



**BANK ĊENTRALI TA' MALTA**  
EUROSISTEMA  
**CENTRAL BANK OF MALTA**

**FINANCIAL STABILITY REPORT UPDATE – JUNE 2011**

This *Update* evaluates developments since the publication of the *Financial Stability Report 2010* to analyse changes to financial stability vulnerabilities identified in the *Report*, and to establish whether new risks have emerged.<sup>1</sup>

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The *Financial Stability Report 2010 (FSR 2010)* had concluded that the local financial system remained resilient, supported by positive economic growth and low unemployment. In the light of unfavourable international economic conditions, however, financial stability considerations continued to be challenging. Credit risks remained elevated particularly as a result of subdued activity in certain economic sectors, which rely to a significant extent on bank credit to fund their business activities. Since credit and concentration risks were identified as the two main vulnerabilities, the *Report* advocated enhanced resilience building, primarily through recommendations for higher capital retention by banks and more prudent loan loss provisioning. The *FSR 2010* also emphasised the need for better liquidity and funding management, through a rebalancing in the composition of liquid assets and the lengthening of deposit maturities.

The risk outlook as contained in the *FSR 2010* remains mainly valid. While the financial sector continues to be exposed to international developments, in particular owing to the feedback loop between risks to global economic recovery and the sovereign debt, no new risks appear to have emerged in recent months. Owing to the current uncertain economic conditions in the euro area, the previously-identified risk of a rapid increase in interest rates appears to have been attenuated and rates are likely to remain stable in the short term. Nevertheless, vigilance is required and needs to be supported by robust risk mitigation practices. The policy measures recommended in the *FSR 2010*, aimed at strengthening the resilience of the financial system, are therefore reaffirmed in this *Update*.

### **Risks from the macro-financial environment**

#### *The Update coincides with the international financial market tensions*

Since the publication of the *FSR 2010* international financial market tensions have increased as a result of concerns about the sustainability of the sovereign debt in a number of euro area Member States. Indeed, a number of sovereign credit rating downgrades contributed to lower market liquidity and to higher asset price volatility. These developments increased the downside risks to financial stability, and hence policy makers worldwide took various initiatives including fiscal consolidation drives.<sup>2</sup> In particular, the European

<sup>1</sup> The cut-off date for data published in this Report is 7 September 2011. The *Update* is based on the same list of banks included in the *FSR 2010*.

<sup>2</sup> This was also confirmed by a press release issued by the Heads of State of Government of the euro area and EU institutions on 21 July 2011.

Financial Stability Facility (EFSF) was revised to deal more effectively with the ongoing crisis.<sup>3</sup> It is expected that until the revised ESFS is functional the ECB will continue with its renewed sovereign bond purchases programme. The US Federal Reserve also committed itself to keep its very low interest rates at least until mid-2013. While in the long term fiscal consolidation is expected to contribute positively to financial stability, it may translate into subdued economic activity in the short run.

### *Notwithstanding the adverse international economic conditions, the domestic economy continued to display a degree of resilience*

Internationally, economic growth in 2011 is likely to be weaker than originally expected in view of higher downside risks. In the latest available Consensus Forecasts, economic growth forecasts for the EU, UK and the US are in the range of 1.2% to 1.7%.<sup>4</sup> The forecasts coincide with the negative financial market sentiment which has resulted in higher prices for safe haven assets (the price of gold has increased by almost 30% since last December) and lower stock market indices. The STOXX Europe 600 and the STOXX Americas 600 were down by 16.6% and 4.6% respectively, compared with the end of 2010.

Nevertheless, national accounts data for the Maltese economy for the first half of 2011 indicate that the shocks stemming from the uncertain world economic climate and the geopolitical problems in North Africa and the Middle East have been absorbed well by the Maltese economy, as suggested by the ongoing economic growth and the relatively low level of unemployment. Looking ahead, although economic conditions abroad may result in some dampening effects on the domestic economy, economic growth is still projected to maintain a sustained pace and to remain higher than the EU average. However, some sectors which rely on domestic bank credit, such as construction, may still lag behind. Other sectors such as manufacturing, financial and insurance activities and business and professional services, which are, however, much less dependent on domestic bank credit, are likely to continue generating higher value added.<sup>5</sup>

### **Risks to the Domestic Financial System**

While credit risk continues to be elevated in Malta, the overall Non-Performing Loans (NPL) ratio (covering both households and corporate borrowers) remained stable at 7.3%, unchanged from December 2010.<sup>6,7</sup> About 76% of total NPLs are backed by collateral, whereas 11% of the total is covered by specific provisions.<sup>8</sup>

### *Households suffered a decline in their net financial wealth but the threat of a rapid increase in loan repayment outlays has receded<sup>9</sup>*

Households' debt repayment capacities remained somewhat stable since December, as they experienced offsetting effects. Households' net financial wealth declined by around 1.8% during the first half of the year, on account of a lower value of their holdings of equity and securities quoted on the Malta Stock Exchange (MSE) and higher bank indebtedness. This effect was partially offset by higher values for insurance policy holdings.<sup>10</sup> On the other hand, the risk of a rapid increase in loan repayment outlays has subsided since interest rates are likely to take longer to return to pre-crisis levels. Although commodity prices remain high by historical standards, the possibility of accelerating international oil and food prices has diminished, with

<sup>3</sup> In particular, the new wider ESFS's scope of activity would allow the ESFS to act on the basis of a precautionary programme, to finance recapitalisation of financial institutions through loans to governments and to intervene in the secondary markets on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability, and on the basis of a decision by mutual agreement of the EFSF Member States to avoid contagion. For further details refer to: [http://www.efsf.europa.eu/attachments/faq\\_en.pdf](http://www.efsf.europa.eu/attachments/faq_en.pdf)

<sup>4</sup> Source: Consensus Forecasts 12 September 2011.

<sup>5</sup> The Business and professional services refer to Professional scientific and technical activities and administrative and support service activities sectors - NACE Rev.2 classification.

<sup>6</sup> The NPL ratio is defined as total NPLs as a proportion of the total loan portfolio.

<sup>7</sup> Non-performing loans: Credit facilities with payments of interest and/or capital overdue by 90 days or more as well as those facilities which a credit institution has reason to doubt the eventual recoverability of funds.

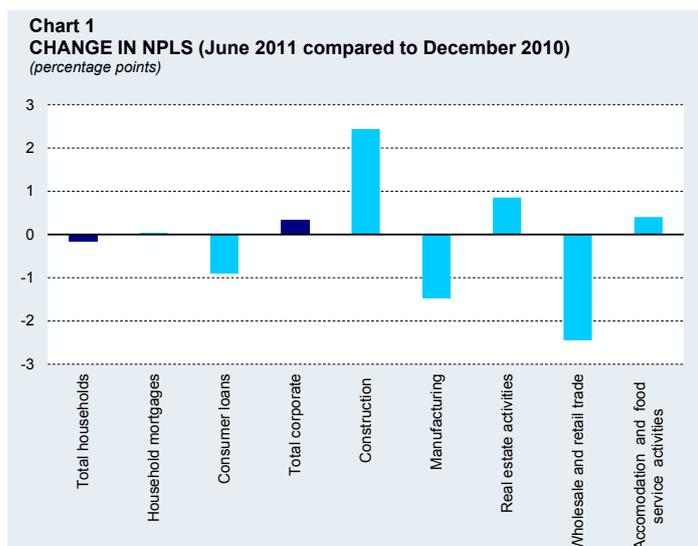
<sup>8</sup> The amount of collateral covering NPLs is estimated by assuming an identical proportion of total collateral to total loans.

<sup>9</sup> Financial wealth calculation is compiled by aggregating data on household holdings of Treasury Bills, Collective Investment Schemes, investments in the Malta Stock Exchange, Cash, Deposits and Insurance and Technical Reserves. Net Financial wealth is estimated by deducting outstanding household loans.

<sup>10</sup> Household insurance holdings refer to technical reserves, which consist of actuarial reserves held by insurance companies against outstanding risks related to both life and non-life insurance policies.

the consequent lower pressure on household finances. At the same time the required fiscal consolidation effort over the medium term is not expected to exert a major impact on households' wealth buffers.

Particularly in view of the labour market resilience, the absolute amount of household loan repayments, which had fallen in arrears, declined slightly during the first half of 2011. The consumer credit NPL ratio dropped to 4.5% from 5.4% while the mortgage NPL ratio remained stable at 2.6%. As a result, the total household NPL ratio declined to 3.0% from 3.2%. The reduction in consumer credit NPLs is a welcome development, particularly as the latter generally serve as a leading indicator of household credit worthiness.



### *Concerns about the corporate sector persist, particularly as the construction sector continues to underperform*

In contrast to the past accumulation of corporate debt, the outstanding value of bank loans and bonds issued on the Stock Exchange declined in nominal terms by 0.7% and 0.3%, respectively. However, a number of firms continued to experience repayment difficulties, attributable both to structural fragilities and to the knock-on effects of subdued economic activity in certain sectors. The NPLs of the resident corporate sector rose by almost EUR8 million compared with December 2010, with the total corporate NPL ratio deteriorating marginally, from 11.7% to 11.9%. The increases during the first six months of 2011 were mainly in the construction, real estate activities, and accommodation and food services activities sectors, while the manufacturing and wholesale and retail trade sectors experienced decreases in their NPLs following an improvement in their financial performance (see Chart 1).

Excess supply conditions in the construction sector are likely to persist for some time as indicated by the Central Bank of Malta's Real Estate Market Survey (REMS).<sup>11</sup> Furthermore, the majority of participants in the REMS indicated that both house prices and commercial real estate prices were overvalued. Almost 90% of respondents stated that residential property prices remained overvalued, while in the case of commercial properties (offices) the survey replies were more balanced, with 56% of respondents reporting an overvaluation and 44% responding that such properties were correctly priced. If the downward pressure on property prices were to persist, this might create further challenges for the banks in terms of loan repayments capabilities, particularly in the construction sector. Meanwhile, the amount of rescheduled facilities, the majority of which were attributable to the construction sector, was up by a further 4.7% since December.

## **Credit and Concentration Risks**

### *Credit and concentration risks remain elevated as provisioning levels remain inadequate*

The elevated credit risk is being partly mitigated by tight credit standards and by cautious lending behaviour by banks, particularly in respect of demand for credit from sectors facing a less optimistic outlook. The annual rate of credit growth eased from 4.7% as at December 2010 to 2.4% as at June 2011. Annual credit growth extended to the non-financial private corporate sector remained low, at around 2%, whereas that to the public non-financial companies decelerated to 5.3%. During the first six months of 2011 mortgage lending continued to grow by 4.4% while consumer credit contracted by 0.7%.

<sup>11</sup> The REMS monitors the business sentiment of real estate agents and covers conditions for residential and commercial property markets.

**Table 1****BALANCE SHEET ASSET COMPOSITION**

	2009		2010		2011 (June)	
	EUR billions	%	EUR billions	%	EUR billions	%
Total assets	14.451	100.0	15.262	100.0	15.348	100.0
<i>of which:</i>						
Property related loans	4.495	31.1	4.476	29.3	4.574	29.8
Other non-interbank loans	3.676	25.4	4.038	26.5	3.988	26.0
MGS	1.164	8.1	1.317	8.6	1.445	9.4
Interbank exposure including repos	1.167	8.1	1.468	9.6	1.320	8.6

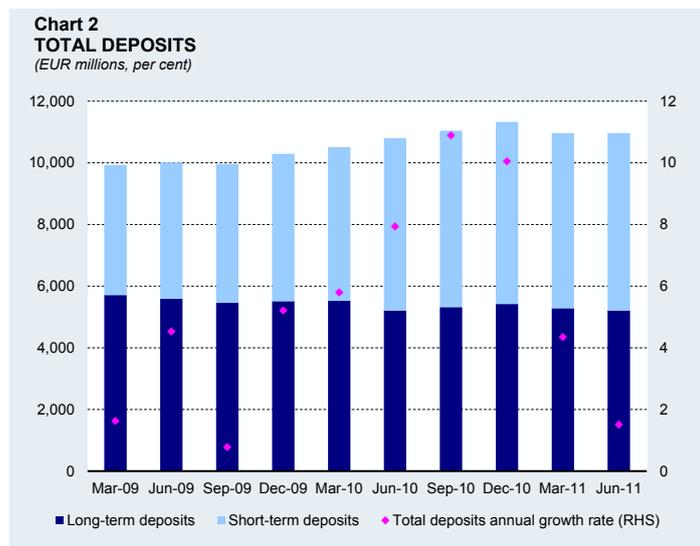
Banks' balance sheet asset composition remained stable with property-related loans still accounting for just under 30% of total assets, or 52% of total loans (see Table 1).<sup>12</sup> Property market concentration risk, however, remained high. In turn, holdings of domestic government bonds amounted to around 10%, while interbank exposures decreased by one percentage point to around 8.6% of total assets. It is recognised that the reduction of concentration risk and the re-composition of assets may be difficult in the short term, but it is important to mitigate this risk through appropriate capital, adequate loan loss provisioning and/or a rebalancing of risks within the banks' portfolio. This remains relevant since the NPLs are not fully covered by collateral and specific provisions.

## Funding and liquidity risks

### *Liquidity ratios remained high but liquid assets were not very diversified*

In terms of liquidity, banks maintained very high ratios when compared with regulatory requirements and conventional funding benchmarks. Indeed, the liquidity ratio (liquid assets to short-term liabilities) increased from 44.6% as at December 2010 to 46.4% by mid-2011. Although this is a positive development, looking ahead banks may be required to further review their liquidity and funding strategies to take into account the more onerous (draft) Capital Requirement Regulation (CRR) transposing the Basel III requirements in this field.<sup>13</sup>

Total deposits declined by 3.2% over the first six months of the year, dropping to almost EUR11 billion from EUR11.3 billion. This drop was entirely the result of lower non-resident deposits as there was a slight increase in resident deposits. The annual growth rate of total deposits thus decelerated from 10% as at December 2010 to 1.5% as at June 2011 (see Chart 2).<sup>14</sup> Nevertheless, apart from fully funding total loans, deposits also provided an additional buffer of around 30%. However, a significant proportion of deposits



<sup>12</sup> Property-related loans include loans to the construction and real estate activities sectors, purchase of hotels and mortgage lending.

<sup>13</sup> On 20 July 2011 the Commission issued 'New Proposals on Capital Requirements' which gives a better indication as to how the Basel III requirements will be implemented across the EU.

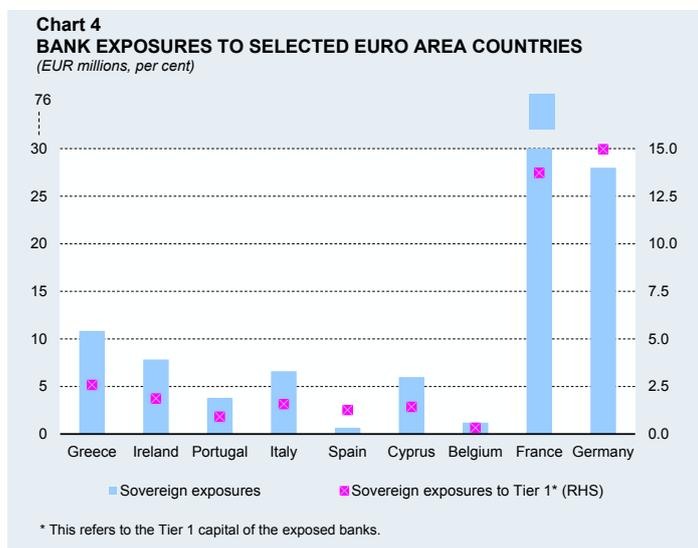
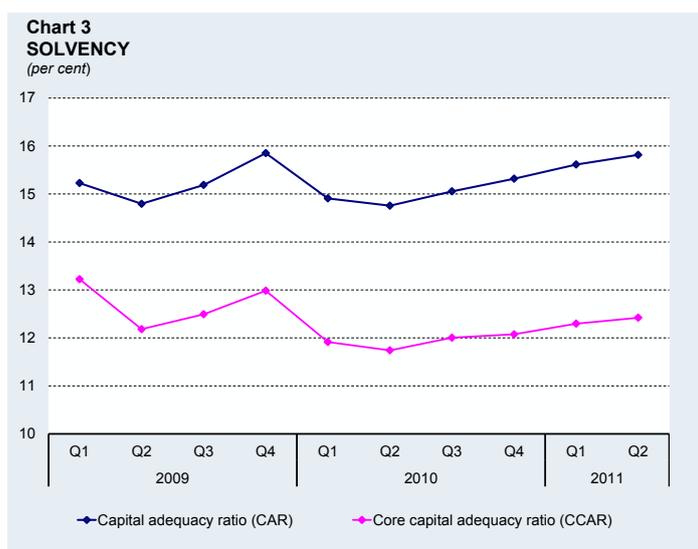
<sup>14</sup> Total deposits include: (i) money market funds (ii) central government (iii) other general government and (iv) other remaining economic sectors, excluding the financial intermediation sector. Short term deposits include current and savings accounts while the remaining deposits are considered as term deposits.

have a short term to maturity, thereby contributing to risks arising from a maturity mismatch. On the other hand, recourse to euro system funding remained marginal, while no concerns exist in relation to USD funding needs of systemically relevant banks in Malta.

## Resilience of the Financial System

### *Solvency ratios increased but they will have to increase further to cover all Pillar II risks*

The Core Capital Adequacy Ratio (CCAR) and the Capital Adequacy Ratio (CAR) increased by 0.3 and 0.5 percentage points, respectively, during the six months to June 2011 to 12.4% and 15.8% (see Chart 3). This largely reflected the issuance of ordinary shares (namely through a bonus issue partly following a transfer from retained earnings) and some scaling back of risk weighted assets. On the basis of these new higher solvency ratios, univariate stress tests carried out in relation to asset quality deterioration, an economic downturn, house price correction and persistent deposit withdrawals (based on the same assumptions and methodologies to those used in the *FSR 2010*) continue to indicate overall resilience of the domestic banking sector to these extreme yet plausible shocks. Indeed, stress test results remained broadly unchanged.<sup>15</sup> This resilience was also confirmed by the results of the latest EU-wide stress testing round.<sup>16</sup> In some cases, however, dividend pay-outs may need to be less generous to ensure further increases in solvency ratios, and to bring them further in line with current risks and ahead of the future capital requirements across the EU. Indeed, the future leverage requirement as envisaged in Basel III may also prove challenging for the banks. Other provisional calculations suggest that, while the current level of



<sup>15</sup> The results derived from univariate stress tests must be evaluated with caution as they assess specific stand-alone scenarios and do not capture the possible amplification of shocks through feedback effects or the occurrence of multiple shocks. The results of these scenario stress tests are not to be considered as a forecast of the financial performance of the participating credit institutions but rather interpreted as the results of 'what-if' scenarios.

<sup>16</sup> As was the case last year, Bank of Valletta p.l.c. participated in the EU-wide stress test 2011. The bank passed the test, with a Core Tier 1 ratio of 10.4%, 5.4 percentage points above the stipulated threshold. The parent banks of domestic subsidiaries, namely BNP Paribas, Deutsche Bank AG, Erste Bank Group, HSBC Holdings plc, National Bank of Greece and Raiffeisen Bank International also passed the test. Oesterreichische Volksbank AG failed the test but after taking account of additional mitigating measures that were taken or committed to after April 2010, this bank would attain a ratio above the stipulated threshold. The results of these scenario stress tests are not to be considered as a forecast of the financial performance of the participating credit institutions but rather interpreted as the results of 'what-if' scenarios.

capital is sufficient to cover Pillar 1 risks (credit, market and operational risks) and Pillar II's interest rate risk in the banking book, banks may need to boost their capital to adequately cover for all concentration risks.

The risks associated with the sovereign debt crisis appear to be generally contained since the total exposure of the banks in Malta to the three countries benefiting from an EU-IMF bailout, Greece, Ireland and Portugal, was limited. In particular, the sovereign exposure vis-à-vis Greece was limited to around EUR10 million and only represents some 2.6% of the Tier 1 capital of the exposed banks (see Chart 4). Both in absolute terms and as a percentage of Tier 1 capital, sovereign exposures vis-à-vis Ireland and Portugal are even lower at 1.8% and 0.9% of Tier 1 capital. Furthermore, as at June 2011, the sovereign exposures to other EU countries such as Italy, Spain, Cyprus and Belgium, remained low at 3.4% of Tier 1 bank capital or 0.2% of total assets of the banks. Exposures to French and German sovereign debt represent 13.7% and 15.0% of Tier 1 capital, or 9.3% and 9.4% of the total own funds of the exposed banks.

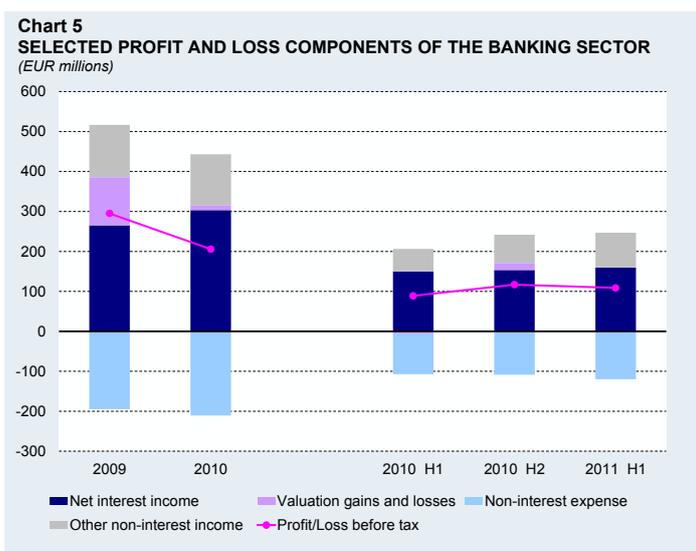
## Profitability

### *Core bank profits increased, driven by higher net interest incomes*

The banks' profitability rose during the first six months, with pre-tax profits standing at EUR225.5 million. This improvement in profitability is also reflected in banks' return on earnings (ROE) and return on assets (ROA) ratios, which increased from 12.8% and 1.4% as at December 2010 to 13.7% and 1.5% as at June 2011. During the first half of 2011, net interest income rose by 6.6% compared with the same period last year, reflecting a larger increase in interest income compared with interest expense. The expansion in interest income was mainly attributable to higher earnings on the loan portfolio, as the weighted average lending rate rose, and to higher income from securities, as sovereign securities holdings increased (see Chart 5). While the strategy of relying on short-term deposits appears profitable as it provides a low cost of funding for banks, the extent of reliance on this source of funding carries risks as such deposits may lose their traditional stability in times of stress, or banks may face higher funding costs in the light of intensified competition amongst deposit taking institutions due to a search for higher yields. The higher non-interest income was driven by dividends receivable and 'other' non-interest income, whereas the rise in non-interest expense mainly reflected higher administrative costs. Going forward, the adverse financial market conditions may exert a negative effect either directly through the profit and loss account or through reserves, since almost three-quarters of banks' security holdings are marked to market, as they are Designated at Fair Value Through Profit and Loss or else classified as Available for Sale (AFS). Meanwhile, Loan Loss Provision charges increased by almost a third in the first half of 2011, and looking ahead, their negative impact on profits may increase in view of the current level of credit risk.

### *Financial stability risks associated with the rest of the domestic financial system remain relatively unchanged*

During the first six months of 2011 the insurance sector reported lower profits mainly in view of lower investment income and to a lesser extent, higher net claims. The main financial stability risks identified in the *FSR 2010* for the insurance sector mainly relating to low re-insurance, to concentration in investment assets and to their interconnectedness with the banking system, remain relevant.



### Updated risk outlook

The updated risk outlook suggests that, on balance, financial stability conditions will remain challenging for the next few months. The intensity and outlook of risks identified in the *FSR 2010* remained largely unchanged since the time of publication. The only exceptions to the predicted risk outlook for the first half of the year relate to changes in risks emanating from outside the financial system, namely the worsening of the sovereign debt crisis in the euro area and to the lower probability of the materialisation of the risk emanating from the upward trend in interest rates. Nevertheless, strong vigilance is requested to maintain intact the resilience of the financial system.

Changes in the risk outlook since the publication of the FSR 2010		
	FSR 2010	FSR 2011 Update
Risks associated with the worsening of the sovereign debt crisis in the euro area	→	↗
Inflationary pressures leading to an upward trend in interest rates	↗	↘

- Increased somewhat 
- Decreased somewhat 
- Unchanged 