

Part I – Key Issues and Lessons Learnt

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Introductory remarks

Adopting the euro as its national currency would imply that the Central Bank of Malta had relinquished control of its monetary policy. This was not so; the bank was mandated to contribute towards the formulation of monetary policy for the euro area. Monetary policy in Malta is dictated by the Governing Council of the European Central Bank and implemented by the CBM.

5.1 Transparency of monetary and financial policies

The CBM has made tremendous strides ahead in its effort to conduct monetary policy in a transparent manner. It has been commended for observing most of the transparency practices outlined in the Code of Good Practices for Transparency in Monetary and Financial Policies. In this perspective, the amended CBM Act of October 2002 is in accordance with the EU requirements.

As a consequence of the amended act of 2002, focus of orientation of monetary policy was placed on the pursuit of price stability. Despite the CBM's commitment in transparency practices, there were shortcomings in the transparency of monetary policy. The major shortcomings identified related to the lack of clarity in the description of the objectives and procedures of the CBM's operations in government securities markets and the lack of monthly information about the CBM's off-balance sheet commitments, especially its forward contracts in the foreign exchange market.¹

It has been suggested by the IMF that for Malta to improve in the transparency of its financial policies, it should define and publicly disclose both (i) the roles of the MFSA and CBM in regulating and supervising the securities depository and settlement system, and (ii) the arrangements for the exchange of information between domestic as well as international supervisory and regulatory authorities.²

5.2 The financial system of Malta

The financial services sector in Malta is relatively large and well-developed, but largely dominated by banks. On average it accounts for about 12 per cent of GDP, employing over 7,000 people. The financial services sector has witnessed an extraordinary 30 per cent annual growth over the last three years. By the end of 2007, banks accounted for 72.8 per cent of the total assets of the financial system. As in Mauritius, no distinction is made

between inshore and offshore banks in Malta. The offshore regime for banks was revoked in 2003.

Financially, international banks seem to be performing better than domestic banks. This is demonstrated by the fact that in 2007, the share of domestic banks dropped to 37.6 per cent from its previous position of 45.6 per cent in 2006. With regard to banking assets, domestic banks accounted for only 19.7 per cent by the end of 2007. The financial system also encompasses the insurance sector, which despite its growth in recent years constitutes only a minor share of total financial assets of 2.8 per cent in 2007.

The existence of a sound and efficient financial system has brought major benefits to the banking sector and to the economy in Malta. This is highlighted by the fact that the banking sector was pretty much unaffected by the recent credit crunch. The well-capitalised position of the banks, coupled with a low reliance on interbank funding and a high dependence on retail deposits, are the main factors insulating the banking sector in Malta. Most of the basic financial sector infrastructure (including payment, securities trading and settlement systems) are in place, are running efficiently and are quite modern. In addition, access to financial services is widely available.

The efficient financial sector has helped in reducing asymmetry in information flow and concurrently promoting innovations. A key attribute instigating efficiency in the financial sector is transparency. Increase in market efficiency has been a direct result of transparency because asymmetric information tends to skew the distribution of information between financial institutions and investors. Low transparency can lead to loss of confidence. It is very important therefore to uphold a good level of transparency and disclosure in line with international best practice, if confidence is to be maintained.

5.2.1 Structure of the banking sector

There are a number of local and foreign banks in Malta. By the end of 2007 there were 22 credit institutions in the banking sector, which is classed under two broad categories. The first category is known as the international banks, which are engaged mostly in foreign currency transactions targeting mainly non-residents. The other category is referred to as the domestic banks and they conduct business with both residents and non-residents. Prior to accession into the EU, foreign banking activity in Malta was heavily controlled as part of the Exchange Control Act, 1972.

The banks have continued to remain competitive and this has been possible through the launching of innovative products. In 2003, there were further developments in mobile and internet banking. A major development that occurred in 2003 was the launching of the Depositor Compensation Scheme (see case study for further details). The main objective of this fund was to provide safety for private depositors by maintaining a fund to be used for payment of compensation in the event of a bank failure.

Overall, banks in Malta are well-capitalised and sufficiently covered for credit risk. It is widely believed that banks on the island are well-positioned to weather the effects of the global crisis. Their strong liquidity position,³ negligible exposure to subprime-related assets and good funding profile are key factors insulating the banks from the financial crisis.

Nonetheless, according to the CBM Annual Report 2007 there is a high concentration in the domestic banks' lending portfolio. With real estate-related loans accounting for some 57 per cent of total resident loans, this poses a potential source of risk and is a cause for concern. In any case, given that domestic banks are adequately hedged, the risk may not be credible. This was confirmed by the bank's stress testing, which found the risk posed to the domestic banks to be limited.

Malta's banking sector was spared by the financial crisis because of their traditional reliance on retail deposits as their primary source of funding. As a result, banks rely less on the interbank market to finance their daily operations. This is in contrast to most countries, whereby banks rely heavily on wholesale funding and market liquidity. As a matter of fact this was one of the main reasons the banking sector in many countries collapsed during the financial crisis. An important lesson to be learnt from the credit crunch is the high degree of exposure to interbank funding. Like Malta, banks in Seychelles were partially insulated from the credit crunch due to limited exposure to interbank activities.

The domestic demand for credit has been a major factor driving growth in the banking sector in Malta. Bank credit to households by the end of 2007 reached 58 per cent of GDP. Bank lending has been the major source of external funding for the corporate sector in 2008. This is illustrated by a substantial increase in the ratio of domestic corporate bank borrowing to GDP from 68 per cent at end 2007 to 75 per cent at end of 2008. Furthermore, in spite of strict lending requirements, lending to households expanded by 12.9 per cent (€813.4 million) in 2008. This ratio surpassed the eurozone average of 52.3 per cent as at end 2008. In spite of the increase in domestic corporate bank borrowing to GDP, the bank remained sufficiently liquid and well-capitalised to sustain its credit to the corporate sector. As a result, the financial situation for the corporate sector made progress.

The continued expansion in credit to the domestic economy at a time when the global economy is facing a severe credit crunch should be a cause for concern. The increased indebtedness of households to banks implies a high debt-servicing ratio. Although the increase in household wealth has been able to withstand the macroeconomic shocks, should the economic downturn persist, debt repayment could become a problem for the banks. In addition, private sector indebtedness in Malta is already high at 124.1 per cent of GDP as at end 2008.

5.2.2 Malta Stock Exchange

The Malta Stock Exchange (MSE) was founded in 1992 following the introduction of the Stock Exchange Act 1990. The act also formed the Stock Exchange Council, headed by a chairman whose responsibility is to manage and oversee stock exchange operations. This involves approval of applications for listing and supervising performance of ongoing obligations of listed companies. The rules and regulations guiding the listing procedure have to be in compliance with EU standards. Since 2001, the MSE has become an Associate Member of the Federation of European Securities Exchanges.

In addition to this, the MSE has been recognised by the UK HM Revenue and Customs under Section 841(10(b) – Income and Corporation Taxes Act of 1998. It has also been approved as a recognised stock exchange for inheritance tax purposes.

Since launching towards the end of 1992, the MSE has grown rapidly in size and importance. By the end of 2004, there were some 14 equity listings and 27 corporate bonds listed on the exchange, along with some Maltese government stocks.⁴ There are also some 40 mutual funds listed, with well-known names such as Fidelity and HSBC. As of end July 2005, total market capitalisation represented Lm2.5 billion, a 19 per cent increase from the previous year. Total market capitalisation as of end 2005 stood at Lm2.9 billion.

The MSE is under the watchful eyes and strict scrutiny of the appointed external bodies to ensure good practice, especially against money laundering, and market abuse. The latter is governed by the Prevention of Financial Markets Abuse Act 2005, which sets the rules regarding inside information and disclosure.

The supervision of money laundering is under the responsibility of the Financial Action Task Force, while market abuse is under the supervision of the Financial Services Authority. Amendments were made to the MSE Act in 2002 to transfer the responsibility of the MSE regulatory functions, in particular those concerning admissions to listing and licensing of stockbrokers, to the Financial Services Authority. Besides covering for market abuse, the Prevention of Financial Markets Abuse Act 2005 also makes provision for issuers and their managers, ordinary investors, national statistics bodies, competent authorities in Malta and abroad, operators of recognised investment exchanges and other insiders.

The MSE has also recently extended its services to transacting in treasury bills issued by the government and to having these cleared and settled on the same day. From the government's point of view, treasury bills are crucial elements in the effective functioning of the institution. Liquid and well-run primary and secondary markets add value to these securities.

5.2.3 MSE performance in 2008

The year 2008 was a pretty bad one for the MSE in term of performance. The MSE index recorded one of its lowest values (3,208) since 2005, making a loss of 35 per cent. The sharp decline in the index is a direct consequence of the slump in value of bank equity. Despite the banks' strong position with regard to weathering the effects of the global crisis, some banks still endured losses from valuation adjustments.

The decline in share prices had created some uncertainty in the market as manifested by an increase in volatility during 2008. The volatility was more pronounced in the case of bank equity, as a result of adverse perception and scepticism in the market. Figure 5.1 below, taken from the Central Bank of Malta's Financial Stability Report 2008, depicts the indices of selected stock exchange.

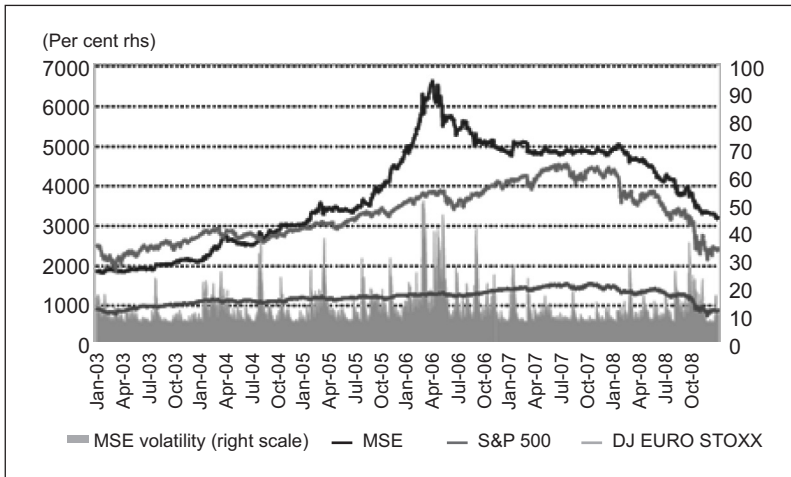


Figure 5.1⁵ Indices of selected stock exchanges (percentage rhs)

5.2.4 Market capitalisation

In spite of a sound and efficient financial system and the strong liquidity position of the banks, market capitalisation reduced to €6.7 billion in 2008. The main factor contributing towards the contraction in market capitalisation was the loss in value of equities. The equity share of market capitalisation dropped from 50.6 per cent in 2007 to 38.3 per cent in 2008. The loss in value of equities was largely attributable to the slump in value of bank equity. The share prices of banks declined by approximately 48 per cent in 2008, following the declaration of a fall in profits.

5.3 The external reserves

Under the Central Bank of Malta Act, the bank is compelled to maintain external reserves in proportion⁶ to its currency and deposit liabilities. The bank also has the responsibility to manage a portfolio of external reserves, one of the purposes of which is to intervene in the foreign exchange market to defend the exchange rate as and when necessary. This is the function of the liquid asset component of the bank's portfolio. The other uses of the external reserves include ensuring adequate funds in various currencies to sustain market needs and to generate income.

The bank has an Investment Management Committee, responsible for the formulation of the reserve management policy. This committee is chaired by the governor and consists of the deputy governor and senior bank officials.

Apart from the liquid assets, part of the bank's portfolio is invested to earn income. The strategy is to diversify its portfolio to minimise risk. The bank's portfolio, according to the CBM Annual Report, mainly comprises placements with foreign banks and debt securities issued by non-residents. It is also made up of gold, Special Drawing Rights and claims on

the International Monetary Fund. To minimise credit risk, the bank only holds claims on top-rated banks and issuers of securities. As part of its risk management strategy the bank has also developed a comprehensive market risk model in line with international best practice in order to safeguard the value of its reserves. Regarding liquidity risk management, the domestic banking sector has developed a comprehensive framework to strengthen its management capabilities in that respect. The framework strategy involves vigorous internal governance, stress testing, monitoring and adequate contingency funding plans.

Figure 5.2 below shows the external reserves in months of imports over the period 1995–2007. Since 2001, the international reserves⁷ have remained around six months of imports.

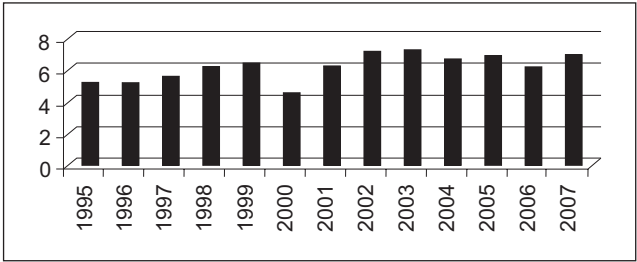


Figure 5.2 External reserves (months of imports), 1995–2007

5.4 Inflation

On average, inflation in Malta has been relatively low over the entire period, with sporadic peaks in 1993, 1994 and more recently in 2008. Overall, the inflation rate has remained at around 3 per cent or below. Nonetheless, as depicted in Figure 5.3 below, the year 2008 has been somewhat of an exception, with an inflation rate of 4.24 per cent. Rising fuel and commodity prices on the international market were noted as the principal causes for the sudden increase in inflation in 2008.

The year 2007, spilling over into 2008, was characterised by surging fuel prices, soaring world commodity prices and the collapse of the subprime market in the USA. These were consequences of a multitude of factors, namely tension in the Middle East, political instability in the Niger Delta (Nigeria) and strong demand from the emerging economy, especially China. As a result, the price of fuel reached a record high in July 2008, before sliding rapidly to a record low due to global recession.

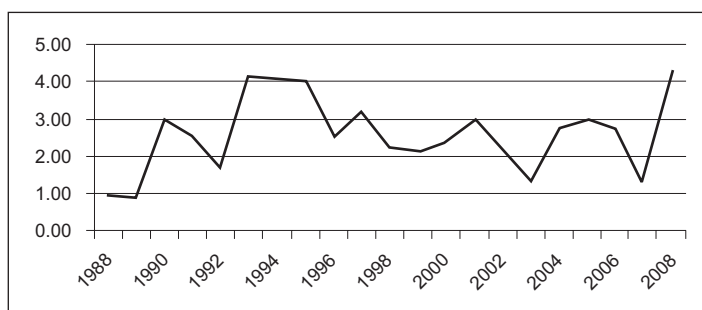


Figure 5.3 Inflation rate measured by CPI, 1988–2008

Figure 5.3 above depicts the inflation rate measured by the consumer price index (CPI) over the period 1988–2008. It is evident from Figure 5.3 that the inflation rate over the entire period has been relatively low.

A similar trend was also depicted in the global commodity prices until around July 2008, when the global recession started kicking in and prices suddenly dropped due to weaker global demand. It is important to note that no country was immune to these global shocks and Malta was no exception, as demonstrated above.

Notes

1. IMF Country Report August 2003.
2. IMF Country Report August 2003.
3. Banks in Malta rely heavily on resident deposits and this has cushioned them from external financial shocks.
4. <http://www.lowtax.net/lowtax/html/jmaoltr.html>
5. MSE is referred to as Malta Stock Exchange.
6. This proportion was set at a minimum of 60 per cent in 1968.
7. International reserves usually comprise foreign currencies, other assets expressed in foreign currencies, gold, SDRs and IM reserve positions. Every country must have international reserves as backup in times of need, for example during an economic crisis, to stabilise the exchange rate. Sometimes the international reserves are denominated in terms of the number of weeks/months of import.

