EXECUTIVE SUMMARY

The first half of 2023 was characterised by a confluence of risk factors, as inflation stayed persistently high, and signs of weaker economic activity abounded. This within a hostile external environment of tighter financing conditions and continued geopolitical conflicts. Furthermore, in the early months of the year, there was a brief fallout in financial markets owing to the failure of three US banks and the takeover of another European bank. Apart from weighing on economic growth, these conditions have further tested the stability of global financial systems. However, the Maltese islands have shown resilience in the face of such external shocks, with the economy still growing by 4.4% over the first six months of 2023.

The build-up of vulnerabilities associated with both strong mortgage growth rates and property prices, unravelled in the euro area, as monetary tightening affected demand for real estate. This led to a slowdown in mortgage lending with property price growth turning negative. Domestically, a much milder slowdown reflected a somewhat lower degree of monetary policy pass-through and the continued supporting stimulus from Government incentives.

The domestic financial sector remained resilient, as banks continued to strengthen their capital and liquidity positions, even under the stressed scenarios tested by the Bank. Furthermore, the quality of the domestic banks' loan book continued to improve, thus minimising prospects of increased credit risk. The rising interest rate environment helped banks' profitability, reflecting higher net interest earned on their loan portfolio as well as from placements held with the Central Bank of Malta. The impact on funding costs has meanwhile remained negligible. However, banks are operating in a more competitive environment for deposit-taking activities, as resident customer deposits contracted in the first half of the year. Credit growth continued to be mainly driven by property-related loans, as mortgage lending remained strong despite slowing down compared to peaks reported in 2022.

Despite some stress in financial markets, the assets of the domestically-relevant insurance companies rose in the first half of the year. This growth was accompanied by robust liquidity and strong capital positions, while remaining profitable. Yet, some of the previously identified risks remained present. Life insurers remain particularly vulnerable to a lower demand for their products, as other more rewarding investment opportunities are coming on stream for policy holders given the higher interest rate environment. The non-life insurance segment is facing increasing costs propelled by the still-high inflationary environment. Domestically-relevant investment funds continued to invest largely in liquid assets and operate with limited leverage. While the level of cash and deposits reached an all-time low, the effect of liquidity mismatches are somewhat limited. The presence of liquidity management tools, such as gating mechanisms and redemption fees limit somewhat the impact of potential runs. While risks to financial stability remain low in Malta, the Bank encourages market players to remain vigilant to existing and potential emerging risks, such as bigger-than- expected shocks to the macroeconomic environment and tighter financial conditions and exposures to the real estate sector. The application of a sectoral systemic risk buffer (sSyRB) on domestic mortgages, starting from the third quarter of 2023, will further assist banks in maintaining a prudent approach to possible vulnerabilities emanating from the residential real estate (RRE) market in Malta, especially given the banks' exposure to such sector. Combined with ongoing surveillance and effective capital and provisioning strategies, this would further contribute to the preservation of the stability of the domestic financial system.

The *Report* also puts forward three articles and a special feature. The first article looks to inform on the various banks' capital requirements. The second provides a refined assessment of the exposures to climate-sensitive sectors originally published in the *Interim Financial Stability Report 2021*. This study aims to reclassify exposures to holding companies to sectors which more appropriately reflect underlying transition risks. The third article looks at the revised methodology for selecting domestically-relevant insurance companies. Meanwhile the special feature looks at an alternative way to assess cyclical risks, with the construction of a semi-structural credit gap derived using a multivariate filter. The study points to a positive credit gap in recent years, confirming that this was driven primarily by the household sector.

The *Interim Financial Stability Report* is prepared by the Central Bank of Malta through the joint efforts of the Financial Stability Surveillance and Research Department, and the Policy, Crisis Management and Stress Testing Department of the Bank. The Report is reviewed by the Bank's Financial Stability Committee, which is responsible to oversee and implement policies related to financial stability and the macroprudential framework.