Address by the Governor of the Central Bank of Malta – Professor Edward Scicluna at the - IFS Annual Dinner - 3 December 2021

Honourable Minister, IFS President and Committee Officials, distinguished guests

There is no better way to celebrate the 60th Anniversary of the Institute than to do it in person as has been the norm throughout the years. Thank you, IFS, for the invitation.

As is well known the European Central Bank's primary mandate, like all national central banks including our own, is price stability. Since the financial crises the European Union has broadened this function to encapsulate financial stability at the EU level, especially at the Eurosystem level. This it did through other appropriate EU institutions, sharing resources with the ECB. These comprise the European Systemic Risk Board and the three European Supervisory Authorities, the EBA, ESMA and EIOPA, and the Single Supervisory Mechanism.

Locally the macro and micro-prudential authorities were entrusted to the CBM and MFSA respectively, while the Joint Financial Stability Board ensured better co-ordination between the two respective insitutions and the Finance Ministry regarding financial stability matters of national importance.

I will briefly touch upon the two inherently interlinked functions and the way they affect our economy. Because finally price stability and financial stability are a means to an end. The end being the country's material welfare and its sustainability.

But before let us look at the economy and its outlook. That the economy has opened up so quickly and so forcefully, as the results of the last reported quarter attest, is due to the realisation that no matter how diversified our economy is, a vibrant tourism sector is important for the economy to reach its full potential. We learnt the lesson that making our island safe for visitors is the best attraction Malta can have at the moment. Being an external and well respected institution the ECDC – the European Centre for Disease Control's own daily health reports at this moment in time compete with the best adverts the MTA might design.

The population at large learnt this basic lesson too and cooperated with the health authorities in their vaccination programmes. The rewards are there for all to see. Not just more tourists, but also low unemployment rates, higher consumer expenditure, and higher value added in most of all the other economic sectors.

The policy support was generous by any standard. Its gradual withdrawal will therefore be expected to be quite challenging, at least no less than the ECB's eventual reduction of its own asset purchase programme. Flying into constant headwinds or should I say cross-winds of labour shortages, supply bottlenecks, rising commodity prices including energy prices, which are so sensitive to daily events is no mean feat in withdrawing, especially, the fiscal supportive policy measures. Not to mention the reintroduction of the Growth and Stability Pact rules in some form or other in 2023. At the moment the ECB is being asked for an opinion on the principles it believes the new fiscal rules should follow.

Despite these challenging times, the Central Bank will be making significant upward revisions to its economic projections, which will be published later this month, based on better than expected recent economic and financial statistical data.

Indeed we still expect the GDP to return to pre-crisis levels next year.

Pushing the economy forward is domestic demand, strong performance of the labour market and high liquidity levels in the private sector - evidenced by the declining up-take of the MDB Guarantee Scheme. In fact in October there were no applications registered under this Scheme. The same may be said for the loan moratoria which are practically phased out. The Budget for 2022 is expected to give an added boost to public and private investment and consumption.

Rising international price pressures will lead to upward revisions to our inflation projections, particularly in 2022. Indeed, the Bank's Business Dialogue indicates that local firms reporting cost increases are now more prevalent than before. However there are no signs as yet of second round effects.

In the international financial markets there is no consensus whether the current inflation is transitory and that it will retreat to levels below Central Bank inflation objectives over the medium term or not.

In any case, at the ECB, it is fair to say that the jury is still out. Within a fortnight at the Governing Council we should have a clearer picture of the outlook and the appropriate monetary policy decision is then taken.

Financial Stability

Each year the Bank identifies a number of systemic risks, some of which may be more elevated than others. Many of them are shared with other members of our Eurosystem in some degree or other. You may read about these in our Fiancial Stability Reports published twice yearly.

Starting with the good news. At the EU level the broadened economic recovery further reduced the risk of widespread defaults in the non-financial private sector. Indeed, following the pronounced decline in 2020, the number of bankruptcies remained below pre-pandemic levels on aggregate in 2021.

I must state that this success story was more accentuated in Malta, thanks to the timely intervention of the state, together with the leading regulatory authorities, the CBM, the MFSA, the MDB which managed to roll out a number of suitable schemes, together with the banking system's ability and its willingness to support its clients. Well done to all.

With respect to credit risk, this remained in check at EU levels, in part reflecting the banks' own strategies as well as policy measures introduced by the authorities, to reduce their legacy stock of NPLs and provisioning prior to the pandemic, and their role in the moratorium during the pandemic.

Speaking for ourselves, credit risk remained broadly stable, although we still expect some residual risk from those with weak business models that did not adequately adapt to the pandemic, and from those who do not do so, by the time all support measures are completely lifted. In this regard, banks are encouraged to stay on course with their prudent internal assessments of their loan books to help identify potential risks at an early stage.

Another risk faced by banks in a number of EU Member States is that of a significant price correction which actually occurred in some EU member state's residential and commercial real estate markets.

In many EU Member States residential real estate prices continued to increase during the pandemic, supported by strong housing demand on the back of low interest rates and a strengthening preference for more living space.

With respect to the EU commercial real estate sector the outlook for low quality structures remains weak. Remote working and environmental concerns led to an increase in high quality buildings, thereby exerting pressure on rents for low-quality buildings.

How does the Bank see the situation locally?

Property prices in Malta had started to moderate prior to the pandemic, reflecting the strong growth experienced in the last few years. However, on the onset of the COVID-19 pandemic, property prices moderated further. This year, growth in transacted property prices resumed, growing by 5.3% in 2021 Q2, exceeding the 3.9% in Q2 2020.

On the supply side, we also saw declines in permits, admittedly from very high levels, thus leaving the construction industry ample order books.

The banks' concentration in their lending portfolio towards property is about 64% of resident lending, with growth in credit being driven by mortgages. One must acknowledge that there was some frontloading due to the temporary government tax incentives, but the recommendation for banks to diversify further their portfolio and reduce their concentration on real estate exposures continues to remain relevant.

The Bank on its part launched borrower-based measures (BBMs) in 2019 to curtail any potential risks from Residentail Real Estate. These contributed towards improvements in the resilience of both borrowers and lenders.

On balance, financial stability risks stemming from the housing market remained contained and may be described as moderate, with no significant signs of misalignment between prices and fundamentals.

With regards to system-wide cyber incidents, what is being observed here is that cyberattacks are becoming more sophisticated. What is at stake is our financial system. The bottom line is that we need to invest more in this area to keep up with the rapid evolution of technology and strengthen our resilience to cyber risks. For this, we may need to be involved in Europe-wide and global cooperation. At present we are participating in a Europe wide effort preparing the ground work for a cooperative monitoring and reporting framework. Cyber attacks know no boundaries.

Lastly some comments on AML/CFT issues. There is not doubt that the FATF recommendations have made some financial operators in the financial industry more aware of the big reforms needed to be carried out within our institutions, regulatory and operators alike. But we need to remind ourselves that some eight years ago if not more there were credit institutions and here I include the correspondent banks who had the foresight to act quickly and do what was need to conform with new international norms, EU AML directives and such like and acted decisively. Recall that Malta's first National Risk Assessment was carried out in 2013 on the advice of Moneyval and the FIAU.

We may recall too, Malta getting the brunt of correspondent banks' de-risking strategies which found Malta's market not profitable enough to outweigh the increasing AML/CFT regulatory exigencies tied to their activities.

Those operators who did not see the writing on the wall with the transpositions of successive EU AML directives Nos 3, 4 and 5 especially, and who thought that their practices need not change, have by now realized that precious time has gone by. To give one example, the days of undertaking manual KYC processes are no longer feasible and investment in effective automated systems are today a minimum pre-requisite for entering new correspondent banking relationships.

Whatever the FATF recommendations are, nobody can deny the need for the banking sector to continuously show that its frameworks are sufficiently robust to address such risks. Indeed, all stakeholders and practitioners in the broader context, and not just the banks, need to do their part and strive to achieve higher standards, which are suited to today's financial world. They will of course be fulfilling the FATF requirements and recommendations as delegated by the G7 no less within the earliest feasible time. Effectiveness in the FATF dictionary reads results now. But to reach that goal we need to raise efficiency. For that to happen systems in certain work areas have to change.

In conclusion, in today's speech I tried to focus on financial stability risks. I would have liked to discuss other important subjects such as digital currencies, payment platforms and green financing. Will definitely find other fora to do that. Thank you for listening.