EXECUTIVE SUMMARY

The post-pandemic global economic recovery was somewhat hampered by the consequences of the war in Ukraine. Heightened inflationary pressures led major central banks to rapidly tighten monetary policy. Volatility in financial markets increased, with both equity and bond prices falling significantly, wiping away gains made in the previous year.

Policy measures shielded the Maltese economy from the direct repercussions of the war in Ukraine owing to the limited economic connections with the two conflict countries, though indirect effects still left their mark, particularly on inflation. The economy continued to grow, supported by Government's measures to mitigate the rise in energy prices, while the Malta Development Bank (MDB) introduced schemes to alleviate liquidity concerns and provided emergency support measures to firms in economic sectors impacted by the war. Against this backdrop, the Maltese banking sector remained resilient. Profitability improved, driven by both net and non-interest income, while a recovery of provisions was also reported. Banks continued to operate with ample liquidity, supported by continued deposit inflows and sufficient capital buffers. Asset quality also improved on the back of lower non-performing loans (NPLs). Stress tests confirm that Maltese banks overall remained adequately capitalised even under stressed conditions. However, going forward further inflationary pressures and interest rate hikes could affect borrowers' repayment capabilities and potentially could lead to asset quality deterioration. Unlike other euro area countries, the interest rate pass through is slower in Malta, given that the banks have ample liquidity. Banks also need to remain aware of possible consequences on their business models of emerging risks related to cyber and climate change. Indeed, this edition of the *Report* carries a box on experimental indicators on climate change for Malta, following the publication of harmonised euro area indicators by the European Central Bank (ECB) as part of its broader climate action plan.

Resident credit growth continued to be driven by higher resident mortgage lending, although a recovery in resident corporate credit also contributed. This recovery in corporate lending reflected pent-up demand following the pandemic, as some real estate projects came onstream. On the other hand, the growth in mortgage lending still reflected carry over effects of supportive fiscal measures targeting this sector, as also indicated in the boxed article on the Bank Lending Surveys (BLSs) conducted during the year. As a result, concentration in the banks' loan portfolios increased further. Owing to the continued build-up of cyclical and concentration risks, the Central Bank of Malta together with the Malta Financial Services Authority (MFSA) decided to phase in the introduction of a sectoral systemic risk buffer (sSyRB) on mortgages secured by residential real estate (RRE) over 2023 and 2024. Given the rising prominence of cyclical risk surveillance, this edition of the *Financial Stability Report* includes a boxed article on a newly constructed domestic cyclical systemic risk indicator (cSRI), as well as another box explaining the introduction of the sSyRB, which was announced in March 2023.

Domestically-relevant insurance companies and investment funds also remained resilient. These firms continued operating with strong capital and liquidity buffers. While still profitable, their performance was adversely impacted by the heightened volatility in financial markets. Going forward, further monetary policy tightening could adversely affect the profitability of domestically-relevant investment funds, given the high share of bond holdings. Non-life insurers could also be adversely impacted through higher costs owing to the strong rise in inflation. At the same time, demand for life cover could slow down, as inflation continues to erode policyholders' disposable incomes.

As part of the Bank's continued effort to strengthen its stress testing capabilities, the *Financial Stability Report* contains a boxed article on a new framework to quantify expected bank credit losses and another box detailing the accounting treatment of debt securities under International Financial Reporting Standard (IFRS) 9. The *Report* also includes a boxed article relating to the impact of inflation and interest rates on households quantified via the household stress testing framework.

The *Report* highlights the importance that the domestic financial sector remains aware of possible adverse developments impacting financial stability going forward, largely emanating from developments related to geopolitical tensions and policy responses to inflation. Domestic banks also need to continue adopting prudent credit risk management policies and identify possible credit losses at an early stage.

The *Report* is prepared by the Central Bank of Malta through the joint efforts of the Financial Stability Surveillance and Research Department, and the Policy, Crisis Management and Stress Testing Department of the Bank. This edition of the *Report* also benefitted from contributions by the Statistics Department. The *Report* is reviewed by the Bank's Financial Stability Committee, which is responsible to oversee and implement policies related to financial stability and the macroprudential framework.