1. MACROPRUDENTIAL RISK ASSESSMENT AND POLICY RESPONSE

1.1 Macroprudential risk assessment

In the first half of 2024, the macro-financial environment was characterised by the interplay of stable global economic conditions and persistent geopolitical uncertainties. The global economic outlook remained stable, with the risk of a severe economic recession diminishing somewhat, although forecasts for the euro area weakened somewhat. Inflationary pressures eased considerably, such that some central banks embarked on policy rate cuts. However, geopolitical tensions continued to pose a considerable risk to financial stability. Such events could trigger a weakening in the macro-financial conditions and affect risk sentiment. This, in turn, could prompt an abrupt sell-off in financial markets. So far, euro area households and businesses showed resilience despite the higher debt-servicing costs experienced in recent years. This was buttressed by a strong labour market.

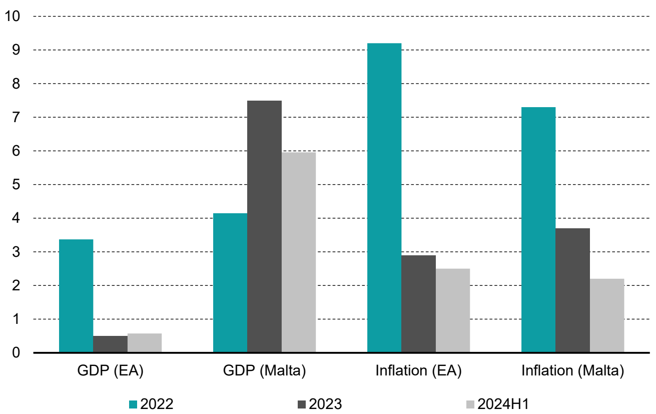
Euro area banks have successfully leveraged the high interest rates to their advantage, while maintaining good asset quality. Essentially, they have been able to benefit from increased earnings on their loans and investments due to the higher rates, without experiencing a notable decline in the quality of their assets. However, the ongoing and expected rate cuts may lower income on variable-rate assets. Financial market developments reflected market participants' expectations of the turnaround in the monetary policy stance.

1.1.1 Vulnerabilities outside the financial system

After rebounding from the pandemic, economic growth in the euro area decelerated to 0.5% in 2023 and continued at the same subdued pace in the first half of 2024 (see Chart 1.1). Inflation inched closer to the ECB's medium-term target rate of 2%, with estimated Harmonised Index of Consumer Prices (HICP) reading 1.8% in September 2024. Domestically, economic growth remained robust but moderated, with real gross domestic product (GDP) growth reading 6.0% for the first half of 2024, compared to the 7.5% in 2023. Inflation in Malta fell at a faster pace compared to other euro area countries, to reach 2.2% in June 2024.

During the first half of this year, financial market developments were mainly dominated by expectations of a reversal in the monetary policy stance of central banks in advanced economies. The ECB lowered its key rates by 0.25 basis points for the first time in June 2024, while the Bank of England followed suit in August 2024, but held rates unchanged in September 2024. The US Federal Reserve also cut its Federal Funds Rate for the first time in four years by 0.5 percentage points, marking the start of a period of monetary easing. This, coupled with the avoidance of an economic recession, pushed the Stoxx 600 higher, up by almost 7% during the first half of the year (see Chart 1.2). The S&P 500 performed better, increasing by 14.5% until June 2024, however this was mainly influenced by the strong performance of technology and Artificial Intelligence (AI) firms. Based on the developments that took place in August 2024, these sectors have shown to be highly susceptible to sudden adverse market corrections, mainly due to their elevated valuations. The SPXT, which excludes companies related to the information technology (IT) sectors, still advanced, up by just over 9% in the first six months. Developments in the fixed-income markets were more volatile as these tend to be more sensitive to interest rate expectations. After peaking in October 2023, both the US and euro area (EA) ten-year

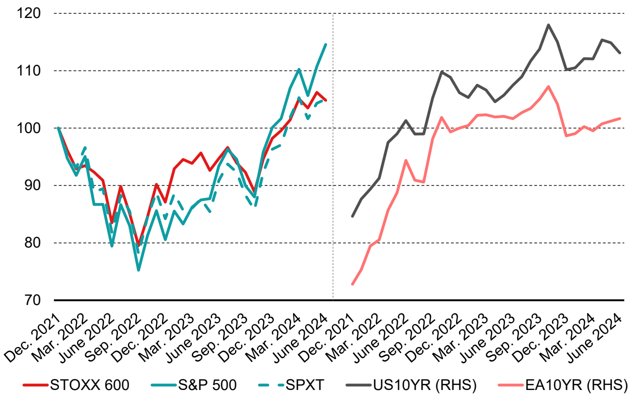
Chart 1.1
ECONOMIC GROWTH AND INFLATION DEVELOPMENTS
(annual growth rate; per cent)



Sources: Eurostat; NSO.
Note: June 2024 GDP figures refer to the growth rate of June 2024 over the same period in 2023.

government bond yields bottomed once more in December 2023. However, as market expectations were corrected, bond yields rose again to reach 4.3% and 3.2% in June 2024, respectively due to uncertainty about the timing of easing of monetary policy because of high wage inflation. Such developments could also have been further impacted by market participants' increased interest in equities given the strong performance observed.

Chart 1.2
FINANCIAL MARKET DEVELOPMENTS
(index, 2021 = 100, per cent)



Sources: Investing.com; ECB.
Note: SPXT is a US-listed ETF tracking the S&P 500 excluding IT companies, including software, technology hardware and equipment, and semiconductor companies.

As further interest rate cuts are expected, funding costs for both private and sovereign debt should ease. The downward trend in euro area government debt as a share of GDP reported post-pandemic persisted in the first half of this year, with the ratio dropping by 0.1 percentage points to 88.1%. Demand for sovereign debt paper was strong as investors tried to lock in higher yields, in anticipation of the prospective rate cuts. Yields on the primary market remained above the average yield on outstanding debt, exerting higher funding costs to sovereign debt.[1] However, heterogeneity across countries could be observed, with some euro area member states recording higher levels of sovereign debt, and a sudden reassessment of sovereign risk could once again increase borrowing costs. Against this backdrop, fiscal fundamentals remained weak and could possibly exert potential adverse spillovers on the wider bond market. Domestically, government debt-to-GDP remained contained, but like other euro area countries, it is expected to increase, reaching 49.8% in 2025, mostly driven by the continuation of primary deficits.[2] Indeed, while the fiscal deficit is declining, it is still expected to remain above the 3% European Union (EU) threshold in 2024 and 2025. The escalation of military activity in the Middle East may have an adverse effect on public debt, particularly in respect of energy support measures in the event of higher commodity prices.

Developments in the euro area residential market seem to be stabilising, as house prices increased once again by 1.3% annually in June 2024, compared to the drop of 2.2% registered in September 2023. Such developments continued to show asynchronous real estate cycles where in Malta, house prices continued to rise steadily, up by 7.0% in June 2024, compared to the 5.3% during the same period last year. This also reflected differences in the transmission of monetary policy onto lending rates, leading to diverging credit cycles with the annual growth in domestic mortgages remaining strong at 8.6%, in sharp contrast with the credit dynamics observed in the euro area, where mortgage growth was close to 0%.[3] Domestic mortgage demand was backed by a 4.2% increase in final deeds of sale in the first half of this year, compared to the same period last year.

Risk outlook

Risks to the euro area macro-financial outlook remain elevated, mostly emanating from heightened geopolitical tensions. Projections indicate a modest recovery in economic growth, with end-of-year GDP expected to be around 0.8%, before trending further upwards to 1.3% in 2025, while inflation is expected to increase to 2.2% by 2025. Global demand may however slow down further if inflation remains higher than expected, which could delay rate cuts and result in sustaining restrictive financing conditions for longer periods. Apart from the direct consequences within the euro area, any delays in monetary policy easing in the United States could lead to higher import prices for the euro area due to a stronger US dollar. Financial markets

[1] See ECB Financial Stability Review, May 2024.
[2] Source: MFIN – [Medium-Term Fiscal Structural Plan 2025 - 2028](#).
[3] Source: ECB.

may experience increased volatility, particularly in equities with stretched valuations, especially if the ongoing geopolitical tensions in the Middle East and Ukraine were to escalate further, compounded by a possible worsening in China-US trade relations, as well as the outcome of the US presidential election.

Domestically, economic growth is projected to moderate in 2024 and 2025. Following the strong growth in net exports in 2023, domestic demand, especially private consumption, is anticipated to be the main engine of economic growth in 2024.[4] Inflation is projected to subside to 2.1% by 2025, reflecting lower inflation in food, services and non-energy industrial goods. The domestic residential real estate (RRE) market is expected to remain buoyant as evidenced by the strong increase in the number of promises of sale agreements which rose by 4.6% in the same period reviewed.

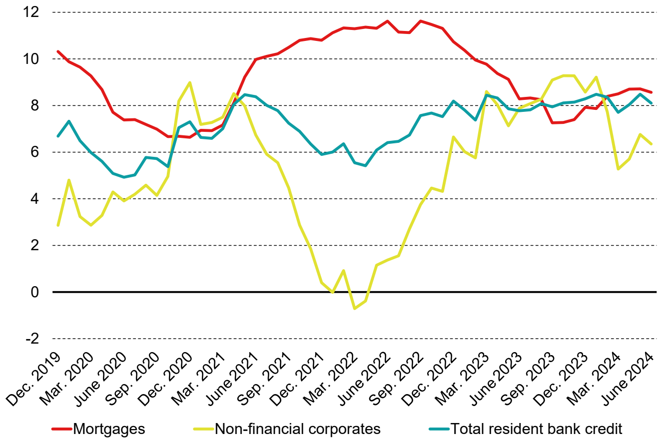
1.1.2 Vulnerabilities within the financial system

Profitability of euro area banks improved marginally in the first six months of the year, with the return on assets (ROA) reaching 0.74%, up from 0.69% six months earlier.[5] Such improvement was mainly the result of improved cost efficiencies, and other non-interest income. Euro area banks continued to show resilience and operated with ample liquidity and strong capital buffers. Indeed, the liquidity coverage ratio (LCR) and the total capital ratio stood at 163.2% and 20.1%, respectively. In addition, despite some tentative signs of deterioration, asset quality remained healthy with an NPL ratio of 1.9%.

Domestic banks remained highly profitable with the ROA stable at 1.3%, whilst that of core domestic banks increased by 0.1 percentage points to 1.1%. Lower net impairment losses were reported, but the increase in net interest income (NII) was met with higher operating expenses, resulting in the operational cost-to-income ratio to edge higher to 56.3%. Despite annual growth in resident credit slowing down marginally to 8.1% (see Chart 1.3), it is still considered robust, highlighting the diverging credit cycles when compared to the euro area. Resident non-financial corporation (NFC) credit growth decelerated to 6.4% from 8.6%, six months earlier, but remained above the average growth rate over the last five years, which stood at 5.1%. Such increase remained highly focused on property-related activities accentuating concentration risk in domestic banks' loan books. The NPL ratio reached a new low of 2.1% on account of a faster drop in NPLs than loans and advances. The improvement was reported in both the mortgages and NFC sectors, with their NPL ratios standing at 1.3% and 3.6%, respectively. Excluding placements with the Central Bank of Malta, the NPL ratio also dropped to a new low of 2.7%. Domestic banks remained resilient on the back of strong capital levels, and operated with generally ample liquidity, as evidenced by a total capital ratio and LCR of 25.5% and 361.0%, respectively.

Amid the mix of economic and market dynamics, domestically-relevant insurers remained resilient and continued to maintain capital positions well-above regulatory requirements, indicating their capacity to adapt to evolving economic conditions. Non-life insurers' gross written premia grew, driven by property damage business, which together with improved investment returns contributed to the strong profitability, despite rising insurance service expenses. In contrast, the life insurance sector reported declining premiums influenced by shifts in customer behaviour amid the still high interest

Chart 1.3
ANNUAL RESIDENT CREDIT GROWTH RATE
(per cent)



Source: Central Bank of Malta.

[4] Central Bank of Malta Outlook for the Maltese Economy 2024:3.
[5] European Banking Authority (EBA) Risk Dashboard, June 2024.

rates. Concurrently, domestically-relevant investment funds experienced renewed growth, driven by strong equity market performance and recovering bond markets. These positive developments were in line with broader trends across the euro area, where economic conditions showed signs of stabilisation. Domestically, the sector remained resilient despite challenges stemming from international market volatility and shifting investor sentiment. The liquidity ratio dropped slightly given the increased exposure to equities, although bonds, which continued to represent the bulk of investments, remained largely liquid, composed mainly of high-rated sovereign debt.

Driven by the developments within the domestic investment funds sector, the narrow measure of non-bank financial intermediation as outlined in Box 5 of the *Financial Stability Report* 2023, experienced solid growth in the first half of 2024, up by over 4%.[6] This expansion was supported by increased activity across both lending institutions and financial vehicle corporations, which also experienced steady increases in their activities. Notwithstanding, systemic risks from entities captured in the narrow measure remained low.

Risk outlook

Euro area banks' profitability may have peaked as NII appears to have plateaued. This could be exacerbated by the sluggish credit growth and a potential narrowing of the loan-deposits spreads as further rate cuts take place. Similarly, yields on high-quality liquid assets (HQLA), including central bank reserves, are likely to decline, further impinging on banks' income generation. This may be partly offset by reduced funding costs for both retail and short-term market borrowing. However, should the pass-through of interest rate cuts on deposit rates be low and lagged, additional pressure on banks' funding costs may be observed. A significant risk factor involves cyber threats, especially as banks are continuously digitalising their operations. In 2023, Single Supervisory Mechanism banks reported that the number of cyber incidents shot up by around 78%, compared with previous years.[7] Furthermore, a survey among 17 large European banks' Chief Risk Officers showed that the vast majority believe that cybersecurity risk is the largest threat to their business operations in 2024.[8] This highlights the importance for banks to continue enhancing their cybersecurity measures in response to these rising cyber threats, with the recent global IT outage exposing the vulnerabilities that can impact critical services.

Similar to euro area banks, the profitability of domestic banks may have also peaked, as remuneration on Central Bank placements, an important component of these banks' balance sheets, is expected to decline. In addition, while resident credit growth is forecasted to slow down further, also possibly impacting profitability, this is expected to remain strong. In addition, banks increased their investment in government bonds to take advantage of the higher yields, in anticipation of the expected continued interest rate cuts. Regarding the insurance sector, a potential escalation of the current conflicts and severe climate-related risks are prompting insurers across the euro area to refine their underwriting strategies and risk models, particularly in property and casualty lines. Furthermore, although inflation has eased significantly, its impact on insurance claims' costs remains a concern across Europe. Within the investment funds sector, challenges persisted in the euro area, driven by possible concerns related to portfolio concentration towards certain geographies and the tech sectors, real estate exposure, and liquidity concerns.

Financial institutions should continue adopting prudent lending practices, while maintaining healthy capital and liquidity buffers to enhance their resilience amid a backdrop of an uncertain global macroeconomic environment. This, coupled with measured dividend payouts, should ensure that capital is preserved, further buttressing the resilience of the domestic financial system.

[6] See: Revisiting non-bank financial intermediation in Malta: a current financial stability overview.
[7] See: ESRB Annual Report 2023 (europa.eu).
[8] See: Cybersecurity remains the top risk for European banks, as heightened geopolitics increases the perceived threat of cyber warfare | EY - Global.

SUMMARY OF RISKS

Main vulnerabilities and risks to financial stability	Description of risk	Risk assessment
Vulnerabilities outside the financial system		
Geopolitical uncertainties	Geopolitical risks heightened further, primarily due to the ongoing wars in Ukraine and the Middle East, as well as the continued tensions between the United States and China. This along with policy and economic uncertainty arising from recent and upcoming elections.	↑
Inflationary pressures	Inflationary pressures eased considerably, and as a result, major central banks began reversing their monetary policy stance. However, negative surprises may arise due to heightened geopolitical risks, which could influence the monetary policy paths adopted by different authorities.	↓
Reassessment in risk premia	Financial markets continued to show signs of overvaluation, particularly in the technology and communications sectors, including AI. A sudden shift in market sentiment, as occurred in August 2024, could negatively impact the valuations of these asset classes, potentially triggering an abrupt sell-off.	↑
Economic conditions in the euro area and public debt sustainability	The likelihood of a severe downturn in the euro area has diminished somewhat, driven by the avoidance of an economic recession, and resilient labour markets, although downside risks remain. Sovereign financing conditions have improved as interest rates continued to decline; however, persistent geopolitical risks may increase borrowing pressures on governments going forward.	↔
Domestic macroeconomic developments	Domestic economic growth moderated slightly in the first half of 2024 and is forecast to slow further over the next few years. Despite contained debt, the deficit level is still above the EU's 3% threshold. However, the economy is expected to remain strong, supported by a resilient labour market and robust private consumption growth.	↔
Real estate market developments	Domestic RRE price growth maintained its momentum, driven by strong de-mand, which has kept estimates of the house price gap in positive territory. Looking ahead, the RRE cycle is expected to remain buoyant, as evidenced by robust increase in the number of signed promises of sale agreements. However, this may raise concerns about overheating, potentially increasing vulnerabilities in the housing sector. Some segments within the domestic commercial real estate market remained weak, though they are not expected to pose any sys-temic risks as overall banks' exposure to this sector is very low.	↔
Vulnerabilities within the financial system		
Developments in mortgage lending	Resident mortgage lending gained momentum and is expected to remain strong, in line with the robust domestic RRE market. Such dynamics have led to a positive mortgage credit gap, potentially signalling excessive credit. However, risks related to the RRE market are somewhat mitigated by prudent bank lending practices and the implementation of macroprudential policies.	↔
Developments in NFC lending	While resident corporate credit slowed slightly, the deceleration was less pronounced than expected and remained above the recent five-year average. As a result, the private corporations credit gap remained in positive territory, driven primarily by the construction and real estate sectors.	↑
Concentration in sectoral lending	Banks' lending towards property-related loans increased further, given the robust property market, fuelling concentration risks in their loan portfolios.	↑
Credit quality of the loan portfolio	Asset quality improved further, driven by both mortgages and corporate loans, and was accompanied by a lower forbearance ratio. However, Stage 2 loans increased, indicating potential rising risks going forward, partly due to the still high interest rate environment.	↔
Developments related to net income	The banking sector reported mixed developments, with overall profitability declining emanating from international bank branches and non-core domestic banks. However, the profitability of the core domestic banks continued to improve, with net income on the rise. While risks remained limited, some deterioration may occur going forward, as net income could be negatively impacted by lower interest income from Eurosystem placements and corporate loans.	↑
Liquidity developments	Banks' liquidity positions remained ample, despite a marginal decline in liquidity ratios and limited growth in customer deposits, largely due to more attractive investment opportunities owing to the still high-yield environment. However, this pressure on liquidity is expected to ease going forward as interest rates decline and bond yields retreat.	↔
Operational risk	While digitalisation presents exciting opportunities for growth and innovation, such process may lead to negative repercussions on banks' operational framework, primarily through an increase in cyber threats.	↑
Domestically-relevant insurances	Both life and non-life insurances reported balance sheet growth and robust capital. Life insurances continued to operate on the back of robust liquidity, alongside a recovery in gross written premia driven by index- and unit-linked products. However, alternative investment opportunities continued to exert pressure on with-profit products, which strained underwriting profitability, even though overall profitability increased. Meanwhile, in the non-life sector, liquidity continued to decline due to their investment holdings, yet strong profitability was reported, driven by solid underwriting and investment returns.	↔
Domestically-relevant investment funds	Domestically-relevant investment funds registered growth in assets. This rebound was largely driven by the recovery in the equity market and a slight increase in fixed income securities. Investments continued to be concentrated in liquid assets, although cash and deposit levels remained low. Redemptions stayed close to historical averages, and leverage remained low and stable. However, risks going forward persist due to the potential for higher risk premia reassessment amid challenging macroeconomic conditions and geopolitical headwinds.	↔

Risk level as at end June 2024: Limited Moderate Elevated

Risk direction within the first half of 2024: Increased ↑ Stable ↔ Decreased ↓

1.2 Macroprudential regulatory developments

This section reports the main developments in macroprudential policy measures during the first half of 2024.

1.2.1 Capital-based macroprudential measures

In accordance with the Capital Requirements Directive and Capital Requirements Regulation, the Central Bank of Malta implements capital-based macroprudential measures to safeguard the stability of the Maltese financial system. The buffers shown in Figure 1.1 form part of the Combined Buffer Requirement, which also includes the Capital Conservation Buffer set at 2.5% of total risk-weighted assets (RWA) for banks operating within the Maltese financial system.

Figure 1.1
BANK SPECIFIC CAPITAL BUFFERS IN MALTA

CCyB

In line with the Central Bank of Malta's quarterly Countercyclical Capital Buffer (CCyB) assessment for the third quarter of 2024, the CCyB remains set at 0% based on the credit-to-GDP ratio which stands at 69.1% and its deviation from the long-term trend at -5.5 percentage points.

sSyRB

The sectoral Systemic Risk Buffer (sSyRB) is set at 1.5% on RWAs held against domestic mortgages to natural persons secured by RRE. The buffer was subject to a phasing-in period and has been fully phased-in since March 2024.

O-SII

In the latest 2024 assessment, the Bank jointly with the Malta Financial Services Authority (MFSA) identified APS Bank plc, MDB Group Limited, HSBC Bank Malta plc and Bank of Valletta plc as O-SIIs with fully phased-in O-SII buffers ranging from 0.50% to 2.00%. The O-SII requirements and transitory provisions are applicable as from January 2025.

Source: Central Bank of Malta.

As per the 2025 other systemically important institutions (O-SIIs) statement of decision published in August, the scores of the four credit institutions identified as O-SIIs for 2025 and the buffer rates applicable from January 2025 are provided in Table 1.1.[9]

Table 1.1
LIST OF IDENTIFIED O-SIIs FOR 2025, CORRESPONDING O-SII SCORES AND EFFECTIVE BUFFER RATES

Institution	Size	Importance	Complexity	Interconnectedness	Total	Fully Loaded Buffer Rate
APS Bank plc	175	480	27	66	748	0.50%(1)
Bank of Valletta plc	694	1,676	189	361	2,921	2.00%
HSBC Bank Malta plc	334	939	84	141	1,498	1.25%
MDB Group Limited	239	205	576	354	1,374	1.00%(1)

Source: Central Bank of Malta.

(1) APS Bank plc and MDB Group Limited are currently following the transitory provisions outlined in Section 2 of the 2025 O-SII Statement of Decision until reaching their fully loaded O-SII buffer.

9 The 2025 statement of decision on the identification of O-SIIs and the related capital buffers can be accessed from the Central Bank of Malta website.

1.2.2 Borrower-based measures

Central Bank of Malta Directive No.16 on borrower-based measures (BBMs) has now entered its sixth year in force. Despite no recent modifications having been implemented to the Directive, the Bank remains vigilant to developments in the domestic RRE market, which may require updates to the Directive to ensure ongoing financial stability.

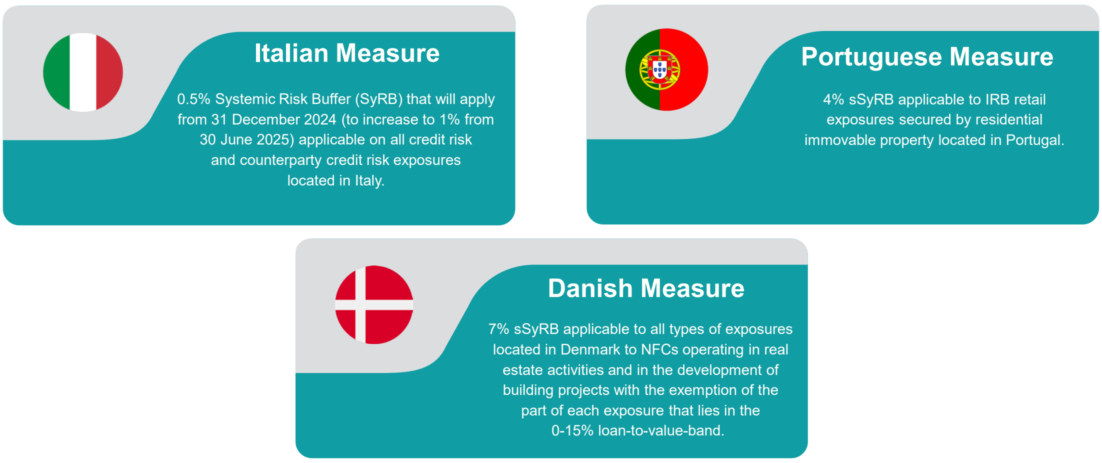
In addition, during the first half of 2024, the banks successfully completed their internal audit exercises to verify compliance with the Directive as stipulated in the same Directive.

1.2.3 Other measures

Voluntary reciprocation

Reciprocation requests received in the first half of 2024 are summarized in Figure 1.2. A decision not to reciprocate was taken on the basis of inapplicability of the measures, given that Maltese credit institutions do not make use of internal ratings-based (IRB) models to quantify their capital allocation but rather use the standardised approach. Specifically, under the IRB approach, banks can use their internal models to quantify their regulatory capital requirements, in contrast to applying a standardized approach which uses a prescribed risk weight schedule for calculating RWA. Additionally, following internal assessments carried out by the Bank, it was determined that Maltese credit institutions do not have material exposures towards the respective markets. No other changes were affected on the reciprocation stance of the Bank with respect to previously communicated measures recommended for reciprocation by other Member States. These remain currently active.

Figure 1.2
RECIPROCATION REQUESTS ANALYSED DURING FIRST HALF OF 2024



Source: Central Bank of Malta.