

## Michael C Bonello: Launch of the Forum for Financial Stability

Introductory remarks by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the launch of the Forum for Financial Stability, Valletta, 23 May 2011.

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Ladies and Gentlemen,

I should first of all like to thank you for having accepted our invitation to today's launch of the Forum for Financial Stability. I would also like to extend a special welcome to our guest speakers, the Chairman of the MFSA, the Secretary General of the MBA and Mr John Fell, Deputy Director General of the ECB's Financial Stability (Directorate General). In my own introductory remarks I shall attempt to provide a context for the creation of this Forum, in which I trust your respective institutions will play an active role.

In this regard it is important to note that central banks have an intrinsic interest in financial stability. Indeed, this interest is recognized in statutory instruments. Thus while the Treaty states that the ECB's primary objective is to maintain price stability, it also stipulates that it should contribute to the stability of the financial system. Echoing this thinking, our own Central Bank of Malta Act, while giving primacy to the implementation of the ECB's monetary policy, also enjoins us to ensure the stability of the financial system.

The concern of central banks with the health of the financial system is explained by the fact that price stability and financial stability complement one another. A monetary policy that succeeds in maintaining stable prices promotes financial stability by encouraging investment and economic growth. Conversely, a stable financial system helps monetary policy achieve its primary objective by, for example, ensuring the smooth propagation of the central bank's interest rate signals throughout the economy.

At this point it is useful to dwell briefly on the meaning of the concept of financial stability. In Malta we define it as "a condition where the financial system – comprising institutions, markets and infrastructure is able to: allocate savings to investment opportunities efficiently; ensure the rapid settlement of payments; effectively manage potential risks that may harm its performance; and absorb shocks without impairing its operations."

If there was ever any doubt as to the importance of ensuring the realization of such conditions, it can surely no longer be the case after the experience of the past three years. The financial crisis has clearly underlined the vital role of central banks in safeguarding financial stability and the importance of adopting a macro-prudential approach to regulation and supervision. This thinking lies behind the many initiatives taken recently to strengthen the institutional framework for financial stability, most notably in the EU and on which Mr Fell will be elaborating later on.

It is not surprising that in this new emphasis on macro-prudential supervision of the financial system, central banks are expected to play a key role. With regard to the situation in Malta, it bears recalling that a Financial Stability Office was created in our central bank as long ago as 2000 when the Bank was still responsible for banking supervision. The decision to add a macro-prudential dimension to our micro-prudential work was motivated by a realization that potential systemic risks were not being adequately monitored. Our work in this field was given a boost in 2002 when Malta became one of the first countries to undergo an IMF/World Bank Financial Sector Assessment Programme (FSAP). Though the Bank had already built up a small stress testing capacity and had undertaken assessments from a macro-prudential perspective, the FSAP proved a very valuable learning experience and gave our work a new sense of purpose and direction.

Since then the Bank has endeavoured to build up expertise in this important field by following closely developments abroad and through exchanges with other national central banks and the ECB. We are even now in the process of restructuring our internal set-up and human

resources to take into account lessons learned during the financial crisis and to be able to participate actively in the newly-established European Systemic Risk Board and its sub-structures. The financial stability function will be composed of two separate offices, one dealing with surveillance and the assessment of systemic risk, the other focusing more on policy, stress testing and crisis management.

The importance of monitoring systemic risks and putting in place an effective response mechanism has indeed been one of the major lessons learnt from the crisis. The cost in terms of the destruction of wealth of being inadequately prepared from a macro-prudential regulation point of view is still today being counted. The contribution of financial stability to sustained economic growth should clearly not be underestimated.

The fact that Malta's financial system has not been directly affected by the global crisis should not, therefore, give rise to complacency. No jurisdiction can be totally immune from systemic shocks, whether of domestic or external origin, or from contagion. Both the MFSA, from their regulatory and supervisory perspective, and the Bank, from a financial stability perspective, are acutely aware of the need to preserve confidence in our financial system. Our co-operation, which is institutionalised through formal arrangements, has to date worked well. Indeed, apart from regular meetings of the Standing Committee envisaged by the Memorandum of Understanding, we also cooperate through the Domestic Standing Group that brings together the Bank, the MFSA and the Ministry of Finance, the Economy and Investment in a forum for crisis management. This mechanism was first tested in 2007 when the financial crisis was about to erupt, and that experience highlighted the importance of coordinated and timely action and of the Ministry as a key player in times of financial instability.

Another notable example of coordination between the Bank and the MFSA concerns stress testing. We have jointly undertaken a series of "constrained" bottom-up stress tests across a number of banks and last year we participated in the EU-wide stress test stress test. This year the Bank is assisting the MFSA in the stress test exercise being conducted by the newly established European Banking Authority.

Together, the Bank and the MFSA now need to build upon this positive track record. The recent changes in the nature and size of the domestic financial system and in the external environment with which it increasingly interacts, in fact, suggest that the time has come for the existing model of cooperation to be further refined and strengthened.

The need to increase the effectiveness of the institutional arrangements for the preservation of financial stability is also related to Malta's aspirations to consolidate its position as a successful financial centre. The financial services industry has grown considerably, particularly since EU membership in 2004. Today there are 25 licenced credit institutions, 14 of which with a majority shareholding from other EU countries. But the fastest growing sector has been the funds industry, with more than 400 funds registered, many having domiciled from other jurisdictions. There has been a similar growth in the insurance business with 50 operators here today. In the process, Malta has become a very important centre for captive insurance in the EU. This increased visibility brings with it the responsibility to ensure that our financial system does not serve as a channel through which risks are transmitted to other countries.

Against this background, the step we are taking today, which is designed to intensify the exchange of views between the authorities and the financial services industry and to deepen the examination of common concerns, assumes even greater importance. Participation in the work of the Forum for Financial Stability should, therefore, prove to be of mutual benefit. From the point of view of the Central Bank of Malta, it should also enable us to refine our analytical work, whose conclusions have since 2009 been published in our annual Financial Stability Report and the mid-year Update. The Report contains insights into the main vulnerabilities of the domestic financial system and into any latent risks, whether in the system itself or in the external environment. It also assesses the robustness of the financial

system and its resilience to particular stress events. By publishing its findings, the Bank aims to foster a constructive dialogue among all stakeholders with the ultimate objective of strengthening the financial system.

The quality of the Bank's assessments, however, depends on access to timely and reliable market intelligence. For, while the statutory data submitted regularly by reporting institutions is thoroughly analysed, this is insufficient to provide a holistic assessment of emerging risks. Financial stability is a forward looking concept. Risks, moreover, may materialise suddenly or with little warning. This is where market intelligence plays an important role. We, therefore, see the Forum as an important complement to our early warning system, particularly since owing to the rapidly changing structure of the financial system and the idiosyncrasies of the Maltese economy, it has proved difficult to construct a more formal early warning system model.

The decision to create the Forum for Financial Stability can also be interpreted as a way of institutionalising current arrangements by enabling a more structured dialogue. Through this channel, the authorities will be able to convey their conclusions and concerns more directly, while market players might wish to offer their views on financial stability issues and their assessment of market developments. The Bank chairs joint committees with the industry in other areas, such as statistics and financial markets, and the experience to date has been very positive. I am sure that discussions in the Forum will be equally productive.

The launch of the Forum for Financial Stability is taking place at a time of radical change in the regulatory and supervisory environment, especially in a cross-border context, both at European and global levels. The feedback the Central Bank of Malta and the MFSA hope to receive from the Forum on reform-related issues should, therefore, also prove useful to these authorities in connection with their participation in the work of the European System of Central Banks, the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB), as well as for the purposes of the technical advice given to Government in the context of EU discussions on such issues.

In conclusion, I would like to express the hope that the deliberations of the Forum, conducted on a confidential basis, will focus attention on the identification of potential systemic risks and on the promotion of effective risk management. I said earlier that complacency must be avoided. It has taken several years of hard work at both the political and technical levels to put Malta on the map as a reputable financial centre. A rigorous but non-intrusive regulatory regime based on international best practice combined with easy access to the single regulator has been a major plus. Other contributory factors are a legal framework based on common and civil law, 55 double-taxation treaties and a competitive fiscal regime, and, not least, membership of the euro area. Malta's tradition of commercial banking based on a conservative funding model in which loans are entirely financed by retail deposits is a source of additional strength. Our banks, moreover, maintain capital and liquidity ratios well above the regulatory minimum and their resilience is confirmed by stress test results. We undoubtedly have reason to be satisfied.

There can, however, be no letup. There is need for both a greater awareness about systemic risks and for enhanced efforts at risk mitigation and resilience building. We should not forget that there is a relatively high concentration of risk on both sides of bank balance sheets, in particular a significant exposure to the real estate sector, both in the form of loans and collateral held against them. At a time when we are witnessing an increase in corporate non-performing loans, I reiterate my call for the banks to expand their provisions commensurately with this heightened credit risk. At the same time, dividend policies must be mindful of the need for higher levels of retained earnings in order to further strengthen capital buffers, also in view of the more onerous requirements of Basel III. Finally, I would encourage risk officers to go beyond simple compliance with regulations and proactively espouse prudent risk management practices and good judgement.

Before I hand over the floor to Professor Bannister, I would like, on this my last official meeting with the financial community, to express my sincere appreciation to you all for the cooperation and understanding I have benefited from over the past twelve years.

Thank you.