature of the domestic insurers. Insurance policies accounted for almost 14.0% of households' net financial wealth in June 2016.<sup>32</sup>

The market structure remained concentrated, with three insurers capturing the largest share in terms of assets and gross premia, at 91.8% and 78.0%, respectively, reflecting the structural landscape of the financial sector in Malta.

Involvement in non-traditional, non-insurance activities (NTNI) through the granting of credit remained marginal, accounting for only 0.3% of the domestic insurers' total assets.

In the first half of 2016, the total assets of the life insurance sector expanded by 1.0% to €3.6 billion. The bulk (77.5%) of these assets was made up of the investment portfolio, recording only a slight contraction during the period under review, owing to lower holdings of equity issued by other financial intermediaries (OFI) in Luxembourg, the United Kingdom, the Cayman Islands and France.

The structure of the investment portfolio remained stable, almost equally divided between bonds and equity (see Chart 11). MGS represented 36.7% of the bond portfolio, expanding slightly over December



<sup>29</sup> The selection of domestic insurance companies is based on four criteria: (i) whether they are subsidiaries of the core domestic banks (ii) the level of resident investment assets (iii) total gross premia written for long-term business and general business for risks situated in Malta and (iv) total gross claims paid for long-term business and general business for risks situated in Malta.

<sup>30</sup> A protected cell company is a single legal entity comprising a core business activity and a number of activities, which are segregated from the main business, called "cells". The undertakings of one cell have no bearing on the other cells, with each cell identified by a unique name. The assets, liabilities and activities of each cell are also ring-fenced from other cells.

<sup>31</sup> Insurance density is measured as gross premia (four-quarter moving sum) per capita. Population estimates are based on 2015 data and sourced from Eurostat.

<sup>32</sup> Such policies include insurance policies, pension and standardised guarantees. These products also include those provided by insurance companies operating from Malta which are not classified as domestic.

2015. The rest of the bond portfolio was mainly composed of holdings that are issued in highly-rated countries, reflecting lower risk of default.

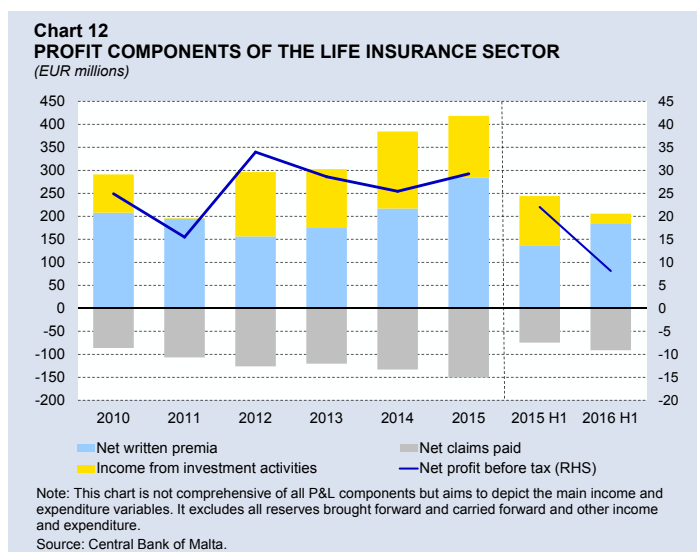
The majority (48.5%) of the equity portfolio was largely composed of equity issued by OFIs in the euro area, mainly based in Luxembourg and Ireland. The rest of the equity portfolio was predominantly composed of equity issued in other non-euro area countries, mainly the United Kingdom and the United States, as well as equity issued by domestic OFIs and NFCs.

The nature of the insurance business, whereby periodic premia are received upfront and obligations typically have a long expected duration, inherently limits funding and liquidity risk. Indeed, liquid assets are 15.3 times the size of current liabilities, reflecting healthy liquidity positions. Moreover, market liquidity risk is curbed by their high-quality investment portfolio, given that they may be regarded as highly marketable.

Net profit before tax of the life insurance sector totalled €8.1 million during the first half of 2016, down from €22.0 million during the corresponding period in 2015 (see Chart 12). The drop was wholly attributable to lower investment income, down from €107.0 million in June 2015 to €22.4 million a year later.<sup>33</sup> This was mainly due to a fall in realised and unrealised capital gains, as well as adverse market movements in relation to unit-linked products and foreign exchange losses. Otherwise, inflows from underwriting business increased, as net written premia rose by €46.2 million to reach €183.2 million during the first half of 2016. Net claims, although rising further, did not offset the rise in premia, reflecting favourable underwriting business.

The ROE stood at 4.4% in June 2016, down from 11.4% in 2015, whilst the ROA dropped to 0.3%, from 0.8% in 2015; below the median levels across the EU.<sup>34</sup>

The leverage ratio of the life insurance sector remained stable at 7.2% in June 2016. The more risk-based Solvency II ratio exceeds 100% for all domestic life insurance companies as at end-June 2016.<sup>35</sup> This means that the insurers' capital is adequate to meet the companies' obligations in the event of a severe shock. The risk retention ratio (defined as net premia to gross premia), signals the risk retained on the insurers' balance sheet. The ratio of the domestic insurance sector stood at 96.3% in June 2016, slightly higher than a year ago and also compared to the median of around 92% in June 2016 among a sample of insurance groups in the EU.<sup>36</sup>



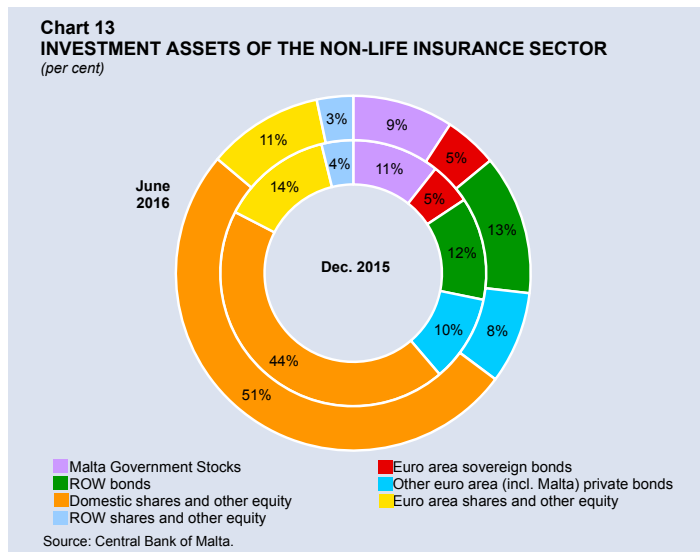
<sup>33</sup> Investment activities include investment income and expenses, exchange gains and unrealised capital gains.

<sup>34</sup> The ROE and ROA are computed using profits after tax, annualised to match average assets and shareholder funds. The ROE for the median company among a sample of 32 large euro area insurance groups (both life and non-life) in the EU and Switzerland amounted to 8.3% in 2015, while the average ROA for life insurers among this sample amounted to 0.4% (Source: EIOPA Financial Stability Report, June 2016).

<sup>35</sup> These are preliminary results based on the first Solvency II data submissions. The Solvency II ratio is defined as eligible own funds divided by Solvency Capital Requirements (SCR). The SCR reflects the amount of capital required to meet all obligations over one year, taking into account all significant quantifiable risks such as underwriting risk, risk pricing, provisional risk, market risk, credit risk, liquidity risk and operational risk. The SCR is measured at a 99.5% VaR confidence level.

<sup>36</sup> Source: ESRB Risk Dashboard, September 2016.

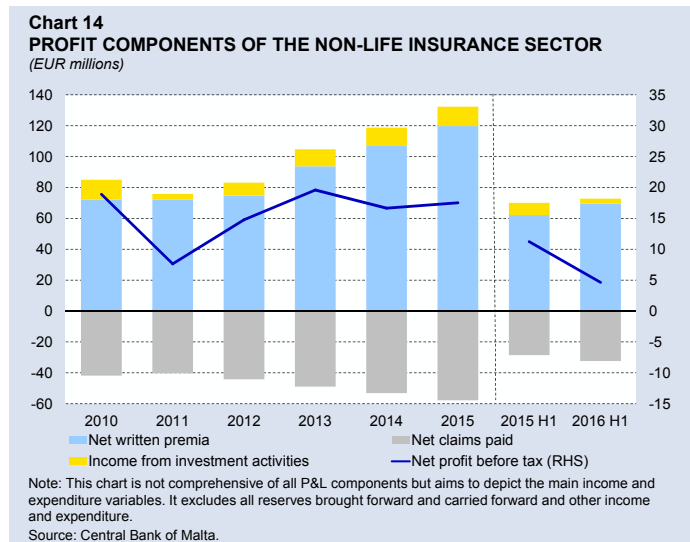
The assets of the non-life insurance sector grew by 2.5% to €360.7 million in June 2016. The investment portfolio of this insurance segment accounts for 45.4% of total assets, with the rest of the assets mainly held in the form of non-financial assets, reserves and other accounts receivable. Non-life insurers reported no notable structural shifts in their investment portfolio, with equity accounting for 64.8% of their investments (see Chart 13). During the first half of the year, equity holdings increased by 8.1% to €106.1 million, mainly relating to higher holdings of equity issued by domestic NFCs. The bulk of the equity portfolio relates to group-holdings within the domestic insurance sector. The rest of the equity portfolio mainly relates to equity issued by OFIs in Germany, Ireland, France, Luxembourg, the United Kingdom and the United States. Meanwhile, the bond portfolio contracted by 7.2% in the first six months of 2016, mainly stemming from bonds issued domestically, namely by Government and OFIs.



Although obligations (claims) are of a shorter-term nature than for life insurers, the liquid assets of non-life domestic insurers amounted to 3.7 times the amount of liquid liabilities in June 2016, considerably lower than that of the life segment.

The non-life sector also registered drops in net profit before tax, from €11.2 million during the first half of 2015 to €4.6 million during the same period of 2016 (see Chart 14). As in the case of the life sector, the drop in profits was wholly attributable to lower investment income. This was due to market volatility, in particular following the events of the UK's EU membership referendum. Meanwhile, net written premia increased by €7.3 million, reaching €69.5 million as at June 2016, outweighing the rise of €3.8 million in claims.

The ROE dropped to 4.9% in June 2016, down from 11.9% in 2015, whilst the ROA dropped to 1.9%, from 5.0% a year earlier.<sup>37</sup> At 81.1%, the combined ratio remained below the 100% threshold, signalling positive underwriting performance



<sup>37</sup> The ROE and ROA ratios are computed using profits after tax, annualised to match average assets and shareholder funds. The ROE of a sample of non-life insurers in the EU and Switzerland approximated 10% in 2015 (Source: EIOPA Financial Stability Report, June 2016).

during the first half of 2016.<sup>38</sup> The risk retention ratio stood at 80.1% in June 2016, up from 79.1% in June 2015.

The leverage ratio (capital to assets) of the non-life insurance sector dropped slightly from 40.9% as at end-2015 to 39.2% in June 2016, following a contraction of 1.8% in capital. As in the case of the life segment, the non-life insurers are well-capitalised, with a Solvency II ratio exceeding the 100% threshold.

Financial stability risks from the activities of domestic insurers are contained, given the stable funding of their operations through upfront policy premia, which are then channelled into prudent investment strategies. Moreover, insurers are well-capitalised and involvement in non-traditional non-insurance activities is minimal. Solvency II, the new EU supervisory framework for insurance, came into force in January 2016 and is expected to enhance resilience through a more risk-oriented approach to insurers' operations and regulatory capital requirements.

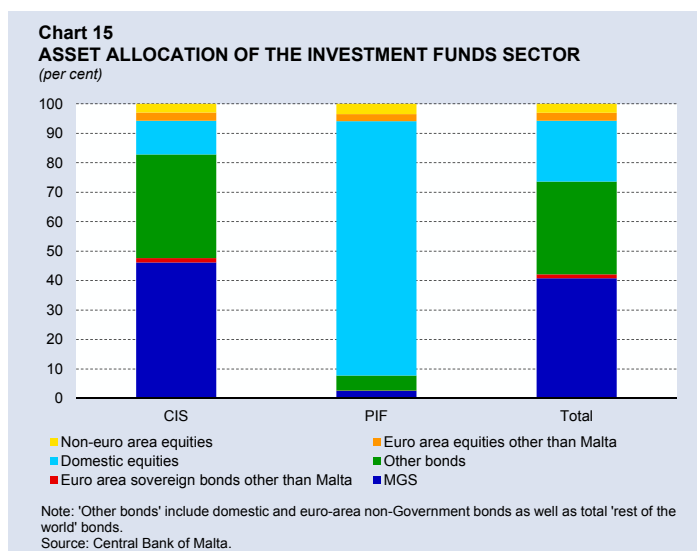
**The domestic investment funds sector continued to grow, but poses no potential financial stability concerns.**

The asset base of the domestic investment funds expanded further to €1.7 billion in June 2016, up by 8.1% over end-2015. Both Collective Investment Schemes (CIS) and Professional Investor Funds (PIF) reported a rise in their total assets.

Assets managed by CIS increased by 7.0% to €1.4 billion over the period under review, attributable to the introduction of a new fund, bringing the number of schemes to seven. Investment assets expanded by 9.1%, to reach €1.3 billion in June 2016. Given that the CIS are composed predominantly of bond funds, bond holdings accounted for over 80% of their investment portfolio (see Chart 15). Higher investment assets mainly resulted from holdings of MGS and bonds issued in the United States. CIS also reported higher holdings of bonds issued in the euro area, mainly in France, Luxembourg and Ireland, and mostly relating to captives and NFCs.

Equities held by CIS, which accounted for around 17% of their investment portfolio, expanded by 5.1%, to €216.2 million in June 2016. The expansion mainly stemmed from higher investments in equities issued by non-money market funds in Luxembourg and by NFCs in Malta. Meanwhile, holdings of equities issued in the United Kingdom and the United States were lower.

In June 2016, assets managed by PIF amounted to €362.9 million, a 12.4% increase over December 2015, with the number of funds remaining unchanged at seven. This expansion related mainly to an expansion in the loan portfolio, which increased by 15.0% to €169.8 million on account of one PIF buying traded loans of a non-core domestic bank. Furthermore, in the first half of 2016, holdings of financial derivatives rose by €11.8 million to €16.8 million, attributable to one fund.



<sup>38</sup> The combined ratio is compiled by dividing the net claims paid and other expenses of non-life insurers by net premia written.



The investment portfolio expanded by 3.6% to €176.2 million, stemming wholly from bond holdings, predominantly issued in countries outside the euro area. On the other hand, investment in equities, which accounted for 92.2% of total investment assets, remained relatively unchanged and consisted mainly of domestic equity issued by non-money market funds.

In the first half of 2016, CIS reported profits before tax of €6.8 million, down from €17.7 million during the corresponding period of 2015, owing to a drop in 'other income'.<sup>39</sup> Expenses remained relatively stable compared to the same period a

year earlier. Meanwhile, PIF reported losses before tax of €0.7 million, down from a profit of €1.8 million in the same period last year. The drop is attributable to lower income and higher expenses. Specifically, income dropped by €1.4 million due to a fall in dividends received, while expenses increased by €1.1 million, arising from management fees, general administrative costs and commissions.

Households remained the main shareholders of CIS, representing 85.0% of the investment funds and reflecting the retail nature of such schemes (see Chart 16). Such holdings accounted for 6.5% of households' net financial wealth. Meanwhile, the main investors in PIF remained MFIs, given the higher amount of investment required. These accounted for 66.2% of the total investment in PIF.

The structural linkages between core domestic banks and the investment funds sector remained significant, as core domestic banks manage almost 74% of the funds' net asset value. Linkages from bank ownership of asset management companies are also evident in the euro area, giving rise to step-in risk, which could result in contagion effects in case of distress. In a local context, although contagion risks are high, their probability is deemed to be low given that the domestic investment funds sector is relatively small in terms of size; equivalent to 8.0% of the assets of the core domestic banks.<sup>40</sup> Furthermore, both the core domestic banks and investment funds have shown strong resilience and stable financial conditions, curtailing possible financial stability concerns.

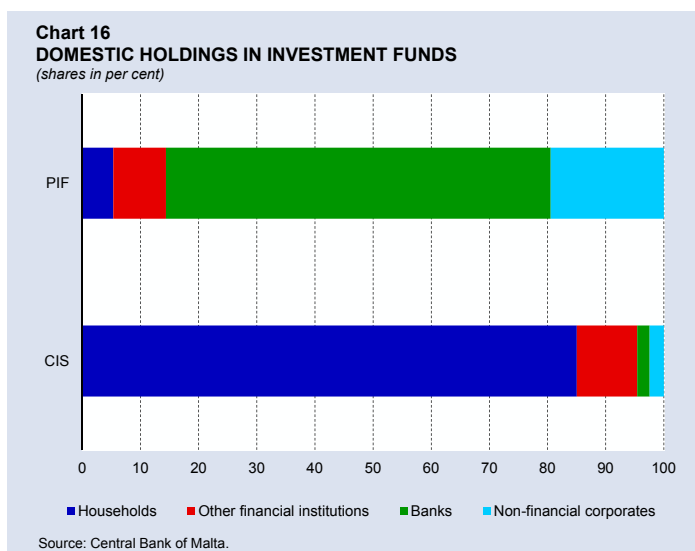
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## The Regulatory Response

### MFSA Banking Rule BR/09

The outlook for financial stability is also supported by the local authorities' micro- and macro prudential frameworks with the sole aim to mitigate any potential rising systemic risks within the local financial system.

Following extensive discussions with both the Central Bank of Malta and the MFSA, the Joint Financial Stability Board (JFSB) has determined the need for the banking sector in Malta to reduce further its level of NPLs and has advocated a more direct approach to achieve this target. The Board also determined that an amended version of the MFSA's Banking Rule 09 issued under the Banking Act (Cap. 371) is the most appropriate instrument to achieve this objective. In this respect, the MFSA issued a "Consultation on the proposed amendments to Banking Rule 9 – Measures addressing Credit Risks arising from the assessment



<sup>39</sup> 'Other income' refers to income from rents; foreign exchange rate gains/losses and revaluation gains/losses of financial assets and investment property.

<sup>40</sup> The size of the domestic investment funds sector is equivalent to 3.6% of the total banking sector's assets.

of the quality of Asset Portfolios of Credit Institutions authorised under the Banking Act 1994”, inviting stakeholders to submit written feedback by 21 October 2016, extended to the 31st of October 2016.

The purpose of the amended Banking Rule 09 is to set up a framework that provides an incentive to credit institutions to resolve NPLs. Credit institutions holding a NPL ratio higher than 6% are being required to draw up a concrete reduction plan to bring their level of NPLs below this ceiling over a five-year period. The proposed ceiling of 6% has been designed to strike a balance between particular traits of the banking industry in Malta, such as the size of the institutions, their structural characteristics, as well as their operational constraints and the ratios observed in other European countries.

In the case where a credit institution, following an annual review by the MFSA, is found to be deviating from any phase of the NPL Reduction Plan, it will be required to allocate capital to a new reserve – ‘Reserve for Excessive NPLs’. The duration of this appropriation will run annually until the NPL reduction plan is back on track and is to be effected from the profits for each corresponding financial year.

### **Reciprocity to policy measures by the Belgian and Estonian authorities**

The framework on voluntary reciprocity for macro-prudential policy measures set out in Recommendation ESRB/2015/2 of the European Systemic Risk Board should ensure that all exposure-based macro-prudential policy measures activated in one Member State are reciprocated in the other Member States.

#### ***Belgium:***

In the light of legislative developments in Belgium with respect to the implementation of the 5-percentage-point risk-weight add-on applied under Article 458(2)(d)(vi) of Regulation (EU) No 575/2013 to Belgian mortgage loan exposures of credit institutions using the internal ratings-based (IRB) approach, the General Board of the European Systemic Risk Board included the Belgian measure in the list of macro-prudential policy measures which are recommended to be reciprocated under Recommendation ESRB/2015/2, on the assessment of cross-border effects of, and voluntary reciprocity for, macro-prudential policy measures (ESRB/2016/3).

Since no domestic credit institution applies the IRB approach, this measure has not been reciprocated.

#### ***Estonia:***

Eesti Pank requested, in accordance with Article 134(4) of Directive 2013/36/EU, for reciprocation of a 1% systemic risk buffer rate applicable to the domestic exposures of all credit institutions authorised in Estonia. The General Board of the European Systemic Risk Board (ESRB) has decided to include the Estonian measure in the list of macro-prudential policy measures which are recommended to be reciprocated under Recommendation ESRB/2015/2 as per amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macro-prudential policy measures (ESRB/2016/4).

Following the JFSB recommendation, the Central Bank of Malta decided to reciprocate the measure subject to a *de minimis* threshold of EUR200 million, i.e. only those domestically authorised institutions which have a total risk exposure higher than the threshold are required to hold a 1% systemic risk buffer on those exposures.

# APPENDIX

**Appendix: Financial Soundness Indicators**

|  | Core Domestic Banks |        |        |           | Non-Core Domestic Banks |        |        |           | International Banks |        |        |        | Total Banks |        |       |        |           |        |       |
|--|---------------------|--------|--------|-----------|-------------------------|--------|--------|-----------|---------------------|--------|--------|--------|-------------|--------|-------|--------|-----------|--------|-------|
|  | 2012                | 2013   | 2014   | June 2015 | 2012                    | 2013   | 2014   | June 2015 | 2012                | 2013   | 2014   | 2015   | June 2016   | 2012   | 2013  | 2014   | June 2016 |        |       |
| <b>Core FSIs</b>   |                     |        |        |           |                         |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Regulatory capital to risk-weighted assets <sup>1</sup>  | 16.08               | 16.51  | 14.47  | 14.59     | 15.75                   | 26.89  | 22.58  | 17.44     | 22.47               | 15.87  | 115.73 | 119.60 | 119.60      | 66.82  | 55.82 | 46.20  | 25.75     | 21.86  | 24.09 |
| Regulatory Tier 1 capital to risk-weighted assets <sup>1</sup>   | 12.12               | 12.88  | 11.55  | 12.15     | 12.97                   | 24.31  | 22.12  | 17.05     | 18.92               | 12.77  | 115.19 | 119.59 | 119.59      | 62.21  | 53.30 | 43.88  | 23.69     | 18.51  | 20.98 |
| Non-performing loans net of specific provisions & interest in suspense to total own funds <sup>1</sup> | 37.44               | 39.01  | 42.60  | 38.04     | 31.65                   | 7.66   | 2.10   | 7.71      | 8.53                | 11.31  | 0.17   | 0.79   | 2.96        | 4.58   | 6.15  | 9.40   | 21.55     | 23.25  | 18.94 |
| Non-performing loans to total gross loans <sup>1</sup>   | 7.75                | 8.95   | 7.62   | 7.17      | 6.43                    | 9.77   | 3.71   | 4.57      | 4.06                | 4.30   | 0.48   | 1.39   | 5.51        | 8.89   | 3.78  | 5.55   | 7.74      | 4.28   | 4.11  |
| Sectoral distribution of resident loans to total loans   |                     |        |        |           |                         |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Agriculture  | 0.29                | 0.29   | 0.25   | 0.24      | 0.19                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.12  | 0.16   | 0.15      | 0.14   | 0.12  |
| Fishing  | 0.11                | 0.13   | 0.09   | 0.11      | 0.09                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.05  | 0.07   | 0.06      | 0.07   | 0.06  |
| Mining and quarrying   | 0.07                | 0.05   | 0.05   | 0.05      | 0.08                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.03  | 0.03   | 0.03      | 0.03   | 0.05  |
| Manufacturing  | 3.34                | 3.20   | 2.90   | 2.77      | 2.57                    | 0.66   | 0.58   | 0.55      | 0.57                | 0.49   | 0.00   | 0.00   | 0.00        | 0.00   | 1.41  | 1.75   | 1.77      | 1.69   | 1.62  |
| Electricity, gas, steam and air conditioning supply  | 2.34                | 2.22   | 3.23   | 2.67      | 2.28                    | 0.00   | 3.27   | 5.14      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.97  | 1.34   | 2.22      | 1.60   | 1.41  |
| Water supply, sewerage waste management and remediation activities                                     |                     |        |        |           |                         |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Construction   | 10.44               | 9.78   | 8.24   | 5.51      | 5.79                    | 11.07  | 10.06  | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.30  | 0.38   | 0.38      | 0.33   | 0.30  |
| Wholesale and retail trade; Repair of motor vehicles and motor cycles                                  | 8.77                | 8.46   | 8.66   | 8.50      | 7.97                    | 4.55   | 1.06   | 0.67      | 1.11                | 0.48   | 0.00   | 0.00   | 0.00        | 0.00   | 4.67  | 5.25   | 4.94      | 3.31   | 3.59  |
| Transportation and storage   | 4.11                | 3.65   | 3.52   | 3.50      | 2.82                    | 1.85   | 1.29   | 0.80      | 0.00                | 0.00   | 0.00   | 0.00   | 0.11        | 0.22   | 3.79  | 4.59   | 5.23      | 5.17   | 4.97  |
| Accommodation and food service activities  | 5.13                | 5.06   | 4.47   | 5.18      | 3.85                    | 0.00   | 0.00   | 0.03      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 1.77  | 2.12   | 2.19      | 2.18   | 1.60  |
| Information and communication  | 1.24                | 1.26   | 0.96   | 0.94      | 0.91                    | 0.25   | 0.18   | 0.11      | 0.11                | 0.08   | 0.00   | 0.00   | 0.00        | 0.00   | 2.14  | 2.72   | 2.68      | 3.12   | 2.39  |
| Financial and insurance activities   | 4.66                | 4.32   | 4.14   | 4.94      | 6.14                    | 0.39   | 0.78   | 0.74      | 0.90                | 2.62   | 0.00   | 0.01   | 0.02        | 0.03   | 0.52  | 0.68   | 0.58      | 0.51   | 0.57  |
| Real estate activities (includes imputed rents of owner-occupied dwellings)                            | 4.63                | 4.78   | 4.83   | 5.69      | 6.61                    | 0.10   | 2.43   | 3.55      | 3.50                | 3.35   | 0.00   | 0.00   | 0.00        | 0.45   | 1.93  | 2.67   | 3.09      | 3.76   | 4.44  |
| Professional, scientific and technical activities  | 0.65                | 0.48   | 0.35   | 0.42      | 0.99                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.27  | 0.26   | 0.21      | 0.25   | 0.61  |
| Administrative and support service activities  | 1.10                | 1.05   | 1.01   | 0.95      | 1.11                    | 0.05   | 0.07   | 0.08      | 0.11                | 0.17   | 0.01   | 0.01   | 0.01        | 0.01   | 0.46  | 0.57   | 0.61      | 0.58   | 0.70  |
| Public administration and defence; Compulsory social security  | 1.30                | 1.48   | 1.55   | 1.60      | 1.02                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.88  | 0.90   | 0.93      | 0.96   | 0.63  |
| Education  | 0.40                | 0.38   | 0.36   | 0.44      | 0.33                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.17  | 0.21   | 0.21      | 0.26   | 0.20  |
| Human health and social work activities  | 0.65                | 0.67   | 0.67   | 0.67      | 0.71                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.27  | 0.36   | 0.40      | 0.41   | 0.44  |
| Arts, entertainment and recreation   | 0.68                | 0.70   | 0.62   | 0.52      | 0.45                    | 0.87   | 0.86   | 0.39      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.31  | 0.40   | 0.39      | 0.32   | 0.29  |
| Other services activities  | 0.36                | 0.39   | 0.33   | 0.36      | 0.28                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.15  | 0.21   | 0.20      | 0.22   | 0.18  |
| Households and individuals (excl. Sole Proprietors)  | 41.35               | 43.27  | 43.54  | 46.12     | 46.33                   | 0.08   | 0.12   | 0.11      | 0.14                | 0.13   | 0.00   | 0.01   | 0.01        | 0.01   | 17.23 | 23.25  | 26.12     | 27.74  | 28.72 |
| Mortgages  | 33.82               | 35.64  | 36.62  | 39.73     | 40.23                   | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 14.09 | 19.25  | 22.08     | 23.89  | 24.93 |
| Activities of extraterritorial organisations and bodies  | 0.00                | 0.00   | 0.00   | 0.00      | 0.00                    | 0.00   | 0.00   | 0.00      | 0.00                | 0.00   | 0.00   | 0.00   | 0.00        | 0.00   | 0.00  | 0.00   | 0.00      | 0.00   | 0.00  |
| Non-resident loans to total loans  | 7.57                | 7.46   | 9.60   | 8.37      | 9.32                    | 80.14  | 86.56  | 87.82     | 83.57               | 92.68  | 99.98  | 99.97  | 98.86       | 99.26  | 80.90 | 49.83  | 45.07     | 44.31  | 43.17 |
| Return on assets <sup>2</sup>  | 1.05                | 1.11   | 0.71   | 0.71      | 0.96                    | 1.23   | 0.29   | -1.32     | 1.44                | 7.76   | 4.55   | 2.28   | 2.38        | 3.38   | 1.09  | 0.64   | 0.71      | 0.85   | 1.26  |
| Interest margin to gross income  | 15.46               | 15.27  | 9.82   | 9.90      | 12.83                   | 6.91   | 1.60   | -6.42     | 1.44                | 7.76   | 4.55   | 2.28   | 2.38        | 3.38   | 5.86  | 3.74   | 3.62      | 5.90   | 18.12 |
| Non-interest expense to gross income   | 61.84               | 63.59  | 64.84  | 64.46     | 63.88                   | 14.66  | 42.04  | 48.31     | 43.54               | 32.43  | 123.25 | 173.55 | 201.85      | 137.82 | 83.14 | 101.18 | 115.13    | 92.95  | 73.23 |
| Non-interest income to gross income  | 45.54               | 47.10  | 51.23  | 54.13     | 54.49                   | 28.69  | 64.77  | 56.14     | 73.39               | 70.20  | 7.06   | 9.96   | 11.87       | 24.83  | 27.44 | 34.89  | 36.76     | 43.32  | 41.97 |
| Non-interest expense to non-interest expenses  | 33.20               | 36.42  | 35.16  | 35.54     | 36.12                   | 71.02  | 57.96  | 53.69     | 56.46               | 67.57  | -24.43 | -73.55 | -101.85     | -37.82 | 19.86 | -1.18  | -15.13    | 7.05   | 26.77 |
| Liquid assets to total assets  | 29.56               | 27.76  | 28.31  | 31.78     | 34.05                   | 15.48  | 20.19  | 31.68     | 36.34               | 33.14  | 9.90   | 23.14  | 19.57       | 22.72  | 19.64 | 26.85  | 27.28     | 31.20  | 34.75 |
| Liquid assets to short-term liabilities  | 51.94               | 51.65  | 50.42  | 50.24     | 54.13                   | 57.90  | 72.06  | 77.92     | 63.26               | 61.30  | 145.98 | 204.20 | 84.73       | 83.59  | 55.61 | 59.56  | 53.69     | 52.61  | 59.96 |
| <b>Other FSIs</b>  |                     |        |        |           |                         |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Total coverage ratio <sup>3</sup>  | 35.30               | 37.87  | 40.40  | 43.52     | 47.21                   | 63.83  | 94.64  | 77.11     | 63.15               | 60.61  | 95.15  | 42.98  | 40.45       | 54.20  | 43.64 | 42.28  | 42.67     | 40.16  | 48.49 |
| Domestic securities to total assets  | 10.90               | 11.00  | 9.69   | 9.30      | 9.33                    | 2.94   | 5.54   | 4.56      | 7.74                | 7.17   | 0.00   | 0.00   | 0.00        | 0.17   | 3.61  | 4.13   | 3.88      | 4.54   | 4.60  |
| Foreign securities to total assets   | 18.02               | 19.33  | 23.27  | 21.62     | 21.47                   | 22.77  | 20.98  | 19.48     | 12.45               | 14.20  | 36.15  | 37.92  | 52.76       | 50.39  | 29.75 | 30.63  | 40.14     | 36.00  | 34.90 |
| Unsecured loans to total lending   | 22.77               | 26.15  | 28.97  | 27.41     | 27.06                   | 71.98  | 74.76  | 65.23     | 70.87               | 74.48  | 55.62  | 57.28  | 48.44       | 30.69  | 42.42 | 41.32  | 37.70     | 30.83  | 30.28 |
| Assets to total capital and reserves   | 13.22               | 12.56  | 14.05  | 13.73     | 13.38                   | 3.22   | 3.41   | 8.41      | 8.42                | 11.08  | 1.45   | 1.33   | 1.67        | 1.96   | 3.14  | 3.85   | 6.43      | 7.98   | 8.11  |
| Large exposure to total own funds <sup>1</sup>   | 102.04              | 107.95 | 103.40 | 96.50     | 64.86                   | 186.57 | 199.90 | 339.94    | 198.51              | 249.17 | 10.78  | 17.08  | 45.31       | 124.79 | 31.40 | 47.99  | 88.86     | 114.02 | 92.33 |
| Gross asset position in financial derivatives to total own funds <sup>1</sup>                          | 2.68                | 2.12   | 2.50   | 2.03      | 2.46                    | 0.33   | 0.44   | 2.33      | 0.33                | 0.38   | 0.54   | 0.01   | 0.88        | 0.56   | 0.86  | 0.50   | 1.62      | 1.29   | 1.24  |
| Gross liability position in financial derivatives to total own funds <sup>1</sup>                      | 9.47                | 4.52   | 8.15   | 3.90      | 5.01                    | 0.80   | 0.45   | 2.83      | 0.67                | 2.88   | 0.07   | 0.12   | 0.55        | 0.25   | 0.36  | 1.12   | 3.68      | 2.12   | 2.76  |
| Personnel expenses to non-interest expenses  | 53.92               | 50.91  | 50.81  | 51.17     | 51.30                   | 39.64  | 42.05  | 44.98     | 44.66               | 43.63  | 25.19  | 33.32  | 27.40       | 23.13  | 48.45 | 48.14  | 43.92     | 43.52  | 41.86 |
| Customer loans to customer deposits  | 72.13               | 67.80  | 63.98  | 58.22     | 58.57                   | 86.04  | 96.24  | 75.69     | 60.68               | 52.82  | 140.60 | 79.50  | 95.05       | 104.24 | 94.03 | 72.29  | 71.79     | 67.91  | 63.89 |
| Net open position in equities to total own funds <sup>1</sup>  | 13.80               | 13.48  | 13.93  | 15.42     | 14.31                   | 139.74 | 169.43 | 45.33     | 82.28               | 135.88 | 0.28   | 0.02   | 0.27        | 2.72   | 7.84  | 10.92  | 9.01      | 18.05  | 16.60 |
| Loans-to-value <sup>4</sup>  |                     |        |        |           |                         |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Residential  | 70.38               | 71.49  | 74.18  | 75.10     | 75.70                   |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |
| Commercial   | 63.19               | 67.20  | 69.00  | 63.30     | 51.30                   |        |        |           |                     |        |        |        |             |        |       |        |           |        |       |

<sup>1</sup> Capital data based on the COREP returns for 2014 and 2015. Large exposures is based on COREP returns for December 2015. NPL data based on FNRP for 2014 and 2015.

<sup>2</sup> Based on profit after tax. For 2016 the ROE and ROA have been annualised.

<sup>3</sup> Based on the core domestic banks. The risk-weighted assets for Core Domestic Banks are per the revised Banking Rule 09/2013, implemented over a three-year period up to 2015.

<sup>4</sup> Based on a sample of core domestic banks. 2016 data refers to Q1 2016.