BOX 4: EVOLUTION OF BANKS' SOVEREIGN INVESTMENT HOLDINGS[1]

Introduction

Holdings of sovereign securities by domestic banks have increased markedly in recent years and constitute a significant share of banks' balance sheets. Such assets play an important role in liquidity management, are generally perceived as low risk, and benefit from favourable regulatory treatment. While banks can contribute to stabilising sovereign bond markets, elevated sovereign exposures may also give rise to an adverse feedback loop, whereby sovereign stress weakens banks' balance sheets, and tighter financing conditions further amplify risks to financial stability.[2] At the same time, given the small size of the Maltese economy, characterised by a relatively narrow local investor base and limited access to international markets due to liquidity factors, banks act as key investors in domestic sovereign paper, thereby contributing to market stability and acting as an important funding channel for government financing needs.

However, the current external environment, characterised by heightened geopolitical tensions, increased market volatility and elevated sovereign debt levels, has brought renewed attention to the risks associated with large sovereign exposures. While euro area sovereign bonds are not subject to any regulatory haircuts for LCR purposes, they remain exposed to valuation risk and may heighten concerns related to the sovereign-bank nexus. Across major advanced economies, sovereign bond markets have faced sustained pressure from rising yields, partly reflecting increased refinancing needs and concerns about fiscal sustainability.

Against this background, this box examines the evolution of banks' sovereign investment holdings, focusing on changes in composition, underlying drivers, and potential implications for financial stability. For the purposes of this analysis, domestic banks are defined as all domestically incorporated institutions, excluding branches of foreign banks. These branches hold around 22% of the overall sovereign securities, with exposures largely concentrated in Turkey and having very limited links to the domestic economy. The remainder of the box first discusses the macro-financial drivers underpinning the expansion in sovereign exposures. It then analyses changes in the composition of these holdings, including by residency and maturity. Finally, it assesses the associated financial stability implications.

Developments in banks' sovereign exposures

Macro-financial drivers of banks' sovereign exposures

Over the past two decades domestic banks have steadily expanded their sovereign securities portfolios, reflecting both cyclical responses to successive crisis episodes and structural features of the domestic financial system. Total sovereign exposures, including domestic and foreign sovereign holdings of all domestic banks increased from €1.8 billion in 2005 to €9.8 billion in 2025, corresponding to a rise from 10.1% to 24.5% of total assets. This expansion was driven primarily by the core domestic banks, which account for the majority of sovereign holdings. Such exposures increased from €1.4 billion in 2005 to €9.5 billion in 2025, equivalent to an increase from 14.1% to 28.6% of assets (see Chart 4a). This growing exposure underscores the increasing importance of the sovereign-bank

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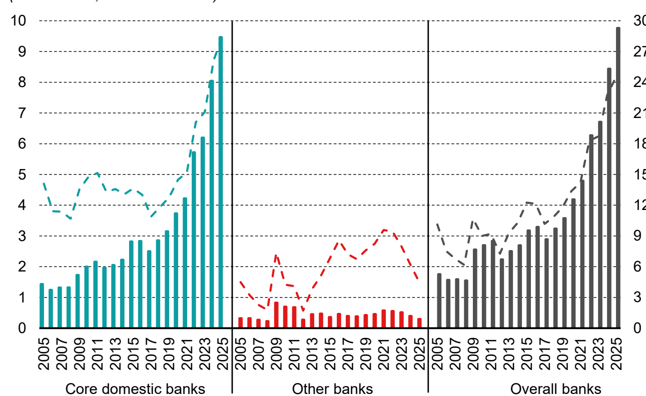
[2] Sovereign bond markets and financial stability: examining the risk to absorption capacity, ECB *Financial Stability Review*, November 2023.

nexus within the domestic financial system.

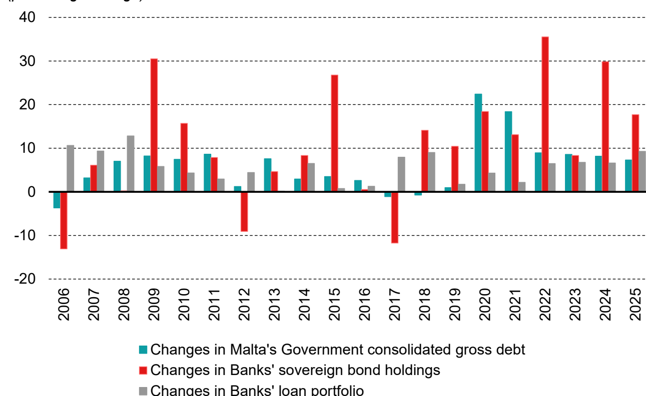
The evolution of these exposures has been closely linked to macro-financial conditions, with certain high-rated sovereign securities often acting as a stabilising asset class during periods of heightened uncertainty, alongside cash and gold. Periods of market stress, notably the global financial crisis, the euro area sovereign debt crisis, and the COVID-19 pandemic, were associated with increases in banks' holdings of sovereign bonds, particularly among core domestic banks (see Chart 4b).[3]

Chart 4a
SOVEREIGN DEBT HOLDINGS AND SHARE OF ASSETS
(EUR billions; % of total assets)



Source: Central Bank of Malta.
Note: Solid columns show holdings in EUR billions (LHS), while the dashed line indicates holdings as a share of assets (RHS). Overall banks exclude the branches of foreign banks.

Chart 4b
ANNUAL DEVELOPMENTS IN MALTA'S GOVERNMENT GROSS DEBT, SOVEREIGN BOND HOLDINGS AND LOAN PORTFOLIO OF CORE DOMESTIC BANKS
(percentage change)



Sources: Central Bank of Malta; Eurostat data.

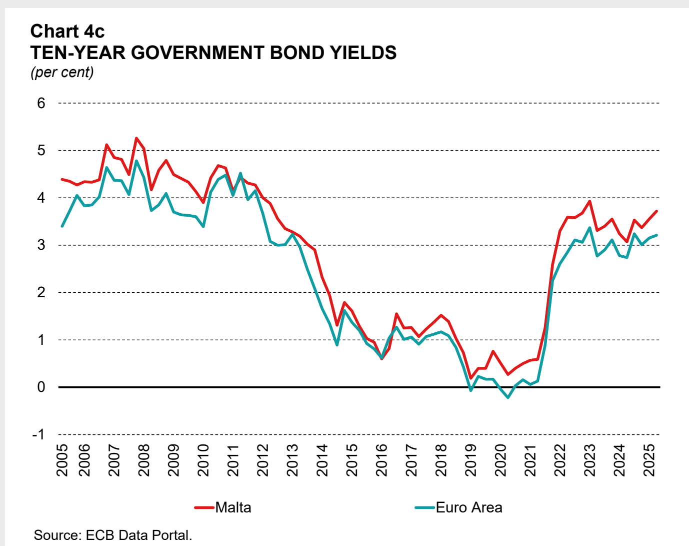
These developments were closely aligned with periods of strong growth in sovereign bond issuance driven by expansionary fiscal policies. At the same time, sovereign bond accumulation by banks often coincided with weaker growth in bank lending, particularly following the global financial crisis, suggesting a reallocation of funds from loans to sovereign securities, and potentially crowding out private credit. However, this relationship should be interpreted with caution, as both developments could be influenced by broader macroeconomic conditions, including weaker loan demand during downturns.[4]

Monetary policy measures also played a key role. In particular, the ECB's asset purchase programmes reinforced this trend through large-scale purchases of government bonds, supporting sovereign bond prices, enhancing market liquidity, and increasing the relative attractiveness of these assets on banks' balance sheets. More recently, monetary policy tightening, including the end of net asset purchases for monetary policy purposes and the related reinvestments, together with the associated rise in sovereign yields, may have increased incentives for banks to expand their sovereign portfolios rather than retaining excess liquidity with the Central Bank of Malta. The sharp increase in

[3] In the case of the sovereign debt crisis, this largely reflected increased holdings of domestic government securities, alongside a gradual reallocation towards higher-rated and more liquid sovereign issuers.
[4] Refer to ECB Working Paper: *Sovereign risk and bank risk-taking, No. 1894 / April 2016*.

both euro area and domestic government bond yields during 2022-23 (see Chart 4c), driven by monetary tightening and elevated geopolitical uncertainty, has sustained the attractiveness of newly issued government securities relative to placements within the Eurosystem, despite the valuation losses on existing holdings triggered by higher interest rates. Yields have remained relatively elevated despite subsequent monetary policy easing, reflecting persistent GPR and ongoing fiscal pressures across advanced economies.

Chart 4c
TEN-YEAR GOVERNMENT BOND YIELDS
(per cent)



Source: ECB Data Portal.

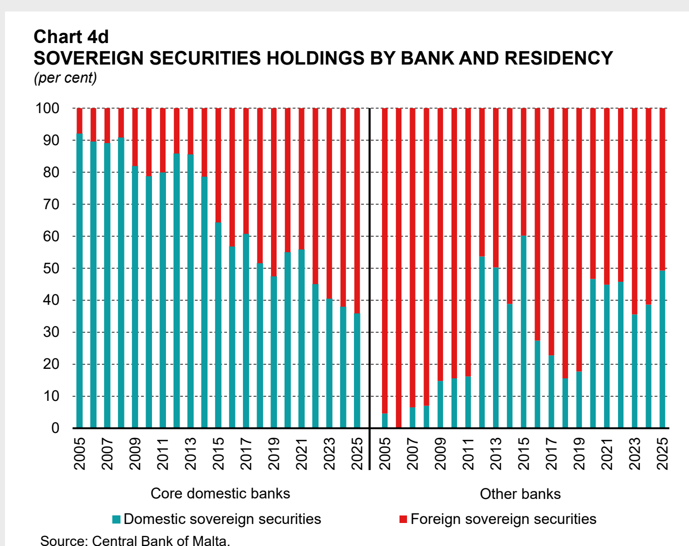
Regulatory developments under Basel III also supported this trend. In particular, the introduction of the LCR increased banks' demand for HQLA, including sovereign bonds.

Sovereign bond holdings by residency

The increase in the overall sovereign bond holdings of domestic banks has been accompanied by a progressive diversification of banks' portfolios, reflecting a gradual decline in home bias. While this has helped to mitigate concentration risk linked to domestic sovereign exposures, it has also altered the risk profile of banks' balance sheets, increasing exposure to cross-border sovereign risk and to global market developments. This trend is particularly evident among core domestic banks.

In 2005, sovereign holdings of core domestic banks were largely concentrated in domestic government securities, with only 7.9% of their holdings invested in foreign sovereign securities (see Chart 4d). Although domestic sovereign holdings continued to grow in absolute terms over time, their relative importance within their portfolios declined steadily. By 2025, domestic exposures accounted for 35.9% of total sovereign securities, indicating a lower home bias compared to the

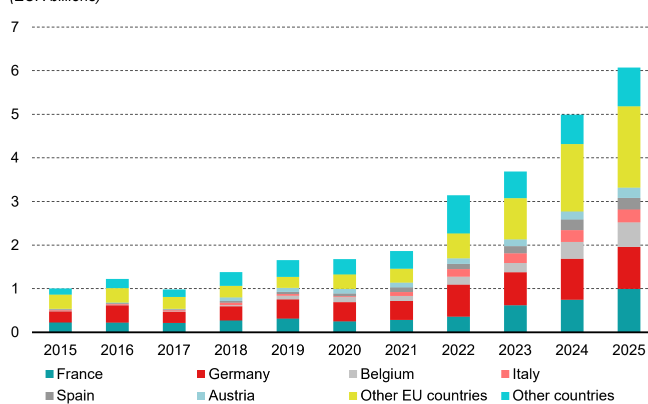
Chart 4d
SOVEREIGN SECURITIES HOLDINGS BY BANK AND RESIDENCY
(per cent)



Source: Central Bank of Malta.

EU/EEA aggregate of 45%.[5] A similar trend has been observed across other euro area countries, where banks have diversified their high-quality liquid asset portfolios towards non-domestic sovereign issuers.[6]

Chart 4e
CORE DOMESTIC BANKS' FOREIGN HOLDINGS OF GOVERNMENT DEBT SECURITIES BY COUNTRY
(EUR billions)



Source: Central Bank of Malta.
Note: Other EU countries include supranational insitutions.

The increase in foreign sovereign exposures was predominantly driven by euro area and supranational institutions. These expanded both in absolute terms and as a share of overall sovereign holdings, reaching around 85% of core domestic banks' foreign portfolios by end-2025. This growth reflected rising exposures to highly rated euro area sovereigns, particularly those of France and Germany, accounting for 16.4% and 15.9%, respectively, and to a lesser extent to issuers in Belgium, Italy and Spain (see Chart 4e). In addition, exposures to non-euro area sovereigns accounted for around 15% of foreign sovereign holdings.

By contrast, other banks were predominantly invested in foreign government paper in 2005, with such exposures accounting for about 95% of their sovereign holdings, reflecting limited participation in domestic government financing. While still relatively small in absolute terms, these banks increased their allocations to domestic government securities during periods of market stress. More recently, however, their overall sovereign holdings have declined, driven primarily by a contraction in foreign holdings, resulting in a more balanced distribution between domestic and foreign sovereign securities. By the end of 2025, foreign sovereign holdings were mainly concentrated in Poland, Spain, and Luxembourg.

Overall, these developments point to increasing diversification of sovereign portfolios among core domestic banks towards highly-rated, predominantly euro-denominated, issuers.[7] An analysis of credit ratings confirms that the majority of foreign sovereign exposures remained concentrated in high-rated categories, which accounted for around 57% in 2025 of their sovereign holdings, with medium-rated holdings representing a further 36%. This composition supports the overall credit quality of banks' foreign sovereign portfolios.

In terms of total sovereign holdings of core domestic banks, around 36% are classified as high-rated, while medium-rated sovereign securities accounted for around 59%. This distribution largely reflects exposures to domestic sovereign debt and continues to underpin the overall stability of the banks' sovereign portfolios.

Maturity structure of sovereign portfolios

The residual maturity profile of sovereign holdings provides important insights into the banks' sensitivity to interest rate risk and their ability to manage their balance sheet flexibly. Monetary policy developments

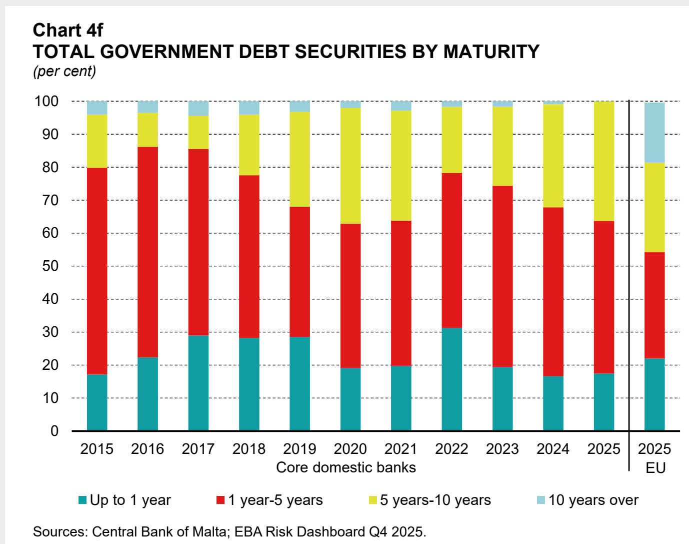
[5] Source: EBA Risk Dashboard, Q4 2025.

[6] Source: ECB *Financial Stability Review*, May 2026.

[7] Investment-grade debt securities carrying a rating of AA- or above are regarded as 'high-rated bonds'. 'Medium-rated debt securities' are those rated between A- and A+, whereas 'low-rated debt securities' are those rated between BBB- and BBB+. Sub-investment grade debt securities are rated lower than BBB-.

play a key role in shaping this profile. During periods of accommodative monetary policy, including low interest rates and asset purchase programmes, banks tend to increase holdings of medium and longer-datedsovereign bonds in search for yield and capital gains.[8] This was also observed during the COVID-19 pandemic, when central banks reduced policy rates to historical lows, compressing yields on short-dated government securities, which in some cases turned negative. Against this backdrop, domestic banks shifted towards medium and longer-dated holdings in 2020, reflecting search for yield (see Chart 4f). However, no strong reversals in medium and longer-dated holdings were observed as interest rates began to rise and remained elevated thereafter. Allocations to such government securities continued to play a central role, allowing banks to benefit from higher yields on newly issued securities.

Chart 4f
TOTAL GOVERNMENT DEBT SECURITIES BY MATURITY
(per cent)



Sources: Central Bank of Malta; EBA Risk Dashboard Q4 2025.

As at end-2025, securities with maturities of between one and five years accounted for around 47% of total sovereign holdings, exceeding the EU/EEA aggregate of about 32%, while holdings with maturities of between five and ten years increased gradually to stand at around 35%, also above the EU/EEA aggregate of about 27%.[9] However, domestic banks maintained a lower share of very long-term maturities (above ten years) compared to the EU/EEA aggregate, indicating a preference for intermediate durations and reduced exposure to long-term interest rate movements.

Overall, the maturity structure of sovereign portfolios suggests a balanced allocation across different maturity buckets, with a notable tilt towards medium-term securities implying greater sensitivity to changes in interest rates, especially in a more volatile macro-financial environment.

Financial stability implications of sovereign exposures

As highlighted in the latest ECB Financial Stability Review, the euro area sovereign bond market may face renewed pressure due to rising long-term yields, elevated public debt levels, and shifts in the investor base.[10]

In this environment, the sizable exposure of domestic banks to sovereign securities represents an important potential channel of risk transmission, particularly through valuation effects on banks' sovereign bond portfolios and the resulting impact on capital positions. Sovereign holdings amount to around 24.5% of total assets (28.6% for core domestic banks), 83.3% of total debt securities portfolios (86.2% for core domestic banks), and 2.7 times the CET1 capital (3.5 times for core domestic banks), indicating that valuation changes could have a material impact on banks' balance sheets and capital positions.

[8] Medium and longer-dated securities consist of those maturities of over one year.
[9] See footnote 5.
[10] See footnote 6.

Owing to the increasing diversification in the sovereign portfolios, the Herfindahl–Hirschman Index (HHI) dropped significantly from around 4,300 in 2015 to about 1,700 in 2025, mainly reflecting the reduced share of domestic sovereign holdings.[11] Similarly, the three largest sovereign exposures now account for 56.1% of total holdings, down from 87.2%, a decade earlier.

While the decline in home bias has reduced direct exposure to domestic sovereign risk, fiscal deficits and public debt in Malta have also declined significantly in the post-COVID period to 2.2% and 46.4% of GDP, respectively, thus lowering risk in domestic sovereign debt exposures. Nevertheless, concentration has remained relatively elevated, becoming increasingly tilted towards a small set of foreign issuers. As such, adverse developments affecting the euro area could still generate significant valuation effects, particularly in a context of heightened global uncertainty and increased sensitivity to sovereign spreads.

The maturity structure and valuation treatment of these exposures are also key to shaping risk transmission. The increasing share of longer-dated assets implies greater sensitivity to interest rate movements and changes to sovereign spreads. While the predominance of amortised cost (AMC) accounting (around four fifths of holdings) mitigates the immediate impact on profit and loss accounts, it does not eliminate underlying economic risks, particularly in the event of liquidity pressures necessitating the sale of such assets.

The increasing allocation to foreign sovereign securities in more recent years introduces an additional layer of risk through cross-border spillovers and foreign currency risk. Although this diversification has contributed to improving the overall credit quality of sovereign portfolios, it also exposes banks to cross-border spillovers, amplifying the transmission of changes in global risk sentiment, sovereign spread widening, and geopolitical developments.

Elevated sovereign exposures may also reinforce the sovereign–bank nexus, whereby vulnerabilities in one sector can amplify weaknesses in the other, potentially creating negative feedback loops.[12] In the event of stress in the banking sector, large holdings of government debt could give rise to contingent liabilities for the public sector, either through explicit support measures or implicit guarantees. In addition, costly resolution policies may adversely affect fiscal accounts. Conversely, a deterioration in sovereign creditworthiness could weaken banks' balance sheets through valuation losses and tighter funding conditions, potentially constraining lending capacity and amplifying macro-financial feedback effects.

Conclusion

Domestic banks' sovereign exposures have increased over time, driven by a combination of cyclical factors, including crisis-related portfolio shifts and changes in the monetary policy environment, as well as structural features of the Maltese financial system and banks' demand for HQLA.

While home bias has declined significantly, the growing exposure to euro area sovereign bonds has altered the risk profile of banks' portfolios. Rising interest rates can generate valuation pressures on medium and longer-dated bond portfolios, increasing sensitivity to changes in yields and sovereign spreads. High sovereign exposures may also reinforce the sovereign-bank nexus, whereby fiscal stress or widening sovereign spreads could affect banks' balance sheets and funding conditions. In addition, while diversification has reduced domestic concentration risk, exposures remain relatively concentrated across a limited number of foreign sovereign issuers, potentially amplifying the transmission of external shocks. Although euro area sovereign bonds remain highly liquid and benefit from

[11] HHI is computed based on available country-level breakdown; therefore, concentration may be underestimated due to the aggregation of smaller exposures under 'Other countries'.

[12] Dell'Ariccia, G. et al. (2018), Managing the sovereign-bank nexus. *ECB Working Paper No. 2177*, Frankfurt: European Central Bank.

favourable regulatory treatment, periods of market stress could still lead to valuation volatility and potential liquidity strains, where assets may need to be sold under pressure.

These risks are partly mitigated by Malta's favourable macro-financial environment, including a resilient economy and a positive domestic fiscal performance in the post-COVID period with public debt declining to significantly below the EU threshold of 60% of GDP. Moreover, domestic banks' increasing allocation towards highly-rated sovereign issuers supports the overall credit quality of their portfolios. In addition, banks' strong capital and liquidity positions, the predominance of AMC accounting, and their largely retail-funded business model contribute to overall resilience and to lower short-term funding pressures.

Nonetheless, the size and concentration of sovereign exposures warrant continued monitoring, including through existing stress-testing frameworks, which already assess banks' resilience to interest rate and sovereign spread shocks. Maintaining strong economic growth coupled with prudent fiscal policies and sound sovereign risk management will be key to limiting vulnerabilities and preventing adverse feedback loops between the banking sector and public finances.