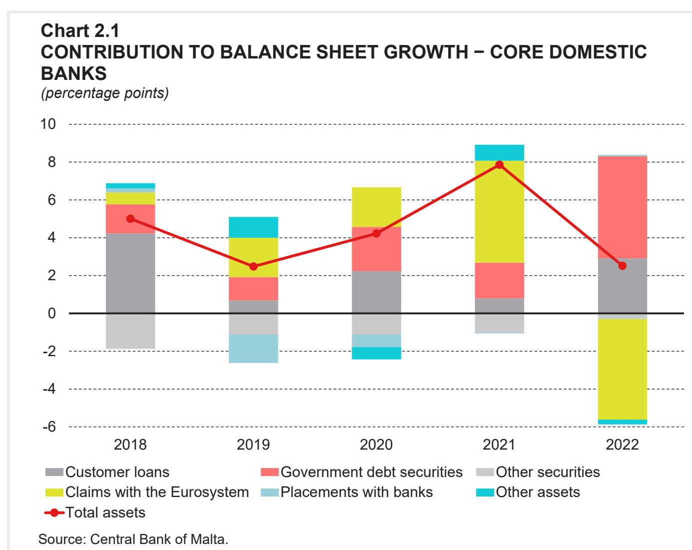
2. DEVELOPMENTS IN THE BANKING SECTOR

2.1 Core domestic banks

The uncertain global macroeconomic environment was challenging for core domestic banks as they continued with their recovery from the pandemic. Their balance sheet expanded by 2.5%, the slowest growth in the last three years. As economic growth surpassed the expansion in banks' balance sheets, the size of the sector relative to GDP dropped by around 16 percentage points to 168.8%. With the early repayment of the targeted longer-term refinancing operations (TLTROs), following the end of the favourable conditions for such funding, an exceptional litigation charge, and opportunities to purchase fixed income instruments after the sharp fall in bond prices, the placements with the Eurosystem decreased by almost a quarter, after several years of sustained growth (see Chart 2.1). However, at 16.2% of assets, such placements still represented an important share of these banks' overall assets. Investment in sovereign bonds increased, given the higher yields owing to the rising interest rate environment. Such bonds are considered liquid, and thus the move from Eurosystem placements to sovereign bonds did not affect these banks' liquidity position (see section 2.1.4). At the same time, lending by the core domestic banks also increased by 6.4% over the previous year.

Chart 2.1
CONTRIBUTION TO BALANCE SHEET GROWTH – CORE DOMESTIC BANKS
(percentage points)

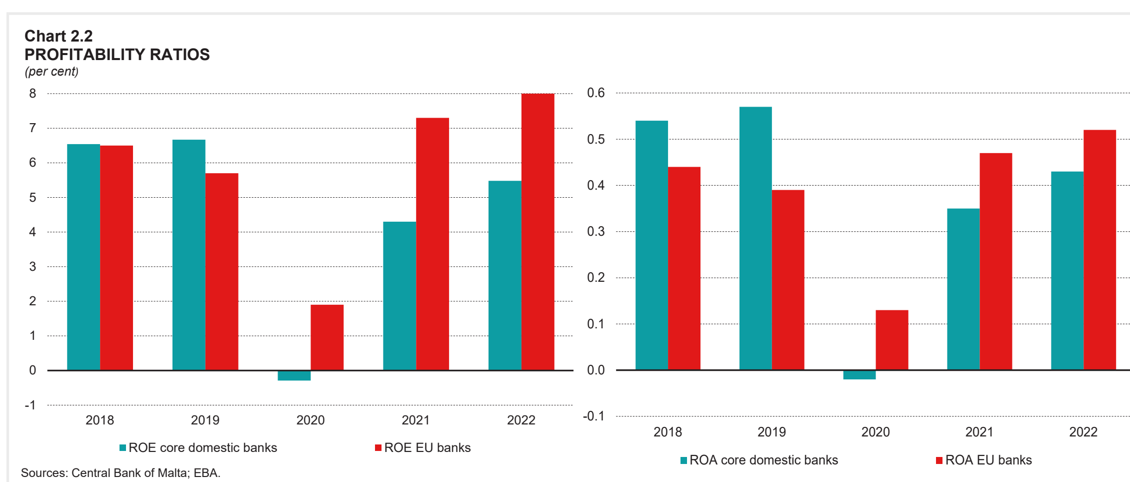


Source: Central Bank of Malta.

2.1.1 Profitability

The core domestic banks' profitability continued to recover, with pre-tax profits up by 27.8% compared to a year earlier. The recovery in overall profitability still lagged that of EU counterparts and pre-pandemic levels, however, this was mainly due to a one-off litigation charge which took place in the first half of the year. Should this be excluded, pre-tax profits would have doubled compared to 2021 figures. The post-tax ROE and Return on Assets (ROA) improved by 1.2 percentage points and 0.1 percentage point, respectively, to reach 5.5% and 0.4% (see Chart 2.2). Excluding the one-off litigation charge, the post-tax ROE and ROA would go up to around 8.5% and 0.7%, respectively, exceeding EU averages.[1]

Chart 2.2
PROFITABILITY RATIOS
(per cent)

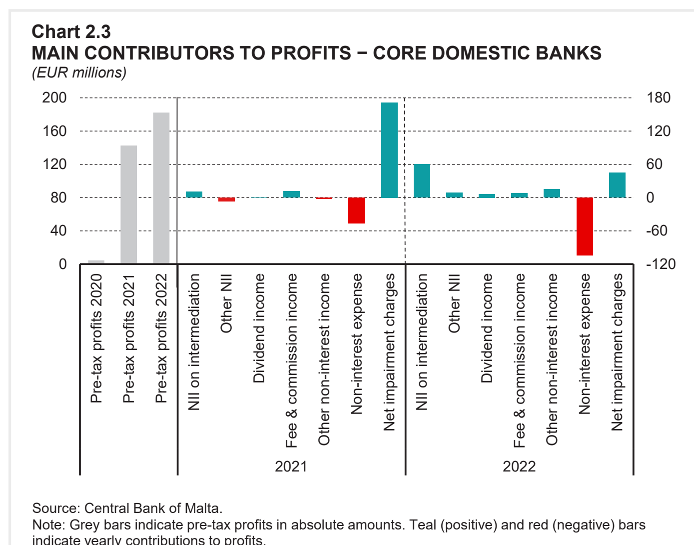


Sources: Central Bank of Malta; EBA.

[1] Source: EBA Risk Dashboard Q4 2022.

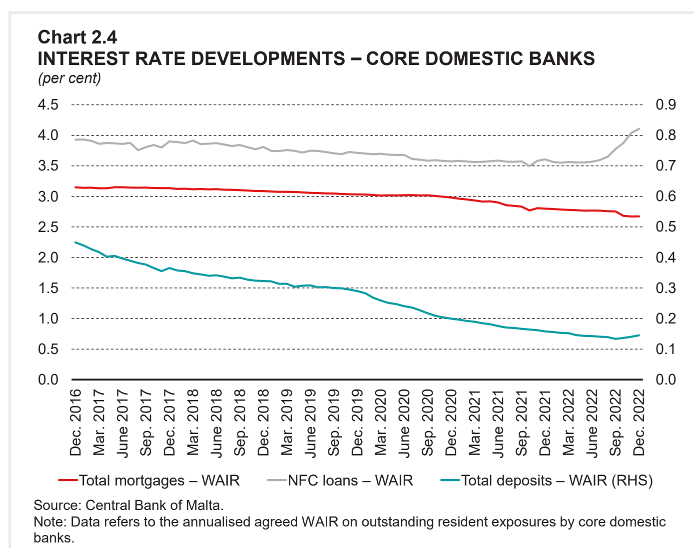
This group of banks reported reversals and recoveries of impairment losses which positively impacted profits. However, this was comparatively lower than in the previous year. The sustained economic recovery, and the increase in the ECB's deposit facility rate boosted NII by almost 18%, largely reflecting increased lending including a strong recovery in corporate lending (see Chart 2.3). At the same time, margins widened, as the weighted average interest rate (WAIR) on outstanding euro-denominated resident corporate loans rose from 3.6% in 2021, to 4.1% in 2022 (see Chart 2.4). While the WAIR on euro-denominated outstanding mortgages fell marginally by 0.1 percentage point to 2.7%, their interest income remained robust on the back of the strong mortgage growth. Funding costs remained contained, supported by the low WAIR on deposits, standing at less than 0.2% due to the on-demand nature of most deposits.

Chart 2.3
MAIN CONTRIBUTORS TO PROFITS – CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Teal (positive) and red (negative) bars indicate yearly contributions to profits.

Chart 2.4
INTEREST RATE DEVELOPMENTS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.
Note: Data refers to the annualised agreed WAIR on outstanding resident exposures by core domestic banks.

Non-interest income also rose, up by a fifth. This mainly reflected dividend income receivable, which almost doubled reflecting the pick-up in economic activity, and other non-interest income, particularly gains on financial assets. Furthermore, fees and commission income stood higher, up by 7.4%, to account for almost 70% of non-interest income.

On the downside, aggregated non-interest expenses climbed further, up by more than a quarter over the previous year, resulting in the cost-to-income ratio to advance by just over 5 percentage points, to 80.4%. This was however driven by a one-off litigation cost by one bank which took place in the first half of the year. Excluding this extraordinary cost, non-interest expenses would have remained generally stable, with the cost-to-income ratio improving by over 10 percentage points to 64.3%, though still above the EU banks' average of 60.6%.[2]

2.1.2 Credit dynamics

Core domestic banks' credit growth picked up momentum, up by 6.5% as at end 2022, compared to 2.2% a year earlier. The pick-up in pace was on account of a significant recovery in resident NFC lending, which grew by almost 6% in 2022, compared to a contraction of 0.4% a year earlier (see Chart 2.5). This was predominantly the result of higher lending towards the real estate sector, reflecting the pent-up demand following the pandemic, as projects which were postponed came on stream. This contributed to the share of lending to construction and real estate sectors to increase by almost 1 percentage point to 13.1% of the overall resident

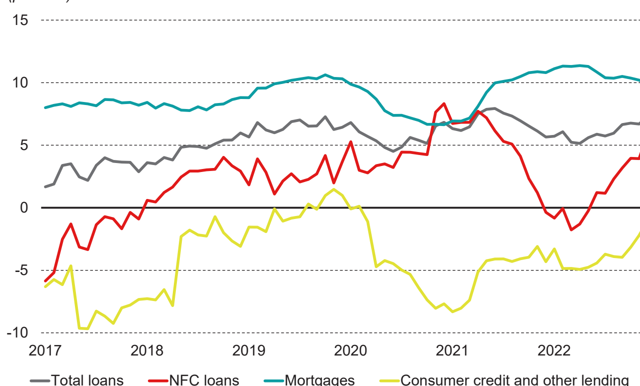
[2] Source: EBA Risk Dashboard Q4 2022.

loan book (see Chart 2.6). This was followed by higher lending towards the wholesale and retail trade, as well as manufacturing. In contrast, loans to accommodation and food services, professional, scientific, and technical activities sectors dropped in 2022.

Despite a slight slowdown, resident mortgages continued to grow strongly. Just shy of a 10% annual growth rate, this segment remained the largest contributor to growth in the core domestic banks' loan book. Such growth remained sustained by the strong demand, as reported by the participants of the BLS (see Box 2). Whilst being a source of growth, this increasing activity is also manifesting itself into higher concentration risks, as banks are being increasingly exposed to the real estate sector.

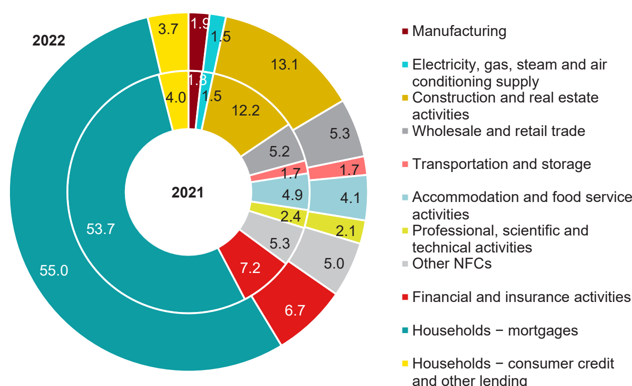
At the same time, resident consumer credit continued to contract for the third consecutive year, though at a much less pronounced rate of 1%, compared to the 4.3% drop reported in the previous year. Non-resident loans, including interbank placements, declined further, to account for just 4.7% of the core domestic banks' overall loan book.

Chart 2.5
ANNUAL GROWTH RATE OF RESIDENT LOANS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.
Note: A break in series was reported in May 2017 with regards to household consumer credit and other lending due to a reclassification exercise.

Chart 2.6
RESIDENT LOANS BY NACE – CORE DOMESTIC BANKS
(per cent)



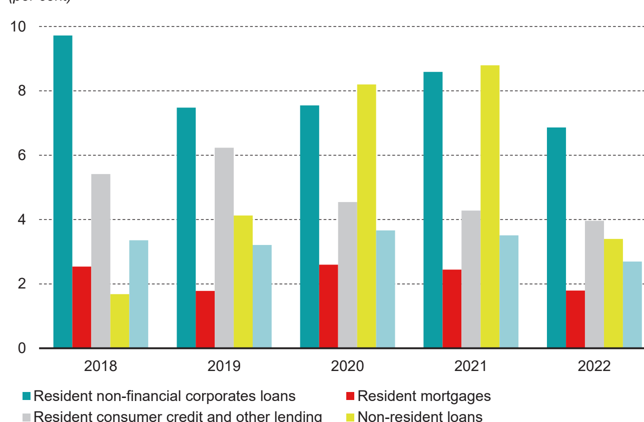
Source: Central Bank of Malta.

2.1.3 Asset quality

Non-performing loans

The overall NPL ratio improved to stand at 2.7% in 2022, down from 3.5% a year earlier (see Chart 2.7).[3] This was exclusively the result of a faster drop in the stock of NPLs, which fell by over a quarter, mainly reflecting recoveries as write-offs were more limited.

Chart 2.7
NPL RATIOS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Lower NPLs stemmed mainly from resident NPLs which fell by 16.7%, largely reflecting firms in the construction sector and the

[3] The NPL ratio stood above the EU banks' average NPL ratio of 1.8%. Source: EBA Risk Dashboard Q4 2022.

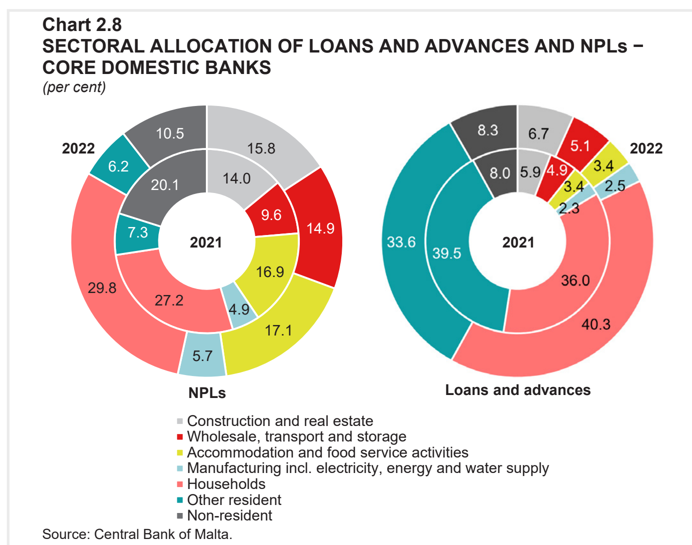
accommodation and food services. As a result, the resident NPL ratio declined by 0.4 percentage point to 2.6% in 2022, while the resident NFC NPL ratio fell by 1.7 percentage points to 6.9% by end-2022. In addition, resident households NPLs contracted by 18.4%, on account of improvements in both mortgages and consumer loans, with the resident household NPL ratio declining by 0.7 percentage point to 2.0%. Concurrently, non-resident NPLs dropped considerably mainly driven by NFCs and other financial intermediaries (OFIs), leading to the share of non-resident NPLs to drop by 9.6 percentage points to 10.5% of overall NPLs (see Chart 2.8). As a result, the non-resident NPL ratio improved by 5.4 percentage points to 3.4% in 2022.

Loans and provisions

Loans classified as Stage 2 and 3 declined by 5.4% and 22.2%, respectively, to account for 8.9% and 3.7% of the overall loan portfolio (see Chart 2.9). This was met with higher Stage 1 loans, to represent over 87% of outstanding loans, thus reflecting a better outlook for credit risk, with a lower share for both non-performing and underperforming loans. Such developments contributed to a drop in overall provisions of over 20%, driven by lower Stage 3 provisions, which however still accounted for around 70% of the total provisions.[4] Stage 1 provisions also dropped, down by over a quarter, to represent less than 15% of the overall provisions. While Stage 2 provisions fell by 13.4%, their share still rose to 15.6%.

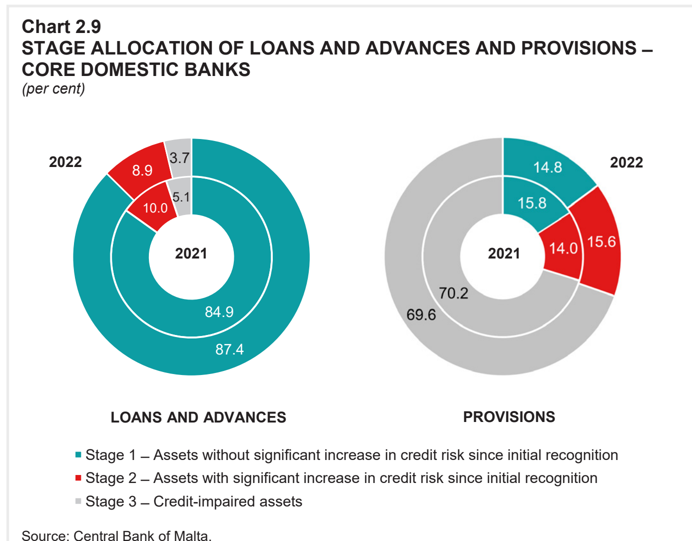
The overall coverage ratio increased to 50.3% in December 2022, from 47.0% a year earlier (see Chart 2.10). Such higher coverage was also supported by collateral backing NPLs, which stood at around 54%

Chart 2.8
SECTORAL ALLOCATION OF LOANS AND ADVANCES AND NPLs – CORE DOMESTIC BANKS
(per cent)



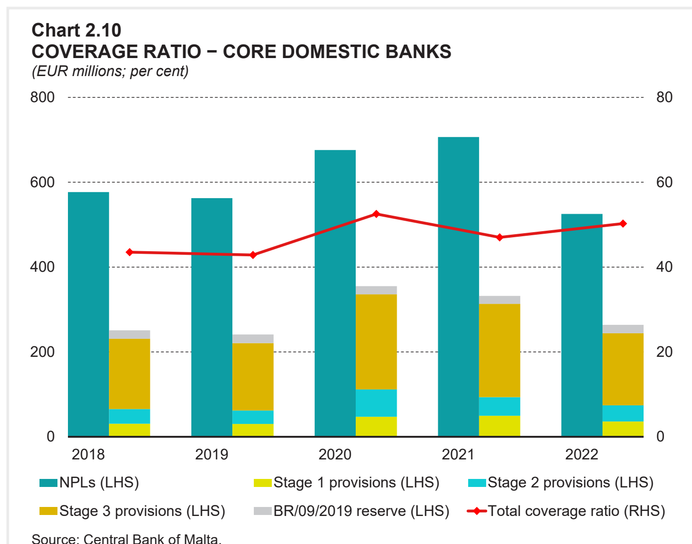
Source: Central Bank of Malta.

Chart 2.9
STAGE ALLOCATION OF LOANS AND ADVANCES AND PROVISIONS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

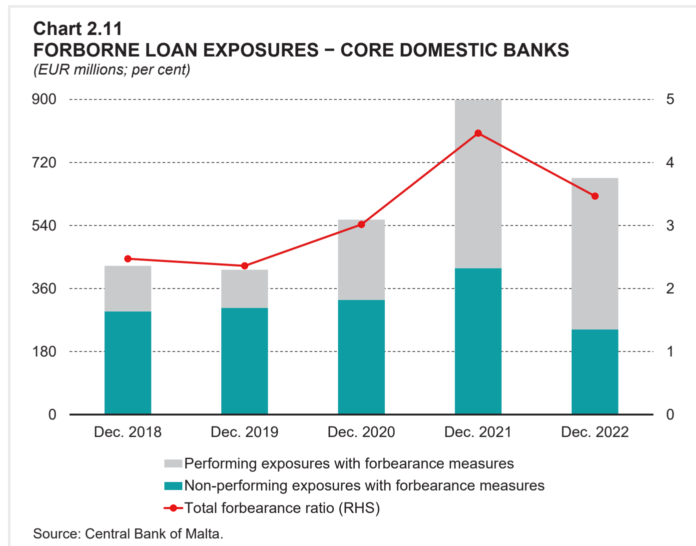
Chart 2.10
COVERAGE RATIO – CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

[4] Stage 1 provisions reflect provisions for loans without significant increase in credit risk, provisions for Stage 2 loans are those which have increased credit risk but not classified as non-performing, and provisions for Stage 3 loans represent NPLs.

of NPLs, resulting in full coverage of NPLs. The cost-of-risk (COR), defined as the change in allowances and provisions as a share of loans subject to impairments, narrowed to 0.2% in 2022 from 0.3% in 2021 and remained below the average of 0.5% for EU banks, implying lower costs for the core domestic banks to generate provisions.[5]



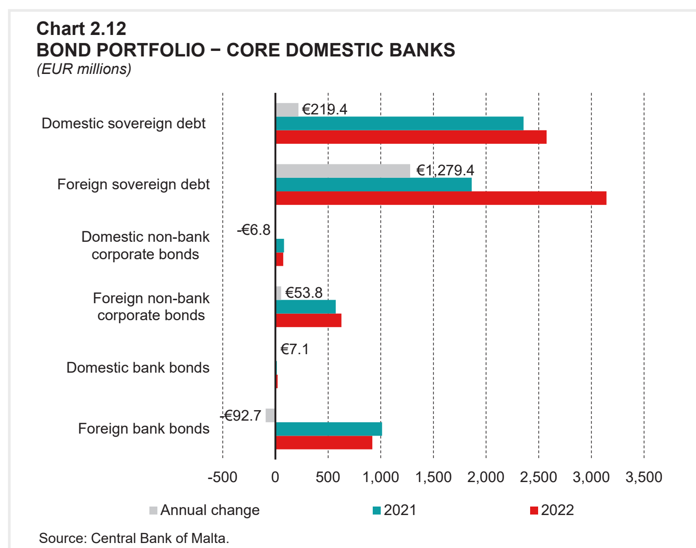
Loan exposures with forbearance measures

Forborne loan exposures fell by around a quarter, with the forbearance ratio dropping to 3.5%, from 4.5% a year earlier (see Chart 2.11). Such a drop stemmed largely from non-performing forborne loans, down by over two-fifths to account for just 36.0% of loans with forbearance measures. Performing forborne loans also decreased, but at a less pronounced rate of around 10%, and as a result their share rose to 64.0% of the overall forborne loans. While this shows enhanced asset quality, the ratio remained higher than in pre-pandemic times, owing to the conditions made to certain performing loans following the expiration of moratoria. In this regard, the core domestic banks need to continue with their rigorous monitoring of such forborne loans amid global adverse macroeconomic developments, which could potentially challenge borrowers' affordability.

The securities portfolios

The securities portfolios of these banks expanded by around 22% to reach €7.8 billion, or just over a quarter of total assets. Such growth was entirely driven by holdings of bonds, up by a quarter, as otherwise equity holdings fell to just 5.5% of the securities portfolio.

The increase in the banks' debt securities holdings was driven by higher sovereign bonds, which rose by over a third, taking advantage of the higher government bond yields, enabling them to diversify their income sources (see Chart 2.12). This was mainly driven by euro area sovereign bonds, which led to holdings of foreign government bonds to account for the larger share of the portfolios, while Malta Government Stocks (MGS) holdings accounted for just over a third. Holdings of corporate bonds remained largely unchanged. Despite the increased concentration in sovereign holdings, these banks mostly hold securities in countries rated A- or better, thus



[5] Source: EBA Risk Dashboard Q4 2022.

contributing to the overall holdings of high and medium rated bonds to remain significant at around 91% of these banks' bond portfolios (see Chart 2.13).

2.1.4 Funding and liquidity

Eurosystem and wholesale funding

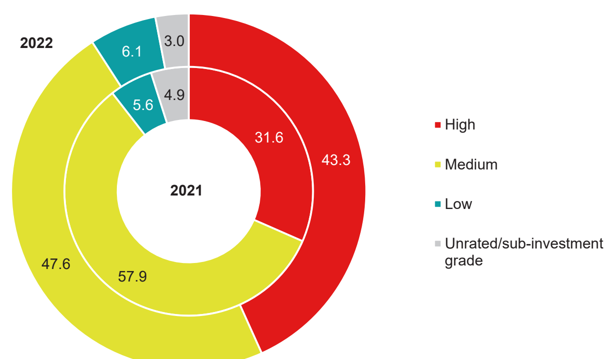
The monetary policy normalisation has tightened funding conditions, slowly ending cheap funding from the Eurosystem. The TLTROs were recalibrated, while market funding costs also increased due to the higher interest rates.[6] In line with these developments, Eurosystem funding by these banks dropped by €519 million by end 2022, to just €10 million, mainly reflecting the early repayment of TLTROs (see Chart 2.14). Similarly, interbank funding contracted by just over €200 million, accounting for less than 1% of total liabilities. During the year, these banks issued €365 million worth of debt securities largely to comply with the minimum requirements for own funds and eligible liabilities (MREL) requirements. This is expected to increase funding costs, albeit to a limited extent, as debt securities issued still accounted for just 2.2% of the overall balance sheet.

Customer deposits

The core domestic banks had to compete with the increasing sovereign and corporate yields to sustain their growth, reflected in marginal increases in interest rates on some retail term deposits. Indeed, following a gradual slowdown during the first three quarters of the year, customer deposits dropped slightly in the last quarter. Still on an annual basis, customer deposits grew by 4.8% (see Chart 2.15).

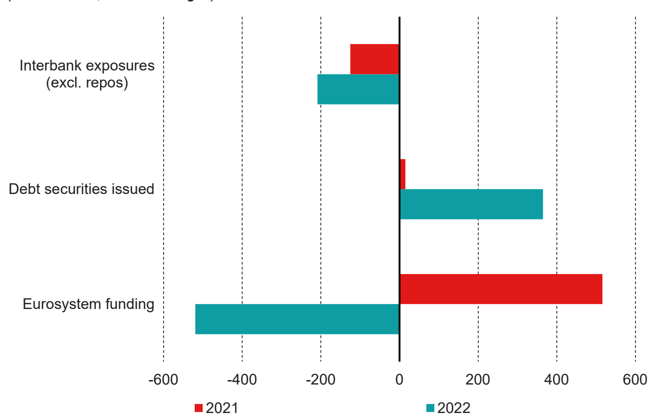
Despite the slowdown, overall customer deposits remained the primary funding source for these

Chart 2.13
BOND HOLDINGS BY RATING – CORE DOMESTIC BANKS
(per cent)



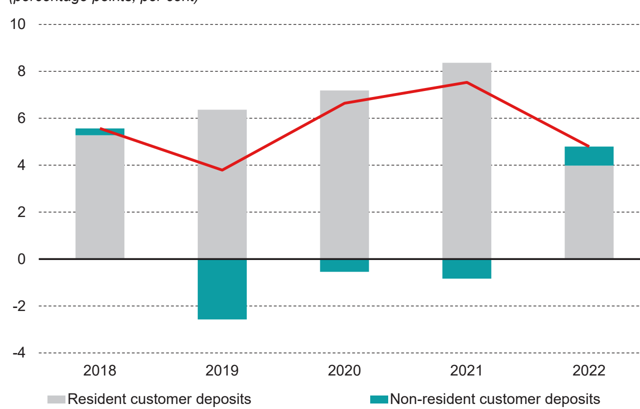
Source: Central Bank of Malta.
Note: Investment-grade bonds carrying a rating of AA- or above are regarded as 'high-rated bonds'. 'Medium-rated bonds' are those rated between A- and A+, whereas 'low-rated bonds' are those rated between BBB- and BBB+. Sub-investment grade bonds are rated lower than BBB-.

Chart 2.14
DEVELOPMENTS IN NON-RETAIL FUNDING – CORE DOMESTIC BANKS
(EUR millions; annual changes)



Source: Central Bank of Malta.

Chart 2.15
CONTRIBUTION TO GROWTH IN CUSTOMER DEPOSITS – CORE DOMESTIC BANKS
(percentage points; per cent)



Source: Central Bank of Malta.

[6] In October 2022, the ECB recalibrated the outstanding TLTROs so that their interest rate would be indexed to average applicable key ECB interest rates. Also, this is accompanied by three additional voluntary early repayment dates introduced for banks wishing to terminate or reduce borrowings before maturity.

banks, financing around 84% of total assets, up by 1.8 percentage points over the previous year, on account of the lower wholesale and Eurosystem funding (see Chart 2.16). These banks continued to source their deposits primarily from resident households, which in 2022 made up around two-thirds of deposits. At the same time, deposits from resident firms also increased, driven primarily by corporates operating in the wholesale and retail trade sector, to reach 14.2% of total deposits. Meanwhile, the contraction in non-resident customer deposits reported since 2019 was reversed, on the back of higher deposits by non-resident financial institutions, albeit non-resident customer deposits represented only about 7.5% of total retail funding.

Liquidity

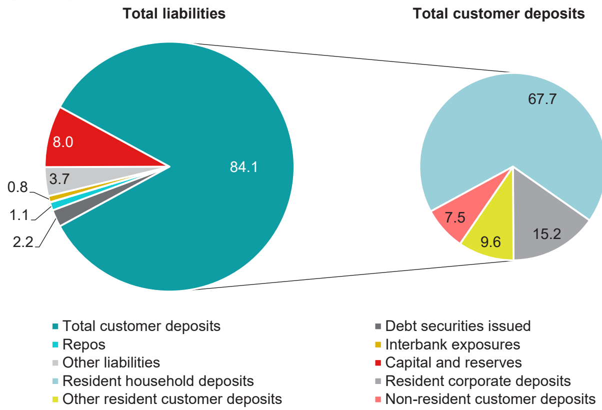
The liquidity position of this group of banks remained very healthy, as the lower reserves with the central bank were compensated for by higher central government assets, and other high-quality liquid assets (HQLA) such as exposures with multilateral development banks and international organisations' assets (see Chart 2.17). This, in conjunction with lower net liquidity outflows, led to the LCR to edge higher to 363% in 2022. The NSFR also strengthened by 12.8 percentage points, to 186.8%. Despite the tighter funding conditions, the customer loans-to-deposits ratio increased by 0.9 percentage point to 56.0%, which is markedly lower than the euro area banks' average of 108.1%.[7]

2.1.5 Capital and leverage

Total own funds decreased marginally by 0.1%, as the lower Tier 1 capital was almost entirely replaced by Tier 2 capital, reflecting higher intra-group subordinated loans (see Chart 2.18). As

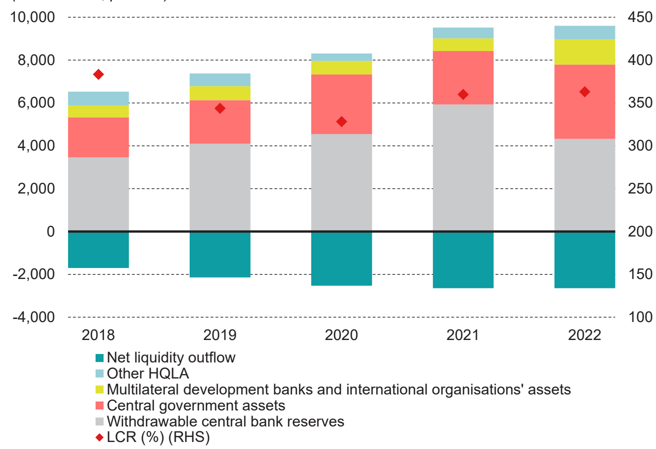
[7] Source: EBA risk dashboard 2022Q4.

Chart 2.16
BANKS' LIABILITIES COMPONENTS – CORE DOMESTIC BANKS (2022)
(per cent)



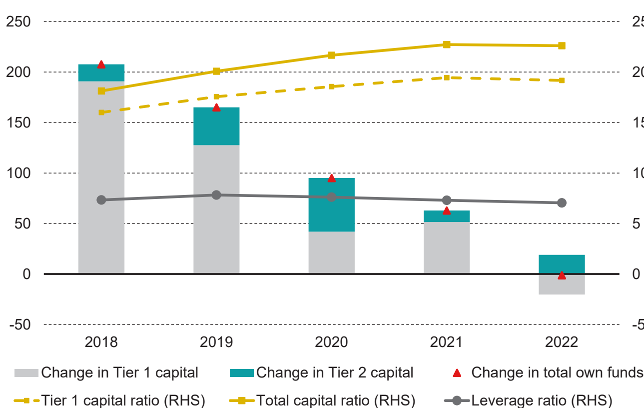
Source: Central Bank of Malta.
Note: Total customer deposits pie chart represents the 84.1% in the total liabilites pie chart. This adds up to 100%.

Chart 2.17
LIQUIDITY COVERAGE RATIO – CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

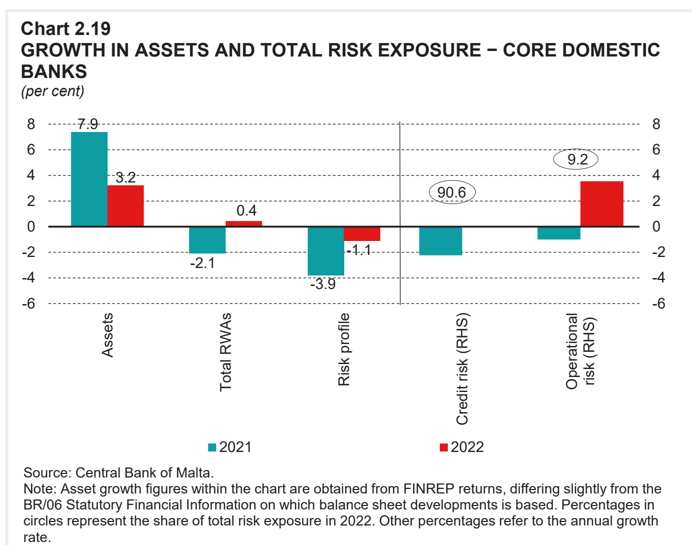
Chart 2.18
CHANGE IN TOTAL OWN FUNDS, CAPITAL AND LEVERAGE RATIOS – CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

total risk exposures rose by 0.4%, the total capital ratio declined marginally by 0.1 percentage point, to 22.6%. The primary increase in total risk exposures emanated from operational risk to account for 9.2% of total risk exposures, mainly reflecting the one-off litigation cost incurred during the first half of the year, as otherwise credit risk exposures remained broadly stable, and at just over 90% represented the largest share of total risk exposures (see Chart 2.19). The risk profile of these banks improved slightly, as the muted increase in total risk exposure was outpaced by a faster increase in their overall assets. Indeed, the ratio of total risk exposures in total assets reached 38.0%, the lowest point in recent years. Meanwhile, the leverage ratio declined by 0.3 percentage point to 7.0%, albeit remaining well-above the minimum regulatory threshold of 3%.

Chart 2.19
GROWTH IN ASSETS AND TOTAL RISK EXPOSURE – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.
Note: Asset growth figures within the chart are obtained from FINREP returns, differing slightly from the BR/06 Statutory Financial Information on which balance sheet developments is based. Percentages in circles represent the share of total risk exposure in 2022. Other percentages refer to the annual growth rate.

2.1.6 Risk outlook

Core domestic banks managed to weather the current uncertain global macroeconomic environment. They managed to register a recovery in their profitability, partly on the back of the rapid credit growth as mortgages kept growing strongly while lending to corporates recovered from the previous lows. However, the latter was mainly driven by the real estate sector, increasing the dominance of property-related loans in these banks' loan book. As a result, caution is warranted, to ensure that going forward credit growth remains healthy and diversified. In light of this, the introduction of an sSyRB on RRE domestic mortgages in 2023 aims to lock-in existing capital while complementing the existing BBMs, ensuring that banks adopt prudent lending practices when granting new loans, without taking undue risks that are not commensurate with their risk profile.

On the funding side, core domestic banks should expect higher funding costs due to the higher interest rate environment, which drove bonds yields higher. Nevertheless, their liquidity position is very healthy and remained buttressed by an ongoing inflow of customer deposits. Despite their strong capital position and benign asset quality, these banks should remain vigilant, given the uncertain macroeconomic environment and the likelihood of further interest rate increases going forward.

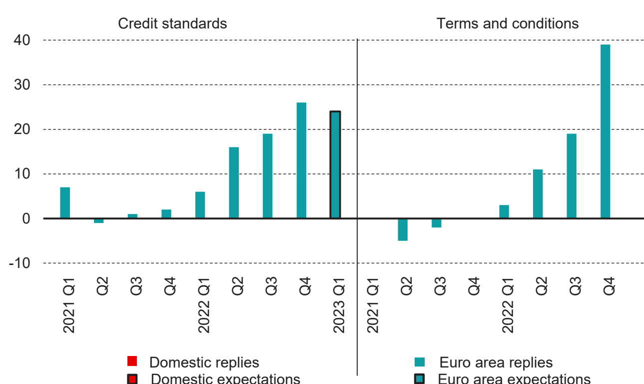
BOX 2: BANK LENDING SURVEY RESULTS[1]

The aim of this boxed article is to provide a summary of the replies to the BLS by the participating banks during the 2022 survey rounds. The BLS was distributed to a sample of around 150 banks across the euro area, including four banks in Malta which captured about 92% of the overall domestic bank credit.[2] The BLS is conducted on a quarterly basis to monitor developments in the lending policies and credit demand of enterprises and households, as well as their expectations.[3] The survey also contained a number of ad hoc questions related to funding conditions and the effect of monetary policy decisions, and new regulatory and supervisory actions on lending standards.

Loans to enterprises

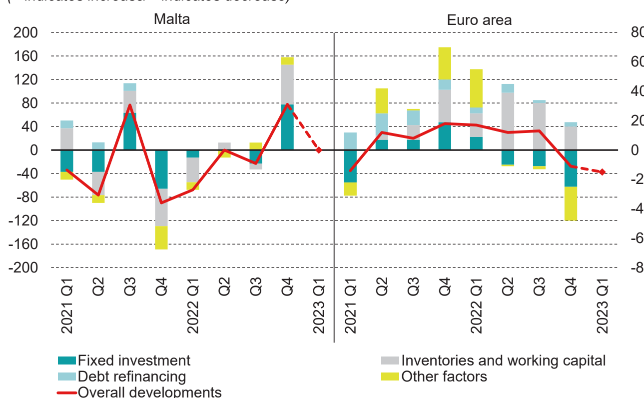
Over the past couple of years, on balance, domestic credit standards and terms and conditions for new loans to enterprises remained stable, but a few banks reported tighter loan-to-value (LTV) towards the CRE sector in the second half of 2022 (see Chart 1). Notwithstanding, net demand for domestic corporate loans improved somewhat in 2022. During the first three quarters of the year, demand declined owing to lower financing needs for inventories and working capital requirements, as well as for fixed investment in the CRE sector, services, and manufacturing, particularly in the energy-intensive firms. However, demand picked up momentum in the last quarter of the year, driven by the wholesale and retail trade sector (see Chart 2). In contrast, euro area banks reported stronger net tightening of corporate credit standards and terms and conditions across all main economic sectors. This was the result of higher risk perceptions and lower risk tolerance due to the weaker

Chart 1
CORPORATE CREDIT STANDARDS, AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.
Note: Given domestic replies indicate no change in lending standards, no domestic developments are visible in the chart.

Chart 2
CORPORATE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting corporate credit demand. Markers plotted on 2023Q1 refer to expectations.

[1] This Box was prepared by Christian Mamo, a Principal Economist, and Shaun Zaffarese, a Financial Analyst, within the Financial Stability Surveillance Office of the Central Bank of Malta.

[2] The BLS data for all euro area countries are published on the ECB's SDW.

[3] Lending policies include credit standards and terms and conditions. Credit standards refer to the bank's internal guidelines or loan approval criteria, established prior to the actual loan negotiation. These specify the required borrower characteristics such as income levels, age, and employment status which banks consider in their credit scoring methods. Credit terms and conditions refer to the conditions of a loan that a bank is willing to grant, namely the interest rate, loan size, fees, collateral requirements, maturity terms and other conditions.

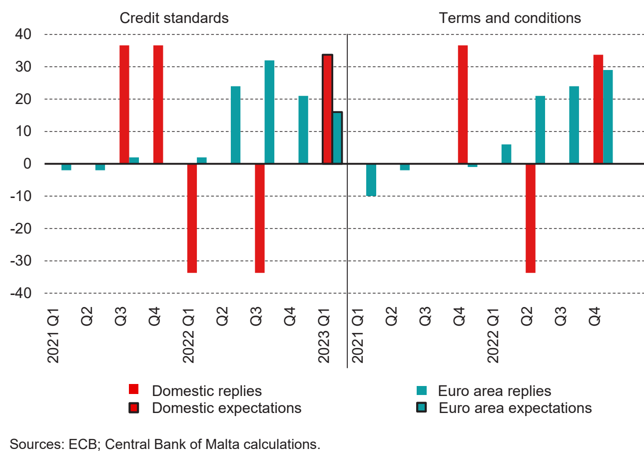
macroeconomic and financial conditions triggered by the war in Ukraine, coupled with industry and firm-specific factors. Consequently, margins on both average and riskier loans widened, while collateral requirements rose. Notwithstanding, euro area banks reported a marginal pick-up in demand for corporate loans in the first nine months of 2022, reflecting higher financing needs for inventories and working capital across all main economic sectors. As lending policies tightened further, demand fell, turning negative in the last quarter of the year, and was expected to decline further in the first quarter of 2023, as credit standards tighten further.

Loans to households for house purchase

Following the net tightening in 2021, sustained competitive pressures led domestic banks to ease their credit standards for mortgages in 2022, following the lifting of the remaining pandemic-related measures (see Chart 3). On balance, the terms and conditions on mortgages remained stable, as margins at first were narrowed due to increased competitive pressures but were later tightened as interest rates started to rise. According to survey respondents, net domestic demand for mortgages recovered in the first quarter of 2022 reflecting improved consumer confidence and remained stable for the rest of year. Surveyed banks expected mortgage demand to remain stable even in the first quarter of 2023 (see Chart 4).

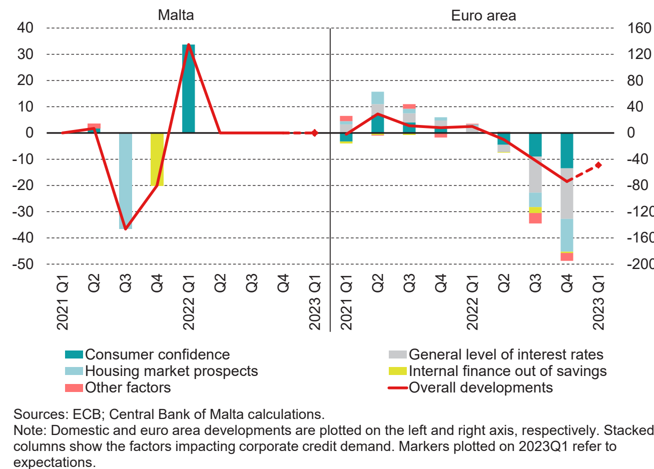
In the euro area, banks tightened mortgages' credit standards and terms and conditions, largely reflecting an adverse economic environment and deteriorating housing market prospects, higher risk perceptions, and rising funding costs. As a result, mortgage demand declined strongly, particularly in the second half of the year, with the drop in the last quarter being the largest ever reported in the BLS. This net tightening was expected to persist in the first quarter of 2023, amid further increases in key policy rates and a worsening in consumer confidence, with expectations that mortgage demand was going to fall further.

Chart 3
MORTGAGE CREDIT STANDARDS, AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

Chart 4
MORTGAGE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)

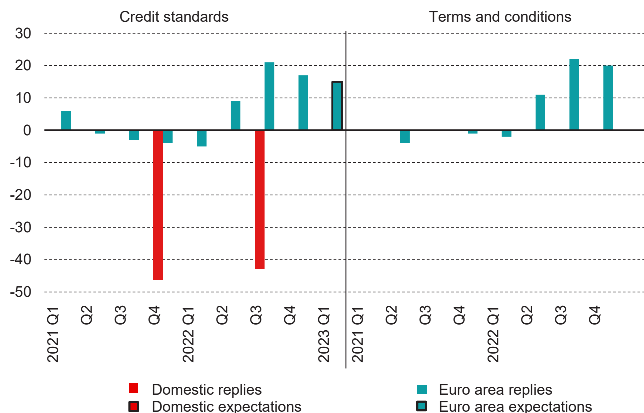


Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting corporate credit demand. Markers plotted on 2023Q1 refer to expectations.

Consumer credit and other lending to households

For the second consecutive year, domestic respondents eased credit standards for consumer lending as the remaining covid-related restrictions were lifted (see Chart 5). On the other hand, terms and conditions remained unchanged throughout the past couple of years. Yet, demand for consumer credit remained largely stable until the third quarter of 2022 but dropped in the last quarter reflecting higher competitive pressures from other banks (see Chart 6).

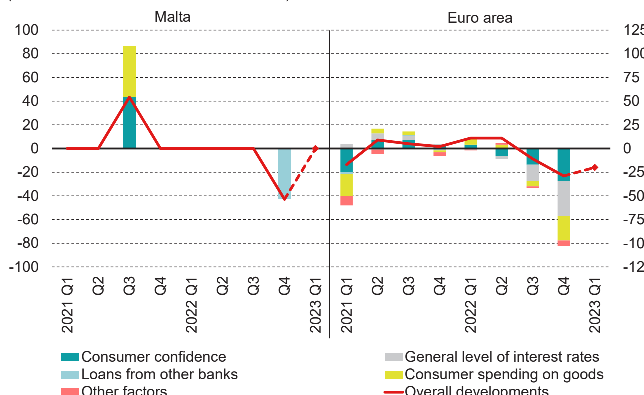
Chart 5
CONSUMER CREDIT STANDARDS, AND TERMS AND CONDITIONS
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

In contrast, euro area banks reported an overall net tightening in both credit standards and terms and conditions, reflecting the perceived deterioration in the general economic activity, worsened borrower creditworthiness, and increased cost of funds and risk perceptions. Up until the first half of 2022, demand for consumer credit rose marginally, mainly to satisfy the higher spending on durable consumer goods. However, as lending policies tightened, and interest rates started to rise, consumer confidence deteriorated, which affected consumer spending. This was expected to persist in the first quarter of 2023 as euro area banks anticipated continued net tightening of consumer credit standards.

Chart 6
CONSUMER CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



Sources: ECB; Central Bank of Malta calculations.
Note: Domestic and euro area developments are plotted on the left and right axis, respectively. Stacked columns show the factors impacting corporate credit demand. Markers plotted on 2023Q1 refer to expectations.

Ad hoc questions

While during 2022 domestic BLS banks did not report any material changes in their wholesale funding, some minor developments were reported in terms of retail funding. One bank continued to strategically focus on short-term deposits, resulting in lower fixed-term deposits. Other respondents noted the more challenging environment in accessing retail funding particularly in the latter half of the year, on the back of the uncertain economic environment driven by the high level of inflation and the corresponding higher fixed-income yields. Consequently, following the ECB's interest rate hikes, some banks raised interest rates on term deposits in a bid to attract more retail funding. Going forward, such developments are expected to persist amidst the uncertain external macroeconomic environment and increasing interest

rates. Euro area banks also reported a similar deterioration in their access to money markets and retail funding.

During the first half of 2022, the ECB's APP continued to affect some domestic banks both on their overall assets, mainly through the lower holdings of sovereign bonds, and the consequent effect on their profitability levels through lower NII. However, once the APP was discontinued as from July 2022, domestic BLS banks found the opportunity to add to their holdings of sovereign bonds, and thus increase their NII from securities. Meanwhile, euro area banks reported that during the first half of the year the APP contributed to increased liquidity, access to market financing, and higher lending for house purchases and corporates. However, as the scaling down of monetary policy accommodation took place, their financial position deteriorated, having a major negative impact on their market financing conditions, liquidity position and slightly on their profitability. They also expected that the end of the APP would bring with it a limited tightening impact on their terms and conditions across all loan categories, which was expected to be translated into lower lending volumes for mortgages during the first half of 2023.

Until July 2022, the negative deposit facility rate adversely impacted the profitability of both the domestic and euro area participant banks owing to lower NII received, which was partly offset by the two-tier system for remunerating excess liquidity holdings.[4]

Domestic participant banks did not participate in TLTRO III operations during 2022, with outstanding amounts repaid early by end 2022, reflecting their abundant liquidity. Meanwhile, euro area banks made much lower use compared to previous operations. Given the discontinuation and early repayment options for TLTROs, euro area banks expected the overall financial and lending conditions to be less favourable, following the gradual monetary policy tightening.

While domestic respondents reported no material impact of the NPL ratio on banks' lending policy, euro area banks reported some small net tightening on credit standards for loans to corporates during the first half of the year, reflecting increased risk perceptions and capital-related funding costs.

Surveyed banks were also asked on the impact of new regulatory and supervisory actions on their total assets and capital position. As some domestic banks actively expanded their balance sheet, they increased their capital base to continue meeting their minimum capital requirements and maintain adequate management buffers, in order to be in a position to address non-performing exposures (NPEs) in line with the recent Banking Rule (BR) 09 update and the general increase in risk weighted assets in view of the upcoming CRR II regulation implementation. These developments are expected to continue in 2023. In addition, some other banks tightened credit margins following the implementation of higher regulatory capital buffers. In the euro area, banks reported an increase in their capital to reflect the new regulatory or supervisory requirements, with banks also tightening their credit standards across all loan categories.

Conclusion

The BLS replies for 2022 and the banks' expectations for early 2023, were very much dominated by the uncertain macroeconomic environment coupled with tighter financial conditions. Nevertheless, domestically, although overall lending standards for corporates were stable throughout 2022, the ad hoc questions highlighted some offsetting factors. Specifically, the availability of funds from previous TLTRO operations allowed banks to apply more flexible credit standards and terms and conditions across all the main economic sectors but tightened somewhat the terms and conditions for CRE loans in the second half of 2022. Notwithstanding the generally stable lending standards, demand for corporate loans

[4] The ECB's two-tier system for reserve remuneration exempts part of credit institutions' liquidity holdings in excess of minimum reserve requirements from negative remuneration at the annual rate of 0%.

declined in the first three quarters of 2022 mainly for CRE, the services sectors and manufacturing, particularly the energy-intensive firms, but recovered significantly during the last quarter of the year, especially in the wholesale and retail trade sector.

With regards to household lending, while on balance terms and conditions remained stable both for mortgages and consumer credit, credit standards for these two loan categories were eased as the pandemic-related tightening was lifted. This was corroborated with a higher demand for mortgages in the first quarter of 2022, while increased competition resulted in the demand for consumer credit to abate for some banks.

On the funding side, domestic banks did not report any significant changes in their usual sources of wholesale funding, albeit retail funding became more challenging and costlier owing to the tighter financial conditions which led some banks to increase, albeit marginally, interest rates on time deposits. Meanwhile, although domestic banks did not participate in the most recent TLTRO III, some still benefited from previous liquidity-providing operations that enabled them to improve their profitability.

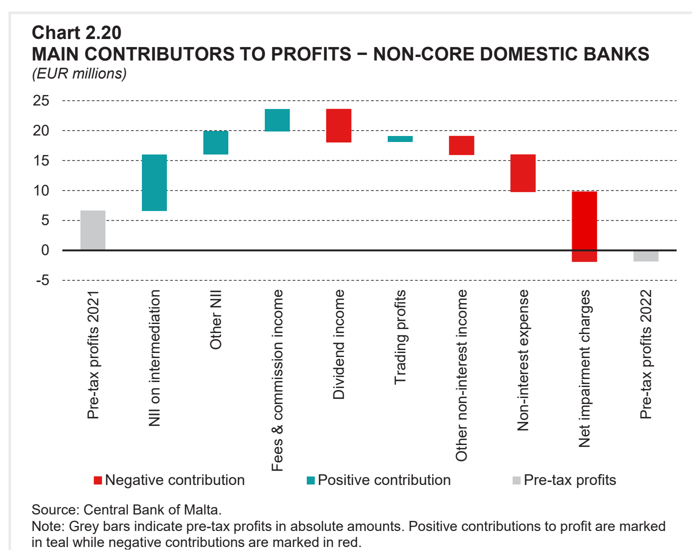
2.2 Non-core domestic banks

Despite the challenging external macroeconomic environment, the non-core domestic banks managed to sustain their growth strategies, albeit at a slower rate, as their balance sheet expanded by 1.3%, to account for around 20% of GDP. While their business activities remained predominately focused on non-residents, business with residents increased over the year, mainly driven by higher resident lending. At the same time, whilst accounting for more than 43% of resident assets, placements with the Central Bank of Malta declined by around 14%. These banks increasingly sought to expand further their business through factoring and forfaiting to increase revenue-generation streams. Their preferred funding source remained customer deposits, particularly from non-residents, though other funding sources also remained important.

2.2.1 Profitability

On aggregate, non-core domestic banks reported losses in 2022, with the post-tax ROE and ROA standing at -0.7% and -0.1%, respectively. Akin to the developments reported during the first year of the pandemic, the drop in profits was mostly due to higher impairment charges, which rose threefold in 2022 compared to 2021 (see Chart 2.20). This reflected lower recoveries and reversals, as otherwise write downs decreased at a much lower extent. Profits were also heavily impacted by an 11.6% increase in operational costs, largely owing to higher staff and administrative expenses. Such higher costs diluted the increase in NII, which rose by almost 51% over the year, to account for more than half of the gross income generated in 2022. This, in part, reflected higher earnings on placements held with the Central Bank of Malta, as the deposit facility rate turned positive and increased rapidly. In addition, higher interest income was generated from the loan portfolio, largely from corporate loans, as the market rates against which some of these loans were pegged, rose during the year. At the same time, these banks recorded higher interest generated from their securities portfolios. However, the ECB's hike in interest rates also placed a dent on these banks' funding costs since deposits became more expensive by the end of 2022.

Chart 2.20
MAIN CONTRIBUTORS TO PROFITS – NON-CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Positive contributions to profit are marked in teal while negative contributions are marked in red.

Income generated from non-interest-bearing activities contracted by around 10%, mainly reflecting lower dividend income received from investments, which may be attributable to adverse financial market developments. While insufficient to overcome such drops, fees and commissions expanded by around 20% to represent almost two-thirds of non-interest income. Trading profits also rose during the period under review. Despite the overall increase in operating costs, and the drop in non-interest income, the increase in NII was enough to contribute to a slight improvement in the non-core domestic banks' cost-to-income ratio, which nonetheless remained elevated at 80.4%.

2.2.2 Credit dynamics

The overall loan book of these banks expanded by almost 15%, mostly reflecting loans to residents, which rose further by 36%. As a result, the share of resident lending on overall customer loans went up by 6.9 percentage points to almost 39%, primarily fuelled by higher corporate lending, which increased by around 41% over the year. This largely reflected companies operating in the real estate sector, which now represent almost 31% of the non-core domestic banks' overall resident loan book (see Chart 2.21). Credit to Maltese households also gained momentum, largely driven by the participation of one bank in the

domestic mortgage market, which however accounted for just 2.3% of the non-core domestic banks' overall resident customer loans.

Growth in loans to non-residents remained anaemic, up by just 0.4%. While lending to foreign financial and insurance companies rose by around 7% to account for more than half of overall non-resident customer lending, lower loans were granted to foreign NFC, especially those operating in the real estate sector (see Chart 2.22). Notwithstanding, non-resident NFC lending still accounted for more than 45% of outstanding non-resident customer loans. While loans to foreign households rose, these remained insignificant.

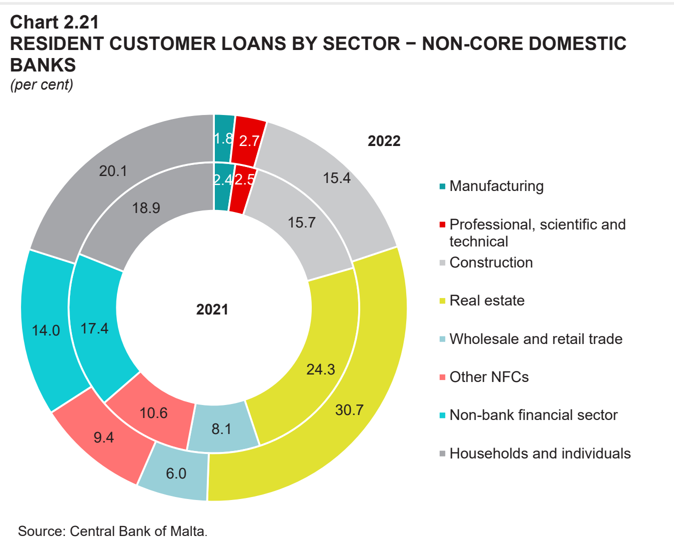
2.2.3 Asset quality

The loan portfolio

Despite the geopolitical and external macroeconomic uncertainties, the NPL ratio of the non-core domestic banks declined by 0.9 percentage point to 4.2% in December 2022, reflecting a shrinking of almost 18% in the stock of NPLs. Such a drop is largely owed to a write-off of debt of foreign companies operating in the wholesale and retail trade and, to a lower extent, the construction sector. Resident corporate NPLs also declined, though at a lower extent. These developments resulted in the overall NFC NPL ratio to drop by 4.0 percentage points to 12.4% by end 2022. Otherwise, despite increasing, household NPLs continue to represent an insignificant amount of overall NPLs.

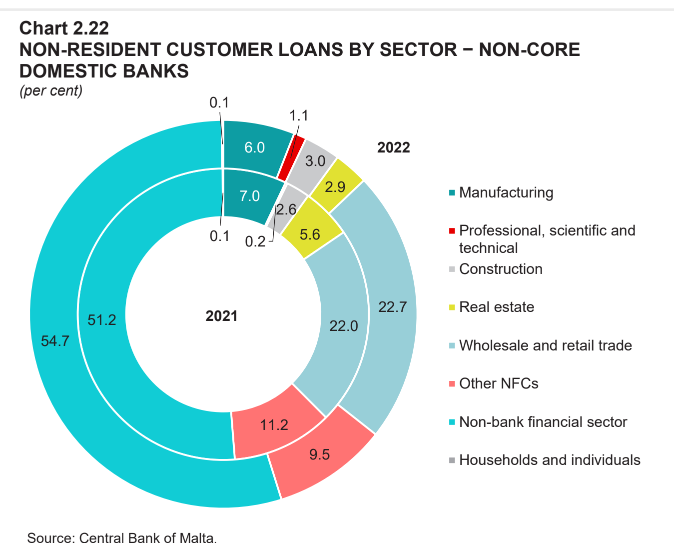
The loan portfolio of these banks registered a decline in distressed loans classified as Stages 2 and 3, which led to their share in the loan portfolio to shrink to 5.1% and 6.0%, respectively (see Chart 2.23). Furthermore, the non-core

Chart 2.21
RESIDENT CUSTOMER LOANS BY SECTOR – NON-CORE DOMESTIC BANKS
(per cent)



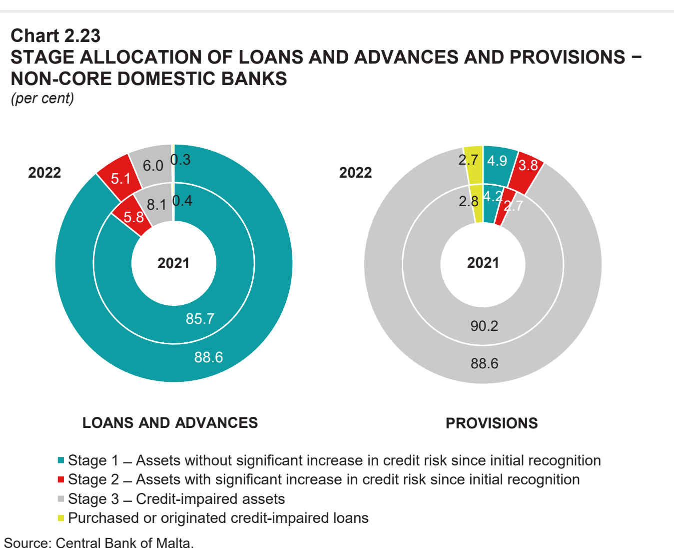
Source: Central Bank of Malta.

Chart 2.22
NON-RESIDENT CUSTOMER LOANS BY SECTOR – NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 2.23
STAGE ALLOCATION OF LOANS AND ADVANCES AND PROVISIONS – NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

domestic banks maintained a prudent approach to credit risk, with the coverage ratio improving to 73.1%, after having increased their provisioning levels for both Stage 1 and Stage 2 loans, which were partly offset by a decline in Stage 3 provisions. As a result, their overall provisions rose by just 0.3%.

To further complement these banks' sound credit quality, lower forborne loans, both non-performing and performing, were reported throughout the year, which led to the overall forbearance ratio to slightly improve to 0.6%.

The securities portfolio

Amidst the volatile financial market environment, the equity portfolio of these banks decreased by nearly 7%, to represent almost one fifth of total securities. This was primarily attributable to equities of foreign companies, although those of domestic firms also fell to negligible amounts. This was instead partly substituted with increased investments in debt securities, due to their increased attractiveness following the rise in interest rates by major central banks. Non-core domestic banks expanded their bond holdings largely of foreign companies, OFIs, and sovereigns particularly located in Germany, though holdings of MGS also rose to account for 45.7% of all sovereign debt holdings (see Chart 2.24).

The bond portfolio continued to consist primarily of high and medium-rated fixed income securities, despite declining by 4.6% and 7.1%, respectively throughout the year to account for around 26% and 40% of the overall bond portfolio. Otherwise, both low and speculative or unrated bond holdings rose to account for another 9% and 22% of the bond portfolio, up by 5.2 and 6.4 percentage points, respectively. Despite these banks' recourse to riskier investments, the quality of the securities portfolio remained sound, as they did not report any non-performing securities by end 2022.

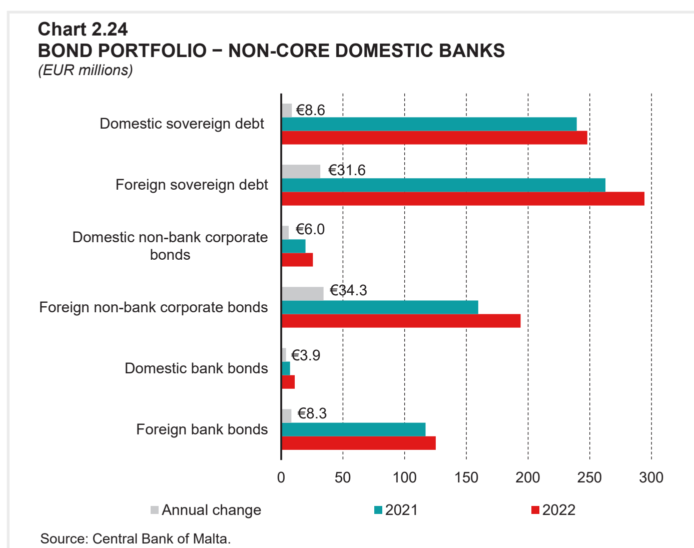


Chart 2.24
BOND PORTFOLIO – NON-CORE DOMESTIC BANKS
(EUR millions)
Source: Central Bank of Malta.

2.2.4 Funding and liquidity

These banks' business model continued to rely mostly on funding from customer deposits, which financed around 70% of assets in 2022. Overall customer deposits rose by 7.5%, on the back of higher non-resident deposits which grew by almost 14% (see Chart 2.25). The bulk originated from German households, adding some concentration towards this jurisdiction, largely in term deposits maturing between two and three years. Otherwise, resident customer deposits, mostly from OFIs, contracted by 12% to account for nearly 20% of

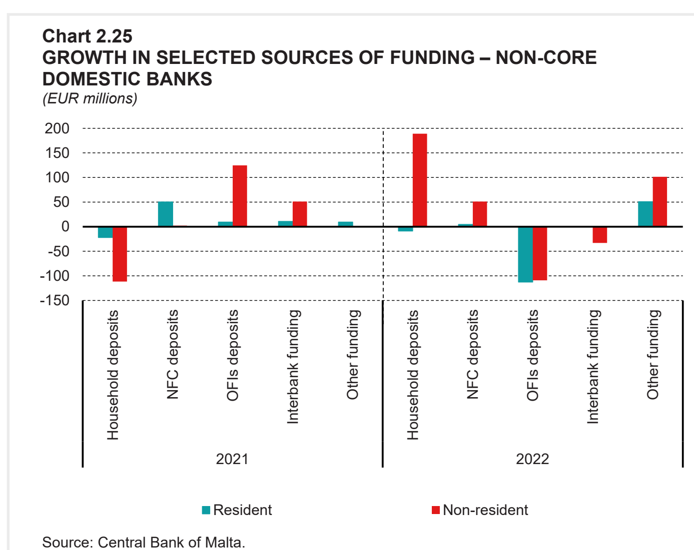


Chart 2.25
GROWTH IN SELECTED SOURCES OF FUNDING – NON-CORE DOMESTIC BANKS
(EUR millions)
Source: Central Bank of Malta.

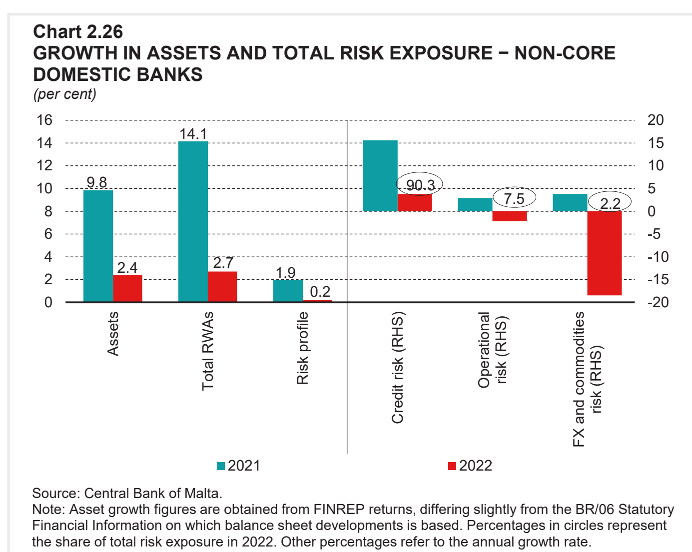
total customer deposits. This influenced the share of term deposits, which ended up accounting for more than half the deposits by the end of 2022, compared to 48.0% a year earlier, thus further reducing roll over risk.

Non-core domestic banks' funding through debt securities remained negligible. At the same time, owing to the tighter financial conditions, interbank funding activity, especially from related credit institutions, retracted by around one fifth in 2022. This was mostly replaced with Eurosystem funding, largely reflecting funding through USD operations, although other liquidity providing operations were also tapped, which by the end of the year funded almost 7% of their assets. In case of immediate liquidity needs, the non-core domestic banks could rely on additional Eurosystem funding given that around two-thirds of their Eurosystem eligible securities, representing 10.9% of their assets, remained unutilised. Lower withdrawable central bank reserves contributed to a 6.0% drop in liquid assets. Concurrently, these banks reported higher net liquidity outflows associated with non-operational deposits. Despite the resulting drop in the LCR, it remained at a robust 325.6%. The NSFR also sufficiently exceeded regulatory minima, at 179.6%.

2.2.5 Capital and leverage

The capital position remained healthy, as the total capital ratio increased by a marginal 0.2 percentage point to 20.5% as at end 2022. Total own funds increased, driven by the bond issuance of one bank, as otherwise Tier 1 capital declined marginally. This led to the Tier 1 capital ratio to narrow by 0.6 percentage point to 19.5%. RWAs also increased, mirroring the expansion reported in these banks' credit portfolio. As a result, despite growing at a slower pace compared to 2021, RWAs from credit risk exposures grew by 3.8%, to continue to constitute by far the largest part of overall RWAs, accounting for 90.3% (see Chart 2.26). RWAs from operational risk followed, with a 7.5% share in the overall RWAs, despite contracting marginally. Meanwhile, the leverage ratio declined by 0.3 percentage point to 9.7%, still significantly exceeding the 3% minima required, reflecting increases in corresponding assets.

Chart 2.26
GROWTH IN ASSETS AND TOTAL RISK EXPOSURE – NON-CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.
Note: Asset growth figures are obtained from FINREP returns, differing slightly from the BR/06 Statutory Financial Information on which balance sheet developments is based. Percentages in circles represent the share of total risk exposure in 2022. Other percentages refer to the annual growth rate.

2.2.6 Risk outlook

The challenges experienced throughout the year by the non-core domestic banks are expected to linger. As a result, it is vital for these banks to continue adapting their risk appetite and addressing underlying structural issues present in their balance sheets. These are particularly crucial for them to mitigate the amplification of adverse financial positions with the expectation of also being better positioned to face potential downside scenarios. The ample liquidity and strong capital ratios, however, continue to provide resilience for them to deal with adverse developments, though a high degree of prudence should be exercised in these banks' provisioning, credit risk management and capital planning policies. Cost pressures, especially arising from the tighter funding conditions, should also continue to be closely monitored to improve profitability in the near-term.

2.3 International banks

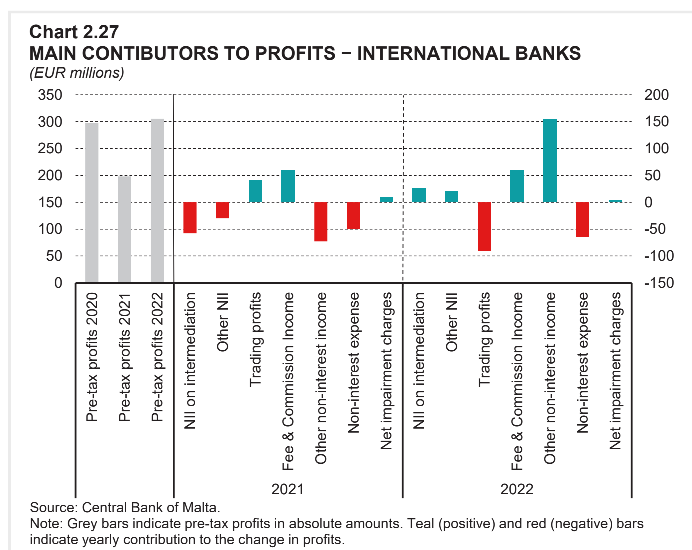
During 2022 a subsidiary of a foreign bank voluntarily surrendered its license bringing the total number of international banks down to nine, of which, five are subsidiaries and stand-alone banks, while the remaining are branches of foreign banks. On aggregate, the balance sheet of international banks contracted by 11.7%

to account for 59.8% of GDP, reflecting the 13.3% decline in the overall assets of the branches of foreign banks, as they continued with the consolidation process embarked in the last few years. Assets of subsidiaries and stand-alone banks also fell, although by a more modest rate of 5.9% over 2021. However, this was exclusively driven by the voluntary closure of the above-mentioned subsidiary, as otherwise the balance sheet of the remaining banks would have expanded by about 11%. The business model of the international banks remained relatively unchanged and oriented towards foreign entities, with the share of resident assets in overall assets decreasing by 2.6 percentage points to 7.3%.

2.3.1 Profitability

The overall profitability of international banks improved substantially in 2022, with pre-tax profits increasing by 54.1%, exclusively due to the positive performance of the branches (see Chart 2.27). As a result, their post-tax ROA rose by almost 2 percentage points to 2.7%. In contrast to the higher profits by branches, net profits before tax earned by the subsidiaries and stand-alone banks fell by more than half, translating into a drop in post-tax ROE and ROA of 5.5 and 2.1 percentage points to 6.1% and 1.8%, respectively.

Chart 2.27
MAIN CONTIBUTORS TO PROFITS – INTERNATIONAL BANKS
(EUR millions)



Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Teal (positive) and red (negative) bars indicate yearly contribution to the change in profits.

The overall improvement in profits stemmed from higher operating income, which rose by 28.8%. At the same time, non-interest income increased by 48.0%, resulting in its share in overall gross income to go up to just over a half in 2022. This mainly reflected the gains on foreign exchange dealings by one branch, as the other branches reported lower trading income and fees. In contrast, subsidiaries and stand-alone banks reported a drop in income earned from non-interest-bearing activities predominantly due to trading losses. However, driven by the non-branches, overall fees and commission income rose by more than a quarter, accounting for more than three quarters of the overall non-interest income of international banks.

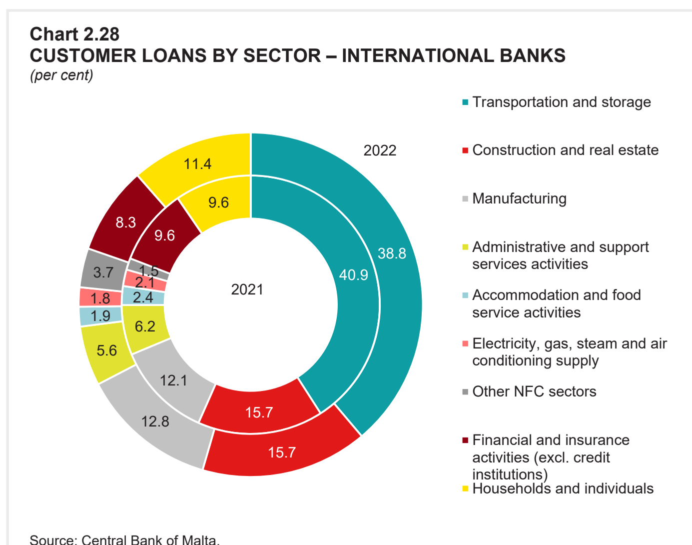
International banks' NII also rose by 13.8%, mainly owing to higher interest income earned on consumer loans. Income from the securities portfolios also rose by more than one fifth. Non-interest expenses grew by 23.4%, exclusively from the subsidiaries and stand-alone banks, as otherwise operating expenses of branches fell by 15.3% reflecting lower administrative costs. Net impairment charges dropped by 3.1% over a year ago.

The cost-efficiency of the international banks improved, with the cost-to-income ratio dropping by 2 percentage points to 45.2%.

2.3.2 Credit dynamics

The customer loan portfolio of international banks rose marginally, but their share in overall assets rose by 4.9 percentage points to 41.8%. While customer loans issued by the subsidiaries and stand-alone banks rose by 3.9%, mainly due to higher lending towards households and OFIs, the customer loan portfolio of the branches declined by 1.6%, due to lower loans to OFIs. Owing to the latter, the overall share of OFI lending dropped to 8.3% of customer loans (see Chart 2.28). Overall NFC lending continued to represent around four-fifths of the international banks' customer loan books, despite falling marginally by 0.6%, mainly driven by the transportation and storage sector and to a lower extent the real estate sector. In contrast, lending towards the construction and public administration and defence sectors rose. Household loans, largely

consisting of consumer credit, rose by almost 20%, with the share in the overall customer loan portfolio rising by 1.9 percentage points to 11.4%. Resident customer loans declined by 1.6% to account for just 0.3% of the international banks' loan portfolio.



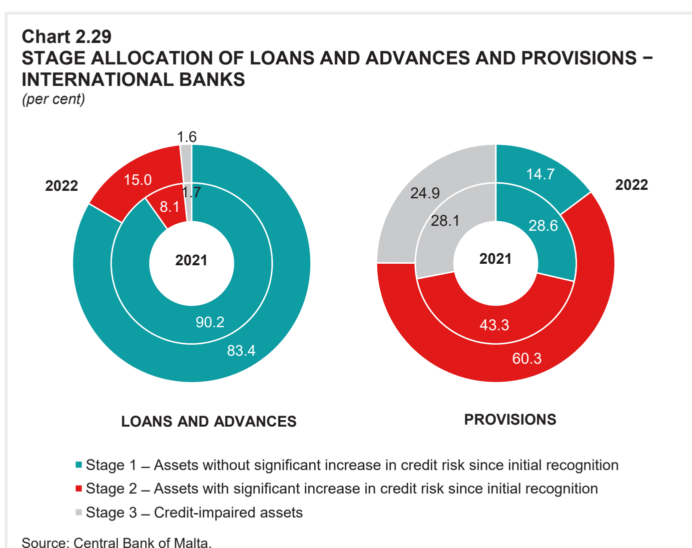
Meanwhile, interbank placements fell by just over a half over 2021, driven predominantly by the branches' balances with unrelated credit institutions. Subsidiaries and stand-alone banks also reported lower placements with related credit institutions, although to a much lower extent. Concurrently, Eurosystem deposits fell by 35.8%, predominantly by the branches of foreign banks.

2.3.3 Asset quality

Loan portfolio

During 2022 the outstanding stock of NPLs held by international banks dropped by almost a quarter, predominantly from foreign households, and to a lower extent foreign firms operating in the transportation and storage sector and foreign OFIs. Concurrently, international banks also reported lower forborne loans, as both performing and NPLs with forbearance measures fell by 14.8% and 69.4%, respectively. However, as loans and advances fell, driven by lower placements, the NPL ratio narrowed only marginally to 1.3%, whilst the forborne loans ratio rose to 7.5%.

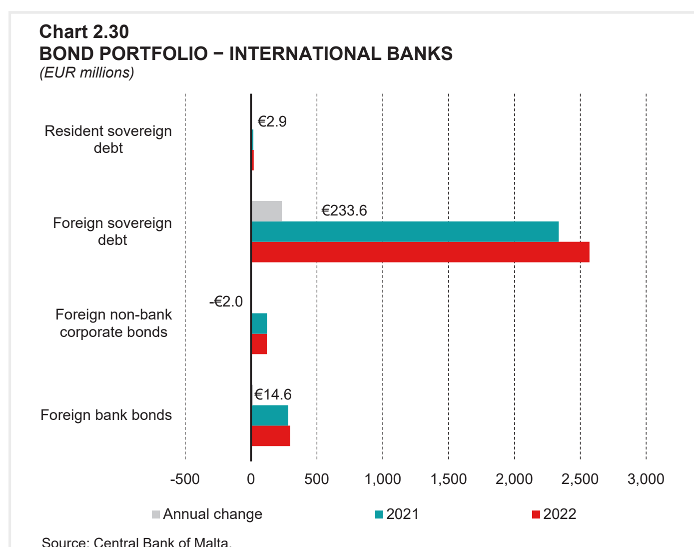
Reflecting the lower interbank placements, Stage 1 loans fell by almost a fifth but at about 83%, these loans still represented the largest share on the banks' portfolio (see Chart 2.29). Similarly, Stage 3 loans declined to account for just 1.6% of total loans. On the other hand, loans classified as Stage 2 rose by more than 60%, driving up their share to 15% of total loans in 2022 from 8.1% a year earlier. Such increase was however driven largely by third country branches. This led to Stage 2 provisions to increase by more than a third, with their share in total provisions reaching 60.3%. Nevertheless, overall provisions still fell by 3.5% over 2021, driven mainly by lower Stage 1, and to a lower extent Stage 3 provisions. The overall coverage ratio also rose from 147.5% to 187.3% in 2022, as the drop in NPLs outpaced the drop in provisions.



Securities portfolio

The securities portfolio of the international banks expanded by 7.6% to 30.8% of these banks' overall assets. The increase was driven by higher bond holdings which rose by 9.0%, driven predominantly by foreign sovereign bonds, largely of the Turkish Government, to account for 85.5% of the overall bond portfolio (see Chart 2.30). Consequently, such bond portfolios were mainly invested in speculative/unrated bonds, with just less than 1% invested in high and medium-rated bonds.

Chart 2.30
BOND PORTFOLIO – INTERNATIONAL BANKS
(EUR millions)



Source: Central Bank of Malta.

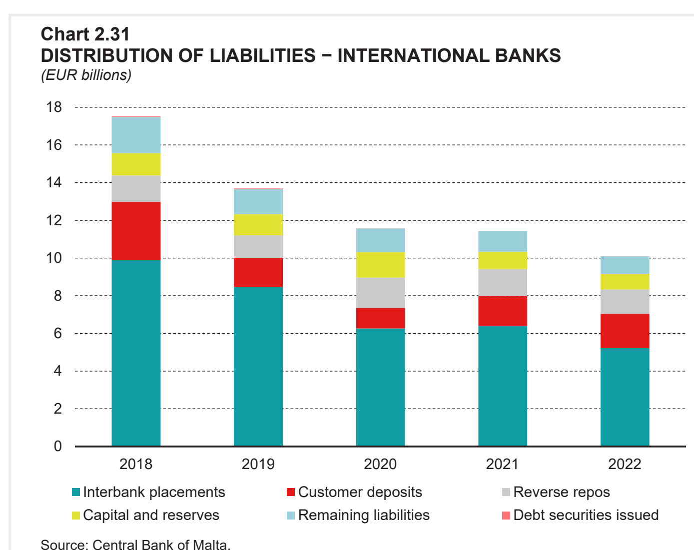
The overall expansion in the bond portfolio stemmed exclusively from the branches, with their overall securities portfolio, which is solely composed of foreign bonds, expanding by 11.8% over 2021. On the other hand, subsidiaries and stand-alone banks reported lower investment bonds, down by 72.5%, as well as less equities which dropped by 23.4%.

2.3.4 Funding and liquidity

The overall funding base of the international banks declined due to lower interbank funding, which fell by 18.5% to account for 51.7% of total liabilities in 2022 (see Chart 2.31). This was attributed predominantly to the branches of foreign banks, largely due to lower placements obtained from their head offices and other related companies. Nonetheless, interbank placements continued to be the main source of funding for such branches, financing 68.2% of their assets. In contrast, subsidiaries and stand-alone banks did not resort to the wholesale market and focused their funding strategy on customer deposits.

Overall, customer deposits held by the international banks rose by 15.0% to finance 18.0% of their assets, up from 13.8% in 2021. Both the branches as well as the subsidiaries and stand-alone banks reported higher inflows. Nonetheless, the increase for branches stemmed from a relatively low base, to finance just 4.4% of their assets, and accounting for only 18.3% of the overall customer deposits held by international banks. In contrast, customer deposits of subsidiaries and stand-alone banks financed more than three fifths of their assets. The overall increase in customer deposits stemmed predominantly from foreign OFIs, accounting for 52.1% of total customer deposits in 2022, up by 21.6 percentage points over 2021. Foreign NFC deposits fell by more than a third, largely driven by deposits from the manufacturing sector held with subsidiaries and stand-alone banks. Non-resident household deposits, mainly from Germany, also declined to account

Chart 2.31
DISTRIBUTION OF LIABILITIES – INTERNATIONAL BANKS
(EUR billions)



Source: Central Bank of Malta.

for 28.7% of the overall customer deposits in 2022. Resident customer deposits remained negligible, financing just 0.9% of these banks' total assets.

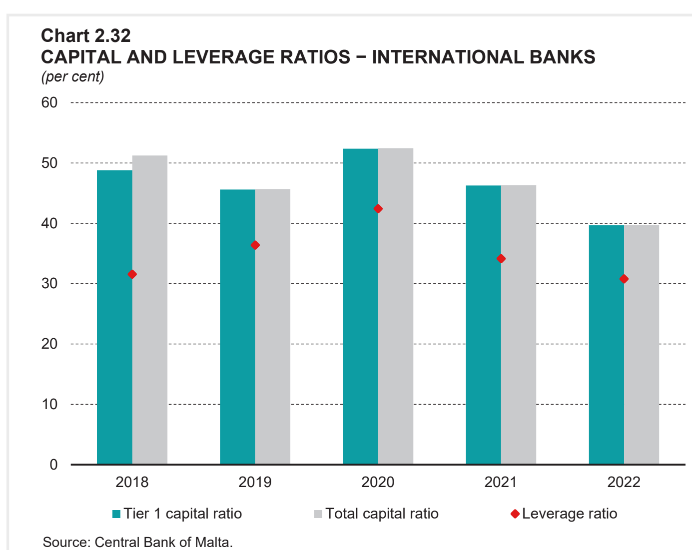
International banks continued to attract long-term retail funding to finance their business activities, which grew by around 20% to represent over half of customer deposits as at end 2022. Such rise in deposits was exclusively driven by the branches of foreign banks. Deposits with maturity exceeding five years rose by 83.0%, while demand deposits grew by 9.2%, driven mainly by the non-branches and to a lower extent the branches of foreign banks.

Despite decreasing, the liquidity position of subsidiaries and stand-alone banks remained strong during 2022, with an LCR of 378.8%, still comfortably above the minimum regulatory requirement. Compared to a year ago, these banks reported higher net outflows, largely from non-operational deposits not covered by the deposit guarantee scheme (DGS). Liquid assets fell by 6.7%, driven by lower withdrawable central bank reserves and to a lower extent government assets. Similarly, the NSFR dropped by 23.6 percentage points over 2021 to 131.6% in 2022.

2.3.5 Capital and leverage

Although the capital position of the subsidiaries and stand-alone banks declined, at 39.7% the total capital ratio and Tier 1 Capital ratio remained comfortably above the minimum regulatory requirements (see Chart 2.32). Total own funds fell by 24.3%, driven by lower Tier 1 capital, also reflecting the voluntary closure of one subsidiary of a foreign bank. RWA also fell, yet by a more modest rate of 11.7%. This reflected lower risk-weighted exposures for credit risk, which despite decreasing by 17.4%, still accounted for the largest share of the overall RWA. Foreign exchange and operational risk exposures rose by 10.2% and 0.9%, respectively, pushing their share in the overall RWA from 2.9% and 36.8% in 2021, to 3.6% and 44.9% a year later. Similarly, the leverage ratio dropped by 3.4 percentage points to 30.8% in 2022.

Chart 2.32
CAPITAL AND LEVERAGE RATIOS – INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

2.3.6 Risk outlook

Given the significant focus on non-resident activity, international banks remained sensitive to global macroeconomic developments, with diverse business models bound to be impacted differently. Banks that relied mostly on interbank funding, particularly the branches of foreign banks, experienced withdrawals and reduced availability of such funding. Funding pressures going forward could intensify, especially if market funding dries up. This led to a shift towards term deposits by retail customers, which are a more stable funding source, albeit costs to maintain such deposits might continue to increase, going forward. On the asset side, banks which focus on non-resident consumer credit are more likely to be adversely impacted by subdued household consumption due to the rise in inflation. However, these banks' interest income improved, with the outlook expected to remain positive, especially if these international banks manage to keep healthy margins. International banks continued to operate with significant management capital buffers and ample liquidity, which are key for financial resilience in an uncertain macroenvironment.