Under the Microscope

A Review of the Maltese Banking Sector for Financial Year 2015/2016

December 2016

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Towards the end of 2015, KPMG in Malta launched the first of its kind publication *Under the Microscope* which looked at analysing the local Banking Industry, its players, trends, opportunities and challenges. In view of the excellent feedback received, we are pleased to publish the second edition of *Under the Microscope* with the aim of providing an insightful analysis of the performance of Maltese licensed banks, over 2015/2016. We intend to develop this into a staple publication for financial services practitioners, filled with assessments and insights directly from our leading local experts.

In this edition of *Under the Microscope* you will find articles about a banking industry which is looking to evolve, quickly and efficiently, whilst managing the ever-increasing burden imposed by a regulatory environment which is changing at breakneck speed.

We have once again looked at the players in the local banking industry and provided an assessment of twenty-three credit institutions operating locally, with the aim of harnessing our thoughts across 100 pages.

Although forming part of the European banking landscape, banking in Malta is a reflection of the Maltese people and local culture coupled with an international dimension which is unique to the Island and a product of the regulatory environment.

Insights into banking in Malta remains relatively limited, which is why we have enhanced the financial metrics in our banking analysis and increased the number of articles highlighting key trends and issues the majority of banks, as well as financial institutions, are facing locally.

We trust you will enjoy the latest edition of *Under the Microscope.*
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Complexity and change are driven by numerous forces, both external (regulations, marketplace events) and internal (new products, business models), all of which impact your organisation. KPMG’s Risk Consulting Team can shape the thinking of Boards and Management regarding complex business issues. The team is composed of dedicated specialists who are well placed to assist you with your efforts towards regulatory compliance and beyond.

The team, which is supported by a wider global network, is experienced in managing diverse issues including, but not limited to, regulatory compliance, anti-money laundering, governance structures and capital management.

We welcome the opportunity to discuss what KPMG’s Risk Consulting Team can offer to you.

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Introduction

Over the years, Malta has become a leading European financial services centre that combines high regulatory standards and rigorous enforcement. Since EU membership, back in 2004, the financial sector locally has grown tremendously and is a key factor for the continuous economic growth that Malta has been experiencing over the years.

The stability and success of the financial system, of which banking plays a colossal part, has led to more entities setting up their operations in Malta. Over the years, we have seen the implications that external factors such as the financial crisis in 2008, have had on financial industries worldwide. We are definitely living in a highly dynamic and globalized environment in which financial companies face ever-lasting challenges. For instance, the recent Panama papers scandal and Brexit have shocked worldwide economies, creating uncertainty and the need for more transparency and probity.

So what characteristics have enabled our tiny island to absorb these shocks and still remain an attractive hub for financial services? Definitely Eurozone membership is undeniably important, but more important is the favourable tax-system for entities and highly-qualified individuals, robust legal and regulatory frameworks, and the highly educated yet cost-effective workforce. These are just some advantages that make Malta an attractive and lower cost domicile for worldwide entities. These remain solely the drivers for Malta, as a jurisdiction to compete. Every industry can benefit from a stable base, including the banking industry.

In the financial services sector we are seeing a form of stability emerge, which has however been brought about at a high cost. The European Macroeconomic environment continues to operate at artificially low interest rates whilst our banks are experiencing dangerously high levels of liquidity, with limited options, in their view to place locally. The regulatory machine continues to drive forward but without a clear vision of the unanticipated consequences, with banks and financial institutions scrambling to minimize the disruption to their business models.

The banking boardroom today is littered with terminology which bankers are struggling to understand, let alone keep up with. We hear of IFRS9, EU Audit Reform, IFRS16, CRS, DCS, SRB, TLTROs, CET1 and Additional Tier 1 Capital instruments. These are just to name a few.

Banks are now, more than ever, re-assessing their business models, with many focusing on curing any legacy issues, attempting to keep in touch with the strides being made in financial technologies whilst positioning themselves to ensure they can meet changing customer needs. They have realized, major change brings major opportunities.

The Publication focuses on analysing the financial positions of the banks that are part of Malta’s financial system as well as bringing insights from our leading experts, hot off the press.
Glossary

AC – Audit Committee
AEOI – Automatic Exchange of Information
AUD – Australian Dollar
AQR – Asset Quality Review
Bn – Billion
CAR – Capital Adequacy Ratio
CAGR – Compounded Annual Growth Rate
CBM – Central Bank of Malta
CET 1 – Common Equity Tier 1
CDO – Chief Data Officer
CIO – Chief Information Officer
CJEU – Court of Justice of the European Union
CRDIV – Capital Requirements Directive IV
CRS – Common Reporting Standard
DCF – Discounted Cash Flow
dcs - Depositor Compensation Scheme
EBIT – Earnings before Interest and Tax
ECB – European Central Bank
EEA – European Economic Area
ESCB – European System of Central Banks
EU – European Union
FASB – Financial Accounting Standards Board
FATCA – Foreign Account Tax Compliance Act
FIAU – Financial Intelligence Analysis Unit
FY – Financial Year
GDP – Gross Domestic Product
GVA – Gross Value Added
IAS – International Accounting Standards
IASB – International Accounting Standards Board
ICAP – Internal Capital Adequacy Assessment Process
IFC – International Financial Centre
IFRS – International Financial Reporting Standards
ILAAP – Internal Liquidity Adequacy Assessment Process
JST – Joint Supervisory Team
LAC – Loans and Advances to Customers
LBT – Loss Before Tax
LSI – Less Significant Institution
MFSA – Malta Financial Services Authority
M&A – Mergers & Acquisitions
NAS – Non-Audit Services
NCA – National Competent Authority
NCB – National Central Bank
NEC – National Exhibition Centre
NII – Net Interest Income
NIL – Net Impairment Losses
NPL – Non-Performing Loans
OECD – Organisation for Economic Co-operation and Development
PBT – Profit Before Tax
PCC – Protected Cell Company
PIE – Public Interest Entity
ROE – Return on Equity
ROU – Right-of-Use
SDC – Sparkassernes Data Centre
SI – Significant Institution
SME – Small and Medium Sized Enterprise
SRB - Single Resolutions Board
SRF – Single Resolution Fund
SSM – Single Supervisory Mechanism
S&P – Standard & Poor’s
TLAC – Total Loss Absorbing Capacity
TLTRO – Targeted Longer Term Refinancing Operation
UK – United Kingdom
US – United States
USD – United States Dollar
VAT – Value-Added Tax
XML – Extensible Markup Language
Key Sector Information
Under the Microscope

**Taxation**

Double taxation treaties exist with more than 65 countries. There is a corporation tax of 35% but with a full imputation tax system which completely eliminates the economic double taxation of company profits. Apart from operating a full imputation system, Malta operates a tax refund system reducing the effective tax rate to between nil and 6.25%.

The maximum personal taxation rate is 35%, for those earning €60,001 upwards. New revised income tax brackets were announced in the 2016 budget which looked at increasing the income on which no tax is payable from €8,500 to €9,100 for those paying tax at single rates.

Highly qualified foreign executives can benefit from a flat rate of 15% tax on income up to €5 m. Any income over and above this is tax free.

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**Economy**

- **Total GDP 2015**: €8.8 bn (Q1 2016: €2.2 billion) (GDP 2014 €8.1 bn)
- **Real GDP Growth for 2015**: 6.3% (Q1 2016: 5.2%)
- **GDP per capita in Purchasing Power Standards relative to the EU-27 average (2015)**: 89%
- **Unemployment rate (2015 Q4)**: 2.8% (Q1 2016: 2.7%)
- **Inflation rate of 1.1% (2015) (June 2016: 1%)**

Largest contributors to Gross Value Added* (2016): Trade, Accommodation (20%), Administration and Defense (16.5%), Professional, Scientific and Technical activities (10.9%), Manufacturing (9.8%), Arts and Entertainment (9.1%)

*Gross value added is the value of output less the value of intermediate consumption. It is a measure of the contribution to GDP made by the individual industries mentioned above.

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**Government**

The current Labour Government came into power in 2013. Next elections are due in 2018.

This Government has promised continued support for the financial services sector.

Malta’s Sovereign rating:
- Fitch: A/F1
- S&P: A/A-2
- Moody’s: A3

Government Deficit end 2015: 1.5% of GDP (2014 2.0%)

Total Government debt end 2015: 63.9% of GDP

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**International Financial Centre (IFC)**

(Global Competitiveness Report 2016/2017 - World Economic Forum)

- Ranked 15th out of 138 economies for strength of auditing and reporting standards
- Ranked 21st out of 138 economies in capacity to attract talent
- Ranked 41st out of 138 economies for Financial Market Development

Highly educated workforce: approximately 60% of students continue onto further education after completing compulsory education.

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**Banks**

- 24 active credit institutions and 3 active branches (December 2016)
- Loans end 2015: €16.5 bn
- Deposits end 2015: €32.9 bn
- Total Assets end 2015: €46.7 bn
- Bank Offices and Branches end 2015: 130
- Ranked 16th out of 138 economies for soundness of banks in 2016/2017

**Return on Assets**
- Core Domestic Banks: 0.7%, Non-core Domestic Banks: 0.2%, International Banks: 1.0% as at December 2015

**Return on Equity**
- Core Domestic Banks: 9.9%, Non-core Domestic Banks: 1.4%, International Banks: 3.0% as at December 2015

**Average Capital Ratio**
- Core Domestic Banks: 15.0%, Non-core Domestic Banks: 22.0%, International Banks: 55.4% as at December 2015

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**Trusts and Funds**

- 71 registered trusts in Malta (September 2016)
- Foreign trusts can re-domicile to Malta without having to dissolve and re-incorporate Funds registered in Malta: 642 (June 2016)

Malta regularly receives high rankings in benchmarking reports. In fact, the June 2015 edition of the Opelosque Roundtable featured Malta as the fastest growing hedge fund industry.

Net Asset Value of funds (domiciled and non-domiciled in Malta) administered in Malta: €8.3 bn (June 2016).

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- Moody’s: A3

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**Total Government debt end 2015:** 63.9% of GDP

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**Net Asset Value of funds (domiciled and non-domiciled in Malta) administered in Malta:**
- £8.3 bn (June 2016)
Insurance

Mature domestic market.
8 domestic players (December 2016)
58 licensed insurance undertakings (December 2016)
  • 43 Non-Life
  • 7 Life
  • 2 Composite
  • 6 Reinsurance

The majority of licensed undertakings can passport their services to other EU countries

The only full European Union member state to offer Protected Cell Company (PCC) legislation, allowing risks to be written through individual cells
Approach

Akbank T.A.S and Garanti Bankasi A.S, being branches of Turkish banks operating in Malta, have been excluded from the analysis. Credit Europe Bank NV Malta, a Dutch branch operating in Malta, has also been excluded from the analysis.

In the assessments of Bank of Valletta plc, AgriBank plc and Mediterranean Bank plc (including Mediterranean Corporate Bank Limited), we used the financial statements for the year ended 2016 given that for these banks their financial year ends during the calendar year. Furthermore, in the assessment of Lombard Bank Malta plc, the results of Redbox limited, which is the Bank’s subsidiary holding shares in Maltapost p.l.c. have also been excluded.

Nemea Bank plc has not yet released its audited financial statements for the year ended 31st December 2015 and has therefore been excluded from this analysis.

All data in pages 34 to 72 has been obtained solely from publicly available sources. The analysis has, in most cases and as much as possible, utilised comparable data to provide meaningful results.
The profile of Maltese Banks
The Central Bank of Malta splits the 24 local banks into three categories:

- Core domestic banks: these can be loosely defined as those credit institutions which provide an array of banking services and are core providers of credit and deposit services in Malta. Typically, these banks operate through a branch network.
- Non-core domestic banks: these play a more restricted role in the Maltese economy, since the suite of banking services they offer to Maltese residents are somewhat limited and usually restricted to deposit taking.
- International banks: these banks are those which predominantly offer their services to persons residing outside Malta.

Malta also hosts three branches, namely two of Turkish credit institutions and one of Dutch origin.

### Core Domestic Banks
- APS Bank Limited
- Banif Bank (Malta) plc
- Bank of Valletta plc
- HSBC Bank Malta plc
- Lombard Bank Malta plc
- Mediterranean Bank plc
- Mediterranean Corporate Bank Limited

### Non-core Domestic Banks
- FCM Bank Limited
- FiMBank plc
- IIG Bank (Malta) Limited
- Izola Bank plc
- MFC Merchant Bank Limited
- Sparkasse Bank Malta plc

### International Banks
- AgriBank plc
- CommmBank Europe Limited
- Credorax Bank Limited
- ECCM Bank plc
- Ferratum Bank plc
- NBG Bank Malta Limited
- Nemea Bank plc
- Novum Bank Limited
- Pilatus Bank plc
- Satabank plc
- Yapı Kredi Bank Malta Ltd

### Branches
- Akbank T.A.S.
- Türkiye Garanti Bankası Anonim Sirketi
- Credit Europe Bank NV Malta Branch

| Total number of Core domestic Banks: 7 | Total number of Non-core domestic Banks: 6 | Total number of International Banks: 11 | Total number of Branches: 3 |
Regulators
Central Bank of Malta (CBM)

The role of the CBM has evolved substantially since it was established in 1968. Originally, the Central Bank of Malta was tasked with the implementation of the exchange rate policy, the management of the country’s reserves, banking supervision, and the provision of currency and banking services to the government, public sector and banks.

In 1994, the CBM’s operations and the industry as a whole began to modernise, with the Bank gaining more autonomy in the determination of monetary policy. In 2002, the CBM was granted full autonomy as Malta prepared for EU membership.

In 2004, responsibility for the supervision of the Malta Stock Exchange and the banking sector was transferred to the MFSA. Since then, the CBM’s sole focus has been the maintenance of financial stability.

Upon gaining EU and Euro-system membership, in 2004 and 2008 respectively, the Central Bank of Malta became part of the European System of Central Banks (ESCB). The CBM is now integrated within the decision making bodies of the ECB.

Malta Financial Services Authority (MFSA)

Since its establishment in 2002, the MFSA has been the sole regulator of financial services in Malta. Its key functions include regulating the conduct of the financial services industry through the publication of guidance notes, rules and regulations, supervising the industry through its various Supervision Units and assisting with national and supranational organisations such as the ECB. The regulation and supervision conducted by the MFSA mainly encompasses credit institutions, financial institutions, securities and investment services, regulated markets, insurance companies, company service providers, pension schemes and trustees. Malta’s Registry of Companies is also housed within the MFSA.

The MFSA is an accessible and commercial regulator yet it fully implements all EU and local regulations stringently, which allows for constructive working relationships with regulated entities.

European Central Bank (ECB)

The ECB is an official EU institution at the heart of the Eurosystem and the Single Supervisory Mechanism (SSM). It performs a range of tasks in close cooperation with the National Central Banks (NCBs) within the Eurosystem and, for banking supervision, with the National Competent Authorities (NCAs) within the Single Supervisory Mechanism.

The main objective of the Eurosystem is to maintain price stability i.e. safeguarding the stability of the Euro. The ECB, through the SSM, is responsible for prudential supervision of significant credit institutions located in the Euro Area and participating Non-Euro Area Member States.

Furthermore, the ECB contributes to the well-being of the banking system and the stability of the financial system within the EU and each Member State, conjointly striving for the highest level of integrity, competence, efficiency and accountability.

Single Supervisory Mechanism (SSM)

The SSM is an integrated system that is based on the cooperation between the NCAs and the ECB. This local integration between the MFSA and the ECB focuses on building a stronger regulatory environment and has led to certain key tasks of banking supervision falling into the direct hands of the ECB rather than under the watch of the NCAs. The SSM also includes a criteria for the classification of banks as Significant Institutions (SIs) or Less Significant Institutions (LSIs). The SIs in Malta are Bank of Valletta plc, HSBC Bank plc, and more recently Mediterranean Bank plc. The fundamental reason for this distinction here is that SIs are supervised by Joint Supervisory Teams (JSTs) which are established for each individual SI, while LSIs are supervised by the NCAs under the ECB’s oversight.

Financial Intelligence Analysis Unit (FIAU)

The FIAU became operational in 2002, and as an independently operating government agency is responsible for the analysis and dissemination of information with a view to combating money laundering and the funding of terrorism. The FIAU is also responsible for monitoring compliance with the relevant legislative provisions.

The FIAU is part of the Egmont Group, the informal international association of Financial Intelligence Units, currently comprised of 151 members.

Alongside its watchdog obligations, the organisation is tasked with the education and training of professionals working in the financial services industry, so as to develop the relevant skills and awareness in anti-money laundering. The FIAU has recently expanded its operations, so as to increase its monitoring, analytical, and administrative capacity to enable it to fully meet the challenges it will face over the coming years.

What is the JST?

Joint Supervisory Teams (JSTs) are one of the main forms of cooperation between the ECB and the NCAs and they are responsible for carrying out the ongoing supervision of significant banks. One of their main tasks is to perform the Supervisory Review and Evaluation Process which is carried out on significant credit institutions. JSTs are composed of a mixture of staff from the ECB and the relevant NCA. Their overall composition and organisation depend on the size, business model and risk profile of the SI they supervise.
Key Figures
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### Common Equity Tier 1 (CET 1) Capital

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For ease of perusal, all figures in the above table exceeding 60.5 million, were rounded up to the nearest €million.

*The figures for Bank of Valletta plc, Mediterranean Bank plc and AgriBank plc are for the financial year ended 2016.

**The figures for Lombard Bank Malta plc were based on a solo basis.

***For these banks, the above figures were converted to Euro using the applicable ECB AUD/GBP/USD to EUR financial year end exchange rates (for Balance Sheet items) and average currency exchange rates (for Income Statement items).
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*Quality above everything else*
Core Domestic Banks
The APS Bank Group ("APS" or "the Group") comprises of APS Bank Limited ("APS" or "the Bank"), APS Consult Limited (the "Subsidiary") and APS Funds Sicav p.l.c. APS Bank Limited was initially established in 1910. Founded by l’Unione Cattolica San Giuseppe, APS offers a range of personal and corporate banking services, with wealth management services provided through the Bank’s subsidiary APS Funds Sicav p.l.c. The Group has managed to maintain sustainable growth which saw its asset base increase to €1.1bn from 2014. The Bank is locally the fifth largest in terms of assets size.

1. Profit Before Tax (PBT)

The Group’s PBT for the year ended 31st December 2015 increased by €2.80m (or 22%) to €15.57m (2014: €12.77m) when compared to financial year ended 2014. This was largely due to an increase in Net Interest Income (NII) of €3.47m and a reduction in Net Impairment Losses of €0.50m when compared to the prior year.

2. Total Assets and Liabilities

As at financial year ended 31st December 2015, the Group’s asset base totalled €1.11bn, representing a slight increase of €3.62m (or 0.3%) year-on-year. Loans and Advances to Customers, gross of provisions, increased by €73.01m (or 11%), driven mainly by a significant increase in Loans and Advances to Households and Individuals of €65.89m (or 16%). However, Debt and Other Fixed Income Instruments decreased by €58.45m (or 16.4%). In his statement for the financial performance of the Bank in 2015, the Chairman commented that the Bank operated a twin policy on interest rates paid on deposits and charged on loans, continued to implement its own base rate, and where possible passed on to borrowers lower rates that corresponded to the risk undertaken and the relative cost of funds. These efforts secured the Bank with both an increase of deposits and loans, alongside an increase in NII. The Group’s liability base totalled €0.99bn, representing a slight increase of €50.09m (or 5.61%).

3. Loans and Advances to Customers (LAC)

The Group’s leading credit risk emanates from lending to households and individuals, representing 66% (2014:63%) of Loans and Advances to Customers, gross of provisions, as at 31st December 2015. The Group’s gross exposure to Small and Medium-Sized Enterprises (SMEs) as at 31st December 2015 amounted to €130.09m (2014: €169.14m).

4. Net Impairment Losses (NIL)

Net Impairment Losses for 2015 decreased by 41% over the previous year, and amounted to €0.71m. Net Impairment Losses mainly consist of individual impairments amounting to €2.17m, partially set off by a reversal of write-downs in individual impairments amounting to €1.65m.

5. Capital Adequacy Ratio (CAR)

The Group has registered a strong CET 1 ratio of 14.79% as at 31st December 2015 (2014: 14.94%), while CAR stood at 16.69% (2014: 17.50%). The reduction in CAR year-on-year is due to regulatory adjustments applied to Tier 2 Capital. Total Capital as at 31st December 2015 amounted to €98.73m (2014: €103.94m), of which CET 1 Capital amounts to €87.48m (2014: €88.69m).

6. Liquidity

The Group’s liquidity ratio was 40% for the year ended 31st December 2015 (2014: 55%), which is in excess of the minimum regulatory requirement of 30%.
Since 2008, Banif Bank (Malta) plc (“Banif” or “the Bank”) has been operating in Malta as a subsidiary of Banco Internacional do Funchal, S.A (“Banif S.A”), during which time it has established itself as one of the industry’s core domestic banks. The Bank has established a network of 12 branches spread across the Maltese islands offering a range of personal and corporate services. Banif’s banking model is mainly geared towards lending to the local community, with a specific focus on Small and Medium-Sized Enterprises (SMEs). On 4th October 2016, Al Faisal Holding acquired 78.46% of the Bank from Oitante S.A., the company which held the Bank’s shares following a regulatory restructuring of the parent in Portugal.

The Bank has registered a slight increase in the Cost-to-Income Ratio from 76.9% in 2014 to 79.4% in 2015.

1. **Profit Before Tax (PBT)**
   
   The Bank’s PBT for the year ended 31st December 2015 increased by €0.09m (or 6%) to €1.49m, when compared to financial year ended 2014. This was mainly due to the registered increase in Net Interest Income (NII) and Net Fees and Commission Income. Although interest income decreased by €3.22m (or 14%), interest expense decreased at a faster rate (33%), resulting in an increase in NII of €1.55m (or 18%). Also, Net Fees and Commission Income increased by €0.08m (or 4%) over 2014.

2. **Total Assets and Liabilities**
   
   As at financial year ended 31st December 2015, the Bank’s asset base totalled €0.52bn, representing a slight decrease of €0.1bn (or 17%) year-on-year. This was largely driven by a decrease in Loans and Advances to Banks amounting to €0.12bn (or 70%) and a decrease in Loans and Advances to Customers totalling €0.18bn (or 5%). On the other hand, Balances with Central Bank of Malta and Cash increased by €0.53bn (181%). The Bank’s liability base totalled €0.49bn, representing a slight increase of €0.1bn (or 18%) year-on-year. Customer deposits represented the biggest part of liabilities, although these decreased by €0.1bn (or 18%) year-on-year. This resulted in a total customer deposit base of €0.47bn as at 31st December 2015 (2014: €0.58bn).

3. **Loans and Advances to Customers (LAC)**
   
   Banif’s credit risk mainly emerges from lending to households and individuals. This represents 68% of Gross Loans and Advances to Customers as at 31st December 2015 (2014: 64%).

4. **Net Impairment Losses (NIL)**
   
   NIL during financial year ended 2015 amounted to €1.37m, registering a decrease of €0.45m (or 25%) over 2014. The NIL relate solely to Loans and Advances to Customers.

5. **Capital Adequacy Ratio (CAR)**
   
   As at 31st December 2015, the Bank reported a CAR of 9.3% (2014: 8.39%), whilst the CET 1 ratio was 7.7% (2014: 6.68%). The Bank’s Own Funds amounted to €22.83m as at that date. The Bank’s CET 1 Capital totalling €18.85m as at year ended 2015 mainly consists of capital instruments and the related share premium accounts (€32.50m) with Retained Earnings accounting for €13.79m.

6. **Liquidity**
   
   The Bank’s Liquid Asset Requirement Ratio stood at 54.8% for the year ended 31st December 2015 (2014: 72.4%).
Bank of Valletta plc (“BOV”)

Financial year ended 30th September 2016

Bank of Valletta p.l.c. (“BOV” or “the Group”) established in 1974, is the largest and the oldest credit institution in Malta. At present, the Maltese Government holds 25.23% of the Group, whilst the Italian Banking giant UniCredit S.p.A holds 14.45%, with the remaining equity held by the general public. BOV presently provides retail and commercial banking services, insurance services as well as administration and management services to various types of investment funds. BOV provides a wide array of banking services to its customers, and is the most diversified bank when compared to other domestic players. The Bank is directly supervised by the ECB under the SSM.

1 Profit Before Tax (PBT)

The Group’s PBT for year ended 30th September 2016 increased by €27,993m (or 24%) to €145,91m, mainly driven by a one-off gain on the Visa transaction of €2751m. The gain on the Visa transaction arose from the disposal of the Bank’s membership interest in Visa Europe. In June 2016, Visa Inc. completed the acquisition of Visa Europe, which transaction resulted in a receipt of an upfront cash consideration, preference shares and a deferred cash payment. Net Interest Income and Net Fee and Commission Income have remained at similar levels, year on year, signifying a retained level of operations and profitability.

2 Total Assets and Liabilities

As at financial year ended 30th September 2016, the Group’s asset base totalled €10.72bn, representing a significant increase of €0.82bn (or 8%) year-on-year. The increase in the Bank’s asset base was mainly driven by an increase in Loans and Advances to Banks of €0.44bn (or 27%) and an increase in Investments of €0.36bn (or 11%). The increase in Loans and Advances to Banks was reflected in term placements held with the Central Bank of Malta which amounted to an increase of €0.73bn (or 82%) year-on-year, whilst exposures to other banks effectively decreased. The Group’s liability base totalled €9.99bn, representing an increase of €0.76bn (or 8%) year-on-year. The increase in the Bank’s liability base was mainly driven by an increase in deposits from customers and from banks, amounting to €0.67bn (or 8%) year-on-year. The financial statements as at 30th September 2016, also highlight an increase in the Bank’s subordinated liabilities of €0.11bn (or 93%).

3 Loans and Advances to Customers (LAC)

The Group’s Loans and Advances to Customers (LAC), as at 30th September 2016 amounted to €4.31bn, representing an increase of €193.1m year-on-year. The increase was mainly driven by a €71.50m (or 4%) increase in Loans and Advances to households and individuals, driven by first time buyers who took advantage of the fiscal measures granted by the Government in relation to stamp duty on acquisition of residential property.

4 Net Impairment Losses (NIL)

During financial year ended 30th September 2016, the Bank registered NIL of €23.14m, representing a decrease of €9.57m (or 29%) year-on-year. This was as a result of a new provisioning methodology introduced in 2015 which focused more on the assessment of individual exposures.

5 Capital Adequacy Ratio (CAR)

BOV registered a CET 1 Ratio of 12.82% (2015: 11.3%) and a Total CAR of 16.84% (2015: 13.4%) as at the end of September 2016. The Group’s Total Own Funds amounted to €0.77bn (2015: €0.61bn) as at 30th September 2016, of which €0.59bn (2015: €0.51bn) represented CET 1 Capital.

6 Liquidity

The Group’s Loan to Deposit Ratio, as at 30th September 2016, stood at 46.3% (2015: 49.2%).
HSBC Bank Malta p.l.c. (‘HSBC’ or ‘the Group’ or ‘the Bank’) is one of the three largest licensed banks in Malta in terms of asset size and is considered to be a systemically important bank. It forms part of the HSBC group which is one of the largest banking and financial services organisations globally that serves customers through four global businesses: Retail Banking and Wealth Management, Commercial Banking, Global Banking and Markets, and Global Private Banking. The Bank in Malta services principally the personal and commercial funding requirements of the domestic market and is actively engaged in enabling domestic players to access international opportunities. The Bank is directly supervised by the ECB under the SSM.

1. Profit Before Tax (PBT)

The Group’s PBT for the year ended 31st December 2015 decreased by €5.35m (or 10%) to €46.77m, when compared to financial year ended 2014. The decline was mainly due to a €14.67m provision for the early voluntary retirement programme in 2015. However, the underlying profit before tax, after excluding the cost of the early voluntary retirement programme, was up 179% reflecting a solid performance by the Bank. Interest Income decreased by €5.22m (or 3%) year-on-year, although NII increased by €4.47m (or 4%) since the drop in Interest Income was offset by the reduction in the cost of funding, as deposit rates continued to decline and more customers moved to shorter-dated deposits.

2. Total Assets and Liabilities

As at financial year ended 31st December 2015, the Group’s asset base totalled €7.24bn, representing a slight increase of €37.84m (or 0.5%) year-on-year. The main contributor to this expansion was the increase in Treasury Bills included within ‘Balances with Central Bank of Malta, Treasury Bills and cash’ of €72.50m (or 230%) year-on-year. As at the end of financial year 2015, the Group’s liabilities base totalled €6.78bn, representing a slight increase of €21.83m (or 0.3%) year-on-year. The main contributor to the increase in liabilities was customer deposits which totalled €6.47bn as at 31st December 2015, registering an increase of €83.13m (or 2%) over the preceding year. Deposits by banks decreased to €14.29m, a reduction of €45.56m (or 76%) year-on-year.

3. Loans and Advances to Customers (LAC)

As at 31st December 2015, the Bank was mainly concentrated in lending to households and individuals, which represented €1.91bn (or 57%) of the Bank’s Total Gross Loans and Advances to Customers. The Bank’s Loans and Advances to households and individuals consisted mainly of residential mortgages amounting to €1.59bn (or 82%).

4. Net Impairment Losses (NIL)

During the financial year ended 2015, the Bank registered NIL of €10.83m, representing a decrease of €11.72m (or 52%) year-on-year. This is a reflection of the Bank’s cautious approach to dealing with non-performing exposures.

5. Capital Adequacy Ratio (CAR)

The Group’s CET 1 Ratio stood at 12.3% (2014: 10.6%) as at 31st December 2015. The Total CAR increased to 14.2% (2014: 13%) and this was a result of an increase in Total Own Funds of €3.10m (or 0.8%) and a decrease in Total Risk Weighted Assets of 0.21bn (or 7%).

6. Liquidity

The Group’s ‘Advances to Core Funding Ratio’, stood at 88% for the year ended 31st December 2015 (2014: 86%). This ratio consisted of the current Loans and Advances to Customers as a percentage of the total of customer deposits and term funding with a remaining term to maturity in excess of one year.

The Bank registered an increase in the Cost-to-Income Ratio from 56.8% in 2014 to 59% in 2015. This increase was driven by the early voluntary retirement programme launched at the end of the financial year and the increases in cost due to enhanced regulatory requirements which were reflected in other administrative expenses that went up by €0.19m (or 1%) to €11.97m year-on-year.
Lombard Bank Malta plc

Financial year ended 31st December 2015

Lombard Bank Malta plc ("Lombard" or "the Bank") was initially established in Malta in 1955 and was subsequently nationalised in 1975. In 1991, the Government sold its equity in the Bank, which was then listed on the Malta Stock Exchange in 1994. The major shareholder of the Bank is Cyprus Popular Bank Public Co Ltd, which has a 48.9% shareholding in the Bank. Moreover, the Bank has an equity holding of 100% in Redbox Limited which holds 70.1% of the Maltese postal operator, MaltaPost p.l.c. Lombard has also extended the range of products offered in the area of transaction banking and it plans to expand its dedicated asset and portfolio management advisory services.

1. Profit Before Tax (PBT)

The Bank’s PBT for the year ended 31st December 2015 was €5.97m (2014: €4.91m), representing an increase of €1.06m (or 19%) when compared to the financial year ended 2014. The main contributor to this was a decline in Impairment losses of €1.53m (or 33%) from prior year driven by a reduction in specific allowances on Loans and Advances to Customers. Net Interest Income declined by €1.16m (or 8%) from 2014 as a result of a €2.87m (or 12%) reduction in Interest Income generated from Loans and Advances to Customers. The decline in NII was partly set-off by a reduction in Interest Expense of €1.72m (or 18%).

2. Total Assets and Liabilities

As at financial year ended 31st December 2015, the Bank’s asset base totalled €0.78bn, representing a slight increase of €83.32m (or 12%) year-on-year. This was driven by an increase in Loans and Advances to Banks of €42.69m (or 23%). Balances with the Central Bank of Malta, Treasury Bills and Cash also recorded a significant increase of €31.46m (or 37%). Conversely, Loans and Advances to Customers declined by €12.85m (or 4%), contributing to a decline in the Bank’s Interest Income and need for Impairment Allowances as noted above. The Bank’s liability base totalled €0.68bn, representing an increase of €78.83m (or 13%) year-on-year. This was mainly driven by a substantial increase in Amounts Owed to Customers, specifically an increase of €76.38m (or 13%), year-on-year.

3. Loans and Advances to Customers (LAC)

The Bank’s credit risk arises mainly from lending to customers within the property and construction industry, which represented €175.89m (or 54%) of the Bank’s Total Gross Advances to Customers and which was retained at the same percentage level as the previous year (2014: 54% or €180.33m).

4. Net Impairment Losses (NIL)

During financial year ended 31st December 2015, the Bank registered NIL of €3.1m, representing a decrease of €1.5m (or 33%) year-on-year. This decrease is a reflection of the improvements in the quality of the Bank’s loan book.

5. Capital Adequacy Ratio (CAR)

The Bank’s CAR stood at 17.4% as at 31st December 2015, registering an increase of 0.6 percentage points over prior year. Moreover, the Bank has registered a strong CET 1 ratio of 16.4% as at 31st December 2015.

6. Liquidity

The Bank’s liquidity ratio, measured as Total Loans to Total Deposits stood at 81.2% for the year ended 31st December 2015 (2014: 86.9%).
Mediterranean Bank plc
Financial year ended 31st March 2016

Mediterranean Bank plc (“the Bank”) was granted a credit institution licence by the MFSA in 2005. The Bank provides a wide array of savings products, wealth management and investment services. In September 2014, the Bank acquired local credit institution Volksbank Malta Limited (“Volksbank”) which has since been rebranded to Mediterranean Corporate Bank Ltd and which is solely focused on the provision of banking services to Corporates. In June 2015, MeDirect Bank SA, which is located in Belgium, was converted from a Branch of the Bank into a fully-fledged subsidiary of Mediterranean Bank plc. The assessment below is undertaken on Mediterranean Bank Group (the “Group”), which includes Mediterranean Bank plc, MeDirect S.A, Mediterranean Corporate Bank Ltd and Medifin Estates. The latter is considered by the Bank to be insignificant. The Bank is directly supervised by the ECB under the SSM.

1 Profit Before Tax (PBT)

The Bank’s PBT for the year ended 31st March 2016 was €13.38m (2015: €34.45m), representing a decrease of €21.08m (or 61%) when compared to the financial year ended 2015. Operating Income in 2016 decreased by €14.39m (or 19%). It is imperative to note that the levels of Operating Income in the prior year were due to a one-off gain of €22.41m on the acquisition of Volksbank. The Group however experienced a growth in income generated from increased levels of activity, predominantly driven by interest income on lending activity. Increase in Operating Expenses of €7.21m (or 20%) also contributed to the reduced levels of PBT. This performance was impacted by increased levels of costs associated with the ECB’s comprehensive assessment process and the new supervisory framework applicable to the Bank, continued investment in the operating infrastructure and growth of its employee base.

2 Total Assets and Liabilities

As at 31st March 2016, the Bank’s asset base totalled €2.27bn, representing a decrease of €0.51bn (or 18%) year-on-year. This decrease was largely attributable to a decrease of €630.97m (or 42%) in Investments and Loans and Advances to Financial Institutions which decreased by €108.22m (or 65%). This decrease was offset by an increase in Loans and Advances to Customers of €191.77m (or 18%) and an increase in Balances with Central Banks, Treasury Bills and Cash of €18.90m (or 131%). The Total Liabilities of the Bank decreased by €543.68m (or 21%) over the prior year.

3 Loans and Advances to Customers (LAC)

The Group continued to build its corporate lending activities both internationally and domestically with corporate lending representing €1.2bn (or 99%) of the Group’s Gross Loans and Advances to Customers.

4 Net Impairment Losses (NIL)

During the year ended 31st March 2016, NIL decreased by €0.52m (or 12%) over the previous reporting period, resulting in total NIL amounting to €3.75m. The NIL related solely to loans and advances to customers.

5 Capital Adequacy Ratio (CAR)

The Group’s Own Funds as at 31st March 2016 totalled €236.50m, and are mainly comprised of CET 1 Capital (€197.66m). At 31st March 2016, the Group’s CAR stood at 15.6% (2015: 14.8%).

6 Liquidity

The Group’s Liquid-Asset Requirement Ratio, measured as Total Loans to Total Deposits, stands at 65% for the year ended 31st March 2016 (2015: 51%).
Non-Core Domestic Banks
FCM Bank Limited

Financial year ended 31 December 2015

FCM Bank Limited (“FCM” or “the Bank”) was licensed to carry out banking activities by the MFSA in July 2010. The majority shareholder of the Bank is a fund administered by Fortelus Capital Management LLP, a private equity firm based in London, UK, which seeks to invest in companies across Europe. In 2012, FCM interacted with the local public through the introduction of its first savings product. The Bank, whose main revenue-generating assets are financial instruments, increased its deposit base through its savings and fixed term products.

Total Assets and Liabilities

The Bank’s asset base totalled €56.80m, representing an increase of €1.17m (or 14%) from year end 2014 to 2015. This increase in total assets was mainly due to a significant increase of Cash and Cash Equivalents amounting to €9.43m. Conversely, the Bank registered a drop in financial instruments held amounting to €2.40m (or 6%). This decrease was mainly driven by a reduction in Held-To-Maturity Investments, amounting to €6.92m (or 33%). These movements led to a change in the asset-mix of the Bank, with a 14% shift from financial instruments to Cash and Cash Equivalents amounting to €9.43m. Conversely, the Bank registered a drop in financial instruments held amounting to €2.40m (or 6%).

Capital Adequacy Ratio (CAR)

The Bank registered an increase of 100 basis points in its CAR, closing the year with a ratio of 15.27%. Total Own Funds, which consist of CET 1 capital only, decreased by €1.01m (or 14%) over the year ended 31st December 2015, whilst the Bank’s Risk Weighted Assets decreased by €9.78m (or 19%).

FIMBank plc

Financial year ended 31 December 2015

FIMBank plc (“the Group” or “FIMBank” or “the Bank”) is an international trade finance specialist and was established in 1994 through the incorporation of First International Merchant Bank Ltd and renamed as FIMBank plc in 2005. Burjank Bank SAK (third largest Kuwaiti Bank in terms of asset size) and United Gulf Bank BSC own 80% shareholding in FIMBank, with the remaining equity held by the general public through the Bank’s listing on the Malta Stock Exchange. Apart from providing international trade finance, the Bank also acts as an intermediary to other financial institutions for international settlements, forfaring and factoring, and loan syndications.

Total Assets and Liabilities

Total assets increased by $33.93m (€31.17m) (or 2%) to $1.44bn (€1.33bn). This increase was largely driven by additional investments in Available-for-Sale financial instruments, achieved through an increase of $109.22m (€100.32m) (or 363%) in shares invested in sub-funds of a local unlisted collective investment scheme, and through additional holdings in debt instruments amounting to $134.72m (€123.73m). Treasury bills and Trading (forfaiting) assets also increased by $69.68m (€64m) and $92.21m (€84.36m) respectively. In contrast to this, Loans and Advances to Banks decreased by $207.47m (€190.56m) (or 48%) and Loans and Advances to Customers decreased by $160.49m (€147.41m) (or 29.21%).

The Group’s liabilities amounted to $1.27bn (€1.17bn). The largest component of liabilities remained Amounts Owed to Banks, which increased by $59.17m (€54.35m) (or 11%) to $723.94m (€670.47m). Amounts Owed to Customers decreased by US$101.77m (€93.48m) (or 19%) to $422.08m (€387.60m). With respect to Amounts Owed to Customers, term deposits decreased by US$2.1m (€1.6m) (or 24%) while deposits repayable on demand decreased by US$39.06m (€35.68m) (or 15%).

Capital Adequacy Ratio (CAR)

The Group registered a CAR of 16.2% (2014: 13.8%) and a CET 1 ratio of 11.6% (2014: 13.3%) as at 31st December 2015. The increase in CAR was mainly attributed to an increase in Tier 2 capital of $50.09m (€46.01m) from 2014 to 2015.

The above figures were converted to Euro using the applicable ECB EUR/USD financial year exchange rates for balance sheet total and average currency exchange rate for income statement items.

Loss Before Tax (LBT)

The Group’s LBT for the year ended 31st December 2015 decreased by €11.33m (€9.73m) (or 77%) to €12.05m (€10.86m), when compared to financial year ended 2014. This significant improvement in results was driven by a reduction in Impairment Charges of €40.39m (€36.41m) (or 80%) down from €50.72m (€38.18m) in December 2014 to €10.33m (€9.31m) in December 2015. The 2015 charges were mainly due to additional provisions required at the Bank and its subsidiaries, namely Meritas Limited (leading Corporate and Financial Services company based in Dubai) and India Factoring and Finance Solutions Limited (company providing factoring and forfaiting services to business entities in India).

The Group has shown improved performance in terms of Net Interest Income, with figures increasing by €1.23m (€1.12m) (or 4%) over the prior year. Conversely, Net Fee and Commission Income decreased from €20.76m (€15.63m) in 2014 to €14.55m (€13.12m) in 2015.
Under the Microscope

IIG Bank (Malta) Ltd

Financial year ended 31st December 2015

IIG Bank (Malta) Ltd ("IIG" or "the Bank") is an affiliate of International Investment Group LLC based in New York, and has been operational in Malta since 2010. International Investment Group LLC mainly engages in the provision of global commodity export services, with particular focus on emerging markets. The Bank offers a portfolio of trade finance and corporate banking services to its clients. Furthermore, IIG Bank has an associate company called IIG Trade Finance that was established in 1994 to source and manage investment funds to finance the special working needs of Small to Medium Sized exporters and traders, with particular focus on the Latin American market.

Total Assets and Liabilities

The Bank’s total Asset base increased by €36.49m (€33.50m) (or 25%) to €192.79m (€177.08m), with the expansion being mainly driven by increases in Loans and Advances to Customers amounting to €20.62m (€19.94m) (or 33%) and Loans and Advances to Banks of €19.44m (€17.85m) (or 25%). Conversely, Total Liabilities increased by €33.17m (€30.47m) (or 24%) to €169.35m (€155.55m), mainly due to an increase in customer deposits amounting to €31.44m (€28.88m) (or 28%).

Capital Adequacy Ratio (CAR)

The Bank’s Tier 1 Capital stood at 15.1% (2014: 17.1%) as at December 2015, with the Bank’s CET 1 Ratio remaining unchanged at 13.7%. The decrease of two percentage points in the Total CAR was due to a decrease of €1.73m (€1.59m) (or 46%) in Tier 2 Capital that stood at €2.02m (€1.84m), and an increase of €43.57m (€40.02m) (or 40.6%) in the Risk Weighted Assets, that stood at €169.35m (€155.55m) as at 31st December 2015. The Bank’s Tier 2 Capital consists of an investment revaluation reserve, which represents gains in the fair values of Available-for-Sale financial assets.

Profit Before Tax (PBT)

The Bank’s PBT for the year ended 31st December 2015 increased significantly by €3.71m (€3.34m) (or 131%), year-on-year, to €6.94m (€5.90m). This increase in profits was largely generated by an increase in Net Interest Income amounting to $1.77m (€1.60m) (or 53%), an increase of $0.86m (€0.80m) (or 42%) in gains on disposal of financial instruments and a decrease in Net Impairment Charges amounting to $0.69m (€0.60m) (or 73%).

The above figures were converted to Euro using the applicable ECB EUR/USD financial year end exchange rates (for Income Statement items) and Tier 2 Capital consists of an investment revaluation of Available-for-Sale financial assets.

The Bank's total Asset base increased by $36.49m (€33.50m) (or 25%) to $192.79m (€177.08m), with the expansion being mainly driven by increases in Loans and Advances to Customers amounting to $20.62m (€19.94m) (or 33%) and Loans and Advances to Banks of $19.44m (€17.85m) (or 25%). Conversely, Total Liabilities increased by $33.17m (€30.47m) (or 24%) to $169.35m (€155.55m), mainly due to an increase in customer deposits amounting to $31.44m (€28.88m) (or 28%).

Capital Adequacy Ratio (CAR)

The Bank’s Tier 1 Capital stood at 15.1% (2014: 17.1%) as at December 2015, with the Bank’s CET 1 Ratio remaining unchanged at 13.7%. The decrease of two percentage points in the Total CAR was due to a decrease of $1.73m (€1.59m) (or 46%) in Tier 2 Capital that stood at $2.02m (€1.84m), and an increase of $43.57m (€40.02m) (or 40.6%) in the Risk Weighted Assets, that stood at $169.35m (€155.55m) as at 31st December 2015. The Bank’s Tier 2 Capital consists of an investment revaluation reserve, which represents gains in the fair values of Available-for-Sale financial assets.

The Bank achieved a strong CAR of 40% (2014: 49%) as at 31st December 2015, although this represented a decrease on the previous year. The 9% decrease in the CAR was a result of an increase in the total Risk Weighted Assets of €14.08m. The Bank had total Own Funds of €24.94m (2014: €24.17m) as at financial year ended 2015, CET 1 Capital contributed to €23.83m (or 94%) of the Bank’s Total Own Funds.

Izola Bank plc

Financial year ended 31st December 2015

Izola Bank plc ("Izola" or "the Bank") was set up in 1994 with the initial intention to service the trading and financial interests of the Belgian Van Marcke Group, a Belgian market leader in sanitary ware and heating installations and which maintains majority shareholding in the Bank. Today, the Bank offers competitive, straightforward and easy-to-use online financial services and products for both personal and corporate clients.

Total Assets and Liabilities

The Bank’s asset base totalled €171.40m, representing an increase of €23.03m (or 15.5%) as at 31st December 2015. The Bank’s asset base expansion was mainly attributable to Loans and Advances to Banks and Customers, which increased by €15.49m (or 91%) and €25.42m (or 77%) respectively. Conversely, Total Liabilities increased by €20.29m (or 16%) to €143.72m, mainly due to an increase in customer deposits amounting to €16.41m (or 28%).

Capital Adequacy Ratio (CAR)

The Bank achieved a strong CAR of 40% (2014: 49%) as at 31st December 2015, although this represented a decrease on the previous year. The 9% decrease in the CAR was a result of an increase in the total Risk Weighted Assets of €14.08m. The Bank had total Own Funds of €24.94m (2014: €24.17m) as at financial year ended 2015, CET 1 Capital contributed to €23.37m (or 94%) of the Bank’s Total Own Funds.
MFC Merchant Bank Limited

Financial year ended 31st December 2015

MFC Merchant Bank Limited, formerly BAWAG Malta Bank Limited, ("MFC Merchant Bank" or "the Bank") was licensed in Malta in June 2003, and up until 1st February 2016 was a fully-owned subsidiary of BAWAG P.S.K Bank. Subsequently, the Bank was acquired by MFC Industrial Limited, a 100% subsidiary of MFC Bancorp Ltd. MFC Bancorp Ltd is an integrated Merchant Banking company which is a solutions provider for industrial companies around the world. During 2015, the Bank’s primary focus was on the provision of direct loan facilities for project finance across public and private sectors in the EU, mainly through loan syndication. The Bank is now in the process of realigning its business model to the provision of supply chain finance and other trade finance products, including structured trade finance solutions. The Bank’s product range will be expanded to cover products and services along the entire trade finance value chain.

Total Assets and Liabilities

As at year end, the Bank was mainly financed through equity. The decrease in interest receivable of the Bank, amounting to €7.44m (or 62%) resulted in Net Interest Income declining by €4.84m (or 60%). The Bank also recorded an increase in Net Impairment Losses of €16.21m (or 37%), year-on-year, driven by significant increases in Loans and Advances to Banks amounting to €88.27m (or 26%) and Balances held with the Central Bank of Malta and Cash of €52.74m (or 368%). Financial instruments (mainly government and local treasury bonds) also increased by €20.52m (or 24%). The increase in Total Assets was financed through an increase in Net Own Funds of €22.16m (2014: €19.47m), representing an increase of €2 million, resulted in a fully authorised and paid up share capital amounting to €98.20m.

Capital Adequacy Ratio (CAR)

Due to the significant contraction in business and the resulting decrease, of €137.84m, in the Risk Weighted Assets of the Bank, Total CAR improved from 34.9% as at 31st December 2014 to 96.9% as at 31st December 2015. The Bank’s Total Own Funds, consisting exclusively of Tier 1 Capital, remained relatively constant at €98.20m.

Sparkasse Bank Malta plc

Financial year ended 31st December 2015

Sparkasse Bank Malta plc ("Sparkasse" or "the Bank") was established in Malta in October 2000, and is a subsidiary of the Austrian Savings Bank and Erste Bank Group. The Bank focuses mainly on the provision of private banking, investment services, as well as custody and depository services.

Total Assets and Liabilities

As at year end, the Bank was mainly financed through equity. The decrease in interest receivable of the Bank, amounting to €7.44m (or 62%) resulted in Net Interest Income declining by €4.84m (or 60%). The Bank also recorded an increase in Net Impairment Losses of €16.21m (or 37%), year-on-year, driven by significant increases in Loans and Advances to Banks amounting to €88.27m (or 26%) and Balances held with the Central Bank of Malta and Cash of €52.74m (or 368%). Financial instruments (mainly government and local treasury bonds) also increased by €20.52m (or 24%). The increase in Total Assets was financed through an increase in Net Own Funds of €22.16m (2014: €19.47m), representing an increase of €2 million, resulted in a fully authorised and paid up share capital amounting to €98.20m.

Capital Adequacy Ratio (CAR)

The Bank’s increase in share capital by €2 million, resulted in a fully authorised and paid up share capital amounting to €98.20m. As at 31st December 2015, the Bank registered Total Own Funds of €604.22m, consisting exclusively of Tier 1 Capital. The Bank’s Total Capital Ratio and Tier 1 Capital Ratio are equivalent to each other and stood at 1751% (2014: 13.8%).
International Banks
AgriBank plc

Financial year ended 30th June 2016

During financial year ended June 2016, the Bank registered an improved performance, turning around the Loss Before Tax (LBT) of £0.49m (£0.68m) registered in 2015 into a Profit Before Tax (PBT) of £0.18m (£0.22m) year-on-year. This was mainly due to a decrease in the Net Fee and Commission Expense of £0.28m (£0.34m) with Net Interest Income (NII) increasing by £0.48m (£0.58m) (or 176%). The main driver for the increase in NII was a significant increase in Interest Income which increased by £0.79m (£0.95m) (or 179%) year-on-year, driven predominantly by an increase in Loans to Customers. Additionally, the Bank’s Net Impairment Losses decreased by £0.29m (£0.35m) (or 71%) for the year ended 2016.

The Bank’s Asset base, as at 30th June 2016, increased by £8.15m (£9.77m) (or 50%) to £24.46m year-on-year, mainly due to an increase in Loans to Customers which rose by £4.35m (£5.22m) to £9.39m (£10.50m) in June 2016. Finance Lease Receivables which increased by £3.33m (£3.99m) to £8.52m (£10.22m) also contributed to the growth in the Bank’s asset base. These receivables comprise amounts due in respect of asset financing provided to farmers in the UK to finance acquisition of various agricultural related equipment, including vehicles and machinery.

The Bank’s liability base totalled £18.93m (£22.70m), representing an increase of £8.15m (£9.77m) (or 50%) year-on-year, mainly driven by an increase in the Amounts Owed to Customers which increased significantly by £7.10m (£8.51m) to £16.05m (£19.24) and Debt Securities in Issue which grew by £0.45m (£0.53m) resulting in Total Own Funds of £5.35m (£6.41m) as at June 2016. The Bank’s Total Capital, as at June 2016, was exclusively made up of Tier 1 Capital.

The Bank registered a CAR of 28.34% as at June 2016 (2015: 29.34%).

CommBank Europe Limited

Financial year ended 30th June 2015

The Bank’s primary income is Net Interest Income (NII). NII for the year ended 30th June 2015 decreased by AUD 10.25m (£7.13m) (or 11%) to AUD 83.93m (£58.44m), with Profit Before Tax (PBT) also declining by AUD 14.89m (£10.36m) (or 15%) to AUD 84.91m (£59.12m). According to the 2015 Annual Report, the decrease in the Bank’s profits is primarily driven by reduced margins on term placements with other banks and the lower amount of capital available for the Bank’s business during the year due to the repatriation of AUD 435m (£298m) in 2014. The Bank is further expecting a decrease in profitability during 2016 due to the AUD 1,635m (£1,124m) repatriation of surplus capital which took place in 2015.

The Bank’s asset base decreased by AUD 1,406.16m (£966.43m) (or 58%) to AUD 1,026.87m (£705.07m). This was largely driven by the decrease in Loans and Advances to Banks of AUD 1,036.45m (£712.34m) (or 80%).

In contrast, total liabilities increased from AUD 263.34m (£181.15m) in 2014 to AUD 222.79m (£159.31m) in 2015. This change in total liabilities of AUD 258.45m (£178.32m) (or 99%) emerged from the uptick in the Amounts Owed to Banks which comprised 94% of the Bank’s total liabilities as at the end of June 2015. These increased by AUD 261.98m (£180.05m) (or 114%), year-on-year, leading to total Amounts Owed to Banks of AUD 491.41m (£337.74m).

The Bank registered a decrease of AUD 1,035m (£752m) in its Own Funds over 30th June 2014, leading to total Own Funds of AUD 500.01m (£343.65m). The Bank’s Own Funds are mainly composed of Share Capital. The Bank registered a CAR of 39% as at 30th June 2015, down from 103% as at 30th June 2014.
Credorax Bank Limited

Financial year ended 31st December 2015

Credorax Bank Limited ("Credorax" or "the Bank"), formerly a Financial Institution operating as Credorax (Malta) Ltd, started operating as a Credit Institution, under the Banking Act 1994, in 2015. The Bank’s principal activity is the provision of integrated acquiring and payment processing services to merchants within the EU and two other EEC States, and is also a principal level member with Visa (Europe), MasterCard and Union Pay.

The Bank’s loss for the year after accounting for taxation amounted to €0.73m which is 75% less than that recorded in the previous year. No Interest Income has as yet been generated by the Bank, however Net Fee and Commission Income increased significantly by €4.95m (or 77%) to €11.43m. This increase was partially set-off by the €3.23m (or 69%) increase in employee compensation and benefits. In contrast to this, Net Impairment Losses decreased by €2.51m (or 79%) to €0.65m. These losses relate to instances where merchants would not be able to fulfill obligations emanating from the merchant agreements in place, with chargebacks exceeding collaterals.

The Bank’s total assets amounted to €85.87m (2014: €53.89m) outlining an increase in its Asset base by €31.98m (or 59%). This is mainly due to the €15.82m investment in Visa Europe Limited as an Available-For-Sale financial asset, reflecting the fair value of the expected consideration to be received following the closing of the transaction. Furthermore, funds receivable from card schemes, relating to receivables from VISA and Mastercard in relation to acquiring transactions and processed on behalf of merchants, have increased by €9.03m (or 72%) to €21.56m. Loans and Advances to Banks Attributable to Merchants increased by €6.35m (or 24%) and Funds Advanced under Collateral Arrangements increased by €4.77m (or 67%).

The Bank’s total liabilities increased by €13.42m (or 29%) to €60.03m. Amounts Owed to Customers increased to €1.76m as at 31st December 2015 (2014: nil), reflecting the fact that the Bank started operating as a credit institution in 2015. Settlement Processing Obligations, relating to the Bank’s liability to merchants, increased by €14.62m (or 35%) to €56.16m as at 31st December 2015 (2014: €21.58m).

The Bank registered a CAR of 33.7% and a Tier 1 capital ratio of 21.6% as at 31st December 2015. The Bank registered a CAR of 33.7% and a Tier 1 capital ratio of 21.6% as at 31st December 2015. The Bank’s Total Own Funds consisted of CET 1 capital of €12.61m (2014: €6.40m) and Tier 2 capital of €708m (2014: €603m), totalling to €19.69m (2014: €5.49m). The increase in CET 1 capital mainly relates to the fair value reserve of the Bank, amounting to €15.82m that was not available in 2014.

With the accelerating speed and complexity of business and risk, Audit Committees and Boards need to focus on a number of areas which go beyond financial risks.

Increased regulatory expectations  Culture and conduct  Regulatory reporting  Stress testing  Model risk management  Cybersecurity  Third party relationships/ vendor management

Internal Auditors are expected to deliver value to the organisation through an effective risk-based process. Clearly though, more needs to be done in this space...

How strongly do companies agree or disagree that their IA function adequately identifies and responds to their emerging risks?*

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Strongly agree</th>
<th>Somewhat agree</th>
<th>Neither agree nor disagree</th>
<th>Somewhat disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>22%</td>
<td></td>
<td></td>
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<td>57%</td>
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</tbody>
</table>

Does your IA function adequately identify and respond to organisations’ emerging risks?*

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Receive today</th>
<th>Most valuable to receive</th>
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</thead>
<tbody>
<tr>
<td>36%</td>
<td></td>
<td>5%</td>
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</table>

Clearly your Internal Audit function needs to take this important step forward. Our Internal Audit solutions are built using a cutting-edge approach and are supported by best-in-class thought leadership. More importantly, we believe in flexibility and communication to provide you with what you really need.

* Source: Seeing Value through Internal Audit, KPMG International, 2016

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Under the Microscope

Ferratum Bank plc

Ferratum Bank plc (“Ferratum” or “the Bank”) was set up in Malta in September 2012 in order to provide additional funding sources and business opportunities to the parent company, Ferratum Group (“the Group”). The Group provides internet and mobile micro-loans, amongst various other services, across a number of countries. It offers fast and readily available banking services, loans and savings both online and on mobile devices.

Financial year ended 31st December 2015

The Bank’s PBT for the year ended 31st December 2015, increased significantly by €3.64m (or 97%) to €7.39m, almost twice the result obtained in the financial year ending 2014. This increase in profit was mainly due to an increase in Net Interest Income of €23.25m, more than double the 2014 result (129%), a direct result of the increase in Loans and Advances to Customers.

As at 31st December 2015, the Bank’s total Asset base was just short of €50m, representing an increase of €28.77m. This expansion was fuelled by an increase in Loans and Advances to Customers of €26.83m mainly funded by an issue of redeemable bonds with a par value of €20.14m during July 2015. This bond issue enabled the Bank to grow by improving its ability to raise additional funding. As a result, the Bank’s total liabilities increased by €26.31m (or 300%) to €35.07m.

Furthermore, approximately 94% of the Bank’s asset base is comprised of Loans and Advances (2014: 92%), with no investment portfolio.

The Bank’s Capital Adequacy Ratio (CAR) declined from 23.1%, as at 31st December 2014, to 16.77%, as at 31st December 2015. The year-on-year decline in CAR was due to higher Total Risk Weighted Assets of €86.67m (or 92%), with no investment portfolio. The Bank’s Capital Adequacy Ratio (CAR) declined from 23.1%, as at 31st December 2014, to 16.77%, as at 31st December 2015, even though Own Funds increased to €14.54m as at 31st December 2015 (2014: €12.44m), all of which was CET 1 capital. The year-on-year decline in CAR was due to higher Total Risk Weighted Assets (2015: €86.67m, 2014: €53.82m) at year end 2015 as compared to year end 2014.

ECCM Bank plc

ECCM Bank plc (“ECCM” or “the Bank”), formerly known as Raiffeisen Malta Bank plc, was registered in Malta in 1996, focusing mainly on transacting with large international customers. The Bank’s shareholders are Banasino Investments Limited and Hillwood Insurance Company Limited, both of which form part of the Kronospan organisation, an Austrian manufacturer of wood-based panels, special and decorative paper as well as other associated value added products.

Highlights

The Bank managed to turn the loss registered in 2014, to a profit of €1.24m.

As at 30th September 2015, the Bank’s Total Asset base amounted to €171.53m, representing an increase of €69.23m (or 68%).

The Bank registered a strong Total Capital Ratio of 73.2%, as at 30th September 2015 (2014: 146%).

During the financial year ended 30th September 2015, being the first full year of operations post acquisition by Kronospan Group, the Bank managed to turn the loss registered in 2014, to a profit of €1.24m. The year ended 30th September 2014 was characterised by acquisition of the new shareholding with the consequential change in business model which resulted in the Bank sustaining a loss for that year. The positive results achieved during the year ended 30th September 2015 were mainly driven by an increase in Loans and Advances to Customers which led to an increase in Net Interest Income of €2.15m, partially offset by the collective impairment loss on financial assets of €0.62m and the increase in Other Operating Expenses of €1.69m.

As at 30th September 2015, the Bank’s Total Asset base amounted to €171.53m, representing an increase of €69.23m (or 68%). This expansion was fuelled by an increase in Loans and Advances to Customers of €84.9m partially offset by a decrease in Loans and Advances to Banks of €16.68m (or 19%). This increase in the asset base was mainly financed by an increase in customer deposits of €67.26m and also by an injection of share capital of €7.55m.

The Bank has registered a strong Total Capital Ratio of 73.2%, as at 30th September 2015 (2014: 146%). The decrease in the capital ratio is mainly driven by an increase in the Risk-Weighted Assets of €71.80m (or 103%). Additionally, Total Own Funds as at 30th September 2015 amounted to €103.73m (2014: €102.15m), being fully constituted of Tier 1 capital.

Highlights

The Bank’s PBT for the year ended 31st December 2015, increased significantly by €3.64m (or 97%) to €7.39m, almost twice the result obtained in the financial year ending 2014. This increase in profit was mainly due to an increase in Net Interest Income of €23.25m, more than double the 2014 result (129%), a direct result of the increase in Loans and Advances to Customers.

As at 31st December 2015, the Bank’s total Asset base was just short of €50m, representing an increase of €28.77m. This expansion was fuelled by an increase in Loans and Advances to Customers of €26.83m mainly funded by an issue of redeemable bonds with a par value of €20.14m during July 2015. This bond issue enabled the Bank to grow by improving its ability to raise additional funding. As a result, the Bank’s total liabilities increased by €26.31m (or 300%) to €35.07m.

Furthermore, approximately 94% of the Bank’s asset base is comprised of Loans and Advances (2014: 92%), with no investment portfolio.

The Bank’s Capital Adequacy Ratio (CAR) declined from 23.1%, as at 31st December 2014, to 16.77%, as at 31st December 2015.
Novum Bank Limited

Novum Bank Limited (“Novum” or “the Bank”) was established in Malta in 2009 and is a subsidiary of Novum Holdings Limited. Since 2014, the Bank has expanded its operations to attract new customers from Germany, Poland, Spain, the Netherlands, France and Austria. This investment is expected to result in further growth and expansion in the coming years.

Financial year ended 31st December 2015

During the financial year ended 31st December 2015, Net Interest Income increased by €0.09m to €0.33m, which was underpinned by an increase in Loans and Advances to Customers. Net Fee and Commission Income also increased by €4m (or 43%) to €14m. This has largely contributed to turning the Loss Before Tax of €2.02m in 2014 into a Profit Before Tax (PBT) of €0.49m during financial year ended 2015.

With respect to the Statement of Financial Position, the Bank’s total asset base increased significantly by €13.36m (or 100%), to €26.78m as at financial year ended 2015. This was mainly driven by the recognition of a Deferred Tax Asset of €8.66m which was not recognised in previous years in view of the Bank’s negative performance. Notwithstanding this, during the year ended 31st December 2015, the Bank generated profits and management’s expectation is to continue to generate sufficient profits in the foreseeable future against which the Deferred Tax Asset can be utilised. Loans and Advances to Banks and Customers increased by €2.50m (or 78%) and by €1.74m (or 33%) respectively. The Bank’s total liabilities increased by €4.01m (or 53%) to €11.56m driven by an increase in Amounts due to Customers of €2.71m (or 122%).

The Bank’s Capital Adequacy Ratio (CAR) and Total Own Funds, as at 31st December 2015, stood at 60% (2014: 49%) and €12.34m (2014: 5.77m) respectively.

NBG Bank Malta Limited

NBG Bank Malta Limited (“NBG” or “the Bank”) obtained a banking licence by the MFSA in 2005. The National Bank of Greece S.A. fully owns NBG through its subsidiary NBG International Holdings B.V., which is registered in the Netherlands. NBG targets mainly high net worth individuals and large corporate clients through the provision of wide-ranging banking services, including the provision of loans and attracting deposits.

Financial year ended 31st December 2015

The Bank’s Profit Before Tax (PBT) increased to €14.01m (or 10%) in 2015 from €12.78m in 2014. This increase was mainly attributable to a reversal of Net Impairment Losses on financial assets amounting to €2.41m (2014: €0.76m). Interest Income and Interest Expense decreased significantly during the year by 64% and 87% respectively resulting in an effect on Net Interest Income which increased by 4% from €16.64m in 2014 to €17.32m in 2015. Interest expense was primarily lower due to lower interest rates recorded in 2015 on its Amounts Owed to Banks and Customers.

The Bank’s total asset base stood at €623.24m as at December 2015, which represented a significant decrease of €751.46m (or 55%) over the previous twelve month period. The reduction in the asset base was brought about by fewer loans and advances to both banks and customers. Loans and Advances to Banks amounted to €61.26m, a decrease of €658.02m (or 91%), over the previous twelve months. Loans and Advances to Customers decreased by €147.48m (or 24%) and stood at €468.74m as at 31st December 2015. The Bank’s total liabilities decreased by €714.96m (or 65%) to €387.89m, with Deposits from Banks declining by €500.15m (or 90%) to €52.83m, while Deposits from Customers declined by €210.20m (or 39%) to €331.38m. The Directors’ Report for the year ended 31st December 2015 outlines that the Bank is not seeking to expand further its loan portfolio for the foreseeable future.

Moreover, in order to mitigate the uncertainty in the Greek economy, the Bank maintained a pledge of €44.27m in cash and €26.51m in securities in favour of the Depositor Compensation Scheme, given that its depositor base is predominantly Greek.

As at financial year ended 2015, the Bank’s Own Funds totalled €220.94m (2014: €270.94m), and comprise only CET 1 Capital. For the year ended 31st December 2015, the Bank also registered a strong Capital Adequacy Ratio (CAR) of 49.65% (2014: 35.25%).
Pilatus Bank plc

Financial year ended 31st December 2015

Pilatus Bank plc, formerly Pilatus Bank Limited, ("Pilatus" or "the Bank") was licensed by the MFSA during the first quarter of 2014. Subsequent to year end, specifically during March 2016, Pilatus Bank Ltd was converted to a public limited company, hence the change in name. Pilatus mainly targets global high net worth individuals through the provision of private and commercial banking services.

Highlights

- The Bank grew significantly in its second year of operations, reporting a Profit Before Tax (PBT) of €3.14m (2014: €0.32m) for the year ended 31st December 2015.
- The increase in PBT of €2.82m, was mainly driven by an increase in Net Interest Income of €2.21m year-on-year, which is a direct effect of a substantial increase in Loans and Advances to Customers.
- As at 31st December 2015, the Bank registered a total asset base of €326.20m (2014: €111.19m), representing an increase of €215.01m. This expansion was fuelled by an increase in Loans and Advances to Customers of €101.56m, as well as an increase in Loans and Advances to Banks of €107.93m. This increase in the asset base was possible through an increase in deposit-taking activity which increased by €212.27m (retail deposits of €141.06m and financial institution deposits of €71.21m).
- The Bank has maintained a strong CAR of 30.45% (2014: 27%) as at 31st December 2015. Additionally, Total Own Funds as at 31st December 2015 amounted to €11.16m (2014: €9.04m), being fully constituted of Tier 1 Capital. Total Own Funds increased as a result of the capital injection of €2m in the form of a shareholders' contribution.

Satabank plc

Financial year ended 31st December 2015

Satabank plc ("Satabank" or "the Bank") was set up in Malta in October 2014 and is a subsidiary of Signia Holding Ltd. Satabank plc is engaged mainly in the provision of retail banking products to individuals, through the provision of standard banking accounts, credit cards as well as e-money accounts. The Bank also provides commercial banking to corporates, which include merchant acquiring facilities and payment services. Financial year ended 31st December 2015 was the first full calendar year of operations of the Bank.

Highlights

- The Bank registered a marginal Loss Before Tax (LBT) of €0.12m for the 15 month period ended 31st December 2015, which includes an Impairment Charge of €0.13m. The Bank registered an Operating Income of €1.16m which comprised mainly of Net Interest Income amounting to €0.53m and Net Fee and Commission Income of €0.64m.
- As at 31st December 2015, the Bank’s total Asset base amounted to €54.50m, mainly made up of Loans and Advances to Banks amounting to €43.12m, Loans and Advances to Customers of €5.45m and Investment Securities of €4.85m. This growth was financed by liabilities consisting mainly of Deposits from Customers amounting to €37.70m, Liabilities towards e-money Holders of €6.26m and an equity injection of €10m.
- The Bank had a healthy Capital Adequacy Ratio (CAR) of 50% as at 31st December 2015, with Total Own Funds amounting to €9.72m, composed entirely of CET 1 Capital.
Yapi Kredi Bank Malta Ltd

Financial year ended 31st December 2015

Yapi Kredi Bank Malta Ltd ("Yapi Kredi" or “the Bank”) was set up in Malta in March 2014 and is a subsidiary of Yapi Kredi Bankasi As which is the fourth largest private Bank in Turkey. Yapi Kredi is engaged in the provision of retail banking, corporate and commercial banking as well as private banking products and services. The financial year ended 31st December 2015 was the first full year of operations of the Bank whilst the 2014 results cover the period from 13th March 2014 to 31st December 2014.

During the financial year ended 31st December 2015, the Bank registered an increase in Loss Before Tax (LBT) of €0.54m (or 398%) despite an increase of €0.25m (or 139%) in Net Interest Income (NII). This increase in NII was offset by the increase in personnel expenses of €0.64m (or 769%), an impairment charge of €0.23m (no impairment charges were recognised during the comparative period) and an increase in Other Operating Expenses of €0.80m (or 639%). As at 31st December 2015, the Bank’s total asset base amounted to €89.59m, representing an increase of €29.71m (or 50%) over the Bank’s asset base as at 31st December 2014. The increase is mainly attributable to the increase in Loans and Advances to Customers of €70.76m (no such assets were recognised as at the end of the comparative period), which was partly offset by a decrease in Loans and Advances to Banks, amounting to €43.46m (or 74%).

The growth in the Bank’s asset base was mainly driven by time deposits from retail customers during financial year ended 2015. The Bank also recognised other liabilities and derivatives held for risk management, amounting to €59.14m (2014: €59.48m), 99.6% of which was mostly composed of CET 1 capital.

The Bank registered a healthy CAR of 67.27% as at 31st December 2015 (2014: 99.84%), with Total Own Funds amounting to €99.59m (2014: €69.90m). The Bank’s CAR decreased from financial year ended 2014 due to an increased level of capital allocated for credit risk (including counterparty risk) of €27.94m.

Implementation of the new upcoming standards can be complex, impacting not just the way you account for transactions, but also tax, processes, internal controls and systems. The upcoming changes cannot be underestimated.

Failure to address these issues in time has the potential of incurring significant costs to your business and may affect your performance and share price.

Key Dates for:
- IFRS 15 Revenue from Contracts with Customers
- IFRS 16 Leases
- IFRS 9 Financial Instruments

How we can help
- Organising awareness sessions to relevant personnel
- Providing technical advice throughout the assessment process
- Providing relevant tools and accelerators
- Providing technical advice on the available accounting policy options
- Assisting in drafting accounting policies and calculating the impact each option will have
- Assisting in drafting accounting manuals and pre-forma financial statements
- Delivering training to relevant personnel
- Addressing any technical issues that arise during implementation
- Providing updates and monitor other upcoming accounting changes that may have potential implications on the ongoing project
- Assisting in the preparation of financial statements
- Delivering training on any subsequent updates and post financial year knowledge re-enforcement
  - In house training
  - IFRS: myBusiness sessions (e-mail ifrsmybusiness@kpmg.com.mt to subscribe)
- KPMG Online CPE platform (www.kpmg.eblearn.net)
- Share lessons learned, identified industry practices around the globe and within the local industry
- Providing ad-hoc technical support on complex accounting matters

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Thought Leadership
Juanita Bencini, Risk Consulting Advisory Services Partner, speaks to Mark Curmi, about banks and the governance challenges emanating from CRDIV

The word “governance” has become a buzzword of late. What is its significance to banks and is it really a new concept for the banking industry?

Analysis of the financial crisis internationally revealed poor quality decision-making and oversight of risk by many bank boards. Banks in Malta have historically faced pressure to improve governance either from the Regulator or from other institutions with which they do business. Over the years, the MFSA has been increasingly upping its demands in relation to governance, but never to the degree being required now by the Single Supervisory Mechanism (SSM). These past two years have seen governance being parachuted into pole position by regulators both across the EU and locally which has left banks struggling to come to terms with the new realities of an intrusive regulatory body that will persistently demand changes within governance structures.

What does good governance look like?

Good governance is an outcome of the engagement of supervisors with the boards of banks – that is today’s reality. It necessitates and encourages a great deal of interaction between the supervisor and a bank’s board and senior management. Good governance is also a question of an institution’s culture and this presents a tough challenge for regulators. We have to ask: what constitutes a “good culture” within a bank? Supervisors are trying to get to uniformity of outcomes, but this can be a challenge given the diversity of banks in the EU. One thing is for certain though - as more time passes, supervisors are exposed to many more structures and thus increasing their knowledge and sharing of such knowledge. Conscious or unconsciously, this is creating a list of criteria for regulators of how a bank’s governance arrangements should be structured. The ECB carried out a thematic review of governance and the results were published last June. Some of the particular issues that have been identified include the lack of relevant knowledge and expertise among non-executive board members, insufficient number of independent board members and concerns that some non-executive directors may be subject to political influence.

What do you mean by an “intrusive” regulatory body?

Supervisors have increased the intensity and intrusiveness of their assessment of banks’ corporate governance structures and policies. First of all, supervisors are taking a more active and intensive approach to conduct thorough assessments of candidates, not only for board membership but also for senior management positions. As you can imagine, this is not without its problems in Malta where the pool of directors and specialist resources, such as risk management professionals, is limited. Secondly, supervisors across the EU are demanding to attend board meetings to experience, first-hand, the interaction between board members and the challenges facing management. We are also seeing the Regulator demanding that banks improve their governance arrangements when governance failings are identified, and then demanding higher Pillar 2 capital add-ons as a result of these failures.

Is governance relevant only to the board of directors and board committees?

Definitely not. Governance is all about the checks and balances within an organisation and although the tone at the top coming from the board is hugely important, the requirement for good governance has to cascade through an organisation to become effective. Senior management has therefore a pivotal role to play in the governance arrangements of an institution, and the concerns around governance are also pertinent to that strata of personnel within the bank’s structure. The two are strongly intertwined. For example, good governance in today’s banks demands that the risk management and compliance functions have direct access to the board or a board committee. The three lines of defence concept is being reinforced as part of banks’ new governance arrangements. Never before have the control functions within a banking institution been so much in the spotlight and working so closely with the board.

Does the ECB have a different approach when assessing governance arrangements compared to how it addresses prudential supervision?

Not really. However, given that governance involves a strong dose of subjectivity, the banks’ reaction is typically much more intense and emotional. Governance is also much more difficult to assess than prudential regulation. A bank’s governance arrangements are to some extent, a product of the company law within the jurisdiction that the bank operates in. We all know how different a two-tier board structure is from that of a unitary board, and yet the governance arrangements are expected to be the same for those operating under both regimes. Governance arrangements are also conditioned by regulation for listed entities when the institution is listed on a stock exchange. Equally, codes of corporate governance for listed entities across Europe vary quite widely. Governance is also influenced by the business culture within the country, therefore by far, it would be the area presenting the biggest headache for regulators trying to harmonise governance arrangements of banks across the EU.

All this emphasis on governance may be warranted for the banks that are directly supervised by the ECB but demands for better governance arrangements seem to be also directed towards the smaller banks (or Less Significant Institutions). Is this the case?

The NCA in each Eurozone country is assisting with the supervision of larger banks through the participation of Joint Supervisory Teams of those banks, and at the same time is directly responsible for the supervision of the Less Significant Institutions (“LSIs”) within the country. The supervisory staff within the local regulators are rubbing shoulders and exchanging views on a daily basis with the ECB staff, so we should not be surprised that some of the pressures being applied to the larger banks are also being directed towards the smaller banks. Whilst there is no denying that the direction for governance in banking is being dictated by the ECB for the Significant Institutions (“SIs”), the danger is that a one size fits all approach is adopted or that the smaller banks will be placed under pressure to adapt to the higher standards in a short period of time. Clearly this needs to be resisted, especially since our experience shows that even the larger banks sometimes struggle to comply with the ECB requirements.
Rethinking Regulatory Reporting

Regulatory reporting requires banks and financial institutions to collect, process and submit vast quantities of data each month and/or each quarter to regulators, as well as provide evidence of its data source traceability, with serious consequences for any errors or misleading conclusions.

The data aggregation task can be onerous, especially for organisations with complex structures and disparate IT systems where data is stored in a range of formats and are often pulled together manually.

With a multitude of reports covering data associated with risk, finance, customer transactions, capital, treasury, profit-and-loss accounts and human resources, there is a significant overlap between different sets of regulatory requirements imposed on banks and, even worse, potential duplication involved in preparing submissions.

The Past
Over the past few years, banks have devoted significant resources to develop processes for data aggregation and regulatory report production. Although some have consolidated and rationalised their technology infrastructures, or built piecemeal systems in response to new directives and regulations, the dynamic nature of the regulatory world means that amendments to existing requirements, as well as new initiatives, continue to pile up demand upon existing systems and reporting processes.

The Present
Given the high degree of commonality between different regulations, now is the ideal time to establish standardised ways of managing data for every type of requirement. By investing in middle and back-office systems, and building an enterprise-wide data infrastructure, organisations can “do it once and do it right” with a single data warehouse rather than creating separate processes to satisfy each regulatory requirement. An integrated view of data across products should lead to more consistent, accurate reporting, with clear sources that can be traced instantly.

The Future
Beyond compliance reporting, there is an opportunity to harness the power of data to improve the quality of decisions and enhance business opportunities. Regulation can be a catalyst for improved data management, analysis and reporting, offering some remarkable insights.
The breadth of the VAT exemption on payment handling services

The Court of Justice of the EU (CJEU) has recently delivered its ruling on the scope of the VAT exemption covering payment-related services in the context of card handling and payment processing operations - hopefully ending a decade-long battle in the UK on the subject. The judgements in question are related to Bookit and National Exhibition Centre (NEC), issued on the same day of May 26th 2016. The cases dispel the myth that the VAT exemption is all-encompassing and confirm that it is highly dependent on the functional aspects of each transaction.

It is remarkable that the judgements were issued almost on the 19th anniversary from the SDC judgement in which the same exemption was discussed. In the case of SDC, it was stated that the VAT exemption applies to services of a banking data handling network. "If those transactions are distinct in character and are specific to, and essential for, the exempt transactions," having the Court revisiting the issue is unsurprising considering that when answering the question as to whether payment-related services qualify as VAT-exempt Transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection and factoring is never a simple textbook exercise.

The cases

In a nutshell:

- Bookit sold cinema tickets as an agent for Odeon cinemas. As well as collecting money from customers on behalf of Odeon, Bookit charged a ‘card handling fee’ when payments were made by credit/debit cards.
- NEC sold venue tickets as an agent for promoters of events, charging the full ticket price plus a ‘booking fee’ when payments were made by credit/debit cards.

Both Bookit and NEC were involved in the process that allowed the secure transmission of funds by collecting customer card details, obtaining authorisation codes from merchant acquirer banks, informing the customer that the operation has been authorised, storing the authorisations codes and transmitting a daily settlement file with the payment information through the merchant acquirer bank.

In essence, the questions referred to the CJEU sought to reconcile two earlier judgements and erase some of the blurred lines between VAT-taxable payment-related services such as SWIFT services and VAT-exempt services that have "the effect of transferring funds and entail changes in the legal and financial situation.”

One supply?

At the outset, the CJEU commented on whether the ‘card handling/booking fees’ were for stand-alone services or for services ancillary to booking. Whilst referring the assessment to the national courts, the CJEU recalled that the fact that a fee is charged and itemised separately on the invoice does not automatically imply that the supply is distinct from, ancillary to or part of the principal supply. It reiterated that particular relevance is whether from the end-customer’s perspective the payment-related service is an aim in itself or a means to facilitate payment of the underlying supply.

Exempt from VAT?

In both cases, the CJEU found that the card handling/booking fees are not exempt from VAT.

The rationale

In support of its conclusions, the CJEU argued that:
- It is solely the transfer of funds between the accounts that creates the change to the legal and financial situation of the parties, irrespective of its cause.
- Whilst the transmission of card data, authorisation codes and settlement files triggered, led to and were essential for the execution of a transfer, such did not warrant the conclusion that the services of Bookit and NEC were VAT-exempt. On the contrary, the services were administrative and technical in nature; and
- A characteristic of VAT-exempt transactions is the extension of the service provider’s liability for the achievement of the changes in the legal and financial situation, which characteristic was not clearly established in either of the references.

The implications

In our view, by applying established principles to the fact pattern of Bookit and NEC, the judgements fell short of providing head-on practicable guidance to clarify the demarcation between VAT-taxable and exempt payment-related services. One aspect seems certain - the breadth of the VAT exemption is thin. It is plainly a no-go to argue for the VAT exemption on the basis that certain functions are indispensable for funds to be transferred - credit and financial institutions currently applying this approach should review their position.

In times when paper money is being replaced by plastic and electronic-money and when payment services merely involve technological communication, it can be difficult to envisage the applicability of the VAT exemption to these processes, whether provided through apps, mobile phones, virtual accounts, payment gateways or other fintech solutions. This may translate into additional levels of VAT as payment services become more fragmented, despite the fact that when a buyer presses ‘Confirm Payment’ on any gadget, his expectation is that within seconds, the entire payment process is performed to ensure that the funds reach the merchant. For banks, their output supplies remain largely VAT-exempt as they partake in the act of altering the positions of their clients - they execute orders by debiting or crediting accounts. Yet, from a costs perspective, banks which outsource certain payment related functions such as automated rescheduling of obligations of credit card clients may need to endure an additional VAT cost. Such a hit to the bottom-line may be augmented if the Bookit interpretation is extended to outsourced handling and processing services related to exempt non-payment financial services, such as deposit management platforms.
The results of the UK referendum on European Union membership has been under the microscope in recent months, with the event being one of the most important in the history of the European Union. The outcome, which was a vote to leave the EU, has had a significant impact on economic performance, Brexit and migration.

Global overview
Several major events took place during 2016, all of which will influence the global economic climate in the near future. Terrorist attacks orchestrated by ISIS terror cells and lone wolves have unnerved the European public, adding to the tensions resulting from the influx of migrants and refugees from Syria and other war-torn regions. The publication of the so-called ‘Panama Papers’ has brought to light the role tax haven nations play in assisting tax avoidance by the wealthy. The much-awaited ‘Brexit’ referendum surprised global markets after the Leave campaign claimed a significant victory, and polls were once again proved inaccurate following Donald Trump’s victory in the United States Presidential Elections.

Global economic trends have remained consistent over the past few years. Global growth is mainly being fuelled by strong performance in developing economies in Asia. Growth in the US has been moderate but is expected to continue improving. In the Euro Area, low inflation, uncertain economic performance in key member states and the effects of the Brexit decision have all played a role in limiting immediate growth prospects. Over in China, the recent slowdown in economic growth is expected to continue, as investors look to shift their business to other developing nations which offer superior competitive advantages. Within OPEC, Saudi Arabia and Iran managed to reach a compromise agreement on limiting output, and both WTI and Brent surged, exceeding the $50 barrier.

European Union
The events of the past few years have left the European Union facing a multitude of challenges which require carefully considered action, and a focused, unified approach from all Member States. Three main challenges stick out in particular: overall economic performance, Brexit and migration.

The economies of the Euro Area are still recovering from the recent financial crises, austerity may have benefitted public finances to some degree, but reduced public expenditure and investment has delayed the much needed economic recovery. Trends over the past few years show growth in major EU economies converging to between 1% and 2%. This may be indicative of a slow return of consumer confidence, however it may not be sufficient to encourage the levels of investment necessary to build up the much needed resilience to economic shocks within European economies.

The results of the UK referendum on European Union membership has been damaging to investor confidence. As a result, some spill over effects are likely to be felt throughout the rest of the EU. Brexit also brings negative implications for the Maltese economy. The UK is the largest source market for the local tourism industry, and UK remains an important trading partner across other industries as well. The economic performance of the UK, as well as the strength of the Pound relative to the Euro will impact the consumption decisions of the British public.

The Maltese Economy
Over the last decade Malta has established a stable and resilient economy. Malta withstood the effects of the 2008 global recession, with the local financial services sector maintaining stability during the financial crisis whilst the more recent turmoil in the Euro Area also failed to stifle growth in the local economy. Real growth in Gross Domestic Product for the year 2015 was estimated in the region of 0.3%, an impressive figure given that recovery efforts across the EU have only recently started to bear fruit. Economic performance during the second quarter of 2016 was also respectable, with real GDP growth of 3% when compared to the same period in 2015.

Much attention has been given to the numerous high-rise construction projects planned around Malta. The projects will give a significant boost to the local construction industry and will serve to feed the demand seen by the real estate market. Recently introduced taxation on construction materials will also mean that these projects will generate additional revenues for government. The proposals have nevertheless been controversial due primarily to concerns over their visual impact and the suitability of existing sewage and road infrastructure.

The financial services sector continues to grow in importance as one of Malta’s most prominent and high value adding industries. During 2015, the sector accounted for over 7% of total Gross Value Added (GVA) generated in the country.

Industry Snapshot
The financial services industry is growing at a fast rate. Between 2011 and 2015, the Compound Annual Growth Rate (CAGR) for the industry was just over 4%, with growth between 2014 and 2015 of over 10% making it one of the fastest growing industries in the country and outperforming the overall nominal GDP growth rate of 8.8%. The latest data for Q2 2016 indicates that the industry is likely to continue seeing strong growth. Growth during the second quarter over the same period in 2015 was 8%.

Statistics published by the Malta Financial Services Authority (MFSA) indicate that as of September 2016, there are 27 licensed credit institutions (3 of which are foreign branches operating locally), and 41 licensed Financial Institutions in Malta.

Mark Bamber
Partner
Advisory Services

"The projects will give a significant boost to the local construction industry and will serve to feed the demand seen by the real estate market.”

Gross Value Added - Financial & Insurance Activities

Source: NSO, KPMG analysis

Malta’s Financial Sector

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Malta’s Financial Sector
In the insurance sector a total of 43 non-life, 7 life, 2 composite, and 6 reinsurance licenses were active as of the end of September 2016, indicating a new non-life licence has been issued since the end of 2015, and one Reinsurance licence has not been renewed. As of September 2016, there was also one license issued for a Reinsurance Special Purpose Vehicle.

Growth has also been seen in the number of locally registered retirement schemes. As at the end of September 2016, there were 44 registered retirement schemes, a growth of 8 since the start of the year, while the number of registered retirement funds has remained constant at two.

With regard to securities investments, as of June 2016 a total of 157 investment services providers were licenced by the MFSA. Over the three quarters of the year a total of 10 new licences were issued, and 2 licences were surrendered. Interested investors assessing local collective investment scheme structures will avail themselves of a wide choice. During the first three quarters of 2016 alone, a total of 82 new licences for collective investment schemes were issued, while 53 licences were surrendered.

Licences for Nominees and Trusts in terms of the Trusts and Trustees Act (2005) are continuing to be phased out following the introduction of the Trusts and Trustees Act (2005). As of the end of June 2016, 12 nominees and 71 trusts remain authorised under the old regulations. A total of 154 licences have been authorised under the newer regulations as of June 2016.

Throughout the first three quarters of 2016 a total of 3,709 new entities have been registered with the Registry of Companies, of these 3,628 were newly registered companies, and 81 were newly registered partnerships. This sustained increase in the number of registered corporate entities has also been a driving force for the rapid increase in company service providers. The licenses for Nominees and Trusts in terms of the Trusts and Trustees Act (1988) are continuing to be phased out following the introduction of the old regulations. A total of 154 licences have been authorised under the newer regulations as of June 2016.

When comparing data for the second quarter of 2016 with the same period in 2015, growth in employment does appear to be negligible. Over the course of one year, the total number of people employed by the industry rose to almost 8,889, an increase of around 0.8% when compared to Q2 of 2015. It is safe to say that financial services have today become fundamentally important to Malta’s economy, accounting for around 4.7% of total employment as at Q2 2016.

The industry in Malta also compares favourably to the EU average. European statistics identify that the main source of employment in the industry falls under the category of “financial service activities, except insurance and pension funding”. It is also interesting to note that the sector has managed to achieve a generally balanced gender split, an achievement when one considers the relatively low female labour participation rate prevalent in Malta. In fact the gender split in Malta is virtually equal to the EU average for the sector.

One factor worth noting from a socio-economic perspective is that this industry is one of the key drivers of the increasingly cosmopolitan nature of Malta’s resident population. With the tight labour market prevailing in past months, job creation growth sectors attract expatriate expertise and generates additional value added. The growth of the expatriate community in Malta enhances the attractiveness of the local market and contributes towards the materiality of indirect and multiplier impacts of local value added.

The financial services industry is one of the main pillars supporting the local economy’s backbone. The industry today employs around 8% of the total workforce and is enjoying an upward trend. Total staff employed by the industry in 2015 surpassed the previous year by around 5.5%, bringing the proportion of total employment generated by the industry up to 5%. Hence, from an employment perspective, the financial services industry has become comparable to other industries such as construction, which have been cornerstones of the local economy for decades.

““The financial services industry is one of the main pillars supporting the local economy’s backbone.”"
5. EU Audit Reform – A New Dawn

On 17th June 2016, new legislation was introduced into the European Audit and Non Audit Services sphere with the ultimate goal of enhancing auditor independence and transparency across the European Union.

The European Directive and Regulations were transposed into Maltese Law on 12th July 2016, through Act No. XXXVI of 2016 Accountancy Profession Act and Other Laws (Amendment) Act, with a 17th June 2016 effective date, in line with the EU requirements. Malta’s adoption of these new requirements is considered to adhere to the baseline measures, whilst also transposing almost all of the applicable derogations within the Law. The reform is founded on three main pillars namely: Mandatory Firm Rotation, Non Audit Service Restrictions and Audit Committee Oversight and Reporting.

“The EU Audit Reform has widened the scope and duties of Audit Committees. However, in reality, most of the requirements which have been imposed on Audit Committees through these Regulations represent current best practice, and in substance, the most significant change is represented by the fact that these requirements have now been enshrined into Law.

Audit Committees shall be mainly tasked with the monitoring of the Statutory Auditor’s independence and tenure. Members of the Committee are required to monitor and approve Non Audit Services provided by the Statutory Audit Firm, whilst also ensuring that, when applicable, the Non Audit Service Fee Cap of 70% is not exceeded. Prescriptive interpretation of the law has resulted in the identification of the fact that Non Audit Service Fees shall not be capped in the first three years, until a three year consecutive financial year average has been established. The Committee is also responsible for monitoring the Auditor relationship through the assessment of the Statutory Auditor’s tenure in order to ensure that the Mandatory Firm Rotation requirements are met. This has also brought about the requirement for Audit Committees to be responsible for the Statutory Auditor selection procedure. Such an audit tendering process is expected to present an increased scheduling challenge to Committees.

The reform is expected to bring about challenges from a pan European perspective in terms of its applicability to EU Public Interest Entity (PIE) Groups operating through different Member States and other European Economic Area States (“EEA”).

The EU Audit Reform has influenced the way we think and also promises to pave the way for increased Corporate Governance and Audit Firm independence across the European market. In essence, we believe that Audit Committees are now required to abide by legal requirements in terms of their financial reporting oversight and their responsibilities for procurement of audit and non-audit services, rather than be simply guided by best practices.

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Partner
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The EU Directives and Regulations have allowed various derogations which in turn has permitted Member States and other EEA States to implement the requirements with varying degrees of stringency, thereby having a potential impact over the convergence across the EU.

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Brought to prominence in the UK through Sir Adrian Cadbury’s ‘Report on the Financial Aspects of Corporate Governance’ in 1992, the duties of Audit Committees have evolved with successive reports and legislative changes.

“Corporate Governance is concerned with holding the balance between economic and social goals and between individual and communal goals … the aim is to align as nearly as possible the interests of individuals, corporations and society.”
(Cadbury, 1992)
The introduction of the new lease accounting standard IFRS 16: Leases, effective from 1 January 2019, will impact different sectors, from airlines, to banks and retailers. The impact on key reporting metrics of these different sectors will vary depending on the size of the lease portfolio. The International Accounting Standards Board (IASB) together with the US Financial Accounting Standards Board (FASB) carried out a study on the current lease accounting model applicable under IAS 17: Leases. The Boards concluded that this model brings about inconsistencies with other accounting standards since the characteristics of assets and liabilities recognised under the current standard are not in line with the definitions of an asset and a liability found in the conceptual framework.

The new right-of-use (ROU) model applicable under the new standard establishes a single method of accounting for all leases by lessees whereby, at inception of every lease (with few exceptions for small-ticket and short-term leases), the lessee recognises a ROU asset on the balance sheet representing the lessee’s right to use the asset. At inception, the lessee also recognises a lease liability representing the obligation to pay future lease payments to the lessor. On the other hand, accounting for leases by lessors under the new standard is relatively unchanged.

Banks undertake leasing arrangements both as lessees and as lessors. Additionally, they also assess lease arrangements throughout their lending activities. For the purpose of this article, the focus will be on banks as lessees and banks as users when analysing clients’ financial statements since lessor accounting will not change significantly from the existing standard.

Banks and other companies having current off-balance-sheet operating lease arrangements will register a substantial increase in assets and liabilities. This will impact financial ratios such as measures of leverage and performance. The new requirements will also impact the income statement due to a change in the nature of the lease expense. Under the new model, the current operating lease expense will be split into an operating component, representing the amortisation of the ROU asset, and a financing component, representing the interest on the lease liability. These changes will impact financial metrics such as earnings before interest and tax (EBIT). Moreover, whereas under the current standard an operating lease expense is recognised straight in line with profit or loss over the lease term, the total periodic expense for an identical lease under the new standard, comprising amortisation and finance costs, will be naturally front-loaded in the earlier years when finance costs are at their highest.

Banks as preparers of financial statements will have to exercise judgment in determining which arrangements meet the definition of a lease and whether the arrangement contains any non-lease components. For leases with multiple lease components and non-lease components (e.g. services), banks will have to develop estimates to allocate the consideration in the contract to each such component for accounting purposes. Banks will therefore incur additional implementation, ongoing compliance and administrative costs in order to comply with the new requirements as they develop new systems or modify existing ones.

The most notable impact on certain banks will be the on-balance sheet recognition of leased corporate facilities and branches which are currently being accounted for as off-balance-sheet operating leases. The recognition of a ROU asset on balance sheet might have implications on banks’ regulatory capital requirements as this might increase the risk-weighted assets and therefore potentially decrease their common equity Tier 1 capital ratios.

Banks as users of financial statements will potentially be affected by changes in the financial statements of other companies, especially when preparing business valuation methodologies and other contractual arrangements. In this regard, banks might also be required to change their prescriptive risk monitoring processes and criteria for both current and prospective clients. Due to the changes brought about by the new standard, companies with leases might also have to renegotiate debt covenants and other arrangements with their banks as a result of the change in financial ratios. Thus, it is very important that banks consider the impacts of such renegotiations.

The implementation of this new standard might also question lease versus buy decisions taken in the past as additional aspects may now need further consideration.
Under the Microscope

7. Living with the new reality of the Single Supervisory Mechanism (SSM) in 2016

One of the most significant announcements each year from the European Central Bank (ECB) is the formal confirmation of the supervisory priorities. Understanding these priorities, that are approved by the Supervisory Board, is essential to know where the ECB will direct their efforts during the year. For 2016 the ECB has chosen to follow on from the 2015 focus areas.

The five key supervisory priorities, identified for 2016 are:

1. **Business models:** Since its inception, the SSM has focused on business models and the ECB has asked banks to justify and provide evidence of the viability and sustainability of their own business models. In 2016, the ECB was committed to gain deeper insights, by looking at profitability drivers at the level of individual banks but also across business models. The ECB has confirmed this as the highest priority for 2016. Most see this ECB priority as a reaction to the widely-held belief that as a direct consequence of the swathe of regulation that banks have seen over the last couple of years, banks’ profitability has suffered mainly due to predominant board focus on regulation rather than generating business.

2. **Credit risk:** Elevated levels of non-performing loans (NPLs) still represent a serious prudential challenge in some European countries. A SSM Task Force has been established to develop consistent approaches on this issue. The Task Force will analyse current national regulations, legal frameworks, accounting regimes and supervisory practices relating to NPLs. Ultimately, the ECB is aiming for consistent supervisory practice in the area of NPL recognition, coverage and write-offs. This work may (will) result in intrusive guidance from regulators on how to tackle NPLs at individual bank level.

An associated topic is the implementation of ‘IFRS 9 – Financial Instruments’ (International Financial Reporting Standards). A thematic review will assess the potential impact of IFRS 9 on banks’ provisioning practices and how banks are preparing for its introduction. Banks are being consistently reminded to undertake a proper analysis of the impact of IFRS9 on their institutions since the impact could be significant.

3. **Capital adequacy:** The ECB is intent on assessing the quality of capital that banks have. The harmonisation of options and national discretions is part of this work as well as the introduction of minimum requirement of own funds and eligible liabilities and Total Loss-Absorbing Capacity (TLAC) requirements. As a result, the internal capital adequacy assessment process (ICAAP) of banks remained a focus during 2016 as well. In Malta we have witnessed banks issuing new paper, in line with CRDIV requirements, to meet their capital requirements. This has been a learning experience for both the institutions and the Regulator alike.

4. **Governance and risk appetite:** In 2015, the ECB performed a review of banks’ governance, for which the Joint Supervisory Teams assessed the organisation and composition of the management of the banks. As part of this, the sophistication of the risk appetite framework was under scrutiny. This theme is further developed in 2016 with the ECB choosing to focus on whether banks’ boards have at their disposal the risk information required to make sound business and risk management decisions. In addition, the ECB has formally indicated that it will carry out a thematic review of banks’ compliance with the Basel Committee on Banking Supervision’s principles for effective risk data aggregation and risk reporting. Finally, assessment of IT infrastructure will also feature under this area.

5. **Liquidity risk and its management** is the fifth priority for 2016. This was an area that surprisingly did not feature to date. The SSM will focus on the reliability of banks’ ILAAP. Banks vary considerably in the sophistication of their ILAAP processes and this may require significant effort from some institutions.

The list of priorities is wide and encompassing. The ECB’s use of on-site inspections and thematic reviews brings it into the position to ‘back-test’ individual bank’s standards versus a market standard. This horizontal view of supervisory issues is a key feature of SSM supervision. The challenge for banks is to ensure that they are aware of best practice in the industry, benchmark themselves against such practices and to integrate the resulting agenda into their own strategic planning and business initiatives.

The danger is that Less Significant Institutions (LSIs) - of which in Malta we have quite a few, may dismiss the above as being something that applies only to those banks that are directly supervised by the ECB. In reality what we are seeing in the market is that the above themes are influencing local regulators in their dealings with LSIs. The areas of focus are largely the same as regulators transfer over the knowledge that they have garnered in being part of the Joint Supervisory Teams supervising the larger banks, to their supervision of the smaller banks, albeit in a more proportional manner. There is no escaping the fact that the SSM is a force to be reckoned with for all and sundry.

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Juanita Bencini
Partner
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Under the Microscope

The Common Reporting Standard (CRS). Are you ready?

FATCA experience suggests that the main challenge for many has been the follow-up process: filling in the gaps required on customer information. We recommend setting targets for reducing the number of gaps in the required data fields as delays in follow-ups will snowball into a backlog of undocumented accounts, risking unwanted attention from the Inland Revenue. Furthermore, it is recommended that banks adopt a more global approach to data collection and request all customers to complete self-certifications on their tax residence and tax identification numbers, whether currently resident in a reportable jurisdiction or not. While this entails a greater data collection effort for banks at the outset, it will save banks having to remediate their entire customer base and ask customers for additional information in the future as more jurisdictions become reportable.

Drawing from the FATCA experience, risk and compliance have not been as integrated as we think they should be in Banks AEOI processes. We believe risk management needs to be a primary part of the CRS project, linking with different areas of the business (such as tax, operations, reporting, IT and legal) to paint a comprehensive picture of the risks involved, controls needed to mitigate risks, tests required, and any escalation process in case issues are identified.

Implementing the CRS project represents without doubt a draw on resources. Banks are thus faced with tough decisions about how to expand their capabilities to meet increasing regulatory demands. In such decisions, banks should consider strategic alternatives. Whilst additional internal resources may be required to handle the AEOI compliance project, consideration should be given to third party software or managed service solutions where reporting is outsourced to a third party service provider.

Making Global Information Reporting Manageable

There are several technological tools in the market that can make compliance more effective and efficient. The KPMG AEOI Reporting tool is a technologically led solution which accelerates and simplifies banks’ path to AEOI compliance. The tool embeds the XML behind the scenes, thereby removing the need for users to deal with the XML itself. This means that it converts systems data into the relevant correct reporting schema and maps, as well as capturing data from banks’ current systems (such as spreadsheets) and running validation in real time by checking the inputted data.

This tool can be provided to banks via a licence, or through a managed service where we securely take the relevant data and needed to mitigate risks, tests required, and any escalation process in case issues are identified. Implementing the CRS project represents without doubt a draw on resources. Banks are thus faced with tough decisions about how to expand their capabilities to meet increasing regulatory demands. In such decisions, banks should consider strategic alternatives. Whilst additional internal resources may be required to handle the AEOI compliance project, consideration should be given to third party software or managed service solutions where reporting is outsourced to a third party service provider.

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### Deadlines

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 September 2016</td>
<td>CRS Registration with Commissioner for Inland Revenue</td>
</tr>
<tr>
<td>31 December 2016</td>
<td>Due Diligence Procedures necessary to identify high value pre-existing individual accounts</td>
</tr>
<tr>
<td>30 April 2017</td>
<td>Reporting in relation to pre-existing high value individual accounts and new entity accounts</td>
</tr>
<tr>
<td>31 December 2017</td>
<td>Due diligence procedures required to identify low-value pre-existing individual accounts and entity accounts</td>
</tr>
<tr>
<td>30 April 2018</td>
<td>Reporting in relation to pre-existing low value individual accounts and pre-existing entity accounts</td>
</tr>
</tbody>
</table>


“CRS is now live in Malta and approximately 60 other jurisdictions, with key CRS deadlines fast approaching.”
The value of equity capital currently invested is generally the bank’s book value of equity. Although still susceptible to
accounting decisions, a bank’s book value of equity tends to offer a more reliable measure of equity invested than for non-
financial service firms:

1. A bank’s assets are often financial assets that are either marked-to-market or repriceable within a short period of time and
thus, deviations between book and market values are usually not that significant; and
2. Tangible assets are normally a small item on a bank’s balance sheet resulting in depreciation being minimal.

Excess return, on the other hand, is estimated as the difference between the return expected to be earned by a bank on its
equity and its cost of equity when applied to the actual equity invested. Hence, a bank not only has to consider where it will
direct its future investments but also needs to take a view on the returns it expects to generate therefrom.

In practice, multiples of comparable banks and/or comparable transactions are also often used to determine a bank’s
value either as a first cut high-level valuation or as a cross-check to the Excess Returns based valuation. The two most widely
used equity multiples are price/earnings and price/book value multiples. Over the period 1 July 2014 to 31 July 2016, 49
transactions were closed involving the acquisition of commercial banks in the European Economic Area (EEA) for which the
purchase price was disclosed, based on the search criteria below. These transacted at an implied price/book value of around
10x. The publicly disclosed implied median and mean price/earnings multiples of such transactions were of 13.0x and 15.2x,
respectively.

<table>
<thead>
<tr>
<th>Purchase Price (EUR m)</th>
<th>Price / Book Value</th>
<th>Price / Earnings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>309</td>
<td>0.9</td>
</tr>
<tr>
<td>Median</td>
<td>131</td>
<td>1.0</td>
</tr>
<tr>
<td>No. of transactions excluding outliers</td>
<td>45</td>
<td>14</td>
</tr>
<tr>
<td>No. of transactions with data</td>
<td>49</td>
<td>17</td>
</tr>
</tbody>
</table>

Source: Market data provided by S&P Capital IQ. Selected transactions consist of acquisitions of a majority stake in commercial banks within the EEA closed
between July 2014 and July 2016.

Note: Total number of transactions amounted to 109. Three outliers were excluded in the computation of Price / Book Value and Price / Earnings.

Although the multiples approach is simpler to understand and apply, it nevertheless has to be used with caution as it may fail
to capture the real drivers of a bank’s value and the inaccuracies of the market in real time can significantly distort the view of
long-term value.

“My goal as Chair of the Supervisory Board of the ECB is to achieve a common euro area banking market in which cross-border
banking mergers would take place, and this would create a truly homogeneous banking system within the Single Supervisory
Mechanism” Danièle Nouy, Chair of the ECB Supervisory Board, 23rd August 2016.

It remains a clear goal for the ECB, through the Single Supervisory Mechanism to support mergers and acquisitions of/
between existing banks, to allow for greater consolidation of players in the European banking industry. The European banking
playing field is plagued by many overcapacities in the sector, particularly in fragmented banking markets, and consolidation may
result in economies of scale and a reduction in the cost-income ratios of banks. Consolidation may also improve the current
substantial discount to book value of banks.

9.

The Art of

Valuing Banks

One of the most widely used methods for a bank’s valuation is the Discounted Cash Flow (DCF) methodology, which looks at the economic benefits that a bank expects to
generate going forward and converts these to free cash flows, typically cash flows after tax and reinvestment but before debt payments. These are then discounted to
present value using the weighted average cost of capital to arrive at the enterprise
value, which relates to the value of both equity and debt holders. Considering the inputs required to undertake such a valuation, it is clear that there are a number of
challenges that stem from factors that characterise the business of banking.

What are the key items to valuing banks?

Banks, in particular retail banks, generate their income primarily from the spread
between the interest paid on customer deposits and that charged on customer
loans. Customer deposits, which could fall under the definition of ‘debt’, is therefore
something which is moulded by banks into other products and then sold to customers
at a margin. Hence, debt to a Bank is more akin to a raw material than merely a source
of capital.

Similarly reinvestment takes on a different form as banks invest primarily in their
people, brand and regulatory capital. Also, given the nature of their business, banks
do not have inventories and typical accounts receivable and payable on their books
resulting in the traditional concept of working capital being largely inapplicable.

When valuing banks another angle to consider is the regulatory dimension that
governs them. In particular, assumptions relating to growth and reinvestment have to be in line with regulatory requirements. A bank’s regulatory environment has to
be carefully considered when measuring risk – changes or expected changes in this
respect add a further layer of uncertainty to a bank’s future outlook resulting in higher
risk.

What valuation methodology may be utilised when valuing banks?

Since a bank’s capital is narrowly defined as equity, as opposed to debt plus equity,
equity valuation models should be used when valuing banks. An approach widely used
is the Excess Returns valuation method. In this method of valuing banks, the value
of a bank is derived by using the bank’s current book value (shareholders equity) as a
starting point. This approach then calculates the additional book value that the bank
will create each year and discounts this value back to the present at the cost of equity.
This implies therefore, that a bank that earns the fair market rate of return, the cost of
equity, on its equity, should see the market value of its equity converge to the equity
capital currently invested in it.

94 Under the Microscope

Hermione Arciola
Director
Deal Advisory

David Pace
Partner
Deal Advisory

...it is clear that there are a number of challenges that stem from factors that characterise the business of banking."
The banker, in the meantime, is like that fisherman who wades through shallow yet murky waters obliged to make a return by catching the odd snapper to take home but then risks walking over a sea urchin, hitting the rocks or perhaps encountering the freak shark. The fisherman continues to be hampered by the use of flotae, flippers and anti-shark repellents which makes fishing often impossible. In the same way, our banker has to make sure that client acceptance and ongoing monitoring procedures and other anti-money laundering procedures are applied more rigorously at the cost of extending the transaction completion period to frustrating lengths.

Perhaps there was never a better moment than today that the popular Maltese catch phrase “korerra ha aporter meta konn agàrb” (We were better when we were worse off) described the banking industry well.

Traditionally, the Maltese placed their savings with local banks. This used to earn them a decent return to supplement their earnings and pensions. Only a small percentage held foreign investments on listed exchanges (then principally in the UK). It was only in the early 1990s that companies in Malta embarked on listing their shares and issuing debt as a means of funding their operations from the domestic capital market. At the time, the first movers were the banks in which government had a stake. It sold part of the shareholding to the public as part of the privatisation strategy at the time.

Since then, the number of issuers having debt and equity securities listed on the Malta Stock Exchange increased significantly as has the number of people venturing to invest in foreign listed securities as brokers in Malta became more active and the market more sophisticated. The setting up of the first investment funds also happened around the same time with retail funds attracting a modest interest. As of today, there is an estimated €3.2 billion worth of retail funds out of a total of €10 billion Maltese registered Assets under management.

I have not carried out an empirical analysis of the state of liquidity in Malta, yet it is not very difficult to observe the current state of affairs. Perhaps one of the best tests to measure this is the increase in customer deposits in our banking system. Deposits from customers in our core banks is estimated to have increased by €2.5 billion over the last 12 months. In percentage terms, this equates to an increase of around 17%, and it is estimated that some €18 billion deposits are retail in nature. So one observation is that the increase in customer deposits over the last 12 months alone represents 80% of the current size of the retail funds market in Malta.

Now, most of these deposits are being left in current or savings accounts earning zero or negligible interest. For instance, if one were to look at Bank of Valletta plc and HSBC Bank plc, demand deposits account for more than 70% of customers deposit liabilities, and even if customers decided to shift their bank savings into longer term products, the yields are today likely to remain exceptionally low.

When considering that the focus of the Island’s economy is presently revolving around construction, financial services, tourism and gaming, banks seem to have a digestion problem in dealing with its liquidity when it comes to the transformation of deposits into loans. 

"When considering that the focus of the Island’s economy is presently revolving around construction, financial services, tourism and gaming, banks seem to have a digestion problem in dealing with its liquidity when it comes to the transformation of deposits into loans."
Focusing on non-interest earning activities such as foreign exchange, commission income, bancassurance, asset dealing with the excess liquidity with a view to mitigate the negative impact on performance as much as possible. Particularly for the larger banks sifting through the good from the bad apples before approving loans in a market that is keeping up with compliance requirements and finding the right people for the job (without mentioning cost). It is ‘fish’ for thought – have we come to a point where the fisherman has now progressed to a big boat that albeit removes the risk of hitting the bottom because of the use of sophisticated equipment, is fishing in an area where there is limited big fish and too many fishing boats. The area has been principally turned into an attraction for water activities and the fishing boats have fishing constraints. In the meantime, costs of keeping the boat running are escalating and it may well be that the boat has become too big. The fisherman may need to rethink his position: does he need to go out to deeper waters with all the risks and rewards which that carries with it, should we downsize and go back to those areas where his bigger boat does not reach, or should he actually refit the boat that would enable it to do other things, or is it a question that he is never satisfied. After all, he did manage a larger boat and the catch has been good for a number of years for most fishermen. At the end of the day, whatever fishermen decide to do, there will still remain fish in the water (perhaps not in the same area) and people still craving for fish (perhaps it’s time to switch to sushi).
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KPMG Malta is part of this network of motivated and highly-skilled individuals. Our staff complement in the local practice amounts to 260 employees, including 29 principals.

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