1. MACROPRUDENTIAL RISK ASSESSMENT AND POLICY RESPONSE

1.1 Macroprudential risk assessment

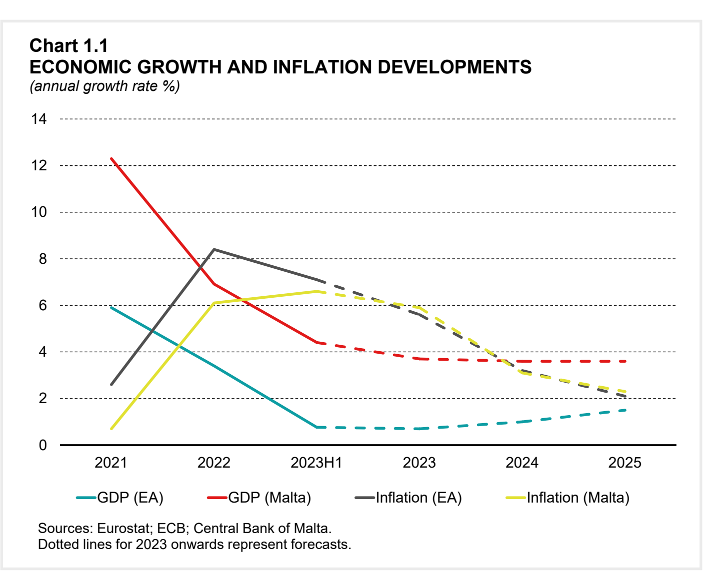
The first half of the year was characterised by events that showcased once again the importance of financial stability and its links with the macroeconomic environment. Policymakers across the world are still facing the challenge of taming inflation, while fostering economic growth and preserving financial stability. Going forward, a possible further tightening of monetary policy to combat inflationary pressures still presents downside short-term risks to economic growth through potentially lower consumer spending and business investment. Despite this, maintaining price stability over the medium term is important to restore business confidence, preserve purchasing power of consumers and therefore, contribute to foster economic growth. These challenges were further exacerbated when at the start of this year, some segments in financial markets faltered because of the failure of three United States (US) banks and the takeover of a failing Swiss bank.[1] Tighter financial and credit conditions are expected to test the resilience of the banking sector, which in turn, depends on the future path of inflation and economic growth.

1.1.1 Vulnerabilities outside the financial system

Despite the recent easing in inflation and the avoidance of a near-term recession, the euro area macro-financial landscape remained weak. After having recovered from the pandemic and peaking at 5.9% in 2021, euro area real gross domestic product (GDP) embarked on a declining trend. While growth remained sustained at 3.4% in 2022, this decelerated to 0.8% in the first half of 2023 (see Chart 1.1). It is expected to remain sluggish at around the same rate for all of 2023 owing to tighter financing conditions and weak demand. Thereafter, growth is expected to recover somewhat to 1.0% and 1.5% in 2024 and 2025, respectively.[2] Domestically, GDP growth slowed down from the 6.9% in 2022, to 4.4% in the first half of 2023 and is expected to moderate to 3.7% in 2023 before largely stabilising at 3.6% in the following two years.[3] Net exports are expected to be the main engine of growth in 2023, albeit driven by base effects following an exceptional investment by the aviation sector in 2022. Domestic consumption remains strong and is expected to be the driver of economic growth in 2024 and 2025.

Following the strong rise in 2022, inflation across the euro area moderated as energy prices retreated. However, with Harmonised Index of Consumer Prices (HICP) at 5.6% in June 2023, inflation is still well-above the European Central Bank's (ECB) target and is expected to remain at elevated levels for the rest of the year, but is expected to ease somewhat to 3.2% and 2.1% in 2024 and 2025, respectively.[4] Since the beginning of this year, the ECB raised interest rates six more times, bringing the main refinancing operations rate to 4.5%; a rate last observed in 2001. Although the pace at which the ECB has increased its key interest rates has slowed down, the future path of interest rates is still uncertain, as underlying inflation remains stubbornly high compared to the ECB's 2% medium-term target. In Malta, fiscal measures introduced

Chart 1.1
ECONOMIC GROWTH AND INFLATION DEVELOPMENTS
(annual growth rate %)



Sources: Eurostat; ECB; Central Bank of Malta.
Dotted lines for 2023 onwards represent forecasts.

[1] Silicon Valley Bank, Signature Bank and First Republic Bank are the US failing banks, and Credit Suisse in Switzerland was acquired by UBS.
[2] ECB – Macroeconomic projections (europa.eu)
[3] NSO - Gross Domestic Product: Q2/2023 and CBM – Outlook for the Maltese economy (2023:3).
[4] Source: Eurostat and ECB – Macroeconomic projections (europa.eu).

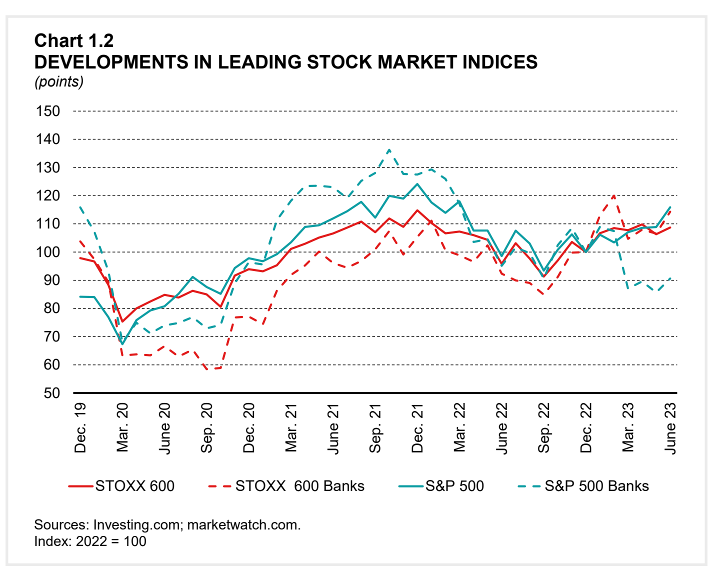
in 2022, particularly those targeting energy prices, contributed to keep inflation below that in the euro area until early 2023. Thereafter, as energy prices fell across the euro area in the first half of the year, the drop in inflation rate was more pronounced than that in Malta, with domestic inflation receding to only 6.2% in June 2023, though at 5.4%, underlying inflation in Malta was slightly below that in the euro area by June. Going forward, inflation is expected to close the year at 5.9%, before easing to 3.1% and 2.3% in the next two years. The higher inflation largely stemmed from the services sector, including restaurants and housing services, particularly due to the other indirect spillovers, such as elevated food prices coupled with the strong rebound in demand for tourism.

During the first half of 2023, financial markets were negatively affected by two main factors, namely the banking sector turmoil which culminated in the failure of three US banks and the takeover of a failing Swiss bank, and tighter financial conditions in general. The former heavily impacted banking stocks, especially those of US banks at the start of the year, offsetting the expected positive effect of the higher interest rates on banks' performance. Indeed, the S&P Banks Index shed 9.4% of its value, compared to the 15.9% surge in S&P 500, mainly led by technology stocks (see Chart 1.2). In Europe, banks' equities performed better than their US counterparts, following a negative bout in March 2023, with the STOXX Europe 600 Banks index returning to positive territory and gaining 14.3% by June 2023. At the same time, bond yields rose, with the ten-year German Bund rising from -0.18% in 2021 to 2.40% in June 2023. Such high rates are providing challenges to banks in attracting funding, as they compete with alternative investment products, thus increasing pressure on their funding costs.

Fiscal support measures across the euro area have decreased slightly, having a positive effect on fiscal deficit.[5] Indeed, the euro area fiscal deficit is projected to decrease to 3.4% of GDP in 2023, from 3.6% in 2022, and is expected to improve further to 2.4% in 2024 and 2025. Concurrently, the euro area government debt-to-GDP ratio is expected to embark on a declining trend, falling from 91.4% at the end of 2022 to 89.0% in 2023.[6] In Malta, the government's deficit declined largely on the back of higher tax revenue, bringing the deficit-to-GDP ratio to 5.8% in 2022 and is expected to end the year at 4.8%. The deficit is expected to improve further to 3.5% and 3.3% of GDP in the subsequent two years, though risks are to the upside, with the deficit increasing due to the restructuring of the national airline. The general government debt-to-GDP ratio is expected to creep up going forward, ending 2023 at 54.0% before edging up to 54.5% and 54.8% in 2024 and 2025, respectively.

Monetary policy tightening also contributed to a turn in the euro area real estate cycle, as demand and prices for commercial and residential properties, as well as mortgage growth, all slowed significantly in the first half of the year. Indeed, house prices across the euro area fell annually by 1.7% in June 2023, compared to a growth of 9.2% during the same period last year.[7] Such developments were also reflected in the ECB's Bank Lending Survey replies, confirming that euro area banks tightened their credit standards. Domestically, growth in resident mortgages decelerated from the post-pandemic peaks of around

Chart 1.2
DEVELOPMENTS IN LEADING STOCK MARKET INDICES
(points)



Sources: Investing.com; marketwatch.com.
Index: 2022 = 100

[5] EU fiscal support is estimated to amount to around 1.8% of euro area GDP in 2023, down from 1.9% in 2022 and to drop steeply to 0.5% of GDP in 2024. Source: Update on euro area fiscal policy responses to the energy crisis and high inflation.
[6] Source: ECB – Macroeconomic projections (europa.eu).
[7] Source: Eurostat.

11% in early 2022, to a still strong growth of 8.4% in June 2023. This slower growth reflected the lower number of final deeds of sale for residential properties signed in the first half of the year. However, during the same period, promises of sale agreements rose by 11.1%, an indication that mortgage growth rates may remain elevated. On aggregate, the still strong demand for property and weak pass-through of monetary policy in Malta continue to support house price inflation, albeit at a slightly slower pace of 4.5% in June 2023, compared to 7.6% in the same period last year.

1.1.2 Vulnerabilities within the financial system

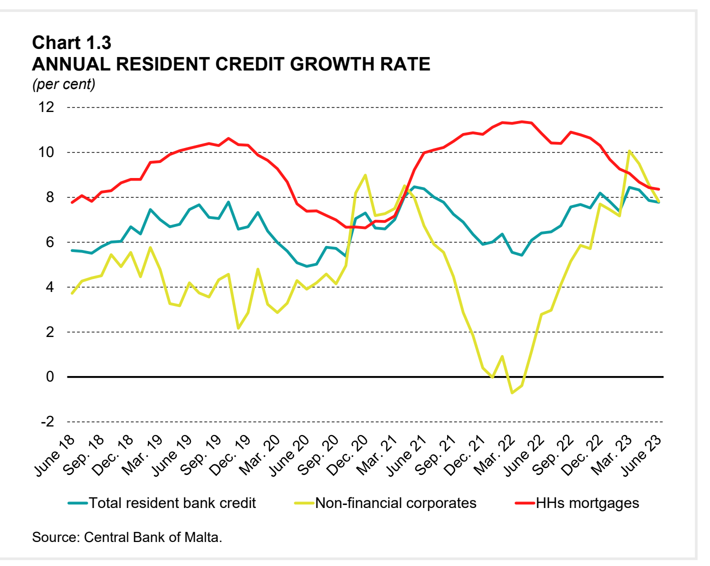
European Union (EU) banks continued to operate with ample liquidity buffers as evidenced by the strong Liquidity Coverage Ratio (LCR) of around 160%.[8] Although the tightening of monetary policy has gradually increased banks' funding costs through higher deposit rates and bond yields, banks were still able to improve their profitability through higher interest margins. As a result, in June 2023 the return on equity (ROE) and return on assets (ROA) for EU banks reached 10.8% and 0.7%, respectively, representing the best performance for at least ten years. This improved profitability contributed to higher capital and since risk-weighted assets (RWAs) remained stable, the total capital ratio rose to 20.0%, up from 19.6% in end 2022.

Similarly, Maltese banks reported higher profits in the first half of the year, mainly driven by higher trading profits and net interest income (NII), coupled with lower operational expenses. This has resulted in the sector's ROA to increase from 0.9% to 1.2%. Furthermore, placements with the Central Bank of Malta now carry a positive remuneration, contributing to further results of positive profitability. Nevertheless, downside risks to profitability remain. This is especially the case if credit growth slows down significantly amidst the uncertain international macroeconomic environment and should funding costs continue to trend higher in the current period of rising interest rates.

To date, the increase in funding costs was contained as most of the deposits are on demand, and the pass-through on the liabilities side has been, as yet very contained. However, going forward funding costs could increase in view of higher competition from other higher yielding products such as sovereign bonds, which are increasingly becoming a more attractive income-generating option. Indeed, the growth in customer deposits has already slowed down, as deposits from corporations contracted, while those from households decelerated. Nonetheless, banks remained shielded by the ample liquidity buffers, with a LCR ratio of about 387%.

Just after the pandemic, annual growth in resident credit abated somewhat, though still rising strongly at 7.8% (see Chart 1.3). Both resident mortgages and corporate credit contributed to this slowdown in credit growth, which could intensify if the pass-through on lending rates accelerates, and economic growth falters. Asset quality of domestic banks improved further, with the non-performing loans (NPL) ratio standing at 2.3%, down by 0.2 percentage point over the previous six months. Such improvement in the loan book is also corroborated by a lower forbearance ratio of 2.3% in June 2023, down from 4.1% as at end 2022, to now stand lower than its pre-pandemic levels.

Chart 1.3
ANNUAL RESIDENT CREDIT GROWTH RATE
(per cent)



Source: Central Bank of Malta.

In the first half of the year, domestically-relevant life insurers experienced modest growth in their

[8] Source: European Banking Authority (EBA) risk dashboard 2023Q2.

balance sheets, largely driven by a substantial increased investment in sovereign bond holdings. This growth coincided with strengthened liquidity and robust capital positions. However, the transition to a high interest rate environment introduced challenges for the life insurance sector, leading to a decrease in demand for insurance products due to the availability of more attractive, higher-yielding investment alternatives. In contrast, the non-life segment exhibited rapid growth and reported reduced claims primarily due to diminished provisions, although sustained inflation may impact further the cost of claims going forward. These local developments align with broader European challenges in the insurance sector. The potential impact of inflation on insurers varies, with those involved in long-term business potentially facing challenges depending on their ability to adjust premia promptly. Despite these multifaceted challenges, the insurance sector has consistently demonstrated resilience and adaptability, ensuring overall profitability in a dynamic financial landscape.

Overall, euro area investment funds' assets grew during the first six months of 2023, prompted by a positive performance of the equity market, along with a less volatile bond market. Such developments also drove up the net asset value (NAV) of domestically-relevant investment funds, following periods of declines. Although concerns regarding redemptions and liquidity remained present among euro area sub-funds, domestically, these risks were somewhat contained. Indeed, during the first half of the year redemptions dropped, returning to the levels registered before the beginning of the tighter monetary policy environment. Furthermore, the sub-funds considered to be domestically-relevant, operated with low leverage rates, while remaining with an elevated liquidity ratio, reflecting the significant share of highly-rated securities in their portfolios. The failure of three US banks and the restructuring of another Swiss Bank also had very limited direct consequence, as domestically-relevant investment funds had limited direct exposures to these entities.

1.1.3 Risk horizon

The domestic financial system remained resilient amid the weakening external macro-financial environment, which nonetheless still has the potential to challenge financial stability going forward. Despite slowing down, the ECB remains focused on achieving its price stability objective such that interest rates are expected to remain elevated until inflation returns sustainably at 2% over the medium-term. Higher interest rates have the potential to increase funding costs for banks, but being largely demand deposits, such increase has been limited so far. Still, the slowdown in deposit growth could result in risks going forward, as competition for deposits intensifies. Transmission of higher interest rates onto lending rates, especially for non-financial corporations (NFCs), could also increase the risk of a deterioration in asset quality, so banks need to remain vigilant to such vulnerabilities. Although overall, households are generally well positioned to deal with interest rate shocks, some vulnerabilities are detected in those households at the lower end of the income distribution, and with already stretched borrower metrics.[9] These, in turn, could also pose asset quality risks to domestic banks.

Some tentative signs of a slowdown in resident mortgages can already be witnessed, although demand remained sustained to date. Going forward, the future path of credit growth much depends on the level of inflation and economic growth, which in turn affect households' and corporates' repayment capabilities. This could have adverse implications on banks' asset quality and profitability. Considering this, it is important for banks to maintain adequate capital and liquidity buffers and keep conservative lending practices. Non-banks remain vulnerable to market corrections, amidst a persistently uncertain macroeconomic environment. Thus, it is important for these institutions to keep ample liquidity buffers and minimise liquidity mismatches to better deal with liquidity shocks. Considering the current uncertain macro-financial environment, financial institutions should remain vigilant to existing pockets of vulnerabilities, whilst undertaking activities that are commensurate with their risk profile.

[9] See *Financial Stability Report* 2022, Box 5: Assessing the vulnerability of Maltese indebted households to inflation and interest rate shocks based on the household stress testing framework.

SUMMARY OF RISKS

Main vulnerabilities and risks to financial stability	Description of risk	Risk assessment in 2023
Vulnerabilities outside the financial system		
Geopolitical uncertainties	Geopolitical risks continue to remain high as a result of the war in Ukraine and escalated further with increased tensions in the Middle East and with ongoing trade tensions with China.	
Inflationary pressures	Although inflation is on a downward path, it remains at elevated levels impacting borrowers' real income. Repayment capabilities could be impacted though locally the impact was limited due to the weak pass through of monetary policy.	
Reassessment in risk premia	The potential for reassessment of risk premia remains high amid stretched asset valuations and tighter liquidity conditions.	
Economic conditions in the euro area and public debt sustainability	Weaker than expected economic growth prospects as well as funding costs increased pressure on public debt sustainability, albeit somewhat mitigated by an expected withdrawal of fiscal support measures.	
Domestic macroeconomic developments	The Maltese economy is expected to continue growing, though at a more moderate pace, on the back of stronger net exports anticipated for 2023.	
Real estate market developments	Although property sales decreased somewhat, the number of promises of sale agreements rebounded indicating sustained demand. At the same time, property price growth remained strong albeit decelerating.	
Vulnerabilities within the financial system		
Developments in mortgage lending	Resident mortgage lending remained buoyant, though growth seems to be moderating somewhat.	
Developments in NFC lending	Growth in resident corporate lending decelerated slightly, due to some slowdown in lending to property-related sectors. However, this remains at high levels, albeit volatile, compared to recent years, also as lending to other sectors picking up .	
Concentration in sectoral lending	Despite the slowdown, resident lending continued to be driven by property-related sectors, with high loan concentration persisting as a result. Risks are somewhat mitigated by the conservative lending practices and the introduction of the sSyRB.	
Credit quality of the loan portfolio	The overall credit quality of banks' loan books improved but may deteriorate amidst the still elevated inflation and possible greater pass through in interest rates going forward.	
Developments related to net income	The higher interest rate environment had a positive effect on domestic banks' income from intermediation and on their placements with the Eurosystem. This was also possible as the increase in funding costs was limited so far, though these could increase going forward.	
Liquidity developments	Banks liquidity continued to be ample reflecting significant level of customer deposits and highly liquid assets limiting concerns of liquidity risks materialising. However, in a rising interest rate environment with higher-yielding investment products, customer deposits declined.	
Operational risk	As banks continued with their digitalisation journey, they are becoming more susceptible to higher operational risks, particularly due to the increasing cyber-threats.	
Domestically-relevant insurances	Insurers' balance sheet grew, maintaining strong liquidity and capital positions. Nonetheless, challenges may arise with declining life insurance premia and concerns in the non-life sector about potential cost increases due to sustained high inflation, if claims rise.	
Domestically-relevant investment funds	Domestic investment funds registered their first growth in assets after a period of declines, largely driven by the rebound in the equity market. Investments remained concentrated in liquid assets, albeit the levels of cash and deposits fell. Risks going forward remain present given the potential of higher reassessment of risk premia given the challenging macroeconomic backdrops and headwinds.	

Risk level: Limited Moderate Elevated

Risk direction: Increased Stable Decreased

BOX 1: REVISITING CLIMATE-SENSITIVE EXPOSURES OF HOLDING COMPANIES[1]

This box is motivated by the Central Bank of Malta's (CBM) increased efforts to correctly identify financial services' exposures to climate-sensitive sectors. Building on its own previously published research, this box article seeks to address one of the key limitations that had been previously identified – the lack of visibility of holding companies' exposures captured within the financial sector.[2] As documented in the previous publication, this could have biased results towards the Low CO_2 intensive sectors, since such exposures did not always reflect the main business operations of these companies and their group. To this end, this box attempts to reclassify the exposures of holding companies to the appropriate sectors of economic activity, in line with the group's main business operations.

The Box is structured as follows. Section 1 describes the methodology adopted in reclassifying exposures of holding companies. Section 2 presents the refined results based on December 2022 data, while Section 3 concludes.

1. Methodology: Reclassifying exposures towards holding companies

In approaching this analysis, it is vital to give some perspective to the presence of holding companies on the financial sector's balance sheet.[3] By end 2022, these accounted for 11.2% and 9.8% of the Maltese banking sector's overall loan and securities portfolio, respectively.[4] For non-banks, such exposures represented 9.5% of their overall securities portfolios, with domestically-relevant investment funds playing the biggest role.[5]

As illustrated in Figure 1, different data sources were used to assess granular exposures for the banks' loans and securities portfolios, the latter also for non-banks. Granular loans data was obtained from the CBM's Central Credit Register (CCR) and the ECB AnaCredit database to supplement the banks' statutory returns. For the securities portfolio, security-by-security data was obtained from the ECB's Securities Holdings Statistics by Sector (SHSS) database, also complemented by regulatory returns to enhance data representativeness and coverage. Due to the unavailability of a consistent data source for all exposures, the assessment of domestic and foreign exposures followed a different methodology as described further below.

1.1 Reclassification of domestic exposures

In the case of banks' resident loans, as the economic activity for each loan reported in the CCR is only reported at the first level NACE, the analysis had to look at all domestic loans granted towards the Financial and Insurance activities (NACE K) and Professional, scientific and technical activities (NACE M). Each loan was matched with information obtained from the Malta Business Registry (MBR) database. Both databases were mapped through common identifiers being either the company ID or the

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[1] Prepared by Ms Joanne Ciantar and Mr Stefan Scerri, both Senior Analysts within Financial Stability and Surveillance Office. The authors would like to thank Mr Andrew Spiteri, Manager within the same office, Ms Wendy Zammit, Head, Financial Stability Surveillance and Research Department and Mr Alan Cassar, Chief Officer Financial Stability and Statistics Division, for their valuable suggestions.

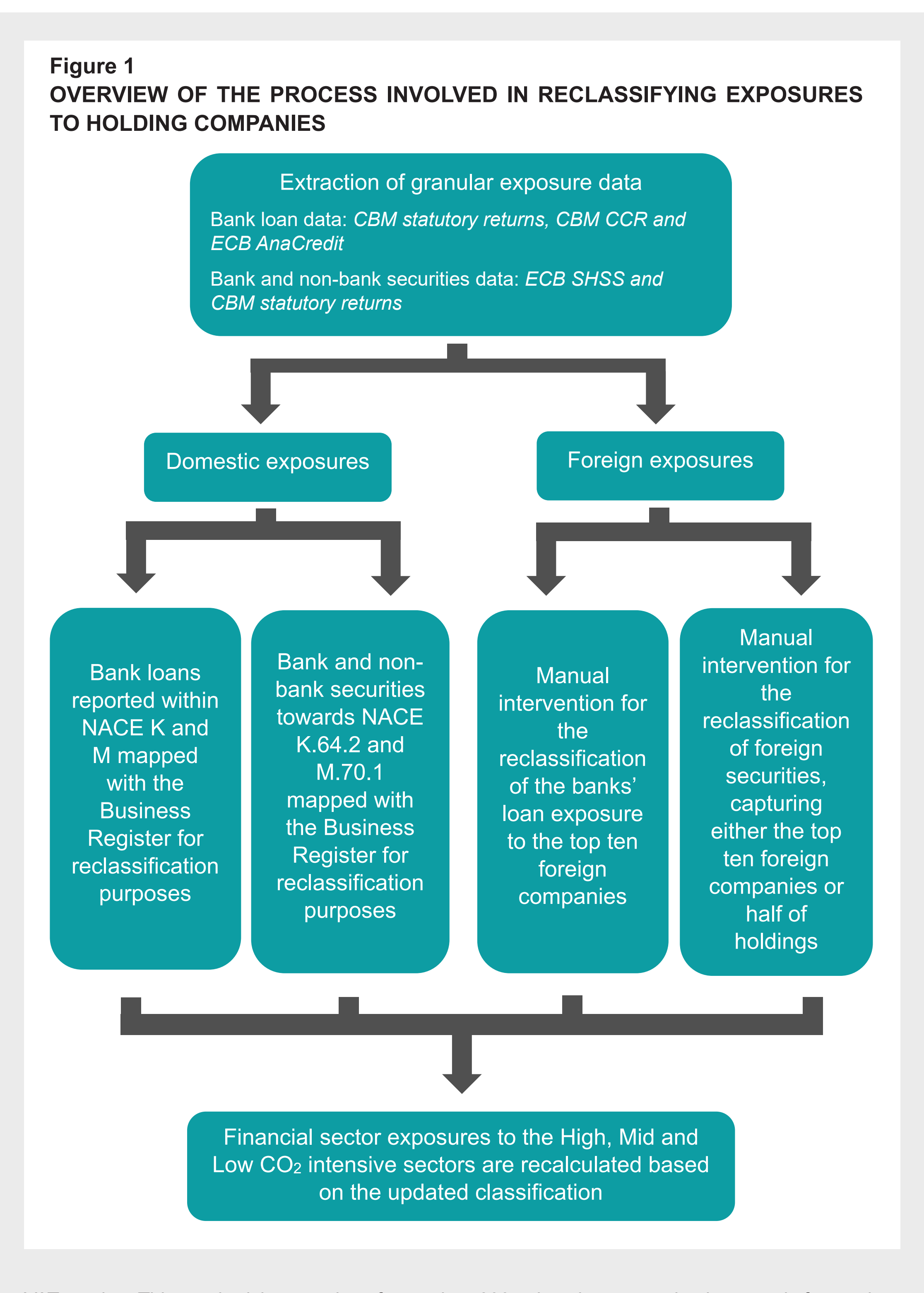
[2] The Maltese Financial Sector's Exposure to Climate-sensitive Sectors (2021).

[3] These include activities reported within NACE K.64.2 and M.70.1. As defined in the Eurostat NACE Rev 2, NACE K.64.2 captures activities of holding companies, *"whose principal activity is owning the group and that do not administer or manage the group"*, while NACE M.70.1 refers to activities of head offices which *"includes overseeing and managing the related units, exercising operational control and day-to-day management"*. Given these are firms which mainly perform financial and operational management functions within a group of firms, the sector of activity in which they are included might not reflect the economic activities to which the group is exposed.

[4] Exposure towards NFCs, financial corporations, other financial intermediaries (OFIs), and insurance corporations, were taken into consideration (excluding exposures to governments) as defined in the ESA 2010 classification.

[5] For the purpose of this analysis, the exposures of the non-bank sector comprise those of the domestically-relevant insurance companies and domestically-relevant investment funds as classified in the *Financial Stability Report* 2022. This includes 37 domestic investment funds and nine domestic insurance companies.

Figure 1
OVERVIEW OF THE PROCESS INVOLVED IN RECLASSIFYING EXPOSURES TO HOLDING COMPANIES



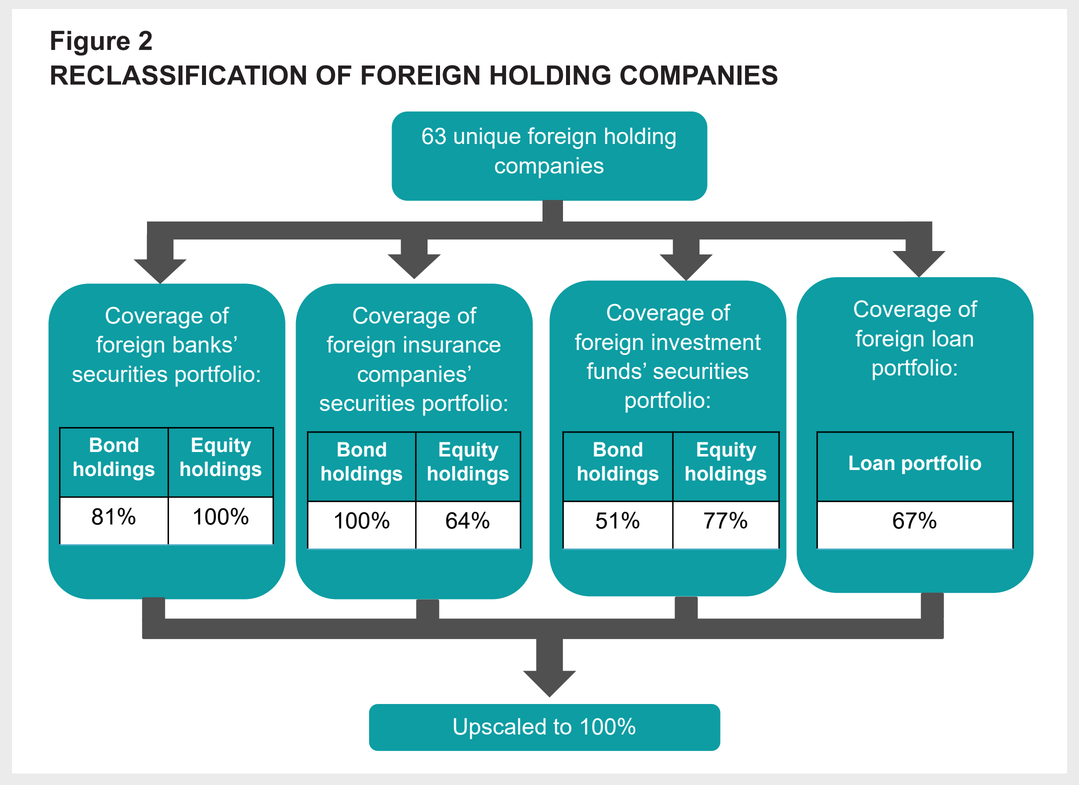
VAT number. This required the mapping of more than 600 unique borrowers, having a total of more than 1,300 domestic loans amounting to €1.2 billion. When no group NACE information was available, these exposures were classified according to publicly available information on these companies.

The MBR was also used for the reclassification of securities issued by holding companies. Given that security-by-security data is reported at the most granular NACE level, only exposures of domestic holding companies were required to be reclassified. These amounted to almost €80 million, spread across roughly 30 Maltese holding companies, and representing nearly 7% of the overall domestic securities holdings. These were nearly equally split between bonds and equities. From an industry perspective, these represented around 4%, 6%, and 11% of domestic securities held by banks, domestically-relevant insurance companies and investment funds, respectively. The reclassification necessitated the mapping of the issuer name, as reported in the SHSS with the information available in the MBR. Like the strategy adopted for the resident loan portfolio, in instances where reclassification could not be carried out through the available databases, publicly available information or other institutions' statutory reporting was used to ensure a harmonised classification throughout the entire exercise.

1.2 Reclassification of foreign exposures

Data availability issues hindered the use of the same methodology adopted for the allocation of domestic exposures. To this end, since a manual search of all individual exposures was not plausible given the large volume of data to be handled, a materiality approach was adopted. As a result, a manual examination of the exposures of the ten largest foreign companies, or at least half of foreign holding companies' presence within the portfolios of banks, domestically-relevant insurances and investment funds, whichever provided the highest coverage, was undertaken.[6] For the securities portfolio, this required the identification and ultimate reclassification of exposures pertaining to 53 foreign holding companies (see Figure 2). In most cases, this reflected almost two thirds of the financial sector's securities exposures. At the same time, for the loan exposures, ten entities were

Figure 2
RECLASSIFICATION OF FOREIGN HOLDING COMPANIES



6 More than ten foreign holding companies present within the bond portfolio of domestically-relevant investment funds to capture half of their foreign bond portfolio.

analysed which represented around two thirds of the overall foreign loans granted towards both NACE sectors K and M, as reported in the CCR. The reclassification was conducted using publicly available information or information available from the CCR, the Anacredit database, the SHSS or statutory reporting. The observed share was imposed onto the remainder of the data to upscale the reclassification to its population size.

Once all respective exposures, both domestic and foreign, were reclassified, the Maltese financial sector's concentration to the High, Mid and Low CO_2 intensive sectors as defined in the Bank's 2021 study was recalculated (see Annex).

2. Results from the refined classification of exposures

2.1 Banking sector's exposures

2.1.1 Banks' lending portfolio

The reclassification of resident loans, as at December 2022, reported under the financial and insurance sector (NACE K) and the professional, scientific, and technical activities (NACE M) led to the share of resident lending towards the Low CO_2 intensive sectors to drop by 9.4 percentage points to 47.3% of the overall resident loan book (see Chart 1). This resulted in the share of lending to Mid CO_2 and High CO_2 intensive sectors to represent more than half of the resident loan book. The most significant shift occurred into the Mid CO_2 intensive sectors, with their share rising by 7.3 percentage points to 26.1%. This increase primarily stemmed from the reclassification of resident loans towards the 'H52 – Warehousing and Support Activities for Transportation' and, to a lesser extent, into the wholesale and retail trade activities (i.e., NACE G46 and G47), as well as rental and leasing activities (NACE N77) (see Chart 2). The increase in loans granted to

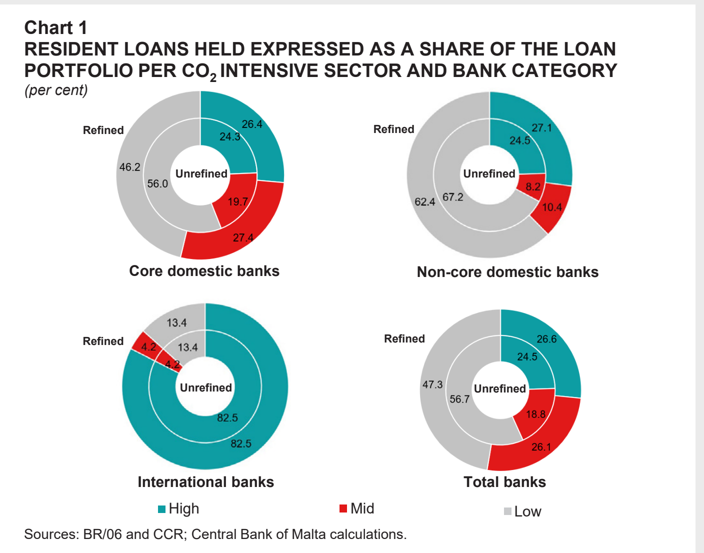


Chart 1
RESIDENT LOANS HELD EXPRESSED AS A SHARE OF THE LOAN PORTFOLIO PER CO_2 INTENSIVE SECTOR AND BANK CATEGORY
(per cent)

Sources: BR/06 and CCR; Central Bank of Malta calculations.

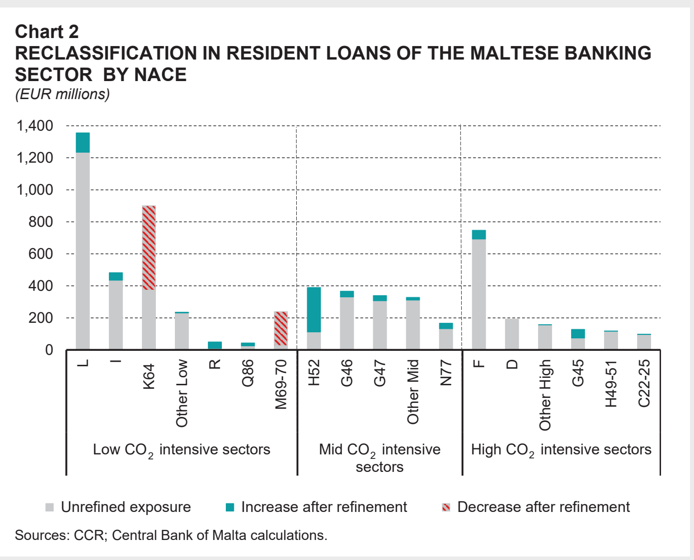


Chart 2
RECLASSIFICATION IN RESIDENT LOANS OF THE MALTESE BANKING SECTOR BY NACE
(EUR millions)

Sources: CCR; Central Bank of Malta calculations.

sectors classified as High CO_2 intensive was more contained, with the share rising by 2.1 percentage points to just above a quarter of the resident loan book. This stemmed predominantly from the construction sector (NACE F) and the wholesale and retail trade and repair of motor vehicles (NACE G45). As a result, the construction sector (NACE F) continued to strengthen its position as the primary recipient of bank financing amongst the High CO_2 intensive sectors, followed by the energy-related sector (NACE D), the wholesale and retail trade and repair of motor vehicles (NACE G45).

From a bank category perspective, 92.3% of resident loans issued are reported on the books of the core domestic banks. Consequently, this group of banks is the main driver behind developments reported for the overall banking sector as explained above and shown in Chart 1. The non-core domestic banks, which granted about 7.5% of the overall resident loans, have a higher share of resident loans towards Low CO_2 intensive sectors. This share fell by almost 5 percentage points post-reclassification, to 62.4% of their resident loan book. This change mainly reflected increases in the Mid CO_2 intensive sectors, which however still accounted for 10.4%. This increase was driven by a significant shift in loans towards 'Rental and Leasing Activities' (NACE N77) and, to a lesser extent, the wholesale trade, except for motor vehicles and motorcycles (NACE G46). Lending to High CO_2 intensive sectors also rose, with the share rising by 2.6 percentage points, to represent more than a quarter of the non-core domestic banks' resident portfolio. This increase was driven by higher loans issued to companies operating in the wholesale and retail trade and repair of motor vehicles (NACE G45) as well as resident companies operating in the construction sector (NACE F). Meanwhile, international banks accounted for only 0.2% of the overall resident loans issued in the Maltese banking sector. The reclassification exercise did not have any material impact on these banks' resident loan portfolio such that these remained concentrated in the High CO_2 intensive sectors at 82.5%.

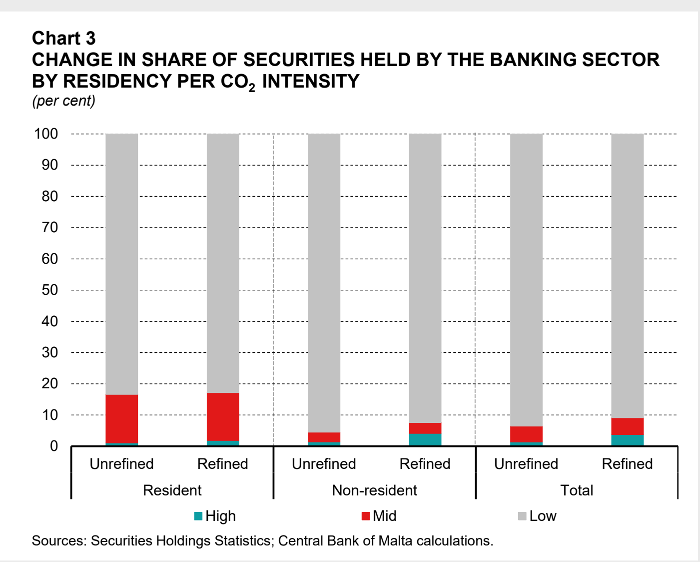
The reclassification exercise had a very marginal impact on foreign loans, with the share of Mid CO_2 intensive sectors increasing by just 1.1 percentage points to 45.2%, being the largest share for these foreign loans, at the expense of loans issued towards Low CO_2 intensive sectors, whose share fell to 31.2%. Meanwhile, the share of High CO_2 intensive sectors remained unchanged at 23.7%.

2.1.2 Banks' securities portfolio

As at the end of 2022, the banking sector's overall securities holdings were valued at €3.3 billion, of which €2.3 billion represented holdings of the core domestic banks, with the rest almost equally split between the non-core domestic banks and international banks. Representing 16.1% of the banking sector's entire securities portfolio, investments in domestic securities is somewhat limited, almost entirely reflecting core domestic banks' activity.

Following the reclassification, both banks' resident and non-resident securities holdings remained concentrated in the Low CO_2 intensive sector at nearly 83% and 92% of the corresponding portfolio, respectively (see Chart 3). All three bank categories reported the bulk of their securities in the Low CO_2 intensive sectors (see Chart 4).

Chart 3
CHANGE IN SHARE OF SECURITIES HELD BY THE BANKING SECTOR BY RESIDENCY PER CO_2 INTENSITY
(per cent)



Sources: Securities Holdings Statistics; Central Bank of Malta calculations.

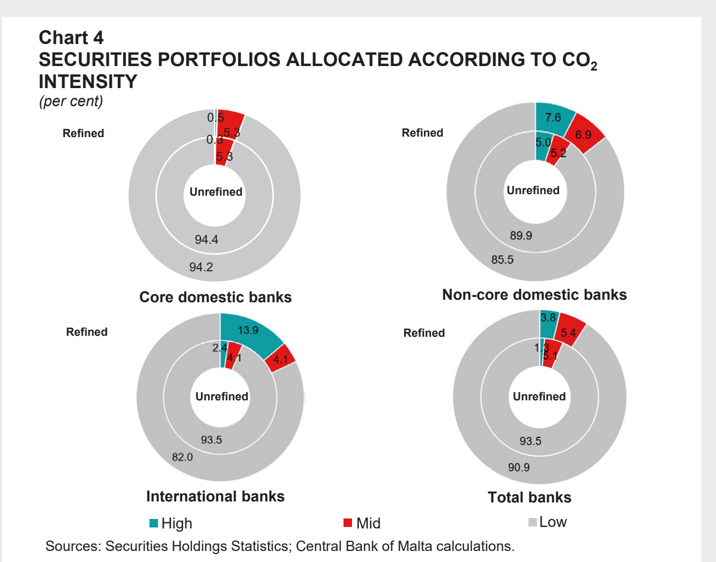
This was to some extent also reinforced by the fact that some of the holding companies were related to banking groups, thus remaining within the financial sector (NACE K64) after the reclassification exercise.

Nevertheless, the value of overall securities exposed to the High CO_2 intensive category more than doubled, with their share advancing by 2.4 percentage points to 3.8% of overall securities in December 2022 (see Chart 4). This owed to the fact that group activity of some holding companies, especially those of foreign origin, is primarily of a higher CO_2 intensity. As can be observed in Chart 5, these were primarily involved in the manufacturing sector (NACE C22-25 and C29-30), and to a lower extent energy (NACE D) and construction (NACE F) industries.

2.2 Non-banking sector's exposures

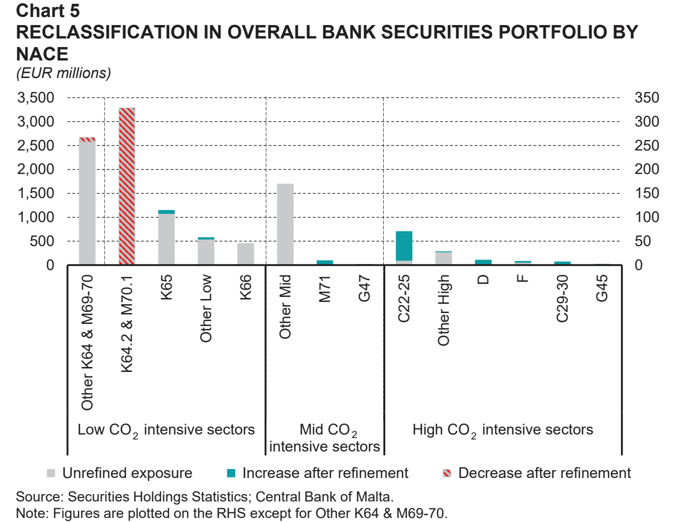
In December 2022, the securities holdings of the non-bank sector amounted to €2.0 billion, of which €650.9 million reflected domestic exposures. The reclassification resulted in exposures of both domestic and foreign holding companies to be distributed in other sectors, primarily in the retail trade (NACE G), energy (NACE D), mining and quarrying (NACE B), and accommodation (NACE I) sectors (see Chart 6). Since most of these sectors are emission intensive, securities holdings falling in the Mid

Chart 4
SECURITIES PORTFOLIOS ALLOCATED ACCORDING TO CO_2 INTENSITY
(per cent)



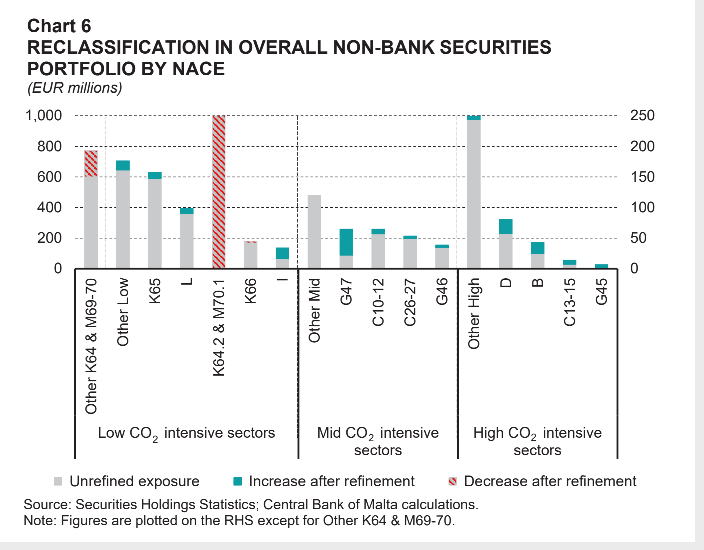
Sources: Securities Holdings Statistics; Central Bank of Malta calculations.

Chart 5
RECLASSIFICATION IN OVERALL BANK SECURITIES PORTFOLIO BY NACE
(EUR millions)



Source: Securities Holdings Statistics; Central Bank of Malta.
Note: Figures are plotted on the RHS except for Other K64 & M69-70.

Chart 6
RECLASSIFICATION IN OVERALL NON-BANK SECURITIES PORTFOLIO BY NACE
(EUR millions)



Source: Securities Holdings Statistics; Central Bank of Malta calculations.
Note: Figures are plotted on the RHS except for Other K64 & M69-70.

and High CO_2 intensive categories expanded by around 21% and 20%, to account for 16.8% and 19.1% of non-banks' overall holdings, respectively. Nevertheless, the share in the Low CO_2 intensive sectors remained significant at more than 64% of overall securities.

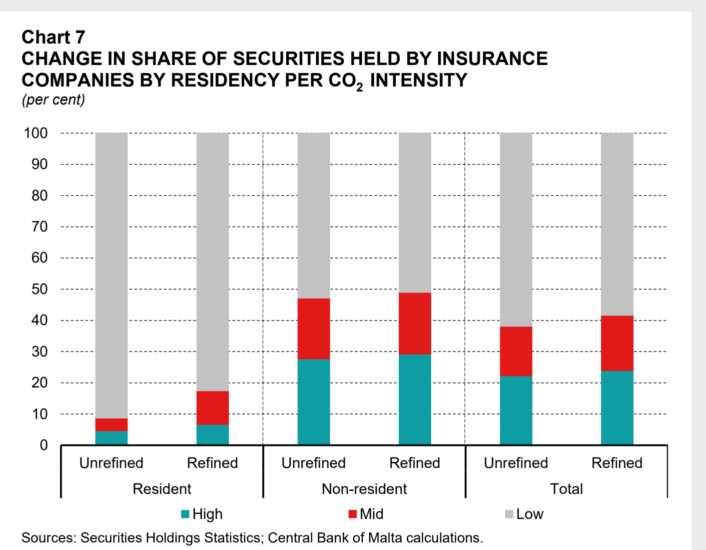


Chart 7
CHANGE IN SHARE OF SECURITIES HELD BY INSURANCE COMPANIES BY RESIDENCY PER CO_2 INTENSITY
(per cent)
Sources: Securities Holdings Statistics; Central Bank of Malta calculations.

As can be observed in Chart 7, the reclassification for the domestically-relevant insurance companies mostly impacted their domestic holdings, such that their exposure to companies operating in the Mid and High CO_2 intensive categories grew. These nevertheless represented a somewhat conservative share of 6.6% and 10.8% of overall resident holdings, respectively. Similarly, the exercise mostly impacted the domestic portfolio of investment funds, as the Mid and High CO_2 intensive categories both expanded to make up 7.7% and 26.4% of their resident investments, respectively (see Chart 8).

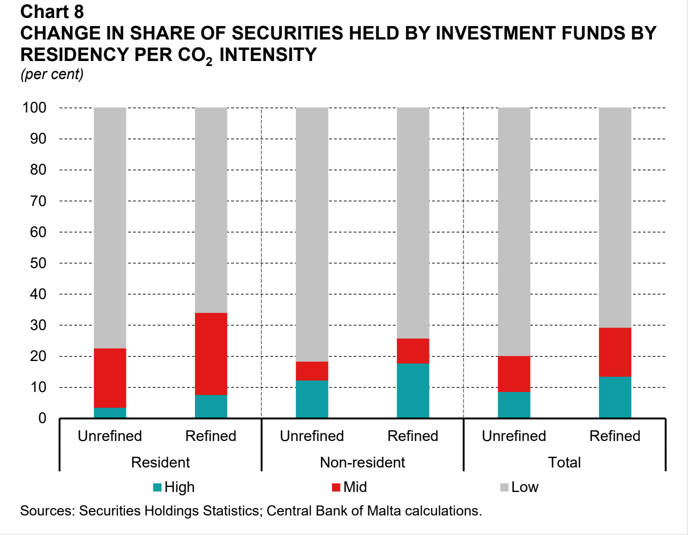


Chart 8
CHANGE IN SHARE OF SECURITIES HELD BY INVESTMENT FUNDS BY RESIDENCY PER CO_2 INTENSITY
(per cent)
Sources: Securities Holdings Statistics; Central Bank of Malta calculations.

2.3 Overall impact of the reclassification

The reclassification exercise led to the share of overall banks' loan portfolio in the High CO_2 intensive sectors to increase by 1.1 percentage points to 24.9%. Similarly, the share of bank loans granted to Mid CO_2 intensive sectors also grew, to account for 36.5%, up from the 32.2% prior to the reclassification exercise. As a result, the share of loans granted to entities operating in the Low CO_2 intensive sectors fell by around 5.3 percentage points to 38.6%.

Banks' share of securities holdings of High CO_2 intensive sectors increased by 2.4 percentage points to 3.8%. Meanwhile, a small impact was observed within the Mid CO_2 intensive category, with their share rising by a mere 0.3 percentage point to 5.4%. As a result, most of the portfolio remained concentrated in securities of Low CO_2 intensive sectors.

Similar results were observed for the securities portfolio of the non-bank sector. About two thirds of the portfolio remained within Low CO_2 intensive sectors. At the same time, the share of exposure towards the High CO_2 intensive industries rose to 19.1%, from the 15.9%, as a result of the reclassification, whilst that for Mid CO_2 intensive industries increased by 2.9 percentage points to 16.8%.

On aggregate, more than half of the Maltese financial sector's exposures remained concentrated in sectors of a Low CO_2 intensity, despite shrinking by 4.8 percentage points to 52.6% in December 2022. The largest increase for the financial industry was registered in activity of a Mid CO_2 intensity, with the share climbing from 24.3% to 27.6%, while exposures to the High CO_2 intensive sectors continued to represent less than one fifth of overall exposures during the same period.

3. Conclusion

This analysis sought to refine the results originally reported by reclassifying the holding companies' loan and securities' exposures into sectors which more appropriately reflect the business activity of their group. This offers a better picture on the extent of possible transition risks for financial stability in Malta. Despite representing just 10.7% of financial institutions' balance sheets, the refinement methodology did result in a significant and more accurate activity-based reclassification of the exposures of holding companies. Indeed, their reclassification resulted in an increased share of exposures to the more climate-sensitive sectors, particularly those defined as being High CO_2 intensive. Nevertheless, following the reclassification exercise, both banks and non-banks reconfirmed the majority of their exposures towards Low CO_2 intensive sectors. This reaffirms the main conclusions of the previous study, that given their concentration in the Low CO_2 intensive sectors, domestic institutions may be less sensitive to regulations and abrupt measures aimed at reaching net zero and hence making Maltese financial institutions somewhat less susceptible to transition risk. Nevertheless, domestic institutions should maintain a cautious approach to mitigate any potential adverse effects on their balance sheets that may occur due to their material exposure to the more climate-sensitive sectors.

Existing data gaps limit the possibility of a more precise reclassification of exposures of holding companies. Nevertheless, the analysis could in the future, benefit from an improvement in data availability to possibly update the underlying methodology of identifying climate-sensitive sectors to better capture climate transition risk. This includes expanding the scope of emissions to capture those of a less direct nature, as well as possibly other forms of greenhouse gases including methane and nitrous oxides. Further studies could also review the concentration of exposure to transition risks, as well as possible links and interlinkages among financial institutions. Another study could assess the banking sector's initiatives in achieving a more sustainable asset portfolio, through the review of their strategies in financing the green transition through an increasing footprint of green loans and investments.

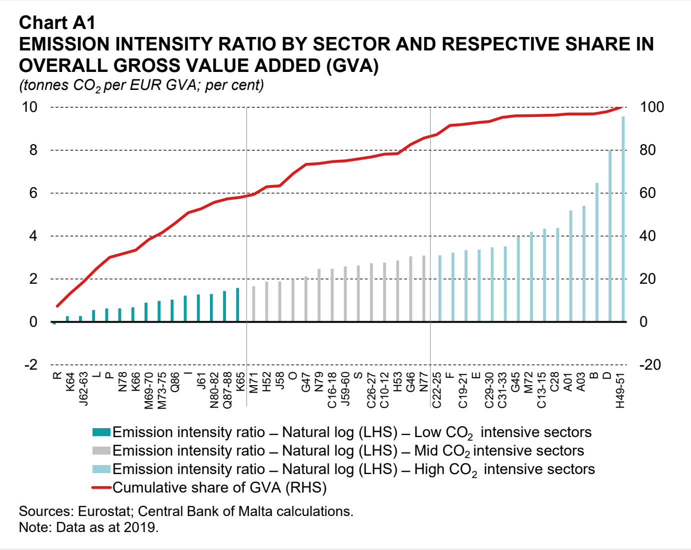
Annex

Table A1
NACE CLASSIFICATION PER CLIMATE-RELATED SENSITIVE SECTORS

NACE Code	Sector	NACE Rev. 2 classification		
		High CO_2 intensive sectors	Mid CO_2 intensive sectors	Low CO_2 intensive sectors
A	Agriculture, forestry, and fishing	A01, A03		
B	Mining and quarrying	B		
C	Manufacturing	C13-C15, C19-C21, C22-C25, C28,C29-C30, C31-C33	C10-C12, C16-C18, C26-C27	
D	Electricity, gas, steam and air conditioning supply	D		
E	Water supply; sewerage waste management and remediation activities	E		
F	Construction	F		
G	Wholesale and retail trade; repair of motor vehicles and motorcycles	G45	G46, G47	
H	Transportation and storage	H49-H51	H52, H53	
I	Accommodation and food service activities			I
J	Information and communication		J58, J59-J60	J61, J62-J63
K	Financial and insurance activities			K64, K65, K66
L	Real estate activities			L
M	Professional, scientific, and technical activities	M72	M71	M69-M70, M73-M75
N	Administrative and support services activities		N77, N79	N78, N80-N82
O	Public administration and defence; compulsory social security		O	
P	Education			P
Q	Human health and social work activities			Q86, Q87-Q88
R	Arts, entertainment and recreation			R
S	Other services activities		S	

Sources: Eurostat; Central Bank of Malta.

Chart A1
EMISSION INTENSITY RATIO BY SECTOR AND RESPECTIVE SHARE IN OVERALL GROSS VALUE ADDED (GVA)
(tonnes CO_2 per EUR GVA; per cent)



Sources: Eurostat; Central Bank of Malta calculations.
Note: Data as at 2019.

1.2 Macroprudential regulatory developments

Identification of Other Systemically Important Institutions (O-SIIs)
On a yearly basis, the Bank and the Malta Financial Services Authority (MFSA) conduct an assessment to identify and apply a capital buffer to domestic (other) systemically important institutions (O-SIIs). This assessment is carried out in line with the CBM-MFSA O-SII policy document. The latest Bank decision on the four designated O-SIIs and their corresponding capital buffer rates for 2023 remained unchanged during the period under review.[10] The next round of assessment is currently underway, and results are expected to be published by the first quarter of 2024.

Countercyclical Capital Buffer (CCyB)
In line with the Central Bank of Malta's quarterly CCyB assessment for the fourth quarter of 2023, a CCyB of 0% remains adequate for the domestic financial system.[11] A standard credit-to-GDP ratio of 71.7%, and its deviation from the long-term trend amounting to -5.9 percentage points confirms this assessment. Furthermore, supplementary indicators suggest that at the current juncture, cyclical risks are being driven by mortgage lending, which are being addressed with the introduction of a sSyRB.

Sectoral Systemic Risk Buffer (sSyRB)
As per the Statement of Decision on the Implementation of a sSyRB for Malta, the Central Bank of Malta together with the MFSA, following the recommendation of the Joint Financial Stability Board, decided to set a sSyRB of 1.5% with effective date being that of 28 March 2023. The aim of the sSyrB is to address the prevailing cyclical and concentration risk related to domestic banks' exposures to the RRE sector risk via mortgage loans to households.[12] The buffer is applicable on the amount of RWAs held against domestic mortgages to natural persons and secured by domestic RRE collateral. Buy-to-let residential loans to natural persons secured by RRE collateral are also in scope of the buffer. The buffer is applicable to all domestic credit institutions which are engaged in mortgage lending, with the sSyRB's first phase of implementation being end September 2023 (1% rate), and fully phased-in (1.5% rate), as of end March 2024.

Borrower-based measures (BBMs)
CBM Directive No.16 on BBMs has now been active domestically for five years since its implementation in July 2019. During 2023, no changes were deemed necessary to the Directive; nonetheless the Bank remains vigilant to developments in the domestic RRE market which may require updates to the Directive so as to continue to safeguard financial stability.

During the first quarter of 2023, the Bank communicated a set of Guidelines for Directive No.16 Internal Audit reports to domestic credit institutions. The aim of these Guidelines is to ensure that checks applied by the respective banks' auditors in their internal assessments are consistent, and to standardise the processes across the reporting banks, thus ensuring better adherence to Directive No. 16.

Voluntary reciprocation of macroprudential measures
As per European Systemic Risk Board (ESRB) Recommendation on the assessment of cross-border effects and voluntary reciprocity for macroprudential measures, the Bank reviews newly implemented measures recommended for reciprocation by Member States. During July 2023, there was one new measure recommended for reciprocation by the Swedish Authorities, comprising of risk weight floors for corporate exposures secured by commercial and residential properties located in Sweden to institutions using the internal ratings-based (IRB) approach for calculating regulatory capital requirements.

After analysing the above recommended policy measure, the Bank did not find any basis for reciprocation owing to the immateriality of listed exposures in the local banking sector, and inapplicability of the policy measure to the domestic financial system. Furthermore, the Bank also maintained its non-reciprocation

[10] Further details on the latest O-SII decision are available in the 2023 CBM-MFSA O-SII statement of decision.
[11] The Countercyclical Capital Buffer Rate.
[12] Statement of decision on the implementation of a sSyRB on RRE domestic mortgages in Malta.

stance unchanged in relation to the previously activated measures recommended for reciprocation by other Member States. Latest available information on the reciprocation stance taken by the CBM can be found in this link.

Identification of material third countries

In accordance with the ESRB Recommendation ESRB/2015/1, on recognising and setting countercyclical buffer rates for exposures to third countries, the Central Bank of Malta identifies annually the third countries to which its domestic banking sector is materially exposed. Furthermore, the Bank monitors the risks to financial stability, stemming from excessive credit growth in those countries.[13]

In line with the criteria laid down in Article 4 of the ESRB Decision 2015/3, the Central Bank of Malta identified the list of material third countries for Malta, for the period Q2 2023 until Q2 2024.[14] The list remains identical to the one determined last year, and comprises the United States of America, the United Kingdom, and the United Arab Emirates.

[13] ESRB 2015/1: Recommendation of the ESRB of 11 December 2015 on recognising and setting countercyclical buffer rates for exposures to third countries.

[14] ESRB/2015/3: Decision of the ESRB of 11 December 2015 on the assessment of materiality of third countries for the Union's banking system in relation to the recognition and setting of countercyclical buffer rates.

BOX 2: AN OVERVIEW OF BANK REGULATORY REQUIREMENTS[1]

In line with the regulatory requirements set in the Capital Requirements Directive (CRD V), Capital Requirements Regulation (CRR II), Bank Recovery and Resolution Directive (BRRD II) and the Single Resolution Mechanism Regulation (SRMR II), banks are required to fulfil multiple regulatory requirements on a going concern basis.[2,3,4,5] In this regard, the aim of this box is to outline the interaction of these regulatory requirements which comprise:

i. Risk-based own funds requirements;
ii. Leverage ratio (LR) requirements;
iii. Minimum requirement for own funds and eligible liabilities (MREL).

As highlighted in Table 1 below, the aim of the prudential requirements is to ensure the resilience of each institution at a national level and of the EU banking system, as per CRD V and complemented by the CRR II; which effectively puts the Basel III international standards into EU law. On the other hand, the aim of MREL within the resolution framework is to ensure that banking institutions have, at all times, sufficient eligible instruments to facilitate the successful implementation of the preferred resolution strategy in the event of a bank failure. The resolution framework is based on the BRRD II and the SRMR II.

Table 1
SUMMARY OF REGULATORY REQUIREMENTS

Regulatory requirement	Purpose	Requirement ratio denominator
Risk-based capital requirements	Ensure that institutions are well-capitalised to cover the level of risk and absorb potential losses	Total risk exposure amount (TREA)
LR requirements	Outline the relationship between a bank's capital and its assets and off-balance-sheet items to restrain excessive leverage	Total leverage ratio exposure (LRE)
MREL	Ensure that institutions have sufficient loss absorbing and recapitalization capacity to facilitate the successful implementation of the preferred resolution strategy	Two parallel requirements: MREL-TREA and MREL-LRE

[1] Prepared by Mr Jurgen Grima, Principal Economist and Mr Paul Giordmaina, Senior Analyst within Policy Crisis Management and Stress Testing Department. The authors would like to thank Dr Ashleigh Neill, Senior Economist and Ms Christine Balzan, Manager within the same Department.

[2] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[3] Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No. 648/2012.

[4] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council.

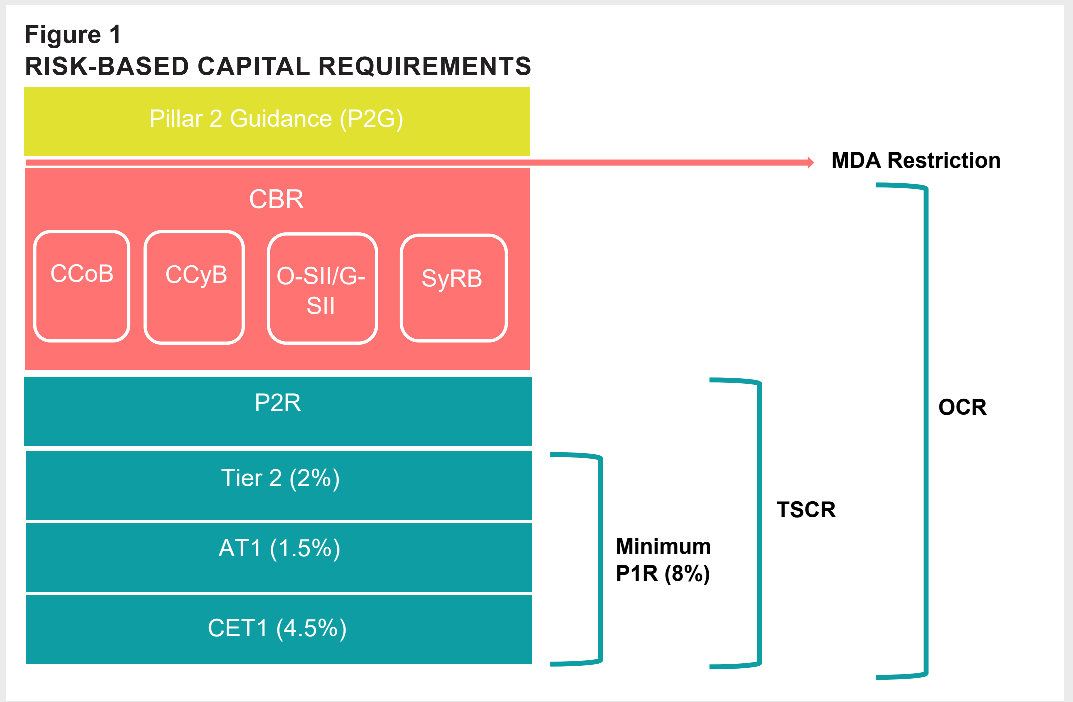
[5] Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010.

Risk-based capital requirements

Banks are required to meet Pillar 1 and Pillar 2 requirements in line with the Basel framework.[6] Pillar 1 requirements (P1R) apply uniformly to all banks and act as minimum capital requirements to cover for developments related to market, credit and operational risk, whereas Pillar 2 requirements (P2R) are bank-specific, depending on the risk profile of the bank, and are intended to cover those risks which are not covered under P1R. Banks are required to hold a minimum P1R of 8% of its TREA at all times. This is segregated into a Common Equity Tier 1 (CET1) ratio of 4.5%, an additional Tier 1 (AT1) ratio of 1.5% and a Tier 2 ratio of 2%.[7] On top of the P1R sits the P2R which is bank-specific and determined through the Supervisory Review and Evaluation Process (SREP).[8] This involves a supervisory assessment conducted either by the ECB or national competent authorities (NCAs), whichever is the case, of each bank's specific risks covering its business model, governance framework and overall risk management practices.[9] The sum of the minimum P1R and P2R is referred to as the Total SREP Capital Requirement (TSCR) as highlighted in Figure 1.

The Overall Capital Requirement (OCR) is then calculated by adding the TSCR and the Combined Buffer Requirement (CBR) which sits on top of P1R and P2R. The CBR includes the Capital Conservation Buffer (CCoB) which is set at 2.5% for all banks, the CCyB, the Global Systemically Important Institutions (G-SII) Buffer, the O-SIIs Buffer and the Systemic Risk Buffer (SyRB)

Figure 1
RISK-BASED CAPITAL REQUIREMENTS



[6] The Basel Framework comprises of the full set of standards of the Basel Committee on Banking Supervision (BCBS), which acts as the primary global standard setter for the prudential regulation of banks.

[7] CET1 instruments comprise of a bank's core capital and mainly include common shares and retained earnings. AT1 instruments include preference shares and high contingent convertible securities whereas Tier 2 instruments may include subordinated debt, undisclosed reserves, general provisions and loss reserves.

[8] As per CRD V, banks can fulfil P2R with a minimum 75% of Tier 1 capital, out of which a minimum of 75% should be held in CET1 and the rest can be met with AT1. The other 25% can be met with Tier 2 instruments.

[9] If a bank is classified as a Significant Institution (SI) for Single Supervisory Mechanism (SSM) purposes, the SREP process is performed by the ECB and the respective Joint Supervisory Teams (JSTs) together with representatives from the domestic NCA. The SREP process for Less Significant Institutions (LSIs) is conducted solely by the respective domestic NCA.

if applicable.[10] These buffers are to be held entirely of CET1 capital. The P2G sits on top of the P1R, P2R and CBR as highlighted in figure 1 and comprises of a bank-specific recommendation on the optimal level of capital a bank should maintain to ensure that it absorbs potential losses resulting from stress testing calibration approaches used to gauge adverse scenarios. The P2G is non-binding and is to be met with CET1 capital instrument types.

LR requirements

In conjunction with the risk-based capital requirements, banks are also requested to maintain an LR P1R of 3% which can be held in Tier 1 capital.[11] When conducting the SREP process, the ECB or NCAs may additionally impose a P2R LR requirement if they determine that a supervised bank has a particularly high risk of excessive leverage.[12] This P2R LR requirement sits on top of the 3% LR P1R, is legally binding and is to be met using CET1 capital as a percentage of the banks' total leverage exposure amount. On top of the P2R LR requirement sits the LR buffer for G-SIIs which is equivalent to 50% of the G-SII buffer imposed by macroprudential authorities on G-SIIs in terms of TREA and is to be held using Tier 1 capital as a percentage of the bank's total leverage exposure amount.[13] Similar to the risk-based capital requirement, on top of the G-SII LR buffer, banks are expected to follow the P2G LR Guidance which is non-binding and is based on individual bank performance in the EU-wide stress tests. This is to be held using CET1 capital as a percentage of the bank's total leverage exposure amount.

Minimum requirements for own funds and eligible liabilities

With regard to requirements for resolution purposes, MREL is set by resolution authorities and follows the Total Loss Absorbing Capacity (TLAC) standard developed by the Financial Stability Board (FSB). This framework seeks to ensure that institutions have sufficient loss absorbing and recapitalization capacity in case of resolution. Overall, MREL ensures the continuity of the bank's critical functions which, in turn, provides better protection to depositors, minimises the recourse to public funds and maintains financial stability. Whilst it is a separate minimum requirement which institutions are required to meet in parallel to its prudential minimum capital requirements, its calibration is linked to the prudential requirements (Pillar I, Pillar II and capital buffers). Instruments eligible for MREL purposes include both own funds which are held by banks to meet their prudential requirements as explained above, and eligible liabilities that are subordinated to all claims arising from excluded liabilities.[14] In addition, similar to the risk-based capital requirements, MREL is expressed as two ratios that have to be met in parallel: (i) as a percentage of TREA (MREL-TREA); and (ii) as a percentage of LRE (MREL-LRE).

As for its calibration, MREL is made up of a loss-absorption amount (LAA) and a Recapitalisation Amount (RCA) for institutions that have resolution as their preferred resolution strategy. The LAA reflects the losses that the bank should be capable of absorbing in the event of failure. In the case of MREL-TREA, it consists of the sum of the Supervisory P1R and P2R, whereas in the case of MREL-LRE, it consists of the LR requirement. In the case of the RCA, it is the amount necessary for an institution to restore compliance after the resolution strategy is implemented so as to continue to comply with its conditions for authorisation and carry on the activities for which it is authorised under the relevant legislation. Similar to the LAA, in the case of MREL-TREA it consists of the sum of the Supervisory P1R and P2R, whereas in the case

[10] The main objective of the CCoB is to have an additional capital layer above the minimum requirements; the CCyB would be applicable to all banks and addresses cyclical risks emanating from excessive credit growth; the G-SII/O-SII buffer would be imposed on either global or domestic 'too big to fail' banks whose failure would have a considerable impact on the financial system and the SyRB may be applied to target different sources of systemic risk and given its flexibility can be applied to different sectors, classes of exposures and to specific institutions.

[11] A bank's LR may be calculated by dividing its Tier 1 capital by its total LRE measure. This 3% LR requirement became binding on 28 June 2021.

[12] This is mainly intended to cover for leverage risk originating from banks using derivatives, securities financing transactions and off-balance-sheet items in their business operations.

[13] As an example, if a specific bank's risk-based G-SII buffer is 1%, its LR G-SII buffer would be 0.50%.

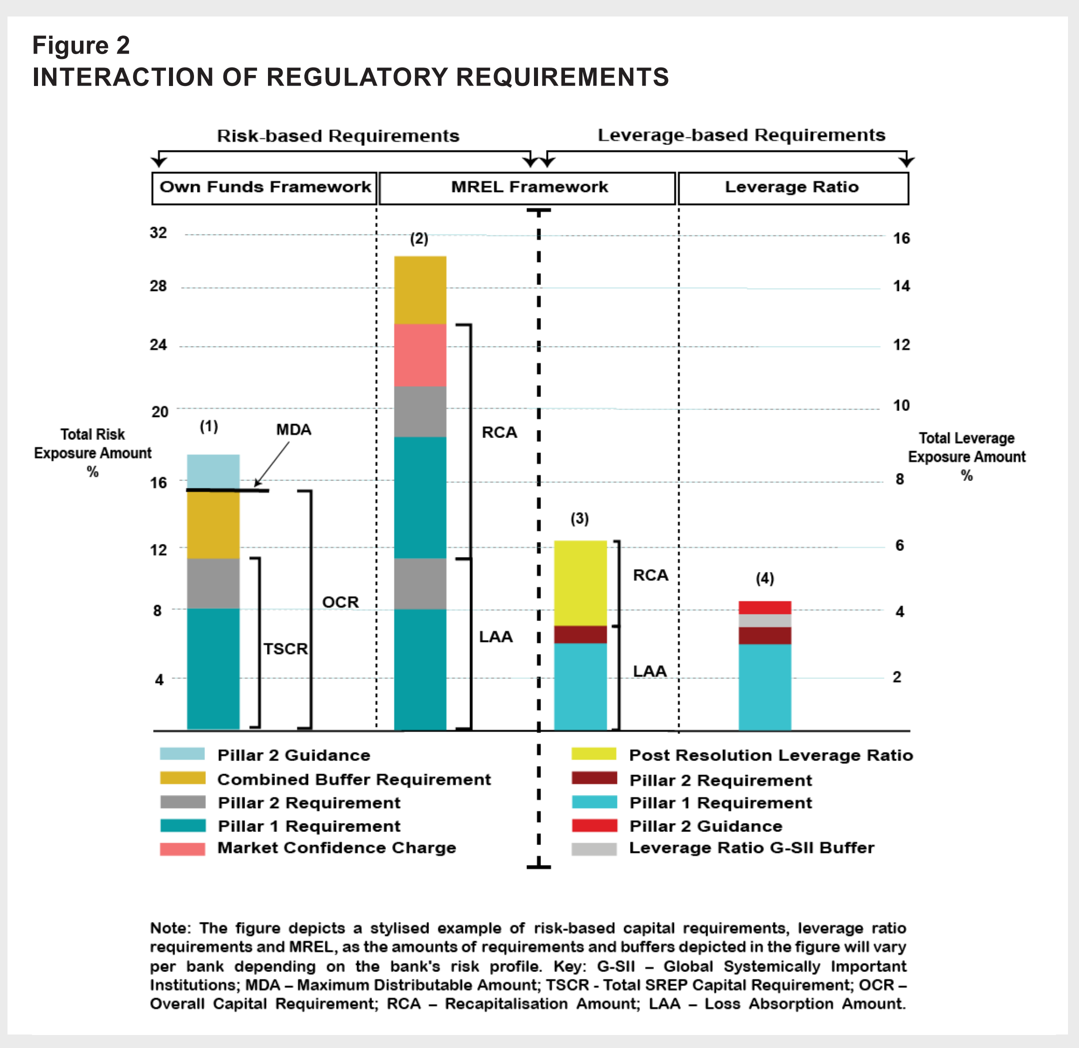
[14] Article 72b (2)(d) CRR for G-SIIs and Article 12d(4) and Article 12d(5) SRMR for Top Tier banks and Other Pillar 1 banks.

of MREL-LRE it consists of the LR requirement. However, in addition, in the case of the RCA the legal framework sets conditions under which this can be adjusted upwards or downwards. One such instance is by applying a Market Confidence Charge (MCC) to ensure that, following resolution, the resolution entity sustains sufficient market confidence. This adjustment relates to the MREL-TREA only and is equal to the CBR minus the CCyB.

On the other hand, entities that would be wound up in normal insolvency procedures have an LAA, but no RCA. In such instances, MREL will be covered by the same own funds which institutions use to meet their prudential capital requirements and hence no additional instruments would be required to be issued.[15] An important consideration is that, in the case of MREL-TREA, CET1 instruments used to meet the latter cannot be used to meet the CBR. Thus, the CBR should be met with CET1 instruments over and above the MREL-TREA requirement.

In conclusion, Figure 2 below highlights how the three regulatory requirements interact with each other. Bar graph (1) outlines the capital requirements banks are required to hold under the risk-based framework in terms of TREA whilst bar graph (4) shows the capital requirements banks are required

Figure 2
INTERACTION OF REGULATORY REQUIREMENTS



Note: The figure depicts a stylised example of risk-based capital requirements, leverage ratio requirements and MREL, as the amounts of requirements and buffers depicted in the figure will vary per bank depending on the bank's risk profile. Key: G-SII – Global Systemically Important Institutions; MDA – Maximum Distributable Amount; TSCR - Total SREP Capital Requirement; OCR – Overall Capital Requirement; RCA – Recapitalisation Amount; LAA – Loss Absorption Amount.

[15] The SRB MREL policy allows in specific instances for an upward adjustment to the LAA for liquidation entities if it is determined that there is any possible impact on financial stability and on the risk of contagion to the financial system.

to meet under the leverage-based framework. As highlighted previously, banks are required to meet in conjunction both a P1R of 8% in terms of TREA and a 3% LR requirement. Subsequently, on top of the P1R sits the P2R, CBR and P2G which, unlike the P1R, differ across banks. In the case of the risk-based requirements, as outlined under Bar graph (1), if a bank's capital level falls below the OCR, a capital conservation plan would need to be submitted to the ECB or respective NCA in line with CRD requirements, outlining the timeframe and set of measures to be implemented to increase the capital ratio. Moreover, the Maximum Distributable Amount (MDA) would be automatically triggered limiting the amount of distributions (such as dividends, share buybacks and bonuses) that a bank can make. For banks which are subject to a resolution action, bar graph (2) depicts the risk-based MREL requirements which banks must hold. As explained before this is made up of LAA and RCA with the CBR sitting on top. On the other hand, bar graph (3) depicts MREL in terms of the leverage-based framework whereby, similar to the risk-based MREL, is made up of the LAA and RCA.