EXECUTIVE SUMMARY

In the first half of 2024, the domestic financial sector demonstrated resilience, despite a challenging macro-financial landscape in the euro area. This environment was characterised, on the one hand by positive factors such as benign prospects for economic growth and lower inflation, and on the other by persistent geopolitical tensions.

The risk of a deep recession lessened, and inflation started converging towards the European Central Bank's (ECB) medium-term target of around 2%. This allowed central banks more flexibility to start reducing policy rates. Domestically, economic growth remained robust even though it moderated somewhat. At the same time, inflation fell at a faster pace in comparison to other euro area countries. However, geopolitical tensions persisted driven mainly by ongoing conflicts in Ukraine and the Middle East, alongside with the political uncertainty stemming from elections in Europe and the United States. This, coupled with the uncertainty over the pace and scale of future interest rate cuts, continues to pose a potential source of market volatility. Still, funding costs for both governments and the private sector are expected to decline. The private sector remained resilient, buoyed by a robust labour market, though downside risks persist due to sluggish economic activity.

The euro area banking sector showed resilience, with profitability improving marginally, driven by enhanced cost-efficiencies and higher non-interest income. Similarly, domestic banks remained highly profitable. Although credit growth in Malta slowed down, it remains robust. However, the heavy concentration in property-related activity heightens concentration risks. Such growth diverges from the broader EU landscape, where credit growth remained subdued. Similarly, diverging developments were also reported in the real estate sector, where house prices continued to rise strongly in Malta as opposed to those in the euro area which registered price declines until the first quarter of 2024. This notwithstanding, credit quality has shown improvement, supported by lower non-performing loans (NPLs) and forbearance ratios. Additionally, banks maintained ample liquidity and solid capital positions, bolstering the sector's resilience against broader economic challenges and unexpected shocks.

The non-bank financial sector experienced growth during the first six months of 2024, reflecting an increase in assets both for domestically-relevant investment funds and insurance companies. The growth in investment funds was supported by a rebound in equity markets and a modest increase in fixed-income securities. While these investments continued to be concentrated in liquid assets, cash and deposits remained low. Redemptions stayed close to historical averages, and leverage remained low and stable. However, going forward, risks persist due to the potential for a reassessment of higher risk premia. In the insurance sector, robust capital and liquidity positions were upheld, although challenges persist, especially in the life insurance segment due to declining premia influenced by shifts in customer behaviour amid still-high interest rates. Meanwhile, the non-life insurance sector reported strong profits through solid underwriting and investment returns, despite further declines in already tighter liquidity levels.

The *Report* includes three boxed articles. Box 1 presents a specialised forecasting framework for key balance sheet items of core domestic banks, with a particular emphasis on profitability. Box 2 introduces a reverse stress test (RST) that is based on one of the liquidity stress testing frameworks of the Bank. Box 3 provides an introductory analysis of pension funds registered in Malta, highlighting their role and importance within the financial landscape.

The *Interim Financial Stability Report* was 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* was reviewed by the Bank's Financial Stability Committee, which is responsible to oversee and implement policies related to financial stability and the macroprudential framework.