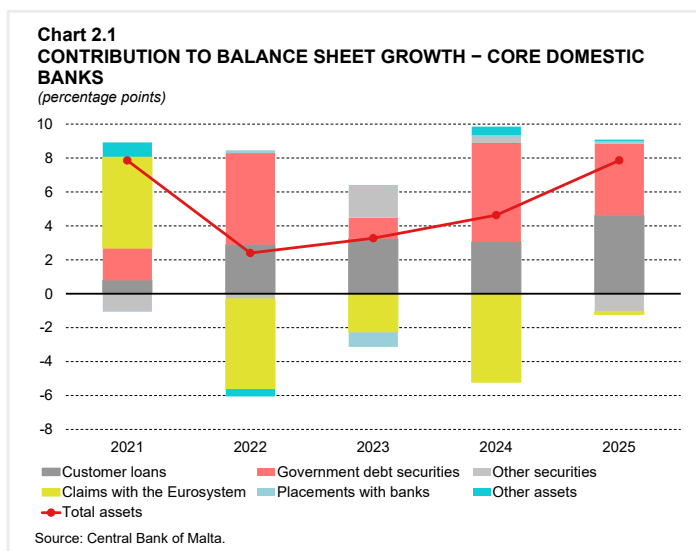


2. DEVELOPMENTS IN THE BANKING SECTOR

2.1 Core domestic banks

Core domestic banks' balance sheet continued to grow in 2025, expanding by nearly 8% to reach approximately 135% of GDP. Growth was mainly driven by continued expansion in customer lending and a further increase in holdings of government debt securities, which rose by 9.3% and 16.8%, respectively (see Chart 2.1). Customer loans accounted for just over half of these banks' assets. Exposures to government debt securities rose to about 27.4% of assets, supported by elevated sovereign bond yields amid higher inflation expectations. By contrast, placements with the Eurosystem declined to account for 7.2% of total assets, as banks continued to reallocate liquidity towards higher-yielding assets to improve returns. Overall, the balance sheet remained focused on traditional intermediation activity, supported by a strong domestic economic environment.

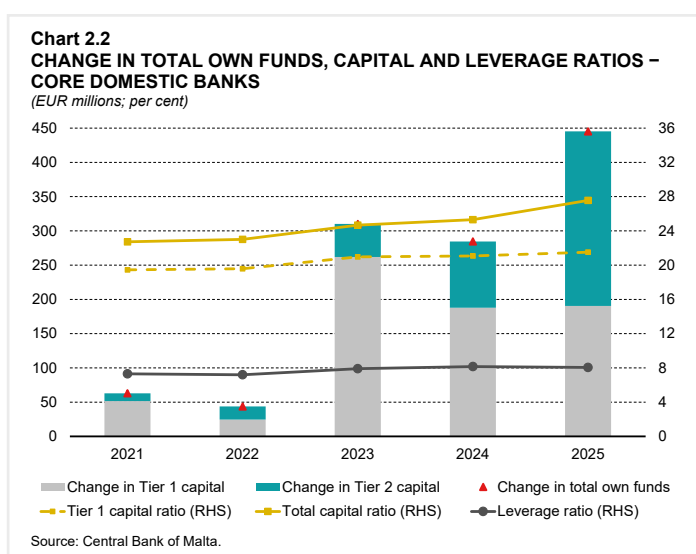


Profitability eased, reflecting lower income from placements with the Eurosystem, higher operating costs and lower net impairment reversals, although this was partly offset by stronger income from traditional lending, sovereign securities and fees. At the same time credit quality improved further, and the banks reported stronger capital ratios and sustained ample liquidity.

2.1.1 Capital and leverage

Total own funds increased by almost 15% in 2025, largely driven by a higher issuance of subordinated debt instruments, which lifted Tier 2 capital, while Tier 1 capital also rose markedly, underpinned by higher retained earnings (see Chart 2.2). Although total risk exposures expanded as total assets continued to grow, this increase was more moderate at 5.3%. As a result, the total capital ratio improved by 2.2 percentage points to 27.6%.

Credit risk continued to dominate the risk profile of core domestic banks, with related risk-weighted assets (RWAs) increasing by



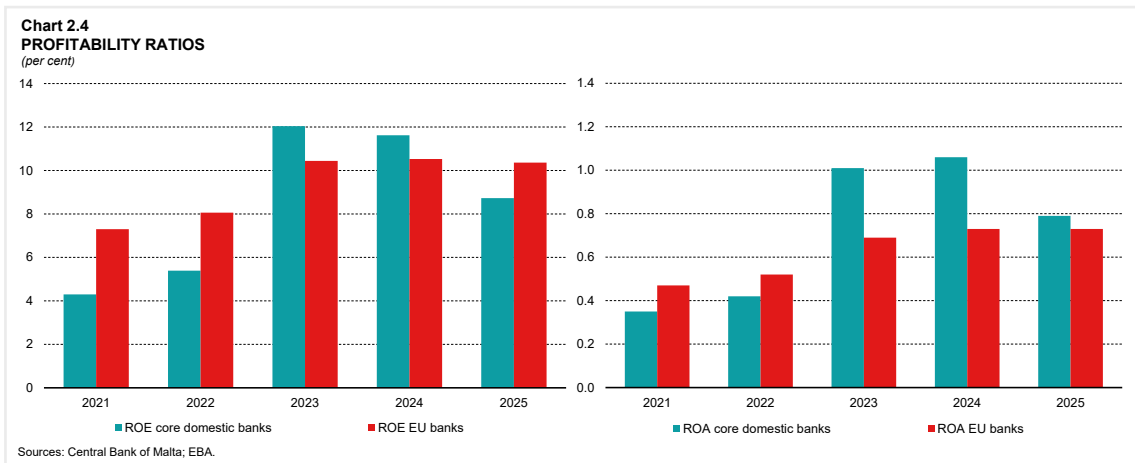
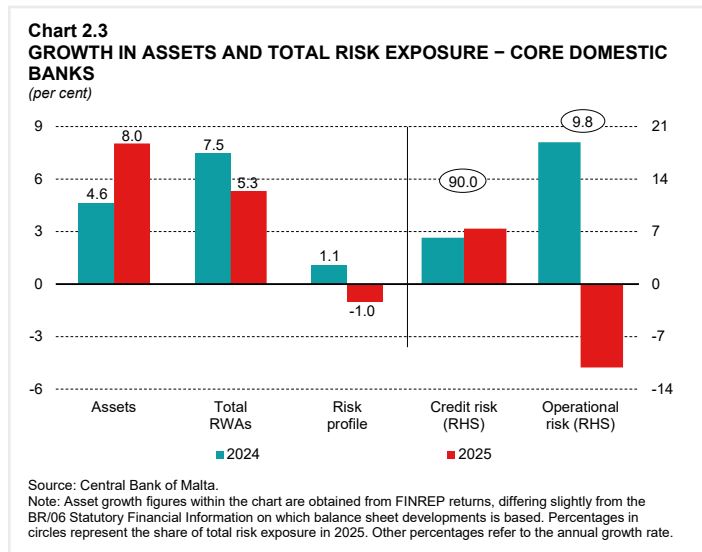
7.4% and accounting for 90.0% of total risk exposures (see Chart 2.3). Operational risk remained the second-largest risk component, representing 9.8% of total RWAs, despite a decline over the year.¹ At the same time, banks continued to place increased emphasis on operational risk management, in response to evolving technology-related and cyber risks.

Amid the strengthening of capital ratios and continued balance sheet expansion, the overall risk profile of core domestic banks improved by 1.0 percentage point to 38.8%, moving closer to the EU average of 35.2%.² Moreover, the leverage ratio remained relatively stable at 8.0%, pointing to continued balance sheet strength and robust loss-absorbing capacity.

2.1.2 Profitability

The core domestic banks' profitability eased in 2025, marking the first decline since the pandemic period. Following a prolonged period of earnings expansion, net profit before tax fell by 18.7% year-on-year. Consequently, key profitability indicators weakened, with post-tax return on equity (ROE) and ROA declining by 2.9 percentage points and 0.3 percentage points, to 8.7% and 0.8%, respectively (see Chart 2.4). As a result, ROE fell below the euro area average, while ROA remained comparatively higher, reflecting lower leverage and a more conservative business model.

NII declined by 3.1%, largely reflecting lower income from placements with the Eurosystem, as key interest rates fell since 2024 (see Chart 2.5).³ By contrast, NII from traditional intermediation activities recorded



¹ Such development in part reflects the methodological change in the computation of RWA for operational risk. See: *Interim FSR 2025 – Box 1: Impact of CRR3 on Maltese Banks' Risk Weights*.

² EBA risk dashboard 2025Q4.

³ The deposit facility rate dropped from a high of 4% until 11 June 2024 to 2% by 11 June 2025.

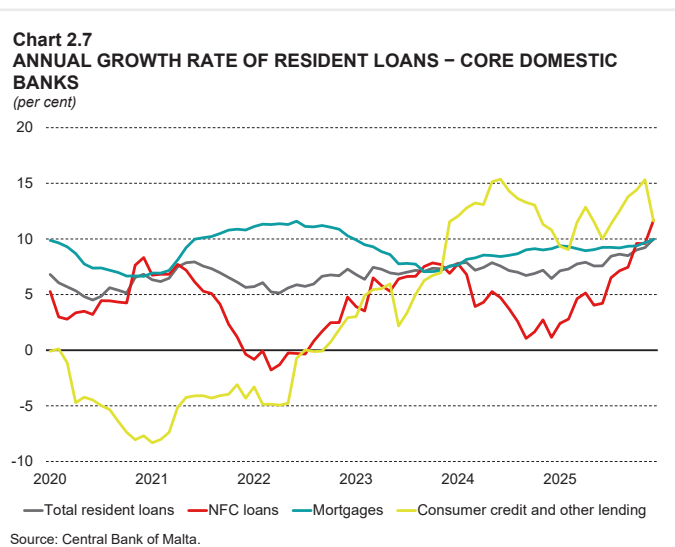
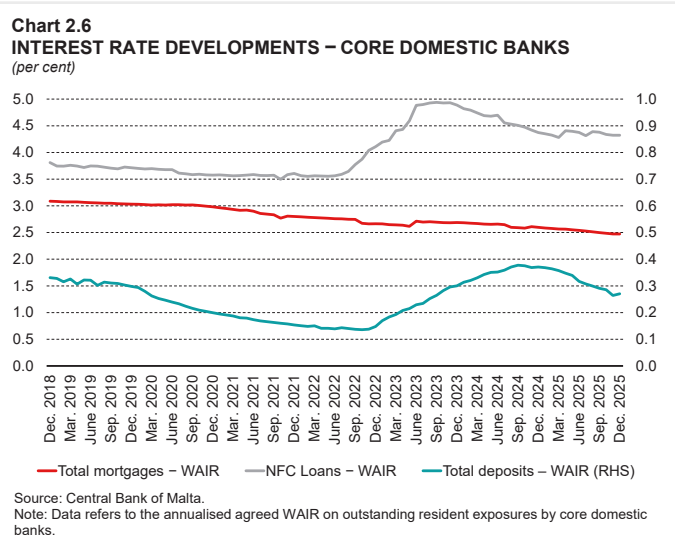
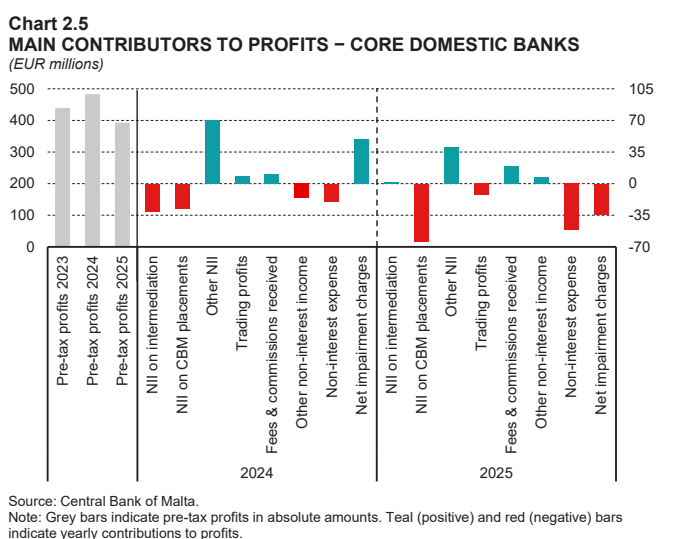
a modest increase of 0.3%, following a contraction observed in the previous year. This improvement was volume-driven, underpinned by continued growth in lending to resident corporates and continued expansion in residential mortgage lending, as otherwise net interest margins remained broadly stable as both lending and deposit rates fell (see Chart 2.6).

Other components of NII rose by over 25%, supported by higher yields on sovereign debt securities coupled with increased holdings of such assets. Non-interest income also improved, driven by higher fee and commission income, although this was partially offset by weaker trading income. On the other hand, profitability was further weighed down by a notable increase in operating expenses, partly driven by higher staff costs. As a result, cost efficiency deteriorated with the cost-to-income ratio rising by 6 percentage points to 58.4%, now exceeding the euro area average of 53.3%.⁴ This marked a change from the pre-2019 period, when Malta consistently recorded a lower ratio than the EU average. The domestic ratio began trending upwards from 2019 onwards, also driven by rising operating costs. At the same time, net impairment reversals went down from around €45 million in 2024 to almost €11 million in 2025, further weighing on profitability.

2.1.3 Credit dynamics

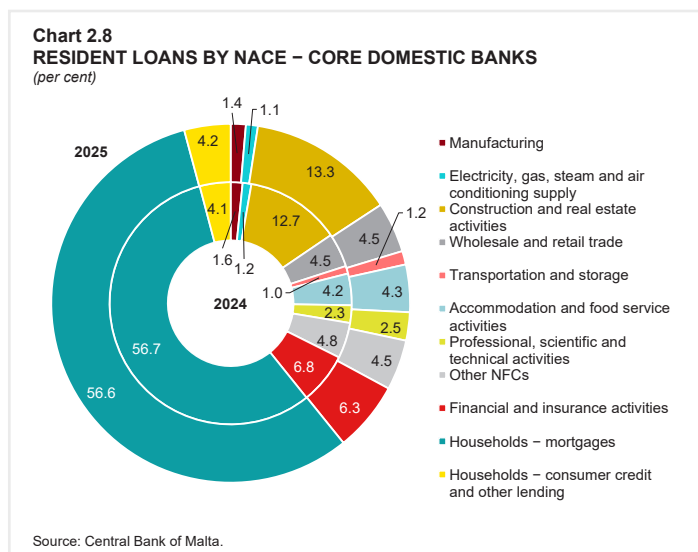
Growth in credit to residents gained further momentum, reaching 10.0% by the end of 2025 from 6.4% a year earlier (see Chart 2.7). This acceleration was mainly driven by NFC lending. Following growth of 1.2% in 2024, it rose by 11.7% in 2025. At a sectoral level, the most notable increase continued to be concentrated in property-related sectors,

⁴ See footnote 2.



where lending rose by 14.2% and accounted for 53.5% of resident NFC loans (see Chart 2.8).⁵

Several other sectors also experienced strong growth, partly driven by base effects after the contraction recorded in the previous year. These include professional, scientific and technical activities, wholesale and retail trade, information and communication and transport and storage. By contrast, the human health and social work, and manufacturing sectors contracted. In the aggregate, non-property related sectors contributed to around a third of the overall resident NFC credit growth.



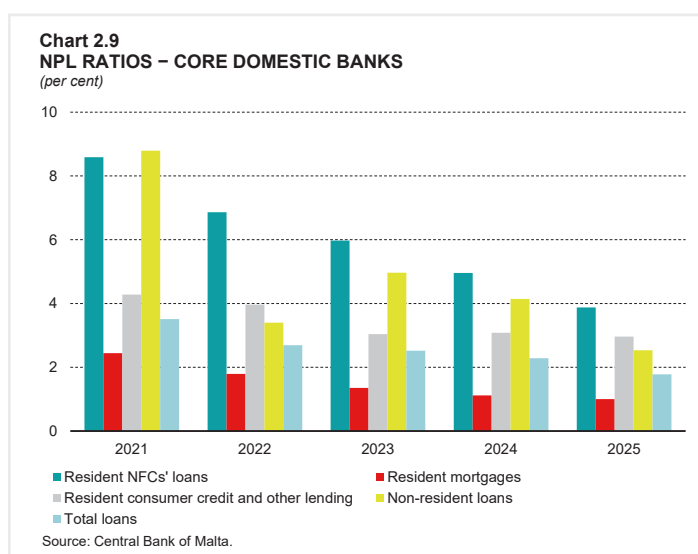
Meanwhile, resident mortgage lending continued to grow strongly, increasing by 9.9%, and further contributing to the concentration of these banks' loan portfolios towards the property market. Consumer credit growth remained elevated at 11.6%, supported by rising household income and strong domestic demand.

By contrast, loans to non-residents declined by 6.6%, largely due to reduced lending to firms operating in manufacturing, professional, scientific and technical activities, and the financial and insurance sector. Lending to non-resident households remained contained, accounting for just 0.5% of their overall loan portfolio.

2.1.4 Credit quality

The credit quality of loan portfolios improved further in 2025, with NPLs declining by 16.4%, underpinned by a strong domestic economy, prudent lending practices and favourable financial conditions, which continued to support borrowers' repayment capacity. Consequently, the overall NPL ratio declined by 0.5 percentage points to a historically low level (at least since 2004) of 1.8% by the end of 2025 (see Chart 2.9). Excluding placements with the Eurosystem, the NPL ratio declined more markedly, by 0.6 percentage points to 2.1%.

The resident NPL ratio improved by 0.4 percentage points to 1.7%, reflecting a broad-based improvement across all loan categories. This improvement was most pronounced in the resident NFC segment, where the NPL ratio declined by 1.1 percentage points to 3.9%. This reflected continued expansion in the loan portfolio alongside a near-20% decline in corresponding NPLs,



⁵ Property-related sectors include construction, real estate, and accommodation and food services activities.

most notably in the health and social work sector, and to a lesser extent in transportation and storage and real estate activities (see Chart 2.10).

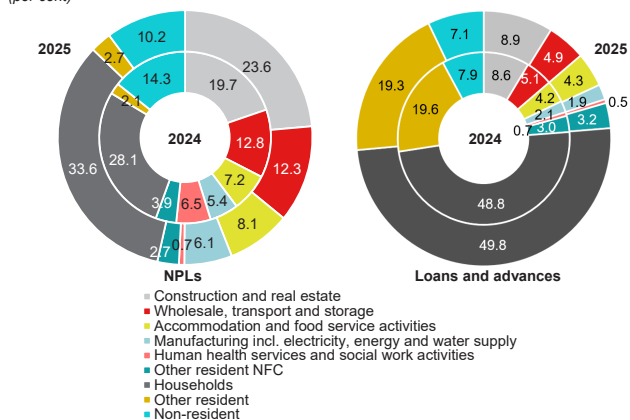
Resident mortgage NPLs declined by 1.8%, driven by both lower mortgage NPLs and further growth in lending volumes. The corresponding NPL ratio thus edged down to just 1.0%. Although resident consumer credit NPLs rose moderately over 2024, continued growth in consumer lending kept the associated NPL ratio broadly stable at around 3.0%.

Credit quality also improved in the non-resident portfolio, with the NPL ratio declining significantly from 4.1% in the previous year to 2.5% in 2025. This improvement was mainly driven by a substantial 40.5% reduction in NPLs, which more than offset the slight contraction recorded in the non-resident loans.

The reduction in NPLs translated into a lower share of Stage 3 loans, which declined by 16.4%, mainly reflecting developments in lending to corporates. However, Stage 2 loans increased by a quarter, across both the households and corporate segments, rising to 5.8% of total lending, although still standing below the average of 7.4% recorded since 2018. This development may signal emerging asset quality pressures going forward (see Chart 2.11). At the same time, continued expansion of the loan book led to an 8.8% increase in Stage 1 loans, consistent with the strong growth in new lending activity.

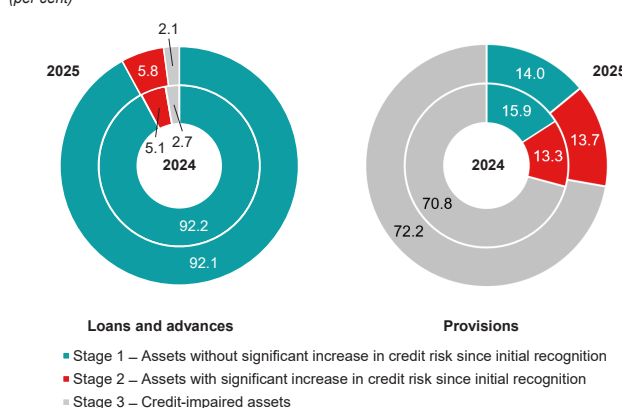
Overall provisions declined by a moderate 2.1%, mainly reflecting lower Stage 1 provisions, although Stage 3 provisions also fell marginally. Nevertheless, the coverage ratio improved significantly, increasing by 6.8 percentage points to 46.3%, supported by the substantial decline in NPLs (see Chart 2.12).

Chart 2.10
SECTORAL ALLOCATION OF LOANS AND ADVANCES AND NPLs – CORE DOMESTIC BANKS
(per cent)



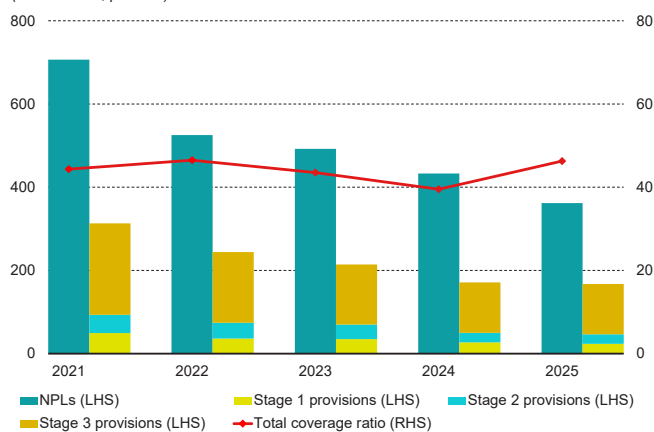
Source: Central Bank of Malta.
Note: "Other resident" loans and advances include placements with the Central Bank of Malta.

Chart 2.11
STAGE ALLOCATION OF LOANS AND ADVANCES AND PROVISIONS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 2.12
COVERAGE RATIO – CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

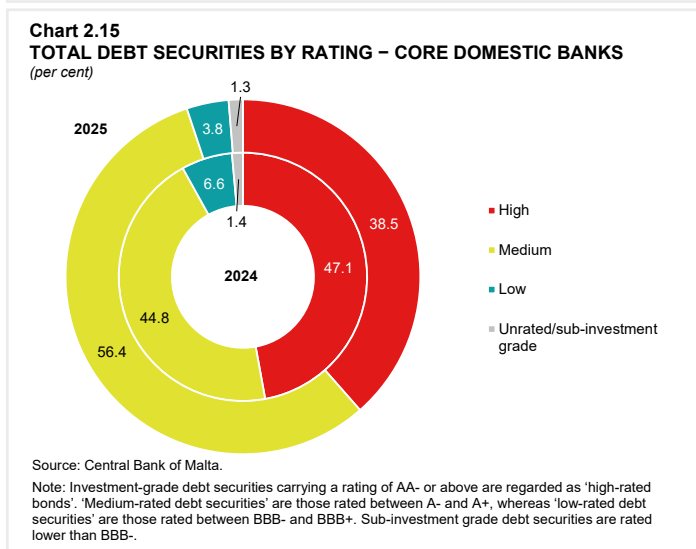
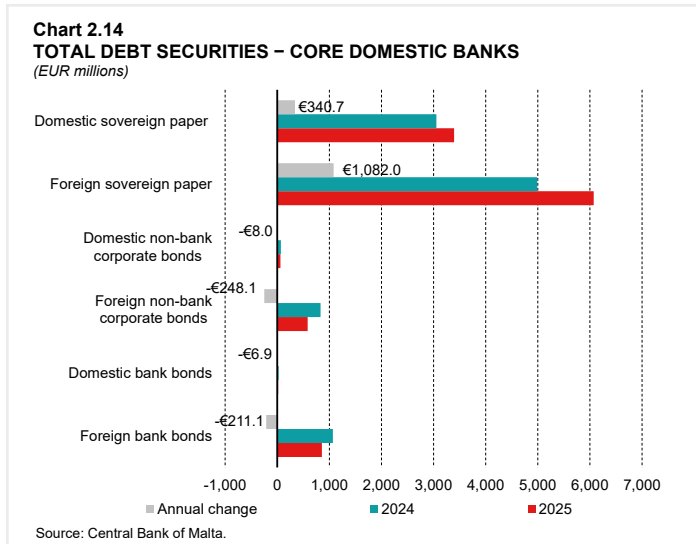
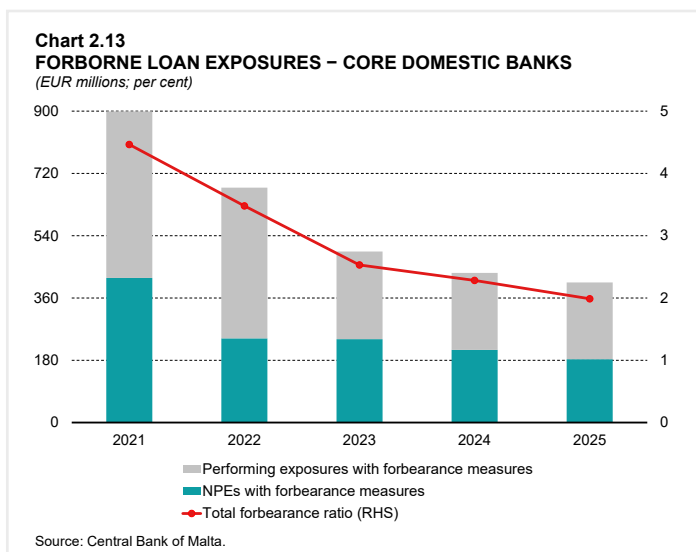
Additionally, after accounting for the value of collateral supporting NPLs, credit risk remained more than fully covered.

Forborne loans decreased further, falling by 6.4%, largely reflecting lower non-performing exposures (NPEs). As a result, the forbearance ratio declined by 0.3 percentage points to just 2.0% (see Chart 2.13).

2.1.5 Securities portfolio

While the lower deposit facility rate led to reduced placements with the Eurosystem, the still-elevated euro area government bond yields supported a continued shift in asset composition towards increased investment in euro area government securities. Indeed, an almost 10% increase in bond holdings was entirely driven by sovereign paper, predominantly issued by foreign governments, as private sector bond holdings contracted over the same period. As a result, sovereign paper remained the most dominant investment class, accounting for around 86% of core domestic banks' bond holdings (see Chart 2.14). The high concentration in sovereign securities highlights the need to continue monitoring exposures to sovereign risk developments (see Box 4).

Overall, the bond portfolio continued to exhibit strong credit quality. While high-rated holdings decreased, this was more than offset by an increase in medium-rated holdings. As a result, around 95% of the portfolio remained in the medium-to-high rating category, limiting exposure to low-rated or unrated securities (see Chart 2.15). Equity holdings increased by 7.4% but remained limited to 1.5% of total assets.



2.1.6 Funding and liquidity

Customer deposits

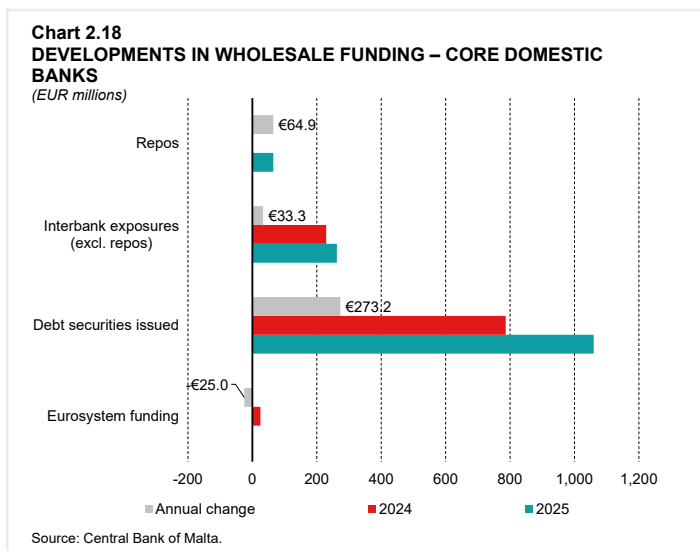
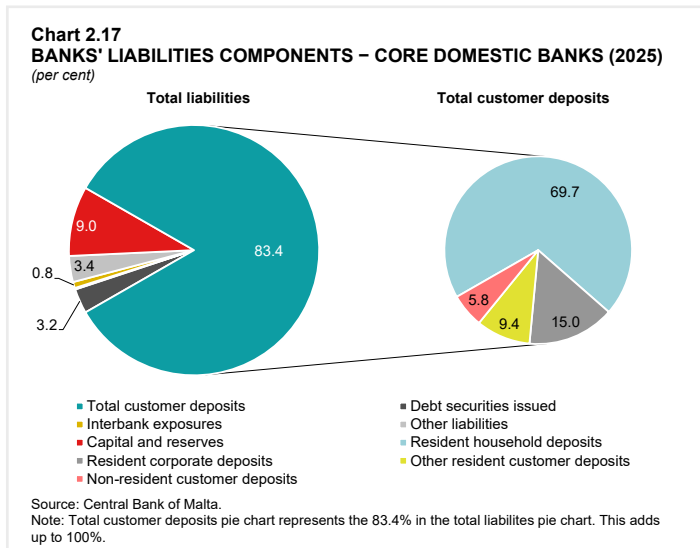
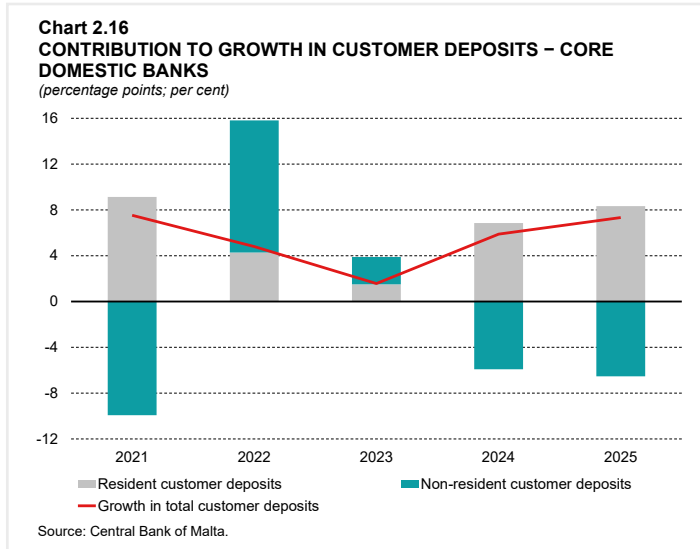
Growth in customer deposits remained strong, up by 7.3%, driven entirely by higher resident customer deposits, which accounted for just over 94% of total customer deposits. Non-resident customer deposits fell further during the year (see Chart 2.16). Resident household deposits remained the main source of retail funding, increasing by 8.6% to account for close to 70% of total customer deposits (see Chart 2.17).

Resident corporate deposits also increased, rising by 2.7%, mainly driven by firms operating in the public administration and construction sectors. Several other sectors also registered growth, albeit to a much lower extent. Meanwhile, resident deposits from the financial and insurance activities sector expanded strongly over the year.

Deposit growth remained concentrated in on-demand instruments, with current and savings deposits rising by 13.0% and 8.5%, respectively. Together, these accounted for 86.7% of total deposits. By contrast, fixed-term deposits declined by nearly 10%, partly reflecting the absence of new fixed-term deposits by some core domestic banks. As a result, their share of total deposits dropped by 2.4 percentage points to 13.3% by year-end.

Wholesale funding

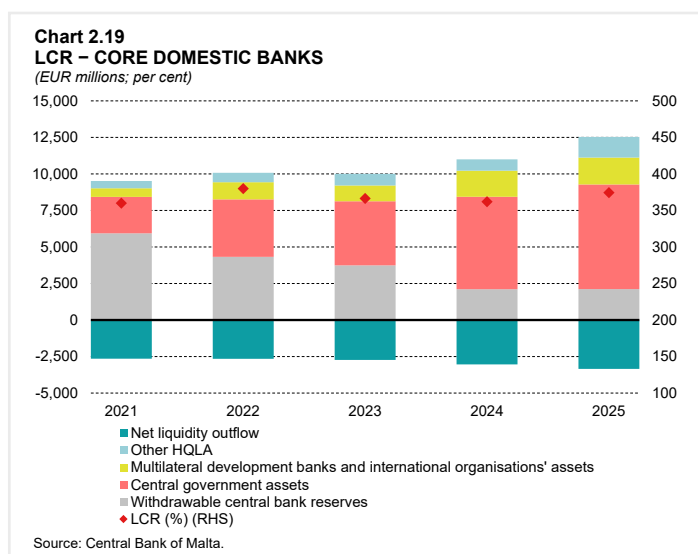
Wholesale funding remained limited, financing just 4.2% of total assets. It continued to be largely concentrated in issued debt securities, which rose by almost 35% during the year, following the issuance of subordinated instruments to strengthen further the banks' Minimum Requirements for own funds and Eligible Liabilities (MREL) (see Chart 2.18).



Interbank funding and repurchase agreements remained negligible despite a slight increase. Core domestic banks also made no use of Eurosystem funding at year-end, reflecting their already ample liquidity positions.

Liquidity

Core domestic banks maintained ample liquidity buffers, as evidenced by the strong LCR of 374.4%, which increased by 12.5 percentage points over the previous year (see Chart 2.19). Despite higher net liquidity outflows, holdings of HQLA increased at a faster pace, mainly driven by increased investments in sovereign bonds.



Longer-term liquidity conditions also improved, with the NSFR rising by 2.6 percentage points, to 186.5%. Despite edging up slightly, the customer loans-to-deposits ratio stood at just over 60%. This was well below the weighted average of 104.8% for euro area banks, which underscores domestic banks' strong funding and liquidity positions.⁶

2.1.7 Risk outlook

Despite the current sound financial position of core domestic banks, the prevailing headwinds from an adverse geopolitical environment pose downside risks to the macroeconomic outlook. Heightened geopolitical tensions, particularly the conflict in the Middle East and the protracted war in Ukraine, are contributing to a highly uncertain global macro-financial environment.

Elevated global uncertainty arising from geopolitical fragmentation, trade tensions and energy market volatility could weaken external demand, disrupt supply chains, and increase input costs for Maltese firms, particularly in those sectors that are sensitive to transportation costs or disruptions such as tourism, manufacturing and wholesale trade. Should further adverse developments materialise and persist, corporate profitability could deteriorate, undermining borrowers' debt-servicing capacity, with adverse implications for banks' asset quality. Some incipient signs of increase in credit risk have been already observed in Stage 2 loans.

A more risk-averse environment and tighter financial conditions could dampen credit growth, thereby constraining income generation from traditional intermediation activities. At the same time, the still-elevated bond yields should continue to support banks' net interest margins. This would partly offset the pressure on margins from the monetary policy easing cycle that had begun in mid-2024.

Beyond macro-financial risks, cross-cutting operational risks, including cyber-threats, remain a key vulnerability. These risks could intensify further amid elevated geopolitical tensions and increased cyber activity. In this context, banks need to continue strengthening their technological capabilities while further enhancing and rigorously implementing robust cybersecurity frameworks. Such efforts remain essential to safeguard sensitive data, preserve confidence in the financial system and ensure the uninterrupted operational continuity of critical financial services.

Overall, while banks' performance continues to be supported by a resilient domestic economy and strong balance sheet positions, vigilance remains warranted. The upward trend in cost-to-income ratios highlights the importance for banks to closely monitor cost dynamics and operational efficiency. At the same time, maintaining prudent lending standards, effective NPL recovery strategies, and robust capital and liquidity buffers remain essential to preserve the sector's resilience should downside risks materialise.

⁶ See footnote 2.

BOX 2: INSIGHTS FROM THE BANK LENDING SURVEY¹

Introduction

The ECB's Bank Lending Survey (BLS) is a key tool providing National Central Banks with direct qualitative insights from credit experts at a representative sample of commercial banks across the euro area. This approach complements traditional quantitative information by providing a deeper understanding of factors underpinning changes in banks' lending policies and developments in borrower demand.² In addition, the survey addresses topical issues such as banks' response to climate-related risks, the geopolitical uncertainty and trade tensions as well as changes in the monetary policy framework.

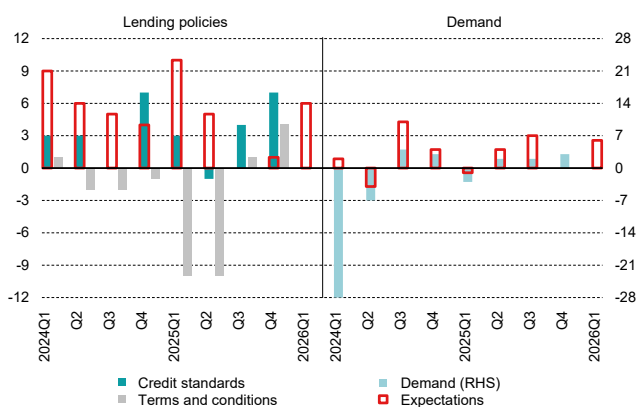
In 2025, more than 150 banks participated in the survey, including four Maltese banks which together accounted for around 92% of resident loans within the Maltese banking system.³

Loans to enterprises

Euro area

Across the euro area, developments in corporate lending during 2025 were characterised by a combination of tightening credit standards alongside generally easing terms and conditions (see Chart 2a). Sampled banks reported heightened perceived risks related to both the general economic environment and firm-specific outlooks, which weighed on their credit standards throughout the year. These concerns were closely associated with NPL ratios and related indicators exerting a persistent tightening influence. Heightened geopolitical uncertainty and changes in trade policies further dampened banks' risk tolerance and contributed to increased differentiation across sectors and firms when granting new loans. In this context, some banks reported intensified monitoring of more vulnerable corporate borrowers, notably exporters with high exposures to the United States. Banks mainly reported tighter standards for CRE, manufacturing (especially motor vehicles and energy-intensive industries), construction as well as wholesale and retail trade.

Chart 2a
EURO AREA CORPORATE LENDING POLICIES AND LOAN DEMAND
(+ indicates net tightening or net increase/- indicates net easing or net decrease)



Source: ECB Data Portal.
Note: Banks' expectations are for one quarter ahead.

¹ Prepared by Mr Shaun Zaffarese, Senior Analyst within the Financial Stability Surveillance and Risk Assessment Department. The author would like to thank Mr Christian Mamo, Principal Economist, Mr Andrew Spiteri, Deputy Head, and Ms Wendy Zammit, Head, within the same Department and Mr Alan Cassar, Chief Officer Financial Stability and Statistics Division, for their valuable suggestions.

² Lending policies consist of credit standards and terms and conditions. Credit standards refer to the banks' internal guidelines or loan approval criteria determined prior to the loan negotiation, including borrower characteristics such as income levels, age, and employment status used in credit scoring. Credit terms and conditions relate to specific features of the loan offered, including the interest rate, loan size, fees, collateral requirements, maturity, and other contractual conditions.

³ Domestic results are weighted according to the size of each participating bank's resident loan portfolio, with separate weights applied to corporate loans, mortgages, and consumer credit.

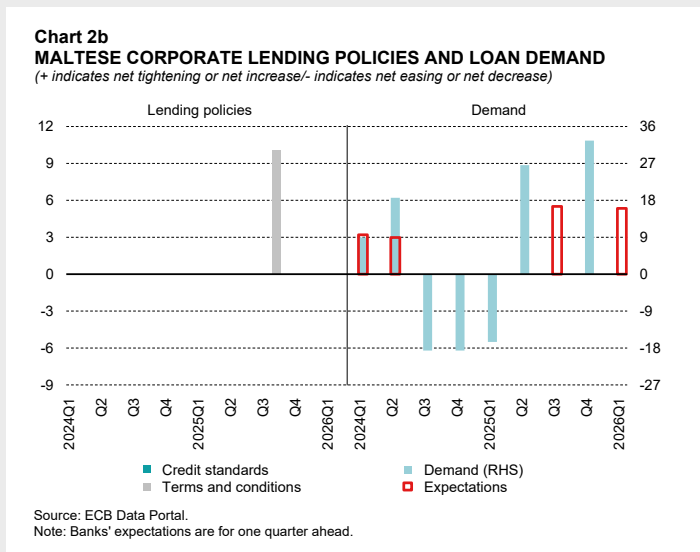
Despite this cautious stance, terms and conditions on euro area corporate loans eased during the first half of the year. This was primarily driven by lower benchmark interest rates, heightened competition, particularly from other banks, and improved access to market financing. From the beginning of the year until mid-June 2025, the ECB implemented four policy rate cuts which were transmitted to benchmark rates, contributing to lower lending rates and narrower margins on average loans. Together with ample liquidity and declining capital costs, these developments supported an overall easing of lending terms and conditions. However, some tightening was reported in the second half of the year, as euro area risk-free rates increased, reflecting heightened trade-related and geopolitical uncertainty, while risk perceptions and tolerance related to specific industry or firms deteriorated. As a result, banks reported some tightening in collateral requirements, credit limits, maturities and loan covenants.

Loan demand from euro area firms remained subdued, although it improved gradually over the course of the year (see Chart 2a). Early in the year, demand weakened despite more favourable terms and conditions, reflecting sufficient inventories and working capital buffers. As borrowing costs declined further in the second quarter, loan demand recovered modestly. Demand for corporate loans was also supported by increased needs for debt refinancing and restructuring amid weaker profitability and limited internal funds. However, elevated global uncertainty and trade tensions continued to weigh on firms' investment plans. By the end of the year, demand was increasingly driven by working capital, inventory needs and other financing needs, as well as mergers and acquisitions activity, while the supportive role of interest rate declines faded as borrowing costs broadly stabilised.

Looking ahead, surveyed euro area banks expected a further tightening of credit standards in the first quarter of 2026, reflecting ongoing uncertainty related to trade policies and their implications on risk tolerance and asset quality, while demand for corporate loans was projected to continue increasing on a net basis.

Malta

Against this euro area backdrop, developments in Malta remained comparatively stable, amid a more resilient sentiment amongst banks. Indeed, Maltese banks did not report heightened risks stemming from the general economic outlook or firm-specific conditions that would warrant tightening credit standards or lending terms for NFCs. Improved asset quality continued to support corporate lending policies with only one domestic BLS respondent reporting some uncertainty related to US trade policy developments, with overall risks perceived as mitigated due to diversified supply chains and limited direct exposures. As a result, credit standards and terms and conditions on corporate lending in Malta were reported to have remained largely unchanged during the year (see Chart 2b). The sole exception was a marginal net tightening of terms and conditions in the third quarter, attributable to



a single bank increasing its margins on average loans to both small and medium-sized enterprises (SMEs) and large firms. This tightening reflected higher capital costs and tighter liquidity conditions for that institution. The same bank also reported a tightening of non-interest charges following a review of processing and commitment fees. Looking ahead, Maltese banks were not foreseeing any changes to their corporate lending policies in the short term.

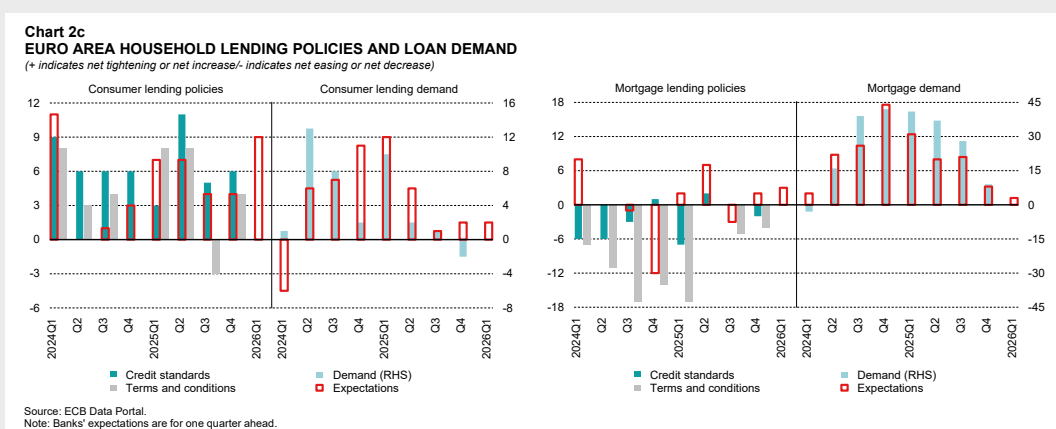
Sampled Maltese banks indicated that on balance, corporate loan demand declined in the first quarter of 2025, reflecting weaker fixed investment and reduced working capital needs. However, towards the end of the year, loan demand strengthened notably, driven by a rebound in fixed investment activity, increased working capital requirements, and the redemption of debt securities by a large firm. The rise in loan demand for fixed investment purposes was particularly evident in the transportation, wholesale and retail trade, scientific and health sectors, as well as in real estate activities. Beyond this, demand was expected to remain sustained.

Loans to households

Euro area

Survey respondents reported heterogeneous lending developments across euro area households. While lending policies for consumer credit and other household lending tightened, mortgage lending generally experienced an easing over the year (see Chart 2c).

For consumer credit, tighter lending policies were mainly driven by higher risk perceptions and lower risk tolerance related to concerns about borrowers' creditworthiness and the broader economic outlook. From the beginning of the year, euro area banks adopted a more cautious lending behaviour, driven by stricter assessments of borrower risk. This caution was reinforced by the higher perceived risk related to NPL ratios and other credit quality indicators. In practice, tighter lending policies were reflected in higher margins on riskier loans, reduced credit limits, shorter loan maturities, and stricter collateral requirements. Overall, this prudent approach outweighed the accommodative effect of lower lending rates observed earlier in the year. Towards the last quarter, as lending rates resumed their upward trajectory, the gap between margins on average and riskier loans widened further, suggesting increased discrimination by borrower risk profile and heightened risk aversion. Demand for consumer credit increased moderately in the first half of the year, supported by lower interest rates, marketing campaigns and stronger spending on durable goods, but weakened gradually thereafter amid falling consumer confidence (see Chart 2c).



In contrast, lending conditions for housing loans in the euro area generally eased in 2025, supported by intensified competition among banks. Terms and conditions eased strongly in the first quarter, driven mainly by lower lending rates and narrower margins on average loans, and to a lesser extent, on riskier loans. This easing quickly translated into a surge in mortgage demand, though the latter was also supported by improved housing market prospects and higher consumer confidence. As the year progressed, however, the decline in lending rates slowed, while the steepening of the euro area risk-free yield curve eventually led to higher mortgage rates in the last quarter, exerting a tightening influence. Notwithstanding this, overall mortgage terms and conditions continued to ease moderately, as competition continued to compress banks' margins, while demand continued to grow, albeit at a slower pace. Credit standards for housing loans also generally eased throughout the year, with only a small net tightening recorded in the second quarter of 2025 as some banks reassessed borrowers' creditworthiness amid rising macroeconomic risks.

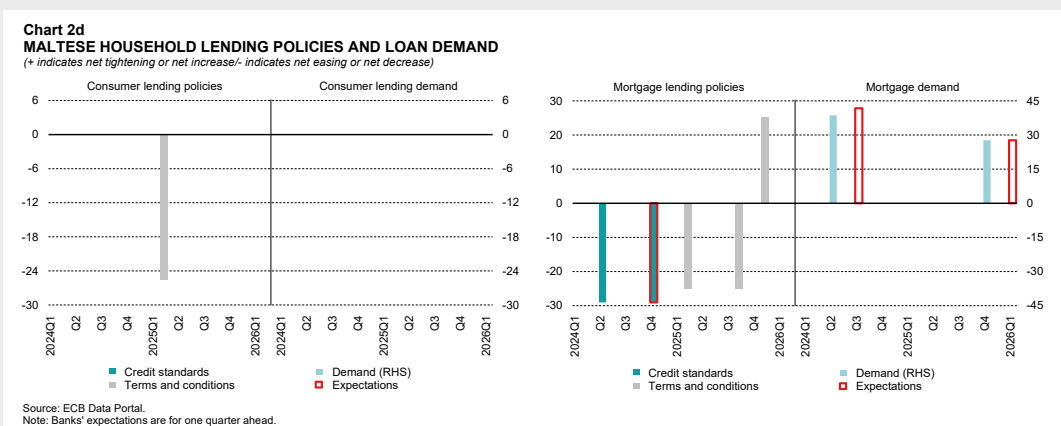
Looking ahead, surveyed euro area banks expected a net tightening of credit standards for households in the first quarter of 2026, particularly for consumer credit. Meanwhile, household credit demand, while still positive, was expected to grow at a slower pace.

Malta

Domestically, household lending policies remained broadly stable throughout 2025, with credit standards and lending conditions for both mortgages and consumer credit largely unchanged, reflecting the continued prudent stance of domestic banks supported by the presence of borrower-based macroprudential measures (see Chart 2d).⁴ This was particularly evident for consumer credit, where only a modest easing was observed in the first quarter of the year, driven by competitive pressures that resulted in slightly lower lending rates and narrower margins.

Mortgage lending policies displayed mixed dynamics over the year. Modest easing was reported in the first and third quarters, as competitive pressures led to lower lending rates, particularly through the introduction of targeted promotional offers linked to specific property values and energy performance criteria. Given the temporary nature of these offers, a mild tightening effect was however recorded in the final quarter of the year. Looking ahead, credit standards for overall household lending were anticipated to remain unchanged over the first quarter of 2026.

Household credit demand was reported to have remained broadly stable during 2025, remaining at elevated levels. The housing market remained resilient, with mortgage lending expanding at a solid



⁴ [Directive No. 16 Regulation on Borrower-Based Measures](#)

pace, supported by strong employment conditions, rising disposable income, and sustained tourism activity. At the same time, BLS results indicate that mortgage demand remained broadly unchanged on a quarter-on-quarter basis during most of the year, albeit at elevated levels. A net increase in mortgage demand was recorded in the last quarter. Similarly, demand for consumer credit remained broadly stable during the year at relatively high levels. This sustained level of demand continued to support steady growth in lending during 2025. The surveyed banks were not anticipating any significant changes in household credit demand in the first quarter of 2026, with growth expected to be sustained.

Additional insights on current conditions

Funding conditions

BLS results indicate that euro area banks experienced broadly stable access to retail funding in 2025, while access to market-based financing improved gradually over the year. The easing was most pronounced for debt securities and, to a lesser extent, for money markets and securitisations, with improvements particularly evident in medium to long-term funding. These developments were supported by favourable financial conditions, including narrowing credit spreads. For the first quarter of 2026, banks expected access to market financing to stabilise with only moderate further easing for debt securities.

In Malta, access to short-term deposits generally improved over the year, reflecting lower funding costs and reduced competitive pressures among banks. At the same time, the lack of new fixed-term deposits offerings by some of the surveyed banks resulted in a net decline in long-term retail funding, prompting a corresponding shift towards overnight deposits. These trends were expected to persist into the first quarter of 2026. With regards to wholesale funding, a net improvement was reported in the access to medium to long-term debt securities around mid-2025.

Climate-related risks and lending practices

Survey results point to euro area banks, including Maltese institutions, increasingly integrating climate-related risks into their lending practices. Banks reported greater differentiation between environmentally sustainable (green), transitioning and high-emission (brown) firms.^{5,6} In general, lending policies were eased for green and transitioning firms, while they were tightened for brown firms, reflecting both transition and physical climate risks. Correspondingly, loan demand shifted towards environmentally sustainable and transition-related financing, while weakening for high-emission sectors. Climate considerations also became more prominent in mortgage lending, with more favourable conditions for energy-efficient buildings and stricter terms for less energy-efficient properties. Overall, climate-related fiscal support measures contributed to easing lending conditions, supported by preferential lending rates for green projects or technologies, while banks continued to refine their risk assessment frameworks.

Looking ahead, these trends were expected to broadly continue, with Maltese surveyed banks also mentioning the possibility of higher LTV haircuts to properties exposed to high physical climate risk. At the euro area level, banks noted that uncertainty around future climate regulation may dampen firms' credit demand, while climate-related fiscal support is likely to underpin the ongoing shift towards greener lending.

⁵ "Green firms" – Firms that do not contribute or contribute little to climate change; "Firms in transition" – Firms in sectors that highly contribute to climate change, which are making relevant progress in the transition; "Brown firms" – Firms in sectors that highly contribute to climate change, which have not yet started or have so far made only little progress in the transition.

⁶ In Malta, exposure to brown firms was reported to be concentrated mainly in manufacturing, and mining and quarrying sectors.

Impact of monetary policy balance sheet normalisation

Surveyed euro area banks reported that the ongoing reduction in the ECB's monetary policy asset portfolio had a small negative impact on market financing conditions and liquidity positions in early 2025. This reflected a gradual tightening linked to the ongoing redemptions of Eurosystem bond holdings. However, banks' assets and overall profitability were reported to be largely unaffected, as banks maintained stable holdings of high-quality liquid assets (HQLA) and, in some cases, slightly increased sovereign bond holdings.

In Malta, surveyed banks similarly reported a modest net increase in their holdings of sovereign and high-quality bonds during 2025, contributing to a rise in total assets. This reallocation was linked to expectations regarding the future path of monetary policy, with banks seeking to lock in yields ahead of anticipated interest rate declines. Overall, these portfolio adjustments supported higher NII and improved capital positions, with these trends at the time expected to persist in the near term. Lending conditions and credit volumes remained broadly unchanged, while a further increase in euro area sovereign bond holdings was expected going forward.

Profitability and interest rate developments

Euro area banks participating in the survey reported that interest rate developments continued to weigh on net interest margins during 2025. However, the impact on lending volumes improved progressively, moving from slightly negative to positive. Despite some support from stronger loan volumes and fee income, overall profitability remained under pressure due to the persistent compression of margins, with banks expecting this challenge to continue in the near term.

In Malta, surveyed banks reported mixed developments with respect to profitability. Some banks reported trends similar to the euro area aggregate, with pressure from weaker non-interest income and narrower margins. Others, however, reported benefits from lower interest rates through reduced funding costs, resulting in a supportive impact on NII. Lending volumes provided some modest support, while the contribution from non-interest income was limited or negative. These developments were expected to persist over the short term.

Regulatory and supervisory environment

The surveyed banks generally acknowledged that regulatory and supervisory actions in 2025, including outcomes of the Supervisory Review and Evaluation Process (SREP), higher Pillar 2 Common Equity Tier 1 (CET1) requirements, macroprudential buffer increases, the implementation of Capital Requirements Regulation (CRR III), and the application of currency-specific liquidity buffers, contributed to stronger bank resilience across the euro area. Banks also reported increases in capital and liquid assets alongside declines in RWAs. This more cautious environment reinforced conservative lending behaviour and contributed to the tightening of credit standards across all loan categories. Banks are also expecting a tightening regulatory impact in 2026, as well as higher capital, liquid assets and RWAs.

In Malta, the surveyed banks stated that CRR III implementation also contributed to a net increase in capital levels, supported by retained earnings and capital issuance. These developments were accompanied by increases in risk-weighted and liquid assets. At the same time, the revised regulatory framework encouraged a more cautious approach to risk-taking, particularly with respect to higher-risk or speculative lending activities.

Conclusion

During 2025, banks across both the euro area and at a national level indicated generally supportive funding conditions, strengthened capital positions following regulatory and supervisory actions, and a growing integration of climate-related considerations into lending practices. Nevertheless, the BLS replies still pointed to a divergence between the euro area and Maltese lending developments.

Overall, while euro area banks navigated a more cautious and tightening credit environment amid heightened external risks, Malta stood out for its relative stability and more muted response to these external shocks. Indeed, in the euro area, lending developments were shaped by elevated uncertainty, which weighed on banks' risk perceptions and led to a tightening of credit standards, especially for corporate and consumer loans. This occurred despite some easing in lending terms and conditions earlier in the year, driven by lower interest rates and competitive pressures. Loan demand remained relatively weak and volatile, constrained by GPRs, trade-related uncertainty and subdued investment activity, although it showed gradual improvement as the year progressed. By contrast, Malta's banking sector experienced a more stable macroeconomic environment. Credit standards and lending conditions remained largely unchanged across both firms and households, reflecting more benign risk perceptions, supportive credit quality indicators, and resilient domestic environment fundamentals. While corporate loan demand weakened initially, it recovered later in the year, supported by renewed investment activity. Household credit demand remained broadly stable at elevated levels, supported by a resilient housing market and favourable labour market conditions.

Looking ahead to 2026, downside risks persist, particularly in the euro area, where geopolitical uncertainty, trade tensions and interest rate uncertainty may continue to weigh on credit conditions. In Malta, while resilience remains, risks may stem from external spillovers and the growing role of climate-related risks affecting collateral values.

2.2 Non-core domestic banks

Monetary policy easing and the associated interest rate cuts by non-core domestic banks contributed to a decline in deposits held with these institutions. In parallel, Eurosystem placements fell by 12.7%, although they still accounted for slightly more than one quarter of these banks' assets. Banks' overall securities portfolios also decreased, mainly reflecting lower holdings of government paper, while customer lending contracted only marginally and continued to represent a core pillar of these banks' business model. From a financial performance perspective, profitability remained supported by contributions from non-interest income and the marked reduction in impairment charges. However, these were more than offset by lower NII and higher expenses, leading to an overall decline in profitability. Credit quality stayed strong amid low NPEs. Liquidity buffers also remained ample, with regulatory ratios staying well above minimum requirements despite some easing over the year. Against this backdrop, the balance sheet contracted further, declining by 5.0% and standing at 13.0% of GDP.

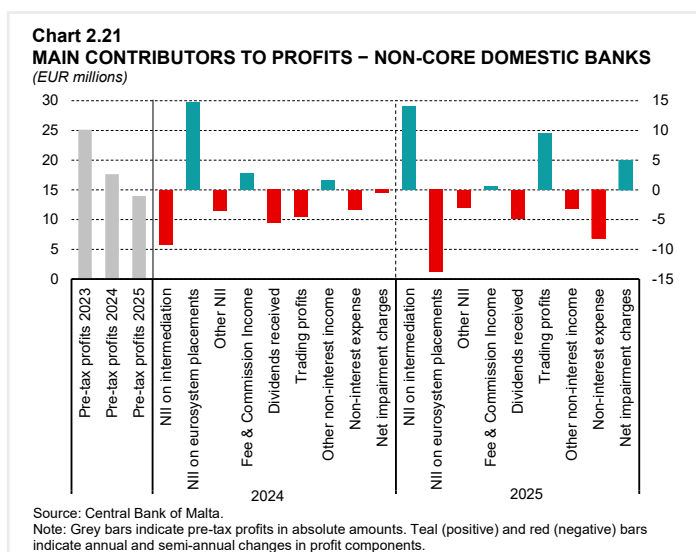
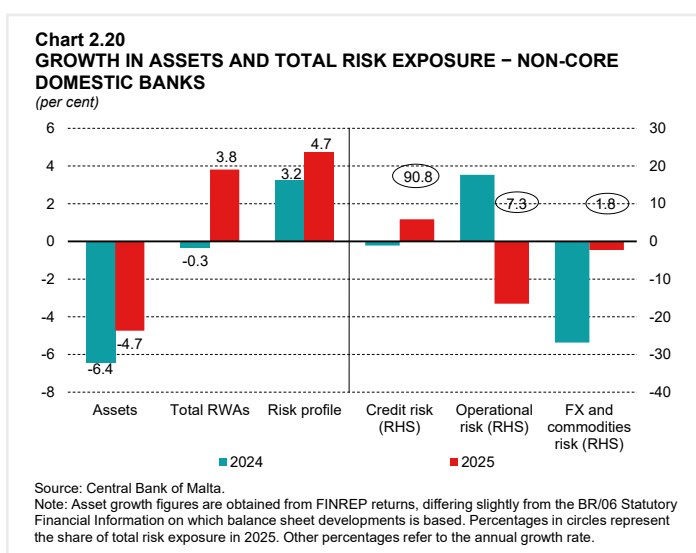
2.2.1 Capital and leverage

The capital position of the non-core domestic banks continued on a downward trajectory, although it remained robust overall. At year-end, the total capital ratio and Tier 1 capital ratio stood at 22.0% and 19.8%, respectively, down from 23.2% and 22.1% in 2024. The decline was attributed to a 3.8% increase in RWA and a 1.5% decline in total own funds, the latter exclusively driven by lower Tier 1 capital. The leverage ratio fell marginally to 10.4%, yet it remained comfortably above the minimum regulatory requirement, indicating continued resilience despite the weakening capital metrics.

The surge in RWA was predominantly driven by credit risk-related exposure, which expanded by 5.9% to account for almost 91% of the overall RWA (see Chart 2.20). Meanwhile, RWA linked to operational risk and foreign exchange risks fell, representing 7.3% and 1.8% of total RWA, respectively. Additionally, the risk profile of these banks deteriorated as the sustained drop in assets coincided with the increase in RWA. This pushed the ratio of RWA to overall assets higher, from 52.8% in 2024 to 57.5% in 2025.

2.2.2 Profitability

For the second consecutive year, non-core domestic banks' pre-tax profitability declined further by nearly 21% (see Chart 2.21). Consequently, their post-tax ROE and ROA weakened by 2.8 and 0.3 percentage points to 1.5% and 0.2%, respectively.

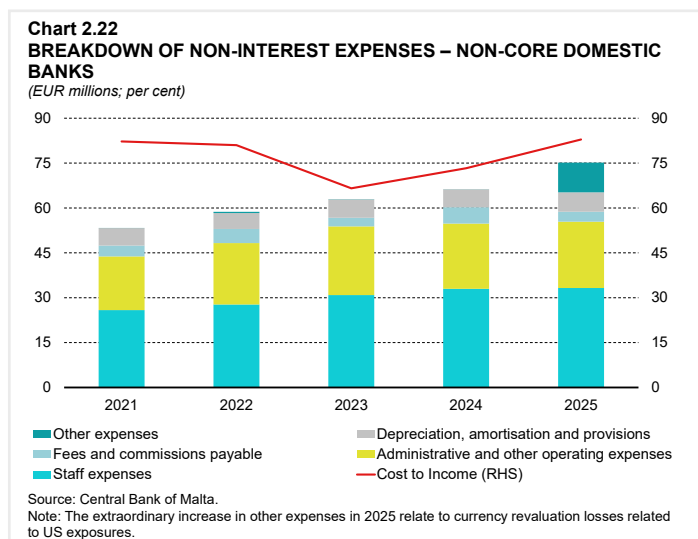


A key contributor to this decline was the reduction in NII, which decreased by 4.3% and accounted for 68.5% of overall gross income. This was primarily driven by lower NII on Eurosystem placements, which fell sharply by around 42%, reflecting both the lower deposit facility rates and reduced volumes of placements. Other NII also retreated by nearly 30%, mainly due to lower government bond holdings.

In contrast, NII from intermediation activities rose by two-thirds, accounting for more than half of total NII. This increase was driven by a faster decline in interest expenses payable on deposits, relative to the drop in interest income on loans. These developments are consistent with the easing monetary policy stance, which has alleviated funding cost pressure.

Non-interest income also contributed positively to these banks' profitability, as trading losses recorded in 2024 shifted to gains in 2025 on account of gains on the disposal of financial assets. Fees and commission income also increased modestly, further underpinning revenues. However, these improvements were partly offset by lower dividends received and reduced earnings from other non-interest sources. Net impairment charges dropped by a substantial 83.2%, reducing their share of gross income by 5.5 percentage points, to just 1.1%.

Meanwhile, profitability was further constrained by a 12.3% increase in non-interest expenses, driven primarily by currency revaluation losses related to US exposures (see Chart 2.22 – classified as 'other expenses'). Higher administrative and other operating costs, and to a lower extent rising staff expenses, also contributed to higher non-interest expenses. Consequently, the combined effect of higher operating expenditure and lower gross income pushed the cost-to-income ratio up by 9.6 percentage points to 82.9% by the end of 2025. This is significantly above the EU average of 53.3%, signalling potential concerns about operational efficiency in this segment.⁷



2.2.3 Credit dynamics

Customer loans granted by the non-core domestic banks declined marginally, but at 39.9% they continued to account for a substantial share of their total assets. The decline was entirely driven by a 1.4% decrease in non-resident customer loans, representing 44.7% of the overall customer loan book. This reduction stemmed exclusively from lower credit to foreign NFCs, which fell by around 15%, primarily reflecting lower lending to the professional, scientific and technical activities sector, as well as the wholesale and retail trade sector (see Chart 2.23). In contrast, lending to foreign non-bank financial entities increased by 7.5%, further strengthening their importance within the non-resident segment, to account for 66% of the non-resident customer loan portfolio. Meanwhile, loans to foreign households remained broadly unchanged and continued to represent a negligible share of the overall portfolio.

Resident customer loans grew by just under 1%, driven exclusively by higher credit to NFCs, particularly those operating in the construction and real estate sectors (see Chart 2.23). As a result, the share of NFC loans increased to 70.3% of the resident customer loan book. In contrast, lending to resident

⁷ See footnote 2.

households contracted by 11.5%, reducing their share to just under one-fifth of resident customer loans. This decline was largely driven by one bank in the domestic consumer credit market. In addition, credit extended to resident non-bank financial entities fell by around 11%, bringing their share of the resident customer loan book to 10.6%.

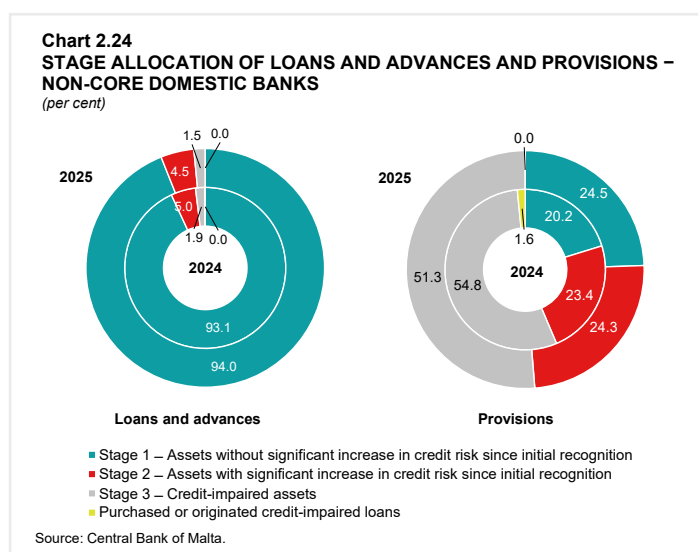
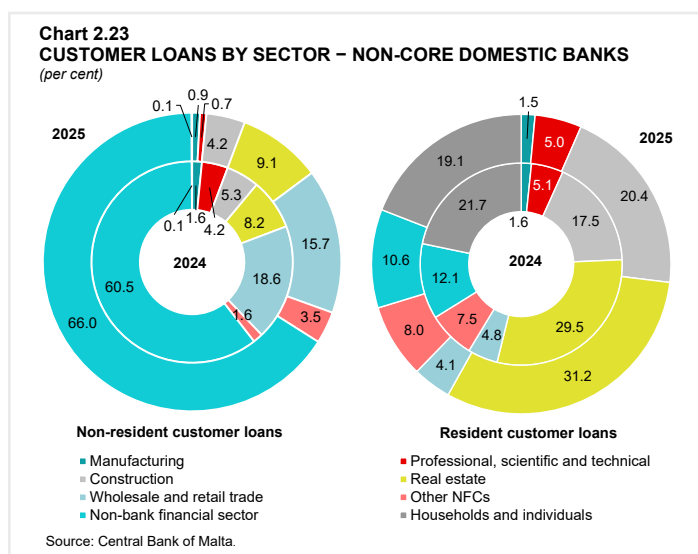
2.2.4 Credit quality

The challenging global macroeconomic environment did not lead to a deterioration in credit quality. Instead, non-core domestic banks' NPL ratio improved by 0.2 percentage points to 0.9%, as the stock of NPLs declined by 20.6%, outpacing the reduction in total outstanding loans and advances. This improvement was even more pronounced when excluding placements with the Central Bank of Malta, with the NPL ratio falling to 1.6% in 2025 from 2.0% in 2024.

The decline in NPLs was primarily driven by lower impairments among NFCs, particularly within the non-resident construction and manufacturing sectors, as well as resident firms operating in the accommodation and food and services activities, and in the real estate sectors. Consequently, the overall NFC NPL ratio decreased by 0.5 percentage points to 2.7%. Asset quality within the household segment also strengthened further, with the household NPL ratio declining from 0.8% in 2024 to 0.5% in 2025, supported by lower impairments on both mortgages and consumer credit. This improvement is consistent with a reduction in Stage 3 loans, which fell by nearly 20% to account for just 1.5% of overall loans and advances. At the same time, Stage 2 loans decreased by around 9%, particularly from NFC exposures, reducing their share to 4.5% of overall loans (see Chart 2.24). Consequently, the relative share of Stage 1 loans within the total loan portfolio increased.

The decline in NPLs led to a reduction in provisions, driven primarily by lower Stage 3 provisions, which nevertheless continued to account for just over half of the overall provisions. Stage 2 provisions decreased, while Stage 1 provisions increased in line with the growth in performing exposures. However, because the drop in NPLs exceeded the decline in provisions, the overall coverage ratio improved by 5.8 percentage points, reaching 77.0% in 2025.

Meanwhile, the forbearance ratio edged up marginally to 1.6%, driven entirely by an increase in performing

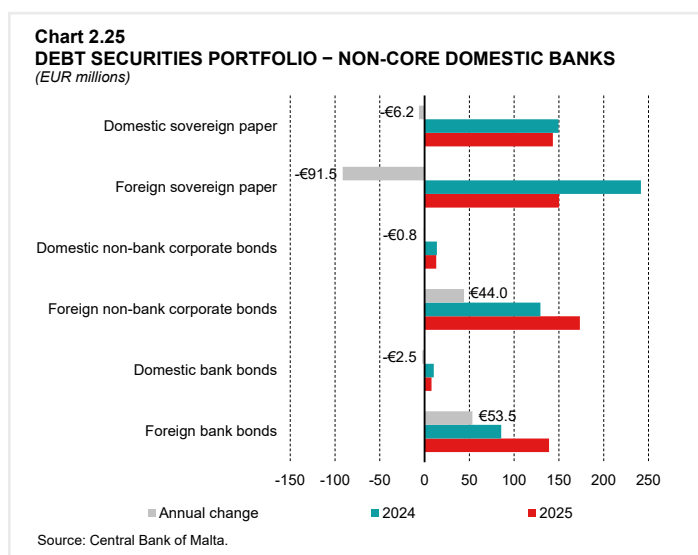


exposures with forbearance measures, which accounted for 72.6% of all forbore loans, as otherwise non-performing exposures with forbore measures fell.

2.2.5 Securities portfolio

The non-core domestic banks' overall securities portfolio declined by 3.0%, reflecting reductions in both equity and fixed-debt securities, to represent 25.0% of overall assets. Equity holdings declined further by 11.0%, to account for 21.4% of the overall securities portfolio. This drop was driven mainly by a decrease in direct equity investments in subsidiaries by one bank, which represents 95% of the overall equity exposures. The remaining holdings consisted largely of positions in non-money market investment funds.

At the same time, the overall decline in debt securities holdings was more contained, at 0.6%, though notable shifts occurred within the portfolio composition. The contraction was driven primarily by a significant reduction in sovereign paper holdings, which fell by one-quarter, largely reflecting lower exposures to foreign sovereign debt (see Chart 2.25). This was entirely attributable to developments at one bank related to its holdings of Luxembourg and United States sovereign paper. Domestic sovereign exposure also declined, though more moderately, by 4.2%. Taken together, these developments reduced the share of sovereign paper within overall debt securities by 15.2 percentage points to around 47%. In contrast, holdings of bank and corporate bonds expanded markedly by 53.3% and 30.1%, respectively, increasing their shares to 23.4% and 29.7% of total debt securities holdings. While these increases partly reflected offsetting portfolio rebalancing by the same bank referred to above, they were also driven by increases in holdings by other banks.



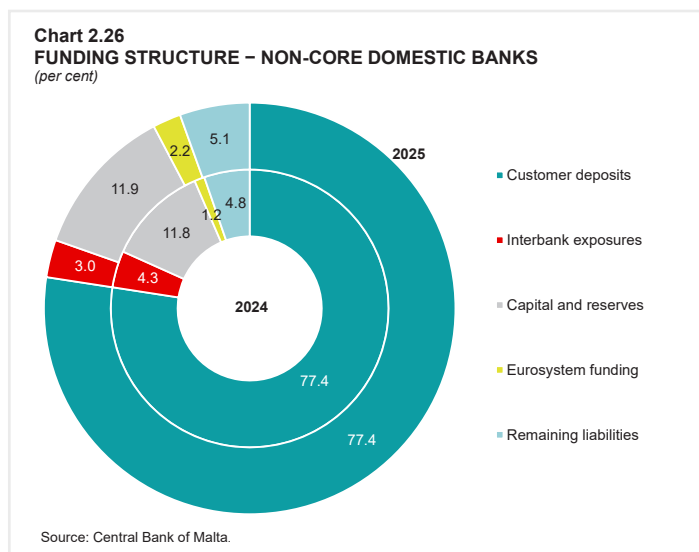
These shifts led to a decline of around 34% in the share of high-rated debt securities, lowering their contributions to total securities by 13.5 percentage points to 27.2%. Nevertheless, an increase in medium-rated holdings partly offset this drop, with the overall portfolio remaining predominantly invested in high and medium-rated bonds, which together accounted for 79.0% of total debt securities. Furthermore, the share of low-rated bonds decreased to 5.0% of the overall securities. However, unrated and speculative bonds increased significantly, largely as one bank increased its holdings in non-resident bonds issued by UK investment companies. This led to a 12.5 percentage points rise in the share of speculative and unrated to the overall securities, to 16.0%. Notwithstanding, this group of banks did not report any non-performing securities (NPS) by the end of 2025.

2.2.6 Funding and liquidity

The contraction in these banks' balance sheet is consistent with a 5.0% reduction in customer deposits. Nonetheless, deposits remained the primary funding source, financing approximately 77% of their assets (see Chart 2.26). The decrease in deposits was entirely driven by non-resident customers, whose balances fell by around 15%, largely due to outflows from non-bank financial entities, which comprise 31.4% of overall customer deposits. Further declines were observed among non-resident private NFCs and households, which represented nearly 6% and 27% of total retail funding, respectively. These outflows partly reflect the

drop in deposit rates by non-core domestic banks.

Conversely, resident customer deposits grew strongly, up by 19.4%, increasing their share of total customer deposits by 7.4 percentage points to around 36%. This growth was mainly driven by higher inflows from non-bank financial entities and households, with the latter accounting for around 56% of resident customer deposits held with these banks. These inflows occurred as deposit rates, despite having declined, remained relatively competitive compared with those offered by core domestic banks. The increase in resident deposits was mainly concentrated in savings accounts, indicating a preference for liquidity. Concurrently, time-deposits also rose, though at a more moderate pace.

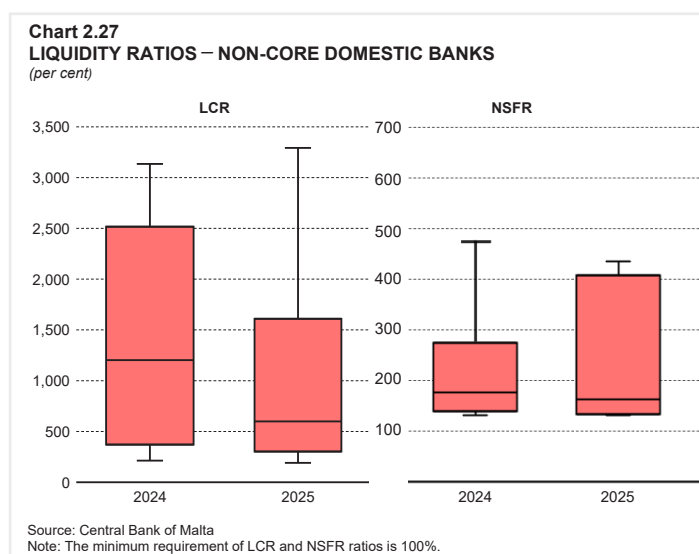


Interbank funding declined by more than a third, financing just 3.0% of total assets. Capital and reserves also fell, but remained an important source of financing, accounting for almost 12% of total assets. In contrast, Eurosystem funding rose substantially by year-end, reflecting higher participation in the main refinancing operations, three-month longer-term refinancing operations (LTROs), and USD operations. As a result, Eurosystem funding financed 2.2% of overall assets by the end of 2025.

The liquidity position of the non-core domestic banks weakened over the year and was particularly reflected in a lower LCR, which declined by 51.1 percentage points to 387.2%. Despite this drop, the ratio remained substantially above the regulatory minimum, with the lowest ratio among these banks still at a supportive 190.8% (see Chart 2.27). This decrease was driven by lower holdings of liquid assets, particularly central bank assets and government securities. The NSFR also declined, falling by 8.2 percentage points to 172.7%, with ratios ranging between 131.1% and 434.5%. Nevertheless, it too remained above regulatory requirements, signalling continued resilience in longer-term funding structures.

2.2.7 Risk outlook

The risk profile of non-core domestic banks is expected to remain elevated over the coming year, shaped by the contraction in their balance sheet and the sustained pressures on profitability. The reduction in Eurosystem placements and lower securities holdings will continue to weigh on core income streams, particularly in an environment characterised by lower interest rate



stance. At the same time, structurally high operating costs and rising cost-to-income ratios suggest that earnings may remain constrained unless these banks implement measures aimed at improving efficiency or broadening their non-interest revenue sources.

Looking ahead, GPRs are likely to play a more prominent role, given these banks' meaningful exposure to cross-border activities. The involvement of some of these banks in regions that are more susceptible to geopolitical tensions, such as parts of the Middle East and North Africa (MENA) region, could heighten vulnerabilities through potential disruptions in non-interest income, and foreign NFC credit exposures. This reinforces the need for close monitoring of their cross-border activities, particularly in markets where volatility, sanctions risk, and policy uncertainty remain elevated.

Despite profitability pressures, current asset quality remained robust, with low NPL ratios, declining Stage 2 exposures and stronger coverage ratios. However, concentration risks, both in foreign sectors and increasingly in the domestic construction and real estate markets, could amplify credit risk should economic conditions weaken or geopolitical uncertainty intensifies. The shift in their funding structures away from non-resident deposits towards resident on-demand deposits helped cushion profitability pressures but may continue to influence balance sheet composition. The decline in liquid asset holdings has somewhat weakened liquidity metrics, and further adjustments in portfolio structures may continue to place pressure on their liquidity buffers, underscoring the need for continued vigilance. However, both the LCR and NSFR remain comfortably above regulatory minima, which together with the strong capital buffers signal continued resilience.

BOX 3: SYSTEMIC RISK PERCEPTIONS OF MALTESE BANKS (H1 2026 SURVEY)¹

The Central Bank of Malta conducted its first edition of the SRPS among 11 domestic banks.² The survey was conducted between April and May 2026, with responses provided primarily by Chief Risk Officers and other senior risk professionals operating in the Maltese banking sector. The survey captures both quantitative and qualitative assessments of key risks affecting the banking sector, as well as forward-looking views on vulnerabilities and profitability. Results are presented on an unweighted basis, with each responding institution assigned equal weight.

Perceptions on the current risk environment

Survey results indicate that banks' risk perceptions are increasingly shaped by operational and external factors, rather than traditional balance sheet risks (see Chart 3a). Cybersecurity and operational factors were the top risks identified by almost two-thirds of banks. Respondents highlighted the increasing sophistication of cyber threats, reliance on third-party infrastructure, and the potentially severe operational and reputational consequences of a major incident.

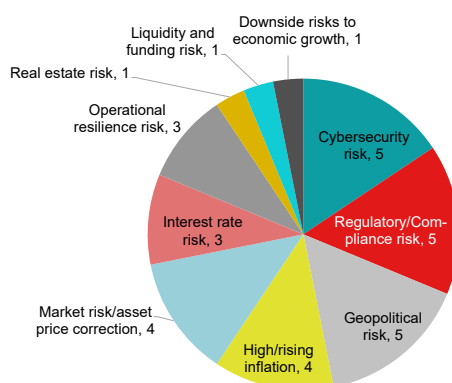
Regulatory and compliance risks were cited by just under half of the banks, reflecting the continued expansion in supervisory expectations, reporting requirements, and capital constraints. Several institutions emphasised the growing operational burden and resource intensity associated with compliance.

GPRs were reported by five out of 11 banks, primarily due to their indirect macro-financial effects, including weaker external demand, supply chain disruptions, and financial market volatility. In this context, inflationary pressures (four banks), market risks (four banks) and interest rate risks (three banks) were also highlighted as key transmission channels affecting borrowers' affordability, funding conditions, and asset valuations.

More traditional risks such as real estate and liquidity risk were generally of secondary importance in banks' current risk assessments. Downside risks to growth were also sparsely mentioned. Overall, results point to a risk environment increasingly driven by external macro-financial shocks and rising operational complexity.

Consistent with these findings, almost two-thirds of banks reported no major concerns regarding systemic risk in the domestic banking sector. However,

Chart 3a
WHICH THREE RISKS DO YOU EXPECT WILL POSE THE GREATEST THREAT TO YOUR INSTITUTION TODAY?
(count)



Source: Central Bank of Malta.

¹ Authored by Mr Andrew Spiteri, Deputy Head within the Financial Stability Surveillance and Risk Assessment Department. The author would like to thank Ms Wendy Zammit, Mr Alan Cassar, Deputy Governors Oliver Bonello and Rita Schembri, and Governor Alexander Demarco for their valuable suggestions. Special thanks are also extended to the survey respondents.

² The banks surveyed consist of the six core domestic banks and five of the non-core domestic banks.

36% of banks identified a moderate build-up of systemic risk, citing factors such as macroeconomic uncertainty, sectoral concentration, notably in real estate, and external shocks. This suggests that, while the banking system is perceived as broadly resilient, vulnerabilities remain in specific areas, warranting continued monitoring.

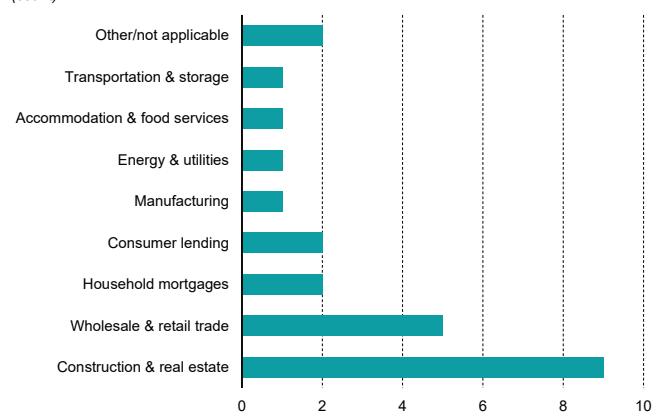
Sectoral sources of credit risk

Credit risk perceptions are strongly concentrated in the construction and real estate sector, which was identified by around four-fifths of banks as one of the most vulnerable sectors (see Chart 3b). This reflects both the significant exposure of banks to property-related lending and concerns regarding sensitivity to interest rate increases, costs escalation, and potential corrections in property valuations. The next most common sector identified was the wholesale and retail trade sector (five banks), reflecting pressures from subdued consumption and structural shifts. Household lending was selected by three banks, including mortgages and consumer credit, which were seen as particularly vulnerable to potential rising debt-servicing costs, especially among the more vulnerable borrower segments and in specific cases such as separations. Additional sector-specific risks (such as commodities or energy) were mentioned by individual banks, typically reflecting business model specialisation.

Evolution of risk over the past 12 months

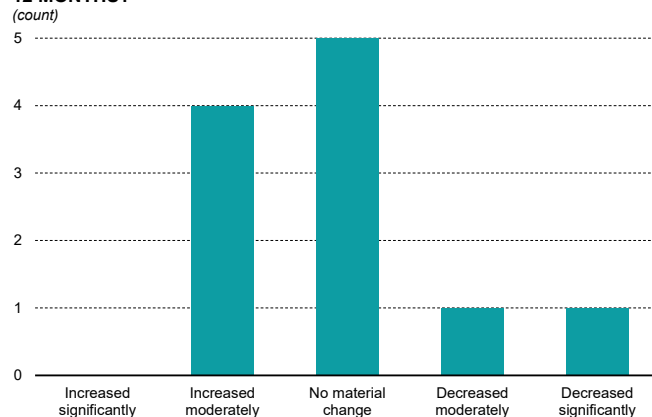
Almost half of the banks (five out of 11 banks) reported no material change in their overall risk profile over the past year (see Chart 3c). At the same time, four banks indicated a moderate increase in risk, often associated with balance sheet expansion, digital transformation, or adverse external developments. Two banks reported a decrease in risk exposure, reflecting their de-risking strategies.

Chart 3b
WHICH SECTORS POSE THE GREATEST CREDIT RISK TO YOUR INSTITUTION OVER THE NEXT 12 MONTHS?
(count)



Source: Central Bank of Malta.

Chart 3c
THINKING ABOUT YOUR INSTITUTION'S AGGREGATE RISK PROFILE, HOW HAS YOUR OVERALL RISK EXPOSURE CHANGED IN THE PAST 12 MONTHS?
(count)



Source: Central Bank of Malta.

Emerging and rapidly evolving risks over the medium term

Looking ahead, banks expect structural and technology-driven risks to play an increasingly important role. Cybersecurity risks and operational resilience were identified as a key and intensifying concern by almost all respondents, underscoring their systemic relevance and expected persistence (see Chart 3d).

In addition, banks identified a range of related technology-driven risks, including AI-related risks (four banks), reflecting growing awareness of model risk, governance challenges, and data integrity concerns, as well as third-party and technology provider risk (three banks), pointing to increasing reliance on external service providers.

Regulatory and compliance risks were cited by around four-fifths of banks, reflecting expectations of continued regulatory tightening and increasing complexity, as well as the associated operational and resource burden on institutions. Meanwhile, climate-related risks were mentioned only by one bank, suggesting that these remain less immediate relative to other emerging vulnerabilities.

Profitability outlook

Banks' profitability expectations for the next 12 months are generally stable to moderately positive. Slightly less than half expect a broadly unchanged ROA. Meanwhile, four banks anticipate an increase in profitability, including two banks expecting increases of above 10 basis points, while two banks expect a decline in profitability, including one anticipating a pronounced reduction.

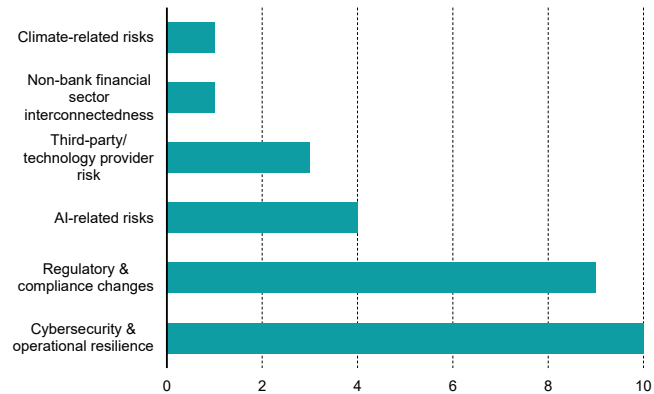
Respondents identified a number of negative factors, such as lower market interest rates, higher funding costs and rising operating expenses. At the same time, supportive factors include balance sheet growth, cost containment, digitalisation, and the expansion of fee-based income. Overall, profitability is expected to remain resilient, albeit subject to potential margin compression and rising cost pressures.

Conclusion

The survey results suggest that the risk landscape for Maltese banks is increasingly shaped by external, operational, and structural factors, with cybersecurity and operational resilience emerging as the most prominent concerns, alongside regulatory and compliance changes. Geopolitical developments continue to be viewed mainly through their macro-financial effects, including related inflationary pressures, market risks, and interest rate risks.

At the same time, more traditional vulnerabilities remain concentrated in specific areas, particularly in the construction and real estate sectors reflecting banks' significant exposure. Notwithstanding, overall risk levels are perceived as broadly stable.

Chart 3d
WHICH EMERGING OR RAPIDLY EVOLVING RISKS ARE MOST CONCERNING FOR YOUR INSTITUTION OVER THE NEXT THREE YEARS?
(count)



Source: Central Bank of Malta.

Looking ahead, the growing importance of technology-driven and system-wide risks, including AI-related challenges and dependence on third-party service providers, highlight the need for continued adaptation of risk management frameworks and supervisory approaches. This underscores the importance for continued vigilance and further strengthening of risk management frameworks, particularly in the areas of operational risk and sectoral concentration, consistent with the Bank's macroprudential policy stance aimed at addressing sectoral vulnerabilities.

2.3 International banks

The balance sheet of international banks' contracted by 12.3% to represent 46.4% of GDP. This reduction was driven entirely by the branches of foreign banks, whose assets shrank by 20.4%, largely due to lower holdings of foreign government securities. This development in part reverses the expansion reported in 2024. In contrast, non-branches continued to grow, with their total assets increasing by 14.6%, fuelled primarily by increased lending activity. Profitability strengthened markedly in 2025, shifting back into profit, with the turnaround driven mainly by the branches, while non-branches continued to record solid earnings despite some margin compression.

The business model of the international banks remained largely oriented towards non-residents, with resident assets accounting for just over one-fifth of total assets, largely in the form of Central Bank of Malta placements. Liquidity conditions differed across business models. Non-branches maintained comfortable regulatory liquidity buffers, whereas branches continued to rely more heavily on wholesale funding. Asset quality improved marginally, with a slightly lower NPL ratio supported by loan growth, although rising Stage 2 exposures point to some early signs of credit-risk migration.

2.3.1 Capital and leverage

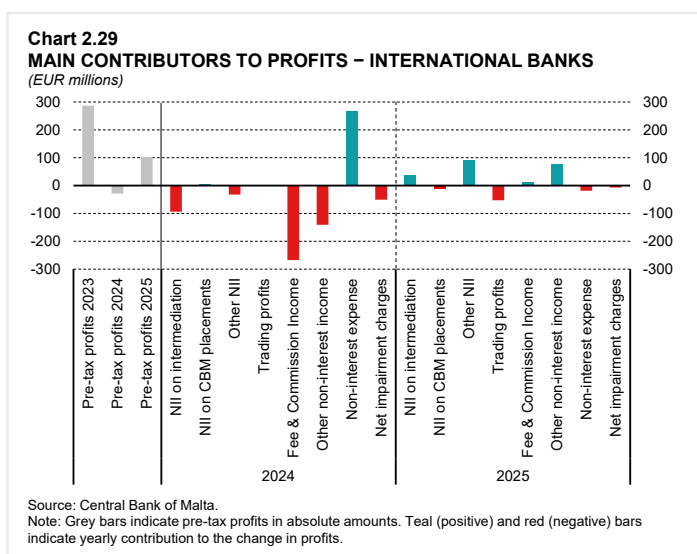
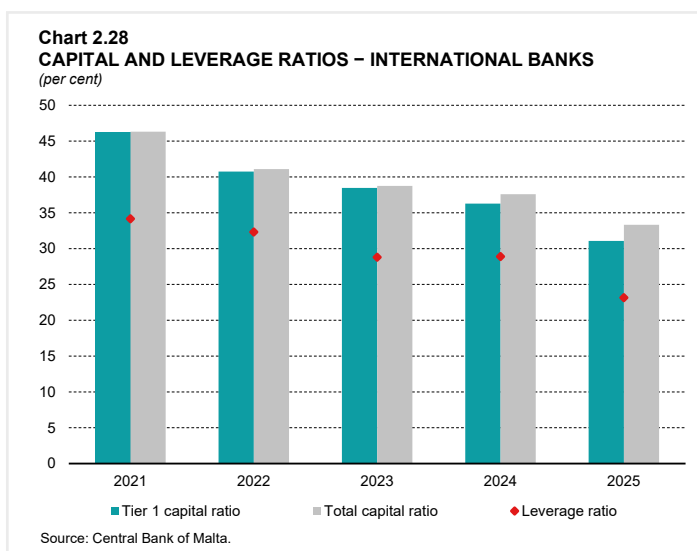
The capital position of the subsidiaries and stand-alone banks remained sound, with the total capital ratio and the Tier 1 capital ratio standing at 33.3% and 31.1%, respectively, notwithstanding the declines relative to 2024 (see Chart 2.28).

This decline was driven solely by a 21.5% increase in RWA, which outpaced the 4.1% growth in total own funds. The rise in RWA was primarily attributable to a 37.7% increase in credit-risk exposures, which accounted for 73.0% of total RWA in 2025. RWA for market risk also rose, more than doubling compared with 2024, and represented 19.0% of total RWA among non-branches. In contrast, RWA for operational risks dropped by almost 60%. Collectively, these developments raised the overall risk profile of the non-branches, with the ratio of RWA to total assets increasing by 4.0 percentage points to 76.0%.

Meanwhile, the leverage ratio for the non-branches declined by 5.7 percentage points relative to 2024, but remained comfortably strong, standing at 23.1%.

2.3.2 Profitability

The financial performance of international banks strengthened in 2025, shifting from a pre-tax loss of almost €30 million in 2024 to a pre-tax profit exceeding €100 million in 2025 (see Chart 2.29).



Consequently, the overall post-tax ROA improved from -0.3% to 0.9%. This turnaround was largely driven by the branches of foreign banks and was supported by stronger operational income. Their post-tax ROA recovered to 0.4% from a negative 1.1% in 2024. Non-branches also saw an increase in their pre-tax profits, up by 8.0%, mainly reflecting stronger net fee and commission income. However, this increase fell short of the balance sheet growth, leaving their post-tax ROE unchanged at 8.7%, while their post-tax ROA narrowed by 0.2 percentage points to 2.1%.

Across all international banks, the strongest contribution to the improvement in profitability stemmed from higher NII, which rose by 82.4%. This increase boosted NII's share of gross income by 2.8 percentage points to 72.6%. The main driver was the sharp decline in interest expenses on repurchase agreements within the branches, which more than offset the weaker interest income earned on government securities. As a result, NII from non-intermediation activities improved significantly.

NII from intermediation activities also increased by around a third, reflecting lower funding costs on branches' interbank placements, as otherwise income generated on the assets declined. Overall growth in NII was driven entirely by the branches, as non-branches reported a 2.9% drop in NII due to lower interest income from their lending portfolios.

Non-interest income went up by 58.7%, mainly reflecting lower FX valuation losses by one branch of foreign bank. In addition, fee and commission income rose by 17%, entirely attributable to the non-branches. In contrast, trading profits more than halved over the year, reflecting lower, albeit still positive, fair value (FV) gains on financial instruments.

Meanwhile, non-interest expenses rose by 12.8%, owing to higher staff and administrative costs, particularly among the non-branches. Non-interest expenses of branches also rose but at a more modest rate. Despite the increase in operating expenses, the stronger growth in operating income resulted in improved cost efficiency across international banks, with the cost-to-income ratio improving markedly from almost 70% in 2024, to 45.0% in 2025, placing it below the EU average.

Net impairment charges rose by 7.4%, reflecting higher charges booked by non-branches, as well as fewer impairment reversals among foreign bank branches.

2.3.3 Credit dynamics

The customer loan portfolio of international banks, composed almost entirely of non-resident loans, grew by 10.8%, with the share in total assets increasing by 8.0 percentage points to 38.5%.⁸ This growth was driven primarily by the non-branches, which reported an increase of nearly 24%, supported by higher lending to households and non-bank financial entities, and to a lower extent, to NFCs. Lending by the branches also rose, though at a slower rate of 1.5%, driven exclusively by higher NFC lending.

Loans to households, composed entirely of non-resident consumer credit by the non-branches, rose by more than one-quarter, to 18.4% of overall customer loans. This was followed by growth in NFC lending, which rose by 5.3%, supported by both branches and non-branches. Despite the increase, NFC loans' share of total customer loans declined by 3.6 percentage points, though it remained substantial at 69.0%. At a sectoral level, the growth in NFC lending stemmed mainly from higher lending to non-resident firms operating in the energy, construction and real estate sectors, which were partly offset by a significant contraction in lending to the transportation and storage sector (see Chart 2.30). Loans to non-bank financial entities also increased markedly, up by more than a quarter compared with 2024, exclusively driven by the non-branches.

Interbank placements rose by more than a half, with their share in total assets rising from 4.7% to 8.2%. This expansion was entirely driven by a significant increase in intragroup placements by branches. As a result, the composition of the interbank deals shifted markedly, with intragroup placements now accounting for almost

⁸ Resident customer loans remained marginal, accounting for only 0.5% of total customer loans. They declined by 5.4%, reflecting mainly lower lending to NFCs and, to a lesser extent, households.

half of the overall interbank placements, up from just 8.7% in 2024. In contrast, placements with unrelated credit institutions declined by 15.3%. This change ensured that available liquidity was preserved within the respective banking group.

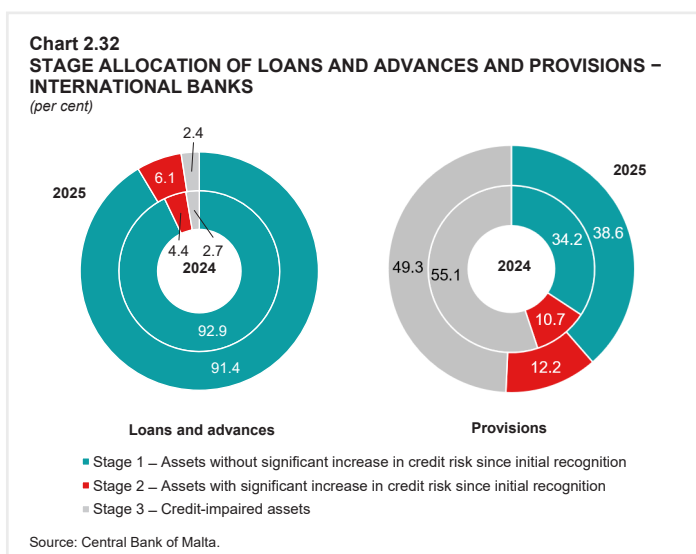
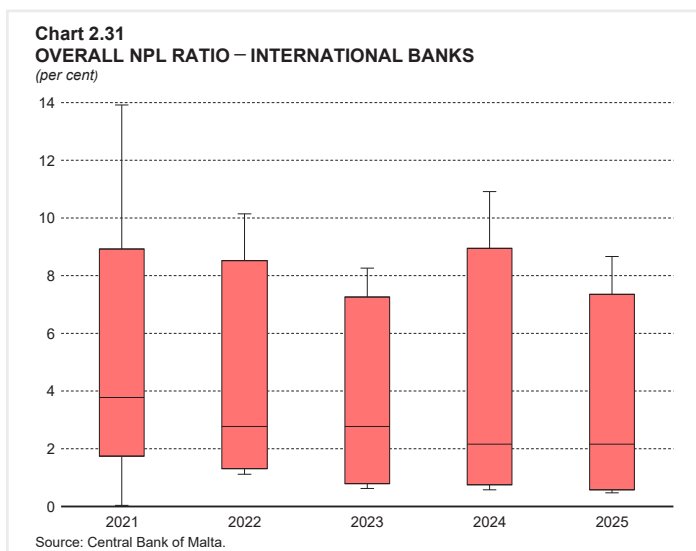
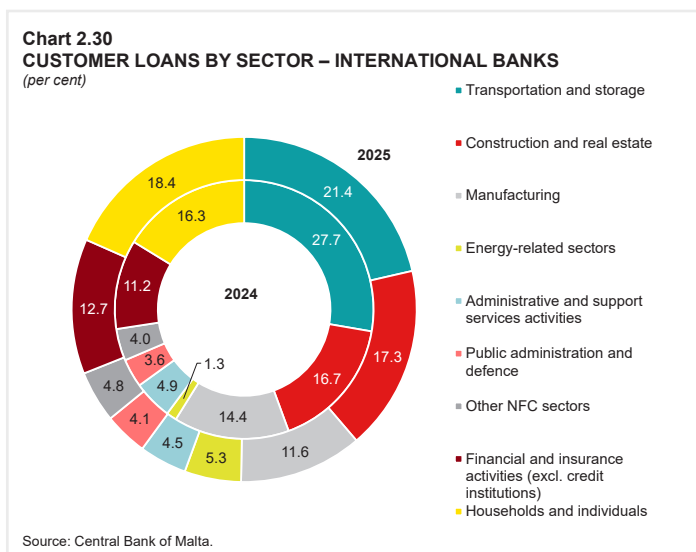
Placements with the Central Bank of Malta fell by 3.4%, mainly driven by lower balances from the non-branches, and to a lower extent from the branches. Despite the decline, such placements still accounted for around 20% of total assets.

2.3.4 Credit quality

The credit quality of international banks improved marginally in 2025, with the NPL ratio declining by 0.1 percentage points to 1.5%. When excluding placements with the Central Bank of Malta, the NPL ratio fell by 0.2 percentage points to 2.4%. The dispersion of NPL ratios across international banks narrowed further, reflecting declines among banks with relatively higher NPL ratios (see Chart 2.31).

This improvement was mainly supported by an expansion of the loan book, alongside a marginal drop in the stock of NPLs, which fell by 0.1%. The contraction in NPLs was largely attributable to exposures to non-bank financial entities and households, where NPL balances declined by 10.3% and 7.8%, respectively. Still, consumer credit NPLs continued to account for the largest share of NPLs, at 88.7% of the total. The household NPL ratio fell from 16.6% to 13.6%. On the other hand, NPLs related to NFCs nearly tripled, although from a very low base, driving the NFC NPL ratio to 0.4% from 0.1%, a year earlier.

Stage 2 loans grew by 51.8%, largely driven by increasing credit risk on NFCs, and to a lower extent consumer credit loans. As a result, their share of total loans rose from 4.4% to 6.1% (see Chart 2.32),



which point to higher expected credit risk going forward. Stage 3 loans remained broadly unchanged to account for 2.4% of total loans in 2025. These developments resulted in the share of Stage 1 loans to decline slightly from 92.9% to 91.4%, despite an 8.1% rise in their absolute level.

Concurrently, provisions fell by 5.9%, driven mainly by a 15.8% reduction in Stage 3 provisions, to represent just under half of the overall provisions. This decrease was driven by one bank. Excluding this effect, Stage 3 provisions would have increased. Meanwhile, provisions for Stage 1 and Stage 2 loans rose by 6.0% and 7.4%, respectively. Since provisions declined at a faster pace than NPLs, the coverage ratio fell from 107.4% to 101.2%, although NPLs remained fully covered on aggregate.

The overall forbearance ratio increased from 1.4% to 2.3% over the year, as loans subject to forbearance measures rose by 73.3%. The increase was driven entirely by performing forborne loans, which grew by 80.4%, while non-performing forborne loans fell by 38.1% to just 2.1% of total forborne loans.

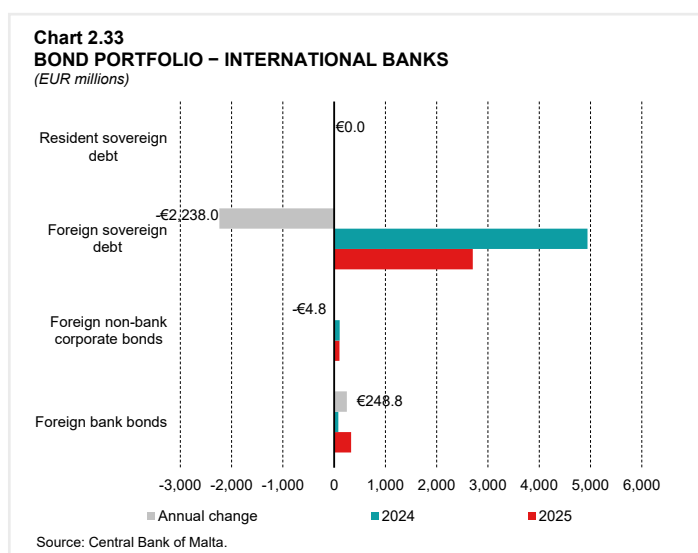
2.3.5 Securities portfolio

The overall securities portfolio of international banks contracted sharply by 38.6%, reducing its share of total assets to 27.8%. This decline was driven entirely by lower bond holdings, particularly among branches. In contrast, equity investments, held exclusively by the non-branches, increased slightly by 0.7%, though they remained negligible overall.

The drop in bond holdings was driven primarily by a substantial reduction in foreign sovereign bond exposures and was particularly evident among the branches of foreign banks (see Chart 2.33). This reflected both lower holdings, largely through sales and to a lower extent unfavourable exchange rate movements, partly offset by positive market valuation effects. This reduction appears to have been motivated by a deliberate reallocation away from Turkish sovereign bonds amid heightened political uncertainty and macro-financial instability in Turkey. Despite declining by more than two-fifths, foreign sovereign bonds continued to account for the largest component of the bond portfolio, representing 86.1% in 2025, down from 96.3% in 2024.

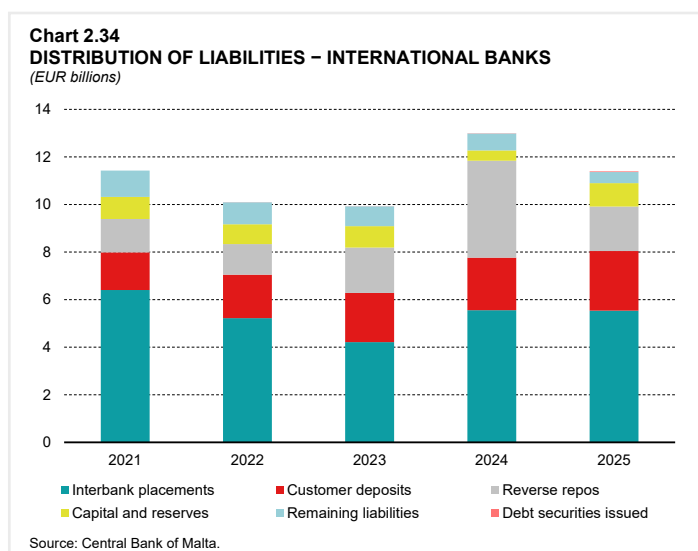
Similarly, foreign NFC bond holdings declined by 4.4%, reducing their share to 3.3% of total bond holdings. In contrast, investment in bank bonds increased more than threefold, with their share in bond holdings rising by 8.9 percentage points to 10.5%. Meanwhile, investments in domestic sovereign paper remained unchanged and minimal, accounting for only 0.1% of the bond portfolio.

Overall, the rating profile of the bond portfolio remained unchanged as it continued to be skewed towards speculative-grade or unrated instruments. This reflected the continued, but reduced, exposure to Turkish sovereign bonds, as well as holdings of foreign bank bonds, which are also classified as speculative or unrated. In 2025, international banks reported NPS for the first time, although such ratio remained low at 0.9%. This development led to an increase in the NPE ratio to 1.3% in 2025, up from 0.9% in 2024.



2.3.6 Funding and liquidity

The overall contraction in the balance sheet was driven primarily by a sharp reduction in the branches' participation in the repo market, which fell by 54.2%. This decline largely offset the significant increase recorded in 2024. As a result, repo funding financed 16.4% of the international banks' total assets, down from 31.4% in the previous year (see Chart 2.34). These developments are closely linked to shifts in the branches' asset holdings, particularly the change in holdings of high-yielding Turkish sovereign bonds.



Indeed, despite a marginal drop of 0.4%, branches' preferred source of funding remained interbank placements, mostly intragroup, with the former financing more than three fifths of their total assets. In contrast, the non-branches continued to rely predominantly on customer deposits, with the share of deposits funding 65.8% of their total assets, declining by 0.6 percentage points. Notwithstanding this reliance, some non-branches did access the wholesale market during 2025, although to a limited extent. In fact, interbank funding accounted for only 1.8% of total assets of non-branches, with the majority sourced from related foreign banks.

Customer deposits across all international banks, predominantly sourced from foreign clients, grew by 13.7% to finance 22.0% of the overall balance sheet. The overall rise in customer deposits was largely driven by higher withdrawable on-demand balances, which increased by more than a fifth, pushing up their share of total customer deposits by 3.1 percentage points to 43.6%. Term deposits also increased, though to a lower extent, going up by 7.7%. The largest inflows stemmed predominantly from households, which recorded an increase of 30.3% to represent almost half of the overall customer deposits, largely from non-resident households. Deposits from private NFCs also rose, up by 13.3%, driven primarily by foreign companies operating in the manufacturing sector. In contrast, deposits from non-bank financial entities declined by 2.2%. This was entirely due to outflows from the non-branches, as branches registered a 20.1% increase in such deposits.

Residents' customer deposits rose by 18.8%, accounting for 8.1% of total customer deposits, but financing only 1.8% of the banks' total assets. This growth was driven mainly by higher inflows from non-bank financial entities, supported by additional household deposits, partly offset by outflows from NFCs operating in selected services activities.

During 2025, the liquidity position of the non-branches remained comfortably sound. Although the LCR fell sharply by 122.4 percentage points, at 300.3%, it stayed well above the minimum regulatory requirement. The deterioration was driven by a 9.2% reduction in liquidity buffers, mainly reflecting lower government paper and placements with the central banks. At the same time, net liquidity outflows rose by more than one-quarter.

Similarly, the NSFR dropped by 14.0 percentage points to 130.5%. Despite this decline, it continued to signal a stable long-term funding profile and remained broadly in line with the EU average.

2.3.7 Risk outlook

The risk profile of international banks remains sensitive to developments in the external environment, particularly through market- and country-risk channels. While branches reduced their exposures in 2025, their remaining concentration in Turkish sovereign securities continues to be a key vulnerability, given elevated geopolitical uncertainty and the potential for renewed exchange-rate and valuation pressures.

Funding and liquidity risks also remain relevant, although unevenly across business models. Branches' greater reliance on wholesale funding, including repo activity, can amplify procyclicality, as collateral valuations and risk appetite may tighten abruptly under stress. By contrast, non-branches benefit from a predominantly deposit-funded structure. However, the rise in withdrawable-on-demand deposits increases deposit outflow sensitivity if not properly managed. Although liquidity ratios remained comfortably above regulatory minima, the decline in liquid asset buffers and higher net outflows warrant continued monitoring.

On the asset quality side, headline indicators remain favourable, but forward-looking metrics point to emerging vulnerabilities. The increase in Stage 2 exposures and the rise in performing forborne loans signal early signs of credit-risk migration, which could intensify in a weaker global macroeconomic environment or if stress materialises among non-resident borrowers. In addition, the securities portfolio remains a potential risk source, reflecting concentrations in lower-rated or unrated instruments and the possible re-emergence of valuation losses under adverse market conditions.

Overall, international banks maintain strong solvency and leverage buffers, providing resilience against plausible adverse shocks. Nonetheless, the outlook remains subject to heightened external uncertainty. Continued focus on concentration risks, the resilience of funding structures, and the monitoring of credit-risk migration indicators will be important to safeguard these institutions against bouts of renewed external volatility.

BOX 4: EVOLUTION OF BANKS' SOVEREIGN INVESTMENT HOLDINGS¹

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

¹ Prepared by Ms Ariana Bartolo, Senior Analyst within the Financial Stability Surveillance and Risk Assessment Department. The author would like to thank Mr Christian Mamo, Principal Economist, Mr Andrew Spiteri, Deputy Head, and Ms Wendy Zammit, Head, within the same Department and Mr Alan Cassar, Chief Officer Financial Stability and Statistics Division, for their valuable suggestions.

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

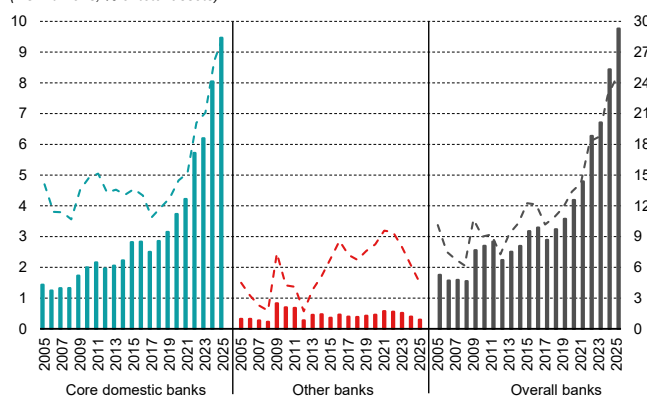
nexus within the domestic financial system.

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

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

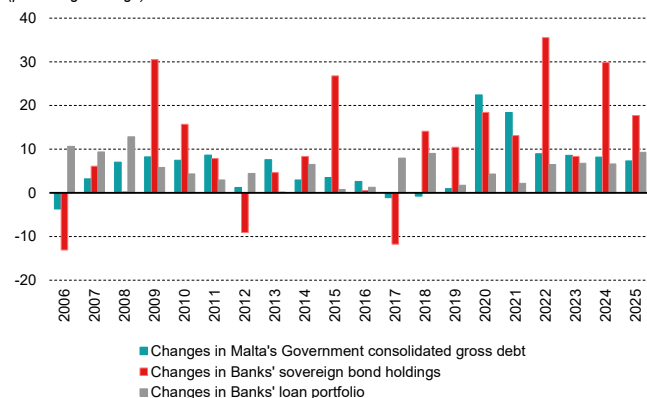
Monetary policy measures also played a key role. In particular, the ECB's asset purchase programmes reinforced this trend through large-scale purchases of government bonds, supporting sovereign bond prices, enhancing market liquidity, and increasing the relative attractiveness of these assets on banks' 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

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)



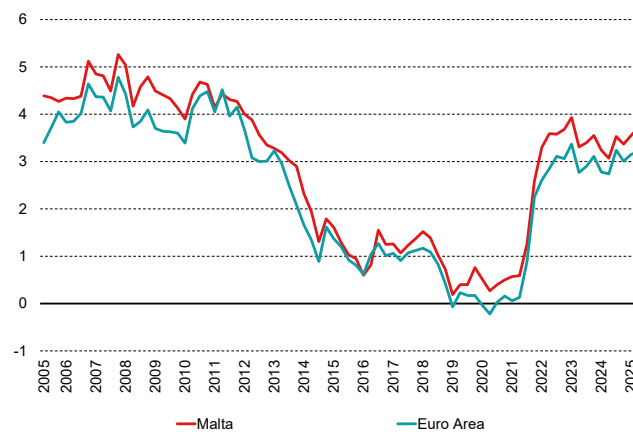
Sources: Central Bank of Malta; Eurostat data.

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.

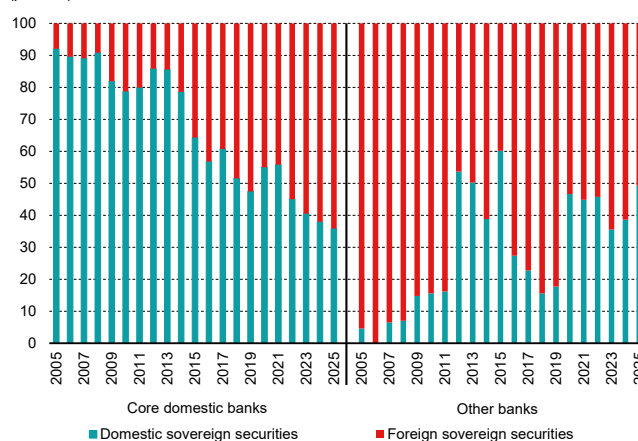
Regulatory developments under Basel III also supported this trend. In particular, the introduction of the LCR increased banks' demand for HQLA, including sovereign bonds.

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

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.

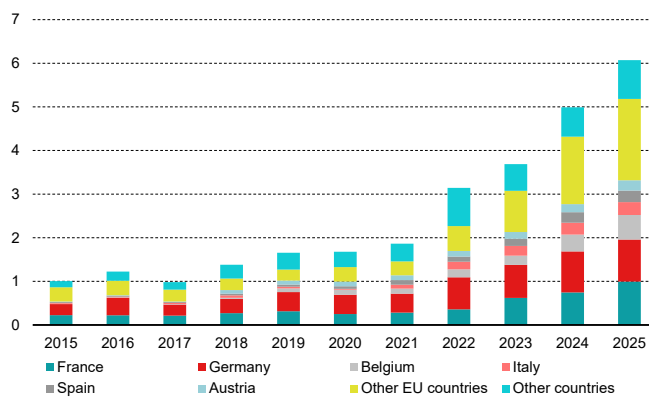
Overall, these developments point to increasing diversification of sovereign portfolios among core domestic banks towards highly-rated, predominantly euro-denominated, issuers.⁷ An analysis of credit ratings confirms that the majority of foreign sovereign exposures remained concentrated in high-rated 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

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 institutions.

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-dated sovereign 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.

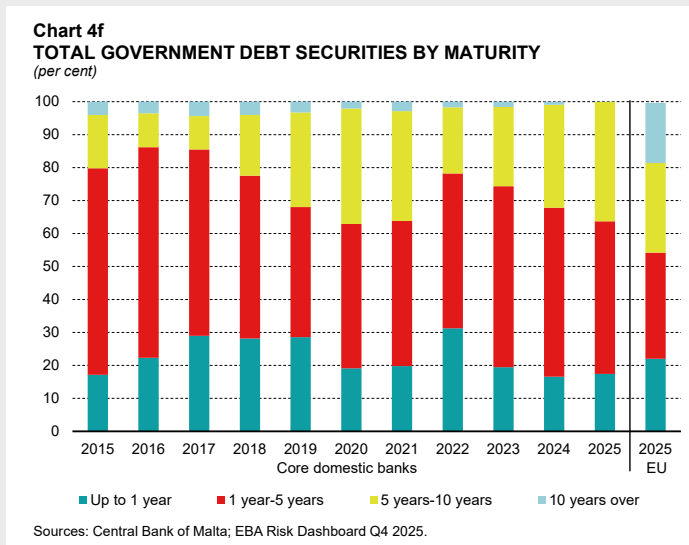
As at end-2025, securities with maturities of between one and five years accounted for around 47% of total sovereign holdings, exceeding the EU/EEA aggregate of about 32%, while holdings with maturities of between five and ten years increased gradually to stand at around 35%, also above the EU/EEA aggregate 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.