Michael C Bonello: Financial crisis impact on the Maltese economy

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the annual dinner of the Malta Institute of Financial Services – Malta, Saint Julian's, 5 December 2008.

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I would first of all like to thank you, Mr President, and your Council for inviting me to address the members of your Institute and their guests. I would also like to commend IFS Malta's growing contribution to the Maltese economy through its learning activities, and in particular its involvement in the Education Council. I understand that it has also been participating actively in the work of the European Banking Training Network, and that it will next year start offering the Foundation Degree Programme of the University of Kent and the IFS School of Finance.

When I addressed this distinguished gathering a year ago, the world was a very different place. At the time, the ECB forecast a euro area growth rate of around 2% for 2009; now the talk is about the likely depth and duration of the incipient recession. A year ago we were concerned about the upside risks to inflation; only twelve months later the prospects are of inflation falling well below the ECB's price stability objective. What has gone so terribly wrong, so quickly?

In The Great Crash, 1929, J.K. Galbraith noted that "Far more important than rate of interest and the supply of credit is the mood". And as the editorial of the November issue of the Institute's journal Financial World goes on to explain, "It is the mood that has fundamentally changed and this change is why, though governments may pump money into banks, share prices are still weak. It is why central banks are cutting rates but Libor is staying put. It is also why, despite public money to provide liquidity to markets, to guarantee bond issues and even to take stakes in banks, stock markets continue to drop like so many stones." Perhaps this is happening because, as former ECB Executive Board member and Italian Economy Minister, Tommaso Padoa Schioppa aptly put it, this is not a crisis in the system, it is a crisis of the system.

As tales of woe beyond our shores multiply, it is appropriate to take stock of what this systemic shock could mean for Malta. First, some background. Our financial system has changed beyond recognition in recent years, driven by a combination of domestic market reforms and international integration. The liberalisation process of the 1990s saw the gradual removal of interest rate restrictions, the easing of capital controls and the privatisation of most of the financial sector. The legal framework was entirely overhauled, bringing it in line with EU standards and laying the foundations for the growth of new areas of financial activity, such as investment services and trusts.

EU membership in 2004 opened up the Maltese financial market to service providers from other member states. Conversely, our financial institutions gained access to the single European market, a factor which encouraged additional inward foreign investment into the sector. At the same time, the last exchange controls were removed. The adoption of the euro last January was a further step in the integration process into the single market. Financial transactions across the euro area can now take place without incurring exchange rate risks.

Furthermore, Maltese banks now have access to the Eurosystem facilities available to credit institutions within the euro area. These include a variety of instruments designed to provide short-term liquidity, as well as standing deposit and lending facilities. At the same time, euro adoption entailed a reduction in the minimum reserve requirements that Maltese banks had to comply with, resulting in the release of additional funds into the banking system.

Euro adoption also led to improvements in the financial infrastructure supporting the Maltese economy. In November 2007, Malta formed part of the first group of countries that joined TARGET2, the payment system used by the Eurosystem for the settlement of large value

interbank transfers in euro. Maltese banks can use TARGET2 to carry out transfers with other banks in Malta and throughout the euro area rapidly, safely and effectively. The Single Euro Payments Area (SEPA), launched in January this year, is a further step towards closer financial integration and aims at making retail payments across the euro area as easy as they currently are within national boundaries.

Liberalisation and integration into the EU have underpinned the rapid growth of the Maltese financial sector. The number of banks rose from 16 in 2004 to 23 in September this year. During the same period, the total assets of the banking system more than doubled to EUR45.1 billion. Nor was growth restricted to the banking sector. The number of local and foreign-based collective schemes climbed from around 70 in 2004 to nearly 400 today, partly reflecting legislative changes that spurred the formation of professional investor funds. Total assets under management have also increased exponentially to over EUR8 billion. More moderate growth was recorded in the insurance sector, though the captive insurance business is growing fast.

These developments in Malta mirrored, to a certain extent, those abroad. Financial liberalisation, deregulation and the expansion of cross-border capital flows have driven the rapid growth of the financial sector globally. Indeed, until the start of the turmoil last year, the global financial system had benefited from a long period of economic expansion, relatively easy monetary conditions and innovation. As a result, the size of the financial industry relative to the economy increased considerably. In the United States it grew to a point where it represented nearly 25 per cent of the stock market capitalization, while financial assets in Britain in 2007 were equivalent to almost nine times the GDP.

Such a favourable combination of circumstances could not last. And when the whole edifice started to crumble, the shock waves travelled fast, a testimony to the efficiency of the transmission channels in a globalized economy. Thus, in no time at all, a crisis that had its roots in a narrow segment of the housing market in the United States moved across the Atlantic to Britain and then to the euro area. And as demand in the advanced economies and commodity prices began to tumble, emerging economies started to decelerate rapidly. So much for the decoupling theory!

Unlike other recent crises, the current turmoil had its origin within the financial system itself. It followed a boom in asset prices, particularly house prices. Although some observers, including central banks, had warned about mispricing of risk, many investors purchased what are now known as “toxic” assets in a search for yield, increasing leverage to generate higher profits. The growing use of securitisation allowed banks to originate loans and distribute them, packaging risk and selling it to other investors. It was believed that this would spread risks more evenly, enhancing the stability of the system as a whole. But the financial engineering involved in this process was so complex that neither the regulators nor the credit rating agencies could calculate the risks.

What the regulators also overlooked were the dangers that were developing as banks moved further away from their customers. On the financing side, banks were becoming increasingly dependent on wholesale investors for funding. On the lending side, the dispersion of credit risks through securitisation lowered the incentive to monitor borrowers’ behaviour and led to increased moral hazard. As information became ever more fragmented and financial instruments more opaque, confidence began to dissipate.

Now as we know, the market economy – and its ultimate objective, the creation of wealth – are predicated upon the efficient intermediation of money between savers and investors, and this in turn depends on the existence of an intangible, but fundamental commodity, trust. This vital ingredient was being steadily, but surely eroded.

The first rumblings of the approaching storm were heard in August 2007, when signs of distress began to emerge in the interbank market, a key component of the monetary policy transmission mechanism. The turmoil then ebbed and flowed in waves, each larger than the previous one. The crisis hit with full force in mid-September this year, however, with the

bankruptcy of Lehman Brothers, the emergency support given to AIG and the disappearance of Merrill Lynch as an independent institution. When a large money market fund that had invested in Lehman Brothers commercial paper failed, other funds stopped buying commercial paper, forcing issuers to draw on their credit lines, bringing interbank lending to a standstill. Credit spreads rose to unprecedented levels and panic overtook the stock market. The crisis rapidly spread to Europe, resulting in the co-ordinated rescue of Fortis by a number of euro area governments, among other episodes.

As the turbulence gathered strength, banks began to record growing valuation losses. The consequent erosion of their capital, and a reassessment of risk, led to a tightening of credit standards. In turn, this gave rise to concerns about "deleveraging" and a growing shortage of credit, which began to adversely affect the real economy.

In the euro area, the Eurosystem's response since the early stages of the crisis was to use the full range of instruments available to inject liquidity into the banking system. Here, the Eurosystem was fortunate in that it was already able to accept a wide range of assets as collateral and could deal with a large number of counterparties. Let us not forget, either, that the focus of the ECB's monetary policy – correctly – was and remained price stability. Though driven by booming commodity prices, the major risk was that high levels of inflation would feed into inflation expectations and trigger second-round effects on wages and prices. At times of heightened uncertainty, the importance of price stability as the central objective of monetary policy cannot be overemphasized.

As the financial crisis impacted the real economy, with the cost of financing rising and credit standards tightening, firms found it harder to raise money. Sovereign issuers, too, began to face higher borrowing costs. Evidence mounted of growing downside risks to economic activity and of moderating inflationary pressures.

The monetary policy response was unprecedented. On 8 October, six of the world's major central banks, including the ECB, cut official interest rates by half a percentage point in a coordinated move. Later in the month, the Eurosystem shifted the conduct of its monetary operations toward the injection of liquidity at fixed rates, with full allotment at the minimum bid rate, to ease funding concerns and to drive money market rates closer to official ones. A further half-point interest rate cut by the ECB followed in November, and yesterday we reduced rates by a further 75 basis points amid growing evidence that inflationary pressures are diminishing further.

The crisis has so far had a limited impact on the domestic financial system and on the Maltese economy. While the latest data point to continued, if slower economic expansion in the third quarter, Maltese banks continue to benefit from an approach based on traditional intermediation between retail depositors and borrowers. Their funding model, therefore, eschews reliance on wholesale markets; they have substantial liquidity, adequate capital and prudent lending policies. Exposures to asset-backed securities or failed institutions are small, while lending in foreign currency to residents is limited.

It would be naïve, indeed dangerous, however, to expect that the turmoil abroad will leave the Maltese economy and its financial system unscathed.

First, Malta has a small open economy, highly dependent on trade. As the recession grips our major markets, Maltese exporters will be increasingly affected. Indeed, firms in the automotive sector have already been hit, while the bleak outlook for the UK economy in particular is likely to have a negative impact on tourism. As the export sector comes under pressure, this will have an adverse effect on domestic demand. Accordingly, the Bank's growth projections for 2009 have been revised downwards to under 2%. This, in turn, could have repercussions for the banking system as asset quality deteriorates.

Second, partly because of the small size of the economy, bank loan portfolios are highly concentrated. More specifically, domestic banks are exposed to the construction, mortgage and property development sectors directly to the extent of over 50% of total loans, and in the

form of collateral securing other lending. Recent international experience shows that strong increases in property prices fuelled by rapid growth in credit are unsustainable. House prices cannot rise faster than incomes indefinitely. Otherwise, housing simply becomes unaffordable. The Bank's property price index – which is based on advertised prices – fell moderately on a year earlier during the September quarter. While domestic banks have been more prudent than banks abroad, however, the continuing high dependence on property as a driver of credit growth, and as collateral for other lending, remains a source of risk.

At the same time, it is important to reiterate the strengths of the domestic banking system. In June 2008, the capital adequacy ratio stood at 14% on average, as against a statutory minimum of 8%, while the average liquidity ratio was 48%, well above the 30% benchmark. The loan to deposit ratio averaged a prudent 77%, while non-performing loans extended their downward trend.

The Central Bank of Malta has been playing an active role in responding to the events I have described.

First, with the support of my Bank colleagues, I have participated in the deliberations and decisions of the Governing Council of the ECB on the provision of liquidity and on monetary policy.

Allow me at this point to digress briefly. As we said in our statement after the November meeting, we expect the banking sector to make its contribution to restoring confidence. Reinforcing this message, the President pointed out that central banks and governments had taken bold decisions, and now commercial banks, too, had to live up to their responsibilities, especially at a time of deteriorating growth prospects. With bank lending rates in Malta being generally set with reference to official policy rates, I would, therefore, expect bank customers, particularly those whose borrowings promise most to support domestic economic activity, to benefit fully from the recent ECB rate cuts, which have totalled 175 basis points.

Apart from its monetary policy role, the Central Bank of Malta is also charged with preserving financial stability, which it defines as a condition where the financial system is able to allocate savings towards investment opportunities and facilitates the efficient settlement of payments. A stable financial system is also one that is able to manage risks that may harm its performance, and consequently that of the economy, and that should be able to absorb shocks without impairing its operations.

The Bank carries out this task through the regular monitoring of the financial system, as well as of the domestic payment and securities settlement systems. The Bank's findings are shared with the Malta Financial Services Authority (MFSA) and with the Ministry of Finance. The Authority is responsible for the prudential regulation and supervision of all financial institutions in Malta, while the Bank remains the lender of last resort. It is, therefore, the only domestic institution with the capacity to inject liquidity into a troubled institution against collateral. The Ministry of Finance, on the other hand, is involved with respect to the possible use of public funds.

As the international financial crisis unfolded, the Bank was in continuous contact, at the highest levels, with both the MFSA and with the Ministry of Finance. It also took steps to obtain more frequent balance sheet data from credit institutions. The Government on its part gave a commitment to protect financial institutions and depositors in Malta should the need ever arise. Meanwhile, and in the light of similar steps taken elsewhere, it decided to raise the guarantee provided on bank deposits to EUR100,000.

Here I would like to remind this audience that the relevant EU Directive emphasises that the cost of financing such guarantee schemes must be borne by the credit institutions themselves. Furthermore, in the light of the Commission's proposals to strengthen the Directive, which have been supported by ECOFIN, it is clear that the resources available to the Maltese Depositor Compensation Scheme need to be significantly enhanced before the end of 2009.

Looking beyond the crisis, we can already anticipate further changes at the international level. Major modifications are likely, for example, in the regulatory framework, covering liquidity, leverage and risk management. The role of credit rating agencies is also being reappraised. Clearly, the models used in the past to evaluate risk have proved inadequate. Entire types of financial institution, such as stand-alone investment banks, may cease to exist while certain categories of financial instruments, such as the more exotic derivatives, may never be traded again.

As regards regulatory arrangements, the crisis has highlighted the importance of a close central bank involvement in prudential oversight. This stems from the fact that central banks need supervisory information to carry out their core functions, including the implementation of monetary policy. Information about the soundness of banks is important for them to be able to assess the health of their counterparties in the conduct of monetary operations. It is also valuable because central banks, including the Central Bank of Malta, are often responsible for the regulation and oversight of payment and settlement systems. Such information becomes essential when central banks are called upon to provide emergency liquidity in times of stress as lenders of last resort.

In Malta, it is important that we maintain our reputation, and the credibility that goes with it, as a sound and well-regulated financial services centre. To this end, the institutional links between the Bank, the MFSA and the Ministry of Finance could be strengthened further in the light of the experience provided by the global financial crisis. Malta, moreover, is one of two euro area member states where the central bank is least involved in the conduct of banking supervision. Although the means already exist for exchanging views and information, it could prove mutually beneficial for the Bank and the supervisory authority to seek to deepen the level of existing cooperation.

As for our capacity to manage any eventual financial crisis, the Domestic Standing Group was set up in 2007, chaired by the Deputy Governor and comprising senior representatives from the Bank, the MFSA and the Ministry. As in other EU countries, a crisis simulation exercise was held soon after to test communications between the parties, co-ordinate decision making and manage potential conflicts of interest. Useful lessons have been learnt.

Another important problem area highlighted by the crisis, and which is also relevant for Malta, relates to cross-border issues. Foremost among these is the co-operation between the home and host regulators. In this regard, the spirit underlying the Memorandum of Understanding on co-operation to safeguard cross-border financial stability signed last June by EU central banks, regulators and ministries of finance, now needs to be translated into clear modalities for effective cooperation. In particular, it is essential from Malta's point of view that the presence of subsidiaries of cross-border banks that are systemically important to a host country be given due weight in determining participation in the college of supervisors.

International experience has also shown that state intervention may be necessary to resolve problems in the financial sector. The state is often the only entity in a democracy that has the political legitimacy, financial strength and credibility to support ailing institutions and, hence, restore confidence in the financial system as a whole. In extreme situations, which require the injection of public funds, the cost to the public purse can be very high. This is an additional reason why maintaining fiscal discipline in the shape of balanced budgets over the economic cycle is important. This would allow a buffer to be built up that could be used in exceptional situations if required, without jeopardising the sustainability of public finances.

Finally, safeguarding the health of the financial sector in these challenging times also calls for prudent behaviour on the part of the market players themselves. Though not under any identifiable threat, Maltese banks should build on their existing strengths by reinforcing their capital base through the retention of a greater proportion of earnings; and, as domestic economic conditions are expected to weaken, loan loss provisioning levels may also need to rise.

The current crisis will not be over until confidence and trust are restored, and the credit channel starts to function fluidly again. This requires greater transparency and a recognition that a sound financial system is one that practices the traditional banking values of integrity and faithfulness. Some of you might recall that these values were captured in the motto of The Chartered Institute of Bankers, *"Probus et Fidelis"*. It is perhaps a sign of the times that the Institute's current logo of two overlapping arrows is, we are told, all about its core value: winning, a value which some market players have pursued with excessive zeal with the calamitous results we all know. It is just possible that we might not have been where we are today had the old, but tested values continued to prevail.