BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

INTERIM FINANCIAL STABILITY REPORT
2020

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The Interim Report covers the first six months of 2020 and evaluates developments which may impact the resilience of the domestic financial system since the publication of the Financial Stability Report 2019. It also analyses whether any new risks have emerged. The Interim Financial Stability Report is prepared by the Financial Stability Department and is subsequently reviewed and endorsed by the Financial Stability Committee of the Central Bank of Malta.

The cut-off date for information relating to banking, insurance and investment funds is 28 August 2020 unless otherwise specified. The source of data in tables and charts is the Central Bank of Malta unless otherwise indicated.

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ABBREVIATIONS

AIF	Alternative Investment Funds
AMC	amortised cost
AML/CFT	anti-money laundering/combating the financing of terrorism
ARB	Asset Recovery Bureau
AUM	Assets under Management
BCBS	Basel Committee on Banking Supervision
BLS	Bank Lending Survey
BR	Banking Rule
BRRD	Bank Recovery and Resolution Directive
CBC	counterbalancing capacity
CBM	Central Bank of Malta
CCyB	Countercyclical Capital Buffer
CET1	Common Equity Tier 1
CFIML	captive financial institutions and money lenders
CIU	Collective Investment Undertakings
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
DAX	Deutscher Aktienindex
DSTI-O	debt-service-to-income at origination
EA	euro area
EBA	European Banking Authority
ECL	expected credit loss
ECB	European Central Bank
EP	European Parliament
EU	European Union
ESRB	European Systemic Risk Board
FIAU	Financial Intelligence Analysis Unit
FSR	Financial Stability Report
FV	fair value
FX	foreign exchange
GDP	gross domestic product
HQLA	high-quality liquid assets
IFRS	International Financial Reporting Standards
LCR	liquidity coverage ratio
LTV-O	loan-to-value at origination
MBR	Malta Business Register
MFI	monetary financial institution
MFSA	Malta Financial Services Authority
MGA	Malta Gaming Authority
MGS	Malta Government Stocks
MMF	money market funds
MREL	minimum requirements for own funds and eligible liabilities
MSE	Malta Stock Exchange
MST	macro stress testing
NAV	net asset value
NFC	non-financial corporations
NII	net interest income
NNII	net non-interest income
NPISH	non-profit institutions serving households
NPL	non-performing loans
O-SIIs	other systemically important institutions
OCR	overall capital requirement
OFI	other financial intermediaries
P&L	profit and loss account
PDW	persistent deposit withdrawals
PIF	Professional Investor Fund
RHS	right-hand scale
ROA	return on assets
ROE	return on equity
RWA	risk-weighted assets
SBS	security by security
SCR	Solvency Capital Requirement
SDW	Statistical Data Warehouse
SME	small and medium-sized enterprise
SRB	Systemic Risk Board
SRMR	Single Resolution Mechanism Regulation
SREP	Supervisory Review and Evaluation Process
SyRB	systemic risk buffer
S&P 500	Standard and Poor's 500
TSCR	total SREP capital requirement
UCITS	Undertakings for the Collective Investment in Transferable Securities
UK	United Kingdom
US	United States of America

1. Macroprudential Risk Assessment and Policy Response

1. MACROPRUDENTIAL RISK ASSESSMENT AND POLICY RESPONSE

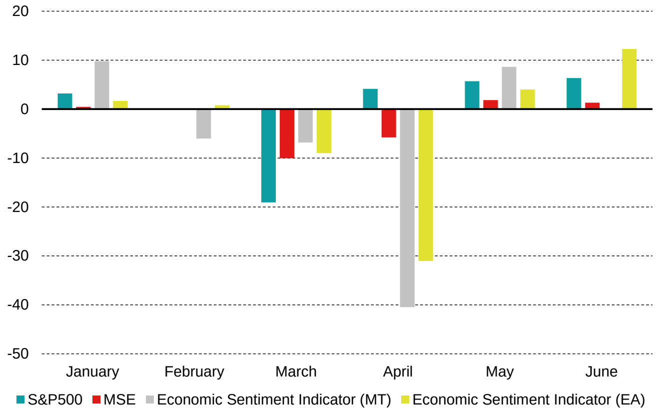
In the first half of 2020, the global economy was severely impacted by the unprecedented restrictions imposed on activity to counter the spread of the COVID-19 pandemic. Measures put in place by governments to limit the transmission of the virus coupled with a collapse in consumer and business confidence have inevitably led to a steep contraction in economic activity.[1] At the same time, the drive for social distancing and contactless ways to conduct activities and payments have created new business opportunities for some economic sectors but also the potential for increased cyber threats, driving up operational costs and demand for more highly-skilled staff.

Geopolitical tensions, particularly between the United States and China persisted, while negotiations on Brexit between the European Union and the United Kingdom have not been concluded. In addition, the November 2020 US presidential election heightened uncertainty, especially concerning future policy direction.

The euro area real GDP decreased by an annual 14.8% in the second quarter of 2020, which represents a record drop in a single quarter, with the unemployment rate also deteriorating by 0.4 percentage point to 7.7%. The euro area economy is forecasted to contract by 8.7% in 2020 before growing by 6.1% in 2021, though these forecasts are subject to great uncertainty and significant risks related to the uncertain evolution of the virus spread.[2] Malta's economic activity also contracted in the second quarter of the year, with real GDP down by 16.2%, as international passenger travel practically came to a stand-still. Wholesale and retail trade, and the transportation and storage sectors were also adversely hit with partial lockdown measures. This had a toll on the labour market, with the unemployment rate rising marginally to 4.3%, but with a sharp drop in the average hours worked for the bulk of the workforce. Malta's economy is forecasted to contract by 6.6% in 2020, before growing by 6.1% in 2021.[3] Underpinning these forecasts is the assumption of gradual recovery of the local and foreign economies and the eventual development of a vaccine, which could all help in restoring market confidence.

During the first half of 2020, the economic sentiment within the euro area deteriorated significantly (see Chart 1.1). In fact, by April it had already dropped by around 36% as a consequence of the negative impact that the pandemic had on economic activity. Investor sentiment also changed, with the S&P500 falling by 34% (by 1148.5 points to 2237.4 points) between February and March. However, in April there were already signs of recovery in financial markets driven by some corporations operating in sectors which benefited from the pandemic (such as the healthcare, communications and technology sectors) but especially due to the swift response of fiscal and monetary policy. Domestically, the MSE index dropped between March and April as the virus started to spread

Chart 1.1
MONTHLY CHANGES IN EQUITY MARKETS AND ECONOMIC SENTIMENT INDICATORS
(per cent)



Sources: EuroStat; Malta Stock Exchange and SPglobal.com.

[1] These measures included full or partial lockdowns, restricted travelling through closure or restrictions in ports, and social distancing measures including the ban of mass gathering events and closure of entertainment and catering establishments, among others.
[2] Source: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1269
[3] https://www.centralbankmalta.org/economic-projections

locally, but the drop was milder in comparison to other major stock markets. In subsequent months, the MSE index recovered some of the losses.

Various supportive measures were implemented across a number of countries to shore up economic activity, including government guarantees for banks to lend, moratoria and fiscal incentives to citizens and selected economic sectors. All these have raised sovereign debt levels, with the euro area government debt standing at 95.1% of GDP by June 2020, up from 84% in end 2019.[4] Similarly, during the first half of 2020, the net MGS issued by the Maltese Treasury amounted to around €245 million to finance these mitigation measures, projected to push up government debt to 56% of GDP at the end of 2020 – up from 42.6% in 2019. Private sector indebtedness edged higher for both households and NFCs, although when expressed as a share of GDP these remained at a more contained level than the euro area average.

The spread of COVID-19 had a severe adverse impact on the financial performance of the global banking industry. Domestic banks were also hit as important economic sectors came to a virtual halt in the first half of the year, consumer spending declined – with repercussions on consumer credit, while mortgages slowed down as the property market came to a standstill owing to a temporary suspension of legal time. As a result, resident credit growth slowed down to 2.7%, 1.7 percentage points lower than in the same period in 2019. On the other hand, while the spread of the pandemic forced some corporates to consolidate their operations, such firms needed liquidity for working capital requirements. Most banks granted more loans to corporates as they met the increased demand, supported by the Malta Development Bank's COVID-19 Guarantee Scheme. This was reported in some of the most impacted sectors, such as the accommodation and food service activities sector, with related lending increasing by 15.2%.

The low-for-longer interest rate environment continues to put pressure on the profitability of European financial institutions, even though low interest rates have a positive effect on the funding costs of institutions in times of economic stress. The profitability of banks was further affected by the COVID-19 spread as income sources diminished. Indeed, the decline in economic activity caused by the pandemic has affected banks' earnings, operations and credit quality. Similar to European banks, in the first half of the year, core domestic banks posted significant declines in net profit before tax, mainly induced by a significant drop in non-interest income and increased net impairment charges. Non-core domestic banks' profitability almost halved, while international banks (excluding branches) posted lower pre-tax net profits. This resulted in the Maltese banks' post-tax ROE dropping by 3.3 percentage points to 3.5%, but remained higher than that reported by European banks, which fell by around 5.2 percentage points to 0.5% as of June 2020.[5]

The impact on asset quality was more contained, although a change in trend was observed, with the overall NPL ratio rising marginally to 3.2%. However, when loan moratoria granted by the banks to the affected sectors of the economy end, NPLs are expected to increase as the repayment capability of households and private firms will be challenged. This is especially so, if the recovery in economic activity becomes slower than currently projected due to a resurgence of the virus spread. A part of the increase in expected NPLs has already been incorporated in banks' balance sheet as their provisions increased by 18.3% during the first six months of 2020. Notwithstanding, the banks' capital and liquidity remained sound with the CET1 and LCR ratios for Maltese banks standing at 24.0% and 345.2% on average, respectively. In this regard, domestic banks are expected to have sufficient capital and liquidity buffers to withstand losses without breaching their regulatory requirements. This is further corroborated by the stress tests conducted by the Bank (see Chapter 3).

The profitability of the domestically-relevant insurance corporations was also significantly impacted by the pandemic, mainly driven by a drop in investment and other income triggered by adverse market movements. Written premia were also dented, with a marked slowdown in new business. While remaining above regulatory requirements, the solvency ratio for domestic insurers was also impacted. This ratio fell by about 37 percentage points to around 190%, largely driven by developments within the life insurance sector. In conjunction, the prolonged low-yield environment also remains a key challenge for the insurance sector. Assets of the

[4] Source: https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=325.GFS.Q.N.I8.W0.S13.S1.C.L.LE.GD.T._Z.XDC_R_B1GQ_CY._T.F.V.N._T
[5] Source: EBA risk dashboard, Q2 2020

domestically-relevant investment funds contracted, mainly reflecting lower equity and debt securities holdings. Going forward, the potential re-pricing in global risk premia could be considered as the main challenge for this sector due to the uncertainty surrounding the pandemic, coupled with geopolitical events. However, locally-relevant funds have reported improved liquidity and leverage in the first half of the year.

The effects of the pandemic will continue to be felt in the near term as governments strive to limit the damage caused in some sectors, notably travel and tourism. Should the virus spread linger, disruptions to economies are likely to persist further. In this regard, institutions are encouraged to preserve capital, while at the same time continue lending prudently and avoid unnecessary forbearance measures and thus continue to recognise provisions in a timely manner. Furthermore, institutions should continue to maintain their prudent investment practices and improve further efficiency to reduce costs, without compromising capital and liquidity buffers.

Table 1.1 below highlights the key vulnerabilities of the domestic financial sector and how they have evolved since 2019.

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 2019	Risk assessment one year ahead
Vulnerabilities within the financial system				
The level of non-performing loans	Credit/Profitability	Cyclical/ Structural	↑	↑
Concentration in sectoral lending	Credit	Structural	↔	↔
Developments in bank credit	Credit	Cyclical/ Structural	↑	↑
Interlinkages between banks and the non-bank financial sector	Contagion	Structural	↔	↔
Operational risk	Contagion	Structural	↑	↔
Developments related to income sources	Profitability	Cyclical	↑	↑
Domestically-relevant Insurances	Liquidity/Solvency/ Profitability	Cyclical/ Structural	↑	↔
Domestically-relevant Investment funds	Credit/Solvency/ Profitability	Cyclical/ Structural	↑	↑
Vulnerabilities outside the financial system				
Domestic macroeconomic developments	Credit/Profitability	Cyclical	↑	↔
Real estate market developments	Credit/Contagion	Cyclical	↑	↔
Exposures of the financial sector to domestic sovereign	Profitability/Contagion	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	↑	↔
Reassessment in risk premia	Profitability	Cyclical	↑	↔

Risk position		Direction of risk	
Moderate		Increased risk	↑
Medium		Stable risk	↔
Elevated		Decreased risk	↓

The Policy Response

Domestic and European authorities continued to monitor closely macroeconomic and financial sector developments in Malta with a view to step up, where necessary, the macroprudential toolkit to prevent adverse events from materialising or to mitigate their effects on the stability of the financial system.

The following is a synopsis of the policy responses during the first half of 2020, including revisions and extensions of previously introduced measures, with the focus being on measures of a macroprudential nature.

Extension of CBM Directive No. 18 on Moratoria on Credit Facilities in Exceptional Circumstances

As outlined in the 2019 *Financial Stability Report* (FSR), the Bank issued Directive No. 18 in April 2020, whereby a six-month moratorium on repayments on capital and interest was offered to borrowers who were negatively impacted by COVID-19. The deadline to apply for loan moratoria was originally set for 30 June 2020 but in view of the uncertainty surrounding the length of the COVID-19 pandemic, it was decided to amend the Directive and extend the application to 30 September 2020 in line with the EBA's guidance. Concurrently, the moratorium period of six months starts from the date of approval of application for new moratoria, while extensions start from the day after the end of the first moratorium period.

Amendments to CBM Directive No. 16 on Borrower-based Measures

In response to the COVID-19 pandemic, the Bank issued a notice on 1 June 2020 to postpone the fully-phased loan-to-value ratio at origination (LTV-O) limit of 75% applicable to Category II borrowers, by one year to July 2021; and to apply a temporary easing in the stressed debt-service-to-income ratio at origination (DSTI-O) limit for new residential real estate loans granted to both Category I and Category II borrowers, subject to conditions as stipulated in the Notice.[6] The Bank granted the concession on the stressed DSTI-O ratio for a period of six months till 1 December 2020.

Identification of Other Systemically Important Institutions (O-SIIs)

The latest Bank decision on the four designated O-SIIs and their corresponding capital buffer rates (resulting from the 2019 revised domestic O-SII methodology) remained unchanged during the period under review. The credit institutions identified as O-SIIs, together with their respective capital buffer rates, are Bank of Valletta Group (2%), HSBC Bank Malta plc (1.5%), MeDirect Group Ltd (0.5%) and APS Bank plc (0.25%).[7] The O-SII identification exercise is undertaken on an annual basis and the next round of results is expected to be published by Q1 2021.

Countercyclical Capital Buffer (CCyB)

In accordance with the Bank's notification concerning the decision on the applicable CCyB rate for the fourth quarter of 2020, cyclical risks remained contained, resulting in a CCyB rate of 0%.[8] This decision was supported by developments in the credit-to-GDP gap, as well as additional supporting indicators, which suggested no excessive credit build up in the financial cycle.

Identification of material third countries

Pursuant to the ESRB Recommendation 2015/1 on recognising and setting countercyclical buffer rates for exposures to third countries, the Bank conducts an annual exercise with the aim of identifying the material third countries to which the domestic banking sector is exposed.[9] In line with the methodology prescribed in Article 4 of the ESRB Decision 2015/3, the United States, United Arab Emirates and Republic of Turkey

[6] Link: https://www.centralbankmalta.org/en/news/79/2020/8823

[7] Bank of Valletta Group, HSBC Bank Malta plc and MDB Group Ltd were previously identified as O-SIIs and have been reconfirmed while APS Bank plc was identified as a new domestic O-SII. In line with established practice, APS Bank plc was granted a transitory period to build the necessary O-SII buffer. This transitory period is specified in the applicable yearly Statement of Decision. https://www.centralbankmalta.org/systemically-important-institutions

[8] Source: https://www.centralbankmalta.org/countercyclical-capital-buffer

[9] ESRB/2015/1: Recommendation of the ESRB of 11 December 2015 on recognising and setting countercyclical buffer rates for exposures to third countries.

are the three third countries which have been identified as material for Malta for the 2020 Q2 – 2021 Q2 period.[10,11]

Voluntary reciprocation of macroprudential measures

In response to the *ESRB Recommendation on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures* and in line with its internal policy framework, the Bank analyses the measures recommended for reciprocation by other EU Member States.[12] No additional new measures were recommended for reciprocation by the ESRB until Q2 2020. The Bank maintained its non-reciprocation stance after reassessing the measures recommended for reciprocation in the previous years, by the Belgian, Swedish, Finnish and French authorities. For further information, refer to the CBM *Financial Stability Report* of 2019.[13]

Main MFSA Circulars and Related European Regulatory Developments

Hereunder is a list of circulars issued by the MFSA in 2020 with a particular focus on those that have financial stability implications and address COVID-19 related issues. Where applicable, reference to related European regulatory developments is also made under this section.

Circular to Financial Institutions authorised in terms of the Financial Institutions Act on Contingency Preparedness in the Context of Coronavirus (COVID-19)

By means of this circular, the MFSA emphasised the need for financial institutions to ensure their operational preparedness to minimise the potential adverse effects of the spread of COVID-19, by taking all actions necessary to respond to the pandemic scenario. In this regard, financial institutions were required to inform the MFSA of any adverse change in customer behaviour, imminent difficulties in ensuring the continuity of services and to inform the MFSA should contingency plan/s be activated.

Circular to credit institutions on the issuance of a new Banking Rule (BR/23)

On 6 July 2020, the MFSA issued a new Banking Rule (BR/23) which aims to implement the provisions and requirements stipulated in the EBA Guidelines on reporting and disclosure of exposures subject to measures applied in response to the COVID-19 crisis (EBA/GL/2020/07).[14] In accordance with this Rule, credit institutions are obliged to regularly report information relating to: i) exposures that are subject to payment moratoria, ii) exposures that are subject to other forbearance measures introduced in response to the COVID-19 crisis, and iii) newly-originated exposures subject to the Malta Development Bank COVID-19 Guarantee Scheme.[15] This Rule became effective upon its publication.

Circular to credit institutions on the extension to the restriction on dividend distributions or share buybacks and variable remuneration

This circular makes reference to the ECB Recommendation ECB/2020/35, which, against the backdrop of heightened economic uncertainty due to COVID-19, repealed and extended its previous recommendation to credit institutions on dividend distributions, share buy-backs and variable remuneration until 1 January 2021.[16] Through this circular, the MFSA declared that the above-mentioned Recommendation is to apply in its entirety to all domestic credit institutions from the date of publication and at least until 1 January 2021.[17]

[10] 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.

[11] https://www.centralbankmalta.org/reciprocity

[12] ESRB/2020/9: Recommendation of the ESRB of 2 June 2020 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures.

[13] Central Bank of Malta Twelfth Financial Stability Report 2019.

[14] EBA Guidelines of 2 June 2020 on reporting and disclosure of exposures subject to measures applied in response to the COVID-19 crisis (EBA/GL/2020/07).

[15] Exposures that that are subject to payment moratoria are in accordance with the Moratorium on Credit Facilities in Exceptional Circumstances Regulations, 2020 (L.N. 142 of 2020) and the Central Bank of Malta Directive No. 18 on Moratoria on Credit Facilities in Exceptional Circumstances.

[16] https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52020HB0035&from=EN

[17] https://www.mfsa.mt/wp-content/uploads/2020/07/Circular-to-Credit-Institutions-on-the-Extension-to-the-Restriction-on-Dividend-Distributions-or-Share-Buy-backs-and-Variable-Remuneration.pdf

Circular to Credit Institutions on IFRS9 in the context of the COVID-19 pandemic

Pursuant to the ECB press release published on 20 March 2020, and the EBA statement issued on 25 March 2020, the ECB issued a letter to all banks that fall under its direct supervision, with the aim to provide further guidance on and references to the use of forecasts.[18,19] The letter also refers to the avoidance of excessively procyclical assumptions in banks' expected credit loss (ECL) estimations during the COVID-19 pandemic and recommends banks to use the IFRS9 transitional arrangements.[20] To this end, the MFSA issued a circular on 6 April 2020 and specified that all domestic credit institutions are to be guided by the contents of the ECB letter.

Other European Regulatory Developments

Systemic Risk Board (SRB) Minimum Requirement for Own Funds and Eligible Liabilities (MREL) Policy 2020

On 20 May 2020, the SRB published the final MREL policy in line with the new Banking Package. Indeed, this policy implements the changes introduced by the Bank Recovery and Resolution Directive 2014/59/EU (BRRD II); the Single Resolution Mechanism Regulation 806/2014/EU (SRMR II); and the Capital Requirements Directive and Regulation (CRD V and CRR II). The updated MREL policy covers four main areas, namely the MREL calibration of resolution entities; their subordination requirements; internal MREL for non-resolution entities; and transition arrangements.[21]

EBA Final Guidelines on the appropriate subsets of exposures in the application of the systemic risk buffer

As per Article 133 (6) of the Fifth Capital Requirement Directive (CRD V), the EBA is mandated to issue guidelines on the appropriate subsets of sectoral exposures towards which a relevant authority may apply a systemic risk buffer.[22,23] With the introduction of a sectoral SyRB, the relevant authorities have more flexibility in using the SyRB to target systemic risk, including the application of such buffer to specific subsets of these sectors. Furthermore, the EBA Guidelines make reference to the fact that the structural element has been removed from the SyRB's definition, which indicates that the SyRB can also be used to address risks of a cyclical nature. The Guidelines also stipulate that a pre-condition when defining a subset of sectoral exposures in the application of a sectoral SyRB is the systemic relevance of the risks stemming from the subset of sectoral exposures. This is to be carried out on the basis of a qualitative and quantitative assessment, whereby a set of important criteria are to be conducted by the relevant authority.[24]

EBA Guidelines on loan origination and monitoring

The EBA Guidelines on loan origination and monitoring issued on 29 May 2020, lay down the internal governance arrangements for granting and monitoring of credit facilities throughout their lifecycle.[25] The aim of the Guidelines is to certify that robust and prudent standards for credit risk taking, management and monitoring are in place in all institutions, and that newly-originated loans are of high credit quality. Furthermore, the objective of the Guidelines is also to ensure that institutions' practices are aligned with consumer protection rules and AML requirements. To this end, the Guidelines present requirements for borrowers' creditworthiness assessment and bring together the EBA's prudential and consumer protection objectives.

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18 https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html

19 The EBA statement issued on 25 March 2020 relates to the application of the prudential framework regarding Default, Forbearance and IFRS 9 in light of COVID19 measures, wherein the EBA highlighted that when applying the IFRS 9 international accounting standard, credit institutions are expected to use a certain degree of judgement.

20 These transitional arrangements are put forward in CRR Article 473a, whereby in order to mitigate the impact of IFRS 9, banks are allowed to add back to CET1 capital a part of the expected credit loss recognised in accounting terms.

21 https://srb.europa.eu/sites/srbsite/files/srb_mrel_policy_2020.pdf

22 Click here for more information.

23 As per the EBA Guidelines, when defining subsets of sectoral exposures, authorities are to employ the following three dimensions: type of debtor or counterparty sector, type of exposure and type of collateral. If deemed appropriate, duly justified and proportionate, the relevant authorities may supplement these dimensions with three additional sub-dimensions: economic activity, risk profile and geographical area.

24 The criteria are size, riskiness and interconnectedness.

25 Click here for more information.

EBA phases out its Guidelines on legislative and non-legislative loan repayments moratoria

On 21 September 2020, the EBA announced its decision to adhere to the Guidelines' stipulated deadline of 30 September 2020.[26] In its decision, the EBA cited the effectiveness of the Guidelines in assisting banks to manage numerous requests for customers to benefit from moratoria, thereby providing important clarifications on the treatment of COVID-19 related loan moratoria. These Guidelines have provided the necessary regulatory flexibility, as well as certainty to address the significant number of actions taken by banks to support their customers as exceptional social restrictions measures were put in place.

ESRB Recommendation on monitoring the financial stability implications of debt moratoria, and public guarantee schemes and other measures of a fiscal nature taken to protect the real economy in response to the COVID-19 pandemic

Pursuant to ESRB Recommendation ESRB/2020/8, national macroprudential authorities are recommended to monitor and assess the financial stability implications of COVID-19 related measures taken by their Member States to protect the real economy, such as debt moratoria, public guarantee schemes and other measures of a fiscal nature. In this regard, it is recommended that relevant authorities monitor the design features and uptake of these measures, as well as the possible implications for financial stability using key indicators. Furthermore, authorities are also recommended to regularly report to the ESRB the information necessary for the ESRB to adequately conduct its monitoring.

In exercising its oversight tasks, the Bank is carrying out a monitoring assessment of the effectiveness and impact of the various measures introduced in Malta to protect the real economy from the COVID-19 pandemic shock. In line with the Recommendation, this information is also being regularly reported to the ESRB to facilitate its EU financial stability oversight role. On its part, the ESRB is evaluating the level of compliance of national macroprudential authorities, with the said recommendation.

European Parliament approves easing of certain CRR rules to encourage banks to lend to companies and households

In June 2020, the European Parliament (EP) announced its approval of the CRR "quick-fixes", which are aimed at easing the currently applicable rules of Regulation (EU) No 575/2013 (CRR). These easing measures are intended to promote the flow of credit to households and businesses, thereby ensuring that the banking sector can adequately support the economy, and be in a position to absorb COVID-19 pandemic-related losses. The temporary amendments were approved by the EP and include the following:

- Deferral of the application of the leverage ratio buffer from January 2022 to January 2023 to allow banks to increase the amount that they would be able to loan.
- Pensioners or employees with a permanent contract will be able to get a loan under more favourable prudential conditions. The loan will be backed by the borrower's pension or salary.
- Bringing forward the application date of a more favourable SME and infrastructure supporting factor, allowing for a more favourable prudential treatment to promote credit towards such sectors.[27]
- Earlier implementation of the allowance to treat some software as their own capital to encourage banks to invest in software and digitalisation.
- Liquidity measures provided by central banks in a crisis context will be effectively channelled by banks to the economy, by excluding exposures towards central banks from the leverage ratio denominator.

MONEYVAL

In October 2020, Malta submitted its final progress report to MONEYVAL, highlighting the progress achieved in strengthening the implementation of anti-money laundering/combating the financing of terrorism (AML/CFT) measures. Over the past months, Malta has been continuously making progress in addressing the recommendations made by MONEYVAL. In June 2020, the Cash Control Regulations were amended to provide greater capacity to the Commissioner of Inland Revenue to seize cash arising from criminal offences.

[26] https://eba.europa.eu/eba-phases-out-its-guidelines-legislative-and-non-legislative-loan-repayments-moratoria

[27] The SME supporting factor allows a 'discount' on the applicable capital requirements on loans granted to SMEs. This means that banks can free up capital resources that can be redeployed in the form of new loans and cheaper lending to SMEs.

In the same month, the MFSA introduced a risk-based approach to supervision, which will place prudential, conduct and financial crime risks at the centre of all MFSA activity.[28] Subsequently, in August 2020, the Residual Balances Fund Act was published with the objective of facilitating the dissolution and winding up process of a solvent credit institutions and, concurrently, ensuring that the necessary AML/CFT checks are being adopted. Additionally, Malta's agencies and institutions, which include the Financial Intelligence Analysis Unit (FIAU), MFSA, Malta Gaming Authority (MGA) and the Malta Business Registry (MBR) have undertaken significant investment, both from an infrastructural and human resources point of view, to boost their respective AML capabilities. More measures are in the process of being introduced to further strengthen the fight against money laundering. Upcoming changes in the Asset Recovery Bureau (ARB) will introduce a system for non-conviction-based confiscation that will make it easier and faster to confiscate proceeds of crime while empowering the ARB to file civil proceedings. In addition, amendments to the Company Service Providers Act will significantly increase the penalties for regulatory breaches. A new cash restriction policy is also in the process of being introduced with the aim of limiting the use of cash in transactions related to the motor industry, real estate sector, and in the sale and acquisition of precious metals and stones. The Bank will continue to contribute, within its remit, to strengthen Malta's AML/CFT regime.

[28] https://www.mfsa.mt/news-item/the-mfsa-publishes-document-outlining-its-risk-based-approach-to-supervision/

2. Developments in the Banking Sector

2. DEVELOPMENTS IN THE BANKING SECTOR

2.1 Core Domestic Banks

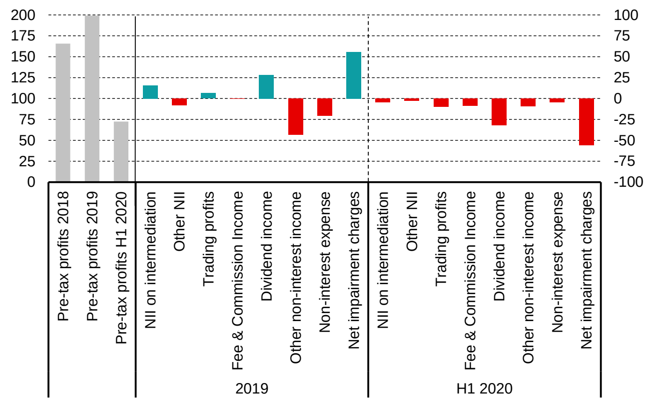
Similar to their European peers, the COVID-19 spread affected negatively the profitability of the six core domestic banks, which declined somewhat during the first half of 2020. Such challenges are expected to linger as the timeframe for recovery much depends on the discovery of a vaccine and subsequent recovery in business and consumer confidence. Furthermore, banks are also grappling with the effects of the low-for-longer interest rate environment. In light of these developments, the post-tax ROE and ROA fell from 6.7% and 0.6% in December 2019 to 2.0% and 0.2% in June 2020, respectively. Nonetheless, core domestic banks' performance was better than that of their European peers, which reported an average weighted ROE and ROA of 0.5% and 0.03%, respectively.[1]

Pre-tax profits declined by 63.6% to €72.5 million on the back of higher net impairment charges of €56.5 million largely reflecting one bank's significant increase in Stage 3 provisions (see Chart 2.1).[2] Other banks have set higher Stage 1 and 2 provisions in a bid to mitigate the impact from any potential deterioration in borrowers' creditworthiness as a result of the pandemic.[3]

Non-interest income – which contracted by 26.2% – also dampened profits as banks received lower dividend income from their subsidiaries and associated companies as these were also adversely affected by the pandemic, coupled with their intention to preserve capital in such stressful times. The correction in financial markets also hit banks' trading profits, wiping out the €8.3 million gains recorded in 2019 and leading to a loss of €1.5 million in June 2020. Fee and commission income declined by around 7% as lower business and consumer credit activity resulted in lower card usage and payments business. Net interest income (NII) contracted by 1.8%, which also contributed to the 10.7% decline in gross operating income. NII from intermediation declined by 1.3% as interest income fell at a faster pace than interest expenses. Similarly, other NII – mainly from securities – fell by 6.4% as the decline in interest paid on securities issued was more than offset by a drop in income from securities holdings.

In a bid to contain the virus spread, banks adopted unprecedented measures to meet the recommendations of health authorities, including enhanced health and safety measures and staff expenses related to support teleworking. Such increased costs were in part mitigated by lower costs as a number of branches closed their doors and employees teleworked. Overall non-interest expenses rose by 1.0%. The operational cost-to-income ratio deteriorated by 12.1 percentage points, to 78.4% in June 2020 – driven by declining income – and surpassed the EU banks' average of about 67%.[4]

Chart 2.1
MAIN COMPONENTS OF PROFITS – CORE DOMESTIC BANKS
(EUR millions)

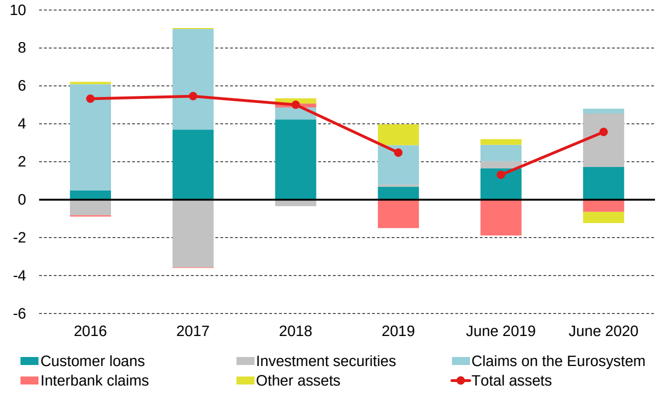


Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Green (positive) and red (negative) bars indicate yearly changes in profit components. NII stands for net interest income.

[1] Source: EBA Risk Dashboard
[2] Profits are based on four-quarter moving sum.
[3] Impairment stages as defined in IFRS 9. 'Stage 1' refers to impairment established on expected credit losses (ECL) resulting from potential default events within the next 12 months. 'Stage 2' refers to impairments established if the credit risk increases significantly since initial recognition and is not considered as low. 'Stage 3' refers to impairment on credit-impaired assets.
[4] Source: EBA Risk Dashboard

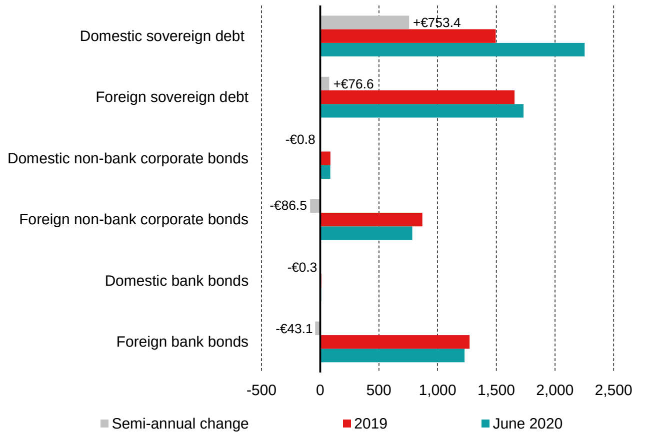
The response of core domestic banks to the COVID-19 pandemic was also evident in the shift in composition of their balance sheet structure. During the first half of 2020, these banks' assets grew by 3.6% to reach €25.6 billion, equivalent to 196.9% of GDP. This was mainly on the back of higher debt security holdings which rose by 13.1% to reach €6.1 billion, accounting for almost a quarter of the banks' balance sheets (see Chart 2.2). Most of these debt securities were domestic government paper, which rose by just over 50% to €2.3 billion, further increasing their liquid assets (see Chart 2.3). Core domestic banks took the opportunity of the new bond issuances as the Government sought to finance its measures to combat the impact of COVID-19. Holdings of foreign sovereign bonds – particularly of European governments – also rose. The risk profile of the bond portfolio deteriorated with medium-rated bonds accounting for just over half of the bond portfolio, up by 7.5 percentage points. This could be partly attributable to the downgrades reported by the various rating agencies, especially in bank bonds. Meanwhile, unrated bonds predominately issued by banks fell, while holdings of low-rated bonds rose. Nonetheless, the share of low and unrated bonds stood lower at 12.4%.[5] Equities contracted by 1.4% to €452.7 million, representing 1.8% of assets.

Chart 2.2
CONTRIBUTION TO BALANCE SHEET GROWTH – CORE DOMESTIC BANKS
(percentage points)



Source: Central Bank of Malta.
Note: June 2019 and June 2020 figures refer to growth in the first half of the respective years

Chart 2.3
BOND PORTFOLIO – CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.

In the first half of the year, outstanding loans grew by 3.3%, driven by both resident and non-resident lending, with the latter reflecting the business profile of one bank. Resident private credit growth decelerated to 2.5% compared to 4.4% in the same period a year earlier. Such slowdown emanated chiefly from lower resident credit to households. Consumer lending contracted by 3.5%, while mortgage growth slowed down to 2.0% compared to December 2019, as the property market came to a virtual halt during the partial lockdown in the second quarter of the year. Such developments are corroborated by the latest Bank Lending Survey (BLS) results where reduced spending was reported on the back of lower consumer confidence and adverse housing market prospects. However, anecdotal evidence indicates that the real estate market recovered somewhat following the end of the containment measures coupled with temporary government tax incentives to support the recovery of the real estate market.

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

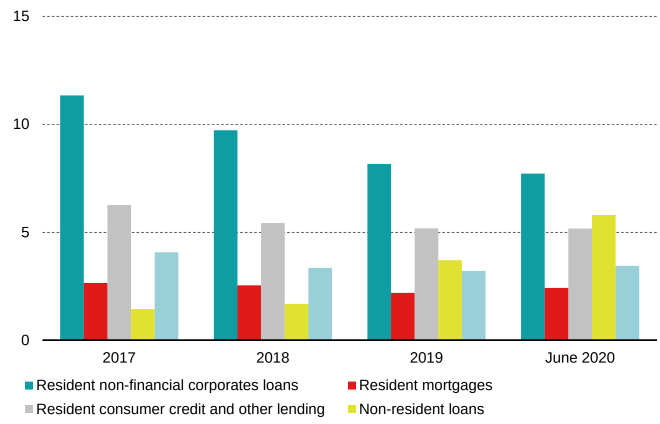
Meanwhile, resident corporate credit remained strong, up by 3.7% compared to the 4.3% reported in the first half of 2019, as firms facing liquidity shortages needed additional credit to finance working capital requirements. This was possible in view of the ample liquidity available at banks, coupled with the introduction of the Malta Development Bank CGS, which provided a partial safety net for commercial banks given that the guarantee is capped at 50% of the funds borrowed under this scheme. At a sectoral level, the wholesale & retail trade, transportation & storage, and accommodation & food service activities sectors benefitted the most from the CGS. According to the July 2020 BLS results, domestic participant banks reported some easing in their terms and conditions for corporate loans.

As at June 2020, placements with other banks fell by just over 10% to €1.4 billion, equivalent to 5.3% of assets. These were held almost entirely with non-residents, around half of which with unrelated credit institutions, the rest pertaining to parent or subsidiaries, almost entirely in the form of deposits. Placements with the Central Bank of Malta have meanwhile advanced by 1.5% to represent 16.6% of total assets reflecting the excess liquidity available for core domestic banks.

Up until mid-2020, the adverse impact of the virus spread on the core domestic banks' asset quality was limited. The EBA introduced supervisory flexibility on the treatment of NPLs, in particular to allow banks to fully benefit from guarantees and moratoria put in place by public authorities to ease the burdens brought by the pandemic. Indeed, while the NPL ratio deteriorated by 0.2 percentage point to 3.5% in June 2020, the increase was bank-specific and largely driven by higher non-resident NPLs, which rose by more than half (see Chart 2.4). These developments were partly offset by an improvement in the resident NPL ratio of 0.1 percentage point to stand at 3.0%, as NPLs of corporates operating in construction, and transportation and storage declined by 18.0%. Consequently, the resident corporate NPL ratio declined by 0.4 percentage point to 7.7% in June 2020. In contrast, the mortgage NPL ratio rose by 0.2 percentage point to 2.4% as the growth in NPLs outpaced that of mortgages. NPLs pertaining to resident consumer lending remained relatively stable, with the NPL ratio hovering at around 5%.

Looking ahead, higher NPLs could be reported when the moratoria granted on credit facilities expire and some customers potentially find it more difficult to meet debt obligations – particularly if the pandemic persists.[6] The latter, however, could be mitigated by fiscal support, targeting affected economic sectors. Against this backdrop, it is important from a financial stability perspective that banks continue to maintain adequate capital and liquidity buffers and set aside additional impairment provisions while avoiding unnecessary forbearance measures on their lending portfolios. Provisions (including the Reserve for General Banking Risks as specified in the BR/09/2019) of the core domestic banks already increased by just over a fifth, with the total coverage ratio rising by almost 5 percentage points to 48.5% in June 2020. Taking into consideration collateral backing NPLs, June 2020 NPLs would be fully covered, hence limiting credit risks for these banks.

Chart 2.4
NPL RATIOS – CORE DOMESTIC BANKS
(per cent)

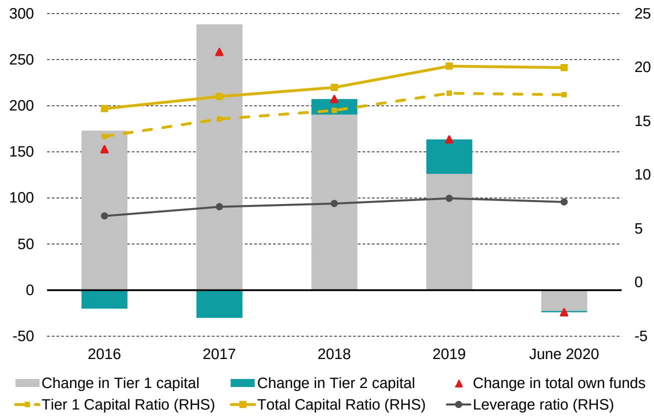


Source: Central Bank of Malta.

The growth in the balance sheet was primarily financed by deposits, which grew by 4.0% to €20.9 billion representing almost 82% of the overall balance sheet value.

[6] The Minister responsible for public health, with the concurrence of and in consultation with the Minister for Finance and Financial Services; the Superintendent of Public Health; and the MFSA, empowered the Central Bank of Malta to issue Directive No. 18 to regulate the Moratorium on Credit Facilities in Exceptional Circumstances.

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



Source: Central Bank of Malta.

Resident deposits increased by 5.2% to account for 91.3% of overall deposits, mainly driven by households' deposits which grew by 5.4%. Reflecting the uncertainties brought about by the pandemic and a number of containment measures, households were constrained to postpone consumption and to increase their savings using short-term deposits. Indeed, preference for short-term deposits over longer-term deposits persisted also during this period, enabling banks to fund their operations at low costs, with a weighted average interest rate on resident deposits of just 0.24%. By contrast, the downward trend in non-resident deposits persisted as banks continued with their de-risking programme. Other sources of funding remained limited, with the increase in interbank exposures somewhat offset by lower debt securities. Against this backdrop, despite declining marginally, the LCR of 330% indicates that in aggregate these banks continued to operate with ample liquidity buffers, sufficient to withstand any liquidity shocks. Such healthy liquidity position is also visible from the higher holdings of unencumbered central bank-eligible Counter Balancing Capacity (CBC), which overall rose by a quarter to represent almost 15% of the aggregate balance sheet, though this varied among individual banks. The unencumbered central bank-eligible share of CBC amounted to 1.5 times the total LCR net cash outflows, suggesting that together these banks can survive around 45 days of net cash outflows in a stressed scenario.

For the first time in recent years, total own funds contracted by 1.1% in the first half of 2020, owing to lower retained earnings by some banks. Total risk-weighted exposures fell by just 0.4%, with the total capital ratio declining marginally to 20.0% (see Chart 2.5). The drop in risk-weighted assets was attributable to lower credit risk exposure, which – however – still accounted for about 90% of the total risk exposures, while contribution to operational risks rose again. At 7.5%, the leverage ratio – which is a non-risk solvency ratio – also abated, yet still remained well above the regulatory thresholds. The banks' risk profile meanwhile improved, dropping by 1.8 percentage points to 44.4%.

2.2 Non-core Domestic Banks

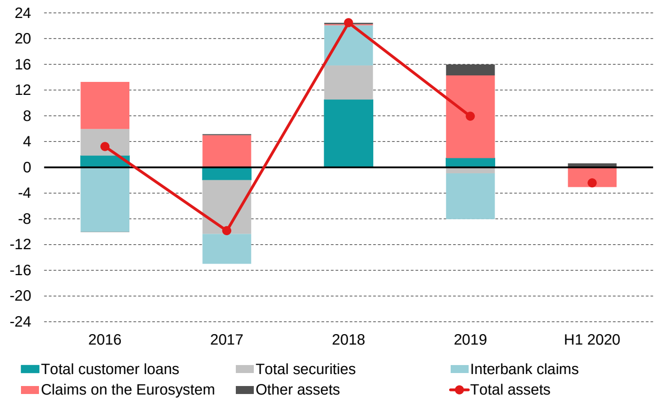
Similar to other banks, both locally and abroad, the five non-core domestic banks were adversely hit by the economic impact of the pandemic, as losses were reported. This was mainly due to higher net impairment charges reflecting a worsening in expectations on the recoverability of loans, coupled with drops in non-interest income. In aggregate, profits halved as impairment losses rose by almost 50%, with one bank reporting a significant rise in NPLs. On the other hand, non-interest income dropped by 9.5% largely due to decreased dividend income as well as lower trading profits, and fees and commissions. Net interest income mainly from intermediation also declined by around 10%, as interest income fell at a faster pace than interest expense. Consequently, the post-tax ROE and ROA narrowed to 5.5% and 0.6% respectively, from 10.6% and 1.2% six months earlier.

Non-core domestic banks' assets contracted by 2.4% to €2.8 billion, mainly due to lower placements with the Bank, which decreased by 12.3% to represent 21.7% of assets (see Chart 2.6). Meanwhile, these banks experienced a slight increase in interbank exposures, mainly driven by deposits from group entities, which offset the decline in lending from unrelated parties.

The securities portfolio decreased slightly to €709.2 million, but remained an important element on their balance sheet. This drop appears to have been motivated by flight to quality as a significant decrease in the equity holdings was offset by higher bond holdings. Equities holdings fell by just over a fourth to 8.4% of the balance sheet, mainly driven by lower holdings in non-MMF investment funds and also in MMFs to a lesser extent. In contrast, bond holdings grew by around a fifth to constitute 13.5% of assets (see Chart 2.7). The large part of these bonds were of domestic sovereigns which now accounted for 28.7% of the bond portfolio, up by 12.8 percentage points over December 2019. Non-core domestic banks also invested in foreign non-bank corporate bonds, largely NFCs. At the same time, these banks shed a significant share of foreign sovereign bond holdings which, nonetheless, at 34% remained the most popular bond holding. The credit quality of the debt securities held by these banks improved significantly as the amount of unrated bonds decreased by around 62.1% – largely due to lower exposure to the financial sector – while high-quality bonds increased by 25.3% and accounted for around two-thirds of the overall bond portfolio of these banks. Medium-rated bonds increased substantially, up by almost 90%, largely due to an increase in MGS.

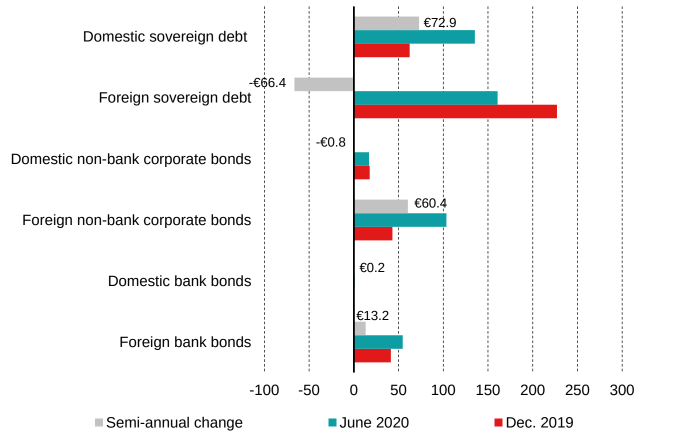
In the first half of the year, growth in customer loans remained muted. Resident customer loans increased by 11.9% as this group of banks continued to increase their resident business through higher lending to the construction sector, wholesale and retail trade, and consumer credit (see Chart 2.8). Lending towards real estate decreased slightly. Resident customer loans

Chart 2.6
CONTRIBUTION TO ASSETS GROWTH – NON-CORE DOMESTIC BANKS
(percentage points)



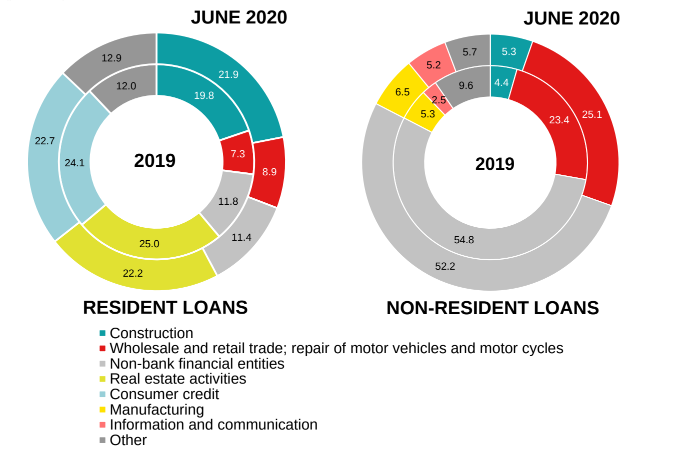
Source: Central Bank of Malta.
Note: H1 2020 figures refer to growth over end 2019.

Chart 2.7
BOND PORTFOLIO – NON-CORE DOMESTIC BANKS
(EUR millions)



Source: Central Bank of Malta.

Chart 2.8
DISTRIBUTION OF RESIDENT LOANS AND NON-RESIDENT LOANS
(per cent)



Source: Central Bank of Malta.

represented 29% of the total customer loan portfolio, up by almost 12 percentage points, though these loans still accounted for only 2.5% of the overall customer lending in the banking sector. Meanwhile, non-resident customer loans decreased by 4.1% mainly due to one bank which reduced its exposures towards non-bank financial institutions and NFCs in the electricity, gas, steam and air conditioning supply sector.

The quality of the loan portfolio deteriorated further, as the NPL ratio increased by 1.6 percentage points to 7.1%. The increase was reported by one bank reflecting higher corporate NPLs within the wholesale and retail trade sector and, to a lower extent, in construction. However, the coverage ratio increased by 3.9 percentage points to 44.9% as provisions rose faster than NPLs, with an additional 25% of NPLs covered by collateral.

Customer deposits, primarily from non-residents, remained the primary source of funding and rose marginally to 73.5% of total liabilities. Meanwhile, resident customer deposits decreased by 1.1% since 2019, and remained limited to 16.6% of the non-core domestic banks' liabilities, and just 2.4% of the resident deposits in the system. Wholesale deposits decreased by just under a third, mainly reflecting lower placements from unrelated credit institutions. The decrease in wholesale funding indicates limitations for this source of funding, as in times of stress it can dry up quickly. In this regard, it is important for such banks to continue diversifying their funding sources, although overall liquidity of the non-core domestic banks remained sound with the LCR ratio increasing to almost 400% in June 2020. Unencumbered central bank-eligible CBC rose by almost 3% to represent around a fourth of the overall balance sheet of non-core domestic banks. This creates further space for such banks to obtain alternative funding, amounting to around three times the overall LCR net cash outflows.

During this period, the total capital ratio of non-core domestic banks improved slightly to 18.7%. This was mainly due to a 9.3% decrease in RWAs reflecting lower credit risk to corporates and collective investment undertakings. However, total own funds and CET1 capital decreased by 8.0% as retained losses increased. The leverage ratio of the banks remained sound above 10%, complying with the regulatory minimum.

2.3 International Banks

International banks consolidated further their balance sheets. In aggregate, their assets declined by 2.7% to €13.2 billion, equivalent to 101.5% of GDP in June 2020. This reflected the sustained contraction in operations of the branches of foreign banks that together account for about four fifths of the overall activity of this bank category. In contrast, the assets of the other banks in this category grew by 4.9% over December 2019. In line with their classification, these banks' activities remained oriented towards non-residents.

Branches of Foreign Banks

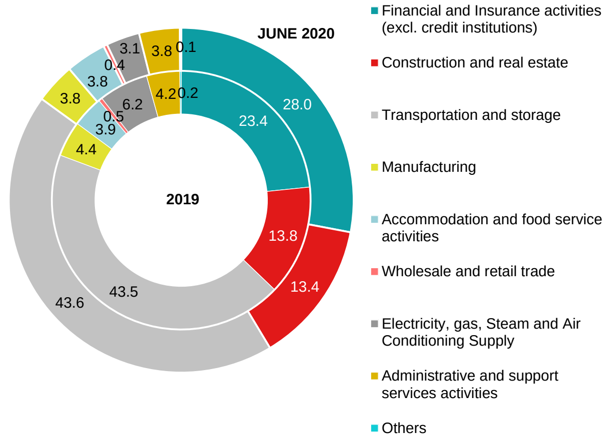
In spite of the challenges brought about by the pandemic, the profitability of branches improved. Such improvement was driven exclusively by one non-EU branch, with the overall pre-tax profits almost doubling during the first half of 2020, pushing the overall post-tax ROA to 1.9%. Income from non-interest-bearing activities more than doubled over 2019 on the back of higher FX revaluations. Similarly, net interest income rose by almost 60%, as interest expenses fell, mainly driven by lower interbank placements, surpassing the drop in interest income from both its investment and lending portfolio. Non-interest expenses dropped by almost 10%, driven by lower fees and commissions payable as well as administrative expenses, offsetting the increase in staff expenses. As a result, the cost efficiency of this category of banks improved further, with the cost-to-income ratio contracting by 3 percentage points to a low of 2.8% in June 2020, mirroring the relatively low expenses incurred by the branches. The increase in profits was in part muted by a significant increase in net impairment charges.

The contraction in assets was mainly due to a 7.4% drop in securities holdings, which stood for almost a third of these banks' balance sheet. Meanwhile, the customer loan book rose by a marginal 0.4%, driven by a 20% increase in loans to non-resident OFIs, which in turn represented around 28% of the total customer loan book. In contrast, NFC loans, predominantly located in Turkey, declined by 5.7%. As can be seen in

Chart 2.9, the NFC loan portfolio of these institutions is mainly exposed to the transportation and storage sector, and construction sector.

At the same time, asset quality improved further – largely driven by a drop in the level of outstanding NPLs mainly to non-resident OFIs and to a lower extent NFCs in the transportation and storage sector, reported by one branch. Consequently, the NPL ratio remained at a low of 1.0% in June 2020, as otherwise the credit risk of the two largest branches is shifted to their head office, in line with their business model.

Chart 2.9
CUSTOMER LOANS BY SECTOR – BRANCHES OF FOREIGN BANKS
(per cent)



Source: Central Bank of Malta.

Meanwhile, funds placed with the Central Bank of Malta fell marginally, to account for 4.2% of total assets.

Intragroup funding declined by 11.3%, but still accounted for around two thirds of total liabilities. At the same time, interbank deposits from unrelated non-resident banks rose by almost 60%, accounting for about 21% of overall liabilities in June 2020. Meanwhile, the contraction in the balance sheet of these banks was supported by a lower customer deposit base, which dropped by more than 80% over 2019, mainly due to higher outflows of non-resident private NFCs specialised in the manufacturing sector, financing only 1.3% of overall assets by mid-2020.

Subsidiaries of Foreign Banks and Stand-alone Banks

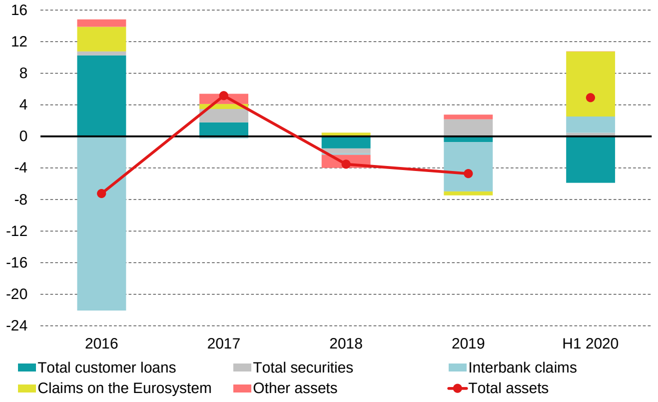
The overall pre-tax profits earned by this group of banks weakened by 23.7% as net impairment charges grew by around 20%, driven predominantly by higher Stage 3 impairments posted by micro lenders. Other banks have also reported lower profits, largely due to lower income. Considering these developments, the post-tax ROE and ROA narrowed by 1.0 and 0.5 percentage point to 6% and 2.4%, respectively.

Despite the challenges in the first half of the year, overall NII increased by 4.1%, owing primarily to higher income earned on lending, and securities holdings to a lower extent. Non-interest income also rose, by 2.3%, on the back of higher fees and commissions. Non-interest expenses increased by 6.2%, driven predominantly by one bank on the back of higher general expenses charged from within its group. This resulted in the overall cost efficiency of these banks to deteriorate, with the cost-to-income ratio narrowing by 1.5 percentage points to 54.8% in the six months to June 2020.

Since end 2019, the customer loan portfolio declined by 8.9% to 57.6% of their overall assets in June 2020, driven by a 12% drop in non-resident NFCs loans (see Chart 2.10). The sectoral composition of the loan book remained largely intact with lending predominantly towards the manufacturing, and the transportation and storage sectors. Non-resident consumer credit fell marginally to account for 18.2% of total customer portfolio. Loans to non-resident OFIs increased by 1.9%, pushing up its share in the loan book to around 7%. Although resident lending increased by 15.6% over 2019, largely driven by OFIs, resident lending remained peripheral to the banks' activities representing just 1.4% of customer lending portfolio.

The asset quality of their loan portfolio deteriorated slightly as the NPL ratio rose by 0.4 percentage point to 3.9%, reflecting a 19.4% increase in NPLs. This was driven predominantly by households, possibly due to increased repayment difficulties during the pandemic as NPLs pertaining to the NFC sector fell by 9.9%, mainly from the wholesale and retail trade sector. Although provisions rose by 10.6% compared to end-2019, these fell short of the increase in NPLs, and consequently the coverage ratio dropped to 101.6%.

Chart 2.10
CONTRIBUTION TO ASSETS GROWTH – SUBSIDIARIES OF FOREIGN BANKS AND STAND-ALONE BANKS
(percentage points)



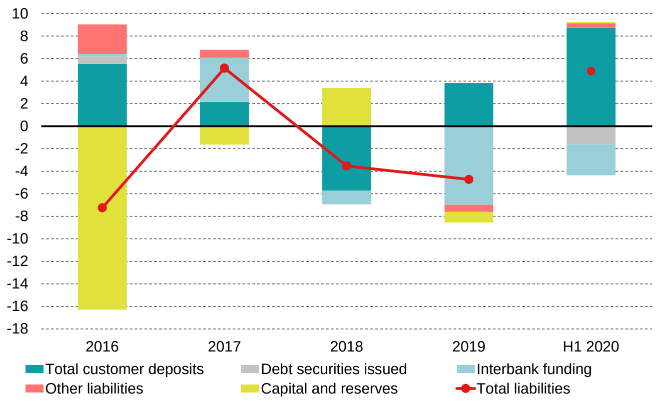
Source: Central Bank of Malta.
Note: H1 2020 figures refer to growth over end 2019.

This category of banks reported higher interbank placements which rose by 17.7% to account for 13.0% of overall assets, mainly driven by placements with related institutions, and to a much lower extent via placements with resident unrelated financial institutions. Claims with the Central Bank of Malta rose by more than 80%, to represent 17.6% of total assets. These developments reflected the abundant liquidity available at these banks, with the LCR standing significantly above the regulatory threshold at around 1,045% in June 2020.

The securities portfolio grew by 6.9% over 2019, mainly reflecting higher holdings of debt securities. Government bonds rose by 2.9%, driven by higher holdings of MGS as this group of banks also tapped into the opportunities arising from the increased government funding needs to finance the COVID-19 mitigation measures. This resulted in an increase in Eurosystem-eligible debt securities that can be pledged to secure funding in Eurosystem monetary policy operations. Although foreign sovereign holdings decreased by 3.4%, these still represented more than four fifths of their sovereign debt holdings. These banks also invested in corporate bonds to account for just under 10% of the bond portfolio. In contrast, MFI bonds fell by 1.5% though these accounted for 28.8% of total debt portfolio. Around 80% of their debt securities were invested in medium-rated bonds, which increased further in the first half of the year, as otherwise holdings of both low and high rated bonds fell.

Exposure in equity instruments rose by 1.2%, mirroring higher investment by one bank in a manufacturing company, to account for 31.6% of securities portfolio.

Chart 2.11
CONTRIBUTION TO LIABILITIES GROWTH – SUBSIDIARIES OF FOREIGN BANKS AND STAND-ALONE BANKS
(percentage points)



Source: Central Bank of Malta.
Note: H1 2020 figures refer to growth over end 2019.

The expansion in the balance sheet was financed by customer deposits, which rose by more than a quarter to around 39.3% of the balance sheet (see Chart 2.11). This mainly reflected higher non-resident households' deposits, and to a lower extent non-resident OFIs, which increased by 52.1% and 12.2%, respectively. Conversely, deposits of non-resident NFCs fell by around two fifths over 2019. Resident customer deposits more than doubled, reflecting higher deposits from NFCs and OFIs. Yet resident customer deposits remained limited to 3.6% of total assets and just 0.5% of total resident deposits in the Maltese banking sector.

Despite a challenging first half of the year, the total capital ratio of these banks increased from 47.2% in 2019 to 51.4% in June 2020, owing to higher retained earnings and lower risk-weighted assets, attributable to lower credit risk from corporate customers. The latter resulted in an improved risk profile as the share of RWA to overall assets dropped from 86.7% in 2019 to 76.1% in June 2020.

3. Stress Tests

3. STRESS TESTS

The Bank Reaffirms the Robustness of Credit Institutions' Solvency and Liquidity Buffers Amid the COVID-19 Pandemic

In fulfilling its core function of safeguarding financial stability, the Bank continued to monitor the resilience of the banking system's capital and liquidity adequacy by running its suite of stress tests and sensitivity analyses which form part of the Bank's financial stability toolkit. This section provides updated results of the stress tests presented in Chapter 3 of the *FSR 2019* (which were based on December 2019 as reference date) and the Special Feature (with reference date March 2020).

3.1 Macro Stress Testing Framework

Following the publication in August 2020 of revised economic projections for the period 2020 to 2022 (2020:3), the Macro Stress Testing (MST) framework was re-run to assess and monitor the resilience of banks in June 2020 under two revised scenarios on the basis of this new information. Although the MST framework was designed as an annual exercise to make use of financial year-end data and the full three-year projection horizon, the framework was modified to provide an update of the resilience of banks from mid-2020 till end-2022. Given that the capital position as at the reference date already captures the realised impact of the pandemic in the first half of the year, the interim MST has a 2.5-year test horizon.

Revisions to the Results Published in the FSR 2019

Following the *FSR 2019* publication, Tier 1 capital ratios for December 2019 have been revised upwards by 0.18 percentage point and 1.59 percentage points for core and non-core domestic banks, respectively. This revision was mainly due to profits for December 2019 which were not yet included in capital for some banks. While the impact by risk type remains the same, the revision in the starting capital ratio results in an upward revision of the post-shock Tier 1 capital ratios for 2022. Hence, looking back at the starting position featured in the *FSR 2019*, core domestic banks would have started the exercise with a Tier 1 capital ratio of 17.58% (0.18 percentage point higher than 17.40%) increasing to 18.18% under the former exercise's baseline scenario and dropping to 14.29% under its adverse scenarios, respectively. Similarly, non-core domestic banks would start the exercise with a Tier 1 capital ratio of 18.11% (1.59 percentage points higher than 16.52%) dropping to 15.30% under the baseline and 10.48% under the adverse scenarios, respectively. These revisions to the starting capital ratio are also reported in Charts 3.1 to 3.4.

Revised Baseline and Adverse Macroeconomic Scenarios

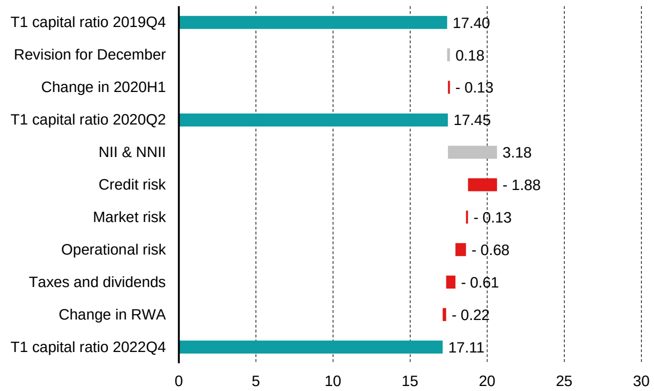
Under the MST's baseline scenario, domestic GDP is projected to contract by 6.6% in 2020 and grow by 6.1% and 4.2% in 2021 and 2022, respectively. Compared to the *FSR 2019* baseline, GDP is revised significantly downwards from -4.8% in 2020 mainly due to a more adverse outlook for tourism exports which offset the enhanced fiscal support. In addition, private consumption and private investment will also contract in 2020 following the shutdown of non-essential services and uncertainty. Thereafter, the economic recovery is mainly driven by domestic demand. The unemployment rate is expected to peak at 4.9% in 2020 and then moderate to 4.6% and 4.4% in 2021 and 2022, respectively, while oil prices remain low to reflect the dip in prices observed between February and March 2020. These economic projections are complemented by an exogenous V-shaped shock to equity prices which would drop by 12% in the first year and partially recover throughout the test horizon. Moreover, under this scenario, it is assumed that dividend income on banks' equity holdings would drop by 50% in 2020 and, similar to equity prices, partially recover throughout the test horizon. Fees and commission income are expected to decline by 10% in each year of the test horizon.

Under the MST's adverse scenario, GDP is expected to decline by 9.3% in 2020 following a sharper drop in tourism exports, and a slower global economic recovery than anticipated. The economy is expected to recover thereafter with GDP growth rates of 5.5% and 3.7% in 2021 and 2022, respectively. The unemployment rate peaks at 5.1% in 2020 and subsequently falls to 4.9% and 4.8% in the following two years. The adverse scenario also features exogenous shocks to equity prices which would drop by 24% (and partially recover over the test horizon), while real estate prices would fall by around 5% in each year compared to the baseline scenario to account for the mild overvaluation observed at the reference date and cancel the baseline growth in property prices. Moreover, under this scenario, it is assumed that banks would not receive any dividend income from their equity holdings in 2020 and, similar to equity prices, dividend income would partially recover throughout the test horizon, while fees and commission income are expected to decline by 15% in each year of the test horizon.

Results

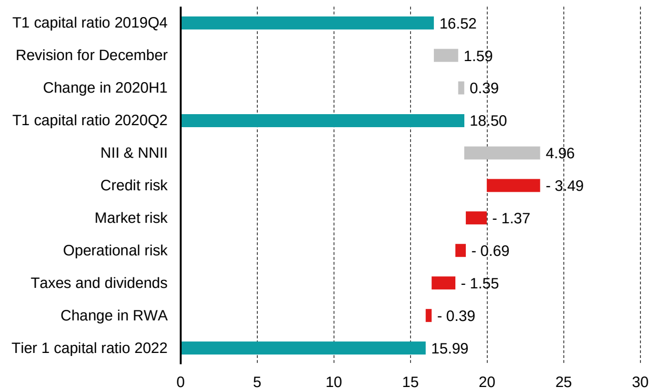
Charts 3.1 and 3.2 present the revisions to the Tier 1 capital ratio relative to figures published in the *FSR 2019* and the contributions of the various risk modules (as a fraction of risk weighted assets) to the evolution of the Tier 1 capital ratio under the baseline scenario for core and non-core domestic banks, respectively. While the impact for credit risk, market risk and operational risk is comparable to the impact presented in the *FSR 2019*, the lower magnitude can be attributed to the shorter test horizon of 2.5 years. These impacts are mainly driven by credit risk losses from impairments held against defaults in debt securities at amortised cost (AMC) and loans, as well as market risk losses in the form of revaluation losses on debt securities, held at fair value (FV). Nonetheless, banks experience a contraction in the offsetting effect attributed to NII and net non-interest income (NNII) relative to the *FSR 2019*. NII is mainly impacted from credit risk with a reduced income stream because of forgone coupons and missed repayments from defaulted debt securities and loans, respectively. NNII is mainly impacted by lower income and higher losses experienced in the first half of 2020 which, by the static balance sheet assumption, are then projected to impact also the second half of 2020 and to be repeated also in the following two years.[1] Overall, core domestic and non-core domestic banks experience a drop in their Tier 1 capital ratio of 0.34 and 2.51 percentage points to reach 17.11% and 15.99%, respectively, under the baseline scenario. Nonetheless, both bank categories remain well above the regulatory requirement of 6%. At

Chart 3.1
STRESS TEST RESULTS – MACRO STRESS TEST BASELINE SCENARIO – RELATIVE CONTRIBUTION OF THE IMPACT ON CORE DOMESTIC BANKS' TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

Chart 3.2
STRESS TEST RESULTS – MACRO STRESS TEST BASELINE SCENARIO – RELATIVE CONTRIBUTION OF THE IMPACT ON NON-CORE DOMESTIC BANKS' TIER 1 CAPITAL RATIO
(per cent)

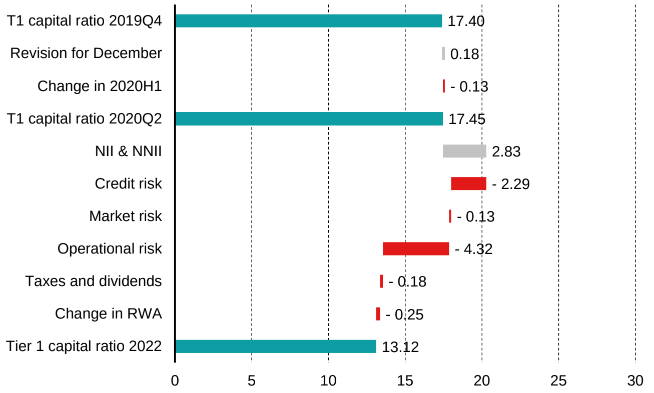


Source: Central Bank of Malta calculations.

[1] The static balance sheet assumption allows for ease of comparison between results by leaving the composition of assets and liabilities constant throughout the test horizon. Any instruments which mature over the test horizon are immediately replaced by instruments with similar characteristics.

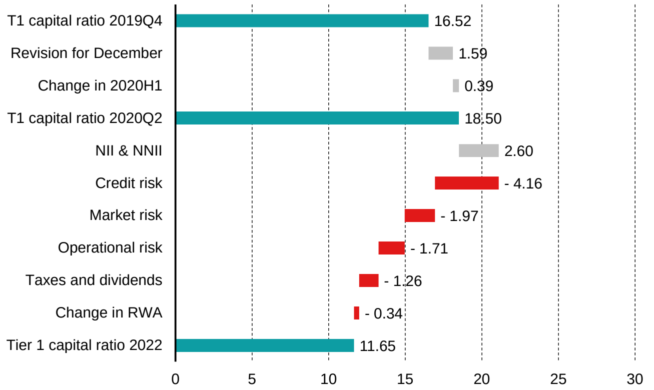
an individual bank level, banks manage to surpass their respective Total SREP Capital Requirement (TSCR).[2]

Chart 3.3
STRESS TEST RESULTS – MACRO STRESS TEST ADVERSE SCENARIO – RELATIVE CONTRIBUTION OF THE IMPACT ON CORE DOMESTIC BANKS' TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

Chart 3.4
STRESS TEST RESULTS – MACRO STRESS TEST ADVERSE SCENARIO – RELATIVE CONTRIBUTION OF THE IMPACT ON NON-CORE DOMESTIC BANKS' TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

Charts 3.3 and 3.4 show that under the adverse scenario, the aggregate Tier 1 capital ratios would drop for both bank categories. Losses would mainly originate from higher levels of NPLs and defaulted bonds that reduce the stream of interest income via missed repayments against these assets. In addition to losses in interest income arising as a consequence of credit risk, NNII is also reduced as a result of the assumed decline in dividend income (100% in 2020 with a partial recovery to approach the 2019 level thereafter) and in fees and commission income (15% in each year of the test horizon). Moreover, operational risk contributes to the impact on core domestic banks' capital while unrealised losses on shares held impact the capital of non-core domestic banks. The Tier 1 capital ratio for core domestic banks falls by 4.33 percentage points (3.29 percentage points in the *FSR 2019*) to reach 13.12% while that of non-core domestic banks falls by 6.85 percentage points (7.63 percentage points in the *FSR 2019*) to reach 11.65%. The overall impact for non-core domestic banks is smaller when compared to December 2019 as a result of a contraction in the balance sheet size, particularly shares held (which are a major source of unrealised losses in December 2019) have reduced by 21% over this 6-month period. It is worth highlighting that these results do not consider any policy intervention or supplementary support measures aimed at mitigating the outcome of the adverse scenario.

The Tier 1 capital ratio for both bank categories remains well above the 6% minimum requirement. Moreover, banks are assessed individually against their respective TSCR, which is the applicable benchmark for an adverse scenario under the SREP guidelines. The TSCR consists of the common 6% Pillar 1 requirement and the 2020 Pillar 2 requirement individually determined for each bank by the respective supervisor. The interim MST results are benchmarked against higher TSCRs than those applicable for December 2019. In

[2] Even though the Overall Capital Requirement (OCR) is the benchmark for a baseline scenario, following the temporary capital relief measures announced by the ECB and the MFSA, banks are allowed to make use of their capital and liquidity buffers and operate below the combined buffers requirement assuming also release of the O-SII buffer. Thus, for this *Interim FSR*, the baseline scenario is assessed against the TSCR which excludes these additional buffers.

general, the financial system exhibits resilience under the more adverse scenario which is designed to test for systemic risks. However, some vulnerabilities are observed in a few small banks.[3]

Sensitivity Analyses

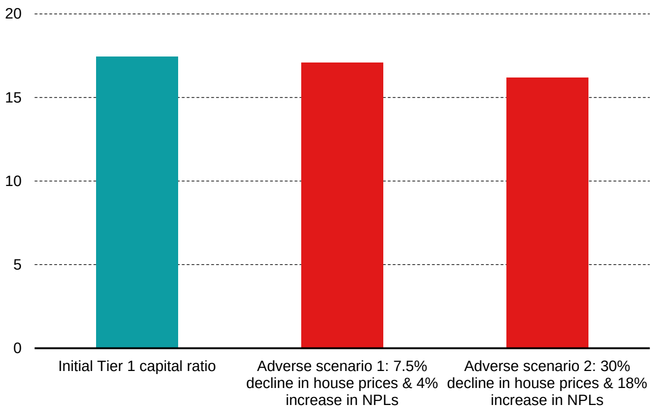
As a complement to the MST framework, sensitivity analyses are conducted to assess the impact on solvency from alternative scenarios in isolation using June 2020 data. As an update to the results for December 2019 presented in Chapter 3 of the *FSR 2019*, (1) the house price correction test targets core domestic banks as the main mortgage providers against an abrupt drop in house prices. Moreover, an update of the results for the three tests included in the Special Feature (as at March 2020), is provided. These tests assess the resilience of core domestic, non-core domestic and international banks against: (2) credit quality deterioration in their debt securities portfolio, (3) an increase in NPLs from an assumed credit quality deterioration in those loans granted a moratorium and (4) a combined scenario of 2 and 3.

House Price Correction

This test focuses on core domestic banks as the main mortgage providers and applies two adverse exogenous shocks to house prices of 7.5% (1 standard deviation) and 30% (4 standard deviation). These shocks affect the valuation of real estate-related collateral backing loans and are combined with a simultaneous increase in NPLs of 4% and 18%, respectively, which translate into higher loan loss provisions.

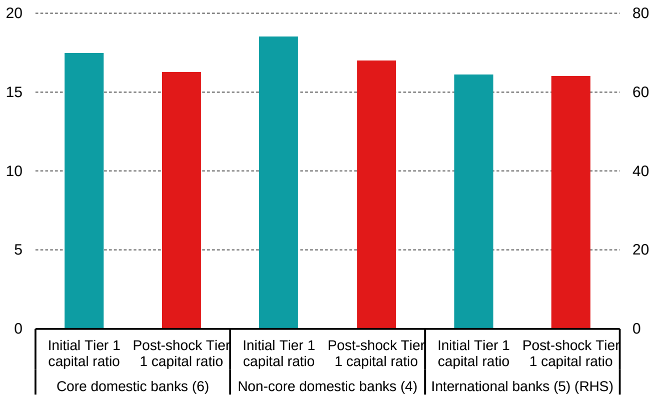
Chart 3.5 shows that core domestic banks' Tier 1 capital ratio fall marginally from 17.45% to 17.11% under adverse scenario 1 and 16.21% under adverse scenario 2. Despite a marginally higher estimated level of provisions required to be set aside in June 2020, the change in the Tier 1 capital ratio results in a marginally lower but comparable impact to the results presented for December 2019.

Chart 3.5
STRESS TEST RESULTS – IMPACT OF A DROP IN HOUSE PRICES ON CORE DOMESTIC BANKS' TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

Chart 3.6
STRESS TEST RESULTS – IMPACT OF DETERIORATION IN DEBT SECURITIES PORTFOLIO ON TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

Credit Quality Deterioration in the Debt Securities Portfolio

This test applies the MST's credit risk module for debt securities in isolation and assesses the core domestic, non-core domestic and international banks against a potential deterioration in the credit quality of their debt securities portfolio. Specifically, the test assumes

[3] The Bank does not comment on individual bank results for its stress tests given that these are designed to test the overall resilience of the system.

a three-notch rating downgrade in debt securities accounted for at AMC, as well as a widening of credit spreads and valuation haircuts applied respectively for non-sovereign and sovereign FV debt securities. The composition of the debt securities portfolio remained broadly stable when compared to March 2020. Indeed, the share of debt securities rated at investment grade (BBB- or higher) stood at 99%, 98% and 90% for the respective bank categories. Moreover, the share of debt securities accounted for at AMC stood at 59%, 48% and 81%, respectively. Chart 3.6 shows that under such a scenario, the Tier 1 capital ratio would fall from 17.45% to 16.28% for core domestic banks, from 18.50% to 16.98% for non-core domestic banks and from 64.44% to 63.98% for international banks. The drop in capital is equivalent to -1.17, -1.52 and -0.46 percentage points, respectively. The drop in capital for core and non-core domestic banks is higher than the impact reported for March 2020 as these banks have increased the size of their debt securities portfolio from €5.3 billion to €6.0 billion and from €0.4 billion to €0.5 billion, respectively.

Increase in NPLs

This sensitivity analysis, which assesses the impact from an increase in NPLs in key sectors, was introduced for the first time in the Special Feature with reference date March 2020. The same approach is adopted to assess the impact on solvency as at June 2020 from a worst-case scenario in which performing loans to the identified productive sensitive sectors (same 12 sectors as listed in Panel A of the Special Feature which were assumed to be mostly impacted by the COVID-19 pandemic) and mortgages, which have been granted a moratorium (up to August 2020), would become non-performing.[4] Relative to March, the banks in scope have increased from 10 to 12, as two international banks have since started granting moratoria. Upon classification of these loans as NPLs, banks would need to set aside loan loss provisions based on the uncollateralised part of the loans, which are charged to the P&L. In the case that operating profits provide only partial loss absorption, banks would need to release capital to offset the residual losses.

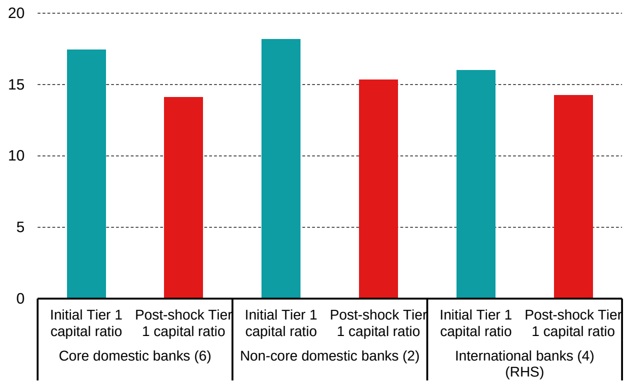
Chart 3.7 shows that in such a scenario, Tier 1 capital ratios would fall from 17.45% to 14.14%, from 18.18% to 15.35% and from 64.06% to 57.03% for core domestic, non-core domestic and international banks, respectively – but remaining well above the regulatory Tier 1 capital ratio requirement of 6%. The impact on the Tier 1 capital ratio of the 12 banks in scope ranges between 1.31 and 11.26 percentage points, and in a worst-case scenario assuming an extreme situation – where none of the borrowers that were granted a moratorium would be in a position to honour their obligations.

Combined Credit Quality Deterioration and Increase in NPLs

To further assess the banks' solvency positions, the previous two sensitivity analyses have been combined to consider a deterioration in both debt securities and loans. The same 15 banks included in the sensitivity analysis on their debt securities portfolio fall within scope of this test.

The quantification of the impact of the combined scenario would result in a drop in the Tier 1 capital ratio of 4.49, 3.98 and 7.38 percentage points for core domestic, non-core

Chart 3.7
STRESS TEST RESULTS – IMPACT OF AN INCREASE IN NPLS IN SENSITIVE SECTORS AND MORTGAGES ON TIER 1 CAPITAL RATIO
(per cent)

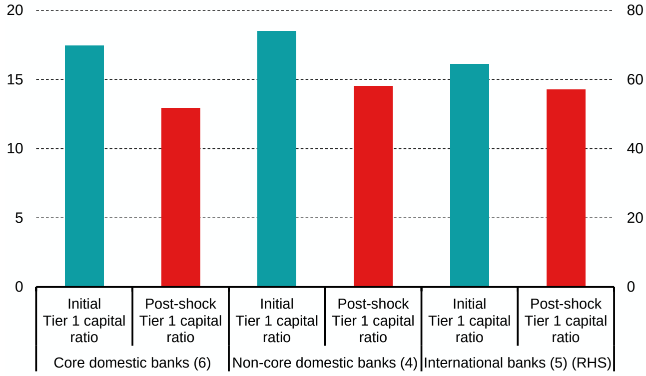


Source: Central Bank of Malta calculations.

[4] While the test refers to bank data as at June 2020, the uptake of moratoria has been calibrated at August 2020 to capture both moratoria granted by banks at the onset of the pandemic, as well as after the Bank issued Directive No. 18 on 13 April 2020 to regulate moratoria granted to credit facilities in exceptional circumstances.

domestic and international banks, respectively. This impact is higher given that, as mentioned above, while the composition of the debt securities portfolio remained relatively stable, the share of loans with moratoria to total loans of banks in scope in this exercise has increased by 1.3 times from 11.83% in May to 15.96% in August 2020. Chart 3.8 shows that their Tier 1 capital ratio would drop from 17.45% to 12.96%, from 18.50% to 14.52% and from 64.44% to 57.06%, respectively. However, the materialisation of the assumed shocks would still leave all three bank categories in a comfortable position to absorb potential losses when compared to the regulatory minimum Tier 1 capital ratio of 6%.

Chart 3.8
STRESS TEST RESULTS – IMPACT OF DETERIORATION IN DEBT SECURITIES PORTFOLIO AND INCREASE IN NPLS IN SENSITIVE SECTORS AND MORTGAGES ON TIER 1 CAPITAL RATIO
(per cent)



Source: Central Bank of Malta calculations.

3.2 Liquidity Stress Testing Framework

Persistent Deposit Withdrawals

The persistent deposit withdrawals (PDW) framework assesses the resilience of banks' liquidity buffers of the highest quality against a bank-run type of scenario. The framework considers extreme shocks over a period of five days and the subsequent three weeks over which the banks' counterbalancing capacity (CBC) is assessed in meeting the assumed withdrawals. The banks' CBC is made up of, *inter alia*: cash; excess on their reserve requirement with the Bank; and funds raised from the sale of marketable securities.

Two adverse scenarios are considered. Under the first scenario, banks can obtain ECB funding against pledged securities and sell FV debt instruments at fire sale prices, while under the second scenario banks obtain ECB funding against all eligible securities and sell remaining unencumbered FV debt instruments at fire sale prices.[5] Banks are assumed to become illiquid if their stressed CBC is not sufficient to meet the assumed withdrawals. The extent of liquidity outflows from deposits is driven by the term-to-maturity and the assumed outflows which differ for retail, corporate and other customer categories.

Tables 3.1 and 3.2 present the results of the PDW framework under both scenarios as at June 2020, with all three bank categories retaining excess liquidity buffers at the end of the stress test horizon under both scenarios. Compared to the March 2020 results published in the Special Feature of the *FSR 2019*, core

Table 3.1
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS – SCENARIO 1, RESTRICTED ECB FUNDING, EXCESS LIQUIDITY TO TOTAL COUNTERBALANCING CAPACITY
(per cent)

Scenario	Day 1	Day 2	Day 3	Day 4	Day 5	Week 2	Week 3	Week 4
Core domestic banks	86	83	79	76	73	69	65	62
Non-core domestic banks	80	74	68	63	57	51	44	39
International banks	90	88	87	85	84	82	79	77

Source: Central Bank of Malta calculations.

[5] Fire sale prices have been calibrated on the basis of market prices observed during the 2008 financial crisis.

Table 3.2
STRESS TEST RESULTS – IMPACT OF PERSISTENT DEPOSIT WITHDRAWALS – SCENARIO 2, UNRESTRICTED ECB FUNDING, EXCESS LIQUIDITY TO TOTAL COUNTERBALANCING CAPACITY
(per cent)

Scenario	Day 1	Day 2	Day 3	Day 4	Day 5	Week 2	Week 3	Week 4
Core domestic banks	89	87	84	81	79	76	73	70
Non-core domestic banks	80	74	68	63	57	51	45	39
International banks	91	89	88	87	86	83	81	79

Source: Central Bank of Malta calculations.

domestic and international banks have marginally improved their excess CBC, while non-core domestic banks have a slightly lower excess CBC over the entire test horizon. Despite the overall positive aggregate results, weaknesses can be observed in a few small banks which can be attributed to the severity of the assumed deposit withdrawals.

LCR-based Liquidity Stress Test

The Liquidity Coverage Ratio (LCR) framework assesses the banks' ratio of high quality liquid assets (HQLA) to net cash outflows over the next 30 days against the LCR regulatory minimum requirement of 100%.

Table 3.3 describes the eight adverse scenarios considered in this framework. The first four adverse scenarios consider higher inflow and outflows rates from those prescribed in the Commission Delegated Regulation (EU) 2015/61 and applied in the baseline, paired together with higher withdrawals in deposits by residents, non-residents, or both. In addition to these standard LCR scenarios, four additional scenarios are considered in which banks experience a partial or full withdrawal of commitments to NFCs and the retail sector.

Chart 3.9 presents the resulting LCR as at June 2020 under the baseline scenario and the eight adverse scenarios. On an aggregate level, the three bank categories manage to surpass the 100% regulatory minimum requirement in all scenarios. Compared to the results for March 2020 published in the Special Feature of the *FSR 2019*, international banks have increased their HQLA, mainly as withdrawable central bank reserves (as reported in Chapter 2), leading to an almost three-times higher LCR ratio. This puts this category of banks in a sounder position against the adverse shocks (in March 2020, international banks fell below the minimum requirement under adverse scenarios 3 and 4). On the other hand, results for core and non-core domestic banks have remained broadly stable.

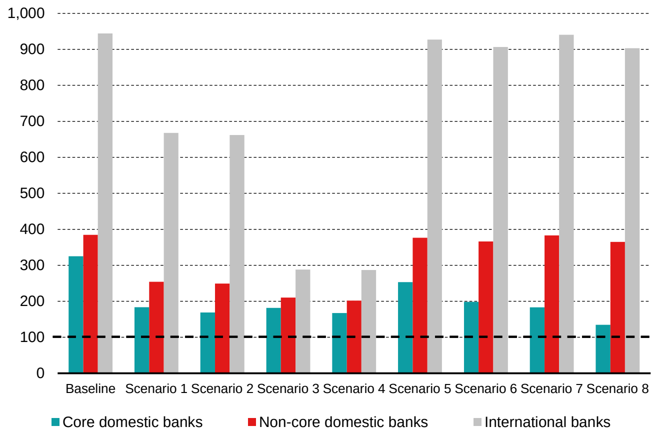
Table 3.3
DESCRIPTION OF BASELINE AND ADVERSE SCENARIOS

Scenario	Description
Baseline	Haircuts and outflow/inflow rates as prescribed by the LCR Delegated Regulation
Adverse:	
Scenario 1	Higher outflows compared to the LCR Delegated Regulation
Scenario 2	Scenario 1 with additional withdrawals of resident time deposits (>30 days)
Scenario 3	Scenario 1 with additional withdrawals of non-resident time deposits (>30 days)
Scenario 4	Scenario 1 with additional withdrawals from both resident and non-resident time deposits
Scenario 5	Baseline scenario with 50% withdrawal of committed facilities to NFCs
Scenario 6	Baseline scenario with 100% withdrawal of committed facilities to NFCs
Scenario 7	Baseline scenario with 100% withdrawal of committed facilities to retail, including mortgages
Scenario 8	Baseline scenario with 100% withdrawal of committed facilities to retail and NFCs

Source: Central Bank of Malta.

Weaknesses can be observed in a few small banks; however, these vulnerabilities have to be seen in the context of the severity of the shocks applied. Moreover, given the current extraordinary circumstances, under the supervisors' authority, banks are allowed to temporarily operate with an LCR below the minimum requirement while providing a plan highlighting ways how the LCR would be restored.

Chart 3.9
STRESS TEST RESULTS – LCR RESULTS FOR ALL BANKS
(per cent)



Source: Central Bank of Malta calculations.

3.3 Interest Rate Risk in the Banking Book

This test analyses the impact that changes in the shape of the yield curve would have on the banks' business model. This is done by applying the six scenarios prescribed by the Basel Committee for Banking Supervision (BCBS) guidelines, consisting of an upward and downward parallel shift at the reference date; an increase and a decrease in the short rate end of the curve; and two composite shifts in the short and long-term rates referred to as the 'steepener' and the 'flattener' scenarios. The shocks are assumed to affect the degree of interest rate risk based on the interest rate type (fixed, variable or a combination thereof), the currency denomination and the reset date of interest-bearing assets and liabilities.

Table 3.4 presents the aggregate post shock Tier 1 capital ratios for the three bank categories. The results are comparable to the results published in the 2019 report with the 'short-rate down' scenario having the biggest negative effect on all three banking groups due to majority of interest bearing assets and liabilities being repriced immediately. For non-core domestic banks, the impact of 'short-rate down' and 'parallel down' is equal, while there was only a marginal difference between these two scenarios for international banks. While profit margins could continue to narrow in the event of further declines in the interest rates, the aggregate post shock Tier 1 capital ratio would remain well-above the 6% regulatory threshold, even in the most adverse scenarios. All the banks would be able to absorb the impact and have a total capital ratio which exceeds the respective TSCR requirements following the largest negative impact. Contrarily, 'short-rate up' seems to have the biggest positive effect for core domestic banks and international banks, with 'parallel up' being a close second. For non-core domestic banks, the impact of 'parallel up' is marginally more positive than for 'short-rate up'.

Table 3.4
STRESS TEST RESULTS – IMPACT OF CHANGES IN NET INTEREST INCOME ON THE TIER 1 CAPITAL RATIO
(per cent)

Scenario	Initial Tier 1 capital ratio	Parallel up	Parallel down	Steepener	Flattener	Short rate up	Short rate down
Core domestic banks	17.5	20.1	15.3	15.8	19.9	20.6	14.9
Non-core domestic banks	18.5	19.6	17.5	17.9	19.3	19.5	17.5
International banks	48.0	49.4	46.7	47.1	49.3	49.6	46.6

Source: Central Bank of Malta calculations.

4. Insurance Companies and Investment Funds

4. INSURANCE COMPANIES AND INVESTMENT FUNDS

4.1 Domestic Insurance Companies

As at June 2020, 67 insurance companies were licensed to operate from Malta, with €14.7 billion in assets, equivalent to 113.1% of GDP. Out of these, eight underwrite risks in Malta, with assets amounting to €3.7 billion. These consisted of three life insurance corporations and five non-life insurance corporations, with two of the latter also licensed to provide life insurance products. When compared to the December 2019, assets of domestically-focused insurance companies declined by 2.8%, equivalent to 28.3% of GDP.

Domestic insurance companies reinsured a median of 17.8% of their premia with foreign reinsurance companies, up by 0.8 percentage point since 2019, reducing the impact of potentially large claims on their balance sheet but strengthening cross-border links.[1] Potential contagion risks are deemed to be contained given that reinsurance is spread across various high-rated companies.

The onset of the COVID-19 pandemic had disrupted somewhat the operations of the insurance sector, potentially challenging the way the sector sells protective cover.

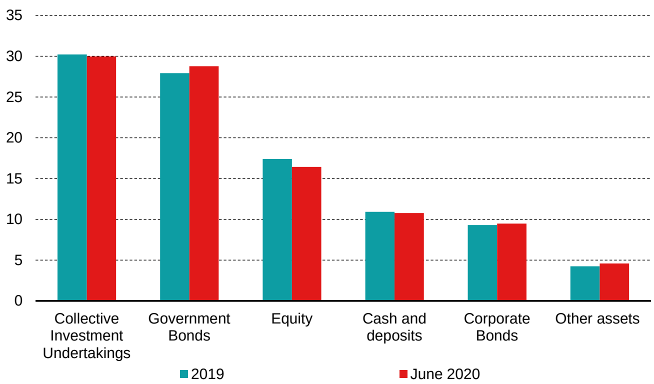
4.1.1 The Domestic Life Insurance Companies

The balance sheet of the domestic life insurers contracted by 3.7% to €3.2 billion, equivalent to 24.6% of GDP, with two of the three life insurance companies accounting for the bulk of written premia. The top line of business remained 'insurance with profit participation' accounting for 76.9% of life insurers' gross written premia, though it contracted by 2.8 percentage points over December 2019.[2] 'Index and unit-linked' products represented around 14% of gross written premia, which grew by 1.9 percentage points, while technical provisions set aside for index and unit-linked products remained limited to 16.7% of the life insurers' technical provisions.[3] The remaining share of gross written premia is classified as 'other life insurance'.

Holdings of corporate and government bonds decreased marginally but their share increased by 0.2 percentage point and 0.9 percentage point, respectively to 9.5% and 28.8% of the life insurers' assets (see Chart 4.1). Sovereign bonds represented almost three fourths of their bond portfolio, with about 43% invested in MGS.

In the first half of the year, insurers recorded some shifts in their corporate bond allocation. Although holdings of high-rated bonds increased, these only accounted for around 6% of total corporate bonds. Meanwhile, there was a general thrust towards lower-rated bonds, as corporate downgrades resulted in medium-rated paper holdings to decline, while holdings of low-rated paper increased. At the same time, insurers shed some of their sub-investment grade bonds, though these still accounted for 16% of the

Chart 4.1
COMPOSITION OF ASSETS HELD BY THE DOMESTIC LIFE INSURANCE SECTOR
(per cent of total assets)



Source: Central Bank of Malta.
Note: Other assets mainly include deferred tax, property, recoverables and receivables, collateralised securities, structured notes, mortgages and loans.

[1] The median reinsurance part of premia for the life and non-life sectors in June 2020 stood at 9.6% and 35.6%, respectively.
[2] 'Insurance with profit participation' refers to a savings product where at the end of each year the insurance company may declare a bonus rate, which forms part of the annual investment return. 'Index and unit-linked' products refer to when the obligation for the life insurance company is represented by the value of the underlying unit.
[3] The rest of the technical reserves were set for non-unit linked products.

corporate bond portfolio (see Chart 4.2).[4] Geographically, corporate bond holdings were almost equally split between euro area (excluding Malta) countries and others outside the euro area, with each standing at just above 46% of the overall corporate bond portfolio. These were mainly issued by NFCs, banks, other financial intermediaries (OFIs) and captives' financial institutions and money lenders (CFIMLs).[5] The remaining were domestic corporate bonds, largely issued by CFIMLs, NFCs and financial auxiliaries.

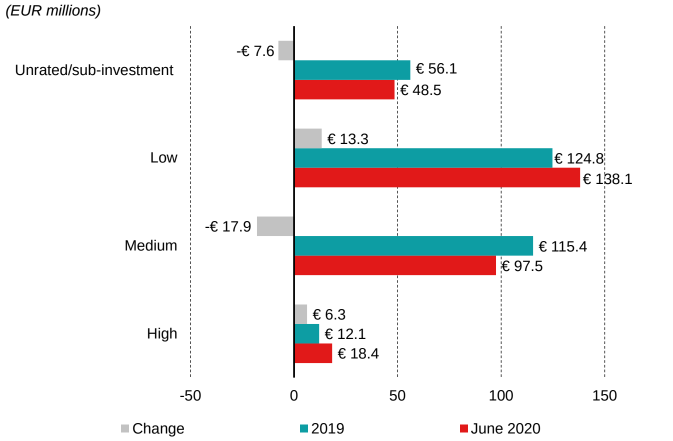
Holdings of equities declined by 9.1%, mainly reflecting the fall in market prices, to account for 16.4% of life insurers' assets. Such holdings were mainly concentrated in NFCs located in the United States and in the euro area, with around 21% pertaining to domestic NFCs mainly in real estate, and financial & insurance activities sectors. Almost 83% of equities related to NFCs were invested in COVID-19 sensitive sectors – mainly in manufacturing, information & communication, and wholesale and retail sectors. Equity holdings of MFIs are contained at 1.3% of total life insurers' assets indicating limited contagion risk in this regard, with only 0.8% of life insurers' assets held with local MFIs.

Participation in Collective Investment Undertakings (CIUs) made up almost a third of life insurers' assets, and are mainly spread across equity, debt, money market and asset allocation funds, predominately in euro area countries other than Malta.

Other assets include tangible real estate mainly held for investment purposes, which stood at 4.2%, up by 0.2 percentage point and loans which remained stable at just 0.6%, indicating the limited participation of domestic life insurers in non-traditional non-insurance activities. Furthermore, domestic life insurances held 10.8% of their assets in the form of cash and deposits, representing a drop of 5.0% compared to December 2019. These were almost all (97.7%) held with domestic banks.

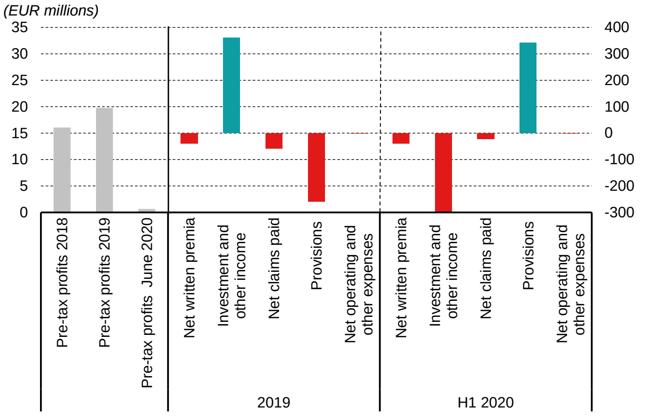
The COVID-19 pandemic impacted the profitability of life insurers. Pre-tax profits amounted to €0.6 million in June 2020, much lower than the reported €19.1 million in December 2019 (see Chart 4.3).[6] Adverse market movements and deterioration in investment activity resulted in a loss of almost €290 million in

Chart 4.2
CORPORATE BOND PORTFOLIO – INVESTMENT RATINGS – LIFE INSURANCE SECTOR
(EUR millions)



Source: Central Bank of Malta.

Chart 4.3
MAIN COMPONENTS OF PROFITS – DOMESTIC LIFE INSURANCE SECTOR
(EUR millions)



Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Teal (positive) and red (negative) bars indicate yearly changes in profit components. These figures are based on management accounts.

4 Investment-grade bonds carrying a rating of AA- or above are regarded as 'high-rated bonds', 'medium-rated bonds' are those rated between A- and A+, whereas 'low-rated bonds' are those rated between BBB- and BBB+. Sub-investment grade bonds are rated lower than BBB- or are unrated.

5 The CFIML consist also of holding companies that hold controlling levels of equity of a group of subsidiary corporations and whose principal activity is of owning the group without providing any other service to the businesses in which the equity is held.

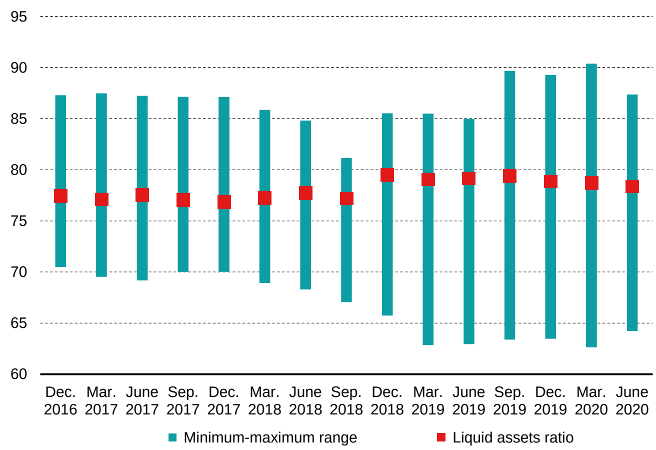
6 Profit figures are based on four-quarter moving sum figures.

allocated investment returns. Furthermore, a decline in economic activity coincided with a reduction in premia, which fell by around 11% mainly due to with-profit participation schemes, and a rise in claims of 8.2%, contributing negatively to the underwriting performance of life insurers. These losses were partly offset by a rise in provisions against unearned premia, claims and other reserves. As a result, pre-tax ROE and ROA plummeted to 0.3% and 0.02% from 7.8% and 0.6%, respectively, in 2019. Pre-tax return on net premia also fell to 0.2% from 5.7% in 2019, driven by a faster increase in net premia than profit before tax.

The macroeconomic impact of COVID-19 also took its toll on the life insurers' capital levels though their sound position prior to the onset of the pandemic provided the insurers with enough cushioning to withstand this unprecedented shock. In June 2020, the Solvency Capital Requirement (SCR) recovered to 160% after dipping to 121.6% in March 2020, though still lower than the 209% in December 2019. The composition remained healthy with almost all own funds held in Tier 1 capital.

At the same time, liquidity was not adversely affected. The liquid assets ratio stood at 78.4%, just marginally lower than in December 2019 (see Chart 4.4).[7] Such high liquidity reflected significant holdings of government bonds and listed equities coupled with increased cash holdings. However, the COVID-19 pandemic may result in liquidity pressures in the future, mainly due to lower volumes of new business which could affect the payment of claims of older policy holders.

Chart 4.4
LIQUID ASSETS RATIO OF THE DOMESTIC LIFE INSURANCE SECTOR
(per cent)



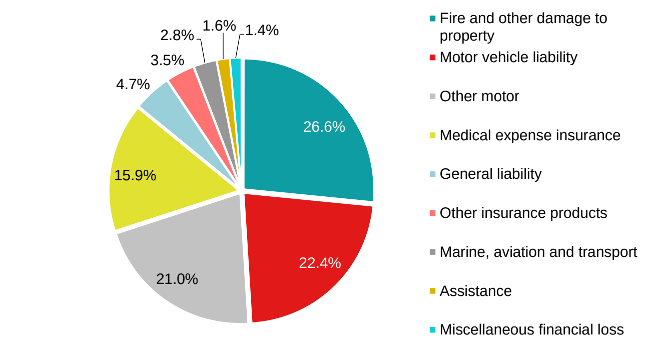
Source: Central Bank of Malta.

4.1.2 The Domestic Non-life Insurance Companies

In contrast to the life insurance sector, the assets of domestic non-life insurers rose by 3.5% to €478.3 million in June 2020, equivalent to 3.7% of GDP. Business remained concentrated in the motor vehicle-related segment, which accounted for 43.4% of the total written premia, followed by fire and other property damage, which represented another 26.6% (see Chart 4.5).

Their investment portfolio contracted as equity holdings fell by 7.7% due to drops in market prices. However, it remained prominent at

Chart 4.5
GROSS WRITTEN PREMIUM OF THE DOMESTIC NON-LIFE INSURANCE SECTOR BY LINE OF BUSINESS
(per cent of total gross written premia)



Source: Central Bank of Malta.
Note: Solvency II Reporting. Other insurance products include workers' compensation, income protection, other life insurance and profit participation, index-linked and unit-linked insurance.

[7] The liquid assets ratio shows the proportion of liquid assets on total assets (excluding assets held for unit-linked). The ratio is calculated by applying different weights (ranging from 100% for cash to 0% for intangible assets) to the different assets, according to their liquidity profile).

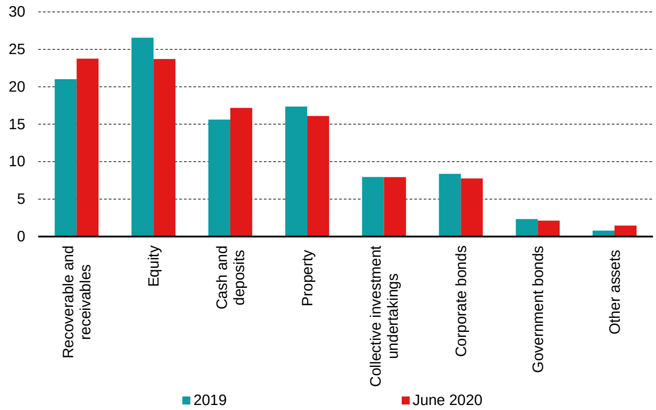
23.7% of non-life insurances' assets (see Chart 4.6). Such equities were predominantly in related insurance companies and other local insurers, implying a high level of interconnectedness due to cross ownership.[8] Bond holdings also fell, down by 4.5% to account for almost 10% of overall assets. Almost 80% were in the form of corporate bonds with more than half invested in foreign firms. Holdings of unrated corporate bonds declined by around 23% to account for 31.0% of assets, while low-rated bonds increased by 17.2% to 35.3%.[9] Holdings of highly-rated bonds contracted by 8.1%, largely driven by corporate downgrades which drove such NFCs to be classified as medium-rated bonds. These rose by 2.4% to stand at 26.8% of overall corporate bonds in June 2020. Sovereign bond holdings were almost equally split between foreign and domestic holdings. Meanwhile, participations in CIUs, mainly in debt, equity and money market funds, remained stable at 7.9% of the non-life insurers' assets.

Recoverable and receivables rose by 2.7 percentage points to 23.7% of non-life insurers' assets.[10] The lower investment holdings were offset by higher cash and deposits which increased by 13.8% since December 2019 to 17.2% of the non-life insurers' assets, with deposits predominately held with domestic banks.

Furthermore, during the first half of 2020, non-life insurers reduced their exposures towards the domestic real estate market as tangible real estate exposures fell to 16.1% of assets from 17.4% in December 2019, in part reflecting sale of properties. More than half of these assets were in the form of office and commercial buildings held for investment purposes, with the rest mainly held for own use. Non-life insurers did not engage in credit intermediation, while uncollateralised loans to domestically-related insurance companies remained stable at 0.2% of assets.

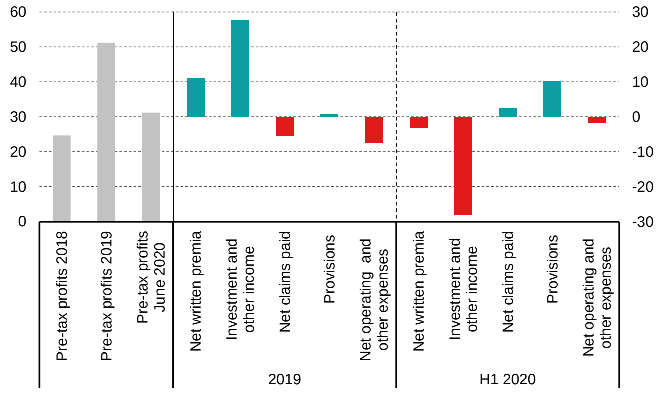
COVID-19 also had a considerable impact on the profitability of non-life insurers, albeit more contained compared with the life insurance companies. Their pre-tax profits decreased by 39.1% to €31.2 million (see Chart 4.7). The pre-tax ROE and ROA declined, at 14.9% and 7.2%, respectively, although

Chart 4.6
COMPOSITION OF ASSETS HELD BY THE DOMESTIC NON-LIFE INSURANCE SECTOR
(per cent of total assets)



Source: Central Bank of Malta.
Note: Other assets mainly include mortgages and loans.

Chart 4.7
MAIN COMPONENTS OF PROFITS − DOMESTIC NON-LIFE INSURANCE SECTOR
(EUR millions)



Source: Central Bank of Malta.
Note: Grey bars indicate pre-tax profits in absolute amounts. Teal (positive) and red (negative) bars indicate yearly changes in profit components. These figures are based on management accounts.

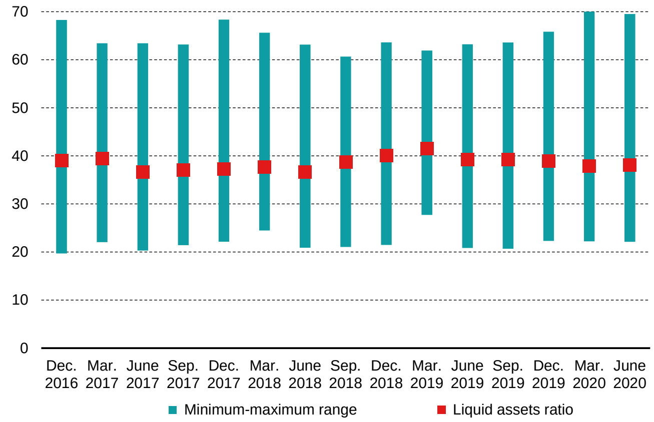
[8] The rest of the domestic holdings were spread among equities in NFCs, CFIML, banks, OFIs and pension funds. Equity holdings in NFCs were largely within the real estate, information & communication, and transportation & storage sectors.

[9] See Footnote 4.

[10] These consisted of recoveries of losses from claims that are reimbursed from the reinsurers and receivables in terms of outstanding premia.

these remained relatively healthy given the current unprecedented circumstances. Similarly, the pre-tax return on net premia stood at 19.6%, down from 31.5% reported in 2019. The reduction in profitability was mainly due to drops in investment income. While a 2.0% decline in net written premia contributed to the weakening in profitability, net claims paid declined by 3.3% to €76.6 million mainly due to motor, medical and general liability business, contributing positively to profitability. As a result, the loss ratio fell slightly to 46.7%, while the combined ratio went down by 4.6 percentage points to around 80% in June 2020. The net expense ratio remained largely stable at 33.2%, with such indicators all pointing towards positive underwriting performance.

Chart 4.8
LIQUID ASSETS RATIO OF THE DOMESTIC NON-LIFE INSURANCE SECTOR
(per cent)



Source: Central Bank of Malta.

Liquidity narrowed slightly during the first half of 2020, with the liquid assets ratio falling by 0.8 percentage point to 38.1%, comparatively low compared to life insurers, owing to the high share of intragroup equity holdings and recoverables and receivables held by non-life insurers, which are considered as illiquid assets and carry zero risk-weighting (see Chart 4.8).[11]

The non-life insurers' capital remained well-above the supervisory requirements with an overall solvency ratio of 251.2%. Although compared to end 2019, this ratio contracted by 5.4 percentage points, it improved since March 2020 when it stood at 233.3%. Most of total own funds were held in Tier 1 capital.

4.1.3 The Domestic Insurance Risk Outlook

The COVID-19 shock affected the economy across several dimensions, and it is expected to have a longer-term impact also on the insurance sector. The second wave of the pandemic could further amplify the effects analysed above. Although containment measures as yet are less severe when compared to the first wave, nevertheless this could imply that the recovery is likely to be slower than previously anticipated. The current main risks for the insurance sector include a weaker than expected macroeconomic environment accompanied by low for longer yields, which could affect asset allocation, profitability as well as solvency of insurers. There is also the risk of further ratings downgrades.

Although capital markets recovered somewhat from the fallout at the start of the COVID-19 spread, uncertainty still remains high and markets are still very fragile, particularly in view of the resurgence of infections at a much higher level than the first wave which is giving rise to renewed containment measures, particularly in Europe. Premia and claims could be further negatively influenced driven by economic developments, further impacting the underwriting performance of insurers. Although the pandemic has decreased profits and affected their capital positions, domestic insurers as yet still have enough headroom to continue dealing with adverse developments.

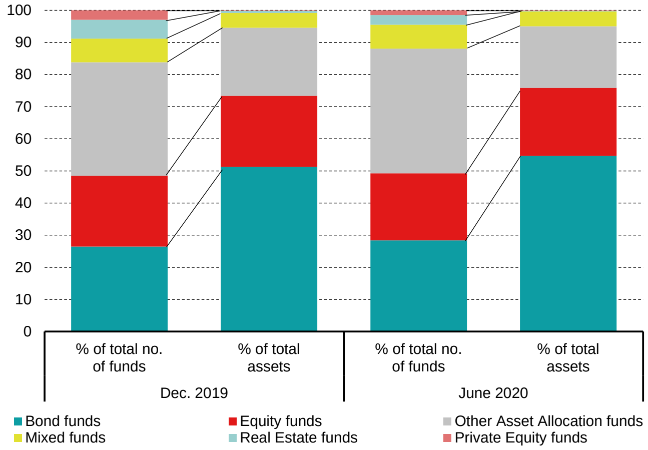
4.2 Domestic Investment Funds

By the end of June 2020, 67 sub-funds were considered to be domestically-relevant, with overall assets decreasing by 7.1% to €2.4 billion, equivalent to 18.2% of GDP. This contraction was mainly due to redemptions coupled with valuation losses on both equity holdings and bonds. This was mainly observed in equities and other asset allocation sub-funds, with their share in overall assets falling by 1.0 and 2.0

[11] Intragroup equity holdings accounted for 18.8% of assets and receivables and recoverables represented another 23.7% of assets.

percentage points to 21.1% and 19.2%, respectively.[12] Bond funds remained the most prominent category of funds where just above one quarter of the sub-funds represented 54.7% of the overall assets, an increase of 3.3 percentage points (see Chart 4.9). In turn, the number of mixed funds remained unchanged and accounted for almost 5% of assets under management. In contrast, assets of real estate funds and private equity funds fell by 71% and 5.3% respectively, to each represent just 0.2% of overall assets.[13]

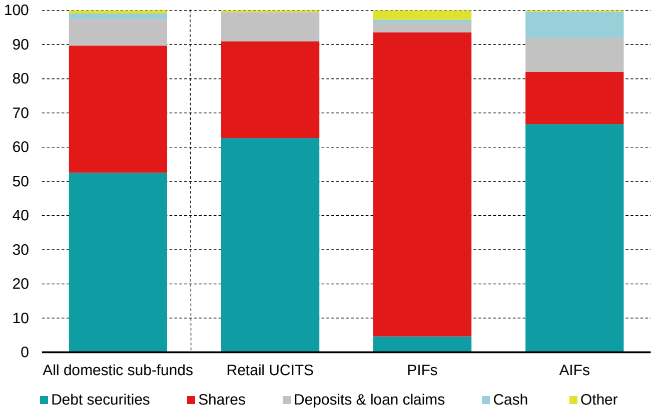
Chart 4.9
DOMESTIC INVESTMENT FUNDS BY MAIN STRATEGY
(per cent of total number of funds and per cent of total assets)



Source: Central Bank of Malta.

Around 55% of the domestically-relevant sub-funds were licensed as retail Undertakings for the Collective Investment in Transferable Securities (UCITS), representing 61.8% of the domestically-relevant sub-funds' assets. Over 60% of their assets consisted of bonds, while equities accounted for around 30% of their assets. UCITS also held 8.6% of their assets as deposits and loan claims, which increased by 1.1 percentage points from December 2019 (see Chart 4.10). Of the remaining sub-funds, around a fourth were licensed as Professional Investor Funds (PIFs), accounting for 18.9% of the total assets. The latter were highly invested in equities and in the first half of 2020 such exposures rose by more than 8 percentage points to tap into potential future higher returns following the significant moves in the stock market. Meanwhile, ten sub-funds were licensed as Alternative Investment Funds (AIFs), representing almost 20% of overall assets, which invested predominantly in debt securities (66.8% of their balance sheet) followed by equity (15.3%), and deposits and loan claims but to a lower extent (9.9%). Nonetheless, AIFs also held 7.7% of their balance sheet in cash, with such share increasing by 1.6 percentage points. Lastly, only two sub-funds were licensed as Notified AIFs, accounting for 0.2% of total assets.[14]

Chart 4.10
ASSET COMPOSITION OF DOMESTIC INVESTMENT FUNDS' BY FUND TYPE
(per cent of total assets)



Source: Central Bank of Malta.

Looking at the holdings of the overall domestic sub-funds, debt securities represented the largest asset component at 52.5% of overall assets, although such holdings declined by 6%, mainly driven by lower financial and bank bonds. More than half of the bond portfolio is in sovereign bonds, of which almost 90% pertained to the Maltese Government. Bonds issued by OFIs, financial auxiliaries and captives represented almost another

[12] Funds are classified as other asset allocation funds if they cannot be classified as any of the other funds. For example, an investment fund investing in commodities is classified as an other asset allocation fund.

[13] Investment funds are classified as mixed funds if they invest in both bonds and equity with no general policy in favour of either one or the other.

[14] The three retail non-UCITS sub-funds reported in December 2019 were removed since they are in the process of being liquidated.

quarter of the portfolio. Around 14% of holdings were in non-financial corporates, of which around half were equally split between Maltese firms and other euro area corporates. Bank bonds represented 7.3% of the overall bond portfolio, with almost half issued by other euro area banks and a further third by local banks.

Holdings of equities decreased by 5.8% to 37.2% of overall assets. The drop in equities was primarily driven by lower participation in non-MMF investment funds, largely domiciled in the euro area, which decreased by almost a third to account for slightly above a quarter of the overall equities. Meanwhile, direct equity holdings also decreased, down by around a quarter to almost two-thirds of overall equities.[15] The drop was largely driven by lower investments in OFIs, financial auxiliaries and captives, which dropped by 85.1%. Shares in NFCs, which accounted for around half of the equity portfolio also fell. These were mainly held in euro area NFCs, which were also adversely impacted as indicated by the drop in some of their equity prices.

During the first six months of 2020, the share of deposits and loan claims decreased by 1.4 percentage points to 7.7% of overall assets, while cash holdings grew marginally to 1.7% of total assets. Other assets, including financial derivatives, stood at 0.9% of total assets, up from 0.7% in December 2019.[16]

Maltese households and NPISH continued to be the principal investors in domestically-relevant sub-funds, largely through their participation in retail UCITS and AIFs, although their share of the overall net asset value (NAV) fell by 11 percentage points to 44.4%. Maltese NFCs meanwhile represented 24.8% of the overall NAV, up by 1.2 percentage points and largely invested in PIFs. Domestic MFIs represented more than 20% of the overall NAV, and are mainly invested in retail UCITS (see Chart 4.12).

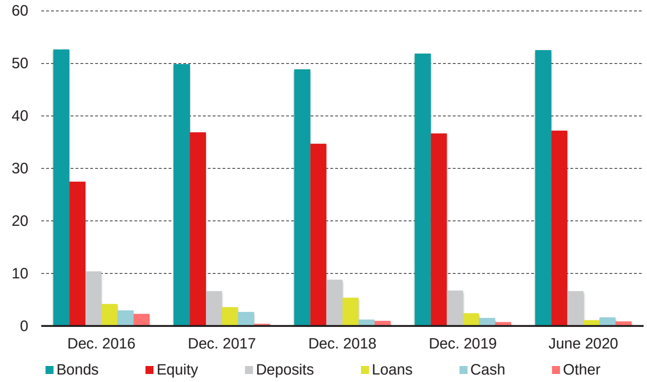
Overall, domestically-relevant investment funds represented 3.5% and 1.9% of the Maltese households' and the NFCs' financial wealth, respectively.

4.2.1 Risk Assessment

Liquidity Profile

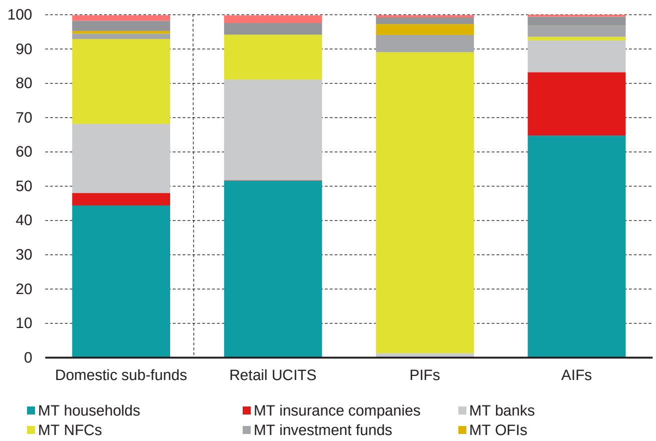
Domestically, PIFs reported the highest liquid assets ratio which rose by 8.1 percentage points to 90.3%.[17] Meanwhile, UCITS, which are globally recognised as highly liquid, reported a liquid assets ratio of 70.5%, just marginally below that

Chart 4.11
ASSETS COMPOSITION OF THE DOMESTICALLY-RELEVANT INVESTMENT FUNDS
(per cent of assets)



Source: Central Bank of Malta.
Note: The 'Other' category consists of other financial assets, non-financial assets (including fixed assets) and, to a lesser extent, financial derivatives.

Chart 4.12
DOMESTIC INVESTMENT FUNDS' NAV BY COUNTERPARTY
(% of NAV)



Source: Central Bank of Malta.

15 Direct equity holdings include investments in MFIs, OFIs, financial auxiliaries and captives, insurance corporations and NFCs.
16 The 'Other' category consists of other financial assets, non-financial assets (including fixed assets) and financial derivatives.
17 Liquid assets include cash and deposits with banks, debt securities issued by MFIs, sovereign bonds, equity and investment fund shares.

of AIFs which stood at 72.4%. As a result, the overall liquid assets ratio of the domestically-relevant investment funds stood at 75.1% in June 2020, up by 0.5 percentage point from December 2019. This shows that, overall, domestic investment funds have increased their capacity to absorb liquidity shocks. However, liquid assets decreased in absolute amounts, particularly due to lower deposits with banks and lower equity and investment fund shares (see Chart 4.13).[18]

Leverage

Domestically, leverage remained limited across all type of sub-funds, with the AUM-to-NAV ratio decreasing marginally to 100.8%. PIFs' AUM-to-NAV ratio stood at 101.4%, while the ratio for both AIFs and retail UCITS was slightly lower at 100.6%. This means that most of the assets are funded through NAV, thus sourced directly from investors (see Chart 4.14).

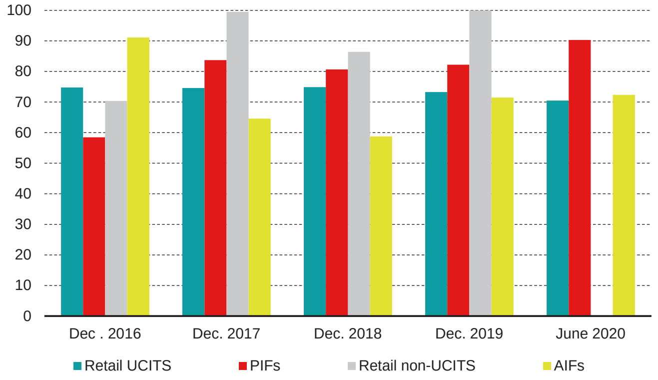
Concentration Risk

In line with their focus on domestic business, around 46% of the securities portfolio of domestically-relevant investment funds is concentrated in Malta, with securities of euro area sovereigns accounting for about 40% of the overall securities portfolio (see Chart 4.15). The bond portfolio is highly concentrated in domestic sovereign paper, with the share of such holdings on the total assets increasing further in the first half of 2020, accounting for almost one quarter of the assets. The increased shift towards local sovereign holdings mainly arises from the relatively higher domestic yields when compared to other countries in the euro area.

4.2.2 Risk Outlook

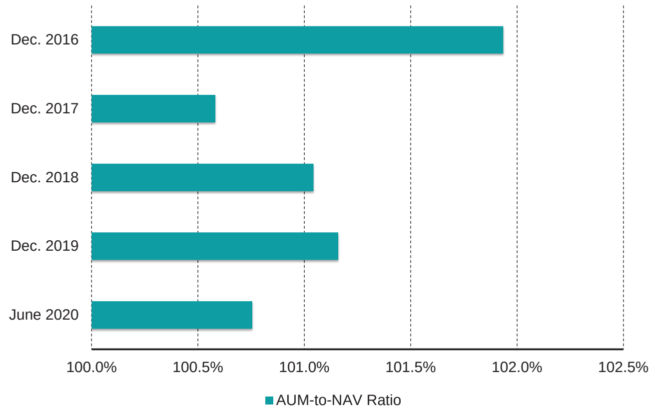
Links of investment funds with other financial services entities remained a structural feature of

Chart 4.13
LIQUID ASSETS RATIO OF THE DOMESTICALLY-RELEVANT INVESTMENT FUNDS BY LICENCE
(per cent of assets)



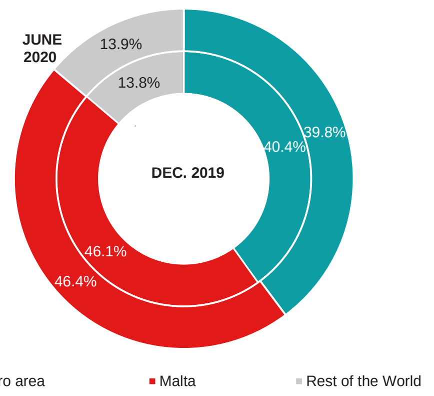
Source: Central Bank of Malta.
Note: Liquid assets include deposits with banks, debt securities issued by MFIs, sovereign bonds, equity and investment fund shares and cash. June 2020 figures exclude domestic Retail Non-UCITS funds since they are currently being liquidated.

Chart 4.14
RATIO OF ASSETS UNDER MANAGEMENT (AUM) TO NAV OF THE DOMESTIC INVESTMENT FUNDS
(per cent)



Source: Central Bank of Malta.

Chart 4.15
COUNTRY EXPOSURE OF THE SECURITIES PORTFOLIO OF DOMESTICALLY-RELEVANT INVESTMENT FUNDS
(per cent of securities portfolio)



Source: Central Bank of Malta

[18] The three domestic Retail Non-UCITS funds are currently being liquidated, therefore they are being excluded from the assessment.

domestically-relevant sub-funds, as some asset management companies are owned by the core domestic banks. Yet, spill-over risks are somewhat mitigated since funds are set up as separate legal entities, although possible step-in and reputational risks remain. Other risks are more cyclical in nature. Implied volatility measured on both the three-month euro-dollar rate and, to a lesser extent, of the S&P 500 and DAX indexes, which are timely indicators of investors' uncertainty, still remained above pre-COVID levels, although well below the highs previously seen at the start of the pandemic, showing unwillingness by some investors to take on risks. Investment funds' exposure to COVID-19 sensitive sectors doubled compared to December 2019, with such securities amounting to 24.1% of assets, mainly driven by higher exposures to real estate sector bonds and shares within the information and communication sector.[19]

Going forward, a protracted economic recovery coupled with increased investor uncertainty amid high levels of market volatility could trigger a reassessment of risk premia, making it more costly for leveraged corporate balance sheets. This, coupled with geopolitical tensions and low-for-longer interest rate environment, could trigger further excessive search-for-yield behaviour.

[19] The share of investment funds exposed to COVID-19 sensitive sectors is based on security-by-security (SBS) data only. SBS data for debt securities represent 98.2% of total debt securities holdings and SBS data for equity holdings represent 64.4% of total equity holdings. COVID-19 sensitive sectors are the same as those considered as such in the *FSR 2019*, Special feature: COVID-19 – Aspects of Financial Sector Resilience.

Appendix

Appendix
Financial Soundness Indicators

	Core Domestic Banks					Non-Core Domestic Banks					International Banks[1]					Total Banks[1]				
	2016	2017	2018	2019	June 2020	2016	2017	2018	2019	June 2020	2016	2017	2018	2019	June 2020	2016	2017	2018	2019	June 2020
Core FSIs																				
Regulatory capital to risk-weighted assets	16.16	17.28	18.13	20.10	19.98	15.48	16.68	17.21	18.41	18.68	49.20	47.93	52.97	47.15	51.41	21.17	21.68	22.66	23.66	23.96
Regulatory Tier 1 capital to risk-weighted assets	13.58	15.19	16.00	17.58	17.45	12.27	13.31	16.99	18.41	18.68	46.69	45.28	34.36	44.44	51.10	18.53	19.39	18.55	21.41	21.99
Non-performing loans net of specific provisions & interest in suspense to total own funds[2]	28.90	22.37	19.78	18.25	19.07	11.98	6.87	11.54	24.89	28.59	8.15	6.89	7.71	2.72	3.69	20.10	16.34	15.34	14.43	15.54
Non-performing loans to total gross loans	5.32	4.07	3.36	3.21	3.45	3.99	2.26	3.64	5.50	7.09	1.70	1.88	2.50	1.82	1.82	4.12	3.23	3.08	2.96	3.23
Sectoral distribution of resident loans to total loans																				
Agriculture	0.19	0.16	0.14	0.15	0.14	0.00	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.12	0.09	0.08	0.09	0.09
Fishing	0.07	0.35	0.23	0.16	0.12	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.05	0.20	0.14	0.10	0.08
Mining and quarrying	0.07	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.04	0.01	0.00	0.00	0.00
Manufacturing	2.57	2.64	2.49	1.78	1.71	0.31	0.43	0.34	0.42	0.42	0.01	0.01	0.00	0.00	0.01	1.60	1.55	1.50	1.14	1.13
Electricity, gas, steam and air conditioning supply	2.30	1.55	1.38	1.48	1.63	0.00	0.00	0.88	0.00	0.00	0.00	0.00	0.00	0.00	0.00	1.41	0.90	0.87	0.93	1.05
Water supply; sewerage waste management and remediation activities	0.46	0.43	0.39	0.36	0.34	0.00	0.00	0.00	0.02	0.02	0.00	0.00	0.00	0.00	0.00	0.28	0.25	0.23	0.23	0.22
Construction	4.88	4.54	4.37	4.54	4.50	0.03	2.51	3.30	4.79	6.04	0.00	0.00	0.00	0.00	0.00	2.99	2.74	2.78	3.10	3.22
Wholesale and retail trade; Repair of motor vehicles and motor cycles	7.80	6.85	6.27	5.38	5.24	0.42	2.23	5.24	1.76	2.46	0.00	0.00	0.01	0.00	0.00	4.80	4.07	4.01	3.46	3.50
Transportation and storage	2.30	2.27	1.68	1.46	1.47	0.00	0.00	0.00	0.51	0.66	0.15	0.16	0.24	0.24	0.24	1.46	1.38	1.09	1.02	1.06
Accomodation and food service activities	3.47	2.78	2.96	3.20	3.56	0.00	0.00	0.00	0.05	0.19	0.00	0.00	0.00	0.00	0.00	2.12	1.61	1.77	2.00	2.30
Information and communication	0.67	0.48	0.52	0.44	0.50	0.02	0.07	0.05	0.12	0.16	0.00	0.00	0.00	0.00	0.00	0.41	0.28	0.31	0.28	0.33
Financial and insurance activities	6.79	6.26	6.13	6.17	6.22	2.59	3.71	1.91	2.87	3.14	1.31	0.06	0.00	0.03	0.10	4.74	3.81	3.76	4.02	4.20
Real estate activities [includes inputed rents of owner-occupied dwellings]	7.26	6.95	6.90	7.38	7.29	4.18	4.36	4.76	6.05	6.12	0.03	0.00	0.00	0.00	0.00	4.70	4.21	4.36	4.94	5.02
Professional, scientific and technical activities	1.26	1.42	1.69	2.59	2.46	0.00	0.86	0.80	0.54	0.80	0.00	0.00	0.00	0.00	0.00	0.77	0.86	1.05	1.65	1.63
Administrative and support service activities	1.02	0.81	0.65	1.18	1.25	0.69	1.09	0.76	1.18	1.24	0.01	0.03	0.03	0.00	0.00	0.67	0.52	0.43	0.80	0.87
Public administration and defence; Compulsory social security	1.13	1.30	1.21	1.13	1.18	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.69	0.76	0.72	0.71	0.76
Education	0.33	0.29	0.28	0.26	0.26	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00	0.00	0.21	0.17	0.17	0.17	0.17
Human health and social work activities	0.71	0.72	0.79	0.76	0.72	0.00	0.00	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.44	0.42	0.47	0.47	0.47
Arts, entertainment and recreation	0.38	0.32	0.27	0.24	0.24	0.00	0.00	0.00	0.01	0.01	0.02	0.00	0.00	0.00	0.00	0.24	0.18	0.16	0.15	0.15
Other services activities	0.21	0.18	0.19	0.27	0.25	0.00	0.00	0.26	0.04	0.05	0.00	0.00	0.00	0.03	0.03	0.13	0.11	0.13	0.18	0.17
Households and individuals (excl. Sole Proprietors)	48.26	47.51	46.85	50.38	49.51	0.14	2.62	3.45	5.84	6.25	0.01	0.00	0.01	0.01	0.01	29.56	27.66	28.16	31.78	32.17
Mortgages	42.28	42.37	42.29	45.85	45.28	0.01	0.00	0.00	0.00	0.00	0.01	0.00	0.00	0.00	0.00	25.89	24.57	25.26	28.63	29.11
Activities of extraterritorial organisations and bodies	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Non-resident loans to total loans	7.84	12.16	14.62	10.67	11.40	91.60	82.10	78.25	75.78	72.43	98.46	99.73	99.72	99.69	99.63	42.57	48.22	47.81	42.80	41.44
Return on assets[3]	0.76	0.70	0.54	0.57	0.17	0.30	0.25	0.16	1.19	0.63	0.96	1.48	1.44	1.09	1.99	0.84	1.04	0.90	0.80	0.82
Return on equity[3]	10.06	9.20	6.54	6.67	1.96	3.38	2.94	1.53	10.60	5.50	3.65	4.91	5.22	5.68	5.96	6.72	7.33	5.72	6.73	3.45
Interest margin to gross income	62.25	70.79	62.28	63.67	70.00	31.24	31.06	37.67	31.69	31.52	92.57	78.82	79.56	55.11	52.01	72.99	73.28	69.28	57.72	58.39
Non-interest expense to gross income	52.21	58.80	64.34	67.83	76.74	66.52	78.25	62.05	46.73	53.85	31.89	28.13	32.13	39.09	32.59	44.70	44.04	48.93	54.20	52.73
Non-interest income to gross income	37.75	29.21	37.72	36.33	30.00	68.76	68.94	62.33	68.31	68.48	7.43	21.18	20.44	44.89	47.99	27.01	26.72	30.72	42.28	41.61
Liquid assets to total assets[4]	36.52	29.36	28.32	30.95	32.44	33.45	28.58	32.02	36.16	33.54	30.14	20.56	19.89	14.08	15.50	35.56	16.60	27.91	30.08	31.13
Liquid assets to short-term liabilities[4]	55.80	43.49	37.16	39.10	36.73	67.79	37.36	38.81	44.78	36.65	96.31	43.69	46.72	27.85	22.41	58.71	42.96	37.81	39.08	37.41
Other FSIs																				
Total coverage ratio[5]	45.91	45.24	44.35	43.64	48.47	53.86	65.89	64.61	40.96	44.88	54.81	51.85	53.19	68.96	72.38	47.96	47.44	45.61	44.99	51.85
Liquidity Coverage Ratio	164.43	276.03	316.07	341.63	329.73	194.89	263.87	421.34	381.66	398.69	357.63	279.41	411.72	371.92	1044.82	173.87	275.31	329.38	344.81	345.19
Domestic debt securities to total assets	7.90	7.00	6.45	6.44	9.17	4.86	3.16	2.00	2.79	5.42	0.09	0.15	0.11	0.08	0.11	4.02	3.57	3.67	4.09	6.04
Foreign debt securities to total assets	20.62	16.83	15.82	15.37	14.63	14.96	11.87	14.08	10.74	11.27	46.91	42.65	29.70	26.33	25.19	32.83	28.89	21.21	18.66	17.75
Unsecured loans to total lending	25.36	27.70	28.59	26.28	25.92	65.39	67.16	73.39	75.94	74.51	26.69	16.23	17.22	22.56	20.82	28.18	24.97	26.83	27.81	26.99
Assets to total capital and reserves	13.33	11.99	12.16	11.51	12.01	12.12	11.49	8.97	8.60	8.83	2.91	3.36	2.83	2.46	2.58	9.56	9.25	8.92	8.60	8.94
Large exposure to total own funds	110.94	88.40	92.84	87.88	103.38	268.59	274.94	205.74	144.65	367.68	128.77	119.22	79.09	84.82	88.73	130.11	111.05	97.90	92.13	121.36
Gross asset position in financial derivatives to total own funds	1.65	0.87	0.63	0.57	0.41	0.61	0.29	0.03	0.03	0.09	103.03	131.24	168.78	125.65	129.76	37.83	42.68	52.90	35.12	36.76
Gross liability position in financial derivatives to total own funds	2.04	1.03	0.92	1.45	1.79	3.60	0.29	0.90	0.05	0.52	69.19	80.24	104.06	81.95	91.38	22.57	26.41	33.01	23.59	26.88
Personnel expenses to non-interest expenses	48.76	48.05	37.85	43.75	43.85	49.74	45.61	49.67	49.26	49.43	19.88	16.22	14.14	14.71	14.16	40.52	37.58	31.19	35.30	34.83
Customer loans to customer deposits	55.95	58.87	60.88	59.49	59.30	46.51	47.14	50.47	47.41	47.07	108.14	111.55	189.84	373.09	489.33	65.66	70.35	78.01	79.36	79.27
Net open position in equities to total own funds	14.01	13.10	10.83	10.45	10.27	146.79	138.75	107.47	100.67	81.30	1.13	3.40	4.81	5.74	5.80	20.17	18.58	16.95	17.24	14.95
Loan-to-value:[6]																				
Residential	75.12	73.53	72.71	75.67	76.60															
Commercial[7]	67.49	65.14	56.65	70.46	57.97															

[1] Satabank plc is excluded from 2018 figures onwards following the MFSA's decision to appoint a competent person in October 2018 in terms of Article 29(1)(c) and (d) of the Banking Act. Its licence was withdrawn on 30 June 2020.
[2] Specific provisions from 2018 refer to Stage 3 allowances.
[3] Based on profits after tax.
[4] The liquid assets to total assets and liquid assets to short-term liabilities figures from 2017 are based on COREP returns.
[5] For the core domestic banks, the ratio includes 'Reserve for General Banking Risks' as per the revised Banking Rule 09/2019.
[6] The loan-to-value ratio is based on a weighted average.
[7] The market share of the banks was adjusted to cater solely for the banks that provided commercial real estate loans. The volume of such transactions is limited which explains the volatility in the weighted indicators.