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Small Countries, Big Banking Systems: How Malta And Luxembourg Differ From Cyprus

Primary Credit Analyst:
Benjamin J Young, London (44) 20-7176-3574; benjamin_young@standardandpoors.com

Secondary Contact:
Frank Gill, London (44) 20-7176-7129; frank_gill@standardandpoors.com

Analytical Group Contact:
SovereignEurope; SovereignEurope@standardandpoors.com

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Standard & Poor's Ratings Services believes that the combination of factors behind Cyprus' difficulties is not currently likely to be replicated elsewhere in Europe. The domestic banks based in Luxembourg and Malta are considerably smaller as a proportion of GDP than the large headline figures suggest. In our view, their domestic banks are not exposed to high and deteriorating credit risk to the extent of Cyprus' banks.

The Cypriot banking crisis was born on the asset, not the liability, side of banks' balance sheets. The banks didn't fail because of the providence or the size of their customer deposits. In our view, similar to the Icelandic and Irish banks and the Spanish cajas before them, the Cypriot banks' difficulties are the result of their lending--not their borrowing--decisions. Assets in Cypriot banks consisted of, in part, impaired loans to the Greek public and private sectors, and were ultimately worth far less than the banks' liabilities. Equity capital was insufficient to make up the difference.

Overview

- We view Cyprus as being in a fairly unique situation, with limited direct implications for other small financial-services-focused sovereigns.
- Cyprus' current difficulties can be attributed primarily to the Greek public- and private-sector defaults to Cyprus' large domestic banks, rather than to past inflows of CIS-based deposits.
- The domestic components of the banking systems in Malta and Luxembourg are far smaller than Cyprus' as a percentage of GDP, with considerably stronger asset quality, in our view.

The size of a banking system alone generally doesn't indicate the likelihood of failure, but it can be seen as a good measure of the potential costliness of a bailout. We typically assume that, when a banking system is in crisis, the sovereign will attempt to bail out that part of the banking system that lends to and borrows from the domestic economy. In Cyprus, this component became too large for the government to save, with total assets at 5.3x GDP at end-2012. Of this, the exposure of domestic banks to Greece and Greek customers totaled 170% of GDP.

Cyprus' case was, in our view, also unusual for another reason: nonresident deposit financing of domestic banks was, overwhelmingly, supporting other economic sectors, in particular business services and real estate. Together with financial services, these sectors represented some 50% of the country's GDP, and a large part of the country's exports, catering to Russian and CIS-based clients. Further complicating the picture, the distinction in Cyprus between "resident" and "nonresident" has always been blurred. What is certain, however, is that Cyprus' banking and business services sectors had both long been major employers, with close ties to the tourism sector.

In our view, no other economy in Europe matches Cyprus' profile of constrained fiscal flexibility together with a financially concentrated economy. Only Ireland comes close in terms of the scale of its banking crisis and the connection between the banks and domestic real estate and private-sector employment. The Irish government--including the National Asset Management Agency--took on an additional 100% of GDP of debt to cover the costs of recapitalization and second-round fiscal deterioration. But the diversity and underlying competitiveness of the Irish economy, its capacity to restructure and to attract substantial net inflows of foreign direct investment, and its clean pre-crisis public balance sheet helped stabilize public debt levels in the context of Ireland's brightening growth prospects.

Nonresident Deposit Growth Wasn't The Direct Cause Of Cyprus' Difficulties

In our view, the rapid and substantial growth of Cyprus' external deposit liabilities (attributable in part to oil price increases and Cyprus' adoption of the euro) did not directly cause its current predicament (see chart 1). However, when we consider the speed of growth of Cyprus' leverage, particularly in the corporate sector, it appears clear to us that there was significant spill-over of non-resident funds into the domestic economy compared with developments in Malta (chart 2). As of September 2012, the Bank of Cyprus' deposit liabilities were about 160% of GDP alone. This was despite prudential requirements governing the usage of non-euro deposits (70% is required to be kept liquid).

Chart 1

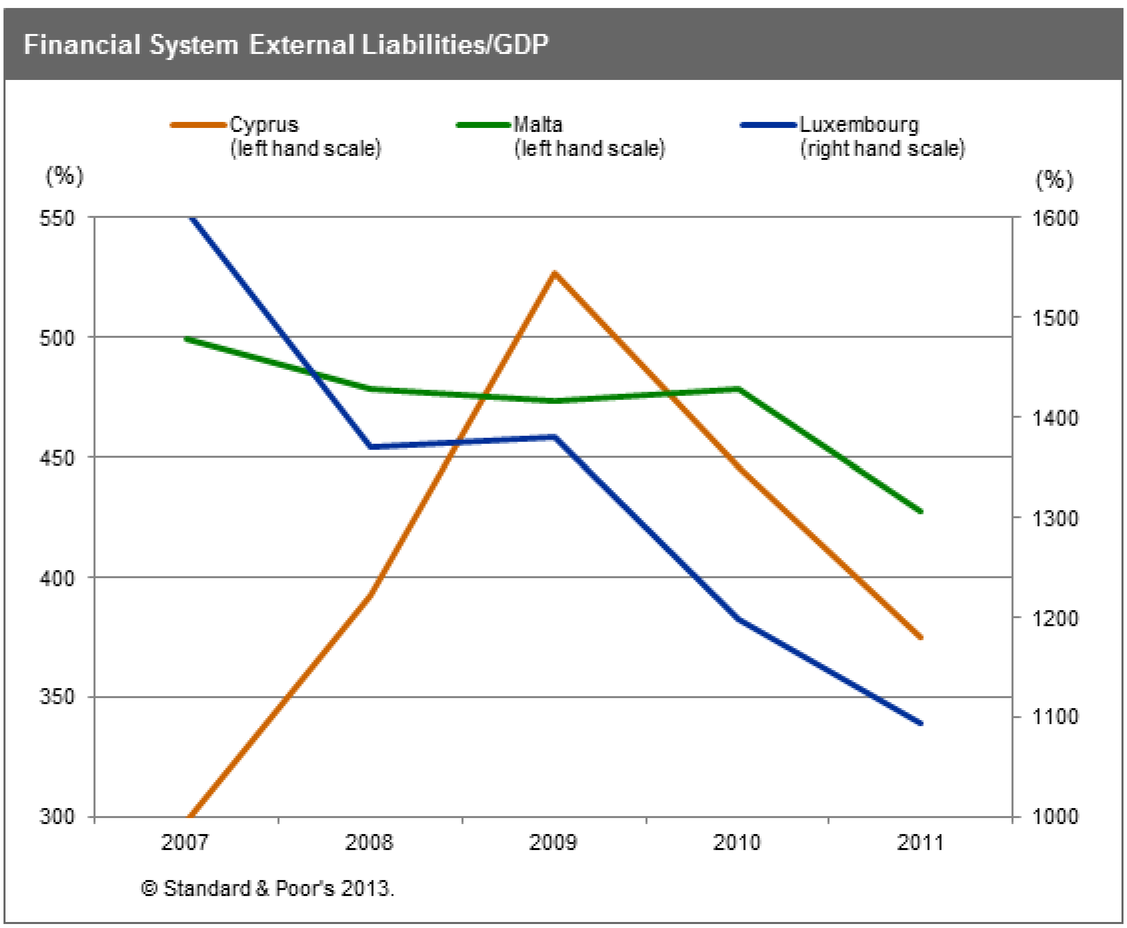
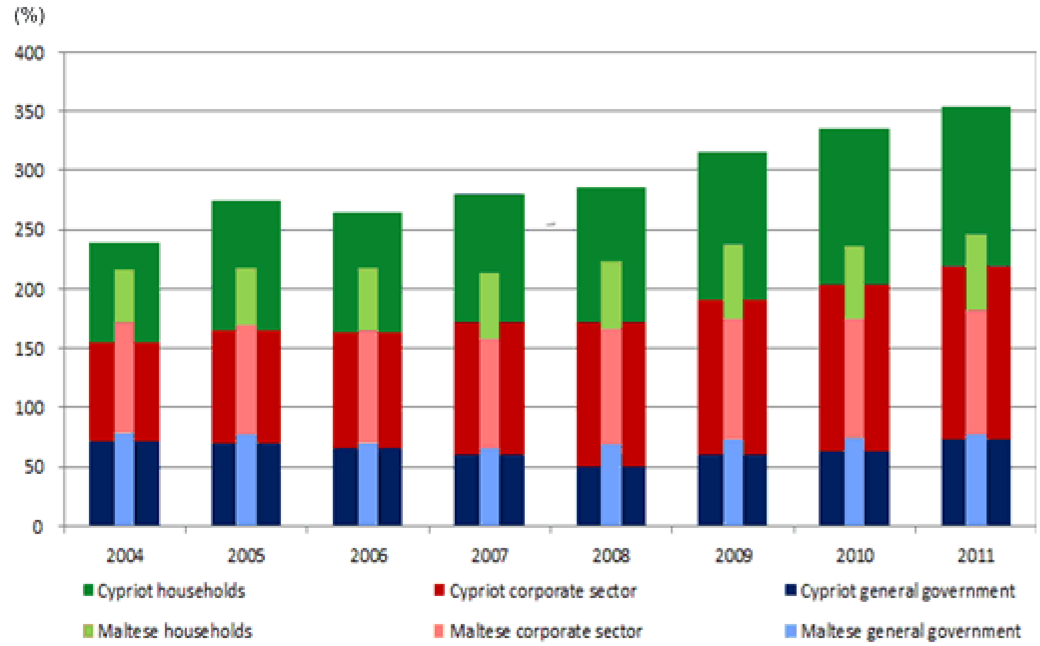


Chart 2

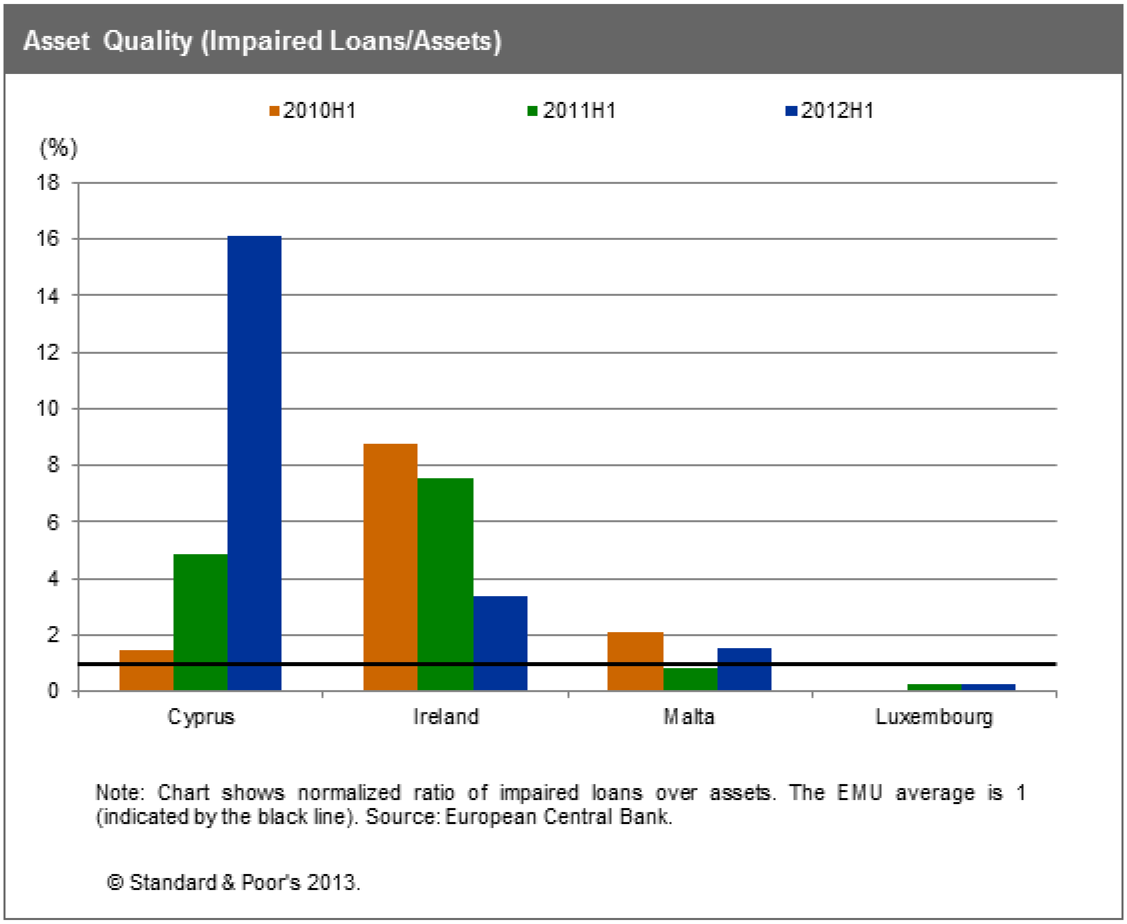
Cyprus And Malta: Debt By Sector/GDP



Source: European Central Bank.

On the asset side, impaired loans increased rapidly in Cyprus (see chart 3). In first-half 2012, Cyprus had 16x the European Economic and Monetary Union (EMU or eurozone) average of impaired assets. In contrast, asset quality has been relatively stable in both Luxembourg and Malta. That said, we believe the financial sectors in both Malta and Luxembourg do face individual challenges, with implications for their real economies. We also note that asset performance indicators do not necessarily indicate that exposures will not deteriorate.

Chart 3



Malta's Internationally-Oriented Banking Is Separate From Domestic Activity

The size of Malta's financial system is large relative to the economy's output. However, we see a limited contingent liability for the government, in a downside scenario.

Malta's financial system, with total system assets of about 7.6x GDP, features a relatively clear delineation between international and domestic banking activity. This separation, in our view, results in almost no spill-over from international activities into Malta's domestic economy. As is the case with Cyprus, our baseline assumption is rather that the Maltese government would support only those banks that take deposits and lend domestically. Assets of these institutions total 2.7x GDP.

HSBC and Bank of Valletta (together 180% of GDP or about 70% of total domestic assets) dominate the domestic system. Malta has also attracted several foreign banking groups, in part through an advantageous regime in which enterprises can reduce their tax liabilities via a series of dividend reimbursements. The largest international banks are subsidiaries of Turkey's Akbank and Garanti Bank with combined assets of about 360% of Maltese GDP. Other foreign participants are mainly from Austria and the U.K.

The Turkish banks use Malta as a booking center for foreign-exchange loans. They do not intermediate with the local economy. They neither take local deposits, nor lend to Maltese residents nor hold any government paper. We believe that if a Turkish bank were, hypothetically, to cease operations in Malta, the result would likely be at worst a minor shock to the economy and nothing like recent events in Cyprus. We expect that Maltese central government fiscal revenues might suffer on the margins, but the real economy would remain more or less unscathed.

We understand that the Maltese authorities do not view local branches of large Turkish banks as systemically relevant. Therefore we would not expect the government to provide financial assistance to them, even in case of need. Further, we expect that if HSBC's Maltese subsidiary found itself in difficulty--which is not our base case--that its U.K. parent, HSBC Bank PLC, would likely extend assistance. HSBC Bank PLC's issuer credit rating is higher than that of the Republic of Malta, and its Maltese subsidiary's assets are what we view as a negligible proportion of the group's balance sheet.

Malta's domestic banks' asset concentration is in the local economy; most are retail-deposit-funded, with loan books diversified in different sectors of the Maltese economy. Domestic deposit levels have been traditionally stable (at about 185% of GDP). However, exposure to domestic real estate is high and property prices have been through a series of corrections. While asset quality may deteriorate further, we expect overall impairments to remain relatively contained. There appears to be little exposure to eurozone "periphery" sovereign or bank debt. We understand that international operations of the large domestic banks are funded by international liabilities (mainly North African interests). Similarly, we do not expect substantial spill-over into the local economy from liabilities collected abroad through the domestic banks, as was the case in Cyprus.

There are several smaller domestic banks with atypical business models. We understand that some specialize in lending to construction companies and some collect domestic deposits through competitive interest rates, which are then used to purchase higher yield securities, sometimes including sovereign debt. With general government debt at about 75% of GDP, the government's ability to assist these banks, if needed, is limited, in our opinion.

Strong Asset Quality And Prudent Capitalization Bolsters Luxembourg's Financial System, But Its Business Model Faces Headwinds

Luxembourg's financial system is essential to its economy, as was the case with Cyprus. As a financial center, we believe it is well diversified with a large funds business, private wealth management, insurance, and group liquidity functions. With assets of nearly €800 billion (about 1,750% of GDP), its banking system clears a significant amount of parent-subsidiary transactions, predominantly from German and French groups, and also manages a substantial amount of global private wealth. The system's international orientation is closely linked to its location at the geographic center of Europe. The strength of the government's balance sheet (general government debt was 21% of GDP in 2012) would, in our opinion, be sufficient to assist systemically important banks (whose assets total some 220% of GDP). The government has also extended assistance to subsidiaries of the former Fortis (now Banque Générale du Luxembourg [BGL]) and Dexia (now Banque International à Luxembourg).

Luxembourg's core domestic banks (Banque et Caisse d'Epargne de l'Etat [BCEE]; BGL; and Banque International à

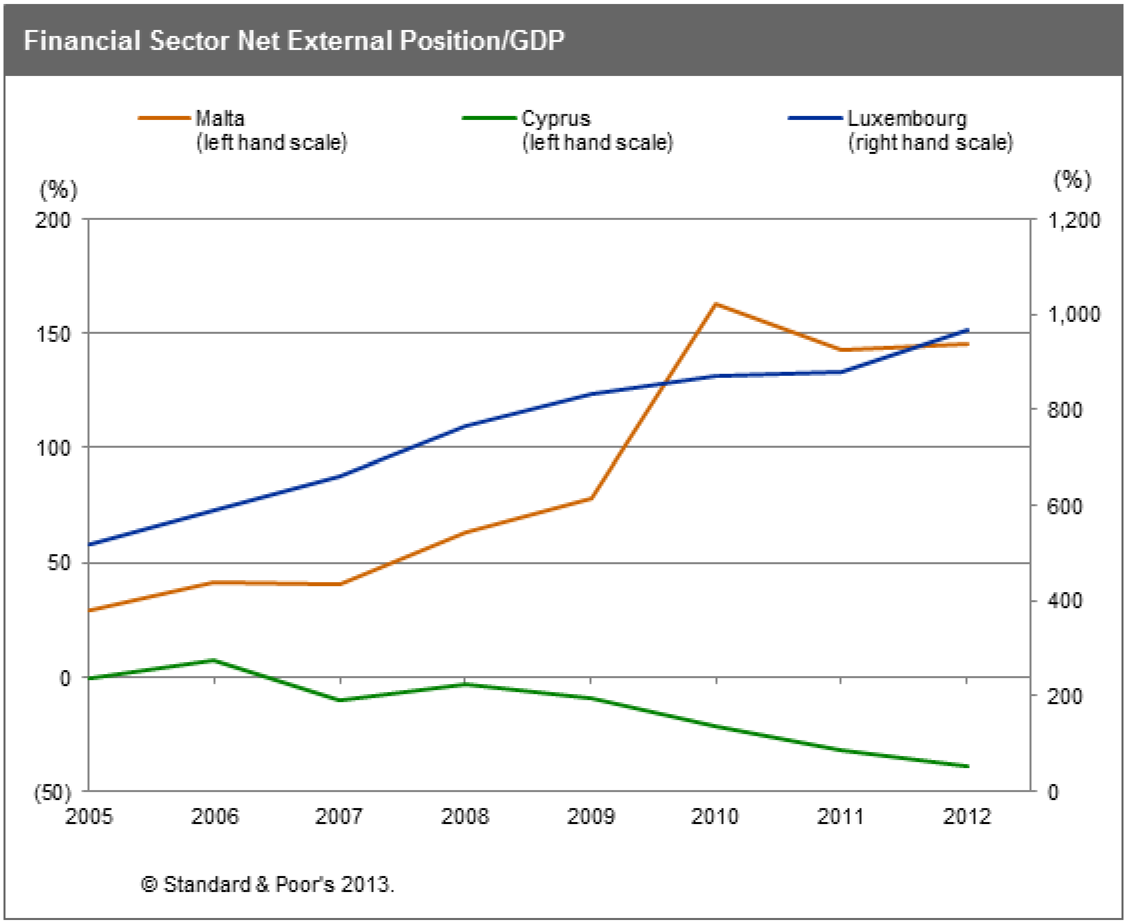
Luxembourg) do hold a significant portion of consolidated assets abroad, mostly in security holdings. Asset quality has held up throughout the global financial crisis (chart 3). Holdings of troubled sovereign debt are limited; most exposures are to neighboring core eurozone countries. The aggregated balance sheets of Luxembourg's banking system illustrate a significant degree of international activity, however. Nondomestic exposures represent, on average, 75% of assets. BGL is the most internationally active of the three main systemically important banks: Of its total credit exposure at end-2012, 67% was abroad, predominantly in France, Germany, Belgium, and the U.K. On the liability side, almost 70% of system deposits are of nonresident origin. However, the domestic economy has little reliance on foreign funding, with resident deposits exceeding loans to residents. Most of the rest of the three banks' loan portfolios comprise domestic commitments, which we also view as sound, with nonperforming loans of 1.3% on Dec. 31, 2012.

We also classify Luxembourg's bank capitalization as prudent as illustrated by their high regulatory capital ratios. In particular, we assess BCEE's capitalization as "strong," taking into account our risk-adjusted capital ratio for the bank of 14.5% at Dec. 31, 2012 (see "Banking Industry Country Risk Assessment: Luxembourg," published Dec. 27, 2012).

While funds flow into Luxembourg's financial system mainly from France, Germany, and Belgium, investors from further afield are commonplace, which helps explain the system's huge external assets and liabilities. Though the size of the financial system may increase its vulnerability to external shocks, it is in a strong net external creditor position of 965% of GDP. This contrasts markedly with Cyprus' net debt position of 40% of GDP (see chart 4).

Under an adverse scenario, such as stress at the parent level, Luxembourg-based subsidiaries could face liquidity withdrawals or accelerated upstreaming to parents. Therefore, we view the health of parent institutions as of key importance to Luxembourg's financial system. However, we would not expect these costs to migrate to the government's balance sheet. Rather, the impact would be felt through reduced tax receipts, disturbing the real economy through, for example, reduced employment, related weaker private consumption, and lower services exports.

Chart 4



Another key risk for Luxembourg, and also Malta, may lie in the EU's regulatory environment. Uncertainty over the extent to which pending regulatory changes--such as the introduction of a financial transaction tax or demands for increased banking transparency--will reduce incentives to do business in these jurisdictions is, in our view, a risk to their business models. However, we believe authorities also recognize that retaining reputational value is key to retaining the confidence of nonresident investors.

Malta And Luxembourg Differ From Cyprus

The size of systemic domestic institutions that Malta and Luxembourg would theoretically need to support in a crisis is a fraction of the 530% of GDP in total assets amassed by Cyprus' domestic banks. Also, while banks in Malta and Luxembourg do take significant foreign deposits, foreign liabilities fund domestic assets only to a limited extent in both jurisdictions.

Meanwhile, assets in Malta and Luxembourg have retained their credit quality, and exposures to insolvent borrowers have remained low and manageable. Further, no banks in Malta or Luxembourg currently rely on financial support from the Emergency Liquidity Assistance (ELA). Cypriot banks' dependency on the ELA intensified during the program negotiations between the Cypriot government and the Eurogroup since 2012.

We therefore see limited direct implications from the Cypriot banking failure for Malta and Luxembourg.

Related Criteria And Research

- Outlook On Cyprus Revised To Stable On Rising Likelihood Of Financial Assistance; Ratings Affirmed At 'CCC/C', April 10, 2013
- How The Cyprus Bailout May Affect Senior Creditors Of Eurozone Banks, March 27, 2013
- Credit FAQ: The Cyprus "Bail-In" And Its Aftermath, March 21, 2013
- Research Update: Long-Term Rating On Malta Lowered To 'BBB+'; Outlook Stable, Jan. 16, 2013
- Malta (Republic of), Jan. 31, 2013
- Luxembourg Outlook Revised To Stable; 'AAA/A-1+' Ratings Affirmed, Jan. 14, 2013
- Banking Industry Country Risk Assessment: Luxembourg, Dec. 27, 2012