# EXECUTIVE SUMMARY

**The financial sector in Malta is large compared to the economy and is strongly connected with the rest of the world.** While Malta has benefited from considerable financial inflows, the associated risks, especially related to money laundering and terrorism financing (ML/TF), need to be closely monitored and addressed.

**Key metrics suggest that the banking system is in good health, but challenges exist.** Banks are well capitalized, liquidity is ample, and profitability is healthy. However, core domestic banks' high exposure to property-related loans, together with the rapid house price appreciation, poses a risk. The significant share of nonresident deposits in international and noncore domestic banks makes them vulnerable, but their exposure to the domestic economy is limited. While nonperforming loans (NPL) remain below the euro area (EA) average, there are pockets of distressed corporate loans that continue to impact banks' balance sheets.

**The banking system remains resilient under a severe scenario, with weaknesses limited to a few small banks.** The system is sufficiently capitalized to absorb losses in the event of a severe macroeconomic shock, but risky exposures would lead to potential losses at a few small banks. Under a stress event, large withdrawals of wholesale and nonresident deposits can put some banks under pressure. Contagion risk is estimated to be limited, but distress could impact smaller banks due to cross-border and cross-sectoral linkages. There is a need to closely monitor banks' evolving business models to detect potential shifts in systemic risks, strengthen the stress test approaches, and enhance data quality and management.

**Continued enhancements are encouraged in the macroprudential framework.** While the recent strengthening of systemic risk monitoring is commendable, the legal framework should be enhanced, data gaps closed, and nonbank risk assessment strengthened. The planned introduction of borrower-based measures to address buildup of vulnerabilities in the housing and household sectors is welcome.

**Ensuring adequate resources is critical to preserve the effectiveness and operational independence of the Malta Financial Services Authority (MFSA).** It is a challenge to meet the increasing demands of supervising the growing number of financial institutions in an evolving and more complex regulatory environment. The MFSA is substantially understaffed, which undermines its effectiveness and operational independence. The authorities should upgrade the MFSA's operational capacity and grant it full autonomy over its recruitment. The authorities should develop a five-year plan to ensure sustained budgetary resources for the MFSA. Further steps should be taken to enhance checks and balances in the MFSA's decision-making process.

**Shortcomings in bank supervision call for urgent action.** To strengthen bank supervision, the MFSA should take timelier supervisory actions, increase the frequency of onsite inspections, make more use of monetary fines as part of the sanctioning regime, and ensure supervisory action is not delayed through judicial appeal. Supervision should focus on main risks (credit, liquidity, and compliance) and the adequacy of risk classification and provisioning. Further actions are needed to align the related-parties framework with the Basel Core Principles (BCP). Improving oversight of non-European Union (EU) branches is also important.

**Actions are needed to support the use of early intervention and resolution powers, and to address weaknesses in the bank liquidation and insolvency framework.** Policies and procedures should be developed for the MFSA's early intervention and resolution powers, including to mitigate legal risks. An administrative bank insolvency framework should be adopted, and the creditor hierarchy clarified. Responsibility for decisions on bank liquidation and insolvency post-license withdrawal should be shifted from the MFSA's supervisory function to its resolution function. The MFSA and the Ministry for Finance (MFIN) should develop their internal crisis management plans.

**Containing financial integrity risks is critical to financial stability.** The cross-border linkages of the large financial sector pose significant ML/TF risks, notably from foreign proceeds of crimes, which create challenges through growing reputational risks, pressure on correspondent banking relationships (CBR) and compliance costs. The fast-growing remote gaming activity, virtual-assets intermediation, and high demand for real estate and the Individual Investment Program (IIP) call for effective measures to contain financial integrity risks.

**A multi-prong approach is needed to address anti-money laundering and combating the financing of terrorism (AML/CFT) deficiencies.** Enhancing the AML/CFT system is required to protect the financial sector and the broader economy from the ML/TF threats. Efforts should focus on banks' application of preventive measures (including customer due diligence with efficient verification of beneficial ownership (BO)), in particular regarding their higher risk activities and clients, including the significant nonresident sector. Additional supervisory resources are needed for Financial Intelligence Analysis Unit (FIAU) and the MFSA to bolster the application of risk-based AML/CFT supervision. The authorities should take appropriate corrective actions—including timely, dissuasive, and proportionate sanctions—in case of breaches of AML/CFT requirements. Establishing an EU-level arrangement responsible for AML/CFT supervision should be supported to facilitate a consistent and comprehensive approach and minimize regulatory arbitrage.