MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Economic & Market Overview

January 2015

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Malta Financial Services Authority

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Executive summary

The year was influenced by geopolitical tensions, weak economic activity, slowdown in global output, and unfavourable business and consumer confidence. The disinflationary trend continued to persist during the year remaining well below the ECB's target of close to but below two per cent. This called for the ECB to implement unconventional monetary policy measures in order to ensure price stability and to stimulate growth over the medium term. Fiscal consolidation within the Euro Area continued to take its stride with further expectations for general government debt to diminish over the forecasted horizon. Conversely, general government gross debt continued to accumulate albeit at a slower pace than that registered during previous years. The labour market registered marginal improvements in certain member states nevertheless divergence in this regard continued to widen coupled by excessive unemployment especially amongst youths. The economic and market outlook for 2015 is expected to be significantly influenced by the downward trend of oil prices, the initial effects emanated by the Quantitative Easing programme launched by the ECB, the euro currency depreciation against other currencies, and the mobilisation of investment projects between 2015 and 2017 through the EU Investment Plan, amongst other factors.

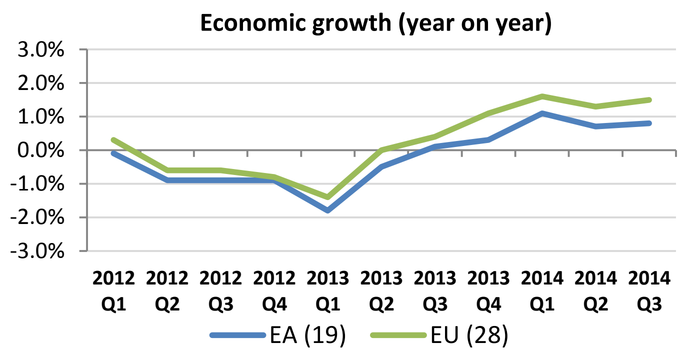
As acknowledged by the IMF through their Concluding Statement of the 2014 Article IV Mission and by the European Commission as documented in its 2015 Winter Economic Forecast report, Malta remained one of the fastest growing economies in the Euro Area and is expected to register strong economic growth in the forecasted horizon. General government deficit is expected to decline further in conjunction with an anticipated narrowing of the debt-to-GDP ratio. The downward price pressures exerted by the reduction in household utility tariffs and weak price pressures originating from foreign economies continued to push inflation lower. Unemployment remained low in Malta compared to that registered by other member states, and the additional females that are joining the workforce continue to be the main driver for employment growth. The financial services sector continued to expand during the year within a robust and forward looking regulatory regime. Developments in the EU financial services landscape continued to shape the dynamics of the sector in terms of tightened regulatory framework, stronger supervision, additional consumer protection and moreover supervisory reforms.

Further insights on the economic performance and outlook of Malta and the Euro Area are provided in the report. Moreover an overview is presented on the key regulatory and supervisory developments that took place during 2014 within the financial services landscape. These include the banking sector reform, the banking comprehensive assessment and the insurance stress test. Finally an overview on the design of the ESRB risk dashboard and an identification of the key elements underlining the performance of the EU financial system are presented in the report.

Economic performance and outlook for the EU and Euro Area

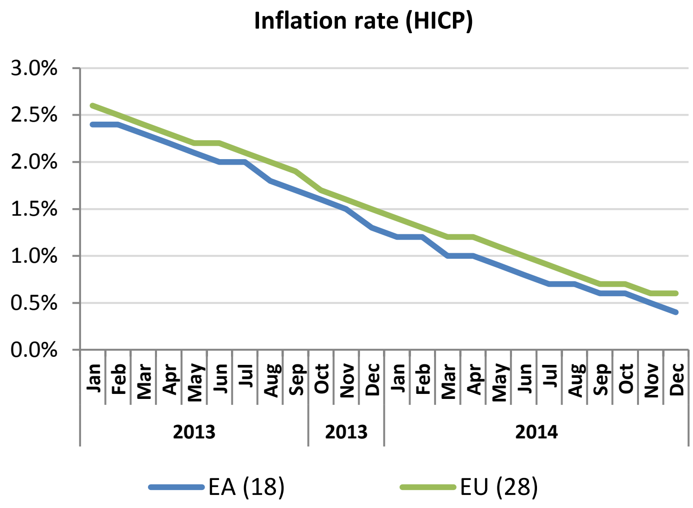
The outlook of the Eurozone economy rests on the extent to which economic policies are designed to adequately and simultaneously support short-term economic dynamics with medium-term economic growth potentials. The Commissioner for Economic and Financial Affairs, Taxation and Customs stated that the current challenges that are being encountered in the European economy must be dealt with through the combined implementation of credible fiscal policies, structural reforms, and public and private sector investment initiatives. The Commission also underlined the importance for member states to push forward their political determination in gearing economic growth and employment opportunities.

In an environment dominated by perilous geopolitical tensions, weak economic activity, and unfavourable business and consumer confidence, the majority of member states began to register positive growth during 2014. However this growth was not as strong as originally projected and falls far from reaching the desired level. Elements of uncertainty continue to persist as to whether recovery would be strong enough in generating momentum in economic growth. Business and consumer confidence fell in view of the building up of neighbouring geopolitical tensions and slowdown in global output and trade growth, contributing further towards subdued growth within the EU.



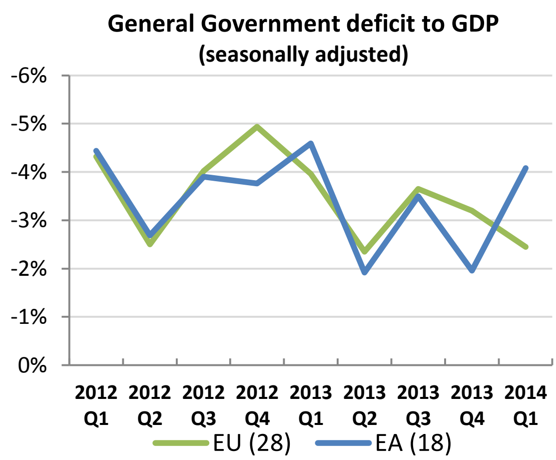
In the Commission's 2015 Winter Economic Forecast report, the forecasted GDP growth rate for 2014 was revised downwards. The Commission forecasted real growth to stand at 0.8 per cent in the Euro Area and 1.3 per cent in the EU for 2014. This was partially due to having low domestic demand persisting in certain member states, which was expected to be the main driver of growth during the year. Furthermore, high unemployment rates together with low productivity gains were other factors that contributed towards such feeble GDP growth projections. Conversely, growth in the Euro Area and EU is forecasted to increase marginally by 1.3 per cent and 1.7 per cent in 2015 and to accelerate further in 2016 by 1.9 per cent and 2.1 per cent respectively. This projected modest acceleration is partly due to the outcomes emanated from the structural reforms undertaken by member states throughout the years. Member states that implemented prompt structural reforms are expected to experience a faster economic recovery, however this will continue to fragment the economic pace amongst member states.

The disinflationary trend that was experienced for the last couple of years continued to persist also during 2014. Inflation remained well below the ECB's target of close to, but below, 2 per cent. As a result the ECB continued to signal its readiness to use additional unconventional instruments within its mandate should it require opportune to do so. HICP inflation in the Euro Area fell to 0.4 per cent and 0.6 per cent in the EU by the end of 2014. The ECB's stance on monetary policy remained that of ensuring price stability, such that the Governing Council reduced its key interest rates twice during 2014. The main refinancing operations rate was brought down to 0.05 per cent, the marginal lending facility was reduced to 0.30 per cent, whereas the deposit facility was brought down to a negative rate of -0.20 per cent. Such cuts form part of the ECB's measures designed to ensure price stability over the medium term.

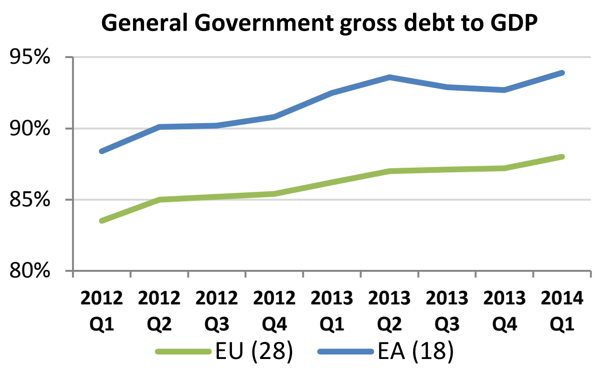


Inflation is forecasted to remain below the ECB's two per cent medium-term price stability benchmark during the forecasted future. The persistently low inflation is mainly a result of stagnant economic growth coupled with a decline in global commodity prices and a lack of aggregate demand. Despite the actions already taken during 2014 by the ECB, a full-scale Quantitative Easing program was launched in the beginning of 2015 in a bid to reverse the deflationary expectations. The low inflationary pressures that persisted in the Euro Area during 2014 are expected to push inflation further towards negative territory in 2015 at -0.1 per cent. Inflation is expected to rebound in 2016 at 1.3 per cent backed by expectations of having weaker impacts from low energy prices and higher import prices due to the depreciation of the Euro.

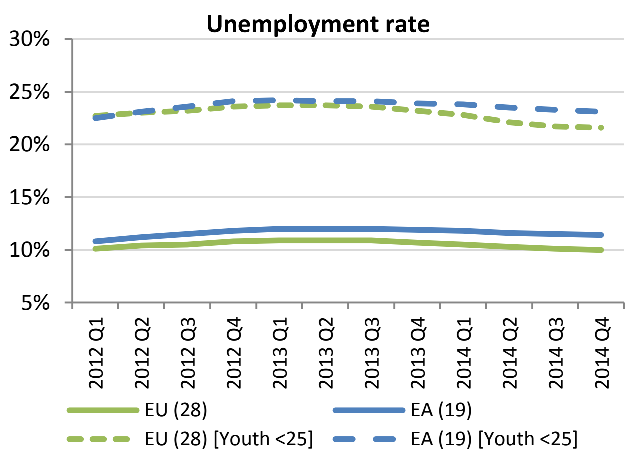
Policy efforts aimed at addressing economic growth and bringing inflation back to a satisfactory level are imperative. However policy makers must ensure that a trade-off between macroeconomic and financial stability is established so as to maintain and build upon the fiscal consolidation efforts undertaken during the years. In view of the consolidation efforts made by general governments across the whole Euro Area, public finances are expected to decline further by the end of 2014. The deficit–to-GDP ratio in both the EU and Euro Area are set to decrease to 3 per cent and 2.6 per cent respectively. This will put the deficit fiscal position of the Euro Area within the Stability and Growth Pact benchmark of 3 per cent. The deficit–to-GDP ratio in both the EU and Euro Area is projected to diminish further over the forecasted horizon. It is projected to fall to 2.6 per cent in the EU and 2.2 per cent in the Euro Area in 2015. Consequently, it is expected to decline further in 2016 to 2.2 per cent and 1.9 per cent of GDP in the EU and the Euro Area respectively.



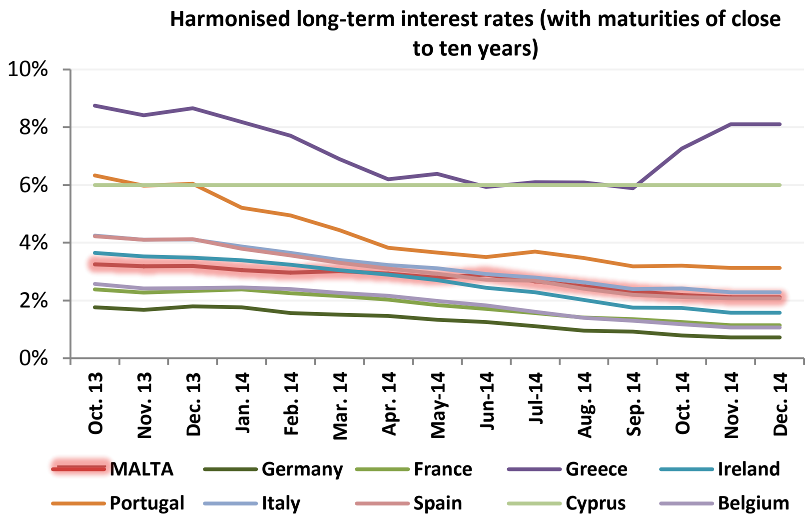
The general government gross debt of member states within the EU and Euro Area has accumulated further during 2014, although this took its stride at a slower pace than that registered in previous years. The general government debt-to-GDP ratio is expected to peak at 88.4 per cent and 94.3 per cent in the EU and Euro Area respectively by the end of 2014. Gross debt during 2015 is expected to decrease slightly in the EU to 88.3 per cent whereas peak in the Euro Area to 94.4 per cent.



Recovery within the labour market is slowly progressing though it still remained weak during the year. Considerable divergence in this regard continued to persist amongst member states. In the current environment constrained with weak economic growth, it is highly unlikely for employment prospects in the short run to register radical

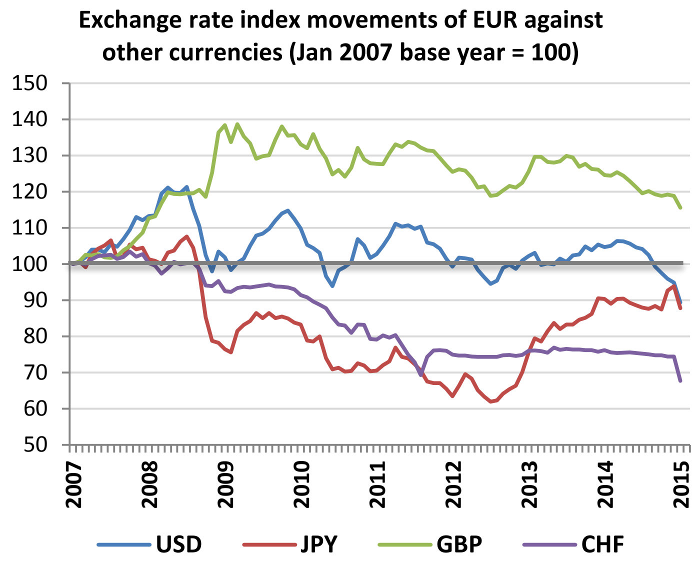


improvements. Unemployment is projected to remain high with expectations of marginal improvements in the forthcoming years. The Commission forecasts that unemployment is expected to fall slightly in 2015 to 11.2 per cent in the Euro Area and 9.8 per cent in the EU, and should reduce further in 2016 to 10.6 per cent and 9.3 per cent respectively. However these rates would still put unemployment rates above pre-crisis levels calling for additional economic stimuli and reform in this regard. Moreover, youth unemployment continued to soar during the year reaching historically high levels. The European Commission together with EU member states engaged in the Youth Guarantee initiative whereby the respective member state is required to ensure good quality employment offers to all young people under the age of 25 suited to their education level, or provide further education to assist them in finding employment in the future. These initiatives must be carried out within 4 months after finalising formal education or after becoming unemployed.



During the year, spreads between ten-year yields of Euro Area member states government bonds against that of German government bonds continued to narrow. Moreover, as a result of investors search for safe-haven investments, German government bonds registered a drop in their ten-year yield. However with regards to Greek government bonds, long-term interest rates spiked upwards during the last three months in view of the ongoing political uncertainty that struck the country.

The euro currency experienced strong fluctuations against major economies especially since the third quarter of 2014. This fluctuation was characterised by diverging growth dynamics in tandem with diverging monetary policy measures implemented across major economies. By the end of January 2015, the Euro depreciated by 9 per cent against the US dollar, 5 per cent against the British Pound, and 8 per cent against the Japanese Yen. The most notable depreciation was that against the Swiss franc whereby the exchange rate fell by 13 per cent. This occurred due to the Swiss National Bank's decision to discontinue its exchange rate cap against the euro on 15th January 2015. The effect of the euro depreciation on Euro Area member states depends on the direction and extent of trade with non-euro area countries, and the exchange movement of the respective trade partners' currencies. The chart indicates the exchange rate movements of major currencies against the euro with January 2007 set as the base year. An increase in the index of another currency implies a euro appreciation whereby euro currency buys more units of the foreign currency; whereas a decrease in another currency index implies a euro depreciation whereby euro currency buys fewer units of the foreign currency.

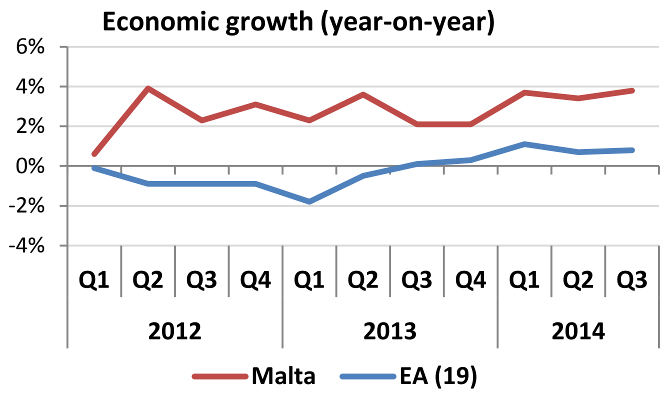


In the securities market, ESMA portrays EU systemic stress in its Trends, Risks, and Vulnerabilities report published in September 2014, as low but volatile, registering minor stress during the third quarter of the year driven mainly by money and equity markets. ESMA's systemic stress indicator measures systemic stress in securities markets focusing on three financial market segments, namely: equity, bond and money markets. Significant gains were reported in the EU securities market in view of a relatively strong risk appetite complimented with a hunt-for-yield investor behaviour as a consequence of the low-interest-rate environment. The risk of valuation corrections continued to increase in view of a continued build-up of imbalances with asset prices reaching historically high levels. Moreover, revaluation risk may already be partially present in lower-rated corporate bond and equity markets.

The European economy is expected to remain subdued in the short to medium term, however the Commission identified four elements that are expected to improve economic activity during 2015. The drop in oil price that prevailed since mid-2014 is expected to be a main contributor in invigorating economic growth and support domestic demand through lower energy costs. However this will drag inflation further down increasing the risk for outright deflation. The launching of the Expanded Asset Purchase Programme for euro-denominated investment-grade securities issued by euro area governments and agencies and EU institutions, known as Quantitative Easing, is expected to generate wide macroeconomic developments. The programme is aimed to support positive inflation expectations, improve business and consumer confidence, and increase credit growth. The euro depreciation against other currencies is another factor which is expected to improve price competitiveness and domestic production by Euro Area member states that export to non-Euro Area countries. Finally, the EU Investment Plan presented by the European Commission will contribute positively towards supporting investment and improved growth outlook. The EU Investment Plan aims at mobilising investments in projects of small and medium-sized enterprises and also long-term infrastructure projects between 2015 and 2017.

Economic performance and outlook for Malta

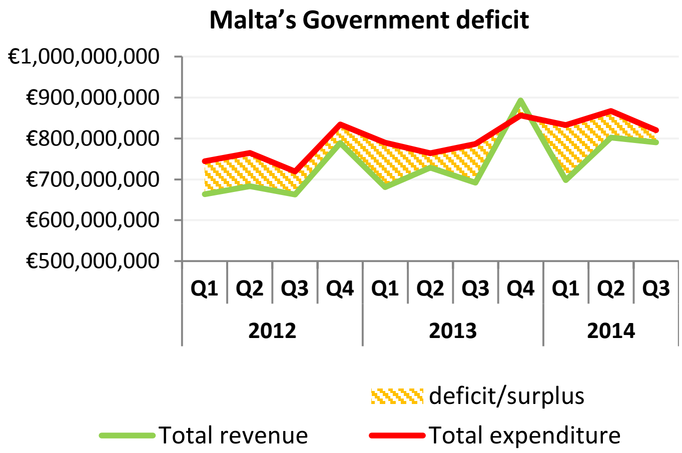
The Maltese economy continued to register growth during the year making it one of the fastest growing economies in the Euro Area. As acknowledged by the IMF through their Concluding Statement of the 2014 Article IV Mission, Malta managed to withstand the global crisis and projects further economic growth during 2015 and 2016. This was also recognised by the European Commission as documented in its 2015 Winter Economic Forecast report where Malta was acknowledged for maintaining a healthy economic momentum during 2014. Malta is also projected to keep recording strong growth relative to that expected by other Euro Area member states economies.



Malta's economic growth during 2014 outperformed that of other major EU member states, registering a year-on-year real GDP growth rate of 3.8 per cent during the third quarter of 2014 as compared to 0.8 per cent registered in the Euro Area. Growth in Malta's Gross Value Added (GVA) during the third quarter of the year was mainly generated by wholesale and retail trade, transportation and storage, accommodation and food service activities; and public administration and defence, education, human health and social work activities. The Commission estimates real GDP growth in Malta for 2014 to record 3.3 per cent, which is a 0.8 percentage point increase from that registered during 2013. Economic growth during 2014 was stimulated predominantly by stronger domestic demand with government spending and investment being the largest contributors.

Domestic demand is expected to remain the main driver of growth during the forecasted horizon. This is expected to emanate from large scale investment projects supported namely by the energy project, and also from private consumption which will be sustained through higher employment and real disposable income. Moreover, favourable exchange rate movements are expected to contribute positively towards economic growth as it boosts demand for Maltese exports from outside the EU. The Commission projects real GDP growth to stabilise at 3.3 per cent in 2015 and to subsequently grow by 2.9 per cent in 2016.

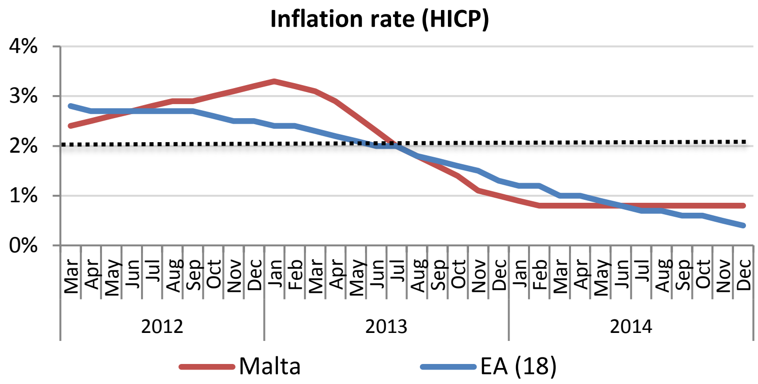
Malta's fiscal position is expected to consolidate further in order to ensure compliance under the EU Council Recommendations on the Excessive Deficit Procedure. Forecasts set by the Commission expect deficit to fall to 2.3 per cent of GDP by end of 2014 as compared to 2.7 per cent registered in the previous year. Malta's general government revenue during the third quarter of 2014 increased by 14.2 per cent compared to that registered during the same quarter of the previous year. The major contributing factors were higher proceeds from current taxes on income and wealth, taxes on production and imports, and net social contributions. Conversely, general government expenditure also increased when comparing the third quarter of 2014 with that of the previous year, registering a 4.2 per cent increase. The main elements contributing to this increase were compensation of employees, and current transfers payable. With respect to general government gross debt, when comparing Malta's third quarter of 2014 with that of the previous year, outstanding debt increased by around 4 per cent. Malta's general government gross debt-to-GDP ratio was estimated to stand at 75 per cent of GDP as at the third quarter of 2014, which reflects a 3 percentage point growth when compared with the same quarter of the previous year.



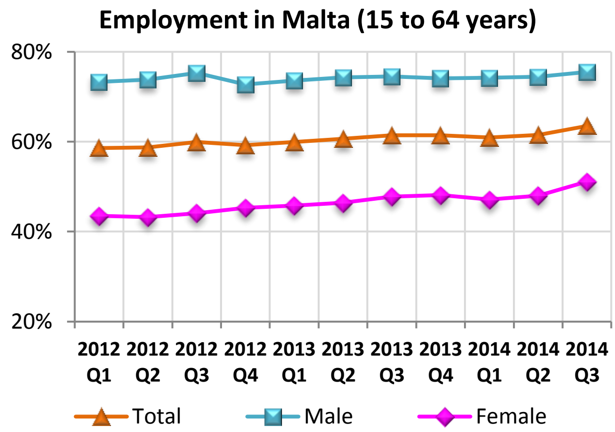
As recorded in Malta's Budgetary Plan for 2015, the general government deficit is forecasted to decline from 2.1 per cent of GDP as registered during 2014 to 1.6 per cent of GDP in 2015, and is expected to fall further to 1 per cent of GDP the following year. The Commission's forecasts are slightly less optimistic as it projects the debt-to-GDP ratio to narrow to 2 per cent in 2015 and consequently decline to 1.8 per cent in 2016. With respect to the general government debt, the Budgetary Plan forecasts the debt-to-GDP ratio to fall by 1.1 percentage points in 2015, and should fall further in 2016 reaching the projected rate of 67 per cent. Similarly, the Commission's forecasts the debt-to-GDP ratio to decrease to 66.8 per cent by the end of 2016.

Inflation in Malta remained subdued during 2014. The factors contributing to such low inflation were mainly the reduction in household utility tariffs and weak price pressures originating from foreign economies. The 12-month moving average rate stabilised at 0.8 per cent during 2014. Inflation in Malta is projected to increase in 2015 to 1 per cent and is expected to rise further to 1.9 per cent in

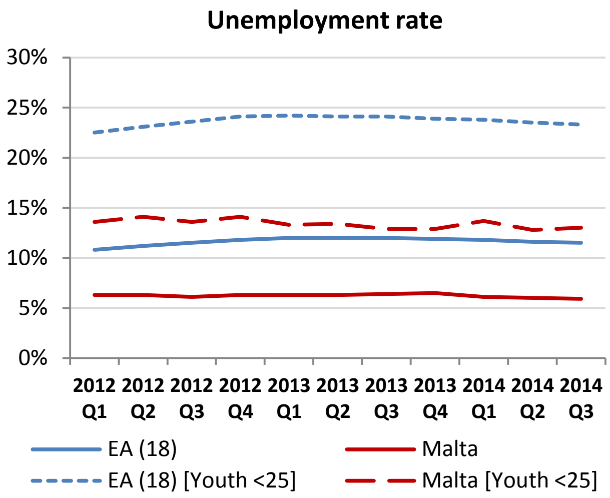
2016. The downward price pressure that the proposed reduction on commercial utility tariff is expected to exert this year should be counterbalanced by the projected upward pressure expected from higher household disposable income. Within the Euro Area, inflation continued to fall reaching 0.4 per cent as at December 2014. A prolonged period of low inflation distressed by weaker than expected economic growth in the Euro Area may give rise to a reduction in external demand for Maltese exports which may give rise to economic slowdown.



The labour market continued to perform well during the year positioning Malta as one of the few Euro Area member states that registered low unemployment. Employment in Malta continued to increase reaching 63.5 per cent as at the third quarter of 2014. This represents a 2.1 percentage points increase from that registered during the same quarter of the previous year. More females continued to join the workforce, making female employment a major contributor to employment growth. As at the third quarter of the year, the female participation rate reached 51.1 per cent. This represents 3.3 percentage points increase for the period under review against that of last year. Male employment registered a 1 percentage point increase during the year reaching 75.5 per cent of total employment at the end of the third quarter of 2014. Employment in Malta is expected to grow further during the forecasted horizon, projecting a 1 percentage point increase in 2015 and subsequently 1.9 percentage points increase the following year. The drive for more females and older workers to join the labour force remains high on Malta's policy agenda. Effective frameworks and support services are necessary in this regard in order to increase the labour supply.



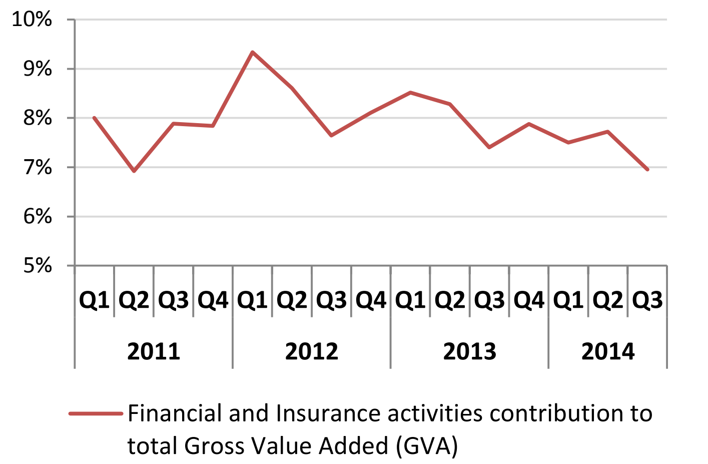
Based on the Labour Force Survey, unemployment in Malta stood at 5.8 per cent as at the fourth quarter of 2014. This represents a 0.7 percentage point drop from that registered during the same quarter of the previous year. Unemployment in the Euro Area registered a slight decrease during 2014, recording 11.4 per cent during the fourth quarter of the year. With respect to unemployment amongst youths, Malta registered 13 per cent as at the fourth quarter of the year. Whereas in the Euro Area youth unemployment stood at 23.1 per cent by the end of the fourth quarter. The unemployment rate in Malta is expected to remain stable over the foreseeable future and youth unemployment is projected to remain one of the lowest in the EU.



The Global Competitiveness report 2014-15 issued by the World Economic Forum also gives Malta a positive score. It ranked the country at 47th place in its Global Competitiveness ranking out of 144 countries. Encouraging scores were also given for other sub-rankings especially within the financial sector, namely: availability of financial services ranked 26th place; affordability of financial services at 24th place; financing through local equity market at 25th place; ease of access to loans at 16th place; and soundness of banks at 10th place.

Financial services sector trends in Malta

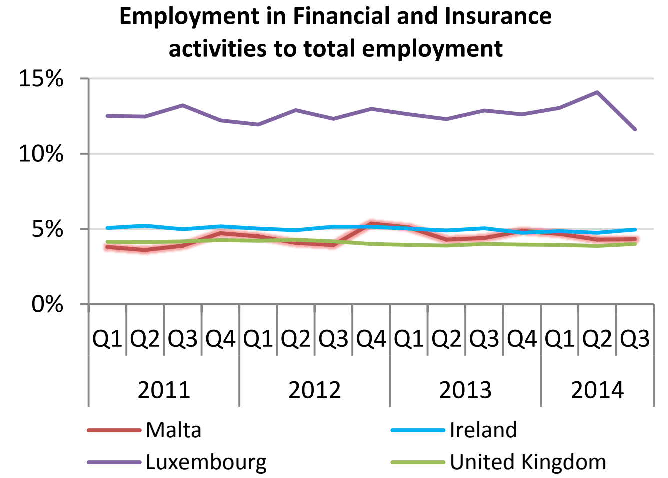
Malta's Financial and Insurance activities contribution to total Gross Value Added



Source: NSO newsletter 232/2014

Total Gross Value Added (GVA) during the third quarter of 2014 registered EUR 1.8 billion in absolute terms. This reflects an increase of 4 per cent compared to that of the same quarter of the previous year, which recorded a total GVA of EUR 1.7 billion. Malta's financial services sector contributed 7 per cent to total GVA during the third quarter of 2014, amounting to EUR 126 million. This represents a relative drop of 0.5 per cent from that recorded during the same quarter of the previous year. Contribution from financial and insurance activities to total GVA during 2011, 2012 and 2013 represented 7.7, 8.4 and 8 per cent respectively.

Employment in Financial and Insurance activities

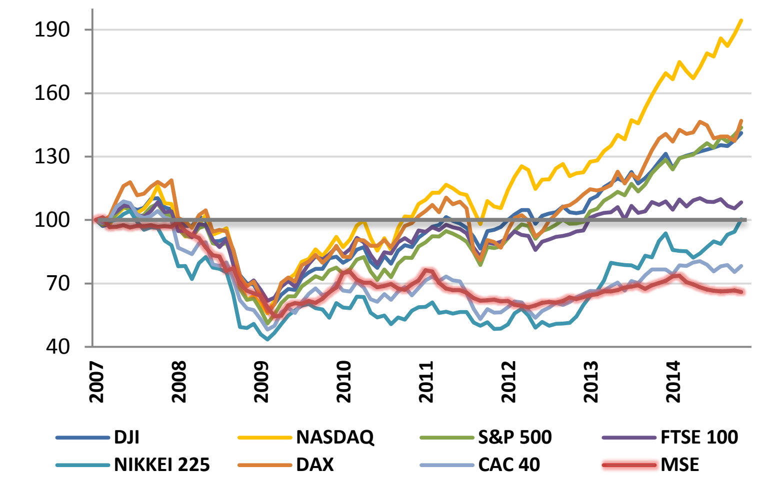


Source: Eurostat

Employment within Malta's financial services sector amounted to 7,800 as at the third quarter of 2014, contributing 4.3 per cent of total employment. By comparison, during 2013, employment in financial and insurance activities contributed 4.7 per cent of total employment, amounting to 7,700 in absolute terms. Employment contribution in member states having a large financial services sector during the third quarter of2014 registered 5 per cent in Ireland, 4 per cent in the UK, and 11.6 per cent in Luxembourg.

Key stock market indices value (Jan 2007 base year = 100)

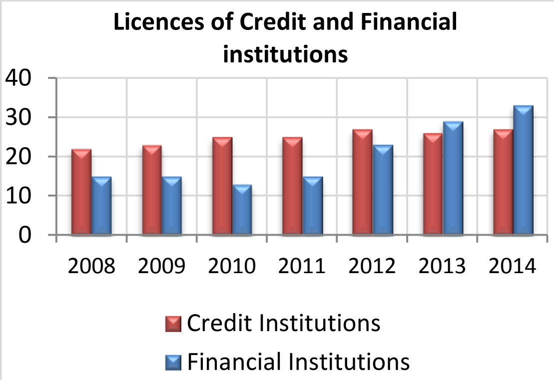
The Chart summarises the performance of key indices of major stock groupings. Each of the indices tracks the performance of a specific basket of stocks representing a particular market or sector. In order to monitor performance of stock indices, a base year at 100 was taken as from January 2007.

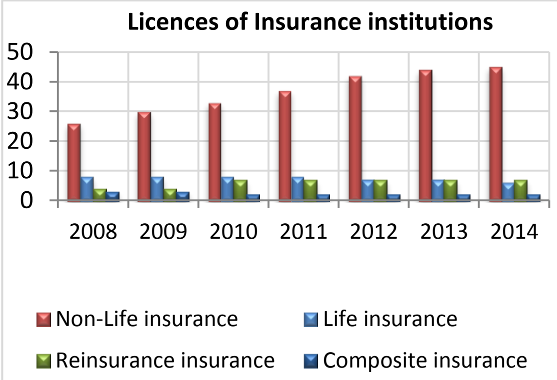


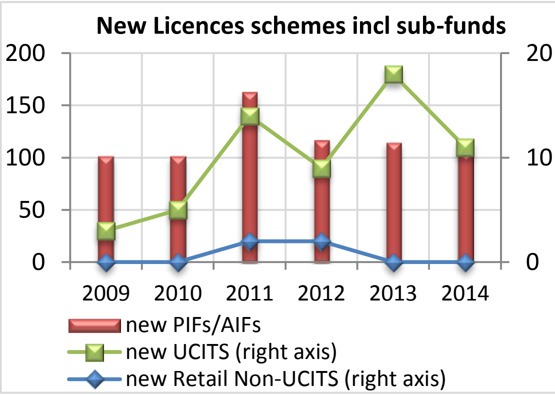
Source: Yahoo! Finance; Malta Stock Exchange

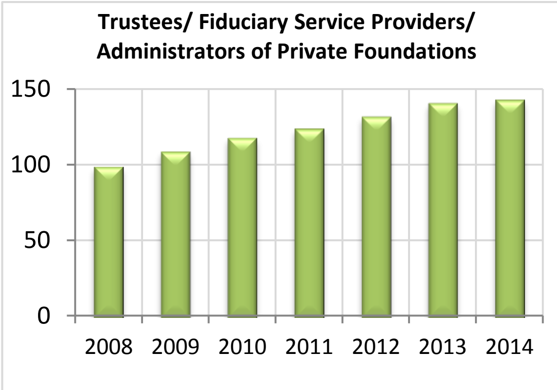
Equity markets registered a favourable upward momentum in those countries that experienced strong economic growth. Equity prices in the S&P500 index rose on the back of an accelerating US economy and also in view of heightened market expectations for the Federal Reserve to lengthen its normalisation process of its non-standard monetary policy measures. In the United Kingdom, the FTSE100 index stabilised amidst fears of an economic slowdown in China together with potential escalation of geopolitical tensions. These expectation pressures were counterbalanced by the favourable positive economic indicators recorded in the United States. Japan stock indices as in the NIKKEI225 index increased reaching its highest level registered since November 2007 on the back of a weakening yen. Equity prices in Europe registered modest gains in view of weakened consumer confidence and economic slowdown of major Euro Area member states. The domestic equity market, through the MSE index, also registered marginal gains reflecting a rise in both the number of shares traded and their prices.

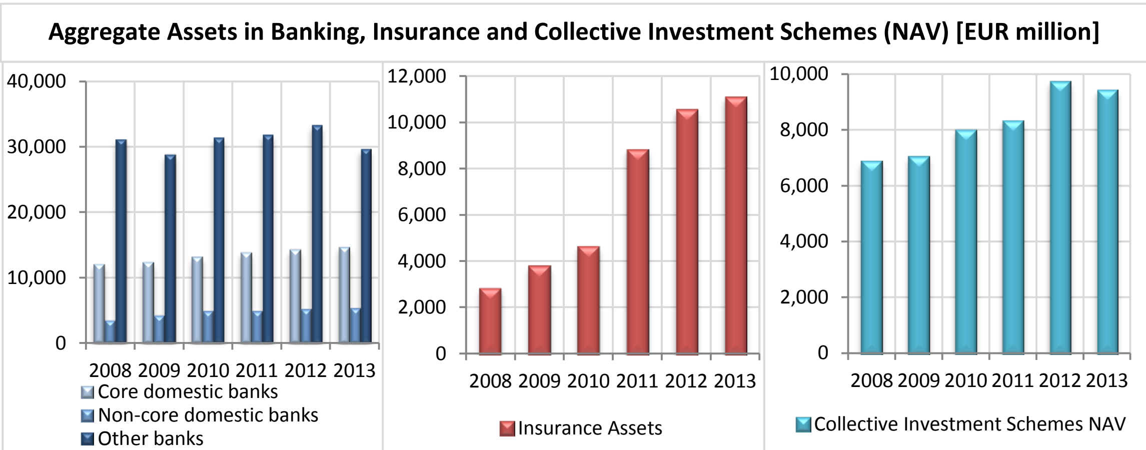
Licences and Assets of Financial institutions licenced by the MFSA











Source: Malta Financial Services Authority

As at the end of 2014, the total number of credit institutions edged up marginally to 27 during the year. Financial institutions licenced by the MFSA continued to increase registering an additional four licences during the year reaching a total of 33 as at the end of the year. These are made up of 22 payment institutions and 7 electronic money institutions. In terms of balance sheet assets, the banking sector retains the largest share totalling EUR 49.7 billion as at 2013, reflecting around 660 per cent of GDP. Over 70 per cent of bank assets belong to international banks having little or no interaction at all with the domestic economy.

As for the insurance sector, the total number of licences registered during the end of 2014 for composite and reinsurance insurance remained the same as that recorded the previous year. Non-life insurance increased by one licence, whereas life insurance decreased by one licence during the year. Therefore, the insurance sector registered a total of 45 non-life, 6 life, 2 composite, and 7 reinsurance licences as at the end of 2014. Assets within the insurance sector continued to increase totalling EUR 11,077 million in 2013, constituting more than 140 per cent of GDP.

Collective Investment Schemes licenced by the MFSA continued to increase registering 118 new licences up until the end of 2014. Professional Investment Funds/Alternative Investment Funds remains the strongest form of scheme registering 106 new licences during the period under review, whereas UCITS grew by an additional 11 funds during the year. Licences with respect to trustees, fiduciary service providers, and administrators of private foundations totalled 142 as at the end of the year. This reflects an additional two licences registered during the year. Total Net Asset Value for Collective Investment Schemes stood at EUR 9,400 million as at 2013, reflecting around 120 per cent of GDP.

World Economic Forum - The Global Competitiveness Report – Malta's rankings

	2010-2011	2011-2012	2012-2013	2013-2014	2014-2015
Global Competitiveness Index rank	50	51	47	41	47
Availability of financial services	33	33	34	27	26
Affordability of financial services	30	28	32	27	24
Financing through local equity market	9	23	24	25	25
Ease of access to loans	12	12	17	15	16
Soundness of banks	10	12	13	14	10

Source: World Economic Forum - The Global Competitiveness Report

Malta’s Sovereign Credit Rating

	Fitch ratings	Moody's ratings	Standard & Poor’s ratings
2008	A+	A1	A
2009	A+	A1	A
2010	A+	A1	A
2011	A+	A2	A
2012	A+	A3	A-
2013	A	A3	BBB+
2014	A	A3	BBB+

Source: Central Bank of Malta – Financial Stability report

Supporting Malta’s positive economic outlook, Fitch ratings has affirmed Malta’s long-term foreign and local currency issuer default ratings at ‘A’ with a stable outlook. The main drivers contributing towards such a rating include strong GDP growth, low unemployment rates, and a resilient banking sector. Public finances on the other hand remained a weakness although Fitch ratings acknowledged a marginal improvement in this regard. Moody’s Investors Service also commended Malta for its robust growth outlook and regarded the country as reliable with respect to access to domestic funding. It affirmed Malta’s ‘A3’ credit rating with a stable outlook. Additionally, a Moody's Assistant Vice President and Analyst stated that Malta’s economy is expected to grow further in 2015 fuelled by higher domestic demand which is expected to be driven by an increase in consumption and government reforms in the energy sector and labour market. Standard and Poor's rating agency also affirmed Malta's ratings at ‘BBB+’ with a stable outlook. It acknowledged Malta’s strong economic growth prospects and the progress currently being made in the energy sector, but underlined caution with respect to the government debt burden.

Regulatory and supervisory developments in the EU

The financial crisis proved that maintaining stability within the financial system is a key element in developing and maintaining a sustainable and prosperous economy. This instigated policy makers to tighten the regulatory framework and strengthen financial sector supervision so as to build a more stable and reliable European financial system. Furthermore, the need for establishing a harmonised prudential framework within the Single market became even more apparent.

Banking sector reform

The Banking System is going through a radical structural transformation most notably through the creation of the Banking Union which has made significant headway in its setup and operation. The Banking Union is based on three major foundations: the Single Supervisory Mechanism, the Single Resolution Mechanism, and the Single Rulebook. Together these elements contribute in strengthening the banking system in terms of crisis prevention, early intervention and crisis management. Crisis prevention is pursued through the setup of an independent European banking supervisor, the application of common rules transmitted by the Capital Requirements Directive IV package, and the compulsory requirement for banks to draw recovery and resolution plans. When banks face difficulties it is imperative to ensure prompt intervention for corrective action. This is addressed though the activation of measures as set out in the bank crisis and resolution framework. Finally, should a bank's financial condition reach a critical state, tools designed to control crisis management will be put into force. These include the Bank Recovery and Resolution Directive, Single Resolution Mechanism and Depositor Guarantee Scheme, which ensure bank resolution and moreover depositor and taxpayer protection.

Banking Comprehensive Assessment

In preparation for the operation of the Single Supervisory Mechanism, the ECB in collaboration with the national competent Authorities carried out a Comprehensive Assessment on significant banks within the Euro Area. This consisted of two key components, an Asset Quality Review (AQR) and a forward-looking stress test. These components coupled with timely remedial actions contribute in strengthened banks' balance sheet, maintain a resilient and transparent financial sector, and induce confidence in the European banking system.

The comprehensive assessment was performed on 130 significant banks in the Euro Area covering approximately 82 per cent of total EU banking assets. The ECB which assumed direct supervision of these banks on 4th November 2014 published the results of the first comprehensive assessment. The shortfalls identified in the AQR or under the baseline stress test scenario must be covered by the end of April 2015, whereas those identified under the adverse stress test scenario must be consolidated by the end of July 2015.

The objective of the AQR was to determine the quality of the different types of assets held on major banks' balance sheets as of 31st December 2013. The assessment was broad in its nature covering credit and market exposures. The portfolios selected varied from one bank to another in order to ensure an in-depth review into exposures with the highest risk. The AQR was undertaken by the ECB and national competent Authorities as a health check of those banks that were to be directly supervised by the ECB, and also to act as a starting point for the forward looking stress test. Moreover, the AQR facilitated comparison amongst participating banks of all member states by adopting common definitions and applying uniform methodologies by means of the AQR Manual published by the ECB. The AQR respected current accounting and prudential regulations, including the CRR/CRD IV capital rules. All asset classes were examined in three phases and the results from the sampled exposures for each participating bank were used to obtain an AQR adjusted Core Tier 1 capital calculation.

The AQR showed that at the end of 2013 the carrying or book values of banks' assets required adjustments of €48 billion which were reflected in the banks' accounts or prudential requirements. Furthermore, it was found that banks non-performing exposures increased by €136 billion to a total of €879 billion. Furthermore, the comprehensive assessment found a capital shortfall under the adverse scenario of €25 billion at 25 banks. Twelve of these banks had already covered their capital shortfalls in 2014 by increasing capital by €15 billion. Banks which incurred shortfalls are required to prepare capital plans within two weeks after the announcement of results. The comprehensive assessment also showed that a severe scenario would deplete the banks' top-quality loss-absorbing Common Equity Tier 1 (CET1) capital by around €263 billion. This would result in the banks' median CET1 ratio to decrease by 4 percentage points from 12.4 per cent to 8.3 per cent.

The forward-looking stress test provided an examination of banks' solvency resilience based on hypothetical adverse and baseline macroeconomic scenarios. The EU stress test was undertaken by the participating banks, together with the ECB and national competent Authorities in coordination with the EBA and ESRB. In order to ensure comparability of results across the EU, all banks were assessed on the basis of common assumptions, definitions and approaches, covering a wide range of risks. Moreover, the methodology adopted for the test rested on a number of constraints. Calculations used for the stress test also took into account new information arising from the AQR. It acted as a prudential exercise to test banks' resilience to adverse economic conditions.

Under the baseline scenario as provided by the European Commission, banks were expected to obtain at least an 8 per cent capital threshold. This scenario was set according to the Commissions economic projections of up to 2016. On the other hand, under the adverse-stress scenario that was set by the ESRB, banks had to obtain at least 5.5 per cent capital threshold. The scenario was set in collaboration with the ECB and EBA. Its aim was to reflect deterioration in macroeconomic developments based on pertinent threats that may affect the stability of the EU banking sector.

The comprehensive assessment was also carried out on credit institutions licensed by the Malta Financial Services Authority, which include Bank of Valletta plc, HSBC Bank Malta plc, and Deutsche Bank (Malta) Ltd. For all three banks no capital shortfalls were identified from both the baseline and adverse scenarios. The CET1 capital ratio for each of these banks remained above the 8 per cent minimum threshold after considering the AQR. Moreover, under the adverse scenario as compiled through the stress test indicated that the CET1 ratio by 2016 for each of these three banks would still remained well above the 5.5 per cent minimum threshold. In this regard, both Bank of Valletta plc and HSBC Bank Malta plc recording a CET1 capital ratio of 8.9 per cent, while Deutsche Bank (Malta) Ltd registered 138.8 per cent. The overall results confirm the soundness and resilience of each of these three banks.

Insurance regulatory development

The insurance sector in Europe is reinforcing its regulatory framework through the development of Solvency II and Omnibus II Directives with the scope of promoting financial stability. The directives aim to introduce a more rigorous risk management framework and implement greater transparency and disclosure requirements so as to increase policyholder protection and consumer confidence in insurance products. The European Parliament and the Council agreed that the Solvency II Directive including the amendments introduced by Omnibus II should apply as of 1st January 2016. Through this the EU will continue to fulfil its regulatory harmonisation plan of developing a single European rulebook.

Insurance Stress Test

In order to gain insight on the Insurance sector's resilience to risks and vulnerabilities, and as an evaluation to potential systemic risk, EIOPA carried out an Insurance Stress Test during 2014. The EIOPA stress test was composed of two independent elements, the Core Module and the Low Yield Module. Although the modules differed in scope having different shock scenarios and sample size, the technical basis for both modules was the upcoming Solvency II insurance regulatory regime.

The adverse market scenarios for the Core Module were developed in collaboration with the ESRB. Key risks as identified in EIOPA's financial stability analysis report were also addressed. The baseline was the starting point for all of these elements where the undertakings' balance sheets, available assets and liabilities, eligible own funds and Solvency Capital Requirements cover were evaluated at end 2013 values. The Core Module comprised of the following elements:

- Scenario CA1 – an asset market shock scenario originating in the EU equity market;
- Scenario CA2 – an asset market shock scenario originating in the non-financial corporate bond market; and
- Insurance specific stresses – a set of single factor insurance stress scenarios

On the other hand the Low Yield Module was a bottom-up stress test exercise entailing calculations performed by insurance undertakings aimed at capturing the impact of several low interest rate scenarios as provided by EIOPA. This is a follow-up to the EIOPA Opinion published in 2013 on the supervisory response to a prolonged period of low interest rates. Two scenarios specified in the Low Yield module are:

- 'Japanese-like scenario' embodying a persistent low interest rate environment
- 'Inverse scenario' with an atypical change in the shape of the yield curve

These scenarios were developed to outline two different interest rate term structures each reflecting historic and hypothetical developments in the context of a prolonged period of low interest rates.

The core module was completed by 60 groups and 107 individual undertakings from all EU Member States as well as Switzerland, Norway and Iceland. This represented 55 per cent of the EU market share as measured by Gross Written Premium. With regards to Maltese participating companies, a total of 9 individual undertakings participated in the Core Module. Whereas the low yield module was completed by 225 individual companies from all EU countries including Norway, which represented 60 per cent of the EU market share as measured by Gross Technical Provisions. The number of Maltese participating companies totalled to 4.

EIOPA had forewarned that it will be refraining from publicly disclosing individual participants' results. The reason being that the Solvency II specification that was used for the stress test was not the final specification that will be implemented in 2016, hence publishing such results would have resulted to misleading information to the market. However the overall results of the EU-wide insurance stress test were published indicating that the sector is sufficiently capitalised in terms of Solvency II. A number of common findings were established, such that EIOPA issued a set of recommendations to National Supervisory Authorities to take the appropriate supervisory action in order to address the vulnerabilities identified from both modules of the stress test.

The overall results of the EU-wide insurance stress test indicate that under the baseline scenario, 14 per cent of the companies representing 3 per cent of total assets had a Solvency Capital Requirement ratio below 100 per cent. The stress test identified that the insurance sector is most vulnerable to a 'double hit' stress scenario where decreases in global asset prices are combined with a lower risk free interest rate level. Hence EU insurers face risks at both their assets and liabilities side of the balance sheet. It was found that 56 per cent of the companies would have had a sufficient level of capital under such a stress scenario. Under the low yield module, it was identified that should the low yield environment prolong further, certain EU insurers would face problems in meeting their promises to policyholders in 8 to 11 years' time. Moreover, 24 per cent of the participating companies would not meet the Solvency Capital Requirement ratio under the persistent low interest rate environment (Japanese-like scenario), whereas 20 per cent of companies will not meet the threshold under the Inverse scenario.

Securities market vulnerabilities to potential systemic risk

In a speech provided by the Chair of the European Securities Markets Authority, Mr Steven Maijoor, it was acknowledged that the securities market is vulnerable to systemic risk, similarly as experienced in the banking and insurance market. Europe's securities market constitutes an integral part of the single market and moreover the European financial system is home to the second largest fund market in the world. In this regards further regulatory development efforts are required so as to minimise vulnerabilities and mitigate systemic risk in the securities market.

The Chair identified a number of elements indicating how investment firms may be susceptible to systemic risk. Interconnectedness within the financial system was one of the main causes of concern. Distress in a financial institution may cause counterparty risk through direct investments and financial intermediation which in turn may impact market liquidity and risk aversion. Another element of concern was the potential cascading effect that may emanate from fire sales which could give rise to market confidence deterioration and adverse financial market behaviour. Furthermore, although the failure of a large fund may generate instability, the collective activities by a group of asset management firms may foster directional market moves and contagion which in turn may give rise to systemic risk. Mr Steven Maijoor reiterated that ESMA remains committed in developing further its understanding on the systemic implications of asset management activities with the scope of designing a framework targeting systemic risk for Europe's securities market.

Commitment in addressing systemic risk in the securities market has also been transmitted by the G20 Leaders whereby they requested the Financial Stability Board in consultation with IOSCO to prepare methodologies to identify systemically important Non-Bank Non-Insurer (NBNI) financial entities. As a result, in January 2014 a consultative document entitled 'Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies' was published. The proposal included a high-level framework for identifying G-SIFIs and implementation approaches that will apply across all NBNI financial entities. It also includes NBNI financial sector-specific methodologies for finance companies, market intermediaries such as securities broker-dealers, and investment funds.

ESRB Risk Dashboard overview

The ESRB together with the statistical support provided by the European Central Bank develops a Risk Dashboard comprising of quantitative and qualitative indicators. These indicators assist in identifying and evaluating potential systemic risks in the EU financial system. The risk dashboard was first published in September 2012 and serves as an input for the General Board's discussion on risks and vulnerabilities.

Based on the EU Regulation 1092/2010 establishing the ESRB, systemic risk is defined to include the risk of disruption to financial services caused by a significant impairment of all or parts of the Union's financial system that have the potential to have serious negative consequences for the internal market and real economy. As a result, the ESRB Risk Dashboard was developed to cover various aspects of risks within the whole EU financial system.

The ESRB Risk Dashboard measures risks through a set of indicators categorised by the following six elements:

i) Interlinkages and composite measures of systemic risk

This category includes a set of synthetic indicators of systemic risk such as the composite indicator of systemic stress (CISS) which measures the current state of instability in different segments of the financial system. Moreover the dashboard includes an indicator measuring the probability of a simultaneous default by two or more large and complex banking groups, as well as the average contribution of individual banks and insurance companies to systemic risk. This category also considers the level of interconnectedness through the banking sector within the European Union by analysing cross border claims.

ii) Macro risk

Macroeconomic data is used to compute various indicators measuring risks in the real economy. Indicators include real GDP growth, credit-to-GDP gap, government fiscal position ratios, national trade positions, and private sector leverage.

iii) Credit risk

Credit risk is monitored for the non-financial private sector by considering movements in residential property markets, magnitude of foreign currency loans in the EU, lending spreads, and impact of changes to credit standards on households and large enterprises.

iv) Funding and liquidity risk

A number of price-based indicators are considered in this category to measure funding and liquidity conditions in the financial sector such as the interbank rate spreads, financial market liquidity indicator, cross-currency basis swap spreads, indicators that evaluate banks funding structures and their reliance on central banks, and also an overview of banks' evolution on long-term debt structure.

v) Market risk

Market risk is partially monitored through market movements which are measured by sector-specific equity indices valuations and volatilities, short-term and long-term interest rate implied volatilities, and exchange rate volatility. Furthermore this category also monitors market risk through investor risk appetite by analysing the global risk aversion indicator which is made up of risk aversion indicators compiled worldwide.

vi) Profitability and solvency

The last category considers indicators that measure the financial performance and solvency of the EU banking and insurance sectors. Indicators for the banking sector measuring profitability include return on equity, cost-to-income ratio, and net interest income to total operating income. Whereas solvency indicators include Tier 1 capital to total assets and impaired loans. As for the insurance sector, profitability measures include return on equity, combined ratio, and gross premiums written. The solvency indicators on the other hand consist of the solvency and retention ratio.

The ESRB risk dashboard is published on a quarterly basis and is made available to the general public through its website. The ESRB also provides an overview on the current risks and vulnerabilities underlining the performance of the financial market, banks and credit supply for the period analysed. Furthermore, two annexes are also published explaining the methodology used in compiling the indicators and also a description of the indicators used in the risk dashboard.

The following is a brief overview underlining the salient elements that were highlighted in the ESRB risk dashboard report (issue 10) with respect to the performance of the EU financial system.

ESRB risk dashboard overview (issue 10 – December 2014)	
Dashboard classifications	**Performance overview**
Interlinkages and composite measures of systemic risk	▪ Market perception of systemic risk remains in line with pre-crisis levels. ▪ Registered some renewed periods of volatility. ▪ Financial contagion remained at a relatively low level.
Macro risk	▪ Further subdued economic recovery in EU member states, and divergence in performance within the Euro Area. ▪ Relatively stable external balances and divergence registered across the EU. ▪ Slight improvement in labour market, with cross-country variations. ▪ Unemployment still remains too high. ▪ General government deficit-to-GDP ratios lower for the majority of countries. ▪ General government debt-to-GDP ratios still remained at high levels. ▪ Credit default swap spreads increased slightly for lower-rated euro-area countries. ▪ Private sector indebtedness for both household and non-financial corporate debt remained high.
Credit risk	▪ Banks generally continued to marginally ease credit standards on new loans to enterprises and households, however not translated across the board into narrower lending margins. ▪ Wide regional divergences in house price dynamics with some countries registering growing house prices and others having stabilised house prices. ▪ Various member states implemented macro-prudential policy measures in order to address issues in their national housing markets.

Funding and liquidity	▪ Funding costs decreased for large firms with direct access to capital, however spreads of riskier high-yield euro area corporate bonds increased over the second half of 2014.
Market risk	▪ Stable money market spreads and financial market liquidity indicators. ▪ Global risk aversion indicator shows risk sentiment to remain in line with pre-crisis levels. ▪ Equity prices losses incurred by non-financial companies due to market tensions have not been fully recovered. ▪ Diminished recovery in equity prices for financial companies. ▪ Uncertainty most notably on euro-area short-term interest rates. ▪ High volatility of the euro exchange rate with other major currencies.
Profitability and solvency	▪ Improved solvency. ▪ Large EU banking groups increased Tier 1 capital to total assets. ▪ Subdued levels of profitability. ▪ Central bank funding decreased in the majority of EU countries, although still remains at a high level. ▪ Banks continue to prolong the maturities of their outstanding debt. ▪ Further deleveraging registered through the declining loan-to-deposit ratio.

The ESRB risk dashboard together with all the additional documentation may be accessed from the following link: https://www.esrb.europa.eu/pub/rd/html/index.en.html

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