EXECUTIVE SUMMARY

In this edition of the *Financial Stability Report (Report)*, the Bank provides a comprehensive analysis of the developments that took place throughout 2023.

Since the last *Report* published in July 2023, the global financial environment remained fragile particularly due to escalating geopolitical unrest, weaker economic growth, persistent elevated albeit declining inflation, and tight financing conditions. These factors have contributed to a challenging landscape for financial institutions worldwide. In the early part of 2023, the accumulation of vulnerabilities during the previous period of low interest rates led to disruptions in some banks in the United States and a major bank in Switzerland. Notwithstanding these developments, the *Report* highlights that the euro area banking and non-banking financial sectors remained resilient.

Despite a decline in inflation during 2023, the outlook for 2024 could be impacted by external developments, particularly by heightened geopolitical tensions. In turn, such risk could result in further market volatility with potential asset price corrections.

On the domestic front, the Maltese economy recorded one of the highest growth rates in the euro area even though it expanded at a more moderate pace compared to a year earlier. This expansion was supported by the recovery in tourism and robust domestic demand. Inflation stood slightly higher than the euro area average. This was mainly driven by the decline in energy prices in the Euro area contrasting the stability of such prices locally, with the latter remaining nevertheless at lower levels, but it is expected to converge to the European Central Bank's (ECB) target by 2025. The Maltese financial sector remained resilient, and the domestic banks continued to operate with ample liquidity and capital headroom above regulatory requirements, providing the capacity to absorb shocks. Profitability recovered significantly, with the banks expected to remain profitable even though some downside risks may develop going forward. Resident credit growth continued to be driven by both resident mortgages and non-financial corporation (NFC) lending. Although mortgage credit slowed down from previous highs, it is expected to continue growing at a robust pace. Growth in resident corporate lending persisted, driven primarily by higher loans to property-related sectors. As a result, concentration risks in banks' loan portfolios have risen further.

To address potential systemic cyclical and increasing concentration risks related to the exposure of the domestic banking system to the residential real estate (RRE) sector, during 2023 the Bank implemented a sectoral systemic risk buffer (sSyRB) to be applied on the amount of risk-weighted assets (RWAs) held against domestic mortgages. A buffer rate of 1% was applicable to all institutions operating domestically as from September 2023, and increased to a fully loaded rate of 1.5% in March 2024. This capital-based measure complements borrower-based measures (BBMs), on which further detail, including an overview of main developments of a macroprudential nature both at the domestic and European level, is included in the *Report.*

The non-bank financial sector also exhibited resilience, supported by overall robust capital and liquidity reserves. The domestic life insurance sector saw a modest recovery in the balance sheet, while domestically-relevant investment funds registered the first positive growth in their balance sheet after a period of declines. Both segments were driven by market gains, which among life insurance companies drove further demand for index-linked (IL) and unit-linked (UL) products. Potential risks going forward could arise from higher reassessment of risk premia, particularly during a challenging macroeconomic backdrop amid geopolitical headwinds.

The *Report* highlights that the Maltese financial system remains vulnerable to external shocks, as geopolitical risks amplified, with potential interest rate decreases possibly adversely affecting banks' profitability. Risks to asset quality remained benign, supported by a healthy domestic economy and limited transmission of increases in interest rates on loans. Going forward, downside risks could develop especially if economic growth slows down and inflation surprises on the upside.

In seeking to measure risks, the Bank carries out stress testing exercises to detect and quantify any weaknesses within the financial system. This year's macro stress testing (MST) framework contemplates a scenario characterised by stagflation and a delay in the lowering of short-term interest rates. The framework is complemented by other risk quantification frameworks. It includes an extension of the persistent deposit withdrawals (PDW) framework to also capture the solvency impact of the necessary offload of liquid assets to meet deposit outflows, as well as dedicated sensitivity analyses. Overall, the domestic banking system remains resilient to the contemplated scenario and assumed shocks, mainly as a result of the strong starting position of banks in terms of both solvency and liquidity.

This edition is also complemented with several boxed articles to supplement its analysis. One article addresses the surge in resident NFC lending, aiming to uncover cyclical patterns in credit to Maltese firms to detect any potential signs of excessive credit growth. Another presents the results of the quarterly Bank Lending Surveys (BLS) in Malta, which are also compared to the euro area. Additionally, two articles focus on the non-bank financial sector. One introduces a methodological update for the calculation of the liquid assets ratio for domestically-relevant insurance companies and investment funds, while the other provides an update on the footprint of the domestic non-bank financial institutions (NBFI) sector and an assessment of the sector's bank-like activities. Lastly, another box investigates the significance and effectiveness of O-SII buffers in Malta.

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. 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.