A review of the 2013 European Commission's Report for Malta:

Malta and Cyprus: A Sea Apart

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On the 10th of April 2013 the European Commission circulated its conclusions on Malta's financial position in a report issued in accordance with Article 5 of Regulation (EU) No 1176/2011 on the Prevention and Correction of Macroeconomic Imbalances (the 'Commission Malta Report 2013').[1] The exercise commenced last year after an Alert Mechanism Report in November[2] (the 'Alert Mechanism Report') was issued, which Report showed signs of potential macroeconomic imbalances in 13 States, including Malta.

The latest happenings in Cyprus have generated a whole new set of questions related to 'which country will follow suit'. Public attention has been drawn to other small eurozone nations with considerable banking sectors, since, in the event of a crisis, such countries could be more exposed to depositor/senior unsecured creditor bail-in. Malta has also been placed under the lens of scrutiny mainly due to its geographical location and relatively sizable banking industry when compared to its GDP.

"The Commission's report reaffirms the confidence that Malta's banks and finance sector have enjoyed for many years" (Finance Minister, Professor Edward Scicluna)

Malta has now been declared by the European Commission as not having excessive fiscal imbalances. The imbalances that were found were deemed to emanate from the way the economy of the country is structured. Malta is one out of the thirteen countries assessed and is one of the eleven countries which have been declared as not having excessive fiscal imbalances. All this has now been further corroborated by Bloomberg Brief and Fitch Ratings in specific reports issued on the island's financial position in April 2013.

1. Background to Malta's Economic Position

Between 2010 and 2012, Malta's economy expanded by 2.9%, 1.7% and 0.8%.[3] This was despite challenging external conditions post the 2008-2009 financial downturn, which might have potentially affected the country's stability. Recent economic forecasts further provide that the country's economy is expected to regain further momentum in 2013 and 2014 , by growing by 1.5% in 2013 (second best among euro area countries) and 2.0% in 2014. [4]

Malta has long been focusing on increasing its exportation ability. In accordance with the Alert Mechanism Report, the latter is expected to contribute to economic growth.[5] This, coupled to the resilience of the employment/ labour market, to the low unemployment rates (in the region of 6-7%) and to the hardiness displayed by the Maltese property market, have all contributed to maintaining the island's economic stability and growth.[6]

The following are main features that contributed to the country's stability:

(1) the country's public finances remain disciplined, mainly due to the fact that none of the banks in Malta required public assistance
(2) the debt-to-GDP ratio is also projected to remain below 3%
(3) the general government gross debt position is expected to stabilize at around 73% of GDP
(4) containment of sovereign roll-over risks of debt are further contained since the majority of sovereign debt is held by residents and

hence shielded from unexpected fluctuations in international financial sentiment.

2. Malta vs Cyprus

2.1. Central Bank Governor Declaration

Recently the Central Bank Governor, Josef Bonnici issued a clear and concise statement negating misconceptions that were being spread internationally about Malta. Such international commentators had erroneously bundled Malta with problematic jurisdictions by presenting hasty comparisons to weak jurisdictions, such as Cyprus. The Governor declared that vis Malta "There were absolutely no abnormal movements."[7]

Cyprus' position and the state of its banking industry, had already been highlighted in another report issued by the European Commission some time before. Actually, nearly a year before the implosion, Cyprus' investors were warned of the potential imminent disaster. "The situation in the Cypriot banking sector also threatens the sustainability of the country's position…Any shock to the banking sector could thus have catastrophic consequences to the economy by compounding the challenges arising from Cyprus' internal imbalances."[8]

On the other hand, when it comes to assessing Malta's financial sector, the Commission is more confident and optimistic.

The Governor, in his statement listed above, has reiterated that Malta's banking sector is robust, sound and diversified with high rates of profitability, liquidity and solvency.

The Commission Malta Report 2013 further corroborated the above statement a day after the Central Bank Governor's public declaration.

"The situation in the Cypriot banking sector also threatens the sustainability of the country's position…Any shock to the banking sector could thus have catastrophic consequences to the economy by compounding the challenges arising from Cyprus' internal imbalances." (Commission Staff Working Document: In-Depth Review for Cyprus)

2.2. Bloomberg Brief Report

Bloomberg Brief, in a detailed commentary in its Crisis Watch Section, has recently also reached the same conclusions.[9] The author and economic commentator, David Powell, has shunned any comparison between Malta's state of affairs and the Cypriot crisis, where depositors in Cypriot banks had been warned of the potential for imminent disaster months before. The commentator provides that "The banks of Cyprus became too large for the state to honour its deposit guarantee without external assistance." Any risk that a similar situation to Cyprus occurs are remote, given that for the Maltese banking system to grow exponentially to an equivalent of the Cyprus' banks would mean that the deposit-to-GDP ratio would have to expand at the same rate it did between 2005 and 2012 for the next 20 years. On the contrary, this is not the situation in Malta given that event the Malta Financial Services Authority (the "MFSA") is seeking to limit an endless increase in the potential liabilities of acceptable funding which are not covered by the Deposit Compensation Scheme (DCS).

2.3. Fitch Ratings Report

In another very recent Special Report, Fitch Ratings also suggests Malta's differences from Cyprus far outweigh the similarities, and that Malta's banking sector does not face the risks of Cyprus' before its bail-out.[10]

All this is attributable mainly to Malta's much smaller domestic banking sector, lesser dependence on non-resident deposit funding (as opposed to Cyprus), insignificant ECB/ELA finance, sturdier asset quality and capital buffers and more real and actual financial supervision.

Banking sector size is also a very important consideration. Whilst both Cyprus' and Malta's banking sectors are relatively large, when compared to the islands' respective GDPs, and whilst such banking sectors rely, to some degree on funding from non-resident depositors, yet it

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is important to note that Malta 'international banks' with negligible links to the domestic economy have assets worth 494% of GDP; 'core domestic banks' that have strong links with the domestic economy and are considered systemically important account for 218% of GDP and 'non-core domestic banks' with smaller operations and links with the domestic economy account for 77% of GDP.[11] In the opinion of FitchRatings the most important category to be considered is the 'core domestic banks' class which was dubbed as 'systematically' important. When analysing the banks that fall under this category (a total of 5 banks with strong links to the domestic economy – vide Appendix A for a full list), one can note that these merely account for 218% of GDP out of the total of 789%.[12]

In the case of contingent liabilities risk, FitchRatings believes that the government of Malta would support such core-domestic banks only (therefore excluding international banks and non-core banks). There will also be further value –added to this positive situation given that it is believed that, if required, HSBC (that accounts to 90% of GDP) would obtain the bulk of support from its parent company. Therefore, all in all, the banking sector contingent liabilities that would need to be supported by the sovereign should not amount to more than 128% of GDP. In Cyprus this was different since the domestic banking sector accounted for 466% of GDP and this proved to be too big to support.

With regards to Malta, all the above, coupled to the fact that only 5% of total non-resident deposits[13] are held at core domestic banks[14] and to the fact that the asset quality in Maltese banks' balance sheets is much better than that of Cyprus[15], continue to differentiate Malta from Cyprus.

Also one should keep in mind that the Deposit Insurance is local. With over 90% of all deposits covered by the Maltese Deposit Compensation Scheme (these being resident deposits held in core domestic banks), should an international bank or a non-core domestic bank run into misfortune, the effect on the Deposit Compensation Scheme should be contained.

"…the majority of the very large financial sector is internationally-oriented with very little link to the domestic economy, and therefore does not pose large risks for domestic stability." (European Commission Malta Report 2013)

3. Improvements

All the above goes to show that the economic condition of the island is deemed to be stable and positive. The Commission adds that "the majority of the very large financial sector is internationally-oriented with very little link to the domestic economy, and therefore does not pose large risks for domestic stability."

Having said that, despite the positivity of the Commission Malta Report 2013, room for improvement was still highlighted. The Commission Malta Report 2013 provides that potential imbalances for Malta in the financial sector are in particular related to its exposure to the real estate market.

Malta should take these suggestions / remarks on board and work on streamlining these key issues.

3.1. Real Estate Market Exposure

It has been claimed that "the main source of risk for core domestic banks in Malta is exposure to construction, real estate and the mortgage market. The housing market is prone to overheating. House prices, which rose sharply in the first half of the decade, fell by 10% in the year to early 2009. Prices subsequently stabilised and remained resilient in 2011 and 2012, growing by 1.3% and 0.5% respectively."[16]

In Malta, owner-occupation rates are high (78%). The Maltese have been, until recent years, very reluctant to rent property for their own personal use (as opposed to renting property for commercial reasons which has a higher rate of occurrence than the former). Customarily the Maltese are also disinclined to transfer property, much of which is considered a family heirloom and passed from generation to generation.

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This mentality also justifies the great proportion of vacant properties on the island which amount to circa 30% of all property in Malta.

Due to the strong link between the real estate market and the banking sector, banks' exposure to the real estate market has been highlighted as being of particular importance. The Commission Malta Report 2013 refers to the fact that, as such, Malta lacks a recurrent property tax. A review of the property tax system has been suggested together with regular monitoring of property price developments and collateral valuation by commercial banks. A further suggestion relates to more support being offered to the rental market in order to prevent excessive price growth and the accumulation of price bubbles.

All the above would be deemed beneficial in providing the right incentives to market participants.

3.2. Domestic Financial Stability Risks

Perils to domestic financial stability originating from the existence of a very large financial sector appear small, this being mainly due to the very limited exposure of internationally-oriented credit institutions to the domestic economy.

Nevertheless, the Commission Malta Report 2013 has recommended continued and consistent observation and assessment, including regular distribution of information of banking soundness indicators, of the activities of the internationally-oriented and the non-core domestic banks and their implication for financial stability. Of particular importance is the remark related to non-core domestic banks, which notwithstanding their smaller relative size and healthy financial soundness indicators, participate in riskier activities that necessitate strict supervision to ensure that risks are curtailed, managed and supervised.

3.3. Core Banks' Provisioning against Loan Losses

The Commission remarked that while the core banks are profitable, specific provisioning against loan losses is rather minimal. The Commission Malta Report 2013 provides that "the stability of the core domestic banks would benefit from strengthening their provisions for loan losses to limit risks arising from their exposure to the property sector".

This is definitely a very appropriate comment that has been further corroborated by the Central Bank Governor. The latter argued that these should increase their loan loss provisions and their capital buffers and diversify their collateral base.

3.4. High Public and Private Debt

The Commission commented that "public debt issuances do not attract significant interest from foreign investors, leaving the burden of funding the government almost entirely on Maltese residents". [17] This could result in a situation where the sustainability of public finances is at risk.

Two factors that could threaten such sustainability and that have been brought up time and time again are pension and healthcare expenditure.

The Commission suggests that a plan is carried out to put public debt on a downward path.

4. Other Jurisdictions

Malta has been assessed with other jurisdictions, such as Belgium, Bulgaria, Denmark, France, Italy, Hungary, the Netherlands, Finland, Sweden and the United Kingdom. In all the above imbalances are not found to be excessive. However the Commission is suggesting that in all these countries the findings of the in-depth reviews are taken into account in their National Reform Programmes and Stability and Convergence Programmes.

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"the Maltese economy demonstrated resilience throughout the crisis" (European Commission Malta Report 2013)

In two other Member States that have been assessed, namely Spain and Slovenia, imbalances can be considered too high. In Spain, risks stemming from the very high domestic and external debt levels continue to present a grim picture for growth and financial stability. In Slovenia, the risks for financial sector stability emanating from corporate indebtedness and deleveraging are considerable, including through inter-linkages with public finances.

For Cyprus, even though also chosen for an in-depth evaluation in the Alert Mechanism Report, as a consequence of the political agreement reached between the Eurogroup and the Cypriot authorities on the key elements of a macroeconomic adjustment Programme and official financing, the in-depth review has not been published.

5. Conclusion

Amongst the various key findings, the Commission Malta Report 2013 concludes that "the Maltese economy demonstrated resilience throughout the crisis". This could be attributed to the domestic macroeconomic circumstances, which have remained supportive of financial stability, and cautious banking methods characterized by healthy solvency and liquidity positions. These factors have jointly ensured that Malta remained resistant to the negative consequences which hit a number of other euro area jurisdictions over the past year. Therefore "Comparisons between Cyprus and Malta continue to appear misplaced" with even the European Commission issuing "a clean bill of health" to the Maltese banking system.[18]

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Appendix A

Core domestic banks	Non-core domestic banks	International banks
APS Bank Limited	BAWAG Malta Bank Ltd	Akbank T.A.S.
Banif Bank (Malta) plc	Credit Europe Bank N.V. Branch Malta	CommBank Europe Limited
Bank of Valletta plc	FIMBank plc	Deutsche Bank (Malta) Limited
HSBC Bank Malta plc	IIG Bank (Malta) Ltd	Erste Bank (Malta) Limited
Lombard Bank Malta plc	Izola Bank plc	FCM Bank Limited
	Mediterranean Bank plc	Fortis Bank Malta Ltd
	Sparkasse Bank Malta plc	Investkredit International Bank plc
	Volksbank Malta Limited	NBG Bank Malta Limited
		Nemea Bank Ltd
		Raiffeisen Malta Bank plc
		Saadgroup Bank Europe Limited
		Turkiye Garanti Bankasi AS
		VoiceCash Bank Limited
	Total assets (EUR billions)	
14,236.1	4,947.4	31,943.6
	Total assets (as % of GDP)	
222.7	77.4	499.6
Source: Central Bank of Malta, Financial Stability Report		

[1] http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/pdf/ocp139_en.pdf
[2] Alert Mechanism Report 2013, European Commission
[3] NSO News Release 049/2013
[4] European Economic Forecast Winter, 2013, European Commission
[5] Alert Mechanism Report 2013, European Commission
[6] IMF Country Report No.12/105
[7] Dr Josef Bonnici (Malta Central Bank Governor), *The Central Bank of Malta's Annual Report 2012, Opening Speech*, 09/04/2013, http://www.centralbankmalta.org/site/pr1main.asp?ItemId=725
[8] Commission Staff Working Document: In-Depth Review for Cyprus. European Commission, May 30, 2012{http://ec.europa.eu/europe2020/pdf/nd/idr2012_cyprus_en.pdf}
[9] David Powell, *Crisis Watch, Malta's Banking Bill of Health Seems Clean though Clarity on Liabilities may be Required,* Crisis Watch – Bloomberg Brief, Economics European Edition, 16/04/2013, P. 2.
[10] FitchRatings, *Malta and Cyprus: Differences Outweigh Similarities,* April 2013, P. 1
[11] Statistics from Central Bank of Malta.
[12] Vide Appendix A for a fill list of banks operating in Malta and their categorisation (Central Bank of Malta, Financial Stability Report)
[13] Amounting to a total of 69% of total deposits
[14] As opposed to the 37% of non-resident deposits in Cyprus in the Cypriot banking system as a whole
[15] Due to the Cypriot banks' exposure to Greek government bonds and to the Greek and Cypriot private sector, deterioration in asset quality in Cyprus was much higher than that in Malta (In Q312, non-performing loans stood at 15.5%). In Malta, core domestic banks' non-performing loans were 8.2% in Q312, up from 7.3% at end-2011. Also important to note that the Maltese banking system's exposure to peripheral eurozone countries is limited, but it is exposed to the domestic property sector.
[16] FitchRatings, *Malta and Cyprus: Differences Outweigh Similarities,* April 2013, P. 5
[17] Commission Malta Report 2013, p 30
[18] David Powell, *Crisis Watch, Malta's Banking Bill of Health Seems Clean though Clarity on Liabilities may be Required,* Crisis Watch – Bloomberg Brief, Economics European Edition, 16/04/2013, P. 2.

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