

BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

TENTH FINANCIAL STABILITY REPORT

2017

© Central Bank of Malta, 2018

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The cut-off date for information relating to banking, insurance and investment funds is 8 March 2018. The source of data in tables and charts is the Central Bank of Malta unless otherwise indicated.

ISSN 2312-5918 (print)

ISSN 2074-2231 (online)

CONTENTS

PREFACE	9
1. MACRO-PRUDENTIAL RISKS AND POLICY RESPONSE	11
Box 1 EU policy initiatives to address non-performing loans	18
2. DEVELOPMENTS IN THE BANKING SECTOR	22
2.1 Core domestic banks	22
2.1.1 Profitability	22
2.1.2 Asset quality	24
Box 2 NFC loans from other corporates – evidence from Malta’s financial accounts statistics	25
Box 3 A review of the corporate bond market in Malta	29
2.1.3 Funding and liquidity	35
2.1.4 Capital and leverage	37
Box 4 Bank lending survey results	38
2.2 Non-core domestic banks	41
2.2.1 Profitability	41
2.2.2 Asset quality	42
2.2.3 Funding and liquidity	44
2.2.4 Capital and leverage	44
2.3 International banks	45
2.3.1 Branches of foreign banks	45
2.3.1.1 Profitability	45
2.3.1.2 Asset quality	46
2.3.1.3 Funding and liquidity	46
2.3.2 Subsidiaries of foreign banks and stand-alone foreign banks	47
2.3.2.1 Profitability	47
2.3.2.2 Asset quality	47
2.3.2.3 Funding and liquidity	48
2.3.2.4 Capital and leverage	48
3. STRESS TESTS	50
4. INSURANCE COMPANIES AND INVESTMENT FUNDS	57
4.1 Domestic insurance companies	57
4.1.1 The domestic life insurance companies	58
4.1.2 The domestic non-life insurance companies	61
4.2 Domestic investment funds	63
APPENDICES	69
GLOSSARY	73

CHARTS & TABLES

Chart 1.1:	Systemic risk indicators	11
Chart 1.2:	Ten-year government bond yields	12
Chart 1.3:	Credit-to-GDP ratio and gap	12
Chart 2.1:	Distribution of assets – core domestic banks	22
Chart 2.2:	Contribution to balance sheet growth – core domestic banks	22
Chart 2.3:	Profitability ratios – core domestic banks	23
Chart 2.4:	Main components of profits – core domestic banks	23
Chart 2.5:	Annual growth rate of resident loans – core domestic banks	24
Chart 2.6:	Resident loans by NACE – core domestic banks	25
Chart 2.7:	Sectoral allocation of loans and advances and NPLs – core domestic banks	33
Chart 2.8:	NPL Ratios – core domestic banks	33
Chart 2.9:	Coverage ratio – core domestic banks	34
Chart 2.10:	Bond portfolio – core domestic banks	34
Chart 2.11:	Bond holdings by rating – core domestic banks (2017)	35
Chart 2.12:	Contribution to growth in customer deposits – core domestic banks	36
Chart 2.13:	Banks' liability components – core domestic banks (2017)	36
Chart 2.14:	Change in total own funds, capital and leverage ratios – core domestic banks	37
Chart 2.15:	Growth in assets and total risk exposure – core domestic banks	38
Chart 2.16:	Profitability – non-core domestic banks	42
Chart 2.17:	Customer loans by sector – non-core domestic banks	42
Chart 2.18:	Customer loans by residency – non-core domestic banks	42
Chart 2.19:	Bond holdings by residency – non-core domestic banks	43
Chart 2.20:	Capital and leverage ratios – non-core domestic banks	44
Chart 2.21:	Profitability – branches of foreign banks	45
Chart 2.22:	Customer loans by sector – branches of foreign banks	46
Chart 2.23:	Profitability – subsidiaries of foreign banks and stand-alone banks	47
Chart 2.24:	Customer loans by residency – subsidiaries of foreign banks and stand-alone banks	48
Chart 2.25:	Capital and leverage ratios – subsidiaries of foreign banks and stand-alone banks	49
Chart 3.1:	Stress test results – impact of deterioration in securities portfolio on Tier 1 capital ratio	51
Chart 3.2:	Stress test results – impact of persistent deposit withdrawals – scenario 1, restricted ECB funding, core domestic banks	52
Chart 3.3:	Stress test results – impact of persistent deposit withdrawals – scenario 2, unrestricted ECB funding, core domestic banks	52
Chart 3.4:	Stress test results – impact of persistent deposit withdrawals – scenario 1, restricted ECB funding, non-core domestic banks	52
Chart 3.5:	Stress test results – impact of persistent deposit withdrawals – scenario 2, unrestricted ECB funding, non-core domestic banks	53
Chart 3.6:	Stress test results – impact of a drop in house prices on Tier 1 capital ratio, core domestic banks	54
Chart 3.7:	Stress test scenarios – change in the term structure of interest rates under the six BCBS scenarios	55
Chart 3.8:	Stress test results – impact of changes in net interest income on Tier 1 capital ratio of core domestic banks	55
Chart 3.9:	Stress test results – impact of changes in net interest income on Tier 1 capital ratio of non-core domestic banks	56
Chart 4.1:	Asset-side links by counterparty (2017)	57
Chart 4.2:	Asset composition of the life insurance sector	58
Chart 4.3:	Bond and equity portfolio of the life insurance sector	59

Chart 4.4:	Profit components of the life insurance sector	59
Chart 4.5:	Liquid assets ratio of the life insurance sector	60
Chart 4.6:	Solvency capital ratio of the life insurance sector	61
Chart 4.7:	Asset composition of the non-life insurance sector	61
Chart 4.8:	Bond and equity portfolio of the non-life insurance sector	61
Chart 4.9:	Profit components of the non-life insurance sector	62
Chart 4.10:	Liquid assets ratio of the non-life insurance sector	63
Chart 4.11:	Solvency capital ratio of the non-life insurance sector	63
Chart 4.12:	Domestic investment funds by main strategy	64
Chart 4.13:	Asset composition of the domestic investment funds	64
Chart 4.14:	Domestic investment funds' NAV by counterparty	65
Table 1.1:	Summary of risks	15

BOX CHARTS & TABLES

Box 1	Chart 1: Overview of EU policy initiatives to address NPLs	19
	Table 1: Minimum coverage levels for unsecured and secured parts of NPLs	21
Box 2	Chart 1: Non-financial corporations' liabilities	26
	Chart 2: NFC loans by counterpart sector	27
	Chart 3: Intercompany loans as a percentage of GDP	27
	Chart 4: Definition of a group	28
	Chart 5: NFC loans by counterpart sector – further splits	28
Box 3	Chart 1: Bond issuance by non-financial corporations	30
	Chart 2: Ownership of outstanding non-bank corporate bonds	31
	Chart 3: Characteristics of corporate bonds – outstanding bonds	31
	Chart 4: Outstanding bonds by sectors	32
	Chart 5: Changes in outstanding bonds and bank credit of selected NFC sectors	32
Box 4	Chart 1: Credit standards	39
	Chart 2: Credit terms and conditions	39
	Chart 3: Corporate credit demand	40
	Chart 4: Mortgage credit demand	40
	Chart 5: Consumer credit and other lending demand	41

APPENDICES

Appendix A: Implemented policy measures	69
Appendix B: Financial soundness indicators	71

ABBREVIATIONS

AIF	Alternative Investment Funds
BCBS	Basel Committee for Banking Supervision
BLS	Bank Lending Survey
BR	Banking Rule
BRRD	Banking Recovery and Resolution Directive
CCyB	Countercyclical Capital Buffer
CET1	Common Equity Tier 1
CIS	Collective Investment Scheme
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
DSTI	debt-service-to-income
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECL	expected credit loss
EIOPA	European Insurance and Occupational Pensions Authority
EME	emerging market economies
EU	European Union
ESRB	European Systemic Risk Board
GDP	gross domestic product
HTM	held-to-maturity
IMF	International Monetary Fund
IRB	Internal ratings-based banks
IRRBB	Interest rate risk in the Banking Book
LCR	Liquidity Coverage Ratio
LTV	loan-to-value
MFI	monetary financial institution
MCR	Minimum Capital Requirement
MFSA	Malta Financial Services Authority
MGS	Malta Government Stocks
MMF	money market funds
MREL	minimum requirements for own funds and eligible liabilities
MSE	Malta Stock Exchange
MTM	marked-to-market
NACE	nomenclature statistique des activités économiques dans la Communauté européenne.
NBB	National Bank of Belgium
NFC	non-financial corporation
NII	net interest income
NIM	net interest margin
NPE	non-performing exposure
NPL	non-performing loan
NSFR	Net Stable Funding Ratio
NSO	National Statistics Office
NTNI	Non-traditional non-insurance
O-SIIs	other systemically important institutions
OFI	other financial intermediaries
PCC	Protected Cell Company
PIF	Professional Investor Funds
RCA	recapitalisation amount
ROA	return on assets
ROE	return on equity

ROW	Rest of the World
RWA	risk-weighted assets
SAFE	Survey on Access to Finance
S&P	Standard and Poor's
SCR	Solvency Capital Requirement
SDW	Statistical Data Warehouse
SME	small and medium-sized enterprises
SRB	systemic risk buffer
SREP	Supervisory Review and Evaluation Process
STREAM	Structural Macro-Econometric Model of the Maltese Economy
UCITS	Undertaking of the Collective Investment in Transferable Securities
UK	United Kingdom
US	United States
VaR	value at risk

THE DOMESTIC FINANCIAL SECTOR

Banks

Core Domestic Banks	Non-Core Domestic Banks	International Banks ⁽²⁾
APS Bank Limited	FCM Bank Limited	AgriBank plc
Bank of Valletta plc	FIMBank plc	Akbank T.A.S. (Branch)
BNF Bank plc	IIG Bank (Malta) Limited	CommBank Europe Limited
HSBC Bank Malta plc	Izola Bank plc	Credit Europe Bank NV (Branch)
Lombard Bank Malta plc	Sparkasse Bank Malta plc	Credorax Bank Limited
MeDirect Bank (Malta) plc ⁽¹⁾		ECCM plc
		Ferratum Bank Limited
		MFC Merchant Bank Limited
		NBG Bank Malta Limited
		Novum Bank Limited
		Pilatus Bank Limited ⁽³⁾
		Satabank plc
		Turkiye Garanti Bankasi A S (Branch)
		Yapi Kredi Bank Malta Limited

Domestic Investment Funds

Amalgamated Growth and Income Fund	HSBC Property Investment Fund	Sound Money Portfolio Fund
APS Income Fund	International Bond Fund	Special Situations Fund
APS Regular Income Ethical Fund	Lancet Private Equity Fund	Vilhena Broad Opportunities Fund
Avialease Fund	Malta Bond Fund	Vilhena Euro Income Fund
BOV Balanced Portfolio Fund	Malta Government Bond Fund (Calamatta Cuschieri)	Vilhena European Multi Manager Fund
BOV Conservative Portfolio Fund	Malta Government Bond Fund (HSBC)	Vilhena Far East Opportunities
BOV Growth Portfolio Fund	Malta Privatisation and Equity Fund	Vilhena Global Themed Fund
Emerging Market Trade Finance Fund	Maltese Assets Fund	Vilhena High Yield Fund
Equity Growth Fund	Melita International Equity Fund	Vilhena Malta Bond Fund
Equivest Fund	Merill Global Equity Income Fund	Vilhena Malta Fund
Euro Equity Fund	Merill High Income Fund	Vilhena Malta Government Bond Fund
Global Balanced Multi-Manager Fund	Merill Total Return Income Fund	Vilhena Maltese Equity Focus Fund
Global Bond Fund Plus	Palvic Fund	Vilhena Maltese Opportunities Fund
High Income Bond Fund - EUR	Personal Care Fund	Vilhena Sterling Income Fund
High Income Bond Fund - USD	Prestige Fund	

Domestic Insurance Companies

Life Insurance Companies	Non-Life Insurance Companies
GlobalCapital Life Insurance	Atlas Insurance PCC Malta
HSBC Life Assurance (Malta) Limited	Citadel Insurance plc
MAPFRE MSV Life plc	Elmo Insurance Limited
	GasamMamo Insurance Malta
	MAPFRE Middlesea plc

⁽¹⁾ On 22 June 2017 Mediterranean Corporate Bank Limited was merged with Mediterranean Bank plc. On November 2017 Mediterranean Bank became MeDirect Bank (Malta) plc.

⁽²⁾ On 23 March 2017 the ECB decided to withdraw Nemea Bank's licence.

⁽³⁾ On the 22 March 2018, the MFSA appointed Mr Lawrence Connell as a 'Competent Person' in terms of Article 29(1)(c) and (d) of the Banking Act and Article 15A(1)(b) and (c) of the Investment Services Act to take charge of the bank.

This edition of the *Financial Stability Report* is based on the above categorisation of banks, domestic insurance companies and investment funds.

PREFACE

A well-functioning financial system plays a fundamental role in supporting sustainable economic growth and higher living standards of citizens through employment and output. At the same time, it enables the channelling of savings into productive investment, while facilitating payment services and other financial activities.

The Financial Stability Department of the Central Bank of Malta carries out assessments to identify any potential systemic risks to the stability of the system and which, in turn, could require policy interventions. The *Financial Stability Report*, hereinafter the *Report*, provides an overview of the Maltese financial system; addressing the main financial stability risks faced by key financial sectors, namely the banking sector, insurance and investment funds. This assessment also looks into their resilience, supported by a number of stress tests targeting the banking sector. The *Report* highlights any measures and policies implemented or proposed to address such risks.

The *Report* is prepared by the Financial Stability Department and reviewed and endorsed by the Financial Stability Committee. The Committee is chaired by the Governor of the Bank, and includes as members the Deputy Governors, Chief Officer – Economics, Chief Officer – Financial Control and Risk, and Head – Financial Stability.

1. MACRO-PRUDENTIAL RISKS AND POLICY RESPONSE

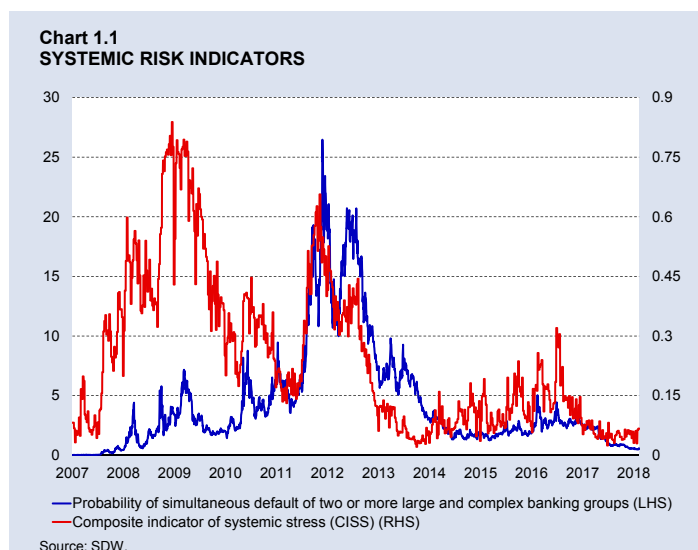
Despite a challenging international environment dominated by geopolitical uncertainty, the stability and resilience of the domestic financial system was preserved throughout 2017, reinforced by the strong momentum of the Maltese economy. Looking ahead, risks to financial stability in Malta remained contained with a positive outlook.

In 2017 there was a broad-based acceleration in growth across major economic blocks. Nonetheless the potential risk of repricing and debt sustainability challenges, amid concerns surrounding Brexit, remained key challenges for the EU financial system.

Global economic conditions remained benign with gross domestic product (GDP) growing by 3.7% in 2017. This upswing was reported across advanced and emerging economies alike, with near-term prospects for the global economy strengthening further to grow by 3.9% in 2018 and 2019.¹ In the euro area, growth accelerated to 2.4% in 2017, fuelled by private consumption and a recovery in capital expenditure; but is anticipated to decelerate slightly to 2.3% in 2018 and 2.0% a year later.² As growth in the euro area economy became more solid while deflationary risks disappeared, the European Central Bank (ECB) announced the end of net purchases under the Asset Purchase Programme. Against this background, systemic risk across the euro area's financial sector remained low throughout 2017 (see Chart 1.1).

Despite a marked economic recovery in the euro area, the potential of an abrupt re-pricing of global risk premia remained a key vulnerability for financial stability. Risk premia were compressed on the back of an accommodative monetary policy and low volatility. If market perceptions were to change abruptly, corrections in assets prices could lead to potential debt sustainability risks for both the private and public sectors in some euro area countries. In Malta, fiscal sustainability concerns remained low reflecting the significant fiscal surplus and continued decline in outstanding public debt, translating into an improvement in Malta's sovereign credit rating.³ Furthermore, the Government's borrowing requirement declined at a time when yields were rising (see Chart 1.2).

The uncertainty stemming from the negotiations of the United Kingdom's withdrawal from the European Union and the potential risk of a 'hard Brexit' continued to weigh on the European Union, particularly with regards to risks for continuity of outstanding cross-border contracts which support institutions' funding and risk management; and also the provision of financial services. While financial institutions need to be prepared for all eventualities, the potential direct adverse implications of a 'hard Brexit' on the Maltese financial system are deemed to be contained given that

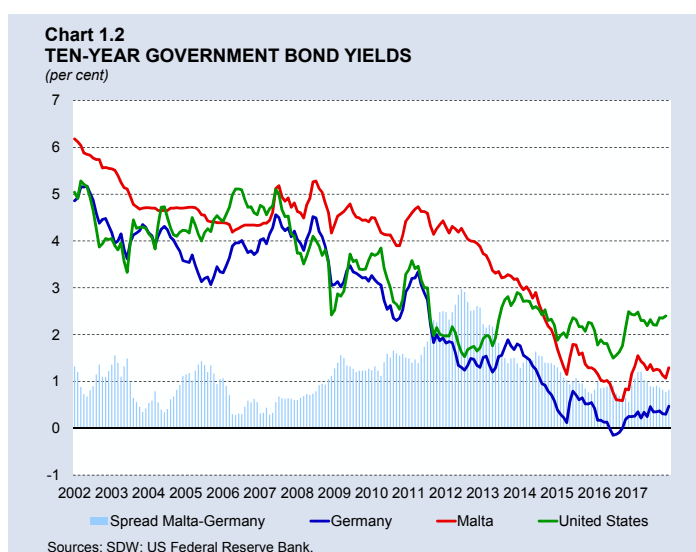


¹ Source: IMF World Economic Outlook Update, January 2018, IMF. <https://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-January-2018>.

² Source: European Economic Forecast, Winter 2018, European Commission. https://ec.europa.eu/info/sites/info/files/economy-finance/ip073_en.pdf.

³ Fitch Ratings upgraded Malta from A with a positive outlook in August 2017 to A+ with a stable outlook a year later, whereas S&P changed their outlook from stable to positive.

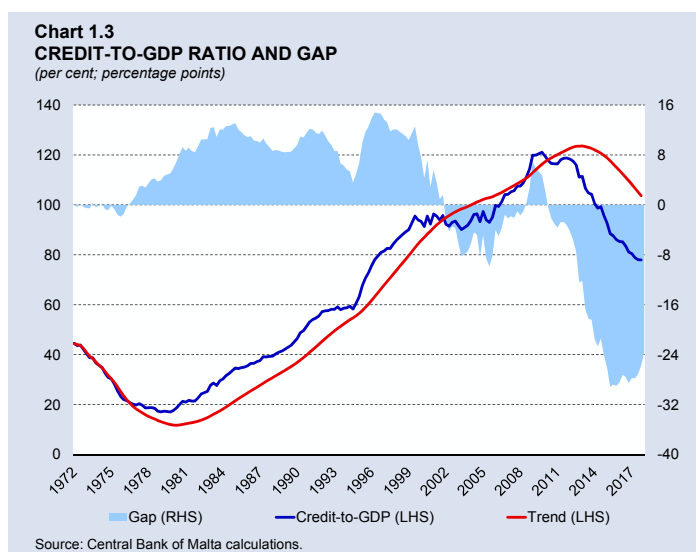
as a share of assets, exposures in Pound Sterling and towards the United Kingdom are limited. Furthermore, sensitivity analysis conducted by the Central Bank of Malta indicated that banks in Malta are able to withstand a significant deterioration in their UK securities portfolio, with capital ratios remaining above regulatory requirements. However, repercussions in terms of a disruptive 'hard Brexit' can also stem from contract continuity of outstanding derivative transactions and potential loss of market access. Such disruptions are bound to impact more the foreign-oriented companies, and hence any direct implications from the possibility of a Brexit cliff-edge scenario are not likely to have significant adverse effects on the soundness of the domestic financial system.



The euro area's financial sector is also facing structural challenges. Despite some recovery in bank profitability, this sector remained ripe for restructuring through the shedding of capital-intensive operations and simplifying businesses to compete more profitably and ensure long-term sustainability. This restructuring was also fuelled by efforts to reduce the stock of legacy non-performing loans (NPL) with the objective to free capital and foster higher credit creation. In Malta, banks actively addressed legacy NPLs and the amended Banking Rule 09/2016 which came into force in January 2017 is likely to drive further down their stock of outstanding NPLs.

Credit growth in Malta was sustained by mortgages, as lending to corporates contracted. However, access to finance is not deemed to be impaired as alternative funding sources are gaining momentum.

Favourable economic developments continued to preserve the resilience of the Maltese financial system. In 2017 the Maltese economy grew by 6.6% in real terms outpacing most of the other European countries. Economic growth was driven by higher net exports though private consumption also increased healthily, reflecting favourable labour market conditions. From a sectoral perspective, services remained the main driver of economic activity which, in part, explains the reason behind the muted credit growth. Such firms have lower working capital needs to conduct their business, resulting in lower demand for credit. Indeed economic growth was not primarily fuelled by bank lending, with the credit-to-GDP remaining in negative territory and the counter-cyclical capital buffer rate kept at 0% (see Chart 1.3).



Resident lending to non-financial corporations (NFC) by core domestic banks declined by 2.1% in 2017 partly indicating that corporates are increasingly moving to alternative funding sources. While banks may have engaged in some credit rationing, debt issuance has more than compensated for this fall, with resident lending by core domestic banks and corporate bond issuance together rose by 2.8%. At the same time, NFCs have increasingly tapped internal funds or increased their lending from intra-group companies and foreign entities, with total NFC debt growing by 5.4% (refer to Box 2). However, when expressed as a share of GDP, total NFC indebtedness declined to 133.6% of GDP, marginally above the euro area average of 131.7%. On a consolidated basis, NFC debt amounted to 69.7% of GDP compared with 80.3% in the euro area. During the year NFCs seemed to have deleveraged somewhat their position given that total assets grew by 8.1%, at a faster pace than total debt. At firm level, the higher level of indebtedness makes NFCs more susceptible to higher funding costs with repercussions on their profitability. The prevailing favourable economic conditions coupled with low interest rate environment should be conducive for NFCs to strengthen further their financial performance and growth prospects, buttressing against downturns in the business cycle.

The quality of the loan portfolio of the core domestic banks improved further, resulting in a lower level of NPLs. Apart from prudent lending practices, such decline also mirrored enhanced creditworthiness and debt repayment capabilities of borrowers.

A considerable amount of write-offs were reported in 2016 by a number of core domestic banks. In 2017 further loans were written off, albeit to a lesser extent. As a result, the fall in NPLs has decelerated somewhat in 2017, down by around 12% compared with 18.5% a year earlier. During the year, the NPL ratio of the core domestic banks declined further to 4.1%, signalling improved creditworthiness consistent with robust economic developments. Nonetheless legacy NPLs continued to account for a large share of outstanding NPLs.⁴ The revised Banking Rule 09/2016 implemented in 2017 will continue to provide further incentives for an orderly reduction of NPLs and also penalises future accumulation of NPLs.

A large share of NPLs, mainly related to the construction and real estate sector, relate to the period when the economy slowed down following the outbreak of the financial crisis. During this period, core domestic banks tightened their credit standards towards the construction and real estate sector and strategically reduced their exposures to this sector. Lending standards were kept tight even as the property market was recovering. Banks hence reduced the concentration of loans towards the construction sector and instead shifted to mortgages, spreading the risk over a large number of borrowers with repayment capabilities dependent on labour market conditions. At the current juncture, the exposure of core domestic banks to immovable property does not raise any concerns; supported by the results of the stress tests carried out by Central Bank of Malta on adverse shocks to real estate prices and their impact on banks' capital (see Chapter 3). This view is also reinforced by the banks' prudent lending practices and healthy capital buffers.

The NPL ratios of the non-core and international banks also declined, signalling a healthy loan portfolio held by these banks.

Growth in property prices decelerated in 2017 while vulnerabilities from the real estate market attenuated.

The positive consumer sentiment coupled with current low interest rates have fed into higher real estate prices, although their rate of growth has decelerated. Transacted property prices slowed down, growing by 4.9% in 2017 Q4, significantly below GDP growth in Malta.⁵ A number of country-specific factors supported demand for property including the continued strong inflow of foreign workers and the various measures adopted by Government to aid first-time buyers or those upgrading their primary residence. According to the Central Bank of Malta's projections residential property prices are expected to remain in line with fundamentals. In contrast, some overpricing is perceived by the real estate agents, as captured by the Real

⁴ Legacy NPLs are those loans which have been classified as non-performing for over a year.

⁵ Source: Eurostat [News Release 114/2018](#) of 10 July 2018.

Estate Market Survey which is conducted by the Central Bank of Malta twice yearly. However, results for the second half of 2017 revealed that a lower proportion of respondents perceived residential property to be overpriced, hovering at around 55% of respondents, down from 80% in the first half of 2017.⁶ On a longer-term perspective, pressures on property prices are expected to attenuate as supply is expanding with more units being made available in the market. In spite of buoyant economic conditions and positive consumer sentiment, banks remained cautious in their lending practices with an average loan-to-value ratio of around 73% and a debt service-to-income ratio of about 23% at loan origination.

Despite the sustained growth in property prices, affordability (measured by the median property price-to-income-ratio) is still below its long-term average. Although the strong growth in mortgage lending has pushed up household debt, as a share of GDP household debt dropped by 1.4 percentage points to about 50%, below the euro area average. While mortgages are granted at variable rates, creditworthiness of households remained strong supported by their robust financial wealth which exceeded three times the size of their debt. Households' financial wealth is predominantly in cash or quasi-cash assets and buttressed by positive labour market developments. Furthermore, while household indebtedness is skewed towards young age cohorts, which are the lowest income-earners; their rising income prospects (compared to older age groups) mitigate the skewed debt distribution.

The performance of the core domestic banks remained healthy. However the prolonged low interest rate environment, slow credit growth and changes in regulatory requirements are exerting pressure on their returns.

The deceleration in resident credit growth reported over the past years was broad-based and a prime factor which led to lower interest income, hampering banks' profits. Net interest income was challenged by other factors including further accumulation of liquidity and the rolling over of maturing paper into lower-yielding financial instruments. Despite such challenges, banks' profitability remained superior to their euro area peers, supported by the local banks' ability to maintain stable interest margins. In 2017 interest income rose while interest expense fell, with net interest income remaining the main income source for the core domestic banks. Pressures on profitability are anticipated to persist also due to increasing regulatory costs. Banks may thus be compelled to seek alternative income-generating activities to sustain their healthy profitability levels. While no major changes were reported in the business model of the banks, emphasis to date was mainly on streamlining operations so as to focus on profitable areas and at the same time de-risking their operations. Cost containment may seem another avenue to improve profits, though cost efficiency in Malta is superior to that of other banks in the euro area, despite the possible diseconomies of scale given the relatively smaller banks operating in Malta.

Systemic implications arising from non-core domestic and international banks remained low. The same can be said for the domestically-oriented insurance companies and investment funds, which remained prudent in their investment strategies in spite of a challenging interest rate environment.

Non-core and international banks' links with the domestic economy remained contained with limited potential systemic implications. Their business model is largely diversified ranging from transacting in wholesale markets to niche services offered to retail customers; reflecting their diverse asset compositions and funding sources. All banks within these two categories held capital buffers well-above regulatory requirements and operated on the back of ample liquidity levels, mitigating potential idiosyncratic risks.

Similarly, risks from the domestic insurance companies and investment funds remained low. Unlike trends observed in the euro area where investment funds are shifting their funds towards lower-rated securities, domestic investment funds remained prudent in their investment portfolio, with Malta Government Stocks (MGS) making up a large proportion of domestic investment funds' assets.

⁶ Results of the Real Estate Market Survey are weighted according to the number of employees of each estate agent which participates in the exercise.

In spite of a challenging year for the insurance sector, following the introduction of the Solvency II risk-based framework, the domestic insurance companies continued to operate with a strong capital base without the need to change their investment strategies. Furthermore, these insurance companies reported considerable improvement in their profitability levels reflecting better underwriting business which is generally corroborated with improved economic conditions.

Table 1.1 summarises the main risks for financial system in Malta, distinguishing between those risks endogenous to the system and those which stem from the surrounding environment.

Vulnerabilities to financial stability have remained largely the same as in 2016, although the level of risk has attenuated somewhat in 2017, supported by the favourable economic environment. While no new systemic risks have emerged, the financial system in Malta is anticipated to remain resilient. Looking ahead the major challenges remain the slow credit demand which have negatively impacted the profitability of the core domestic banks, and on the external pressures arising from the international environment. Despite the pick-up in the euro area economic growth this remains overshadowed by uncertainties surrounding geopolitical developments. Brexit negotiations have come a long way since the triggering of Article 50 in March 2017; however implications on the European Union and Malta are still unclear.

Table 1.1 SUMMARY OF RISKS				
Main vulnerabilities and risks for the financial system	Type of risk	Nature of risk	Change in risk level since FSR 2016	Risk outlook for 2018
Vulnerabilities within the financial system				
The level of non-performing loans	Credit	Cyclical/ Structural	↓	↔
Concentration in bank lending	Credit	Structural	↔	↔
Subdued credit developments	Profitability	Structural	↔	↔
Interlinkages between banks and the non-bank financial sector	Contagion	Structural	↔	↔
Vulnerabilities outside the financial system				
Domestic macroeconomic developments	Credit, Profitability	Cyclical	↓	↔
Performance of key economic sectors reliant on bank credit	Credit	Cyclical/ Structural	↓	↔
Real estate market developments	Credit/Contagion	Cyclical	↔	↔
Exposures of the financial sector to domestic sovereign securities	Profitability	Structural	↓	↔
Economic conditions in the euro area and public debt sustainability	Credit, Profitability	Cyclical	↓	↔
Geopolitical uncertainties	Contagion	Structural	↑	↔
Prolonged low interest rate environment	Profitability	Cyclical	↔	↔
Risk position		Direction of risk		
Moderate		Increased risk	↑	
Medium		Stable risk	↔	
Elevated		Decreased risk	↓	

Despite such favourable economic conditions which is likely to persist in the coming years, banks need to remain vigilant in their business strategies and continue strengthening their capital buffers. The latter is imperative to meet the prospective regulatory frameworks which will come into force in 2018 and 2019, including the implementation of IFRS 9. As pressures on profitability are expected to endure, banks are encouraged to continue exploring alternative business sources without compromising their risk profile.

The policy response

Countercyclical Capital Buffer

Credit developments remained contained. In the absence of cyclical risks, the domestic countercyclical capital buffer (CCyB) rate was set at 0%. The relevant credit-to-GDP ratio stood at 78.1% in December 2017 and its deviation from the long-term trend was -25.6 percentage points. The assessment on the developments in other supplementary indicators does not indicate any signs of excessive credit growth.

Identification of material third countries

Recommendation ESRB/2015/1 on recognising and setting CCyB rates for exposures to third countries, recommends national authorities to identify, annually, third countries to which their domestic banking sector is materially exposed to and subsequently monitor the risks to financial stability emanating from excessive credit growth in those countries.

In accordance with Article 4 of the ESRB's Decision 2015/3,⁷ the Central Bank of Malta identified material exposures towards the United Arab Emirates, the Russian Federation, the Republic of Turkey and the United States of America. The monitoring for excessive credit growth risks from such countries and the setting of equivalent CCyB rates falls under the auspices of the ESRB and the Central Bank of Malta.

Capital buffer for Other Systemically Important Institutions

The Central Bank of Malta and MFSA's Statement of Decision has reconfirmed the list of Other Systemically Important Institutions (O-SII) to include MeDirect Group Ltd, HSBC Group Malta and Bank of Valletta Group.⁸ On the basis of the domestic O-SII identification methodology, no changes in the capital buffer rates were registered for 2017 compared to the results of the previous year.⁹ These credit institutions shall continue to build-up their O-SII capital buffers until 1 January 2019, as established in the 2015 Policy Document.¹⁰

Macroprudential policy reciprocity

ESRB/2016/3 Recommendation of the ESRB of 24 March 2016 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures¹¹

The binding stricter national macroprudential measure introduced by the National Bank of Belgium (NBB) in line with Article 458 of the CRR, expired on 28 May 2017. This measure, introduced in 2014, required internal ratings based (IRB) banks to maintain a 5 percentage point risk weight add-on on mortgages having collateral situated in Belgium. The NBB subsequently issued a non-binding recommendation for IRB banks to maintain the additional risk-weight add-on on a voluntary basis. However, NBB proposed an alternative measure to mitigate risks emanating from the Belgian residential real estate sector. The new measure entered into force in April 2018 and adds to the 5 percentage point risk-weight add-on by also requiring banks to further apply a 33% risk weight add-on over and above the risk weight applied on their mortgage portfolio. The ESRB is proposing amending Recommendation 2018/1 in order to recommend

⁷ ESRB/2015/3: Decision of the ESRB of 11 December 2015 on the assessment of materiality of third countries for the Union's banking system in relation to the recognition and setting of countercyclical buffer rates.

⁸ Central Bank of Malta and MFSA (Jan 18): "Statement of Decision on the methodology for the identification of other systemically important institutions and the related capital buffer calibration".

⁹ MeDirect Group Ltd. is to maintain an O-SII Capital Buffer of 0.5%, HSBC Group Malta 1.5%, and Bank of Valletta Group 2.0%: Source: <https://www.centralbankmalta.org/systemically-important-institutions>.

¹⁰ Central Bank of Malta (2015): Policy Document on the methodology for the identification of other systemically important institutions and the related capital buffer calibration.

¹¹ ESRB Recommendation (March 2016). Source: https://www.esrb.europa.eu/pub/pdf/recommendations/2016/ESRB_2016_3.en.pdf.

other Member States to recognise this measure when exposures exceed EUR 2 billion. Once the measure is recommended for reciprocation, the Central Bank of Malta would assess the domestic reciprocation of this measure.

ESRB/2016/4 Recommendation of the ESRB of 24 June 2016 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures¹²

As per ESRB/2016/4, the ESRB recommends Member States to reciprocate the measure proposed by Eesti Pank, the Estonian Macroprudential Authority, and requires credit institutions to hold a systemic risk buffer (SRB) of Common Equity Tier 1 capital of 1% on total risk exposures located in Estonia when exposures exceed EUR 200 million. Notwithstanding the current immaterial exposures towards Estonia, the Central Bank of Malta has reciprocated the Estonian measure as a matter of principle since 2016, as provided for in Recommendation ESRB/2015/2.¹³

IFRS 9

IFRS 9 became applicable on 1 January 2018 in accordance with EU regulation 2016/2067.¹⁴ The most significant innovation introduced by IFRS 9 is the change from an incurred credit loss approach to an expected credit loss (ECL) approach. The use of IFRS 9 may potentially lead to a sudden increase in ECL provisions and thereby a fall in the level of regulatory capital ratios. The review package of the current legislation on banks' capital requirements (CRD IV/CRR) included transitional arrangements over a five-year period, aimed at preventing unwarranted impact of the introduction of IFRS 9 on banks' regulatory capital. Institutions referred to under Article 473a of the CRR may either phase-in the implementation of IFRS 9 on analogous ECLs on capital and leverage ratios or they can recognise the full impact of IFRS 9 and analogous ECLs on capital and leverage ratios from 1 January 2018 or before the end of the transitional period (i.e. 2022).

The European Parliament adopted these provisions in the CRR in plenary on 30 November 2017. The Council adopted the Act on 8 December and the final Act was signed on 12 December 2017. The adoption of these transitional arrangements is at the discretion of institutions on condition that the domestic competent authority is duly notified. During the five-year phase-in period banks will be allowed to add a portion of the additional ECL provisions back to regulatory capital (CET1). The adjustments refer to provisions arising at the point of transition and the added amount will progressively decrease to zero during the course of the transitional period. The add-back to CET1 capital is 95% (2018), 85% (2019), 70% (2020), 50% (2021) and 25% (2022). Domestically, thirteen institutions opted for the transitional approach of IFRS 9.

Creditor hierarchy – Amendments to Article 108 of the BRRD

In 2017 the EU adopted Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy ('the Directive'). The Directive harmonises the creditor hierarchy in insolvency with a view to facilitate the resolution of EU credit institutions by introducing a new class of unsecured senior debt, which ranks below, and therefore subordinated to the current class of unsecured claims. This new class of non-preferred senior debt will rank in insolvency above own funds instruments and subordinated liabilities that do not qualify as own funds instruments, but below other senior liabilities. It is therefore free from any no-creditor-worse-off risks and can be used for the purposes of meeting the subordination requirement.

Liabilities issued under this new class must have the following features; (i) original contractual maturity of at least one year, (ii) contains no embedded derivatives and are not derivatives themselves, and (iii) the

¹² ESRB Recommendation (June 2016). Source: https://www.esrb.europa.eu/pub/pdf/recommendations/2016/ESRB_2016_4.en.pdf.

¹³ Central Bank of Malta (2016): Statement of Decision on the reciprocity of the Systemic Risk Buffer of Estonia.

¹⁴ Commission Regulation (EU) 2016/2067 of 22 November 2016 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 9 (Text with EEA relevance) <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32016R2067&from=EN>.

relevant contractual documentation and, where applicable, the prospectus related to the issuance explicitly refer to the lower ranking mentioned above.

To reduce to a minimum the costs of compliance with the subordination requirement and any negative impact on funding costs, Directive (EU) 2017/2399 allows Member States to keep, where applicable, the existing class of ordinary unsecured senior debt, which is less costly for institutions to issue than any other subordinated liabilities. The MFSA is expected to publish a consultation paper as part of the process in transposing the above-mentioned directive.

SRB's MREL Policy

In December 2017, the Systemic Risk Board (SRB) published its second policy statement on MREL in order to set binding targets for banks under its remit. The 2017 MREL policy will bring about changes to the 2016 policy related to the broadening of the policy to include a number of bank-specific adjustments to the calculation of the Recapitalisation Amount (RCA), clarify its position in relation to the requirements for eligible liabilities and introduce a minimum level of subordination for O-SIIs. Furthermore, banks are expected to build their MREL in a proportionate way, within a maximum time period of four years. With regards to the MREL computation, it will remain calibrated for bail-in strategies, until the transfer strategy policies are further elaborated. In fact, for 2018, the development of a policy for transfer strategies is one of the main targets for the SRB together with the enhancement of the MREL targets based on the outcome of the SRB's resolvability assessment and developing a framework for individual and internal MREL.

BOX 1: EU POLICY INITIATIVES TO ADDRESS NON-PERFORMING LOANS

High levels of NPLs are a recurrent feature of financial crises. High NPLs have an adverse impact on a country's economic growth prospects as banks' capacity for allocating credit, particularly to SMEs is hindered. Although the average NPL ratio in the European Union has dropped by more than a third since 2014, the aggregate stock of NPLs remains elevated. Progress in NPL reduction has remained slow in certain EU jurisdictions due to a number of factors. Asymmetric information in the NPL market, structural inefficiencies in debt and collateral enforcement, all contribute to the slow resolution of NPLs.^{1,2} Elevated stocks of NPLs need to be addressed by means of a comprehensive policy response at both the national and EU level. As per EU Council Action Plan, National and European authorities joined forces to address this issue and accordingly embarked on a number of initiatives.³ Domestically, in 2016 the Central Bank of Malta and the MFSA had implemented further measures to incentivise credit institutions to resolve their NPLs and maintain a maximum NPL ratio of 6.0% or lower.⁴ Banks subject to the reduction plan are managing to reduce their NPL ratios below this threshold. The NPL ratio of domestic banks has been following a downward trend since 2014 Q2 and reached a level which is in line with the EU/euro area average. This Box aims at providing an overview of EU initiatives dealing with NPLs.

On 11 July 2017, the EU Council established a comprehensive European strategy to address high levels of NPLs in Europe by implementing a mix of policy actions (see Chart 1). The Council identified four main policy areas: (i) banking supervision (ii) insolvency and debt recovery laws (iii) secondary markets for distressed assets, and (iv) restructuring of the banking system. A number of actions have already been taken with respect to these four areas.

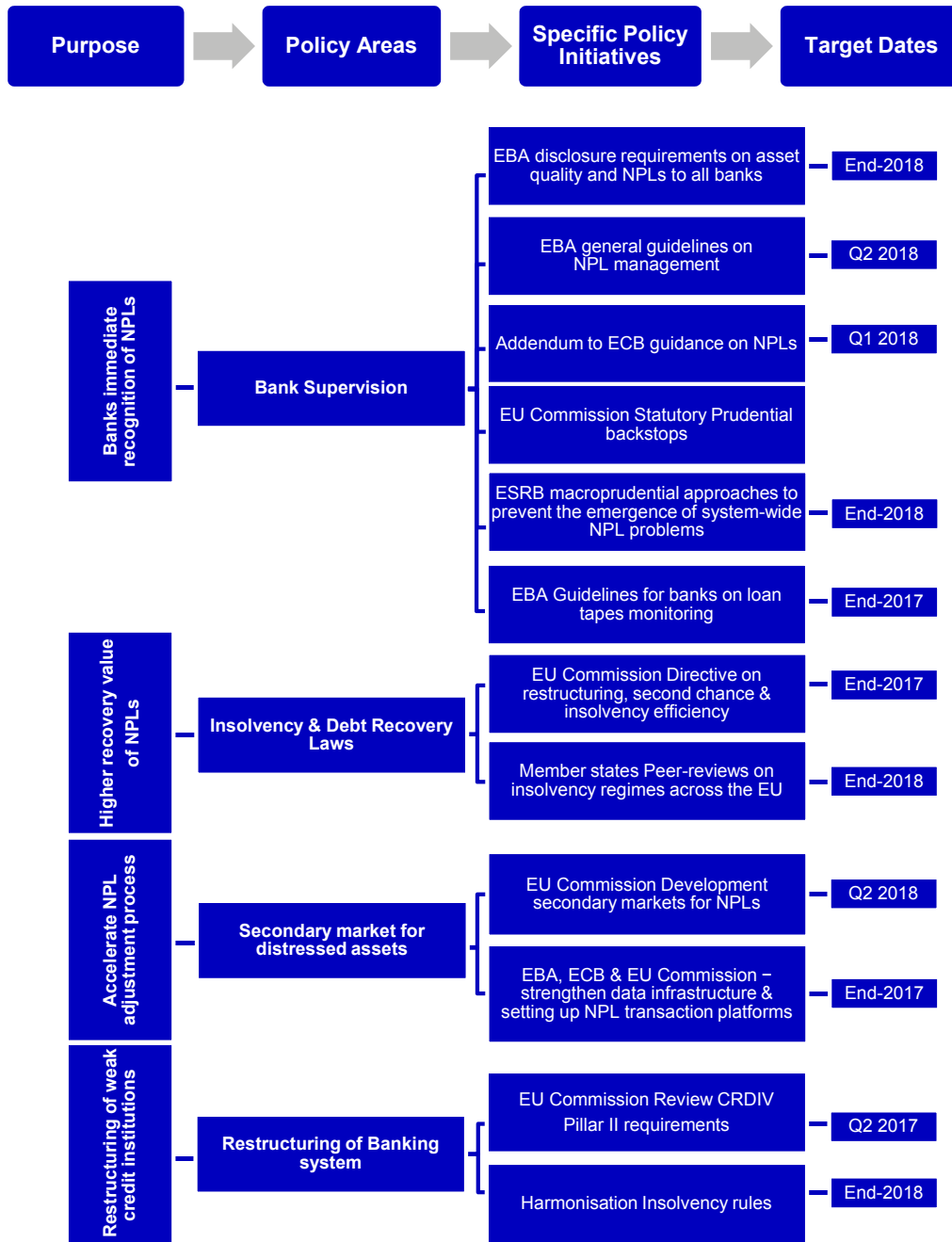
¹ European Commission Banking Union: 'First Progress Report on the tackling of non-performing loans to support the risk-reduction agenda'.

² The problem of asymmetric information in the NPL context could arise as buyers would know less about asset quality than the sellers. For example buyers may feel that they are bidding for low-quality assets leading them to bid a low price compelling the sellers to trade in the low-quality assets only.

³ Council conclusions on Action plan to tackle NPLs in Europe, 11 July 2017.

⁴ Banking rules – 'Measures addressing credit risks arising from the assessment of the quality of asset portfolios of credit institutions authorised under the Banking Act 1994'.

Chart 1
OVERVIEW OF EU POLICY INITIATIVES TO ADDRESS NPLs



Source: Central Bank of Malta.

On 20 March 2017, the ECB published its non-binding guidance to banks on NPLs (NPL Guidance) with respect to banking supervision.⁵ The NPL Guidance clarifies supervisory expectations regarding the identification, management, measurement and write-off of NPLs in the context of existing regulations, directives and guidelines. The NPL Guidance sets out the minimum capital provisioning required for prudential purpose for exposures that are newly-classified as NPLs as of 1 April 2018. Accordingly, the ECB expects banks to provide full coverage after two years at the latest for the unsecured portion of the new NPLs and after seven years at the latest for the secured portion of new NPLs with a linear path starting from year three onwards. Furthermore, the ESRB will be developing macroprudential approaches to mitigate the emergence of system-wide NPL problems. In addition, the EBA in consultation with European Securities and Markets Authority, and competent authorities are committed to implement, by the end of 2018, enhanced disclosure requirements on asset quality and NPLs to all banks. The disclosure templates proposed are aimed at enabling potential bidders to perform a detailed analysis of the assets, widen the investor base, lower entry barriers to potential investors, support price discovery, improve data and availability, thereby facilitating the development of a secondary market for NPLs. Moreover, the EBA is developing guidelines on management of NPLs and forbore exposures that provide supervisory guidance and set rules to be applied by credit institutions.

With regards to insolvency and debt recovery laws, EU Governments are to review their insolvency laws to soften the burden of resolution of NPLs. In Malta, work is underway to address this issue and amendments have been implemented in the Companies Act to expedite out of court settlements.⁶ The European Commission published a consultation document on the development of a secondary market for NPLs and distressed assets and for the protection of secured creditors from borrowers' default. The purpose of the public consultation is to enable the Commission to evaluate the practical problems and legal restrictions that might currently hamper the development of secondary markets for NPLs and loan contracts. Furthermore, the consultation document discusses the potential introduction of a new "accelerated loan security" instrument.⁷ This instrument may lead to faster out-of-court settlement. In this respect, a Directive was proposed by the Commission in March 2018.⁸

Further work is required to complete the EU Council conclusions on the restructuring of the banking system. EU legislators have to focus on specific issues to implement the appropriate framework, including the review of the CRD IV Pillar II requirements which comprise capital deductions, the implementation of a secondary market for distressed assets and harmonisation of insolvency rules. In this regard, the Commission is proposing to put in place a detailed mapping of national enforcement and insolvency systems to provide an overview of the range of procedures available to banks to recover the value from defaulting loans.

On 2 November 2016, the Commission introduced a proposal for a Directive on restructuring, second chance and insolvency efficiency, with the aim of reducing the number of unnecessary liquidations of viable companies whilst also protecting the legitimate interests of creditors.⁹ According to the Commission, this approach would boost entrepreneurial activity in Europe and improve the effectiveness

⁵ ECB (March 2017): "Guidance to banks on non-performing loans".

⁶ Chapter 386 Companies Act.

⁷ An accelerated loan security instrument gives the lender the right to demand the entire loan amount (principal plus interest) to be paid at once, in case the borrower fails to make payments or gets into serious financial difficulties thereby not meeting the repayment obligations set in the loan agreement.

⁸ Proposal for a Directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral.

⁹ Proposal for a directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive' - 2012/30/EU <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52016PC0723&from=EN>.

of all restructuring, insolvency and second chance procedures by reducing both the associated costs and the timeframes to settle such procedures.

Furthermore, on 10 November 2017, the European Commission published a consultation document on the statutory prudential backstops addressing insufficient provisioning for NPLs.¹⁰ In this consultation document, the Commission put forward possible minimum coverage levels for unsecured and secured parts of NPLs. The consultation document propose a backstop linear approach for unsecured exposures with a minimum coverage of 50% after year 1 and 100% of coverage after year 2, whereas the proposed progressive approach provides a minimum coverage of 35% after year 1 and 100% after year 2 (see Table 1).

On 14 March 2018 the EU Commission issued a proposal for a regulation pertaining to the minimum loss coverage for non-performing exposures. In this regulation, the Commission proposes a progressive scalar calibration for unsecured exposures, to facilitate better early recoveries of loans.¹¹ The proposed prudential backstop would apply only to exposures originated after 14 March 2018. In this regard, the EBA undertook an impact assessment on a projected horizon of 20 years.¹² The EBA's estimates indicate that the option with a linear coverage path would lead to an average reduction in EU banks' CET1 capital ratio of between 231 to 239 bps on a cumulative basis over 20 years. In contrast, applying a progressive coverage path would slightly lower the average impact, leading to an average reduction in EU banks' CET1 capital ratio of between 217 to 227 bps for the same time period. Furthermore, the regulation puts forward a distinction between non-performing exposures (NPE) where the obligor is past due more than 90 days and NPEs of 'unlikely to pay' obligors. In cases where the obligor is past due more than 90 days, a full coverage level would be necessary. NPEs of 'unlikely to pay' obligors would be required to cover up to 80% of the exposure value after two years for unsecured NPEs and after eight years for secured exposures.

Table 1
MINIMUM COVERAGE LEVELS FOR UNSECURED AND SECURED PARTS OF NPLs

Vintage	Unsecured (parts of) NPLs			Secured (parts of) NPLs		
	No scalar	Progressive	Linear	No scalar	Progressive	Linear
Min. coverage after 1y	0%	35%	50%	0%	5%	12.50%
Min. coverage after 2y	100%	100%	100%	0%	10%	25%
Min. coverage after 3y				0%	17.50%	37.50%
Min. coverage after 4y				0%	27.50%	50%
Min. coverage after 5y				0%	40%	62.50%
Min. coverage after 6y				0%	55%	75%
Min. coverage after 7y				0%/35%/50%	75%	87.50%
Min. coverage after 8y				100%	100%	100%

Source: European Commission consultation document.

¹⁰ 'Consultation document statutory prudential backstops addressing insufficient provisioning for newly originated loans that turn non-performing' – https://ec.europa.eu/info/sites/info/files/2017-non-performing-loans-backstops-consultation-document_en.pdf

¹¹ 'Proposal for a regulation of the European Parliament and of the council on amending Regulation No 575/2013 as regards minimum loss coverage for non-performing exposures' – https://ec.europa.eu/info/law/better-regulation/initiatives/com-2018-134_en

¹² The sample assessed by the EBA consisted of 129 EU banks, 98 from the euro area and 31 from non-euro area member states.

2. DEVELOPMENTS IN THE BANKING SECTOR

2.1 Core domestic banks

In 2017 the balance sheet of the six core domestic banks expanded by 5.4%. As nominal gross domestic product (GDP) grew at a faster pace, their assets as a proportion to nominal output shrank to 206.6%. The ratio for the banks in the euro area stood at 241.6% of GDP (see Chart 2.1).¹

As observed in the past two years, these banks are characterised by excess liquidity which was in turn placed overnight with the Central Bank of Malta. These placements grew by almost 50% in 2017 (see Chart 2.2). Customer lending also contributed significantly to their balance sheet growth. However, this was largely driven by one bank which transferred its non-resident loan portfolio from its foreign subsidiary. Lending to residents, largely mortgages also increased. Interbank claims remained relatively unchanged while securities holdings declined. The growth in the balance sheet was generally funded through higher resident customer deposits and interbank funding, with the latter mainly reflecting the operations of one bank within its own group.

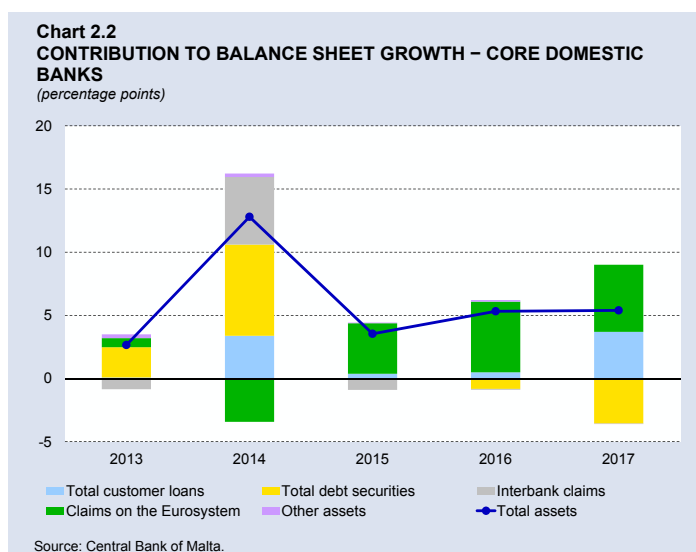
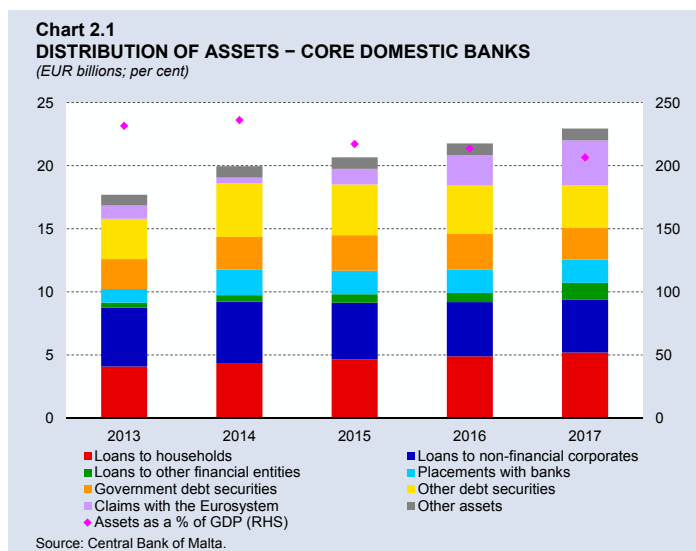
The banks continued to focus on domestic business with about two-thirds of total assets composed of domestic assets. Debt securities accounted for more than half of foreign assets, while placements with foreign banks represented approximately 25%, with the bulk relating to intra-group placements. The rest is mainly composed of non-resident customer loans.

The majority of assets are denominated in euro, while assets denominated in foreign currencies represented 11.4% of the banks' total assets, predominantly in US dollar and Pound Sterling.

2.1.1 Profitability

In 2017 core domestic banks posted lower profits, pushing down the after-tax return on equity (ROE) and return on assets (ROA) to 9.3% and 0.68%, respectively, from 10.2% and 0.74% a year earlier. Yet, they

¹ Source: ECB Statistical Data Warehouse (SDW).



continued to outperform their peers in the euro area which reported a post-tax ROE and ROA of 4.6% and 0.5%, respectively (see Chart 2.3).²

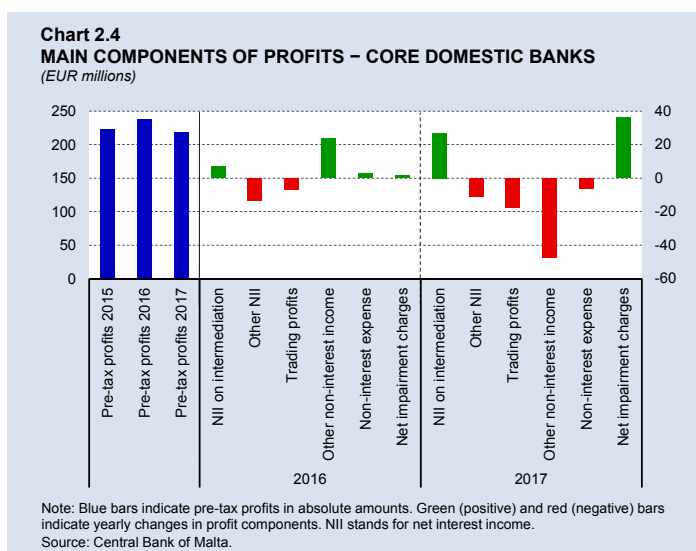
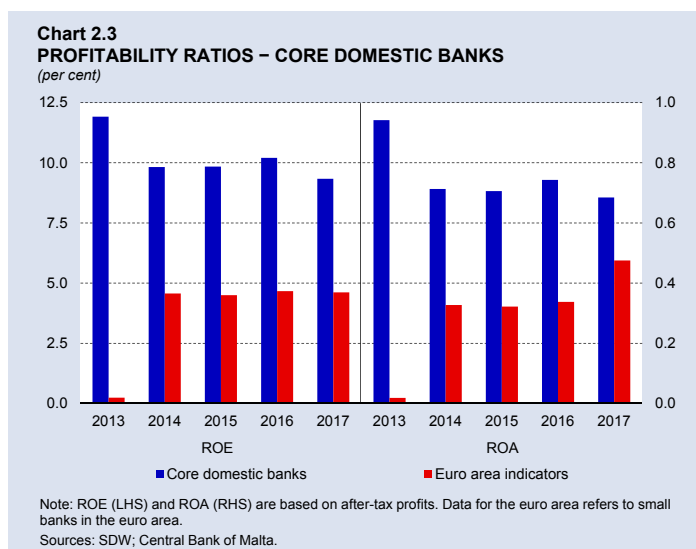
Pre-tax profits declined by 8.1% to €218.3 million owing to a number of one-off events that occurred in the last two years. These include the sale of the Visa Inc. business line in 2016 together with the increased provisioning for brokerage remediation and collective agreement benefits by one bank in 2016 and to a lesser extent in 2017. Adjusting for these one-off events, pre-tax profits would have risen by 9.2% to €224.1 million indicating that income from the banks' main business lines improved in 2017.

Net interest income (NII) increased by 4.4% with its share in gross income exceeding 70%. This mirrored the extensive engagement in financial intermediation activities, with income from this activity rising by 8.8% to about 62% of the banks' gross income (see Chart 2.4). Such improvement occurred as the average interest rate on deposits fell at a faster pace than that on loans, resulting in a marginal widening of the margin. Meanwhile, NII related to non-intermediation activities contracted by 18.8% as net income from debt securities decreased, partly reflecting lower bond holdings and interest paid on debt securities issued.

Non-interest income dropped by €65.0 million owing to lower trading and non-trading profits and also reduced dividend income. Such decline also reflected a base effect due to the one-off gains reported in 2016. Adjusting for these one-off events, the fall in non-interest income would have been contained at €22.8 million.

Non-interest expenses such as higher operating expenses, staff wages and amortisation costs increased by 2.1% denting somewhat the banks' profitability.³ On the other hand, lower net impairment charges contributed positively to their profitability. These dropped by €36.2 million mainly from lower bad debts written-off and higher write-backs of specific provisions, which were partly offset by higher collective provision charges.

The operational cost-to-income ratio deteriorated by 6.6 percentage points to 57.0% in 2017, as total operating expenses rose while gross income fell. After accounting for the exceptional events in 2016 and 2017,



² Source: ECB Statistical Data Warehouse. These ratios refer to the average of domestic euro area small banks.

³ Adjusting for the one-off expenses incurred in 2016 and 2017, non-interest expenses would have increased by a larger extent.

the cost-to-income ratio of the core domestic banks would decline marginally to 55.6%. Comparatively, core domestic banks remained more efficient than other small banks in the euro area with an average cost-to-income ratio of about 69%.⁴

2.1.2 Asset quality

The loan portfolio

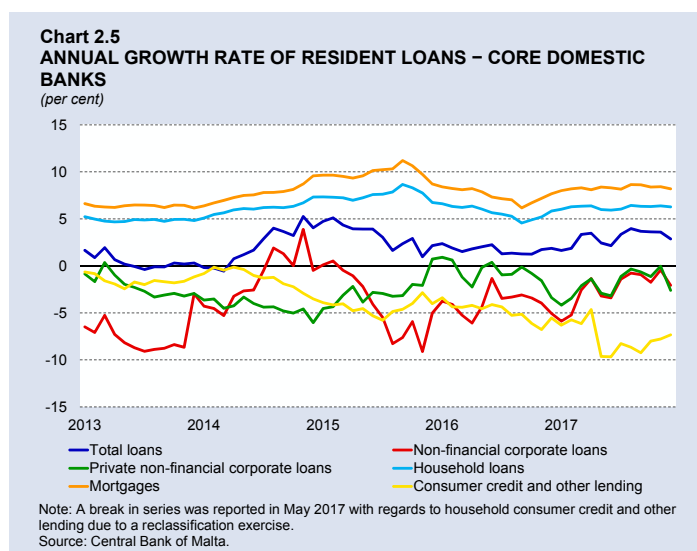
The loan portfolio remained the largest asset component of the core domestic banks, accounting for 46.8% of their balance sheet; around one percentage point higher than a year earlier. Lending remained primarily channelled towards residents, though lending to non-residents also increased driven primarily by developments in one bank.

In 2017, resident credit growth accelerated by 2.9%, entirely driven by loans for house purchases (see Chart 2.5). Mortgage lending grew by 8.2%, at a slightly faster pace than in the previous year (see Box 4). Higher mortgage demand continued to be spurred by a number of factors including job-rich economic growth coupled with higher disposable income, in part reflecting increased female participation in the labour market. The persistent growth in mortgages over the years has resulted in a larger proportion of mortgages in total loans. However the severity of concentration risk has declined, as loans are being spread among a wider borrower base with repayment capability reflective of general economic conditions. Furthermore, internal lending policies of the core domestic banks at loan origination stage remained conservative, with an average loan-to-value (LTV) ratio of 73.5% for residential properties. The debt-service-to-income (DSTI) ratio hovered around 23% while the loan-to-income (LTI) ratio stood at about 430%, with an average maturity term of 28 years.⁵ Such policies were relatively tighter for non-first time buyers compared with first-time buyers, although the latter reflect the younger cohort age and their increasing earnings prospects.

Similarly as the rental market flourished in Malta on the back of the influx of foreign workers and the low-interest rate environment, banks remained cautious in the buy-to-let business by adopting more conservative lending policies compared to the residential segment for own-use. The average LTV and LTI ratios stood at almost 67% and 224%, respectively, whereas the DSTI ratio hovered at around 38% with an average repayment term for the loan of 19 years.

Resident consumer credit and other household lending contracted by 7.3%, suggesting that households are relying more on their savings or on alternative funding sources, such as hire purchase. The decline in consumer credit and other household lending was overshadowed by mortgage growth, resulting in an overall household lending growth of 6.3%.

Lending to resident non-financial corporations (NFC) went down by 2.1% in 2017. The energy sector; accommodation and food service activities; and to a lesser extent the professional, scientific and technical activities; and transportation and storage sectors, all contributed



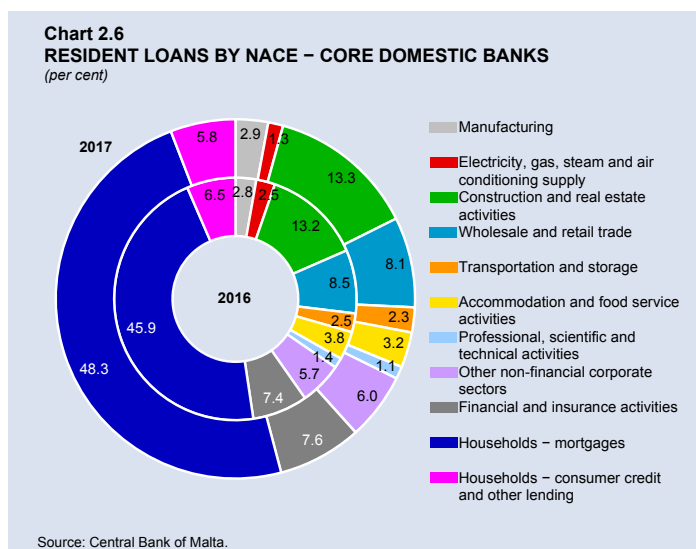
⁴ Source: ECB Statistical Data Warehouse.

⁵ Data are based on a quarterly survey by the Central Bank of Malta on a sample of new loans for house purchase.

to the contraction (see Chart 2.6). Meanwhile, loans to construction and real estate sector continued to expand slightly in response to better housing market prospects. Credit to manufacturing also increased, though to a much lesser extent.⁶

The contraction in NFC lending resulted from loans channelled towards the private sector as otherwise lending towards public NFCs recovered. The former dropped by 2.6% in 2017 despite a 0.2 percentage point decline in the weighted average lending rate for corporate loans to 4.0% in December 2017. Empirical evidence indicated that NFCs are increasingly relying on

other sources of financing, including loans from related companies, retained earnings, as well as debt issuance (see Box 2). The latter reflected the lower funding costs related to market financing and the opportunity to lock-in debt at a fixed rate and with longer maturity terms. In 2017 net bond issuance by NFCs on Malta Stock Exchange (MSE) increased by an additional 22% to €1.2 billion. Considering overall credit towards private NFCs and debt securities issued, total borrowing by NFCs grew by 2.9% (see Box 3).



BOX 2: NFC LOANS FROM OTHER CORPORATES – EVIDENCE FROM MALTA'S FINANCIAL ACCOUNTS STATISTICS

Introduction

A main pillar of the expansion in gross value added, apart from the financial institutions sector, remains the NFC sector.¹ Indeed, the assessment of the financing of NFCs has become a focus primarily because of the changing nature of its sources of finance.² Moreover, NFCs have strong linkages with other sectors in the economy, and account for the majority of private sector debt in Malta, which makes them systemically important.

The International Monetary Fund (IMF) has recently focused on the financing structure of NFCs in Malta, noting the current disintermediation taking place within the sector.³ Using financial accounts statistics for Malta, their analysis highlighted the increased reliance on non-bank sources of funding, mainly intercompany lending, shifting away from traditional sources of debt financing such as bank loans. The IMF refers to intercompany lending as “lending between domestic NFCs, including

¹ The NFC sector (S.11), as defined in the European System of Accounts 2010, consists of institutional units which are independent legal entities and market producers, and whose principal activity is the production of goods and non-financial services. The NFC sector also includes non-financial quasi-corporations.

² Zerafa, S. (2017), “Access to finance for firms in Malta: Estimating the impact of reduced credit”, Policy Note March 2017, Central Bank of Malta.

³ IMF, 2018. “Non-Bank sources of corporate financing in Malta”. Malta Selected issues, Article IV 2018.

⁶ In 2017 permits for dwellings increased by 30.9% to 9,826 units.

unrelated NFCs and intra-group lending.”⁴ It also rightly noted that at the time of carrying out the exercise, data sources did not allow the disentangling of intercompany lending and loans from unrelated NFCs. The shift towards non-bank financial sources of funding was also observed among euro area countries following the financial crisis.⁵

Intercompany lending can be subdivided into two different categories. The first category is intra-group lending, that is, lending from corporates within the same group of companies. The second category is lending from other corporates, that is, lending that does not originate from within the same group of companies but from other corporates. This box focuses on the statistical subdivision between these two lending categories following further statistical research and analysis. Data on the corporates’ group structure is used to differentiate between the two categories, and thus shed light on the quantification of lending within a group as against the other type of lending.

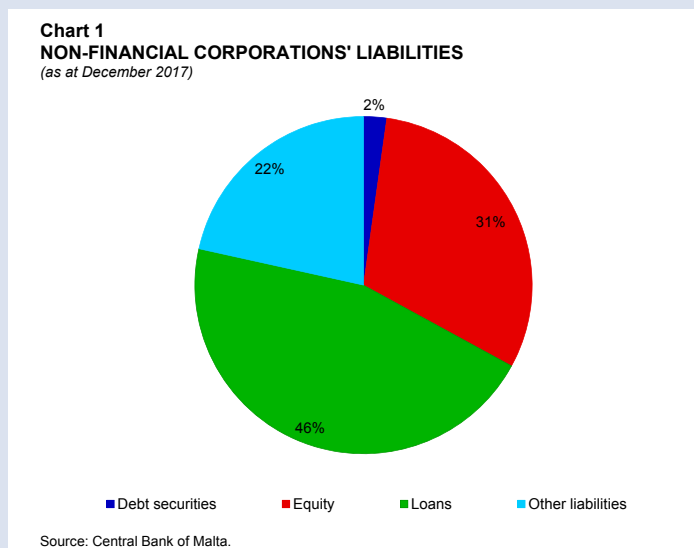
The IMF highlighted that the macro-financial implications of intercompany lending may be very different to traditional sources of funding. In turn, the macro-financial implications of corporates that source their funds within a group are very different to those that finance debt from unrelated corporates.⁶

This Box is divided into the following sections. The first section outlines the evolution of the NFC balance sheet over the years. The second section contains the disaggregation of the intercompany lending into intra-group and non-group lending. The final section presents some concluding remarks.

The aggregated balance sheet of the NFCs in Malta

A quarterly aggregated balance sheet of the NFC sector is published by the Bank as part of Malta’s financial accounts statistics.⁷ In turn, “from-whom-to-whom” data enable the analysis of the financial inter-linkages between the sectors of the economy.⁸ For example, such analysis sheds light on how a particular change in the composition of financial assets or liabilities of the NFC sector is transmitted to other sectors such as households, the financial sector, government, and the rest of the world sectors.⁹

Chart 1 shows the liabilities side of the NFC balance



⁴ See footnote 3.

⁵ Constâncio, V. (2018) “Past and future of the ECB monetary policy, speech, at the Conference on “Central Banks in Historical Perspective: What Changed After the Financial Crisis?”, organised by the Central Bank of Malta, Valletta, 4th May.

⁶ Hertkorn, A (2015), “Consolidated and non-consolidated debt measures of non-financial corporations.” In IFC Bulletin No. 39.

⁷ The balance sheet of the NFC sector forms part of the aggregated balance sheet of all institutional sectors of the resident economy. For further details on financial accounts statistics see Muscat, J., Mamo, K. (2016), “Sectoral financial linkages using Malta’s financial accounts”, *Annual Report 2016*, pp.30-35, Central Bank of Malta.

⁸ “From-whom-to-whom” data are published on the Bank’s website at <https://www.centralbankmalta.org/financial-accounts>.

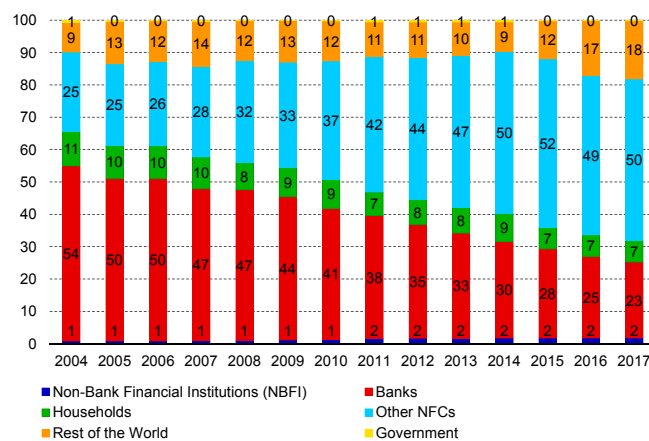
⁹ The rest of the world sector as defined in the European System of Accounts 2010 consists of non-resident units engaged in transactions with resident units or have other economic links with resident units.

sheet. As at December 2017, debt (defined as loans and debt securities) made up to 48% of the total balance sheet of NFCs and 46% of such debt constituted of loans.

To better understand the development in the composition of loans to NFCs, Chart 2 shows the outstanding amounts of loans by the lending sector – that is, non-bank financial institutions, banks, households, NFCs, government and the rest of the world – over the period 2004-2017. In 2004, the primary source of loans to NFCs was the banking sector. However, the reliance on bank credit has steadily declined over the last few years, as non-bank financing became more prominent. Indeed, whereas lending from other corporates made up only a quarter in 2004, this has increased to half of total NFC loans as at 2017, amounting to €7.1 billion. This is consistent with the general observation that NFCs have shifted their sources of finance away from traditional bank credit towards alternative sources, primarily to lending from other corporates.¹⁰

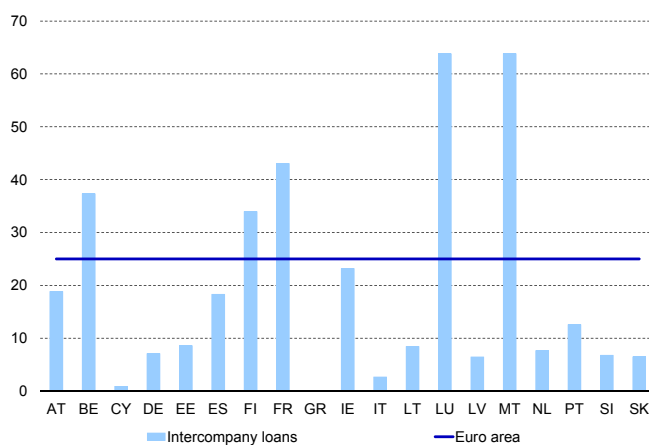
A comparison with other euro area countries also points to the above-average importance of intercompany loans for Maltese corporates.¹¹ Chart 3 shows that the average share for intercompany loans in the euro area amounts to around 25% of GDP, well below the 65% ratio for Malta.

Chart 2
NFC LOANS BY COUNTERPART SECTOR
(per cent)



Source: Central Bank of Malta.

Chart 3
INTERCOMPANY LOANS AS A PERCENTAGE OF GDP
(as at December 2017)



Source: Eurostat.

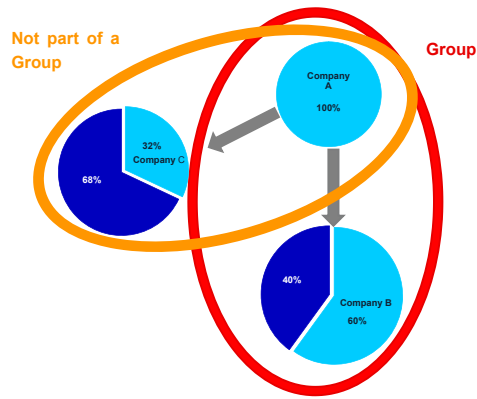
¹⁰ See Darmanin, J. (2017), "The Financing of Companies in Malta", *Quarterly Review* 2017:4, pp. 53-58, Central Bank of Malta and Micallef, B. (2015), "Estimating a Credit Gap for Non-Financial Corporations in Malta", Working Paper 04/2015, Central Bank of Malta.

¹¹ There is a degree of heterogeneity in estimating intercompany loans in the euro area. In particular, some countries use company-by-company accounts while others use group accounts to estimate intercompany loans. In our case, we use information from company-by-company accounts, which might lead to a larger estimate of intercompany loans when compared to countries that use group accounts (Hertkorn, 2015).

Disentangling intercompany lending

To distinguish between the two categories of intercompany and intra-group lending, data on corporates' group structure is used. In this data, companies are said to form part of a group when a company owns more than 50% of the shareholding in another company. Chart 4 illustrates two examples demonstrating the definition of a group used in the register data. Firstly, company A owns 60% shareholding of company B, hence companies A and B are said to form part of a group. On the other hand, if company A owns 32% of company C, according to the definition mentioned above, companies A and C do not form part of a group but are still related companies.

Chart 4
DEFINITION OF A GROUP

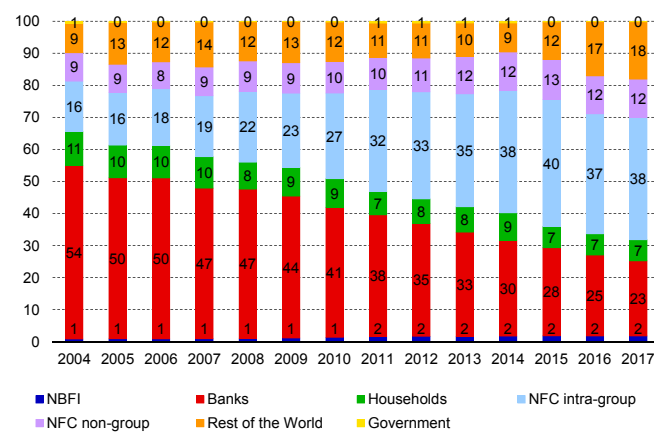


Source: Eurostat.

By combining the group structure data with NFC balance sheet data, intercompany lending can be split into two, namely intra-group loans and non-group lending. If the reporting company falls within the definition of a group, then any loans reported to be originating from related parties are assumed to be intra-group financing. Chart 5 shows that by end 2017, around 38% of total NFC loans were intra-group lending, while only around 12% of total NFC loans fall under the non-group NFC lending category.

Over the period 2004-2017, on average, 72% of intercompany loans were reported by NFCs which are within a group and 28% by NFCs which are not part of a group. It is important to note that not all non-group lending can be said to be financed by unrelated companies. Indeed, an NFC which is not part of a group could be financed by other corporates which hold a minority shareholding in that particular company.¹² Although precise information

Chart 5
NFC LOANS BY COUNTERPART SECTOR – FURTHER SPLITS
(per cent)



Source: Central Bank of Malta.

¹² As a robustness check, a sample of 172 NFCs, which cover 41% of total loans and 54% of intercompany loans, was used to investigate in more detail the results obtained from the population data. The audited accounts of such companies were used for comparison purposes which broadly confirmed the results obtained in the exercise explained above.

regarding the size of lending of the non-group category is not available, initial estimates indicate that around half of non-intragroup lending involves lending with related parties.

Concluding remarks

Malta's financial accounts statistics show that lending by NFCs has indeed increased but this is to a significant extent between companies of the same group (intra-group). This is consistent with the other findings in the literature which show that typically intercompany lending takes place within the same group, and only small amounts can be attributed to loans between companies that do not form part of a group.¹³ This shift indicates that companies are preferring to use internal funds rather than resorting to bank lending. Indeed, the incentive for NFCs to decrease their reliance on bank lending could be varied and includes (i) practically no forgone interest on deposit funds owing to the low interest rate environment; (ii) use of internal resources instead of increasing capital; (iii) reduce costs of bank interest charges on loans; (iv) tax advantages associated with borrowing relative to equity financing and (v) easier access to funding without the rigorous process of obtaining bank financing. Furthermore, internal sources of finance may be less bureaucratic and it reduces borrowing costs other than interest rates.¹⁴ Finally, the robust economic activity in Malta has led to strong improvement in profitability, which in turn increases the availability of internal sources of finance.¹⁵ From a policy perspective, removing tax distortions between borrowing and equity financing could encourage NFCs to increase equity within the group rather than intra-group lending.

¹³ Hertkorn, A (2015), "Consolidated and non-consolidated debt measures of non-financial corporations." In IFC Bulletin No. 39.

¹⁴ Darmanin, J. (2017), "The Financing of Companies in Malta", *Quarterly Review* 2017:4, pp. 53-58, Central Bank of Malta.

¹⁵ IMF, 2017. "Non-Bank sources of corporate financing in Malta". Malta Selected issues, Article IV 2017.

BOX 3: A REVIEW OF THE CORPORATE BOND MARKET IN MALTA

Since the onset of the financial and sovereign debt crises, tighter financial conditions were observed as liquidity dried up particularly in wholesale markets. As a consequence, central banks around the globe responded with the implementation of non-standard monetary policy measures and stricter regulatory requirements. The latter have restricted the banks' willingness to lend, and in turn brought about some tightening in their lending standards. Such developments were also observed domestically; as banks became more cautious in their corporate lending decisions mainly due to concerns arising from the general economic activity and industry or firm-specific developments. At the same time banks had to actively safeguard their capital buffers in anticipation of more onerous regulations. Lower bank credit however also reflected demand-side developments. While the impact of the recession on Malta was less severe and lasted less than in other euro area countries, NFCs have lowered their demand for credit. As the economy recovered, demand for bank credit by NFCs did not return to previous levels as corporates opted to use alternative funding sources, either using own funds or via intra-group lending which grew in relevance compared to bank lending.¹ Furthermore, NFCs tapped other alternative funding sources, namely that of market funding with the issuance of debt securities, enabling them to take advantage of the more favourable funding conditions resulting from abundance in liquidity and a low interest rate environment. The latter was also reported across the rest of the euro area, where issued debt by NFCs increased, noticeably.

Despite this, the share of debt securities in total debt financing of resident NFCs remained more contained in Malta compared to other euro area countries. Results from the Survey on Access to

¹ J. Darmanin, 'The financing of companies in Malta', Central Bank of Malta, July 2017.

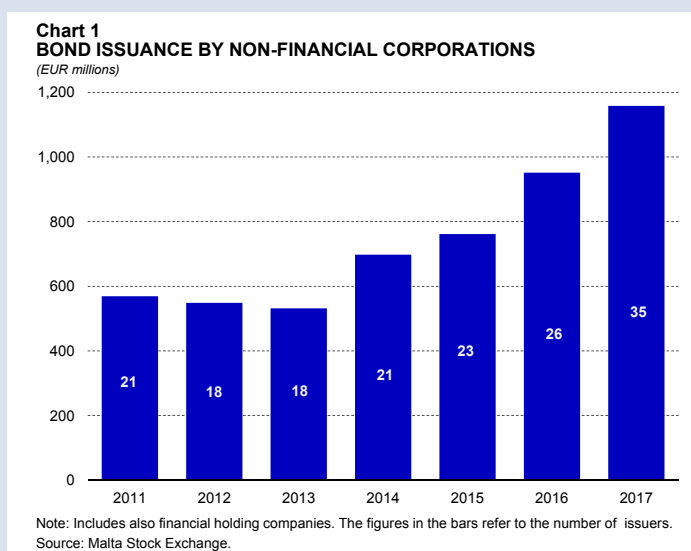
Finance (SAFE) show that domestic small and medium enterprises (SME) remain considerably more reliant on bank funding when compared to firms in other EU countries, though access to finance does not seem to be their main concern.² The latter could possibly be due to the number of initiatives to address the barriers faced by SMEs. Banks have collaborated with the European Investment Fund and launched various lending programmes targeting SMEs to obtain easier and cheaper bank credit, which require less collateral requirements. Meanwhile, the MSE launched the National Capital Markets Strategic Plan in October 2016 with the objective to develop a liquid and efficient securities market. The MSE also provided SMEs with the opportunity to issue bonds or equity through the use of the Prospects multi-trading facility (MTF).³ By end 2017 this platform was tapped by four domestic companies with a total nominal value of €11.7 million in bonds issued. This, however, can be considered to be still in its infancy compared to the size of the regular capital market, representing just 1.0% of total outstanding (non-bank) corporate bonds.

Trends and characteristics of bonds issued on the MSE

In recent years, the number of non-bank companies quoted on the MSE surged with outstanding debt issued doubling since 2011 to just below €1.2 billion (see Chart 1). This trend accentuated the disintermediation process, and is considered to be beneficial for financial stability through the diversification of credit risk among diverse market participants, while at the same time fostering the growth of the local capital market. Nevertheless, concerns for investors still remain as bonds do not carry similar safety nets as in the case of bank deposits and are also subject to market movements and interest rate risks. This is particularly important for retail investors given their significant exposure. The main holders of non-bank corporate bonds listed on the MSE were resident households, with their share in such bond holdings remaining relatively stable since 2011, standing at about 81% of the outstanding NFC bonds as at end 2017. The second largest holders of corporate debt are financial institutions accounting for about 14% of the outstanding bonds in 2017, largely as units in collective investment schemes (non-MMFs) (see Chart 2). The share of non-bank bonds held by non-residents increased over the years but remained contained at 3.4% in 2017.

Out of the outstanding bonds listed on the MSE, only about one-fourth were secured, whereas almost half of the corporate bonds were guaranteed by other related companies or guarantors (see Chart 3). Furthermore, less than 7% of outstanding bonds required the setting up of a sinking fund to support the repayment of these bonds.

About 4.5% of the outstanding bonds are callable where the issuers may redeem all or part of the debt before the specified maturity date. Typically, the



² European Commission (2017), 'SME access to finance conditions 2017 SAFE results – Malta'.

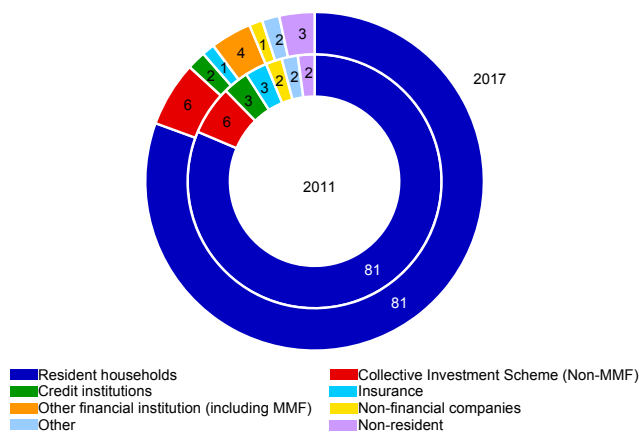
³ <https://borzamalta.com.mt/markets-prospectsmtf>.

issuer exercises this call when yields fall below the coupon rate. Consequently, the investor will be faced with re-investment risk at the prevailing market rates. Moreover when yields fall, the potential holding gain is not realised if the issuer calls in the bond at par. However, investors are generally compensated through higher yields via a bond premium. The latter could be one of the reasons why this practice is limited; coupled with the fact that around 40% of outstanding bonds issued were specifically to roll-over existing debt. An additional 22% was used to repay outstanding bank loans or other debt. Consequently, over 60% of issued debt was utilised to refinance existing debt. To date, the market has been rather accommodative to roll over such debt, even at lower yields. However if investors' (which are mainly retail in nature) preferences should change and invest their excess funds in other assets, NFCs may face higher funding costs, which in turn, will hamper their profitability. This risk is particularly relevant for those bonds which do not have underwriters. The remaining 37% of the net proceeds of bonds were used to finance further business activities or for general funding purposes, including the purchase of real estate for business purposes (see Chart 3).

Apart from higher bond issuance, the disintermediation process is clearly visible when identifying trends in bank credit by key economic sectors. The main sectors which reported higher bond issuance are the same ones which reported lower borrowing from banks.⁴ Between 2011 and 2017, the accommodation and food and services activities maintained its position as the sector which issued most bonds, up by €210.4million (79.7%), to account for about 40% of the outstanding bonds in 2017 (see Charts 4 and 5). Such increase offsets the drop in bank credit towards this sector which during the same period declined by 34.9%, equivalent to €160.2 million.

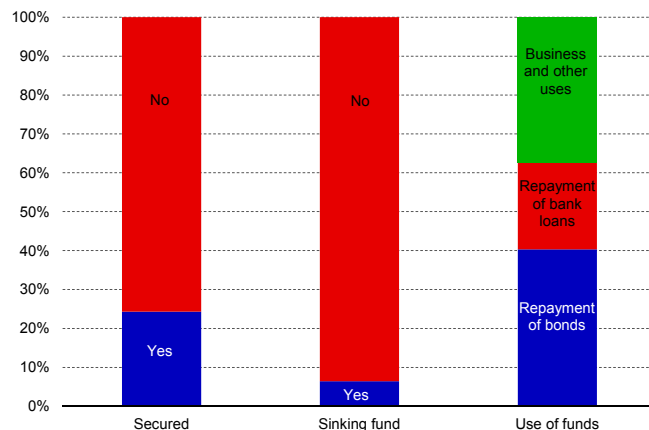
⁴ As most bonds are listed by holding companies, which are classified in the 'Financial and Insurance activities' sector, the NACE of the group was used where necessary. When this was not possible, the purpose behind the bond issue was assessed and classified accordingly.

Chart 2
OWNERSHIP OF OUTSTANDING NON-BANK CORPORATE BONDS
(per cent)



Source: Malta Stock Exchange.

Chart 3
CHARACTERISTICS OF CORPORATE BONDS – OUTSTANDING BONDS AS AT END 2017

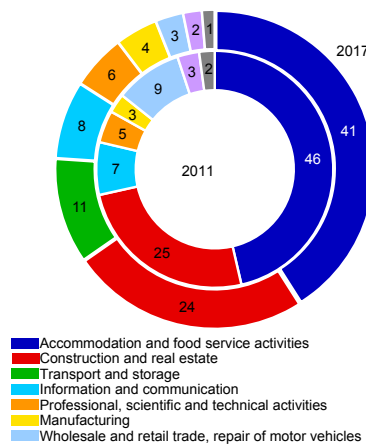


Sources: Malta Stock Exchange; Central Bank of Malta workings.

Similarly, corporates active in the construction and real estate markets increased their issued debt, up by €139.0 million (97.1%) to account for 24.4% of the outstanding corporate bonds as at end 2017. Meanwhile, resident loans to the construction and real estate sectors declined significantly by about €150 million, or 10.7%. A similar trend was observed in companies operating in the transport and storage, and the information and communication sectors. For these two sectors, outstanding bonds rose by around €125 million and €50 million, respectively, while bank lending declined by about €178 million (-45.6%) and €62.5 million (-54.9%), respectively.

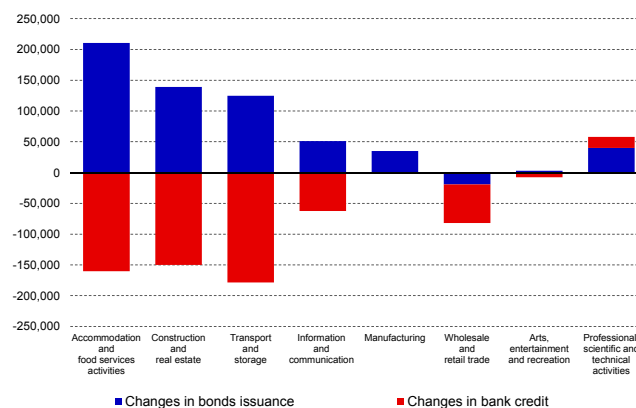
The wholesale and retail trade sector reported lower outstanding bonds and bank lending, while the professional, scientific and technical activities reported increased outstanding debt, both in terms of bonds and bank credit.

Chart 4
OUTSTANDING BONDS BY SECTORS
(per cent)



Sources: Malta Stock Exchange; Central Bank of Malta.

Chart 5
CHANGES IN OUTSTANDING BONDS AND BANK CREDIT OF SELECTED NFC SECTORS (2011-2017)
(EUR millions)



Note: Bars show the changes in bond issuance and banks credit between 2011 and 2017.
Sources: Malta Stock Exchange; Central Bank of Malta.

Advantages of disintermediation through higher bond issuance

Both supply and demand factors contributed to the strong growth in corporate bonds issued on the MSE. Such shift to the corporate bond markets gave corporates access to more diverse sources of funding and also offered more investment opportunities to investors. This partly reflected the development of Prospects MTF by the MSE, which created new capital market opportunities for SMEs, with the increased access to the capital market, leading to more efficient utilisation of capital resources by enterprises. In addition, higher reliance on market funding gave NFCs the opportunity to lock-in lower funding costs ahead of a possible turn in the interest rate cycle. The weighted average interest rate for outstanding bonds indeed declined from 6.6% in 2011 to 4.7% in 2017, with all sectors reporting drops. These yields however remained higher when compared to the weighted average interest rate of bank lending. Over this period, however, the spread between the two weighted average interest rates almost halved converging to just 0.7 percentage point in 2017. The spread could also be attributed to the differences in maturity terms.

Debt securities financing however also provided NFCs with longer-term maturities and, possibly, with less conditionality than those imposed by banks when taking up loans. Moreover, the terms of issuance can be customised to the corporates' needs, providing corporate issuers with more flexibility and larger access compared to bank funding. Debt securities financing, relative to bank credit, help issuers to improve their cash flow, although issuers should not rely on the possibility of rolling over debt securities as market conditions may change over time, and therefore should act prudently and build a sinking fund through the life of the security.

At the same time, as NFC funding shifts from the banking to the capital market, risk and rewards are divested amongst a broader base of bond holders. Retail investors are able to obtain a higher return than from bank deposits reflecting differences in relative risk, which are further accentuated in the current low interest rate environment, providing alternative investment avenue other than real estate. Thus, the disintermediation process through the deepening of the bond market addresses concerns derived from tightened bank credit conditions, bringing positive contributions to the economy, and offering various advantages to both issuers and investors.

Non-performing loans

In 2017 outstanding non-performing loans (NPL) declined by 12.1%; entirely attributed to an improvement in resident NPLs which fell by 13.1%, while non-resident NPLs increased. Nevertheless, the latter remained contained to just 6.7% of total NPLs (see Chart 2.7).

Corporate NPLs dropped by 13.7%, particularly from wholesale and retail trade, manufacturing and construction and real estate sectors; though the latter remained the largest share of outstanding NPLs. Households also contributed to the drop in NPLs, with both mortgages and consumer credit and other lending falling by 4.7% and 3.2%, respectively.

The NPL ratio improved significantly, falling to 4.1% from 5.3% in 2016 on the back of lower outstanding NPLs and an expansion in the loan books of banks (see Chart 2.8). This development stemmed from resident loans with an improvement across all loan categories, while the NPL ratio for non-resident loans remained stable at 1.7%.

Chart 2.7
SECTORAL ALLOCATION OF LOANS AND ADVANCES AND NPLs – CORE DOMESTIC BANKS
(per cent)

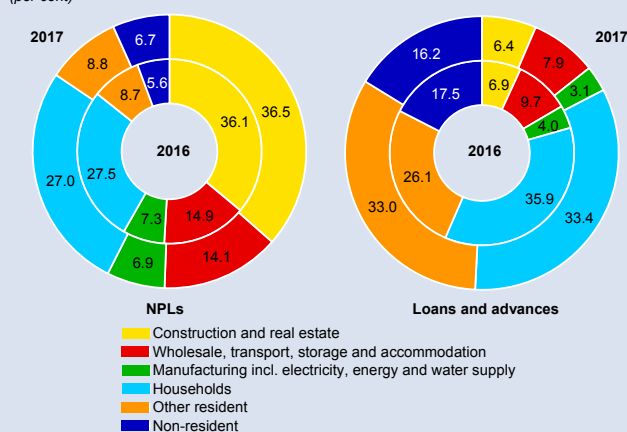
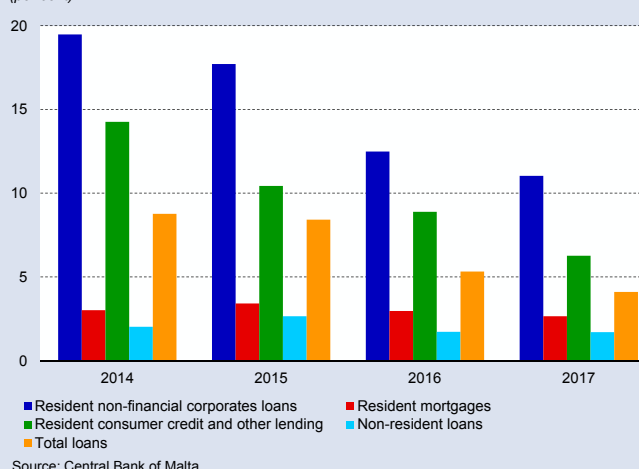


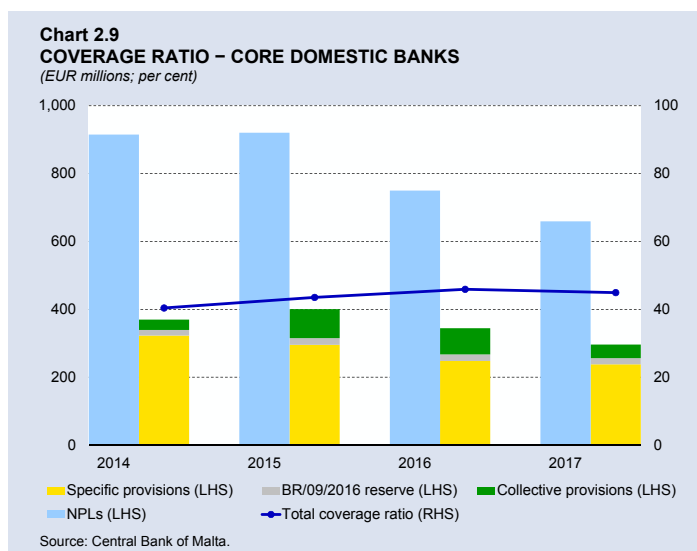
Chart 2.8
NPL RATIOS – CORE DOMESTIC BANKS
(per cent)



The NPL ratio of resident NFCs dropped further to 11.0% from 12.5% in 2016. The household NPL ratio fell by 0.8 percentage point to 3.3%. The resident mortgage NPL ratio improved further to 2.7% while the ratio for consumer credit and other household lending declined significantly by 2.6 percentage points to 6.3% in 2017.

Loan loss provisions

During 2017, core domestic banks reported a slightly lower coverage ratio of 44.9% (see Chart 2.9). The lower stock of specific provisions mirrored the drop in NPLs, which however remained the main form of coverage, resulting in a specific coverage ratio of 36.1% (specific provisions to NPLs). Collective provisions contributed to an additional 6.1 percentage points of the total coverage ratio, whereas the “Reserve for General Banking Risks” (as required by the Banking Rule 09/2016) remained stable, contributing to 2.8 percentage points of the coverage ratio.

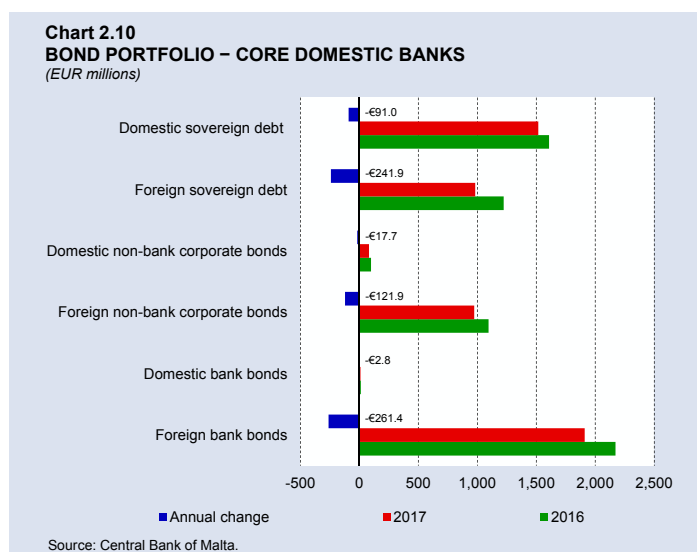


The reliance of the core domestic banks on collateral as a credit risk mitigating factor remained strong, with almost two thirds of the outstanding NPLs were backed by collateral, largely real estate. This partly explains the relatively lower coverage ratios when compared with other European countries and corroborates a study by the European Central Bank (ECB) which found an inverse relationship between coverage ratio and collateralisation of NPLs.⁷ Furthermore, core domestic banks remained cautious in terms of credit risk as they maintained adequate valuation haircuts on real estate collateral, ranging between 10% and 30%, to safeguard their balance sheets for any potential loss in value and the time it takes to sell the collateral. Taking into consideration collateral and provisions, NPLs are more than covered indicating adequate hedging against potential credit defaults.

The securities portfolio

The securities portfolio represented the second largest asset class for the core domestic banks. At €5.9 billion, this accounted for 25.7% of the banks’ total assets by the end of 2017, five percentage points lower than in the previous year.

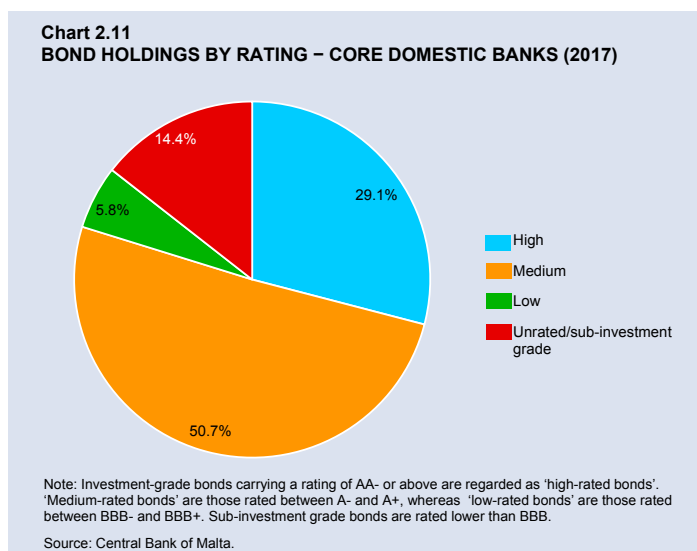
The banks’ securities holdings declined by 11.6%, mainly stemming from lower bond holdings, down by almost 12%. Holdings of foreign securities accounted for the largest decline, down by €625.2 million, predominantly related to debt issued by banks and sovereigns (see Chart 2.10). Still, the



⁷ Source: ECB Financial Stability Review, November 2017, p. 70.

majority of foreign bond holdings remained mainly exposed to countries which had been assigned a high investment-grade rating by the major rating agencies.⁸

Holdings of domestic bonds remained mainly composed of sovereign paper amounting to €1.5 billion. The latter declined by €91.0 million to reach 6.6% of total assets. These represented around 28% of total bonds held, an increase of 2 percentage points when compared to 2016. Changes in domestic NFC and holdings of bank bonds were marginal.



The contraction in the securities portfolio consisted mainly of bonds booked as 'available for sale'. As a result, the share of bonds booked as 'held-to-maturity' gained further ground reaching around 60% of total bonds held; indicating a lesser exposure to adverse market movements which would have a direct impact on their profits.

Equity holdings accounted for a minor share of the securities portfolio equivalent to 7.2%, or less than 2% of the banks' total assets. Such exposure decreased by 8.3% in 2017, largely driven by the group restructuring of one bank which consolidated its position.

Securities asset quality

Around half of the debt securities portfolio of the core domestic banks consisted of medium investment-grade bonds (see Chart 2.11). This mirrored the relatively high proportion of domestic sovereign debt holdings, which represented more than half of such medium-rated debt. High-rated investment-grade bonds accounted for almost one third of bond holdings, whereas low-rated investment-grade bond holdings accounted for just 5.8% of securities. The rest consisted of unlisted or unrated bonds.

In terms of asset quality, securities portfolio remained sound, with no bonds being classified as non-performing. In 2017 the non-performing exposure (NPE) ratio improved further to 3.1% from 3.7% in 2016.

2.1.3 Funding and liquidity

Customer deposits

Core domestic banks continued to fund their operations mainly through customer deposits, which represented almost 80% of their total assets. The growth in customer deposits has decelerated over the past years to 2.8% in 2017, owing to a 10.9% contraction in non-resident customer deposits, largely due to an outflow of deposits by other financial intermediaries (OFI) and private NFCs (see Chart 2.12). As a result, the proportion of non-resident deposits to total deposits fell to 12.1%, financing less than 10% of the core domestic banks' total assets.

In contrast, resident customer deposits grew in importance as a funding source for core domestic banks, to account for almost 88% of total customer deposits. During the year resident customer deposits grew by

⁸ High-rated countries are those countries which are rated AA- or above by Moody's, S&P and Fitch Ratings.

5.0% in 2017, though at a slightly slower rate than last year. Household deposits advanced by 6.4% and financed almost half of the banks' balance sheet (see Chart 2.13). Such growth was sustained despite the further tightening of interest rates paid on deposits with the weighted average deposit rate standing at 0.32% (2016: 0.39%).

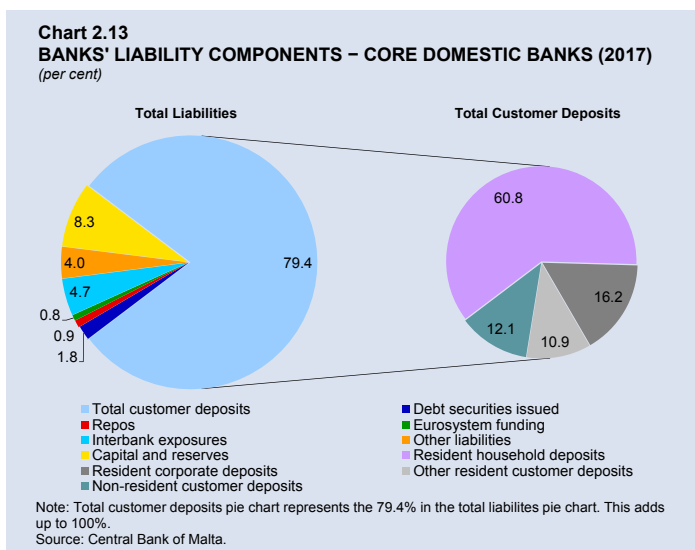
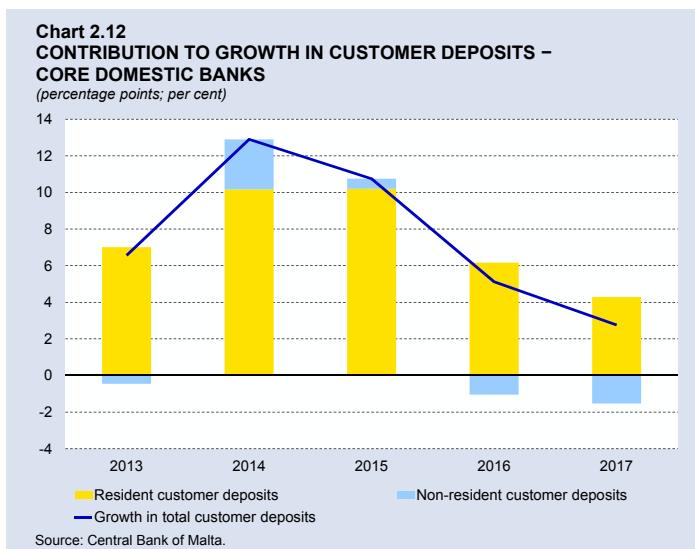
Deposits from private resident NFCs rebounded in 2017 up by 5.6% in 2017, reversing the fall reported in 2016. Such deposits accounted for 16.2% of total customer deposits. The rest of the resident customer deposits, which include funds from non-bank financial corporates, declined by 3.1%.⁹

The customers' preference for highly-liquid instruments persisted as demand deposits rose by 6.3% to over three-fourths of total deposits. Conversely, term deposits with maturity of up to one year and over one-year, declined by 7.6% and 10.4%, representing 16.9% and 6.6% of total deposits, respectively. Euro-denominated deposits grew while foreign currency deposits contracted. As a result, euro-denominated customer deposits accounted for 88.7% of total customer deposits; an increase of 1.4 percentage points when compared to 2016. Foreign currency deposits remained largely denominated in US dollars and the Pound Sterling. Exposure to the latter is however deemed to be contained with limited direct implications from developments linked to Brexit negotiations.

Eurosystem and wholesale funding

Eurosystem funding rose marginally over a year ago, but remained limited to 0.8% of total liabilities. Such funding was tapped by a number of banks which opted to benefit from favourable funding conditions.

Interbank funding (excluding repos) rose by 3.6 percentage points to 4.7% of total liabilities in 2017, mainly reflecting intra-group funding by one bank.



⁹ 'Other resident customer deposits' include deposits from captive financial institutions and money lenders, government, insurance companies and public corporations.

During the year, financing from debt securities declined by 8.3%; accounting for 1.8% of the total balance sheet value. This fall resulted from one bank which opted not to roll-over its maturing debt. Funding from repos and 'other' liabilities also contracted and continued to finance a minor share of total assets equivalent to 0.9% and 4.0%, respectively.

Liquidity

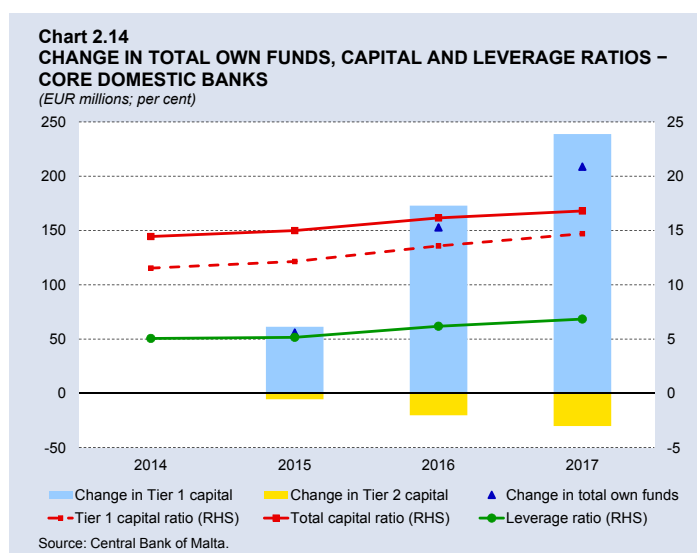
Core domestic banks remained characterised by ample liquidity with the liquid assets to short-term liabilities ratio rising by further 2.0 percentage points to 57.8%.¹⁰ The liquidity coverage ratio (LCR) which ascertains that short-term liquidity obligations under a 30-day stress period can be met; rose to 183.8%, remaining well-above the fully-phased-in LCR requirement of 100%. This improvement resulted from higher liquid assets which progressed by 11.7%, largely owing to higher central bank reserves which can be withdrawn on demand. The customers' loan-to-deposit ratio, which stood at 58.9% significantly below the euro area average of about 98%, also suggests ample liquidity buffers.¹¹

An assessment of the Net Stable Funding Ratio (NSFR) for a sample of core domestic banks indicated that these banks are already in a position to meet the regulatory requirement of 100% ahead of its implementation.

2.1.4 Capital and leverage

Throughout 2017, the core domestic banks strengthened further their capital base through the successful equity issuance and group capital contributions. This resulted in the banks' total own funds to expand by 12.9% to €1.8 billion by the end of 2017. Such an increase reversed the weakening in the banks' total capital ratio reported during the first half of 2017, while it enhanced their capital position in view of the increasing phase-in requirements of the various capital add-ons. These developments pushed up the total capital ratio by 0.6 percentage point to 16.8%, mirrored in higher Tier 1 capital, as otherwise Tier 2 capital decreased (see Chart 2.14). The Tier 1 capital ratio improved by 1.1 percentage points to 14.7%, comfortably above the minimum regulatory requirements and the additional capital add-ons highlighted under the Capital Requirements Directive (CRD) IV. The latter include the gradual phasing-in of the capital conservation buffer, which stood at 1.25 percentage points on Tier 1 capital ratio for 2017; the Other Systemically Important Institutions buffer; and Pillar II requirements.¹² The Countercyclical Capital Buffer has remained unchanged at 0%.¹³

The enhanced capital position was also accompanied by a healthier leverage ratio. Under the fully phased-in definition governed by the Capital Requirements Regulation (CRR), the leverage ratio increased to 6.8%; 0.7 percentage point higher than in



¹⁰ Such ratio was above the minimum regulatory requirement of 30%. However, following the full implementation of LCR requirement of 100% on 1 January 2018 the liquid assets to short-term liabilities ratio is no longer applicable.

¹¹ Source: ECB Statistical Data Warehouse.

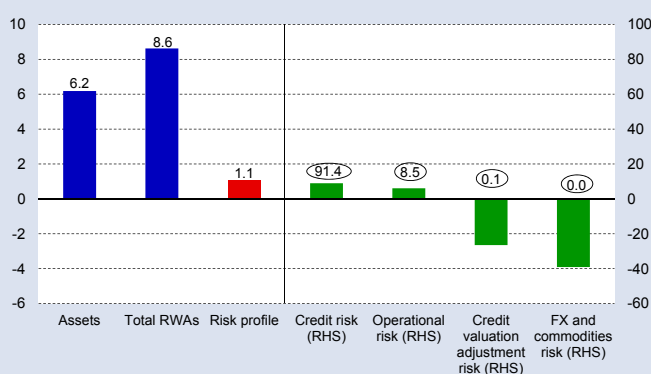
¹² Pillar II requirements include capital buffer arising Supervisory Review and Evaluation Process (SREP) and guidance levels.

¹³ See <https://www.centralbankmalta.org/tools>.

2016 and significantly above the 3% minimum requirement.

Meanwhile, their risk profile (defined as total risk exposures to total assets) weakened by 1.1 percentage points to 48.2% (see Chart 2.15). The higher risk-weighted assets (RWA) was mainly on account of higher credit risk related to corporate exposures. Operational risks also resulted in higher RWA, albeit to a lower extent. Other contributors to developments in RWA declined and remained minimal in the composition of RWA.

Chart 2.15
GROWTH IN ASSETS AND TOTAL RISK EXPOSURE – CORE DOMESTIC BANKS
(per cent)



Note: Percentages in circles represents the share of total risk exposure as at end-2017. Other percentages refer to the annual growth rate.
Source: Central Bank of Malta.

BOX 4: BANK LENDING SURVEY RESULTS

The Bank Lending Survey (BLS) conducted every quarter by the ECB gathers qualitative information on the loan policies of 143 euro area banks.¹ Four core domestic banks which account for more than 90% of the total resident lending also participate. The survey covers questions on credit supply, as indicated by banks' credit standards and terms and conditions, as well credit demand conditions.² Such information reflects past developments and expectations across loan categories: mortgages, consumer credit and other lending to households, and loans to enterprises. The survey also includes a number of ad hoc questions on specific topics of interest. Domestic results are weighted according to the banks' outstanding loans of participating banks.

Credit supply conditions

In the second quarter of 2017 Maltese banks eased slightly their credit standards on loans to enterprises owing to competitive pressures and a favourable economic climate (see Chart 1). Throughout the rest of the year credit standards were kept unchanged and no changes were expected for the first quarter of 2018. Similarly, terms and conditions for corporate loans were eased in the second quarter of 2017 due to stiffer competition and higher risk tolerance by the banks. This was manifested in narrower interest margins on average loans and less strict loan covenants (see Chart 2).³ No further changes were reported in the second half of the year.

Throughout the year, euro area banks covered in the BLS eased marginally their credit standards for loans to enterprises, mainly due to increased competition. Such trend was expected to persist also into the first quarter of 2018. Similarly, euro area banks eased corporate terms and conditions

¹ The BLS data for all euro area countries are published on the ECB's Statistical Data Warehouse (SDW).

² Credit standards refer to the bank's internal guidelines on loan approval criteria, established prior to the actual loan negotiation. These specify borrower characteristics such as income levels, age and employment status which banks consider in their credit scoring methods. Credit terms and conditions refer to the conditions of a loan, namely the interest rate, loan size, fees, collateral requirements, maturity terms and other conditions.

³ Loan covenants are stated in the loan contract as part of its terms and conditions. These refer to certain actions which the borrower should or should not take.

in 2017, primarily on the back of higher competitive pressures which led to compressed margins on average loans.

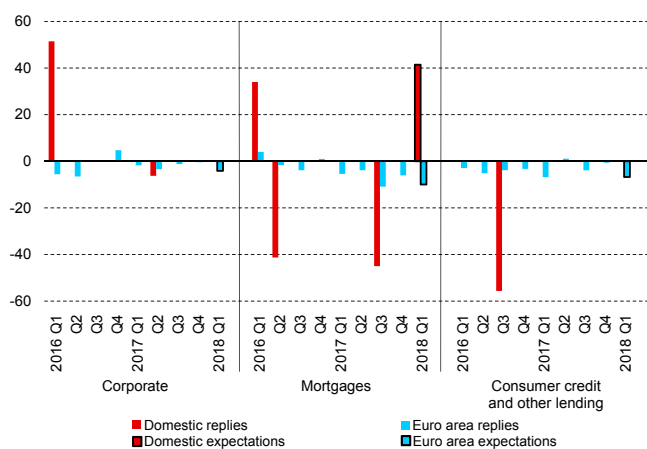
Following a period of stable credit standards on mortgages, domestic participants reported some easing in the third quarter of 2017, owing to stiffer competition (see Chart 1). These standards remained unchanged in the last quarter of the year, while some tightening was projected for the first three months of 2018. Mortgage terms and conditions were left unchanged, following some easing in the beginning of 2016 (see Chart 2).

Euro area respondents eased mortgage credit standards and terms and conditions throughout 2017, driven by competitive pressures, which resulted in narrower interest margins on average loans. Mortgage credit standards were also expected to ease in the first quarter of 2018.

Following some easing in 2016 owing to higher bank risk-tolerance, domestic respondents kept credit standards on consumer credit and other lending to households stable throughout 2017, with no changes anticipated for the first quarter of 2018 (see Chart 1). Terms and conditions of this loan category have been kept unchanged since 2015 (see Chart 2).

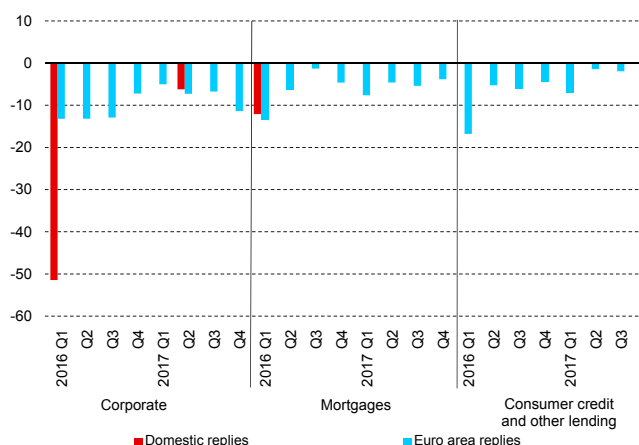
In the euro area, factors such as stiffer competition, stronger customers' creditworthiness and favourable economic conditions led to a relaxation in overall credit standards on consumer credit and other lending in 2017. Credit standards were anticipated to ease further in the first quarter of 2018. Competitive pressures also led euro area participant banks to ease their terms and conditions on consumer credit and other lending mainly through narrowing interest margins on average loans in 2017.

**Chart 1
CREDIT STANDARDS**
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

**Chart 2
CREDIT TERMS AND CONDITIONS**
(+ indicates net tightening/- indicates net easing)



Sources: ECB; Central Bank of Malta calculations.

Credit demand conditions

In the first half of 2017, domestic corporate loan demand was driven by higher fixed investment. Inventories and working capital, as well as debt restructuring needs also contributed, but to a lesser extent (see Chart 3). The upward trend in corporate loan demand was reversed in the third quarter of the year as a result of stiffer competition from other banks. No changes were reported in the last quarter of the year and none were projected for the first quarter of 2018. In the euro area, corporate loan demand was positive, mainly on the back of the low interest rate environment and higher fixed investment needs. This momentum was anticipated to persist in the first quarter of 2018.

Maltese banks reported a slowdown in mortgage demand in the first quarter of 2017, exclusively driven by competitive pressures (see Chart 4). However, this was reversed in subsequent quarters owing to

stronger consumer confidence, better housing market prospects and the persistently low level of interest rates. In the euro area, mortgage demand was buoyant owing to the same factors identified by Maltese respondents. In the first three months of 2018, Maltese banks anticipated mortgage demand to remain in line with the previous quarter, while further growth was anticipated in the euro area.

Competitive pressures from other domestic banks lowered the demand for consumer credit and other lending among Maltese banks in the first quarter of 2017 (see Chart 5). However, this was reversed marginally in the third quarter of the year, driven by both improved consumer confi-

Chart 3
CORPORATE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)

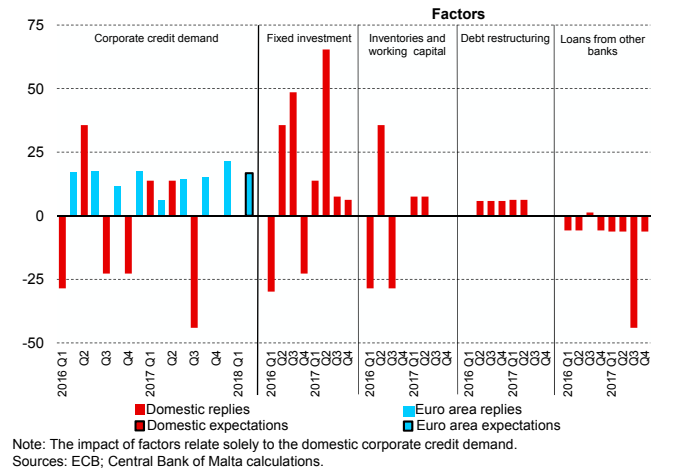
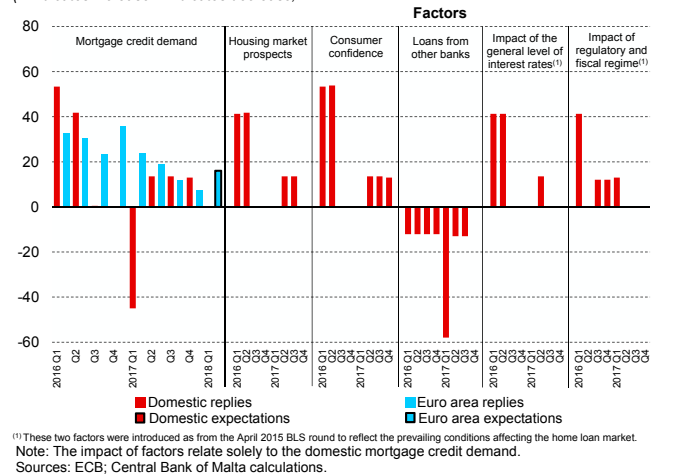
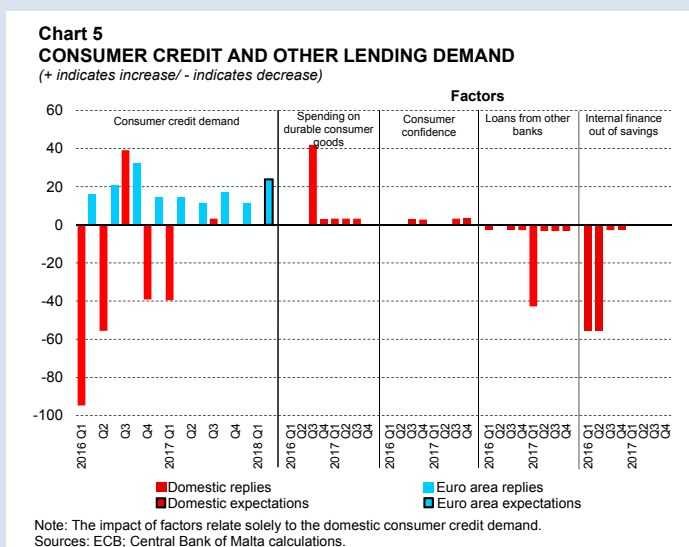


Chart 4
MORTGAGE CREDIT DEMAND
(+ indicates increase/ - indicates decrease)



dence and higher spending on durable goods. No changes were expected in the first quarter of 2018. In the euro area, demand for consumer credit and other household lending was positive throughout 2017, and was projected to pick-up further in the first three months of 2018. This reflected higher consumer confidence and spending on durable consumer goods, as well as the positive impact stemming from the very low interest rates.



2.2 Non-core domestic banks

The financial resilience and the level of profitability of the non-core domestic banks remained strong and comparable to previous years. In 2017 the number of non-core domestic banks remained unchanged at five, but their balance sheet size contracted by almost 10% to 19.8% of GDP owing to lower business with non-residents. The largest bank within this category is involved in international trade finance, providing letters of credit, documentary collections, guarantees and back-to-back facilities in support of cross-border transactions. The activities of the other four banks range from deposit-taking, international trade finance, factoring, corporate banking, remittances and settlements, and foreign exchange services. In 2017, this group of banks experienced lower profitability but their after-tax ROE and ROA ratios remained relatively stable when compared to the previous year. Furthermore, apart from wholesale funding, these banks have also shifted towards retail funding. Resident deposits rose as opposed to non-resident deposits; but funding sources remained predominantly non-resident. The non-core domestic banks also increased their lending to residents. Credit risk in their balance sheet is very low and continued to decrease. Non-core domestic banks have sound liquidity with regulatory ratios well-above requirements while capital ratios also strengthened when compared to the previous year.

2.2.1 Profitability

Non-core domestic banks registered a 12.3% drop in net profit before tax largely on account of lower non-interest income. This reflected foreign exchange losses following the depreciation of the US dollar vis-à-vis the euro and to a lesser extent, the depreciation of the Pound Sterling. Such losses were partly compensated for by higher trading profits from the disposal of financial assets and larger dividends from subsidiaries.

Income from interest-bearing activities also fell owing to lower interest received on debt securities, largely reflecting the contraction in their securities portfolio. Interest income from lending activities however increased as the extent of interest rates charged on customer loans compensated for the contraction in the customer loan book. The lower interest expenses arising from a smaller customer deposit base and higher interest income from intermediation was not enough to offset the drop in interest income from securities, resulting in a lower NII for the year.

In general, these banks became less cost efficient owing to lower gross income and higher administrative costs. As a result, the cost-to-income ratio increased to 77.5%. However, the post-tax ROE and ROA remained relatively stable at 3.0% and 0.3%, respectively (see Chart 2.16).

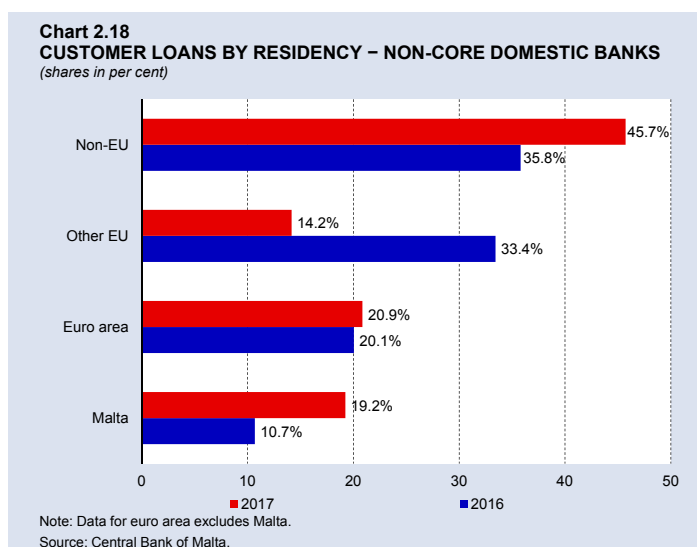
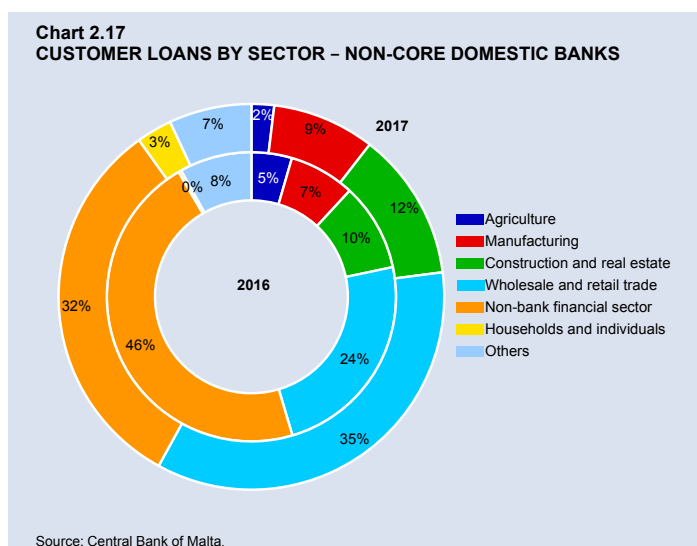
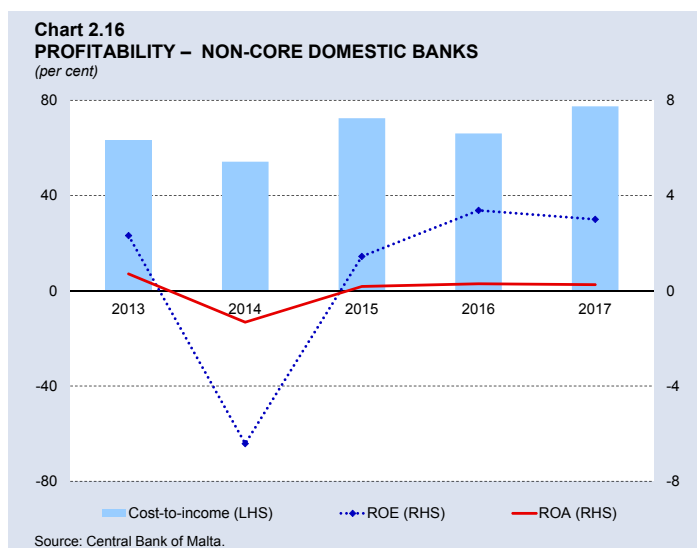
2.2.2 Asset quality

The loan portfolio

In 2017 customer loans contracted by 6.4% and accounted for less than a third of the banks' total assets. This fall largely stemmed from lending channelled to the non-bank financial sector, whose share in total customer loans dropped by 14.1 percentage points to 32.1% (see Chart 2.17). This was compensated for by higher loans channelled to the wholesale and retail trade sector. Lending to other economic sectors remained broadly stable during the year.

Lending to non-residents, which accounted for around 80% of their customer loan portfolio, contracted by 15.3%. This development was largely driven by one bank rather than reflecting a trend across the five non-core domestic banks. From a geographic perspective, the drop in customer loans granted to EU countries (excluding Malta) outweighed the increase in loans to customers from non-EU countries (see Chart 2.18).

Lending towards residents rose to 19.2% of the customer loan book, as a number of banks changed their business strategy and tapped further the local market. Such lending is largely concentrated in the construction and real estate sector, non-bank-financial sector, and to a lesser extent,



households and wholesale and retail sector. In general, lending to residents was offered at rates which were more competitive than those offered by the core domestic banks. Around a third of the resident customer loans were denominated in foreign currency, mostly in US dollar. While resident lending accounted for 19.2% of the total loan portfolio, such lending represented 1.4% of the total customer loans in the whole banking sector.

The share of placements with banks to total assets dropped by almost 3 percentage points to around 20% of total assets, reflecting lower interbank loans to unrelated foreign credit institutions. Placements with the Central Bank of Malta increased by more than half and corresponded to around 16% of the non-core domestic banks' total assets; reflecting the comfortable liquidity buffers of this group of banks.

Credit risk from the loan portfolio decreased further as the NPL ratio continued on its downward path to 2.2% from 3.5% in 2016, reflecting lower non-resident NPLs. The coverage ratio improved by around 12 percentage points to 66.1% as total provisions fell at a slower pace than the outstanding level of NPLs.

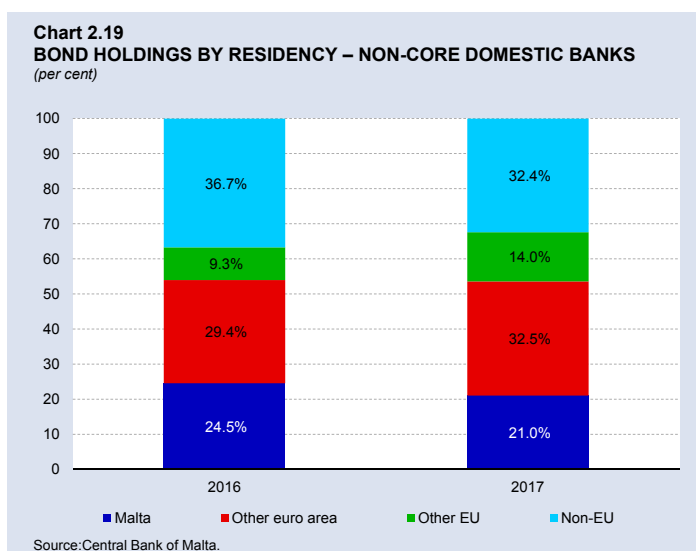
The securities portfolio

In 2017 non-core domestic banks decreased their securities portfolio to 28.3% of their balance sheet from just over a third a year earlier. Their resident bond portfolio, which predominately consisted of Malta Government Stocks (MGS), declined to 3.2% of their total assets; or just over a fifth of their total bond holdings from 24.5% a year earlier (see Chart 2.19). In terms of foreign bonds, this group of banks held lower debt issued in the United States, Spain, Germany and Italy.

Despite these changes, the composition of the bond portfolio remained broadly stable, and largely invested in sovereign debt and MFI bonds, though the latter by a lower extent. In addition, investment in corporate bonds almost halved, accounting for around 8% of the total bond portfolio. Furthermore their investment profile remained prudent and improved further as the proportion of high investment-grade bonds increased by more than 5 percentage points to 72.3% of total bond holdings.¹⁴

Equity holdings declined by around 15% reflecting lower units in resident non-MMF investment funds. Nevertheless, such exposure corresponded to almost half of the banks' equity holdings, whereas the other half consisted of equities issued predominantly in the United Kingdom and the Netherlands by non-bank financial intermediaries.

At 1.8%, the NPE ratio remained low indicating the banks' conservative investment strategy.



¹⁴ High investment-grade bonds are rated as AA- or better.

2.2.3 Funding and liquidity

Despite declining by 7.6%, customer deposits remained the main funding source for the non-core domestic banks, financing just over two-thirds of their total assets. This fall was driven by non-resident customer deposits, while resident customer deposits rose by almost a third, largely from OFIs. By the end of 2017 resident customer deposits financed almost 25% of the non-core domestic banks' balance sheet, with households accounting for the largest source of resident funding for such banks, financing 10.5% of assets. The weighted average interest rate for euro-denominated resident deposits exceeded the weighted average rate of the core domestic banks. Despite more favourable interest rates, the resident retail funding remained low at just 3.1% of the total resident customer deposits in the banking system.

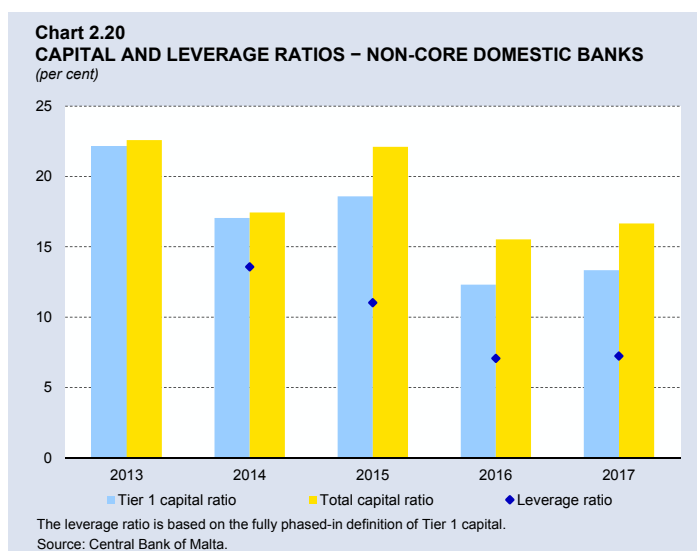
Interbank funding, predominantly from unrelated credit institutions outside the European Union, contracted further in 2017 to stand at 16.5% of assets. This development mirrored the changing nature of the funding strategies predominantly by one non-core domestic bank as it shifted away from wholesale funding and relying more on retail funding.

Capital and reserves remained fairly stable and accounted for 8.7% of the total balance sheet size. Non-core domestic banks kept their reliance on Eurosystem funding to a minimum, with the outstanding balance accounting for just 1.1% of total assets as at the end of 2017. During the year three banks participated in such operations, benefiting from the advantageous funding conditions rather than due to liquidity shortages. This is evidenced by the high Liquidity Coverage Ratio (LCR) governed under the CRR/CRDIV framework which stood at 263.9%, well-above the 80% regulatory minimum for 2017 and also exceeding the fully-phased in threshold of 100%.¹⁵ All banks reported a liquidity ratio above this threshold. Similarly, the customer loan-to-deposit ratio remained low compared to the previous year hovering at around 47% in 2017, also pointing towards the ample liquidity buffers of these banks.

2.2.4 Capital and leverage

In 2017 the capital ratios improved over the previous year as risk exposures fell at a faster pace than total own funds. As a result, the total capital ratio and Tier 1 capital ratio both rose by around 1 percentage point to 16.7% and 13.3%, respectively (see Chart 2.20). The risk profile of these banks (defined as total risk exposures to total assets), dropped by 5.0 percentage points to 59.1%, mirroring the shedding of some assets that carried high risk-weights.

Similarly, the leverage ratio, which is a non-risk based measure of capital and governed under the CRR/CRD IV framework stood marginally higher at 7.2%. All banks reported a leverage ratio above the 3% regulatory minimum.



¹⁵ The LCR ratio will be progressively implemented in accordance with the CRR as follows: 80% from 1 January 2017, and 100% from 1 January 2018.

2.3 International banks

There are currently 14 institutions classified as international banks, of which three are branches of foreign banks and a further 11 are subsidiaries of foreign banks and stand-alone banks.¹⁶ These banks are licensed and incorporated in Malta and must hold capital, locally. The three licensed branches are not incorporated locally, so they do not hold capital in Malta. Nonetheless, these banks are still subject to applicable prudential reporting requirements.

The profitability and financial resilience of the international banks remained strong when compared to the previous year. Their total assets grew by 3.7% to €22.8 billion in 2017, representing 205.4% of GDP. The assets of the three branches amounted to €19.6 billion, equivalent to 176.2% of GDP. Links of international banks with the domestic economy remained low and contained, as their operations were largely oriented towards non-residents, with resident assets accounting for just 5.7% of their balance sheet value. Resident deposits of international banks financed just 1.2% of their total assets. International banks engaged in different business activities including trade financing and factoring; payments and settlements; wealth management; and lending towards private NFCs.

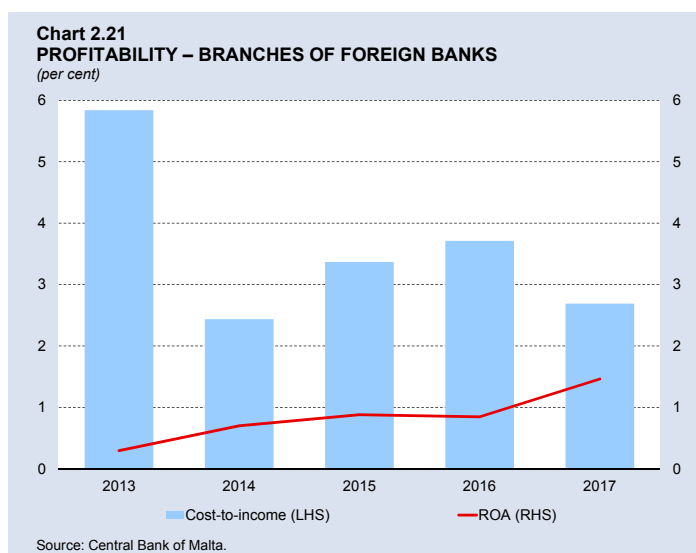
2.3.1 Branches of foreign banks¹⁷

2.3.1.1 Profitability

The three branches of international banks posted higher profits, with post-tax ROA advancing by 0.6 percentage point to 1.5% (see Chart 2.21). These developments in part reflected a base effect owing to foreign exchange losses posted in the previous year coupled with gains on disposal of financial assets in 2016. Consequently, income from non-interest activities was less negative than in the previous year.

NII remained the major source of income, and rose by 16.1% by end 2017. A larger loan portfolio channelled to NFCs abroad pushed up their returns from interest-bearing activities. In contrast, interest income from securities dropped as one branch sold a portion of its fixed-income securities. Interest expenses fell significantly due to lower customer deposits by one bank coupled with reduced inter-bank funding costs incurred by the other two banks. These developments all contributed to push up NII for the year.

Although higher staff costs drove up operating expenses, the cost-efficiency of these branches still improved with the cost-to-income ratio narrowing by 1 percentage point to 2.7% due to a faster increase in operating income.



¹⁶ By end 2017 two subsidiaries of foreign banks and nine stand-alone banks were operating in Malta.

¹⁷ Out of the three branches licenced in Malta, one is a third-country branch, while the other two branches have their parent company located within the euro area.

2.3.1.2 Asset quality

The loan portfolio

Customer loans grew by around 45% to account for just over a quarter of the total assets of these branches of foreign banks. Such loans were largely granted to foreign NFCs operating in the transportation and storage sector; wholesale and retail trade; energy-related activities; human health and social work activities; financial institutions and insurance and also in manufacturing (see Chart 2.22).

Interbank placements (including deposits reported on the assets side) fell by more than a quarter by the end of 2017. This contraction reflected lower placements with

unrelated banks located primarily in the United Kingdom and Turkey, as well as lower exposures with the parent and subsidiary companies, though to a lesser degree. Despite decreasing, placements with unrelated credit institutions still accounted for the majority of interbank exposures.

The loan quality of the branches of foreign banks remained sound with an NPL ratio of just 0.6%. The coverage ratio stood at 65.6% with NPLs being fully-covered when taking into consideration the collateral underlying these loans.

The securities portfolio

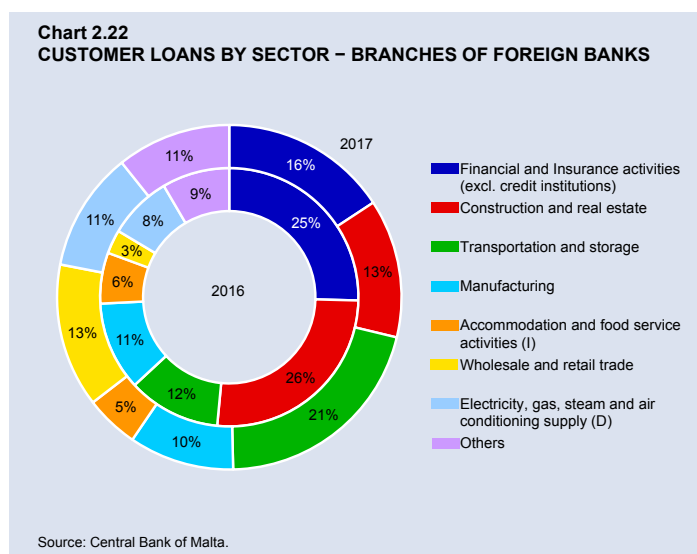
The securities portfolio which is exclusively held by the branches of Turkish banks, is entirely composed of fixed-income securities, predominately in the form of Turkish sovereign paper. During the year under review, the securities portfolio contracted by 6.3% to around 48% of total assets. The contraction in the securities portfolio stemmed mainly from the disposal of fixed-income securities issued by unrelated credit institutions located predominantly in Turkey. Moreover, the three branches of foreign banks did not hold MGS.

2.3.1.3 Funding and liquidity

While wholesale funding declined compared to a year ago, it continued to be the most preferred source of funding for the branches of foreign banks, financing around 70% of their total assets. Wholesale funding fell by 7.1 percentage points over the preceding year, mainly due to lower loans from unrelated UK banks, as otherwise dependence on the head office for funding purposes increased by 12.2% over the period reviewed, representing almost half of wholesale funding.

Non-resident customer deposits rose by about 26% during the year and financed just under a quarter of the activities of these branches. These deposits mainly originated from the financial and insurance sector, wholesale and retail trade, and manufacturing sectors. Links of these branches of foreign banks with the domestic economy remained very limited, with resident customer deposits shrinking further to just €2 million.

The three branches of foreign banks have no other links with the domestic economy and the rest of the financial sector, as they do not participate in the domestic interbank market and do not have any exposures with domestic insurance companies or investment funds. Funding is primarily from non-resident deposits.

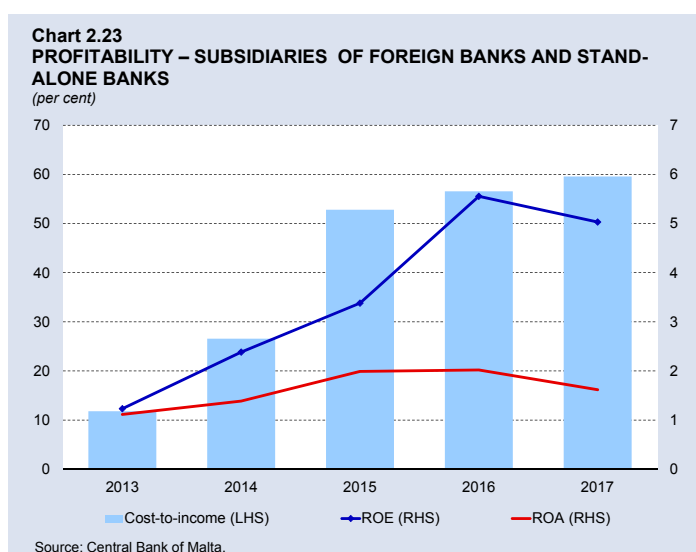


Furthermore these banks do not legally qualify to hold covered deposits under the Depositor Guarantee Scheme (DGS) as deposits are insured by their respective foreign country.

2.3.2. Subsidiaries of foreign banks and stand-alone foreign banks

2.3.2.1. Profitability

In 2017 this group of banks registered a marginal increase in pre-tax profits, up by 1.7% over the previous year. Owing to lower post-tax profits, post-tax ROE and ROA narrowed to 5.0% and 1.6% in 2017, respectively, from 5.6% and 2.0% a year earlier (see Chart 2.23).



The rise in pre-tax profits reflected growth in NII, largely driven by one bank that offers micro-lending to non-resident households. Interest expenses also rose owing to a larger deposit base; but at a slower pace than interest income. The remaining banks registered higher income from non-interest bearing activities which rose by 4.3% and remained the second largest contributor of income; mainly from higher fees and commission income and fair value gains on foreign exchange transactions.

Non-interest expenses rose by 20.1% reflecting higher administrative and staff-related costs. Moreover, loan impairment charges increased mainly owing to higher write-offs. Due to a faster rise in non-interest expense, the cost-efficiency of these international banks deteriorated, with the cost-to-income ratio increasing to 59.6% in 2017 from 56.6% in 2016.

2.3.2.2. Asset quality

The loan portfolio

During 2017 the loan portfolio (including deposits on the assets side) expanded by 7.3% and remained largely oriented towards non-residents. From a sectoral perspective the largest increase stemmed from higher holdings with their parent and subsidiaries and higher loans issued towards other unrelated non-resident banks, though to a lower extent.

Customer loans, which represented around 62% of total loans issued by these banks, rose by 2.7% over 2016, mainly channelled to manufacturing, transportation and storage, households, energy-related activities and mining and quarrying.

In terms of geographical location, the increase in customer loans was mainly reported in loans channelled to countries in the euro area (excluding Malta); which rose by 16.6% to account for 41.6% of total customer loans. Meanwhile, lending to non-EU residents fell by 10.7% to €497.5 million, corresponding to 28.7% of total customer loans. Similarly, resident customer loans decreased considerably to just 1.1% of customer loans in 2017, thereby reducing further their links with the domestic economy (see Chart 2.24).

The asset quality of the loan portfolio improved, as evidenced by the 1 percentage point drop in the NPL ratio to 5.3% by end 2017, driven by a drop in NPLs and an expansion in the loan book. Since these NPLs were

significantly provided for, specific provisions dropped, pushing down the coverage ratio from 52.7% in 2016 to around 37% in 2017. Considering total extendable collateral and total provisions, NPLs held by this group of banks are fully-covered; hence minimising potential credit risks on the balance sheet.

The securities portfolio

The securities portfolio held by subsidiaries of foreign banks and stand-alone foreign banks expanded by 44.7%, accounting for 8.8% of total assets held by this group of banks. This growth stemmed primarily from higher holdings of sovereign bonds issued mainly by the US Treasury, European and Canadian governments. Despite increasing by 75.5% over 2016, holdings of MGS stood at 11.7% of their securities portfolio and a mere 1.0% of their balance sheet size. This group of banks also reported an increase in bonds issued by credit institutions located mainly in Europe and to lesser extent, in the United States. An additional 9.0% of the securities portfolio is invested in corporate bonds issued by non-resident NFCs. The overall quality of the bond portfolio is high, as the majority of the securities portfolio is invested in countries with a high credit rating.

Equity holdings increased threefold, owing to higher investments in US corporates, though accounting for just 11.7% of the securities portfolio of these banks.

2.3.2.3 Funding and liquidity

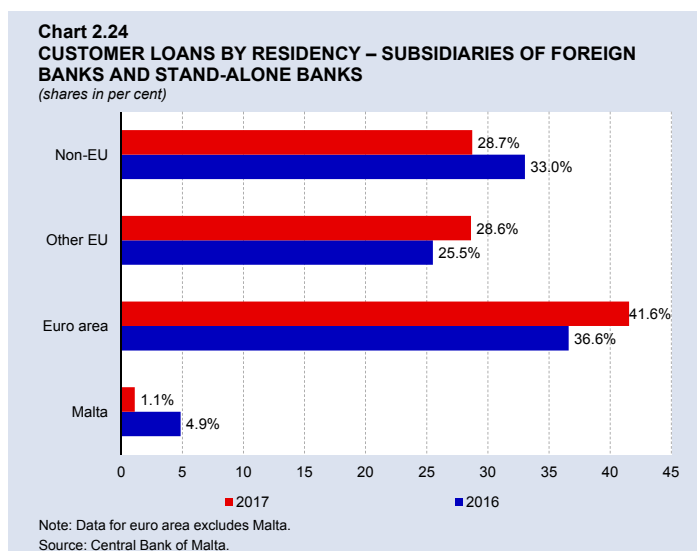
During the year the funding structure remained broadly stable with these banks funding their operations largely through the retail market; financing about 39% of total assets. Customer deposits increased by 16.1%, largely driven by higher inflows of deposits held by non-residents NFCs mostly located in European countries. This group of banks also reported an increase in resident customer deposits, mainly from NFCs. In terms of economic activity, these deposits were mainly from the financial and insurance sector; households; wholesale and retail trade; professional, scientific and technical activities; other services activities and manufacturing. Although increasing, resident customer deposits remained limited to 1.7% of the overall resident customer deposits in the banking system by end 2017.

Reliance on wholesale funding intensified during 2017, accounting for around a fifth of total liabilities. Most of these international banks relied on parent funding, but some also resorted to financing from other unrelated credit institutions. Capital and reserves accounted for almost 30% of total assets.

With a LCR of 280.7%, these banks are highly-liquid and are well-placed to meet their short-term obligations.

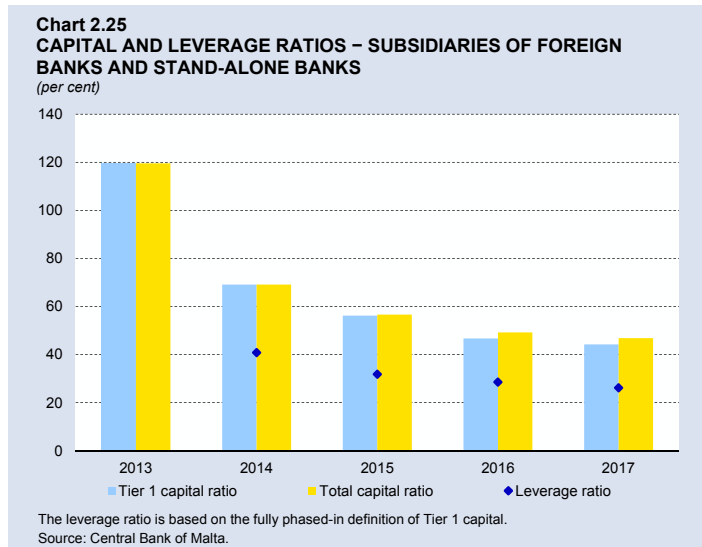
2.3.2.4 Capital and leverage

The total capital ratio contracted by 2.4 percentage points to 46.8%, but remained way in excess of the minimum regulatory requirement (see Chart 2.25). This occurred as total own funds narrowed while at the same time the total risk exposure rose somewhat. At 26.2%, the leverage ratio remained way above the 3%



regulatory minimum; with all banks exceeding this requirement.

Linkages of these banks with the domestic economy remained contained, originating primarily from retail deposits. Nevertheless, resident customer deposits accounted for just 8.7% of their balance sheet and only 1.7% of the total resident customer deposits in the whole banking system. Additionally, linkages with other local banks remained negligible and hence do not pose any contagion risks on the rest of the financial system and the economy at large.



3. STRESS TESTS

The Central Bank of Malta runs a range of stress tests and risk models to assess the resilience of the domestic financial system to extreme yet plausible events under different hypothetical adverse scenarios. Any areas of vulnerability are then highlighted. The degree of severity of the tested scenarios is a fundamental aspect of scenario design. Hence it is ensured that adopted scenarios are economically reasonable while effectively testing relevant risk factors that could potentially have a significant impact on the banks should the scenario materialise.

The four stress tests presented in this Chapter capture elements of credit risk, market risk, sovereign risk and liquidity risk; and consist of:

- (i) credit quality deterioration in the securities portfolio
- (ii) persistent deposit withdrawals
- (iii) a drop in property prices
- (iv) interest rate risk in the banking book.

The stress tests reveal that the core domestic and non-core domestic banking system is resilient to the different tested scenarios.

These stress test exercises are univariate in nature and the results presented are to be considered as indicative given that possible second round effects and the effect of simultaneous shocks are excluded. The results are not entirely comparable to those presented in the *2016 Financial Stability Review* given that one bank was excluded from the non-core domestic banks' tests.

Scenario 1: Credit quality deterioration

Core domestic and non-core domestic banks' securities portfolio is assessed against deterioration in its credit quality. The methodology, which builds on preceding EBA EU-wide stress testing exercises, allows for a distinction in the accounting treatment of banks' securities, i.e. whether marked-to-market (MTM) or held-to-maturity (HTM). In case of the former, the shock to the market price of credit risk is sourced from the iTraxx European Senior Financial index, given that the vast majority of banks' securities are denominated in euro. The widening of spreads for MTM securities is commensurate with the largest almost monotonic increase in the index between April 2011 and September 2011. Conversely, credit risk on securities which are HTM is quantified by assuming a three-notch downgrade in the securities' credit quality and applying the respective higher probability of default by credit grade. HTM securities are amortised and therefore not affected by market price movements. However, when the amortised cost is higher than the nominal value, the difference needs also to be provided for. By contrast, if the amortised cost is below par, the booked difference already takes into account part of the losses assumed to materialise. In line with international practice, a loss given default of 30-40% is assumed when quantifying the expected loss.

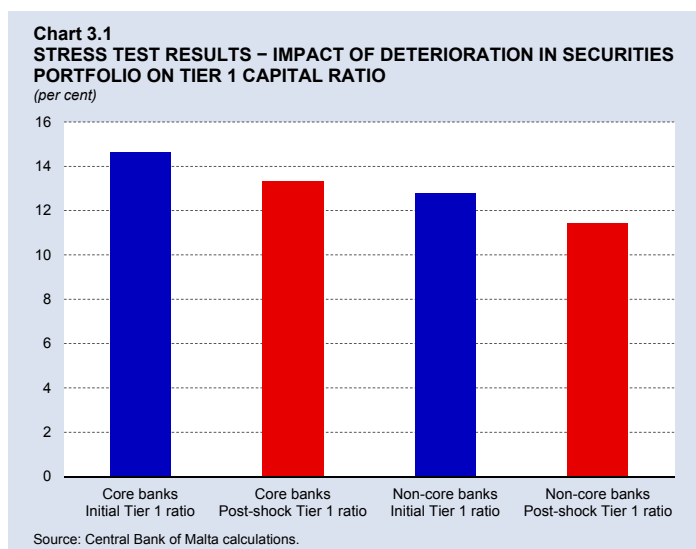
The magnitude of the shocks applied to the securities portfolio distinguishes between sovereign and non-sovereign exposures. Resulting losses are charged directly to capital while risk-weighted assets are assumed to remain constant.

Both core domestic and non-core domestic banks largely invest in investment-grade securities. Indeed, around 90% of core domestic banks' portfolio and 86% of non-core domestic banks' securities portfolio was rated at A- or better as at December 2017.¹ The structure of the securities portfolio of core domestic and non-core domestic banks remained broadly similar when compared to end 2016; however, a slight shift towards fixed-rate securities was noted in both core domestic and non-core domestic banks' securities portfolios, with core domestic banks to a more minor extent. The vast majority of the core domestic banks' portfolio, with the exception of one bank, is accounted for as non-HTM, while the non-core domestic banks' entire

¹ The rating grades are based on an internal index based on the second best credit rating of the three major rating agencies; namely Fitch Ratings, Moody's and Standard & Poor's.

portfolio is MTM; hence any market movements, both adverse and otherwise, would directly hit the banks' balance sheets.

The quantification of the aforementioned magnitude of shocks to HTM and non-HTM securities would result in a drop in the Tier 1 capital ratio of 1.34 percentage points and 1.36 percentage points for core domestic and non-core domestic banks, respectively with a resulting capital ratio of 13.3% and 11.5%, respectively. The materialisation of the assumed shocks would therefore leave domestic banks in a comfortable position to absorb potential losses when compared to the regulatory minimum Tier 1 capital ratio of 6% (see Chart 3.1 for an exhibit of results).



Scenario 2: Persistent deposit withdrawals

The liquidity stress testing framework is run on both core domestic and non-core domestic banks and tests for a bank-run type of scenario. In order to reflect times of severe liquidity shortage, extreme shocks are necessary as only the liquidity buffers of highest quality can ultimately safeguard banks. The test assesses whether individual banks' counterbalancing capacity is sufficient to meet assumed liquidity outflows arising from persistent deposit withdrawals. A survival period of five consecutive days and up to four weeks is assumed.

Among a number of data sources, the test makes use of granular information on banks' bond holdings as well as market information to assess individual banks' counterbalancing capacity. The latter is defined as the quantity of funds at the disposal of a financial institution to meet liquidity requirements and includes elements such as cash, the excess on the reserve deposit requirements, and the sale of marketable assets, amongst others. Banks' counterbalancing capacity, is shocked so as to reproduce adverse liquidity conditions when a bank is forced to sell fair value securities to meet deposit withdrawals under two different scenarios. The test also assumes that intra-group funding and interbank lending would be unavailable given that such funding may not be considered as guaranteed in times of stress.

Under the first scenario, banks are allowed to obtain European Central Bank (ECB) funding only against securities that were pledged with the ECB as at the reference date – December 2017.² Under this scenario, banks would have to sell the remaining fair value securities at fire sale prices. Banks that hold securities until maturity (which are in the minority) would be at a disadvantage given that, by way of assumption, unless these are pledged, no use of such securities can be made to obtain liquidity.

Under the second scenario, banks are allowed to pledge all eligible securities with the ECB and sell the remaining fair value securities at fire sale prices.³ The main difference between the two sets of conditions relates to the use of unpledged eligible securities. Given that the haircuts assumed for fire sale prices are higher than the valuation haircuts that would be implemented by the ECB, the second set of conditions renders the test slightly more lenient than the first but more plausible.⁴

² Securities pledged with ECB are subject to a liquidity haircut as per ECB Guideline <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:02015O0035-20180416&from=EN>.

³ Eligible securities refer to securities that can be pledged with the ECB as collateral for Eurosystem credit operations.

⁴ See Box 2 in the *Financial Stability Report 2015* for further detail on the methodology and haircuts applied in the liquidity stress test. The haircuts on ECB eligible assets are updated in line with guidelines issued by the ECB. Other haircuts may also be revised.

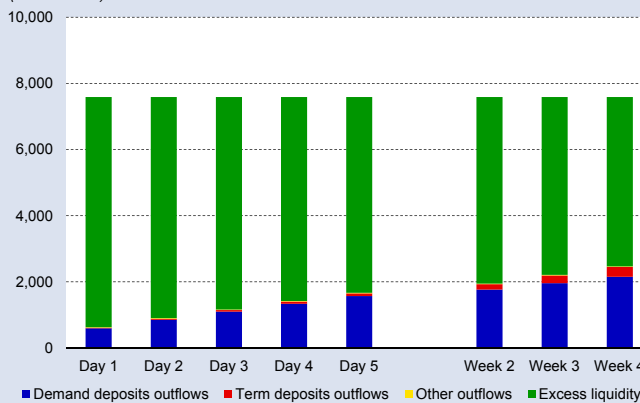
In terms of outflows, the magnitude of deposit withdrawals during the survival period differs by type of customer as well as term to maturity.

Charts 3.2 to 3.5 present the results for core domestic and non-core domestic banks under the two respective scenarios. The bar chart plots the liquidity flows and the excess liquidity for the first five days followed by the subsequent three weeks. The total length of the bar in the chart represents the counterbalancing capacity which is assumed to remain fixed during the survival period. As the scenario proceeds in time, the liquidity outflows increase and excess liquidity contracts. The system will remain liquid if all deposit withdrawals are met by the available post-shock counterbalancing capacity.

As mentioned in Chapter 2 banks are currently operating with ample liquidity and have sufficient liquidity buffers to cater for withdrawals within the survival period. During 2017, an increase in counterbalancing capacity was noted, particularly in placements with the Central Bank of Malta even though such deposits attract negative rates.⁵ Indeed, both core domestic and non-core domestic banks would be able to survive the rather conservative assumptions applied in the test with relative ease.

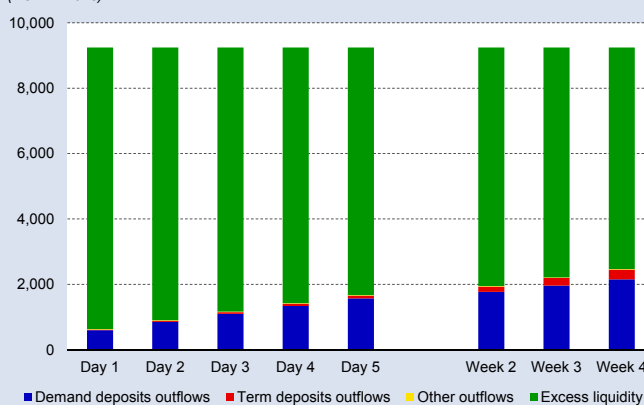
As expected *a priori*, excess liquidity stemming from the difference between counterbalancing capacity and outflows under the second Scenario is higher than the excess liquidity under the first Scenario. Excess liquidity is reflected by the green bar in Charts 3.2 to 3.5. Deposit outflows remain the same under both scenarios on the basis of the applicable assumptions. The tests demonstrate that both

Chart 3.2
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS – SCENARIO 1, RESTRICTED ECB FUNDING, CORE DOMESTIC BANKS
(EUR millions)



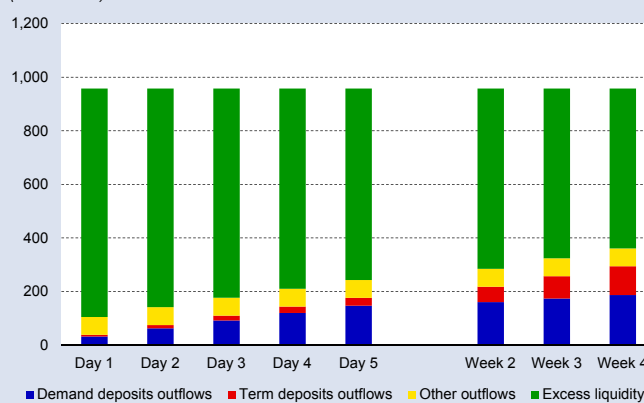
Source: Central Bank of Malta.

Chart 3.3
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS – SCENARIO 2, UNRESTRICTED ECB FUNDING, CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.

Chart 3.4
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS – SCENARIO 1, RESTRICTED ECB FUNDING, NON-CORE DOMESTIC BANKS
(EUR millions)



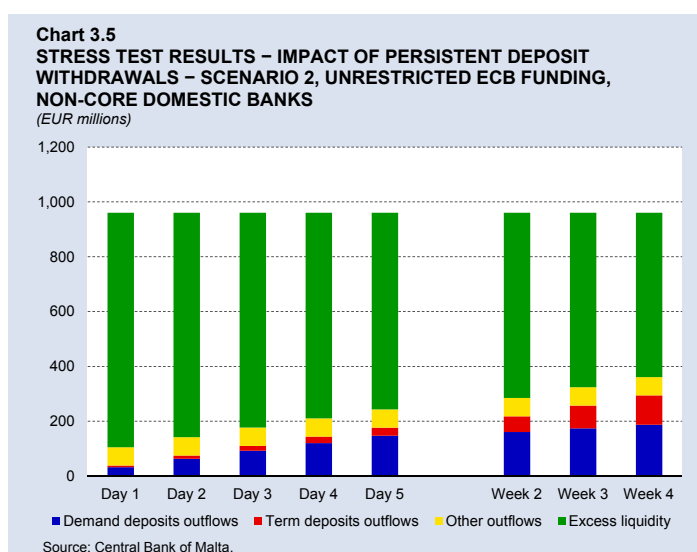
Source: Central Bank of Malta.

⁵ https://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

the core domestic and non-core domestic banks remain with ample liquidity even following four weeks of persistent deposit withdrawals.

Scenario 3: A drop in property prices

The scenario tests for the impact of exogenous shocks to house prices on core domestic banks' balance sheets over a one-year simulation horizon.⁶ The shocks would affect banks' capital position owing to a drop in the value of collateral and to a corresponding increase in non-performing loans. The results are comparable to the *Financial Stability Report 2016*, but not to preceding reports given that in 2016, refinements were carried out to the framework; whereby, the existing relationship between house prices and NPLs is now determined via STREAM, the Bank's macro-econometric model.⁷ Also, the revised framework caters for a different reaction of households' and non-financial corporations' (NFC) NPLs to changes in house prices, as determined within the model.



The magnitude of the assumed shocks to house prices is determined on the basis of the historical standard deviations of the property price index. Two scenarios are considered: a 7.5% shock under a baseline scenario, approximately equivalent to one historical standard deviation; and a 30% drop in house prices under an adverse scenario, equivalent to around four historical standard deviations.⁸ To note that the shock to property prices is rather extreme given that it is applied to collateral values that are already discounted by haircuts that banks normally apply when approving loans.

The test considers that as collateral values decline, loan loss provisions would have to increase accordingly, to satisfy the requirement of full coverage of NPLs. Furthermore, the drop in property prices coincides with an increase in NPLs arising from negative wealth effects, with additional NPLs leading to a further increase in loan loss provisions.

The impact of the assumed shocks under this scenario would influence both the numerator and denominator of the Tier 1 capital ratio. On the one hand, the increase in provisions due to the drop in house prices and the consequent increase in NPLs is charged to capital by the equivalent of the uncollateralised part of the facility affecting the numerator. On the other hand, the increase in NPLs is assumed to influence the level of risk-weighted assets owing to higher risk weights applicable to performing loans affecting the denominator of the capital ratio.

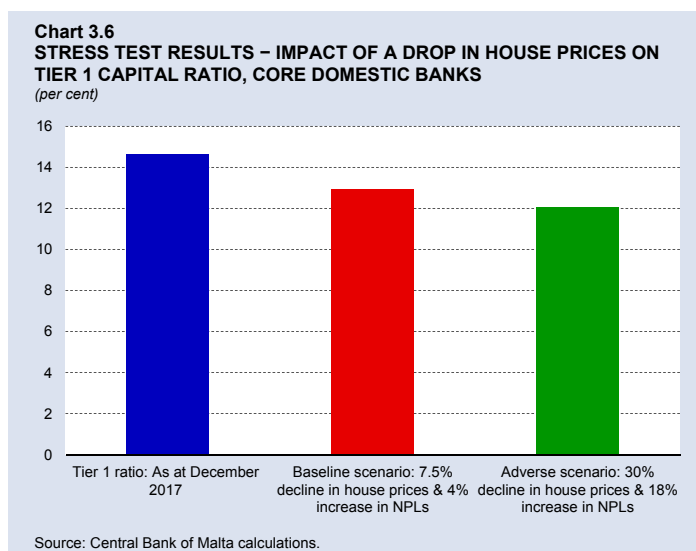
⁶ The test is run on core domestic banks only as they are the main mortgage lenders. The drop in property prices is assumed to fully translate into lower property-related collateral values. Thus, non-real estate related syndicated loans are excluded from the exercise in order for the test to be applied only to the relevant portfolio of loans.

⁷ <https://www.centralbankmalta.org/macro-econometric-model>

⁸ To note that the magnitude of the adverse shock is comparable to the real estate shocks applied in the 2016 Irish FSAP (Financial Sector Assessment Programme) and the 2016 UK stress test. "Ireland Financial Sector Assessment Program, Technical note – Stress Testing the Banking System", IMF Country Report No. 16/315, September 2016. Publication available at <https://www.imf.org/external/pubs/ft/scr/2016/cr16315.pdf>. Stress testing the UK banking system: 2016 results", Bank of England, November 2016. Publication available at <http://www.bankofengland.co.uk/financialstability/Documents/fpc/results301116.pdf>.

Results show that at the aggregate level, core domestic banks would comfortably withstand the applied shocks, both under the baseline and adverse scenario. During 2017, core domestic banks continued to increase their capital levels, thereby improving their loss absorption capacity. Core domestic banks' Tier 1 capital ratio would drop by 1.3 percentage points to 13.4% under the more adverse scenario (see Chart 3.6).

Scenario 4: Interest rate risk in the banking book – Impact on net interest income



Interest rate risk in the banking book (IRRBB) refers to the current or prospective risk to banks' capital and earnings arising from movements in interest rates. On the one hand, when interest rates change, the economic value of equity (EVE) is affected due to the revised present value of future cash flows. On the other hand, changes in the interest rates would also impact banks' net interest income (NII) instantaneously by altering interest rate sensitive income and expenses. Both effects are complementary to each other and need to be taken into account; however, this exercise is a sensitivity analysis which aims to quantify solely the impact of changes in interest rates on NII.⁹

The exercise applies six scenarios of changes in the interest rate term structure on the banking book of core domestic and non-core domestic banks as prescribed by the Basel Committee for Banking Supervision (BCBS) and the EBA guidelines.^{10,11} The scenarios considered in this exercise affect the term structure of interest rates differently depending on the maturity of the instruments being considered and the currency in which they are denominated.¹² Only EUR, GBP and USD are being considered as the material currencies in which the banking book is denominated. The shocks applied in the six scenarios are hypothetical and exhaustive as they consider all possible changes in the term structure of interest rates and consequently do not in any way indicate any scenario as being more likely than the other. Chart 3.7 shows the six scenarios for the EUR yield curve as at December 2017.¹³

This exercise focuses on the resulting NII from the scenarios' impact on loans, securities, deposits, own bond issuances and interbank (assets and liabilities with other credit institutions) held in the banking book. In the absence of granular information on derivatives, these instruments, particularly those held to hedge against adverse movements in interest rates, are excluded from the exercise. The sensitivity analysis assumes a constant balance sheet over a one-year horizon; thereby, any instruments which mature within the year are rolled over with similar instruments at the prevailing interest rates in the respective scenario. The impact on NII would influence banks' retained earnings and in turn their capital positions through a

⁹ Refer to *Financial Stability Report 2016* Chapter 4 for more detail on the methodology for the IRRBB test. The same methodology is applied.

¹⁰ Refer to Annex 2 of www.bis.org/bcbs/publ/d368.pdf and the EBA Guidelines on the Management of interest rate risk arising from non-trading activities <https://www.eba.europa.eu/documents/10180/1084098/EBA-GL-2015-08+GL+on+the+management+of+interest+rate+risk+.pdf>.

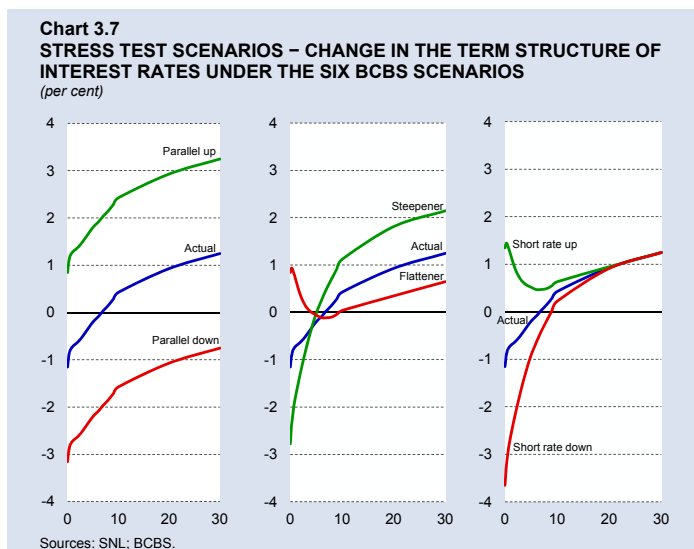
¹¹ In its 2017 sensitivity analysis of interest rate changes on the banks' banking books as part of its Annual Supervisory Review and Evaluation Process (SREP), the ECB also applied its hypothetical shocks from the BCBS standards <https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/sr170228.en.html>.

¹² The BCBS prescribed scenarios considered are: Parallel Up; Parallel Down; Steepener; Flattener; Short Rate Up and Short Rate Down.

¹³ Given that the scenarios for each currency display similar movements, only the EUR yield curve is being reported.

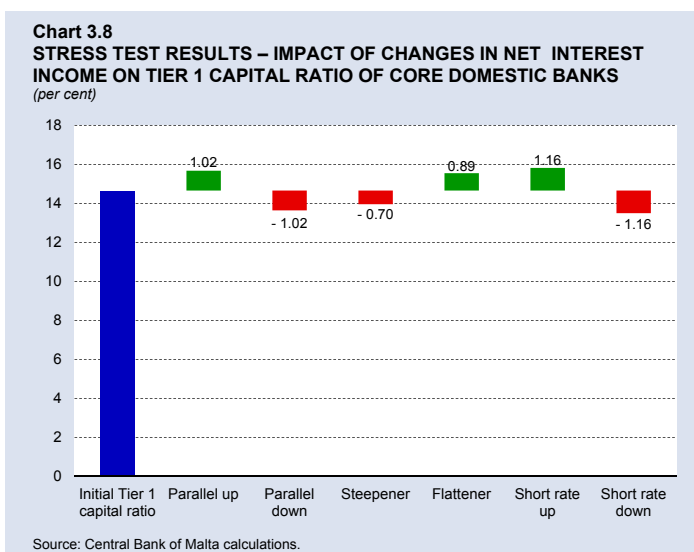
release or accumulation of capital. Results are presented hereunder in terms of banks' Tier 1 capital ratios under the various scenarios applied.

Given that the vast majority of loans have a variable interest rate and are thus re-priced immediately, the largest impact would occur under the 'Short Rate Down' scenario. On the contrary, impact of the shocks on the securities portfolio depends on the maturities of the securities held by the respective bank. The largest impact on NII occurs under the 'Parallel Down' or the 'Short Rate Down' scenario given that more than half of core domestic and non-core domestic banks' securities will mature within two years.



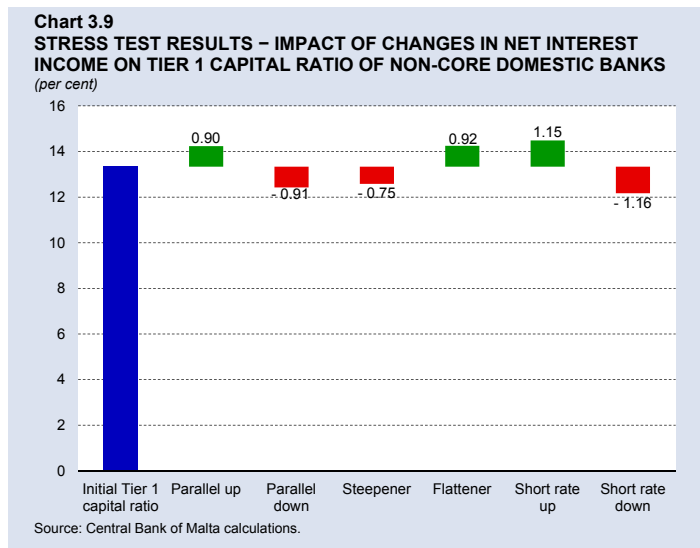
In the case of deposits, the change in NII is influenced by the sight and current deposits, as well as, fixed-term deposits which are locked for less than a year, as the latter are rolled over at the prevailing shocked interest rate. The highest shock to interest rates on deposits is assumed under the 'Short Rate Up' scenario. As for interbank exposures, with the exception of one bank, domestic banks are net holders of interbank assets and experience the worst outcome for NII under the 'Short Rate Down' scenario. With regards to own bond issues, only two banks had quoted bonds on the Malta Stock Exchange as at the reference date, which are bound to mature within the year. Given the static balance sheet assumption, the quoted bonds are rolled over at the prevailing interest rates hence the negative impact on NII via a higher expense is experienced under the scenarios assuming an increase in interest rates. Conversely, this source of funding becomes cheaper under the scenarios that assume a decrease in interest rates.

Upon netting for all asset and liability classes tested in the sensitivity analysis referred to above, the worst impacts from the six BCBS exhaustive scenarios on NII for aggregate core domestic and non-core domestic banks occur under the 'Short Rate Down' scenario. Under this scenario, the net interest margin (NIM), expressed as the difference between interest income and expenses divided by the interest-bearing assets, is equal to -1.01% and -1.25%, respectively for core domestic and non-core domestic banks. In addition, this scenario leads to a drop of 1.16 percentage points for both core domestic and non-core domestic banks resulting in a capital ratio of 13.50% and 12.17%, respectively. Consequently, the banks' Tier 1 capital ratios remain well-above both the minimum regulatory requirement of 6%.



In contrast, the 'Short Rate Up' scenario yields the most favourable results. In this case, the NIM is equal to 1.01% and 1.24%, for core domestic and non-core domestic banks, respectively. In addition, this scenario leads to an increase of 1.16 and 1.15 percentage points in the capital ratio to 15.82% and 14.48%, respectively for core domestic and non-core domestic banks.

See Charts 3.8 and 3.9 for an exhibit of results under all scenarios for both core domestic and non-core domestic banks.



4. INSURANCE COMPANIES AND INVESTMENT FUNDS

4.1 Domestic insurance companies

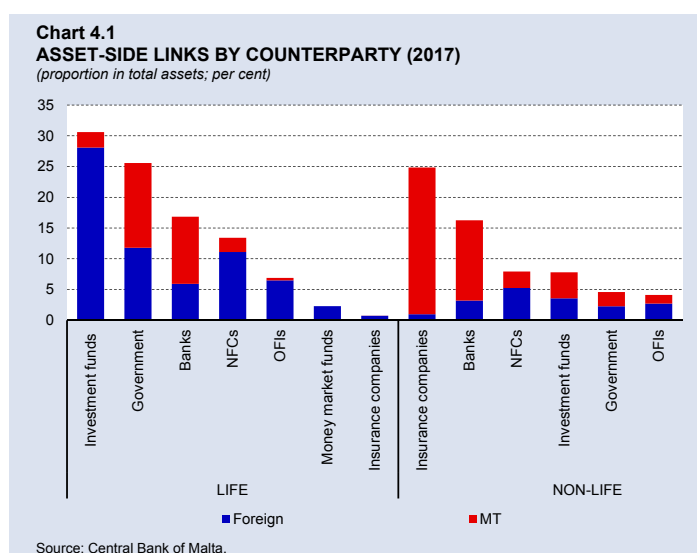
The insurance industry in Malta composed of 63 insurance and reinsurance companies, managed total assets of €10.9 billion in 2017, equivalent to 97.8% of GDP.¹ Gross premia per capita (insurance density) in Malta amounted to €9,216.2 in 2017, up from €8,139.5 a year earlier. In 2017 Malta ranked fourth in the euro area in terms of insurance density, preceded by Liechtenstein, Luxembourg and Ireland.² The penetration rate defined as gross premia to gross domestic product (GDP) rose from 36.7% in 2016 to 39.0% in 2017.

Out of these 63 insurance companies domiciled in Malta, only eight companies underwrite risks situated in Malta as their main line of business. These domestically-focused companies consisted of three life insurance companies, four non-life insurance companies and one non-life protected cell company (PCC). By end 2017 total assets of these insurance companies stood at €3.9 billion, down by 0.2% over the previous year, and equivalent to 34.8% of GDP. Given their systemic relevance to the domestic economy, these eight companies will be the focus of this Chapter.

The domestic insurance industry is structurally-linked with the Maltese banking sector as two of the domestic life insurance companies and one non-life company are part of the same group of two core domestic banks. These companies are however set up as separate legal entities, isolating potential spill-over effects from one company to the next within the same group. Furthermore, on the asset side, links with the local banking sector accounted for 11.1% of the domestic insurers' total assets, mainly in the form of deposits (see Chart 4.1).

Life and non-life domestic insurance companies also have business links with reinsurance companies, most of which are situated in other European countries and in the rest of the world. The median reinsurance part of their premia stood at 13.4%, compared with an EU life and non-life median of around 5% in December 2017.³ Contagion and default risks are however minimised given that reinsurance is spread across a number of reinsurers which are generally highly-rated.

Counterparty exposures of the domestic insurance companies vary considerably between the life and non-life segment. Life insurance companies had 28.1% of their assets invested in foreign investment funds. Malta Government Stocks (MGS) accounted for 13.8% of their assets, followed by holdings of foreign sovereign securities. However, life insurers are small players in the local Government's funding plans, as their MGS holdings are equivalent to less than 8% of outstanding government debt. A further 11.1% is held in the form of common equity and bonds in foreign non-financial corporations (NFC). In contrast, non-life insurers are linked to other related domestic insurance companies within their group through holding of share capital.



¹ During the year, one new insurance licence was issued and one insurance company surrendered its licence.

² Source: EIOPA Financial Stability Report June 2018.

³ The median reinsurance part of premia for the life and non-life sectors in 2017 stood at 4.5% and 27.3%, respectively. The figure for the European Union refers to both the life and the non-life insurance sectors. Data is sourced from EIOPA Risk Dashboard April 2018.

The funding of the domestic insurance companies is mainly generated through premia paid by resident households. Indeed, technical reserves booked against policies held by domestic households accounted for 71.5% of their balance sheet. On the other hand, insurance products sold by these eight companies accounted for around 14% of the Maltese households' net financial wealth and only 0.3% of the financial assets of domestic NFCs in 2017.^{4,5}

During the year, risks stemming from the domestic insurance sector remained contained, with the sector remaining resilient to external challenges such as low interest rates. Capital levels remained adequate and performance was positive, with minimal involvement in bank-like activities. Profitability remained strong and liquidity levels were ample. The level of interconnectedness of these companies with local banks and the Government remained at similar levels as the previous year. Contagion risk is considered to be low and contained.

4.1.1 The domestic life insurance companies

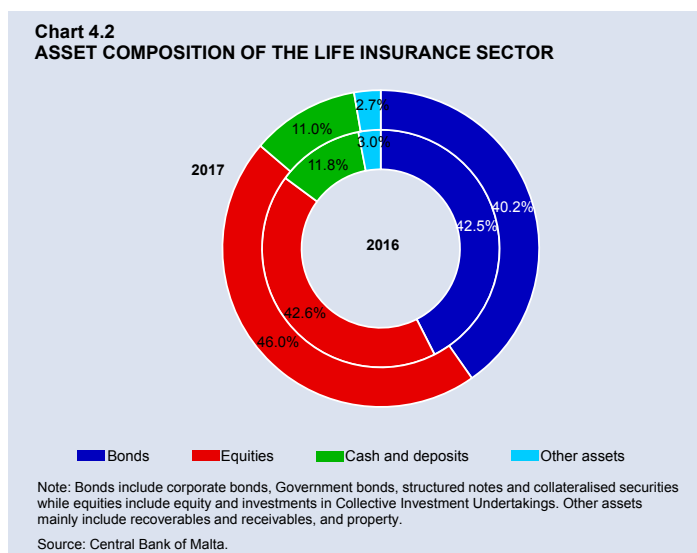
In 2017 total assets of the domestic life sector reached €3.4 billion, equivalent to 31.0% of GDP. These assets remained concentrated in two companies, which held 96.7% of gross premia written by the life segment.

Euro area life insurance companies moved towards index- or unit-linked business, with these products accounting for 35.1% of technical provisions in 2017, from 33.6% a year earlier. In contrast, domestic life insurers decreased their index- or unit-linked business from 39.1% of technical reserves in 2016 to 32.1% in 2017.⁶ The latter move was possibly due to the heightened volatility in international markets, driving policy holders to opt for plain vanilla products, offering lower risk and possibly lower returns.

Asset quality

The domestic life insurers did not make particular changes in their asset allocation, remaining mainly invested in bonds and equity, accounting for 40.2% and 46.0% of their total assets, respectively, in 2017. The rest was mainly composed of cash and deposits (see Chart 4.2). In terms of currencies, the bulk of their assets were denominated in euro, with a limited amount denominated in Pound Sterling. Furthermore, only 4.0% of total assets were held in the United Kingdom, restricting the direct adverse implications from a 'hard Brexit'.

Sovereign debt accounted for over two thirds of their bond portfolio, with MGS representing more than half of the sovereign bond portfolio (see Chart 4.3). The rest of the sovereign debt holdings related to issues by the Italian, French and German governments. The overall quality of the life sector's sovereign bond portfolio is of medium investment-grade.⁷



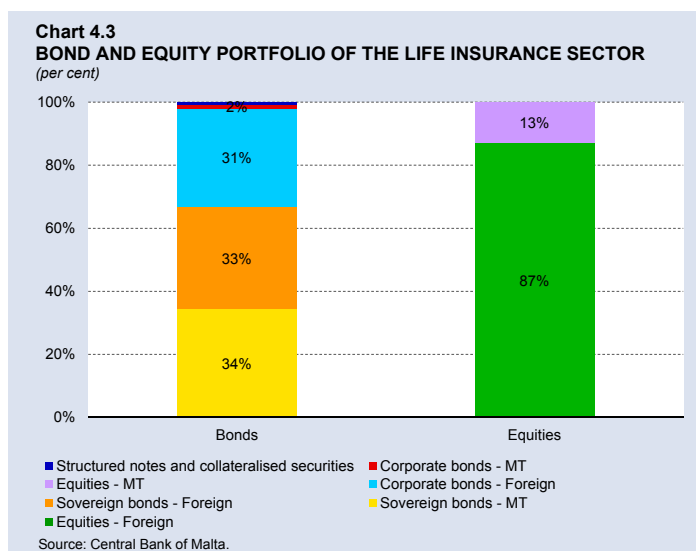
⁴ These percentages include insurance, pension funds and standardised guarantees.

⁵ Source: Central Bank of Malta.

⁶ Source: EIOPA. For unit-linked policies, part of the premium paid is utilised to provide insurance cover to the policy holders, while the rest is invested on behalf of the policyholder. For index-linked policies, the returns are linked to the performance of one or more indices.

⁷ High-rated bonds range from AAA to AA-, medium-rated bonds range from A- to A+ and low-rated bonds range from BBB+ to BBB- (S&P).

More than half of the corporate bonds were issued outside the euro area, largely bank bonds in several jurisdictions and NFC bonds in various countries, mainly the United States.⁸ Holdings of euro area corporate bonds (excluding Malta) accounted for 42.6% of the corporate bond portfolio, and were largely composed of bonds issued by NFCs in France and other financial intermediaries (OFI) in the Netherlands. Holdings of domestic corporate bonds, which made up less than 5% of the corporate bond portfolio, were mainly issued by OFIs, banks and NFCs. Over 60% of the corporate bonds were held in the form of plain vanilla bonds, followed by hybrid bonds, representing another 21.2% of corporate bond holdings.⁹

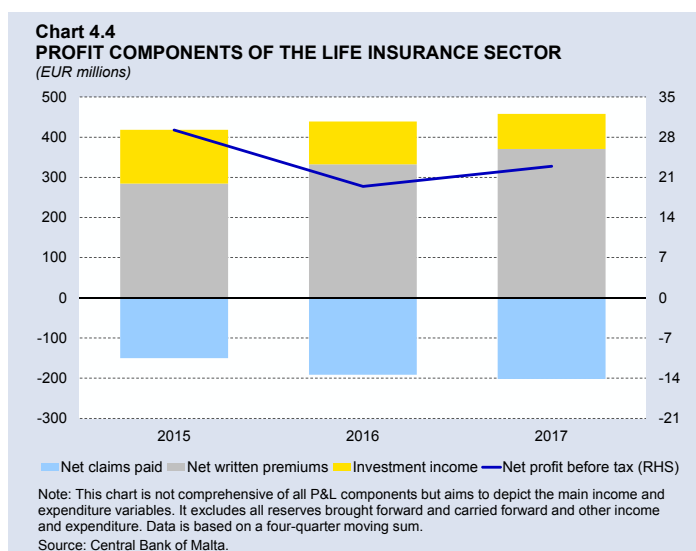


Equity holdings were concentrated in equity funds abroad, predominantly in the euro area, followed by common equity and units in debt funds, mainly abroad. Equity issued in Malta corresponded to 13.0% of total equity holdings.

The life insurance companies did not show particular signs of search-for-yield behaviour in 2017. Their participation in non-traditional non-insurance activities (NTNI) through loans remained low and contained, equivalent to only 0.2% of their total assets, largely loans channelled to NFCs.¹⁰

Profitability

The performance of the domestic life insurance sector remained positive with pre-tax profits rising by 18.1% to around €23 million (see Chart 4.4). Net premia grew by 11.5%, driven by new and rolled over 'with-profits single premium' products which were partly offset by an increase of 5.5% in net claims.¹¹ Higher profits pushed up the post-tax profits as a share of the excess of assets over liabilities, which is a proxy to the return on equity (ROE). For the domestic life insurance companies, this ratio improved by 1.5 percentage points to 6.2% in 2017, but still below the



⁸ The corporate bond portfolio includes corporate bonds, structured notes and collateralised securities.

⁹ Hybrid bonds are bonds with debt and equity-like features.

¹⁰ NTNI activities refer to bank-like activities such as credit intermediation.

¹¹ Single premium business is a lump sum investment plan with returns determined by the performance of the insurance company.

EU median of about 7%.¹² The post-tax return on assets (ROA) improved from 0.4% in 2016 to 0.5% by 2017, in line with the EU median for 2017Q4.¹³

Insurance (underwriting) risk of the domestic life insurance sector remained contained, as growth in gross written premia of 11.0% was largely in line with that reported in 2016. Such increase in premia exceeded the median of around 6% reported across EU life insurance companies in December 2017.¹⁴ The post-tax return on premia stood at 4.8% for domestic life companies in 2017, up from 4.0% a year earlier.

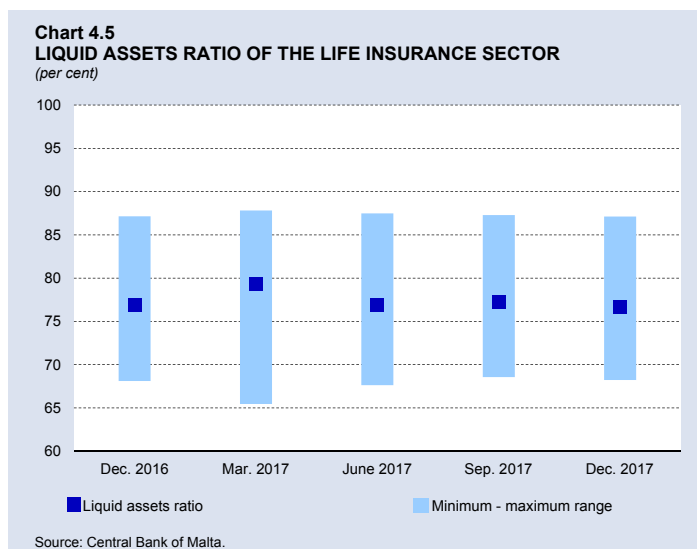
Income from investments dropped by around 18% with the ratio of investment returns to average assets falling from 3.0% in 2016 to 2.5% in 2017. Such developments reflected net fair value losses arising from both exchange rates and price fluctuations.¹⁵

Liquidity

The life insurance sector remained highly liquid with a liquid asset ratio of 76.7% compared to 77.3% a year earlier, higher than the EU median (for both the life and non-life sector) of around 67% (see Chart 4.5).^{16,17} A healthy level of liquidity enables insurers to meet unexpected cash withdrawals without the need to fire sale holdings of other assets, which may result in substantial realised losses.

Capital adequacy

Shareholders' funds, predominately composed of the reconciliation reserve, ordinary share capital (gross of own shares) and the surplus fund, declined by 1.7% to €255.4 million.¹⁸ All the domestic life insurers remained adequately capitalised with a median Solvency Capital Requirement (SCR) of 286.5%. This rose by almost 22 percentage points during the year, well-above the 100% minimum threshold and exceeding the EU median of around 185% in December 2017 (see Chart 4.6).¹⁹ The capital com-



¹² Source: EIOPA Risk Dashboard April 2018 – Figure refers to both the life and non-life sectors.

¹³ See footnote 12.

¹⁴ Source: EIOPA Risk Dashboard April 2018.

¹⁵ Investment returns capture interest receivable, dividends receivable, rental income, exchange differences, income from financial investments at fair value through Profit and Loss, gains/losses from revaluation of financial assets (net fair value gains/losses), gains/losses from revaluation of investment property (net fair value gains/losses) and gains/losses from revaluation of investment property (net fair value gains/losses), other technical income, interest expense, share of losses from related parties, investment expenses and other “allocated investment return”.

¹⁶ The assets having a liquidity weighting of 100% are cash and cash equivalents, Government bonds and listed equities. Corporate bonds and deposits other than cash equivalents have a liquidity weighting of 80%. Assets having a weighting of 30% include collateralised securities, structured notes, units in Collective Investments Undertakings, derivatives, unlisted equities, other investments, property (other than for own use), own shares (held directly) and pension benefit surplus. Amounts due in respect of own fund items or initial fund called up but not yet paid in have a liquidity weighting of 4%.

¹⁷ See footnote 14.

¹⁸ The surplus fund refers to any amount over and above the reserve level to ensure that insurance companies have enough financial resources to meet claims.

¹⁹ The SCR reflects the amount of capital required to meet all obligations over one year, taking into account underwriting risk, pricing risk, provisional risk, market risk, credit risk, liquidity risk and operational risk, and is measured at a 99.5% VaR confidence level. Breach of an adequate level of capital commensurate with the risks faced by the individual insurers will compromise the protection of policyholders and beneficiaries, and result in supervisory consequences. The MCR reflects the minimum level of security below which the amount of financial resources should not fall. If the level of eligible basic own funds falls below the MCR, the authorisation of the insurer would be withdrawn.

position of the life insurance segment remained of very high quality, almost all in Tier 1 own funds.

4.1.2 The domestic non-life insurance companies

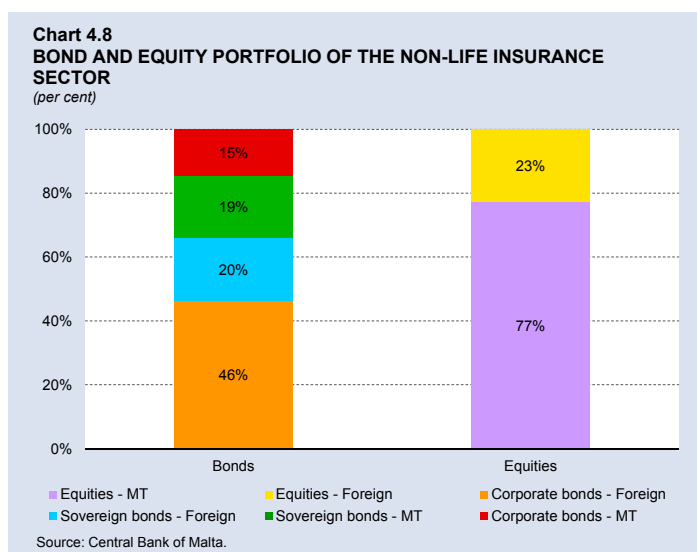
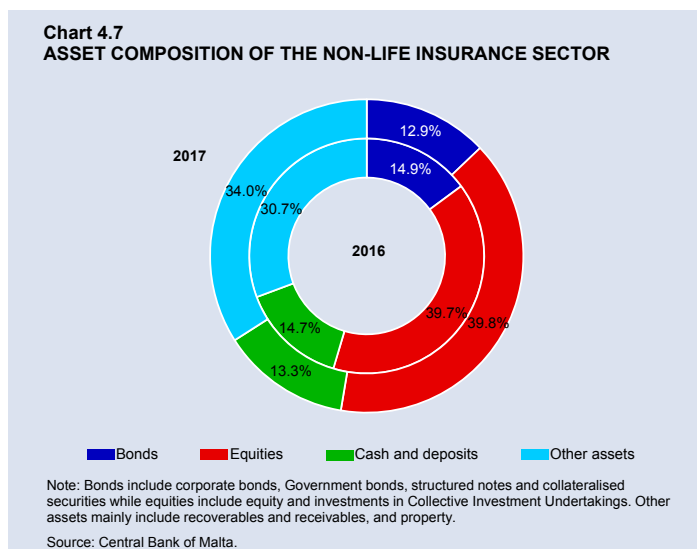
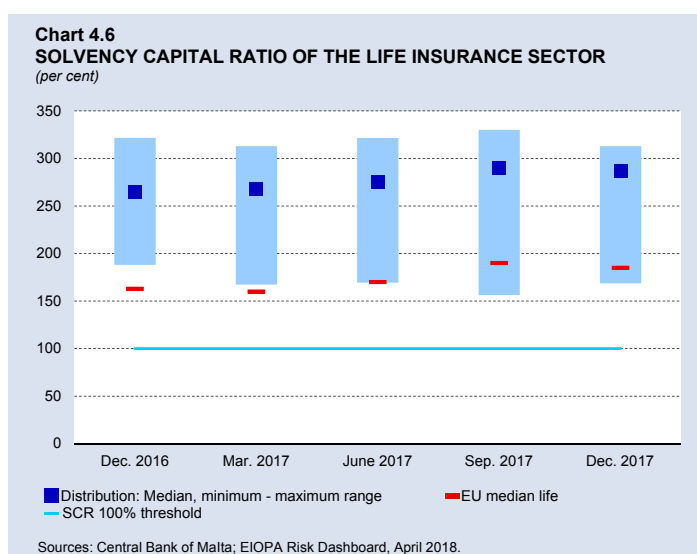
Assets held by the domestic non-life insurance sector increased by 10.0% to €419.1 million in 2017, equivalent to 3.8% of GDP.

Asset quality

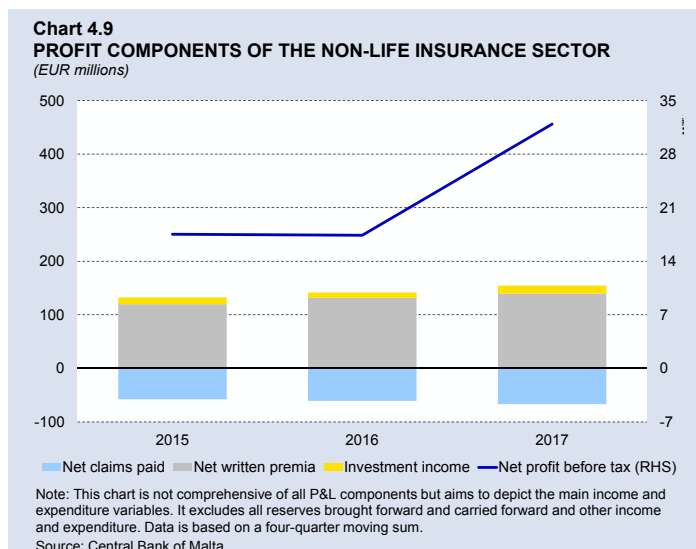
At 39.8%, equity holdings remained the largest component of the domestic non-life sector's assets (see Chart 4.7). Bond holdings accounted for 12.9% of the non-life insurers' assets, with the rest consisting of recoverables and receivables, as well as cash, deposits and fixed assets. In terms of currency denomination, the large majority of their assets were held in euro, with only a limited share held in Pound Sterling. Assets held in the United Kingdom amounted to around 2% in 2017. The direct implications from a 'hard Brexit' for domestically-focused non-life insurers on their exposures are thus limited.

Over three fourths of the non-life's equity holdings were issued in Malta and consisted mainly of common equity in related companies, which increased by 1.8% during the year (see Chart 4.8). Holdings of foreign equities also grew to around 23% of overall equity holdings. These were largely issued in Ireland, Germany and France, mostly as common equity in NFCs and as units in investment funds.

Almost half of the bond portfolio was composed of foreign corporate bonds, mainly issued in the United States, the United Kingdom and the Netherlands, while another 14.6% were corporate bonds issued in Malta. The overall rating of their



corporate bond portfolio is medium.²⁰ Foreign sovereign bonds, mainly issued in Italy and Spain, accounted for around one fifth of the non-life insurers' bond portfolio, and another 19.5% was held in MGS. The overall rating of the non-life sovereign bond portfolio is of medium investment-grade. There were no particular changes in the geographical diversification of the bond portfolio. At 0.8% of their assets, loans by the non-life insurance sector remained low and contained. These primarily consisted of uncollateralised loans to unrelated domestic insurance companies.



Profitability

The improvement in profits of the non-life insurance sector was more pronounced than in the life insurance segment, with pre-tax profits surging by around 83% (see Chart 4.9). This notable increase was driven by the results of one company, which posted a rise in income on the back of an increase in motor insurance tariffs. Overall, net premia for the non-life insurance sector increased by 5.9% and were in part outweighed by a 10.0% increase in net claims paid. Profits were also boosted by investment returns, up by around 54%, largely driven by one company which registered higher intra-group dividends and favourable fair value movements on property investments. At the end of 2017, the post-tax return on premia stood at 17.0%, up from 9.7% at the end of 2016, whereas the investment return to average assets increased from 2.6% to 3.6% in 2017.²¹

The non-life insurance sector continued to make underwriting profit, as shown by the combined ratio which compared the insurers' expense with their main income. It stood at 74.3% in 2017, down from 91.7% in 2016 and remaining significantly below the 100% threshold.²² The improvement was due to drops in net claims incurred and operating expenses, though the latter to a lesser degree.²³ The combined ratio of the domestic non-life segment indicated better underwriting performance than in the rest of the EU countries, whose median stood at around 98% in December 2017.²⁴

In 2017, the return on excess of assets over liabilities for the non-life insurance segment rose to 11.8% from 6.6% in 2016, whereas the ROA after tax improved from 3.4% in 2016 to 5.9% by the end of 2017.

Liquidity

The liquidity level of the non-life sector was lower than that for the life sector, with a liquid asset ratio of 35.3% in 2017. This is mainly due to the fact that almost one fourth of their assets are tied in intra-group equity holdings and around 13% of their assets are reported as recoverables and receivables. Both asset classes are considered as illiquid (see Chart 4.10).²⁵

²⁰ High Rated bonds range from AAA to AA-, medium-rated bonds range from A- to A+ and low rated bonds range from BBB+ to BBB- (S&P).

²¹ Return to premium is calculated as profit after tax as a proportion of net premium.

²² The combined ratio is measured as the sum of net claims incurred and the net operating expenses as a proportion of net earned premia. A combined ratio of less than 100% portrays underwriting profit as insurers are taking in more in premia than paying out in claims and other expenses.

²³ Net claims incurred are reported when an insured event has happened and against which the insurer may be liable if a claim is made. Conversely, net claims paid are triggered at the time a claim is paid, rather than at the time a claim is first reported or at the time the injury or damage occurs.

²⁴ Source: EIOPA Risk Dashboard April 2018.

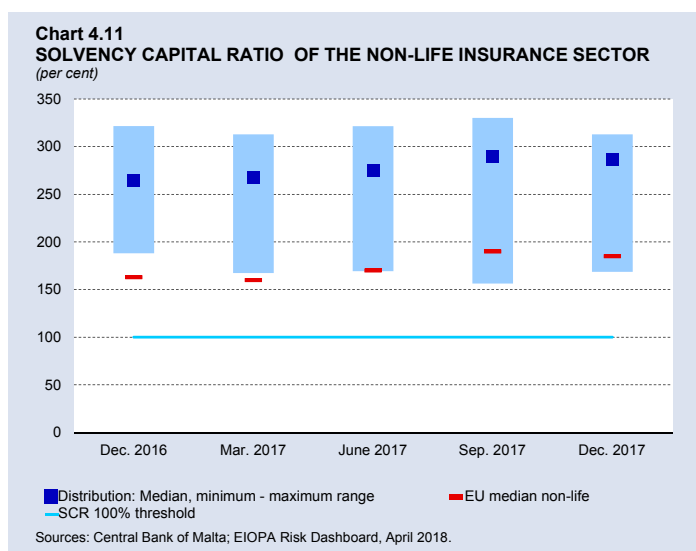
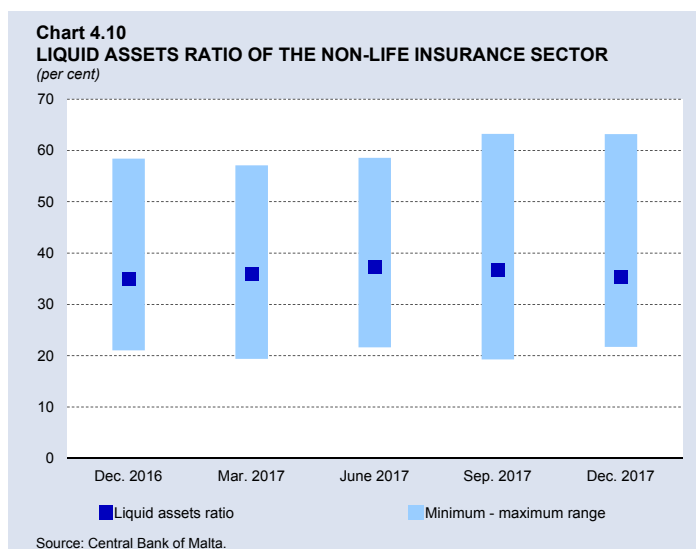
²⁵ Intra-group equity holdings and receivables and recoverables carry a zero weighting when determining the extent of liquidity.

Capital

The median SCR coverage ratio of the domestic non-life sector stood at 254.0%. This ratio decreased by almost 5 percentage points from a year earlier, but still remained higher than the EU median for the non-life insurance sector of around 210% in December 2017 (see Chart 4.11).²⁶ The large majority of total own funds was in Tier 1 own funds.

Risk outlook

Overall, the outlook for the domestically-focused insurance sector remains positive, buttressed by a healthy economic scenario. Possible changes to passporting rights following Brexit are not expected to significantly impinge upon the performance of the domestic insurance companies, given their domestic scope. In 2017 the majority of the life and non-life insurers' assets remained denominated in euro, thus direct exposures through asset holdings in Pound Sterling are limited. Moreover, asset exposures to the United Kingdom were contained to around 4% of total assets. Solvency II requirements are anticipated to be maintained by the United Kingdom, suggesting that Brexit should have a limited impact on the UK's legislative and supervisory approach.



4.2 Domestic investment funds

As at December 2017, 44 sub-funds were considered as systemically-relevant for Malta, given that their main investors are residents of Malta, up from 37 in the previous year as three sub-funds licensed in 2016 started reporting in 2017, coupled with four newly-licensed sub-funds in 2017. The universe of resident investment funds consisted of 26 retail Undertakings for the Collective Investment in Transferable Securities (UCITS) (61.2% of the domestic funds' NAV), followed by seven Alternative Investment Funds (AIF) (29.7%), eight Professional Investor Funds (PIF) (8.9%) and three retail non-UCITS (0.2%). The net asset value (NAV) of these funds stood at €1.8 billion in 2017, up by 0.5% to account for 16.1% of GDP.

The majority (60.2% of the NAV) of the domestic investment funds invest primarily in bonds, with the rest mainly split among equity funds, asset allocation and mixed strategy funds (see Chart 4.12). The latter two

²⁶ Source: EIOPA Risk Dashboard April 2018.

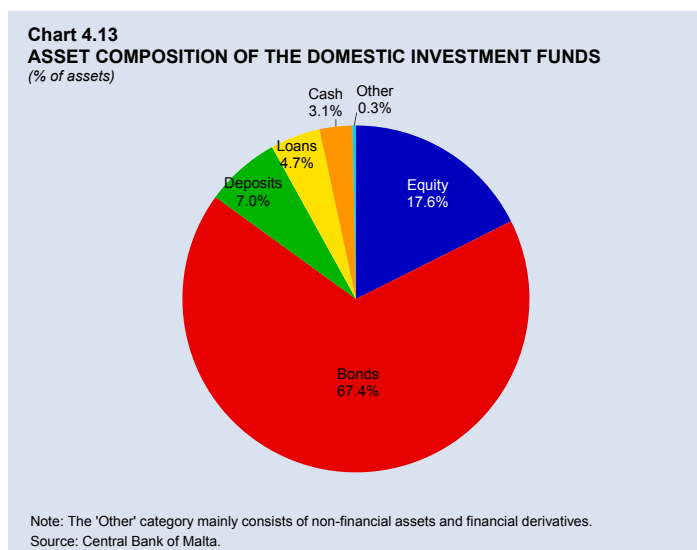
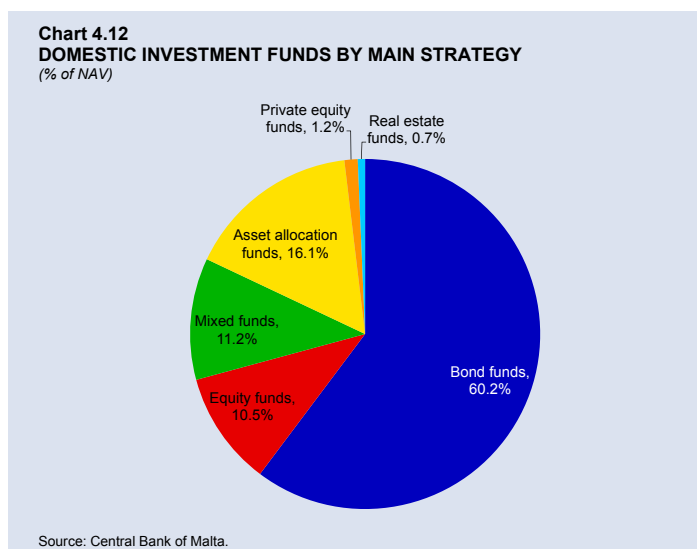
types of funds provide investors with a more diversified portfolio of investments across various assets classes and diverse investment strategies. The domestic funds' asset composition remained rather stable during 2017, with assets primarily composed of bonds (67.4%) in line with their main strategy, and equities (17.6%), followed by deposits, which amounted to 7.0% of assets (see Chart 4.13). A small share (4.7%) of the funds' assets was composed of loans by one AIF, mainly to banks outside the European Union.

At the end of 2017 the bond portfolio of domestic investment funds amounted to €1.2 billion, mainly consisting of sovereign paper (about 54%) with the rest in corporate bonds. During the year, the bond portfolio increased by 5.1%, driven by an expansion of around 16% in the corporate bonds as otherwise, sovereign bond holdings dropped by approximately 2%. Corporate bonds amounted to around €494 million in 2017, and were mainly issued by NFCs based in Malta, the United States, France and the United Kingdom; 'captive financial institutions and money lenders' situated in Malta, Luxembourg and the Netherlands; as well as in banks located in Malta, the United States and the United Kingdom. Sovereign bond holdings were predominately issued by the Maltese Government, leading to an overall medium investment-grade rating.

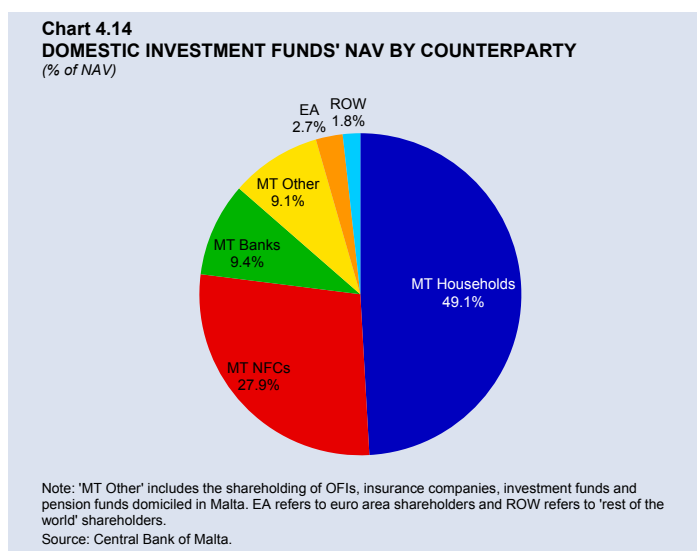
Equity holdings rose by 20.3% to €317.4 million in 2017 predominantly due to higher units in investment funds domiciled in Malta and Ireland. The equity portfolio largely consisted of units in investment funds located in Ireland, Luxembourg, Malta, the United Kingdom and the United States, and equities in Maltese NFCs and banks.

Maltese households are the main shareholders of retail UCITS, whereas retail non-UCITS funds' main shareholders remained insurance corporations and pension funds. On the other hand, NFCs were the main shareholders of PIFs and AIFs. Overall, the investors in domestic investment funds are predominantly resident households (49.1%), followed by NFCs located in Malta (27.9%) and local banks (9.4%) (see Chart 4.14).²⁷ In 2017, 3.5% of the households' financial assets were in investment funds whereas only 2% of NFC's balance sheet was invested in investment funds.

²⁷ There is no split by counterparty for Rest of the World (ROW).



Risks posed by the domestic investment funds are deemed to have remained low in 2017. Contagion risk through direct links between core domestic banks and the investment funds sector remained relevant, since 24 sub-funds (76.4% of the domestic sub-funds' NAV) are managed by the core domestic banks. Other links with the domestic economy related to shareholding by different counterparties in domestic investment funds. In spite of these potential contagion channels, such risks remained controlled as investment funds are separate legal entities subject to the provisions in the Maltese companies' law and the Investment Services Act. Furthermore, investment funds have embedded tools such as gating mechanisms and liquidity fees to limit any potential runs. Also, both the investment funds and the core domestic banks have prudent business strategies mitigating the possibility of transmittable distress.



**APPENDICES
AND
GLOSSARY**

Appendix A

IMPLEMENTED POLICY MEASURES

Capital Buffer for Other Systemically Important Institutions (O-SII)	2016		2017		2018	2019	Implementation date				
Medirect	0.125%		0.250%		0.375%	0.500%	1 Jan. 2016				
HSBC Group Malta	0.375%		0.750%		1.125%	1.500%					
Bank of Valletta Group	0.500%		1.000%		1.500%	2.000%					
Countercyclical Capital Buffer (CCyB)	2016				2017				2018		Implementation date
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	
All credit institutions	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	1 Jan. 2016
Macro-prudential policy Reciprocity	2016		2017		2018		Implementation date				
Reciprocity of the Systemic Risk Buffer implemented by Estonia	1.0% for risk exposures exceeding €200 million		1.0% for risk exposures exceeding €200 million		1.0% for risk exposures exceeding €200 million		24 Oct. 2016				
Measures Addressing Credit Risk (BR/09/2016)	2017				2018				Implementation date		
All credit institutions	Implementation of NPL Reduction Plan for banks which exceed the 6% NPL ratio threshold				Implementation of NPL Reduction Plan for banks which exceed the 6% NPL ratio threshold				2 Jan. 2017		

Glossary

Alternative Investment Funds (AIF): are collective investment schemes which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and which does not qualify as a UCITS Scheme in terms of the UCITS Directive.

Asset Purchase Programme (APP): includes all purchase programmes under which private sector and public sector securities are purchased to address the risks of a too prolonged period of low inflation.

Collective Investment Undertakings: are undertakings that raise capital from investors (fund holders) to carry out collective investments in transferable securities and/or in other financial assets.

Collective provisions: are the amount of provisions allocated for the estimated losses incurred on a collective basis, but which have yet to be individually identified.

Combined ratio: is the sum of net claims incurred and net operating expenses as a proportion of net premia earned. A combined ratio of less than 100% signals underwriting profit.

Composite Indicator of Systemic Stress (CISS): is an indicator compiled by the European Central Bank which is based on 15 financial stress measures split equally in five categories, including the financial intermediaries sector, money markets, equity markets, bond markets and foreign exchange markets.

Cost-to-income ratio: is defined as operating expenses (net of amortisation but including intangible assets other than goodwill) to gross income (net interest income and non-interest income).

Countercyclical Capital Buffer (CCyB): requires credit institutions to set aside additional common equity tier 1 capital during periods of excessive credit growth. The aim of the CCyB is to increase banks' resilience in good times to be able to absorb potential losses that could arise in a downturn, enabling the continued supply of credit to the real economy.

Coverage ratio: is the ratio of total provisions and interest in suspense to total non-performing loans (NPL).

Credit standards: refer to the banks' internal guidelines for loan approvals. These specify the borrower's characteristics such as income levels, age and employment status, which the banks consider in their credit scoring methods.

Credit terms and conditions: refer to the conditions of a specific loan. These consist of the interest rate, loan size, fees, collateral requirements, maturity and other conditions.

Customer deposits: are deposits of (i) money market funds (ii) central government (iii) other general government, and (iv) other remaining economic sectors, including households and corporates, but excluding the financial intermediation sector.

Customer loans: are loans of (i) money market funds (ii) central government (iii) other general government, and (iv) other remaining economic sectors, including households and corporates, but excluding the financial intermediation sector.

Eurosystem funding: is credit provided to eligible counterparties (banks) on a collateralised basis. The ECB coordinates the operations and the national central banks carry out these transactions.

Expected credit loss (ECL): under IFRS 9, lifetime ECL is the expected present value of losses that arise if borrowers default on their obligations at some time during the life of the financial asset. For a portfolio, the ECL is the weighted average credit losses (loss-given-default) with the probability of default as the weight.

Fair value: is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IFRS 13).

Haircut: is a risk control measure applied to underlying assets whereby the value of such assets is calculated as the market value less a percentage (the “haircut”). The size of the haircut reflects the perceived risk of holding such an asset.

High Quality Liquid Assets (HQLA): comprise of Level 1, Level 2A and Level 2B assets. Level 1 assets include cash, central bank reserves, and certain marketable securities backed by sovereigns and central banks, among others. Level 2A assets include, for example, certain government securities, covered bonds and corporate debt securities. Level 2B assets include lower-rated corporate bonds, residential mortgage-backed securities and equities that meet certain conditions.

Impairment charges: are costs incurred as a result of the decline in the value of assets. These include write-down of loans, investments and non-financial assets, net of recoveries and reversals from an impaired state.

Index-linked policies: are life insurance policies where the insurance premia are invested in instruments whose returns are linked to the performance of one or more indices.

Internal rating-based banks (IRB): under the Basel II guidelines, banks are allowed to use their own estimated risk parameters for the purpose of calculating regulatory capital. This is known as the internal ratings-based approach to capital requirements for credit risk.

Intercompany lending: is lending between domestic non-financial corporations (NFC), including unrelated NFCs and intra-group lending.

Intra-group lending: is lending from corporates within the same group of companies.

iTraxx European Senior Financial index: is an index composed of credit default swaps covering senior European financials.

Leverage ratio: is calculated by dividing Tier 1 capital by the bank’s average total consolidated assets (sum of the exposures of all assets and non-balance sheet items). Credit institutions are required to maintain a minimum leverage ratio of 3%.

Liquid asset ratio for the insurance sector: is calculated by weighting all liquid assets, as a share of assets less those held for unit linked contracts.

Liquidity coverage ratio (LCR): promotes the short-term resilience of a bank’s liquidity risk profile by ensuring that a bank has an adequate stock of unencumbered high-quality liquid assets (HQLA) that can be easily and immediately converted into cash to meet a bank’s liquidity needs for a 30-calendar day liquidity stress scenario.

Loan loss provisions: include collective provisions and specific provisions.

Loan-to-deposit ratio: is the ratio for assessing a bank’s liquidity by dividing the bank’s total loans by its total deposits. If the ratio is too high, it means that banks might not have enough liquidity to cover any unforeseen funding requirements; if the ratio is too low, banks may not be earning as much as they could be earning.

Loan-to-value ratio: is the amount lent for the purchase of a property expressed as a proportion of the market value of the property purchased.

Minimum Requirement for own funds and Eligible Liabilities (MREL): banks need to meet a minimum requirement for own funds and eligible liabilities so as to be able to absorb losses and restore their capital position, allowing banks to continuously perform their critical economic functions during, and after a crisis.

Minimum Capital Requirement (MCR): refers to the minimum level below which the amount of eligible basic own funds should not fall. When the latter falls below the MCR, there would be supervisory intervention and the insurer's license can be withdrawn, if it is unable to re-establish the amount of eligible basic own funds at the level of the MCR within a short period of time.

Net Interest Income: is the difference between the revenue/interest generated by a bank from assets and the expenses/interest paid on its liabilities.

Non-Interest Income/Expenses: this refers to the income/expenses related to non-interest activities, such as dividend and trading income, fees and commission income, and operating expenses.

Non-performing exposures: are credit facilities and debt securities which are classified as non-performing. The non-performing exposures ratio is calculated by taking the value of non-performing loans and securities as a share of the total credit facilities and debt securities held by the bank.

Non-performing loans: are credit facilities with payments of interest and/or capital overdue by 90 days or more, as well as those facilities about which a credit institution has reason to doubt the eventual recoverability of funds. The non-performing loans ratio is calculated by expressing non-performing loans as a percentage of total outstanding loans and advances.

Own funds: refer to the summation of Common Equity Tier 1 (CET1) capital, Additional Tier 1 capital, Tier 2 capital.

Other Systemically Important Institutions (O-SII): are institutions that, due to their systemic importance, are more likely to create risks to financial stability. While maximising private benefits through rational decisions, these institutions may bring negative externalities into the system and contribute to market distortions.

Plain vanilla bond: is a bond that pays a constant interest and at maturity pays back the principal that was originally invested. A plain vanilla bond is the most basic of debt instruments with no special features such as embedded options. It is also known as a straight bond or a bullet bond.

Probability of default: is the likelihood that a debt will not be paid on time.

Professional Investor Funds (PIF): are a special class of collective investment schemes subject to the Investment Services Rules for Professional Investor Funds. There are three classes of Professional Investor Funds, namely those targeting experienced investors with an entry level of €10 thousand; qualifying investors with an entry level of €75 thousand; and extraordinary investors with a minimum investment of €750 thousand.

Protected Cell Company (PCC): is a corporate structure in which a single legal entity is comprised of a core and several cells that have separate assets and liabilities. The PCC has a similar design to a hub and spoke, with the central core organisation linked to individual cells. Each cell is independent of each other and of the company's core, but the entire unit is still a single legal entity.

Recapitalisation amount: shall be at least equal to the amount necessary to satisfy applicable capital requirements necessary to comply with the conditions for authorisation after the implementation of the preferred resolution strategy.

Retail non-UCITS Schemes: are open-ended or closed-ended retail schemes set up in accordance with or existing under the laws of Malta.

Return on assets (post-tax): is the annual post-tax profits/losses divided by a 12-month average of total assets.

Return on equity (post-tax): is the annual post-tax profits/losses divided by a 12-month average of shareholders' funds.

Risk-weighted assets (RWA): are assets multiplied by their respective risk weights as specified in the Capital Requirements Directive.

Solvency Capital Requirement (SCR): is the capital required for insurers to meet their obligations over the next twelve months with a probability of at least 99.5%.

Specific provisions: are set aside for doubtful/loss facilities. Specific provisions should at least be equal to the loss not covered by collateral in the event of default.

STREAM: is the Central Bank of Malta's Structural Macro-Econometric Model of the Maltese economy, which is a traditional structural model built around the neo-classical synthesis.

Systemic Risk Buffer: aims to address systemic risks of a long-term, non-cyclical nature that are not covered by the Capital Requirements Regulation. The buffer level may vary across institutions or sets of institutions. There is no maximum limit on the rate applicable for this buffer, but depending on its level and the impact on other Member States, authorisation from the European Commission may be required.

Technical reserves: are liabilities to policyholders and beneficiaries which represent the amounts identified by insurance companies to account for the prepayment of insurance premiums and reserves for unpaid claims incurred but not yet paid.

Tier 1 Capital ratio: Tier 1 capital which is mainly composed of equity and retained earnings, expressed as a percentage of risk-weighted assets.

Tier 2 Capital: includes, inter alia, undisclosed reserves, revaluation reserves, general provisions, and subordinated term debt.

Undertakings for Collective Investment in Transferable Securities (UCITS): are collective investment schemes, whether of the unit trust or open ended investment company variety, falling within the scope of and authorised in terms of the UCITS Directive.

Unit-linked Insurance Plan: is a product offered by insurance companies whereby investors are given an opportunity of obtaining insurance cover and simultaneously invest part of the premium in equity and debt instruments.

Value at Risk (VaR): measures the worst expected loss under normal conditions over a specific time interval, at a given confidence level.