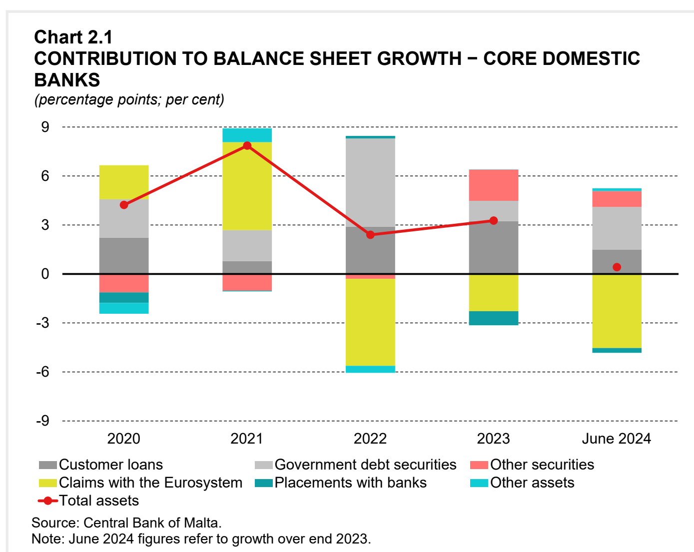
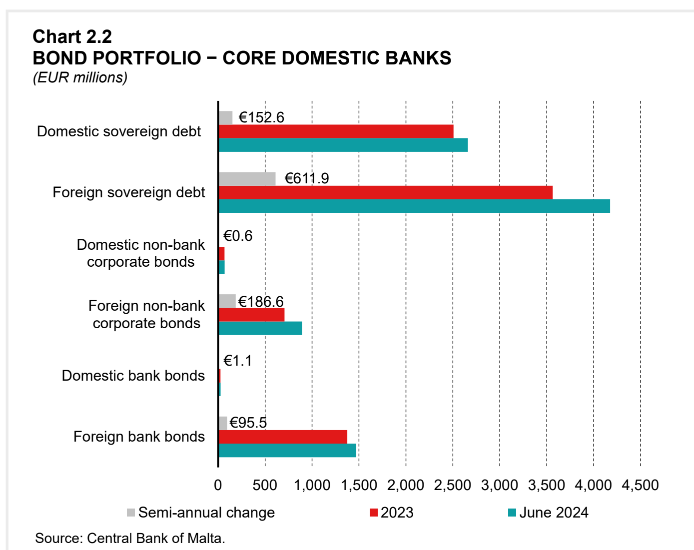
2. DEVELOPMENTS IN THE BANKING SECTOR

2.1 Core domestic banks

During the first half of 2024, the balance sheet of core domestic banks grew by 0.4%, equivalent to 136.6% of GDP. Despite the modest growth, the balance sheet of core domestic banks continued to reflect an increase in debt securities holdings and a further expansion in the customer loan books. In contrast, these banks continued to decrease their claims with the Eurosystem, down by a third, to account for 9.0% of total assets. Meanwhile, interbank placements remained negligible, accounting for less than 4% of total assets, largely held in the form of deposits with related institutions (see Chart 2.1).





Sovereign bond holdings rose by 12.6% during the first half of the year, registering more than twice the growth rate of 2023. Such increase was mainly concentrated in foreign government bonds, largely issued by European governments, although these banks also increased their investments in domestic government bonds (see Chart 2.2). On aggregate, sovereign debt accounted for almost three fourths of overall bond holdings. Such development partly reflected the banks' bid to lock-in the higher bond yields in anticipation of the expected interest rate cuts. Holdings of foreign corporate and bank bonds also rose during the first half of the year. In view of these developments, core domestic banks continued to increase their holdings of foreign bonds, which on aggregate accounted for just above 70% of the bond portfolios.

Core domestic banks continued to invest largely in high and medium-rated bonds, which together accounted for more than 90% of the debt securities holdings.[1] High-rated bonds rose by 16.3%, in part driven by the continued shift towards improving the quality of the bond portfolio. Concurrently, holdings of medium-rated bonds also increased, up by 9.7%. Although holdings of low-rated and speculative/unrated bonds also rose, up by 13.0% and 0.2%, respectively, these remained limited to just 7.4% and 1.5% of the overall bond portfolio.

Banks remain potentially vulnerable to sudden adverse movements in bond prices triggered by heightened geopolitical risks and, indirectly, through the broader market reactions for possible delays in central banks' monetary policy actions. However, most of these bonds are measured at amortised cost (AMC), reducing

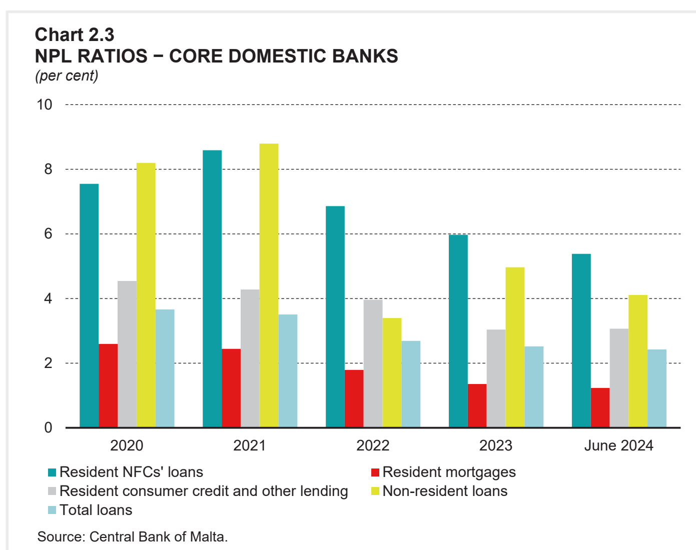
[1] Investment-grade bonds carrying a rate of AA- or above are considered as 'high-rated bonds'. 'Medium-rated bonds' are those rated between A- and A+, whereas 'low-rated bonds' are those rated between BBB- and BBB+.

the sensitivity of banks' potential for realised losses owing to market movements. Equity holdings remained relatively stable during the first half of the year, representing just 1.5% of these banks' overall assets.

In the first six months of the year, customer loans grew by 3.1%, representing half of these banks' overall assets. Such growth was exclusively driven by higher resident lending, up by 3.4%, particularly mortgages, which rose by 4.5% in the first six months of the year, compared to the 3.7% in the same period last year. Resident mortgages continued to account for more than 55% of resident customer loans, reinforcing concentration risks in the banks' loan books. Concurrently, resident consumer credit grew at a faster pace when compared to the same period last year, up by 5.7%, although from a much smaller base. Growth in credit to resident NFCs rose by 1.1%, mainly driven by resident lending towards companies operating in real estate and construction activities, and wholesale and retail trade sectors. Meanwhile, non-resident lending fell by 5.5%, reflecting lower loans towards energy-related sectors.

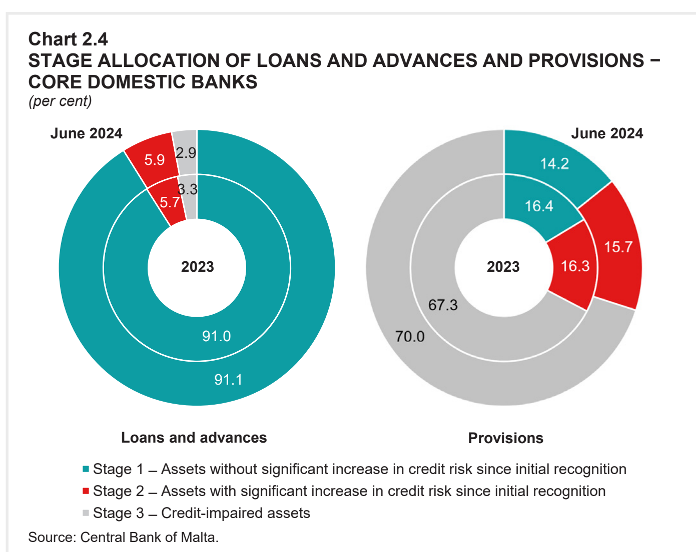
The overall stock of NPLs for this group of banks continued to improve, dropping significantly by 8.4% in the first six months of the year. As a result, the NPL ratio went down by 0.1 percentage points to 2.4% in June 2024 (see Chart 2.3). The drop in the NPL ratio was contained, as overall loans and advances also dropped by 4.9% driven by the lower Eurosystem placements. In fact, excluding such placements, the overall NPL ratio improved by a larger scale, declining by 0.4 percentage points to 2.9%. The drop in NPLs was largely driven by lower resident NPLs which fell by over 6%. However, as the total resident loans and advances shrank by almost 5%, the resident NPL ratio remained stable at 2.3%. The lower resident NPLs largely stemmed from NFCs, down by 7.4%, mainly those operating in accommodation and food services, as well as the real estate and construction sectors. Coupled with an increase in the outstanding loans, this led to the resident corporate NPL ratio to drop by 0.6 percentage points to 5.4%. Although to a lesser extent, the resident mortgage NPL ratio also declined by a mere 0.1 percentage points to 1.2%, while the NPL ratio for consumer credit and other lending rose marginally to 3.1%. Non-resident NPLs also dropped considerably, down by more than a fifth, largely related to other financial intermediaries (OFIs) and households to a lower extent, as otherwise non-resident corporate NPLs rose. This resulted in the non-resident NPL ratio to decrease by 0.9 percentage points to 4.1%.

Chart 2.3
NPL RATIOS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

Chart 2.4
STAGE ALLOCATION OF LOANS AND ADVANCES AND PROVISIONS – CORE DOMESTIC BANKS
(per cent)



Source: Central Bank of Malta.

The lower NPLs also meant that Stage 3 loans fell to represent just 2.9% of overall loans (see Chart 2.4). However, Stage 2 loans increased by 8.2% to represent

5.9% of the loan book, with the remaining share classified as Stage 1. Banks reduced their provisioning levels by 4.2% in the first half of the year. This drop was reported across all stages, largely those identified as Stage 1, which fell by 16.6% and to a lesser extent Stage 2 and Stage 3, decreasing by 7.7% and 0.4%, respectively. Notwithstanding, the coverage ratio improved by 2.0 percentage points to 45.5% in June 2024, as NPLs fell at a faster pace than provisions. Moreover, when considering the additional collateral securing NPLs, the coverage ratio exceeds the 100% mark, hence implying that credit risk for these banks is more than fully covered.

Concurrently, loans with forbearance measures decreased by 8.6% in the first six months of 2024, to now represent just 2.4% of total loans. This drop was entirely due to lower non-performing forborne loans which fell by a fifth, as otherwise still-performing forborne loans rose slightly by 2.6%, accounting for around 58% of overall forborne loans.

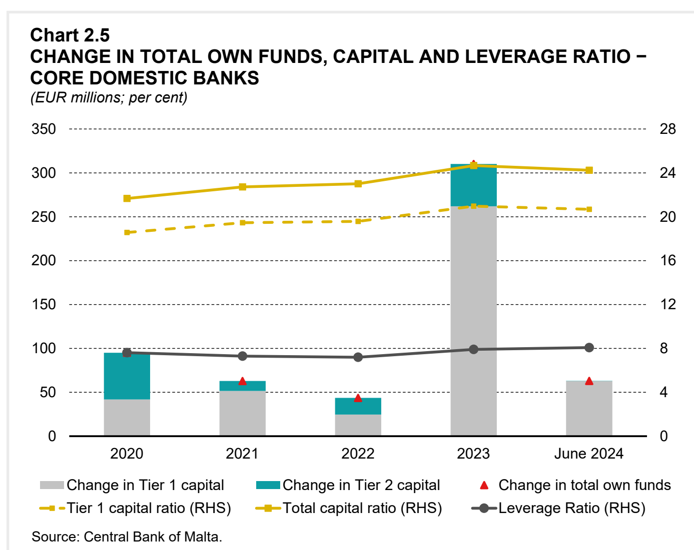
The monetary policy tightening had a somewhat negative effect on some banks' ability to attract retail funding, with limited growth in customer deposits reported in 2023 as higher-yielding investment alternatives, such as fixed-income instruments, proved more attractive.[2] Challenges persisted in the first half of 2024, with customer deposits increasing by only 0.2%. This marginal growth was solely driven by a 0.3% rise in resident customer deposits, primarily from households, while resident deposits from both financial institutions and NFCs declined. Meanwhile, representing just 7.4% of total customer deposits, non-resident deposits decreased by 1.7% primarily due to withdrawals by households.

The high-interest rate environment led the core domestic banks to increase their rates on term deposits, while demand deposits remained largely unremunerated. This affected the composition of deposits, with customers' preference shifting further towards term deposits. These grew by 4.4% in the first half of the year to represent 15.4% of overall deposits. Meanwhile, deposits withdrawable on-demand fell marginally by 0.7%. Customer deposits remained the main funding source, financing about 83% of core domestic banks' assets. However, interbank exposures and other liabilities also increased, although their share remained limited at around 5% collectively. On the other hand, repurchase agreements decreased considerably by three fifths, while Eurosystem funding and debt securities issued remained relatively stable, also in line with the ample liquidity buffers held by these banks.

Despite a notable drop of almost 18 percentage points in the LCR of core domestic banks, it remained robust at 351.2% in June 2024, significantly above the minimum threshold. The lower LCR is the result of higher net liquidity outflows, which increased by 3.4%, in conjunction with a drop of 1.7% in liquid assets, mainly owing to withdrawals of central bank reserves. The net stable funding ratio (NSFR) remained relatively unchanged at around 176%, which is also well-above regulatory requirements, and points towards a stable long-term funding position. The level of unencumbered central bank-eligible counterbalancing capacity (CBC) assets increased significantly by 13.4%. These accounted for almost a third of these banks' balance sheet and 3.2 times their total net liquidity outflows, implying funding could possibly be obtained to meet 110 days of net cash outflows in case of a stressed scenario, corroborating other indicators that signal ample liquidity.

Core domestic banks also maintained their strong capital position, with the total capital ratio still exceeding 24% by June 2024 (see Chart 2.5). However, a marginal

Chart 2.5
CHANGE IN TOTAL OWN FUNDS, CAPITAL AND LEVERAGE RATIO – CORE DOMESTIC BANKS
(EUR millions; per cent)



Source: Central Bank of Malta.

[2] See Box 3: The impact of the ECB's monetary policy tightening on deposit flows and interest margins.

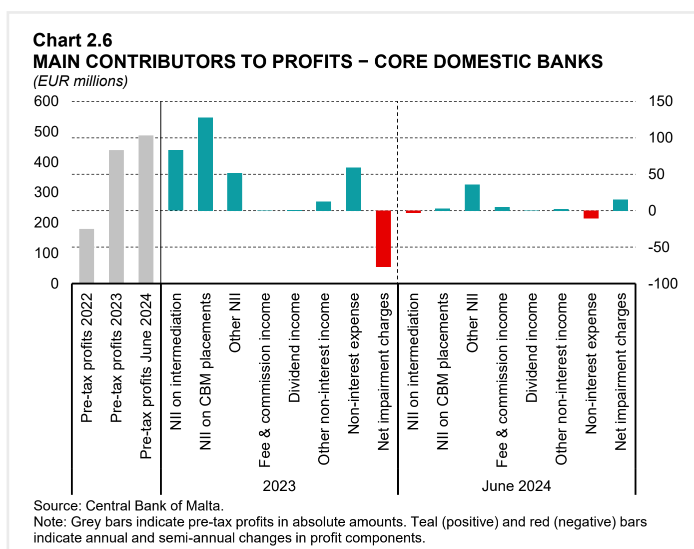


Chart 2.6
MAIN CONTRIBUTORS TO PROFITS – CORE DOMESTIC BANKS
(EUR millions)

Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Teal (positive) and red (negative) bars indicate annual and semi-annual changes in profit components.

dip of half a percentage point was recorded in the first six months of the year due to higher RWAs, which increased by 4.1%. This increase partly offset a 2.3% increase in own funds, largely stemming from higher retained earnings. As a result, the risk profile was impacted marginally, with the share of RWAs in total assets increasing by 1.4 percentage points, albeit remaining conservative at 40.2% in June 2024. Meanwhile, at 8.1%, the leverage ratio stood well above the regulatory threshold.

Following, a very profitable 2023, the core domestic banks continued to capitalise on the tight monetary policy, with their four-quarter pre-tax profits reaching almost €490 million as at June 2024 (see Chart 2.6).[3] Consequently, the post-tax return on equity (ROE) and ROA for June 2024 stood at 12.4% and 1.1%, compared to 12.0% and 1.0% in December 2023, respectively. Such ratios exceeded those of European peers, which reported a weighted average ROE and ROA of 10.9% and 0.7%, respectively.[4]

The higher interest rate environment continued to boost NII, which rose by 5.0% in the first six months of the year, accounting for 78.9% of total gross income. However, in contrast with developments reported in 2023, whereby NII from placements with the Central Bank of Malta and intermediation activities was the main driver to NII growth, such growth this time stemmed from other NII sources, predominately from government securities. Indeed, during the period under review, NII from placements with the Central Bank of Malta grew by just 2.1% while NII from intermediation dropped marginally, albeit the latter still accounting for the largest portion of gross income. The drop from intermediation net income largely reflected lower interest income from corporates and higher interest expenses from households. On the contrary, NII from OFIs and insurance companies rose to partly reverse the drop in overall NII.

Non-interest income increased by 4.2%, owing to higher trading profits, fees and commissions, income and dividends received. Non-interest expenses rose by 2.3%, driven predominantly by higher staff expenses and other administrative expenses. Concurrently, these banks registered some reversals of net impairment charges, indicating that credit risk has somewhat improved when compared to 2023. The operational cost-to-income ratio decreased from 51.0% in December 2023 to just below 50% in June 2024.

During the first half of the year, this group of banks successfully maintained their profitability, despite ongoing global macroeconomic challenges. They effectively capitalised on the tight monetary policy by investing more heavily in government bonds, thereby securing higher yields. However, NII from intermediation fell slightly due to narrower interest margins. Looking ahead, the anticipated reversal of monetary policy is expected to have limited impact on loan interest rates, as these rates remained relatively stable during the tightening phase. A lower interest rate environment is likely to reduce interest income from Eurosystem placements. Asset quality remains benign, supported by conservative lending practices and robust domestic economy and labour market. Given the ongoing risks and vulnerabilities from external sources, including regulatory and potentially supervisory measures, banks should remain vigilant and continue to preserve capital and liquidity buffers.

[3] Profits are based on four-quarter moving sums.
[4] Source: EBA Risk Dashboard Q2 2024.

BOX 1: FORECASTING SOME KEY FINANCIAL INDICATORS FOR CORE DOMESTIC BANKS IN MALTA[1]

This box documents a framework which was recently developed to forecast key balance sheet items of selected Maltese core domestic banks, with particular interest in bank profitability. A Factor-Augmented Vector Autoregression (FAVAR) and a Bayesian Vector Autoregression (BVAR) are employed to produce forecasts for both bank-level and aggregate variables, such as loans, deposits and profitability. Both the FAVAR and BVAR models used in this analysis possess numerous shared characteristics. While the former generates bank-level forecasts, allowing for the examination of dynamics within individual banks' balance sheets, the latter is based on aggregate bank time series and provides forecasts that serve as a cross-check for the FAVAR's output. Bayesian methods are used to estimate probabilistic density forecasts, and to overcome short data samples. The full methodology is explained in Andreani (2024).[2]

The Maltese core domestic banks represent a category of credit institutions with the highest domestic relevance for Malta's financial system, with balance sheets collectively equivalent to 151% of domestic GDP in 2023. Despite adverse conditions between 2020 and 2022,[3] the core domestic banking sector continues to exhibit resilience and sustained recovery, with a 144% profit growth in 2023 compared to the previous year, and an increasing trend in domestic lending.[4] On the other hand, deposits continue to constitute the primary funding source, financing more than 80% of overall core domestic banks' assets (Central Bank of Malta, 2024).[5]

The relationship between profitability of the international banking sector and financial stability has been extensively analysed and strengthened by various studies (Aspachs et al., 2006; ECB, 2016; TengTeng et al., 2019).[6] Previous research related to the Maltese banking sector has analysed banks' heterogeneity in generating profits (Camilleri, 2005),[7] and the significance of real activity cycles in determining banking activity performance (Attard, 2014).[8]

The analysis in this box employs key macroeconomic variables and confidential bank-level time series data to capture the interaction between real macroeconomic aggregates for both Malta and the euro area, along with bank-level information specific to selected Maltese core domestic banks.[9] All data is in quarterly frequency, using a sample ranging from 2006Q4 to 2023Q3.[10]

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[1] Written by Dr Michele Andreani, Principal Research Economist within the Financial Stability Research Office of the Central Bank of Malta. The author would like to thank Dr William Gatt Fenech, Ms Wendy Zammit, Mr Alan Cassar, Dr Aaron Grech, Mr Oliver Bonello and Mr Alexander Demarco for their helpful comments and suggestions.

[2] Andreani, M. (2024). A forecasting framework for core domestic banks in Malta, Central Bank of Malta *Working Paper* WP/05/2024.

[3] Such as the COVID-19 pandemic, the monetary policy tightening subsequent to the recent surge in inflation, and bank-specific events which likely have impacted the overall profitability of core domestic banks.

[4] Placements with the Central Bank have recently emerged as a key component driving interest income and, consequently, banks' earnings.

[5] Central Bank of Malta (2024). *Financial Stability Report 2023*.

[6] Aspachs, O., Goodhart, C., Segoviano, M., Tsomocos, D., Zicchino, L., et al. (2006). Searching for a metric for financial stability. Special paper-LSE financial markets group, 167. ECB (2016). *Financial Stability Review*. TengTeng, X., Kun, H., and Udaibir S, D. (2019). Bank Profitability and Financial Stability. IMF *Working Papers*, WP/19/5.

[7] Camilleri, S. J. (2005). An analysis of the profitability, risk and growth indicators of banks operating in Malta. Bank of Valletta Review, (31).

[8] Attard, A. A. (2014). Economic, business cycles and banks' profitability: evidence from Maltese banks from the periods 2003-2013. B.Com. thesis, University of Malta.

[9] Only four core domestic banks out of six are considered in this study, as for two of these banks the data are available only for a shorter time period, which is not ideal for the estimation of a model.

[10] I consider macroeconomic data starting from 2006Q4, as this aligns with the first observation available for bank-level data.

The macroeconomic block utilized in the models comprises real GDP and real house prices for Malta, real GDP and the HICP for the euro area, the monetary policy stance (measured by the Shadow Short Rate, as per Krippner (2020)),[11] and the Interest Rate Spread.[12] The inclusion of these variables captures the dynamics between economic activity of both the Maltese and euro area economies, the stance of conventional and unconventional monetary policy, and the banking sector.

Confidential bank-level data is collected for the Maltese core domestic banks and includes key balance sheet variables essential for contributing to the overall profitability of banks. The bank-level block includes a measure of profitability, interest income and expenses, loans to residents, total deposits, total assets, and capital plus reserves. Bank profitability in this context is calculated as the ratio of profits before tax (computed as a four-quarter moving sum of flows) to total assets, which can be conveniently interpreted as the ROA.

Forecasting models

These two models offer distinct perspectives on the core domestic banking environment: while the BVAR, despite being less computationally intensive, is estimated for and produces forecasts for aggregates, the FAVAR enables the examination of bank-level projections, that is, forecasts for each bank balance sheet included in the dataset. Both models are equipped with an identical macroeconomic block, with the main difference in the transformation applied to bank-level data. The BVAR model is estimated using *aggregated* bank-level series, whereas the FAVAR model utilizes four bank-level *factors* derived through Principal Component Analysis.[13] Both the FAVAR and the BVAR are estimated using Bayesian methods, where *block exogeneity* is imposed on equations concerning euro area variables, under the small country assumption that domestic variables have neither contemporaneous nor lagged effects on the euro area block.

To evaluate the predictive accuracy of the two models, in-sample unconditional forecasts are estimated across many subsamples, and subsequently compared with the observed data, to obtain a metric to quantify forecast errors. To enhance the validation of this measure, a comparison is conducted between the forecasting accuracy of the Vector Autoregression (VAR) models and a naive benchmark model, namely the Random Walk (RW).[14] This comparison assesses whether the VAR models provide added value to forecasts when compared to the simpler RW model. The forecasting evaluation exercise indicates that neither of the two models demonstrates superior performance over the other. While they may yield comparable outcomes from an aggregate perspective, it is noteworthy that one of the two models, namely the FAVAR, possesses the capability to forecast at bank-level. In this instance, the model generates interesting outcomes, demonstrating its capacity to provide reasonably accurate forecasts for selected Maltese core domestic banks' balance sheets items. However, results are heterogeneous across banks. Additional details regarding the forecast evaluation results can be found in Andreani (2024).[15]

Moreover, the two models are capable to provide out-of-sample predictions of selected balance sheet items of the banks included in the sample, conditional on the projected macroeconomic scenario and the monetary policy stance. An illustration of how these models can be used in practice follows. In this

[11] Krippner, L. (2020). Documentation for Shadow Short Rate estimates.

[12] Computed as the difference between the average interest rate on loans and deposits, which serves as a proxy for the interest rate margin for core domestic banks.

[13] When estimated over the entire sample, the first four principal components cumulatively represent 61% of the dataset's cumulative explained variance.

[14] The RW model extends the last observed value of a variable into the future.

[15] See footnote 2.

Table 1
MACROECONOMIC CONDITIONING PATHS

Variables	Source
Real GDP (MT)	CBM projections
Real house prices (MT)	CBM projections
Real GDP (EA)	ECB projections, Dec. 2023
HICP (EA)	ECB projections, Dec. 2023
Shadow Short Rate	Capital market, short-term forecasts

Sources: Central Bank of Malta, Economic Analysis Department; ECB Macroeconomic projections; LJK macro finance analysis; ECB Data Portal.

Note: All conditioning paths are in quarterly frequency. Projection horizon: 2023Q4 - 2025Q4.

analysis, a forecasting horizon from 2023Q4 to 2025Q4 is adopted. In this scenario, HICP inflation for the euro area is assumed to reach the target level of 2% by mid-2025, while the real estate market in Malta is assumed to maintain its robust growth trajectory. The monetary policy is assumed to remain steady throughout 2024, with a possible easing in 2025.[16] Finally, Malta's GDP is forecasted to grow at a rate below 5% from 2024 onwards.[17] Table 1 lists the sources of the conditioning paths used to derive the conditional forecasts.

Cross-checking forecasts across models

The conditional forecasts from the two models are illustrated in Charts 1 to 4, specifically comparing the outlooks for selected core domestic banks provided by the FAVAR and the BVAR. The comparison between the two models' output aims to evaluate the extent to which they offer a similar outlook. Aggregated forecasts are computed for the FAVAR to directly compare bank-level forecasts with those from the BVAR.[18] Since the models are estimated using data available up to 2023Q3, the charts also incorporate observations for 2023Q4 and 2024Q1 to further illustrate the forecasting performance.

Both models predict that profitability for the core domestic banks included in the sample will surpass the level recorded prior to the COVID-19 pandemic (see Chart 1), while the interest rate spread is projected to remain stable, although the FAVAR model predicts the spread to peak in 2025Q1 (see Chart 2). Additionally, both loans and deposits are expected to experience growth over the forecast horizon (see Charts 3 and 4, respectively). The credible sets, which represent probability distributions over expected outcomes, largely overlap, except for deposits in the very short-term forecast horizon, indicating similar forecast uncertainty between the two models. Notably, the median forecast for loans from the FAVAR (see Chart 3, black solid line) is strongly in line with actual data for 2023Q4 and 2024Q1 (see Chart 3, teal solid line).

To summarize, the two models predict a stable outlook for the sampled Maltese core domestic banks for the next two years. Profitability is expected to exceed 2019 levels, while the interest rate margin is forecasted to remain stable, accompanied by an increase in the growth of loans and deposits.

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[16] This assumption is based on the ECB forecasts for Capital markets – short-term interest rates – Winter, published in March 2024, and is used here for illustration purposes. However, it should be noted that this conditioning path is outdated by the time of this publication.

[17] This indicates that the Maltese economy will continue to expand, albeit at a slower pace compared to the last two years.

[18] In this case, ROA is the weighted average of bank-level ROA, where the weight is the share of total assets for each core domestic bank. Loans and deposits are the year-on-year growth rate of the sum of loans and deposits across banks, respectively.

Chart 1
ROA FORECASTS
(ratio; per cent)

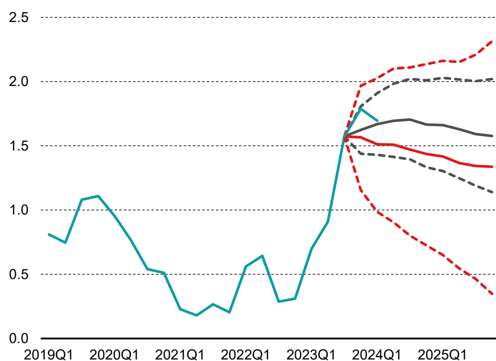


Chart 2
INTEREST RATE SPREAD FORECASTS
(per cent)

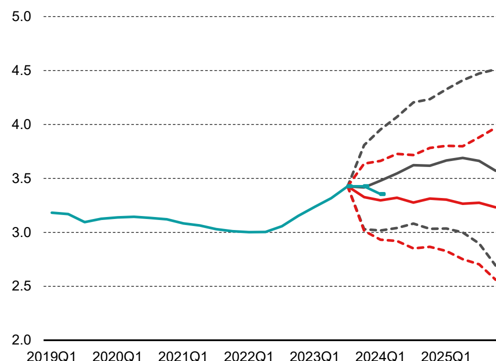


Chart 3
LOANS TO RESIDENTS FORECASTS
(year-on-year growth rate; per cent)

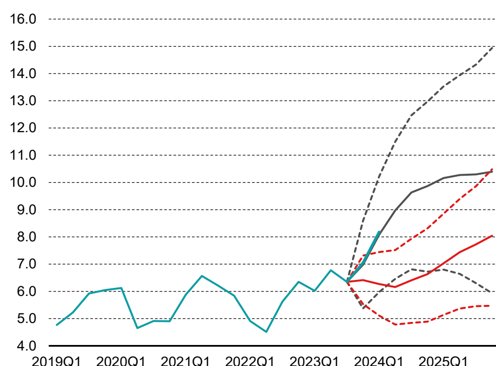
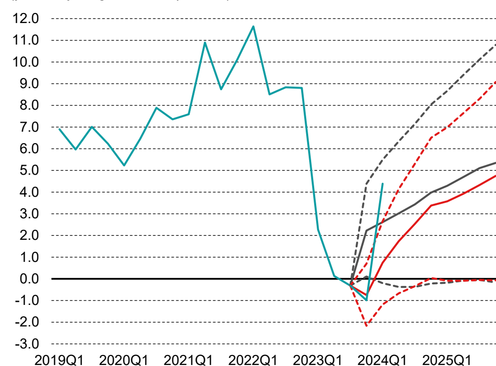


Chart 4
TOTAL DEPOSITS FORECASTS
(year-on-year growth rate; per cent)



Actual data FAVAR BVAR

Note: the dashed lines in red and grey each represent 68% credible sets around the central forecast.

Applications of the framework

The framework presented in this box allows for the formation of an outlook for the core domestic banking system in Malta, which is useful as part of the Central Bank of Malta's task to monitor and maintain financial stability. These models can be utilised to provide an outlook for the aggregate banking sector, focus on a specific bank of interest, and potentially inform stress testing scenarios. The estimated conditional density forecasts, driven by official macroeconomic projections, can offer a range of plausible trajectories for the Maltese core domestic banking system. Further extensions of these models could include additional balance sheet items and expand the sample of banks involved in the analysis. Finally, these models are sufficiently flexible to accommodate further developments in both local and euro area macroeconomic conditions, as well as future changes in monetary policy decisions.

2.2 Non-core domestic banks

The balance sheet of the non-core domestic banks contracted marginally over 2023, with total assets equivalent to 16.5% of GDP in June 2024. The decline in assets was mainly driven by a reduction in the securities portfolio and, to a lesser extent, in interbank claims. Such developments were partially offset by increased placements with the Central Bank of Malta and customer loans (see Chart 2.7).

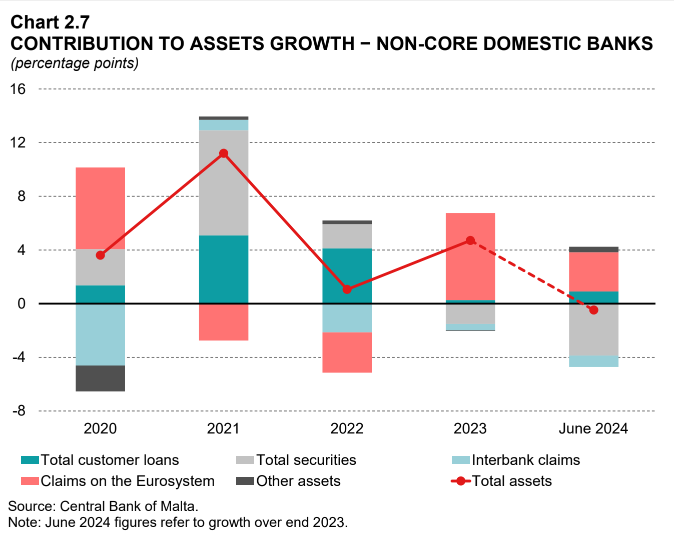


Chart 2.7
CONTRIBUTION TO ASSETS GROWTH – NON-CORE DOMESTIC BANKS
(percentage points)

Source: Central Bank of Malta.
Note: June 2024 figures refer to growth over end 2023.

The securities portfolio contracted by 13.2%, representing just over a quarter of non-core domestic banks' overall assets. Such drop stemmed predominantly from their bond portfolio, driven mainly by sales, though their equity holdings also fell to represent just above a fifth of overall securities. As shown in Chart 2.8, the decrease in bond holdings occurred across all main components, with a significant drop reported in both foreign and domestic sovereign bonds. Nonetheless, despite falling by 13.4%, such sovereign bond holdings continued to represent most of the debt securities holdings, making up 61.8% of the total bond portfolio. In the first half of 2024, corporate bonds also declined by 18.7%, and so did bank bonds by 1.5%, accounting for 21.7% and 16.5% of the portfolio, respectively. Non-core domestic banks continued to strengthen the quality of their bond holdings, with medium and high-rated bonds representing 43.2% and 42.8% of the overall bond holdings in June 2024. As a result, the share of investments in low and speculative/unrated bonds, on aggregate, fell compared to December 2023.

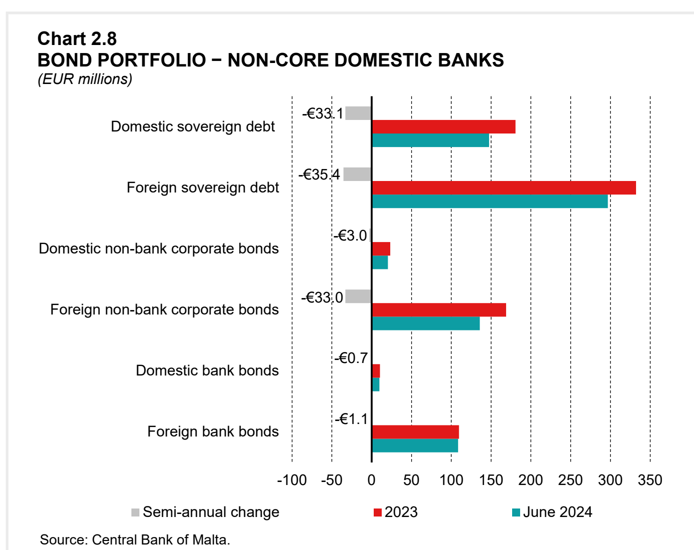


Chart 2.8
BOND PORTFOLIO – NON-CORE DOMESTIC BANKS
(EUR millions)

Source: Central Bank of Malta.

Interbank claims contracted by 13.2% in the first half of 2024, representing 5.6% of total assets, which were almost all held with unrelated parties. This decline was driven by lower placements with foreign unrelated banks, although placements with domestic credit institutions also declined. In contrast, they increased their placements with the Central Bank of Malta, up by 12.1% over 2023, to account for 27.3% of assets in June 2024.

In the first half of the year, the loan book expanded by 2.5%, to account for 37.8% of these banks' balance sheet. This growth was driven exclusively by higher resident loans, which increased by 9.0% to account for 52.8% of overall loans (see Chart 2.9). The most substantial contribution came from an increase of 10.3% of resident NFC loans, mainly driven by lending towards companies operating in the construction and real estate activities. Lending towards resident OFIs and households also rose, by a more modest rate, to account for 5.8% and 11.3% of overall customer loans, respectively. Conversely, non-resident customer loans fell

by 4.0% over 2023, driven by lower loans issued towards non-bank financial entities, as otherwise loans to foreign NFCs rose.

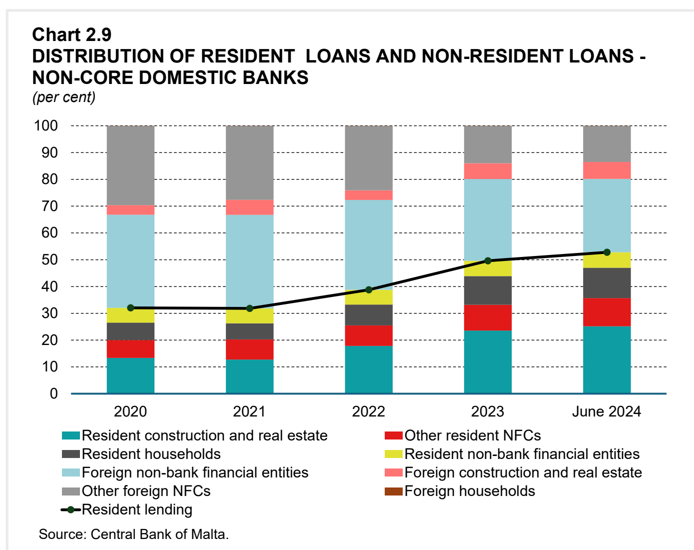


Chart 2.9
DISTRIBUTION OF RESIDENT LOANS AND NON-RESIDENT LOANS - NON-CORE DOMESTIC BANKS
(per cent)

Source: Central Bank of Malta.

The asset quality of the non-core domestic banks' loan portfolio deteriorated slightly, with the NPL ratio rising by 0.1 percentage points to 1.3% in June 2024. This was primarily driven by a 12.5% increase in the stock of NPLs, which was in part offset by higher loans and advances. The increase in NPLs was driven by a significant growth in resident household NPLs of one bank, pushing the overall household NPL ratio to 4.0% in June 2024 from 0.3% six months earlier. In contrast, NFC NPLs declined by 8.7%, driven exclusively by non-residents, which resulted in the share of overall NPLs to drop by 15.5 percentage points to 69.7%. As a result, the NFC NPL ratio fell by 0.5 percentage points to 3.0%. Excluding placements, the NPL ratio edged up by 0.2 percentage points to 2.2%.

The increase in NPLs brought with it higher provisions, up by 10.8%, driven by higher Stage 2 and Stage 3 provisions. However, such increase fell short of the increase in NPLs, with the coverage ratio deteriorating by 1.0 percentage point to 59.1% in June 2024. At the same time, the forbearance ratio rose marginally to 1.2%, driven mainly by higher non-performing exposures with forbearance measures.

The funding of non-core domestic banks continued to be driven by customer deposits, which rose by 4.6% over 2023, to finance about 78% of their total assets. This growth was driven by resident household deposits, which increased by almost a fifth, reflecting customers' increased preference to place funds in banks offering more attractive returns. Indeed, the overall weighted average interest rate of non-core domestic banks stood at 2.9% in June 2024, much higher than the 0.4% offered by the core domestic banks. Nonetheless, resident customer deposits still accounted for less than a quarter of their total customer deposits, and a small fraction of the overall resident deposits in the banking system. Non-resident customer deposits also increased, although by a more modest rate of 0.8%, mainly on the back of higher NFC deposits. In terms of term structure, the growth in customer deposits was driven exclusively by an increase in withdrawable on-demand deposits, which rose by 12.5% over 2023. At the same time, term deposits declined by 1.7% to 52.6% of deposits by June 2024.

In contrast, interbank funding retreated by almost 30%, financing just 3.6% of total assets. This drop was largely driven by lower placements from unrelated banks, mostly foreign institutions. By June 2024, Eurosystem funding plummeted by around 90%, albeit from a relatively low base, accounting for just 0.3% of overall liabilities. This drop is mainly due to lower participation in the seven-day US dollar (USD) operations, and to a lower extent, other Eurosystem funding such as the main refinancing operations (MROs), longer-term refinancing operations (LTROs) and targeted longer-term refinancing operations (TLTRO III).

Non-core domestic banks maintained strong liquidity positions, with the LCR and NSFR improving by 23.1 percentage points and 1.0 percentage point, respectively, to 428.3% and 192.3%. These strong liquidity levels largely reflected higher liquid assets, mainly in the form of central bank assets.

At the same time, non-core domestic banks also remained well capitalised, with the total capital ratio and the Tier 1 capital ratio standing at 20.7% and 19.6% in June 2024, both down by a marginal 0.1 percentage points when compared to December 2023. This reflected a slightly higher increase in RWA, which was in turn mainly driven by higher credit risk. Consequently, the risk profile of this group of banks deteriorated marginally, with

the total RWA on total assets ratio increasing by a 0.5 percentage points to 50.1%. The leverage ratio stood unchanged at 9.5%.

During the first half of 2024, non-core domestic banks' pre-tax profits declined by 7.0%, leading to a drop in their post-tax ROE and ROA, to 5.2% and 0.5%, respectively. The reduction was primarily driven by a 7.1% drop in non-interest income, largely due to lower trading and non-trading gains, along with a contraction in fees and commissions income. Additionally, higher non-interest expenses also contributed to lower profitability, rising by 2.4% over 2023, mainly due to increased staff costs. On the other hand, NII rose by 2.6%, pushing up its share in total gross income by 2.2 percentage points to 68.4%. Such improvement stemmed exclusively on the back of non-intermediation activities, as otherwise NII earned from these banks' lending portfolio dropped by almost 19%. This came about because of a higher interest payable on household deposits, resulting in the operational cost-to-income ratio to rise from 66.6% in December 2023 to 68.7% in June 2024. Concurrently, net impairment charges dropped by 6.8%.

Non-core domestic banks are increasing their focus on the domestic economy in an effort to diversify their operations and better manage the uncertain global economic environment. Recently, these banks have grown their assets by leveraging on the robust economic developments, leading to a notable increase in loans to residents. To this end, ongoing oversight in this respect is crucial to maintain robust asset quality and a healthy balance sheet.

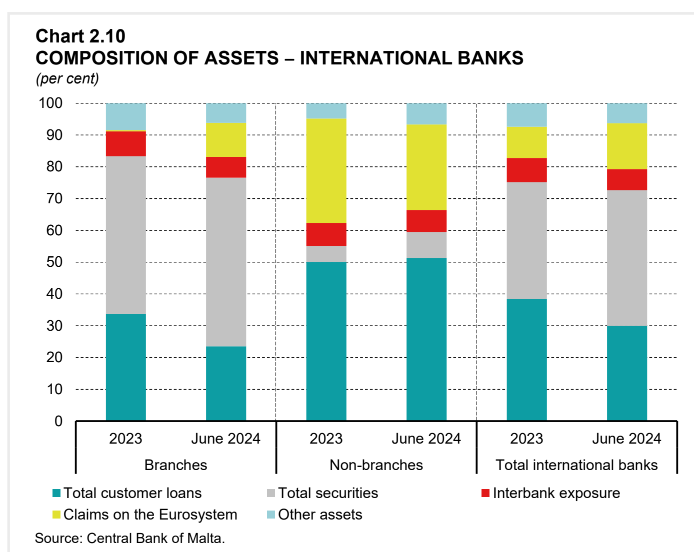
2.3 International banks

After six years of consecutive declines in international banks' assets, these institutions recorded an expansion of nearly 26% in the first half of 2024. As a result, their assets-to-GDP ratio increased by 9.8 percentage points to 57.9%. Most of the growth originated from the branches of foreign banks, as their assets expanded by 36.0%. At the same time, the assets of non-branches rose at a much more modest rate of 1.0% over the same period.

The growth of the branches' balance sheets was primarily driven by an increase in claims held with the Central Bank of Malta, which as at June 2024, represented 10.7% of their assets, an increase of 10.2 percentage points in the first six months of the year (see Chart 2.10). In contrast, the growth reported by the non-branches was spurred by a 62.6% increase in security holdings. Nevertheless, these assets accounted for only a modest 8.2% of their total holdings. Despite these developments, branches continued to hold the bulk of their assets in securities, while non-branches focused on customer loans, both making up over half of their respective total assets in June 2024. The share of interbank assets fell for both branches and non-branches, down by 1.3 percentage points to 6.6%, and by 0.3 percentage points to 6.9% of their respective assets.

Nearly 99% of the securities portfolio of the international banks consisted of debt securities, mostly issued by foreign sovereigns. This mainly reflected the strong investment in Turkish Government bonds by the branches. Notwithstanding, these same branches also increased their investments in US Government bonds. Higher holdings by non-branches were primarily driven by investments in bonds issued by foreign monetary financial institutions (MFIs) and OFIs, which make up the majority of their debt securities. Consequently, the share

Chart 2.10
COMPOSITION OF ASSETS – INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.

of medium and high-rated bonds among international banks increased slightly, representing 4.1% of the overall bonds held in June 2024.

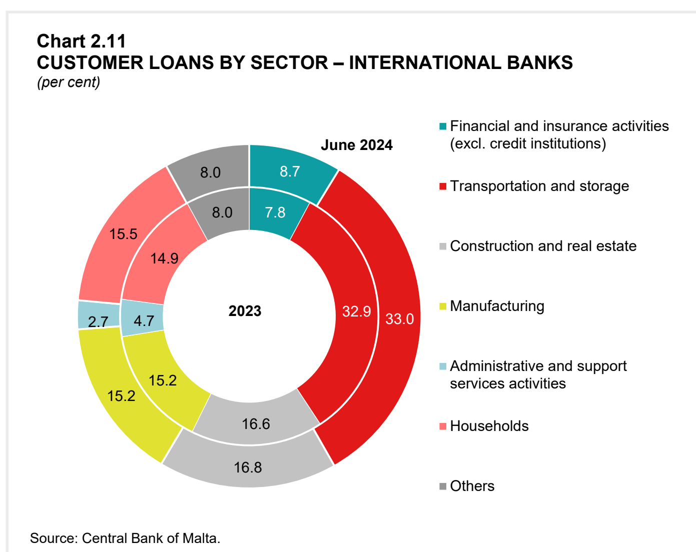
The developments on the customer loan book were also driven by the branches, which resulted in this asset class to contract by 1.8% for all international banks in the first six months of 2024 (see Chart 2.10). This occurred despite the 3.5% growth reported by non-branches, which largely reflected an increase in loans to non-resident financial and insurance companies. The overall decline was mainly driven by reduced lending to non-resident firms operating in the administrative and support service activities. Otherwise, the composition of the loan book for international banks remained relatively unchanged, with the transportation and storage sector accounting for almost a third of the overall customer loans (see Chart 2.11). Lending remained predominantly focused on non-resident customers, with resident customers making up only 0.5% of total customer loans.

In terms of asset quality, although the NPL ratio improved marginally by 0.1 percentage points to 1.4%, the stock of NPLs grew by an additional 8.3% compared to the end of 2023. This increase was primarily driven by the branches, mostly relating to loans in the administrative and support service activities, and to a much lower extent, in the manufacturing sector. Household NPLs entirely relating to consumer credit rose by 1.9%, driven exclusively by the non-branches. Notwithstanding, the household NPL ratio remained stable at an elevated level of 13.4%, reflecting some of the banks' business models within this cohort. NPLs remained adequately backed by provisions, with a coverage ratio of 118.9%. However, this fell by 6.4 percentage points as the 2.7% increase in provisions, largely with respect to Stage 3 loans, fell short of the increase in NPLs.

Accounting for over 94% of total loans, the loan portfolio continued to be predominantly composed of loans classified as Stage 1, largely in line with the share reported in 2023. Otherwise, higher Stage 3 loans were reported, in part offset by lower Stage 2 loans (see Chart 2.12). After a sharp decline in 2023, the overall forbearance ratio fell further to stand at 1.2% in June 2024.

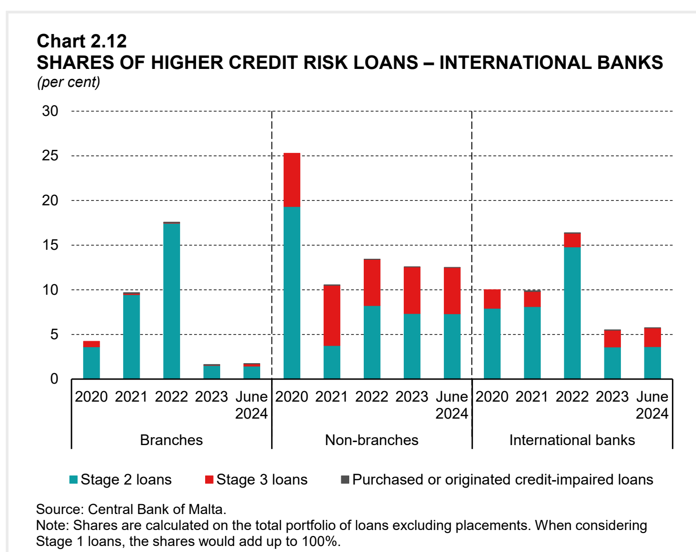
With respect to capital, non-branches reported a 1.7 percentage point decline in their total capital ratio in the first half of 2024. Despite this drop, at 37.1%, the ratio remained well above the regulatory minimum. The decline was driven by a faster increase in RWA, which rose by 7.5% compared to

Chart 2.11
CUSTOMER LOANS BY SECTOR – INTERNATIONAL BANKS
(per cent)



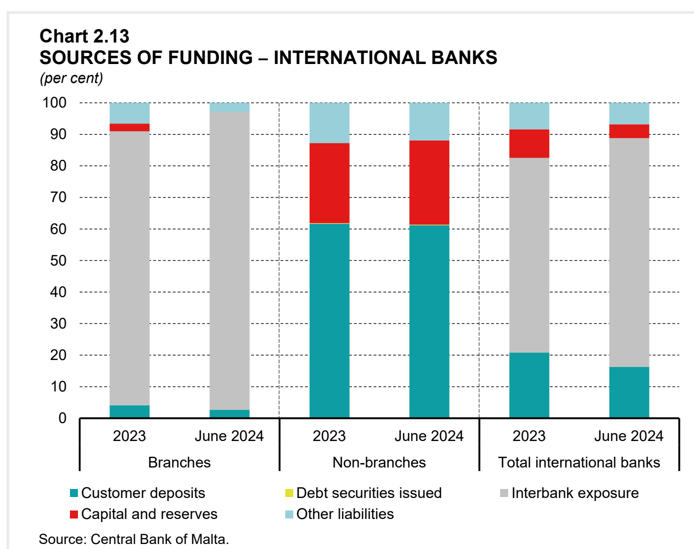
Source: Central Bank of Malta.

Chart 2.12
SHARES OF HIGHER CREDIT RISK LOANS – INTERNATIONAL BANKS
(per cent)



Source: Central Bank of Malta.
Note: Shares are calculated on the total portfolio of loans excluding placements. When considering Stage 1 loans, the shares would add up to 100%.

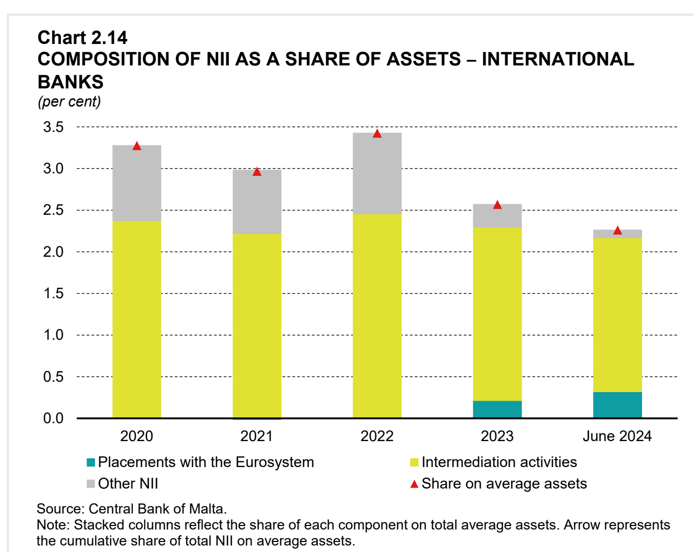
total own funds, which expanded by 2.9%. The growth in own funds originated exclusively from Common Equity Tier 1 (CET1) capital. At the same time, the rise in RWAs was mainly due to higher foreign exchange and commodities risks, with a smaller contribution coming from credit risk. Meanwhile, the leverage ratio for international banks remained strong, standing at 29.6% in June 2024, an increase of a 0.8 percentage points compared to December 2023.



International banks continued to rely heavily on interbank funding to finance their balance sheets, with this source making up over 70% of total assets in June 2024 (see Chart 2.13). This reliance was driven entirely by the branches as the non-branches continued to avoid this type of funding. Instead, the non-branches financed nearly 62% of their operations through customer deposits primarily from non-resident OFIs and households. Deposits continued to be predominantly time deposits, with withdrawable on-demand deposits making up a smaller share of 13.3% of overall deposits with all international banks in June 2024. This declining trend was observed in both branches and non-branches. Other sources of funding included capital and reserves and other liabilities.

While deteriorating during the first half of 2024, non-branches continued to operate with ample liquidity positions, as evidenced by a robust LCR of 396.8% and an NSFR of 124.7%. The drop in LCR was driven by a reduction in liquid assets, mainly central bank assets and reserves, along with increased liquidity outflows from operational and, to a lesser extent, non-operational deposits.

The overall profitability of international banks declined by 19.5% in the first six months of 2024, resulting in a 0.5 percentage point drop in their post-tax ROA to 2.0%. This contraction in profitability was driven by the branches, which reported a reduction in both NII and non-interest income, and higher non-interest expenses. In contrast, non-branches' profitability increased, driven by a 6.7% rise in NII and an 8.8% increase in non-interest income. Both offset the higher non-interest expenses and a 6.5% increase in net impairment charges.



The overall decline in NII occurred primarily due to lower net interest earned on intermediation activities, which continued to constitute the biggest component of NII for international banks, and equivalent to almost 2% of total average assets (see Chart 2.14). Other NII also fell,

driven by increased expenses from interbank exposures. These both outweighed the nearly 50% increase in net interest earned on placements with the Eurosystem. As expenses outgrew income earned, the cost-to-income ratio of international banks deteriorated by 7.5 percentage points to 63.3% in June 2024.

A possible continued deterioration in NII, potentially driven by further interest rate cuts, coupled with additional increases in operational costs, may continue to pose risks to profitability for international banks going forward. Despite declines in both capital and liquidity positions, these continued to remain robust, providing the resilience needed to absorb potential shocks on their balance sheets. The sustainability of long-term liquidity still warrants close monitoring given that the NSFR stood closer to the minimum regulatory requirement. As a result, exercising a high degree of prudence in these banks' liquidity and credit risk management policies remains vital to mitigate growing risks.