Michael C Bonello: The banking environment in Malta

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the Raiffeisen Economic Forum, St Julians, 21 May 2004.

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The history of banking in Malta goes back at least to the earliest decades of the nineteenth century, when the island's strategic importance as a centre for entrepot trade encouraged the establishment of banking institutions. Among the better known foreign names before World War II was that of Barclays Bank DCO. This was a time when Malta was a British colony and part of the sterling area. Barclays remained in Malta after independence and the subsequent break with sterling in 1972, and contributed to the development of a cadre of bankers trained in the British banking tradition. It left only when the larger banks were nationalised during the 1970s.

This coincided with the adoption of a policy of economic autarchy. The major banks were publicly owned and lending rates were set by the Minister of Finance, while the Central Bank controlled deposit rates. Nominal interest rates were kept artificially low, often resulting in negative real rates. Strict exchange controls were imposed to sustain the value of the Maltese lira.

In the absence of money and capital markets, the banking sector dominated the financial system. In the circumstances, however, the sector did not operate efficiently. In particular, the banks were unable to adjust lending rates according to the perceived creditworthiness of borrowers, and resorted instead to significant collateral requirements and to credit rationing. Furthermore, because the scarcity of land in Malta seemed to guarantee that its value would never go down, property has always been considered a safe investment, so that Maltese banks relied heavily on real estate as collateral, attaching insufficient importance to the viability of projects. As a result, many potential customers were denied access to credit. This, together with the absence of a capital market, meant that savings could not be channelled effectively into productive private investment and tended to flow instead either into inefficient Government-owned enterprises, into the property market or, despite exchange controls, into overseas assets.

This situation created imbalances in bank balance sheets, which, when the economy was liberalised and exposed to market forces, came to represent a potential threat to financial stability. For example, the changes in relative prices that occurred in the wake of liberalisation tended, in some cases, to result in a deterioration in loan quality. Furthermore, bank balance sheets included a large number of Government-guaranteed loans to public corporations and utilities that were largely shielded from competition. Despite these distortions, however, no major bank collapse or financial crisis was experienced.

A major change occurred in the late 1980s and early 1990s when a programme of financial liberalisation and privatisation fundamentally transformed the economic climate. For a start, the Government's shareholding in the banks was reduced. In addition, on account of the high liquidity levels prevailing in the banking system, reserve requirements were introduced. The capital structure of the banks was also strengthened through new share issues and an augmentation of internal reserves, while a capital market, in the form of the Malta Stock Exchange, was set up. Supporting economic reforms included a relaxation of the extensive system of import controls, the partial lifting of wage-price controls and an overhaul of the income tax system.

The introduction of reserve requirements and of open market operations by the Central Bank of Malta in 1994 opened the way for the removal of administered interest rates. At the same time, the Bank encouraged banks to manage their liquid assets more actively, setting the stage for the development of an interbank market.

The Central Bank of Malta's engagement in open market operations was followed by the establishment of a market-driven interest rate structure, which is, of course, of paramount importance for the transmission of monetary policy signals. The Bank began to use weekly auctions to influence the size of the monetary base, while gaining control over the excess liquidity in the banking system.

Maximum interest rates on bank loans and advances were linked to the Central Bank's discount rate, injecting some flexibility into the interest rate structure. Soon after, preferential lending rates were abolished, with a margin of three percentage points above the discount rate being permitted for almost all categories of lending. Furthermore, the Central Bank removed the ceiling on bank deposit rates, although it maintained a minimum rate to protect savers.

Also in 1994 a strategic decision was taken to turn Malta into an international financial centre, and a comprehensive package of legislation consisting of a number of new financial laws complemented by amendments to existing ones was enacted. These included a new Banking Act, a Financial Institutions Act, an Investment Services Act, a Prevention of Money Laundering Act, an Insider Dealing Act and a Professional Secrecy Act. This legislation was backed by a number of Directives, Bye-Laws, Policy Documents, Codes and Regulations.

At the same time the Central Bank of Malta was given responsibility for monetary policy and lending rates. The Bank responded by widening the margin above the discount rate from three percentage points to ten, thus effectively freeing lending rates. The lifting of restrictions on both domestic lending and deposit rates simultaneously ensured adequate profit margins for the banks. In 1999 all restrictions on deposit rates were abolished, while in 2002 domestic lending was completely liberalised.

With financial markets in an early stage of development, exchange control liberalisation had to proceed cautiously. It was felt that domestic markets should be allowed to grow, and financial asset prices to adjust, before being exposed to free cross-border movements of capital. A sequencing policy was adopted aimed at easing controls on longer-term capital flows while continuing to restrict short-term flows.

Exchange control liberalisation began in earnest in the mid-nineties when Malta accepted the Article VIII obligations of the IMF's Articles of Agreement and the process was completed immediately prior to Malta's accession to the European Union on May 1st this year.

The deregulation measures I have described were accompanied by institutional restructuring, which ensured that throughout the reform process the financial system was not subject to shocks.

The new 1994 Banking Act and the related Directives brought Malta's legislation in line with EU standards governing bank solvency, capital adequacy and large exposures. At the same time, the Malta Financial Services Centre was established as the regulator for financial services other than banking, which remained the responsibility of the Central Bank of Malta.

At this time, the Central Bank undertook a number of initiatives to develop a properly functioning money market, focusing mainly on the three-month Treasury bill. An interbank market also began to operate and the Bank began to trade actively in the money market through regular auctions of term deposits and repos. The Central Bank also ceased to extend credit to the Government, thus further underlining its independence.

To reduce its influence further, the Government privatised a small bank in 1994 and one of the larger banks the following year. In 1999 it sold its majority shareholding in the other major bank to a global banking institution, HSBC. The arrival of this bank spurred competition and helped to promote better practices. In addition, operating licences were granted to several foreign-owned banks, including, I should add, Austrian banking institutions, whose presence here is most welcome.

Thus, from a highly regulated system dominated by the public sector, the Maltese banking system was transformed into a modern market-based system, geared to meet the financial needs of a growing and increasingly outward-looking economy. As at the end of 2003, there were sixteen banks licensed to operate in or from Malta. Of these, eight were deposit money banks catering largely for the domestic market and licensed to transact in both the domestic and in foreign currencies. The other eight were international banks licensed to carry on banking business almost exclusively with non-residents and in foreign currency only.

It should be noted that the distinction between domestic and international banks is administrative rather than legal, and is based simply on each institution's choice as to whether or not to apply for a licence to operate domestically or to deal only with non-residents. Otherwise all banking institutions are subject to the same regulatory and supervisory regime. With the coming into force of the single European Passport for Credit Institutions, moreover, even this administrative distinction will become largely irrelevant. Nevertheless, the international banks are without exception wholesale banks, while at least half of the domestic banks are retail banks, of which two have an extensive branch network.

The impact of the international banks on employment and national income is still modest, although it is growing steadily. But they contribute substantially to the transfer of financial and technological know-how and to increased competition, as well as to the international integration of the Maltese financial system. Last year, for instance, one of these banks, which specialises in trade finance, acquired a controlling share in the London Forfaiting Company plc, and more recently concluded a deal for factoring in India.

As for the domestic banking sector, which at the end of 2003 accounted for over 60% of the lending portfolio and 80% of the deposit liabilities of the entire banking system, this remains highly concentrated, reflecting the small size of the market and the history of the industry. In fact, until recently, the two largest banks accounted for over 90% of the sector's assets, though this share is now closer to 75% as another two banks have since been licensed to operate domestically.

Today Maltese banks are almost entirely in private hands, and at least five of the domestic banks, including one of the major ones, are foreign owned, while another, smaller bank is partly foreign owned. The Government still retains a 25% stake in Bank of Valletta, one of the two larger domestic banks, but it has stated its intention to divest itself of this holding and is currently looking for a strategic partner.

As the economy developed and confidence in the banks increased, bank intermediation in Malta, which was rather low in the 1970s, reached very high levels. By the end of 2003 for example, the domestic banks' assets amounted to over 277% of GDP, compared with a euro area average of 273%, while the ratio of domestic bank credit to GDP stood at 155%, as against 143% in the euro area. More significantly, spreads between short-term lending and deposit rates in Malta, at 2.41 percentage points in 2003, were even narrower than the euro area average of 3.48 points. This suggests that the local banks compare favourably in terms of efficiency with banks elsewhere in the European Union.

Furthermore, despite the global economic slowdown and the recent weak performance of the Maltese economy, the profitability of banks in Malta, as evidenced by the return on assets, has been fairly stable at around 0.8%. This compares with an average return of 0.6% recorded by European banks in 2001. At the same time, bank liquidity remains very high, with the domestic banks' holdings of liquid assets as a share of short-term liabilities, just under 50% at the end of 2003, consistently exceeding the 30% prudential requirement. Maltese banks are also strongly capitalized. Their aggregate capital adequacy ratio, defined as the ratio of own funds to risk-weighted assets, stood at 16.7%.

On the other hand, the banks' loan portfolio still tends to be concentrated on a few sectors, reflecting the structure and small size of the Maltese economy. Furthermore, they still rely too heavily on property as collateral. In addition, the level of non-performing loans has been on the high side, and certainly higher than the EU average, even though it has recently started to decline. Here I should perhaps point out that in Malta we adopt a relatively conservative definition of non-performing loans.

The expanded economic role of the banks has been accompanied by significant progress in creating an independent and effective regulatory framework in line with international standards. In 2002 the Malta Financial Services Centre was renamed the Malta Financial Services Authority, and took over from the Central bank the responsibility for supervising the banks and the Malta Stock Exchange to become the single supervisory and regulatory body. The division of responsibilities between the Authority and the Bank requires effective cooperation, and for this purpose a Memorandum of Understanding has been signed.

At the same time, the Central Bank was given formal independence in the conduct of monetary policy, in overseeing payment systems and in safeguarding the overall stability of the financial system. The Bank uses a number of approaches to identify possible threats to the system. It analyses data from prudential returns submitted by the banks and other financial institutions. This, coupled with further analysis of the corporate sector in terms of leverage, profitability and liquidity, complements the monitoring of credit risk within the banking system. Stress testing is also carried out in order to identify potential losses resulting from abnormal market conditions. This is applied both to the banks' loan portfolio and to market risks arising from their foreign currency, interest rate, liquidity, equity and commodity risk exposures.

Finally, a Financial Intelligence Analysis Unit was established, thus completing the institutional framework for strengthening the anti-money laundering regime and for combating the financing of terrorism.

It is worth noting here that both the 1994 and the 2002 financial reforms were unanimously approved by Malta's Parliament - a rare event, and one that should inspire investor confidence.

A further important development in Malta's efforts to establish itself as a reputable financial centre occurred in late 2002 when Malta requested the IMF/World Bank to conduct a Financial Sector

Assessment Programme (FSAP). The assessment, which was published in August 2003, noted that Malta's financial system appeared to be healthy and well supervised, and that its domestic banks were profitable, liquid and well capitalised. Moreover, it had a comprehensive legal framework and adhered strongly to most international standards and codes. At the same time, the report noted that, mainly because of the predominance of two large banks, the system was highly concentrated and exposed to the country's narrow economic base.

Among the more recent developments on the banking scene has been the introduction of a number of innovative products and delivery channels, such as equity-linked deposits and mobile and internet banking. On the legislative front, a major development has been the introduction of a Depositor Compensation Scheme. Malta has also adopted the European Directive of 4th April 2001 on the reorganisation and winding up of credit institutions and their branches in Member States, which should facilitate the harmonisation of any eventual measures that may have to be taken in this regard.

In compliance with EU legislation on the promotion of international payments, the Central Bank has meanwhile brought into force the Directive on Cross-border Credit Transfers. Another Directive, on Electronic Payments Services, which seeks to ensure a high level of consumer protection in the field of electronic payment instruments, came into force on May 1st this year.

Looking forward, we believe that Malta's financial system is well placed to benefit from EU membership. While the banks may face some challenges from increased competition, there will also be opportunities for growth. In particular, Malta is well positioned to serve as a bridgehead between Europe and North Africa, and some Maltese banks have already been exploiting this market niche, participating actively in the Mediterranean Bank Network set up after the Barcelona Declaration of 1995. The recent emergence of Libya on the international scene, a country with considerable potential with which Malta has long maintained close commercial ties, should also open up further opportunities in this direction.

Malta's inherent qualities, moreover, make it an attractive location. The island has a stable economic and political environment as well as a highly qualified and motivated workforce in the legal, accounting and consulting services professions and in banking and finance. Indeed, the University of Malta and other specialized institutions provide training and tuition leading to professional qualifications in all these fields. In addition, Malta benefits from a wide network of Double Taxation Agreements, covering some 40 countries, while investment by both the public and private sectors has provided a modern and efficient telecommunications system and airport facilities (the latter now under Austrian management), good hotels and office space and housing of high quality. These attributes, complemented by Malta's favorable geographical position and climate, make the island a profitable place to do business from.