Fitch Affirms Malta at 'A'; Outlook Stable

Fitch Ratings, London, 18 February 2016: **Fitch** Ratings has affirmed Malta's Long-term foreign and local currency Issuer Default Rating (IDRs) at 'A' with Stable Outlooks. The issue ratings on Malta's senior unsecured foreign and local currency bonds are also affirmed at 'A'. The Short-term foreign currency IDR is affirmed at 'F1' and the Country Ceiling at 'AAA'.

KEY RATING DRIVERS

Malta's IDR and Stable Outlook reflect the following main factors:

- Fitch expects the Maltese economy will continue to outperform Eurozone peers, with a projected average real GDP growth of 3.2% in 2016-2017, broadly in line with the 'A' median. Exports' contribution to growth will rise gradually as external demand recovers and investment slows. Tertiary industries will remain the main engine of growth, in particular the pharmaceutical and gaming industries, healthcare services and tourism. Growth will be down from an estimated 4.7% in 2015 due to the completion of large-scale energy investment projects and the expiration of the EU funding cycle.

- Malta's external position compares favourably with 'A' rated peers, with a net international investment position estimated at 35% of GDP in the first quarter of 2015. The current account surplus is set to improve in 2016 as large import-intensive investments related to energy projects fall. Recovering external demand will support a gradual increase in services exports, which, along with sturdy tourism inflows, will push up the current account surplus to a projected average of 3.1% of GDP in 2016-2017. The ongoing improvement of the external position both rests on a steep acceleration of service exports, denoting the structural shift of the economy towards more added-value sectors, and significant revision of external data in 2014.

- Malta's headline fiscal deficit is lower than the 'A' median and is expected to narrow further, due to strong growth and consolidation. The deficit is forecast to narrow to 1.1% of GDP in 2016 and 1% of GDP in 2017, down from 1.6% of GDP in 2015. Key to the improvement in 2016 is the assumption that no additional capital injection will be required for Air Malta as the company returns to profitability. Revenues will grow at a slower pace than nominal GDP, notably due to the reduction in income tax for those on low incomes, while the pension reforms included in the 2016 Budget and the upcoming wage settlement will push up public spending.

- General government gross debt is on a declining trend and is estimated at 64.3% of GDP at end-2015 from almost 70% in 2013. It is set to decrease further over the medium term to 60.5% in 2017, but remain well above the 'A' median of 44.5% of GDP at end-2015. This is on the back of an improved primary surplus and strong nominal GDP growth. A slowdown in growth or a rapid increase in expenditure are the main risks to debt reduction.

- Government-guaranteed liabilities stood at 16.8% of GDP in 2015, among the highest in the European Union. Risks stemming from the potential crystallisation of contingent liabilities, the majority of which related to utility company Enemalta, are however reducing. After its partial privatization in 2015, the company has improved its balance sheet and paid-off arrears to the government. The construction of an interconnector with Italy and completion of two gas-power plants should further help by reducing energy import costs. The company is expected to return to profitability this year, limiting any additional support from the government.

- The Maltese banking sector is robust, despite its substantial size (538% of GDP as of September 2015). Capitalization and liquidity ratios of systemically important core domestic banks (representing 239% of GDP) are well above the minimum regulatory requirements, at 13.9% and 52.1% respectively as of June 2015, and profitability is improving. The sector is however largely concentrated with the two largest banks – Bank of Valetta and HSBC Bank Malta – holding more than 80% of loans to residents and more than 90% of deposits. Banks are also highly exposed to the sovereign through the holding of securities and financing of government-related entities, and to the housing market, as real estate and construction represent the bulk of the loan portfolio and two-thirds of bank loans are secured by real estate collateral.

RATING SENSITIVITIES
Future developments that could individually or collectively, result in positive rating action include:
-A further track record in consolidating the public finances that leads to a lower government debt/GDP ratio.
-A significant decline in contingent liabilities.

Future developments that could individually or collectively, result in negative rating action include:
-Significant slippage from fiscal targets leading to deteriorating public debt dynamics.
-Crystallisation of material contingent liabilities or a shock to the banking sector that requires fiscal support.

KEY ASSUMPTIONS
Fitch assumes that in case of need, the government of Malta would only be predisposed towards supporting the core domestic banks, which are systemically important, in particular Bank of Valletta (102% of GDP) and Mediterranean Bank. For HSBC Bank Malta (89% of GDP), Fitch believes that any necessary support would come from its parent company. In Fitch's view, the Maltese government would be very unlikely to support the international banks and would probably not support noncore banks either.

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