Michael C Bonello: The Central Bank of Malta and financial stability

Speech by Mr Michael C Bonello, Governor of the Central Bank of Malta, at the conference "Onshore Europe", organised by the Malta Financial Services Authority, St Julians, 13 September 2004.

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The title chosen for this conference is as significant as it is brief. The two words "Onshore Europe" neatly capture Malta's current reality, that of a financial centre with solid credentials which affords its players both the guarantees and the opportunities to be offered by the Single European Market for Financial Services.

As we commemorate Malta's first ten years as an international financial centre, it is appropriate to record that if we are able to look back with satisfaction at past achievements, it is only because our legislators had the political vision to adopt a consensual approach to the task at hand in 1994. This involved a radical overhaul of existing laws and the drafting of new ones to lay the foundations of a modern financial centre governed by the highest standards and yet flexible enough to allow new opportunities for growth and development to be seized to the country's economic advantage. I would, therefore, like to pay tribute to all those who saw the project through to a successful conclusion.

An analysis of Malta's track record leads to another important conclusion, which is that having in place an appropriate legislative and institutional framework is a necessary, but not a sufficient condition for success. Recent experience around the world suggests that the potential of a financial centre cannot be maximized unless it possesses another essential attribute. That other ingredient is stability and it is this aspect that I propose to explore today.

Ensuring financial stability is a statutory responsibility of the Central Bank of Malta. The Bank is thus obliged to participate actively in the maintenance of a stable and efficient financial system and to contribute towards its development. This applies not only to the payment and settlement system, of which the Bank is the regulator, but to the entire financial system. The Bank has an on-going role to play in assessing the robustness of the system. It must draw attention to any problems and ensure that these do not in any way impede the functioning of the financial markets as efficient providers of capital for companies and households. The Bank's approach is therefore to consider the general risks to the system rather than the situation of individual credit and financial institutions. The latter is the task of the Malta Financial Services Authority (MFSA), which has successfully assumed, over the last ten years, full responsibility for the supervision of institutions providing financial services.

Why central banks promote financial stability

There are several reasons why the maintenance of a healthy financial sector is an essential function of central banks, and this irrespective of their involvement or otherwise in regulation and supervision. First, by virtue of their role as providers of liquidity to the banking system and their involvement in payment systems, central banks have a vested interest in the quality of their counterparties. Any developments that could affect the financial health of their counterparties are of direct interest to a central bank, not least because the inability of the former to honour their commitments would have negative financial implications for the central bank. Furthermore, instability in the financial system could hinder central banks from successfully pursuing their other objectives, particularly the achievement of price stability through monetary policy measures.

Indeed, monetary policy can only be implemented effectively if the financial system is stable, for only then can financial intermediaries respond to changes in interest rates and in liquidity conditions engineered by the central bank, and thus transmit these impulses on to non-financial intermediaries. At the same time, by pursuing price stability central banks contribute directly to financial stability, since a stable price environment reduces volatility in financial variables and ensures the smooth functioning of markets.

From a central bank perspective, it is also evident that a healthy financial system contributes to stability in the exchange rate particularly where, in countries like Malta, a fixed exchange regime coexists with the absence of capital controls. Thus, in a situation where there are concerns about the robustness of the financial infrastructure, the regulatory framework or the integrity of financial intermediaries, the external account may be undermined through sizeable outflows of capital. In other words, what starts off as a crisis in an individual institution could easily develop into a balance of payments and currency crisis, which may, in turn, trigger off secondary effects throughout the rest of the financial sector, disrupting other sectors of the economy in the process and thus resulting in a full-blown financial crisis.

In the case of the Central Bank of Malta, these considerations assume even greater importance given the Maltese economy's small size, openness and lack of natural resources, which make it highly dependent on foreign markets. The small size of the domestic market, moreover, also has implications for savings and investment. Thus a limited pool of savings is in turn reflected in a low volume of internally generated resources for investment purposes, making the country highly dependent on external financing. This dependence is evidenced by the private savings ratio, which is not only low by international standards, at around 22% of GDP, but has also been falling in recent years as public sector imbalances have widened to unsustainable proportions.

The Central Bank of Malta's approach to financial stability

Against this economic background, therefore, price and exchange rate stability assume particular importance and the need for a stable financial environment becomes all the more crucial. The maintenance of financial stability was accordingly recognized in the legislation setting up the Central Bank of Malta in 1968, but it was only pursuant to the 2002 amendments to this legislation that the Bank's responsibility was made more explicit.[1] These amendments also recognized the Bank's role in preserving a sound and efficient payment system.

The Bank's efforts to strengthen its capacity in the area of financial stability commenced before its responsibility for banking regulation and supervision was transferred to the Malta Financial Services Authority (MFSA) in January 2002. In fact in 2000, a Financial Stability Office was set up to identify and analyse potential systemic threats not only in banks, but also in other parts of the financial system, such as the insurance and investment sectors, the securities markets and also selected large corporations in the non-financial sector.

The Office has since developed a set of financial soundness indicators and a model which detects and assesses the impact of different types of risks. It has also introduced shock scenario techniques to stress-test the resilience of the banking system. This year the Bank has also started to conduct a bi-annual financial stability review whereby developments abroad as well as in the domestic macroeconomic, regulatory and operational environment are assessed in one analytical framework designed to detect potential weaknesses and to devise appropriate remedial measures.

These activities are supplemented by the work of the Bank's Payment Systems Office, which is responsible for the maintenance and oversight of the payment system. This is an important function because modern electronic payment systems have the potential to serve as channels of contagion by transmitting the payment difficulties of one, or a few, large financial intermediaries to others in the system.

In 2002 a Retail Gross Settlement System based on the Bank for International Settlements' ten core principles[2] was introduced in Malta through which inter-bank domestic payment orders are now transmitted, cleared and settled with greater efficiency than previously. The Bank has also issued a number of directives which seek to provide participating banks with an adequate degree of protection against legal and systemic risks associated with participation in such systems. Other directives seek to ensure that the rights of banks' clients to adequate information concerning retail payments are upheld by the intermediaries rendering payment services. In this way, credibility in the integrity of the infrastructure used for the settlement of payments is preserved at both wholesale and retail level.

The Bank's role in financial stability has more recently been enhanced by membership of the European System of Central Banks (ESCB) from May 2004. It has started to participate in the ESCB

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[1] The 1967 Act referred to the Bank's role in promoting a sound financial structure and to foster an orderly capital market in Malta. Article 4 (2) of the revised Act specifically states that it shall be one of the objective of the Bank to "ensure the stability of the financial system."

[2] The core principles recommended by the Committee on Payment and Securities Settlement Systems of the Bank for International Settlements (BIS).

committee dealing with financial stability, the Banking Supervision Committee, and at the EU level the Bank also participates in the Economic and Finance Committee and in its Financial Stability Table.

The importance of two-way cooperation with the MFSA

The initiatives I have described have strengthened the Bank’s ability to monitor and analyse developments in the financial system in a wider context. It is nevertheless becoming increasingly clear that to carry out this role effectively, the Bank’s efforts in this area need to be supported by the activities of the overall supervisor in the financial field, that is the MFSA.

It is, therefore, reassuring to note that good co-operation already exists between the Bank and the Authority. More specifically, the Authority’s focus on the health of individual service providers complements the Bank’s macroprudential analysis of the financial system as a whole and its oversight of the payment and settlement systems.

In undertaking their respective tasks, both these institutions have access to information that may not be readily available to the other. Thus, for example, through its involvement with payment systems and the daily monitoring of the banks’ foreign exchange exposures, the Central Bank of Malta has daily information on the amount of liquidity and the extent of foreign exchange risk prevalent in the inter-bank market. Similar information, however, only becomes available to the Authority with a delay, through the monthly statistical reports submitted by the individual financial intermediaries. Furthermore, the Bank’s macro perspective assessment of financial developments may identify general risks to the system that may not be apparent when the prudential supervision of individual financial institutions is undertaken. This may occur, for example, if the risk profiles of the institutions in question show a high degree of similarity, making the system especially vulnerable to a particular type of shock. Supervision at the micro level, therefore, has to be complemented with a macro analysis of the interlinkages between different segments of the domestic financial sector and its links with the payment system, the rest of the economy and its counterparts abroad.

On the other hand, it is also true that the Bank’s macroprudential analysis may not provide precise information on individual institutions, particularly those that may be on the brink of insolvency. Here, the Authority, through regular inspections of individual service providers will have a more in-depth knowledge of the health of single intermediaries and market segments, including those which play a peripheral role in the monetary policy transmission process and with which the Bank’s relationship is, at least on a one-to-one basis, rather distant. In this sense, the Authority also contributes to the soundness of the Bank’s counterparties. It is also the Authority which ensures that only sound institutions are licensed to enter the Maltese market. Furthermore, confidential supervisory information available to the Authority could be useful to the Bank as an input into its overall analysis of the financial system, enabling it to respond to liquidity and related constraints that could set off negative ripple effects.

The potential for synergies between the two institutions prompted them to sign two Memoranda of Understanding in 2002 to provide for enhanced co-operation, including through the establishment of a Standing Committee.

This cooperation framework has contributed to the general soundness and stability of the financial system. The profitability of our banks, for example, has remained stable with an average return on assets after tax of 0.8% in 2003, the same level as that recorded by European banks. Furthermore, bank liquidity and capitalization levels have both remained strong. Liquid asset holdings as a percentage of short-term liabilities were close to 53% at the end of 2003, compared to a minimum threshold of 30%. Meanwhile, the banks’ aggregate capital adequacy ratio, defined as the ratio of own funds to risk-weighted assets, currently stands at 23%, compared to a minimum of 8%. In the insurance sector and collective investment schemes steady growth continues to be registered.

This positive performance notwithstanding, there remains scope for further improvement in the framework through which the Bank and the Authority seek to safeguard the health of the domestic financial system. It is becoming increasingly evident, for example, that a proper analysis of the system’s robustness requires detailed statistics about entities for which data are currently either not available or are fragmented. This is particularly the case of the non-bank financial sector, and also of the corporate and household sectors, although in this latter area some progress is being made through the joint efforts of the Bank, the Authority and the National Statistics Office.

Another aspect warranting particular attention is that of financial crisis management. While the current institutional and regulatory framework has been successful in keeping at bay any major systemic disturbance, further progress is required, for example by defining the specific roles and responsibilities of the Bank, the Authority and the Government. In this respect, the Joint Contingency Plan for systemically important banks drawn-up by the Bank and the Authority already takes into account the involvement of the Ministry of Finance with respect to the possible use of public funds and the Bank's lender of last resort function. This framework is currently in the process of being refined further.

The need for improved cross-border cooperation

On the other hand, it is a matter of some concern that whereas modalities for crisis management have been, or are in the process of being formalised effectively in most jurisdictions, including Malta, the way forward for the resolution of crises of a cross-border nature, and requiring the prompt intervention of central banks and supervisors that operate in different time zones and with different day-to-day practices, is not yet clearly defined.

Some progress in this respect has been made at the EU level through the formalisation of the Memoranda of Understanding of the ESCB on high-level principles of co-operation in crisis management situations and between payment systems overseers and banking supervisors. However, these agreements, to which the Central Bank of Malta and the MFSA are also a party, do not go far enough. The implications of systemic crises whose resolution would, for example, require some form of fiscal input and possibly also the contribution of other entities spanning different jurisdictions are not yet articulated. This issue will hopefully be addressed during the forthcoming review of the EU Banking Codified Directive of March 2000.

As the two key institutions with financial stability responsibilities, the Bank and the Authority have a direct interest in the future evolution of international co-operative arrangements. Such arrangements, moreover, will also impact on the way in which the two institutions seek to co-operate with each other and with similar authorities based abroad. In particular, the activities and institutions which the Bank and the Authority will be expected to monitor will become more complex as the number of financial intermediaries with a presence both in Malta and in other countries, either directly through the establishment of branches or subsidiaries, or indirectly through the provision of cross-border services via the internet or otherwise, continues to grow in the light of the incorporation of EU passporting rights in Maltese legislation. The coming into effect of Basle II and, at the EU level, CAD III will be significant factors in this regard. At the same time, the tendency of companies to seek multiple listings in different securities markets means that interest rates and stock market valuations in one country will increasingly mirror those in other countries, even though the underlying economic fundamentals of that country might warrant some divergence in such variables.

Indeed, as has been the experience of other countries, the trend towards consolidation and merger activity in the various segments of the market, from banking and the selling of insurance and investment funds to the provision of payment services and trading facilities, will lead to a situation where the institutions to be supervised will vastly exceed the financial resources and technical expertise available to supervisors and central banks. This will be further accentuated by the current trends whereby financial intermediaries outsource activities both on a domestic and cross-border level, while the introduction of the European Union Directive on the European Single Company Statute, the so called Societas Europea, will present new regulatory and financial stability challenges on a regional level.

The implications of international developments for Malta

These observations are particularly relevant for Malta. First, whereas the size and complexity of financial intermediaries, and that of corporate entities to which they are exposed, has grown disproportionately relative to the resources available to regulators and liquidity providers across the globe, this divergence is magnified further in a small jurisdiction such as ours.

Second, because the characteristics of the Maltese economy make it vulnerable to developments abroad, the financial sector is especially exposed to changes in the perceptions of foreign investors about the sustainability of prevailing economic policies and the capacity of the financial sector to absorb external shocks.

Given the ease with which funds can now move in and out of the country, moreover, and the scope for disparity between the size of the economy and that of foreign institutional investors, the need to maintain confidence in the domestic financial sector assumes particular importance. This risk is further accentuated by the fact that while most sectors of the economy operate in a competitive environment, in many sectors business remains concentrated among a small set of market players. The financial sector is no exception in this regard.

Furthermore, while the structure of the domestic financial sector has evolved considerably over time, its level of development still falls short of that of the more advanced EU Member States. Thus, for example, although in the past few years the number of players in the non-bank sector has increased in terms of both number and variety, financial intermediation in Malta remains largely bank-based. Within the domestic banking sector, moreover, two banks together account for around 90% of total loans and deposits. A similar picture emerges in the capital market where the degree of capitalisation, the number of market participants and the volume of turnover are still relatively low. In 2003, for example, the ratio of stock market capitalisation to GDP stood at 37%. While this was higher than in most of the other new Member States, it was only around half of the euro area average. Annual turnover was even lower, hovering around 4% of GDP and 12% of stock market capitalization.

Where, as in Malta, the performance of the financial sector hinges crucially on the fate of a small number of players and where the lack of depth and liquidity in capital markets often causes the market value of a particular debt instrument to deviate from underlying fundamentals, the risk of contagion within the system, as well as, from other systems is accentuated.[3]

This latter aspect might become less relevant as financial services providers in Malta and in the EU respond to the introduction of the Financial Services Action Plan and the eventual establishment of a single market in financial services. On the positive side, such initiatives provide better income-earning and liquidity management opportunities, improve the efficiency with which the sector operates and enhance its capacity to weather sector-specific shocks.

On the other hand, the advent of liberalisation and heightened levels of competition could well spur service providers domiciled in Malta to take on new risks and venture into non-traditional lines of business. Furthermore, as a result of passporting rights, competition is likely to become more acute. The ensuing interdependence between different sectors and countries could well expose the domestic system to new vulnerabilities, including possible contagion from systemic shocks.

This will be especially the case upon Malta’s entry in the euro area as such a move would provide further momentum to the pace of financial market integration. Moreover, the eventual linkage of the domestic payment system with TARGET will also facilitate the transmission of certain risks, not least those of an operational nature.

Conclusion

There are clearly several good reasons why sound regulatory and oversight practices remain vital for the stability of our financial system and why, therefore, the Central Bank of Malta and the MFSA must work more effectively together. It is also evident, however, that on their own these two institutions cannot provide full protection against systemic disturbances, and that the modalities for co-operation which are in place locally need to be strengthened further and extended to other bodies with comparable responsibilities at the international, and particularly at the EU level.

[3] ECB. 2002. Financial Sectors in EU Accession Countries.