BANK ĊENTRALI TA' MALTA
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The Countercyclical Capital Buffer Rate

June 2017
Financial Stability Department

The Countercyclical Capital Buffer (CCyB)

In accordance with Article 136(7) of EU Directive 2013/36/EU, transposed in the Central Bank of Malta Directive 11 “Macro-prudential Policy”, the Central Bank of Malta is hereby notifying its decision on the applicable buffer rate for the third quarter of 2017.

Notification

- The applicable countercyclical capital buffer rate: 0%
- The relevant credit-to-GDP ratio: 84.6% and its deviation from the long-term trend: -24.8 percentage points.
- The buffer guide: 0%

Analysis

The aim of the countercyclical capital buffer (CCyB) is to protect the banking sector from losses that could stem from the build-up of excessive credit growth. The CCyB is built during the upswing of the financial cycle, to absorb losses that may arise in a subsequent downturn, without interrupting the supply of credit to the real economy.

The Central Bank of Malta assesses variables related to private sector lending and other banking sector indicators with the aim to decide on the need for activating the buffer. This note provides the rationale for the proposed buffer rate to be set at 0%.[1] The main indicator backing this proposal is the deviation of credit-to-GDP ratio from its long-term trend. The analysis is also supplemented by a sub-set of additional quantitative indicators and expert judgement.[2]

Indicators used in the assessment of the countercyclical capital buffer rate

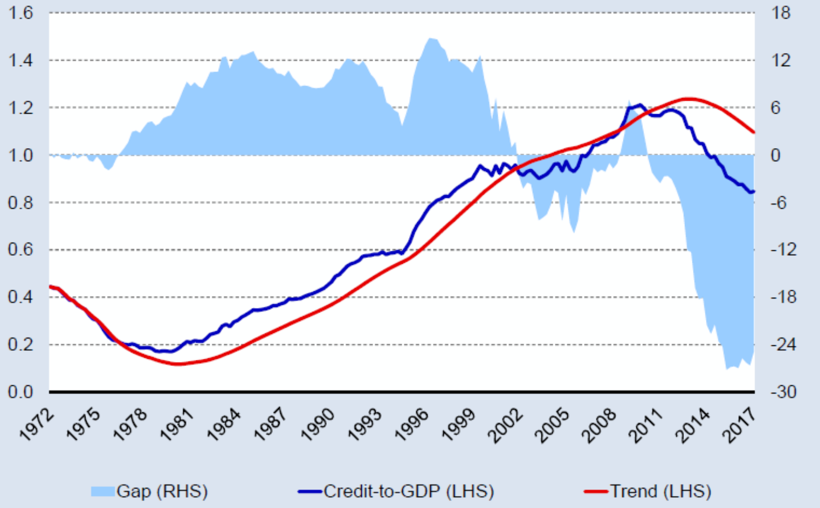
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of a one-sided Hodrick-Prescott (HP) filter of the

[1] The analysis is based on the guidelines issued by the European Systemic Risk Board (ESRB) and Bank of International Settlements (BIS) as well as the experience of relevant international and European authorities.

[2] ESRB/2014/1 - Recommendation on the Guidance for Setting Countercyclical Buffer Rates.

credit-to-GDP ratio for Malta.[3] The trend represents the smoothed version of the actual series of the ratio of credit-to-GDP, both plotted on the left hand axis. The gap between the two is reflected in the light blue histogram which is plotted on the right-hand axis.

Chart 1
HODRICK-PRESCOTT FILTER (LAMBDA = 400,000) APPLIED TO THE CREDIT-TO-GDP RATIO
(per cent; percentage points)



Source: Central Bank of Malta calculations.

In the first quarter of 2017, the credit-to-GDP ratio narrowed slightly to 24.8pp below the trend, in line with 2015 levels. Nevertheless the gap remains significantly negative, with the CCyB rate of zero still remaining appropriate. Furthermore, based on historical developments, the narrowing of the gap is expected to take several quarters before it returns in positive territory.

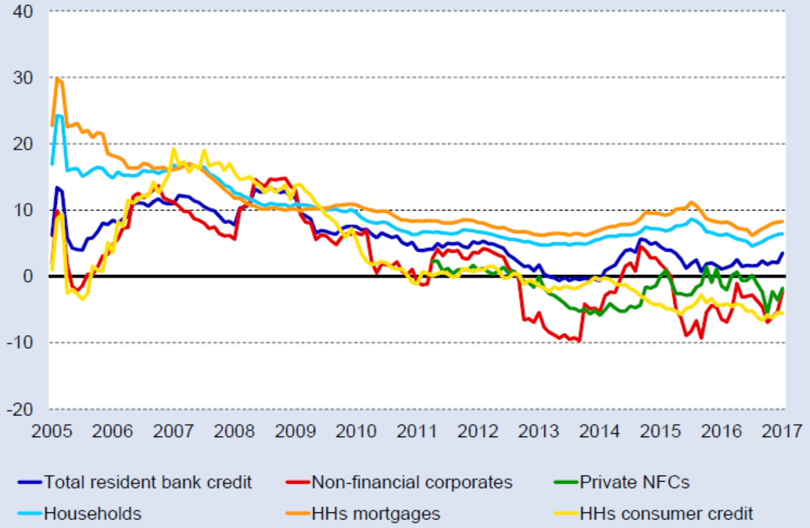
Credit Growth

Resident credit growth remained contained, increasing by an annual 3.6% in March 2017. The historically slow credit growth continued to reflect subdued developments in credit to NFCs which remained in negative growth territory, although contracting at a slower pace of -2.2% annually in March 2017, down from a contraction of -6.9% in December 2016. Lending to private NFC also fell, albeit at a lower rate than the overall NFC loans. This also reflects the increased disintermediation that is taking place, where NFCs are tapping the capital market in an attempt to lock-in lower rates. In the first quarter of 2017, the annual mortgage

[3] Credit represents total bank credit. CRD IV Article 136 (2a) states that "an indicator of growth of levels of credit within that jurisdiction" shall be used by the authority. Even though Drehmann (2013) showed that the credit gaps based on total credit outperform the credit gaps based on bank credit as early warning indicators for banking crises this might be not so relevant for Malta because the domestic economy is strongly reliant on bank credit and therefore the use of total bank credit is highly appropriate for this purpose. Besides, total credit data revealed breaks in the series over time which could lead to reliability issues in the estimations that were undertaken.

growth rate continued to gain momentum, growing annually by 8.3% in March 2017. Consumer credit growth remained in negative territory since 2013 (see Chart 2).

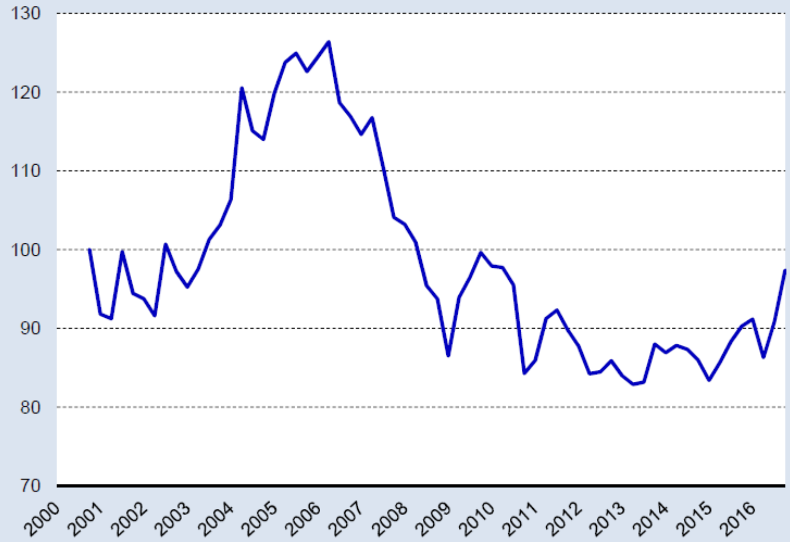
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



Source: Central Bank of Malta.

Although lending for house purchases remained buoyant, the strong economic performance coupled with an all-time low unemployment rate and high home ownership rates sustained the growth in mortgages. Since 2015, the median advertised property price-to-income ratio resumed its upward trend, but housing affordability is not jeopardised and stood well below its peak in 2006 and its average since 2000 (see Chart 3).

Chart 3
MEDIAN PROPERTY PRICE TO INCOME RATIO



Note: Based on the Central Bank of Malta advertised property prices.
Source: Central Bank of Malta.

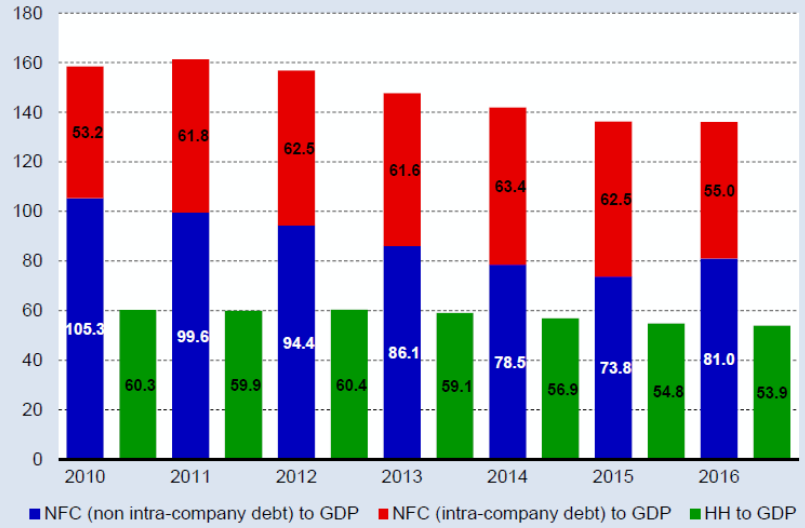
In the last quarter of 2016, property prices continued on their upward trend, albeit at a slower pace when compared to a year ago. However, the conservative haircuts and relatively low loan-to-value ratios applied by banks help to mitigate potential vulnerabilities that could stem from real estate market. Moreover, delinquency rates on mortgages have traditionally been low and on a decreasing path, whereas household disposable income is growing at a healthy rate as economic activity remains strong. Overall risks stemming from the housing market remain contained.

Household and Corporate Debt

While both household and corporate indebtedness increased in absolute terms, these dropped somewhat when expressed as a percentage of GDP (see Chart 4). Household debt stood at 53.9% of GDP in December 2016, below the euro area average notwithstanding the high home-ownership rate which stands at around 80%. Furthermore, despite the increase in household debt in absolute terms, up by an annual rate of 4.9%, growth in households' net financial wealth was stronger, up by 6.6% to 183.9% of GDP. Higher deposit holdings pushed up households' wealth, but holdings of equity, debt securities, and insurance, pension and standardised guarantees, also contributed.

In 2016, corporate debt to GDP dropped marginally to 136% in December 2016. Given that 40.5% of NFC debt consists of intra-company debt, on a consolidated basis, NFC indebtedness stood at 81.0% of GDP - lower than the euro area average. Furthermore, NFCs have a strong financial position with financial assets significantly exceeding indebtedness.

Chart 4
HOUSEHOLD AND CORPORATE DEBT TO GDP
(per cent)

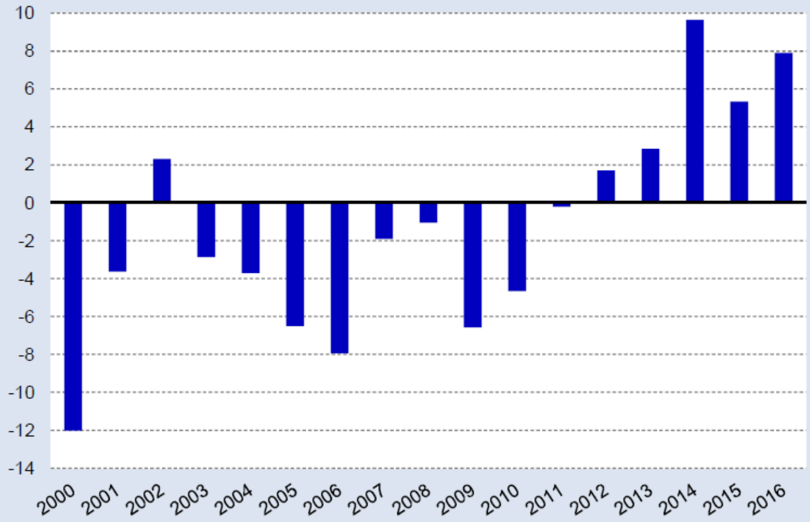


Sources: Central Bank of Malta; NSO.

Current Account

On the external front, following several years of current account deficits prior to 2011, the current account surplus reached 7.9% of GDP in 2016, indicating that Malta is not currently resorting to external debt financing (see Chart 5).

Chart 5
CURRENT ACCOUNT TO GDP
(per cent)



Source: NSO.

In sum, the core domestic banks remained resilient and profitable, with robust capital ratios, backed by ample liquidity and stable funding. All the relevant quantitative and qualitative information assessed were judged to convey strong indications that at the current juncture, the CCyB rate for Malta should continue to be set at zero. The standardised bank credit-to-GDP gap is currently negative at -24.8pp, which is well below the lower reference threshold of 2pp proposed in the BCBS guidance.