BANK ĊENTRALI TA' MALTA
EUROSISTEMA
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The Countercyclical Capital Buffer Rate

December 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 first quarter of 2018.

Notification

- The applicable countercyclical capital buffer rate: 0%
- The relevant credit-to-GDP ratio: 80.4% and its deviation from the long-term trend: -26.0 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. In this regard, 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 throughout the economic cycle.

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 to activate this 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 but the analysis is further supplemented by a sub-set of additional quantitative indicators and expert judgement.[2]

Indicators used in the assessment of the countercyclical capital buffer rate

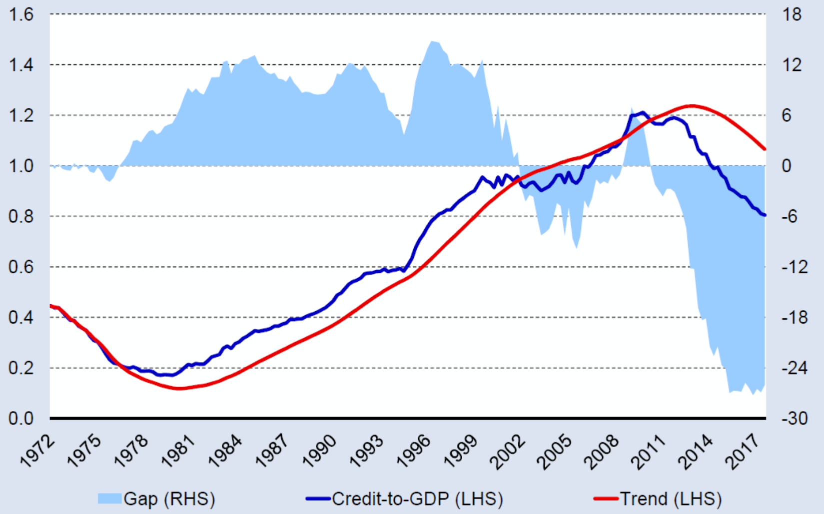
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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.

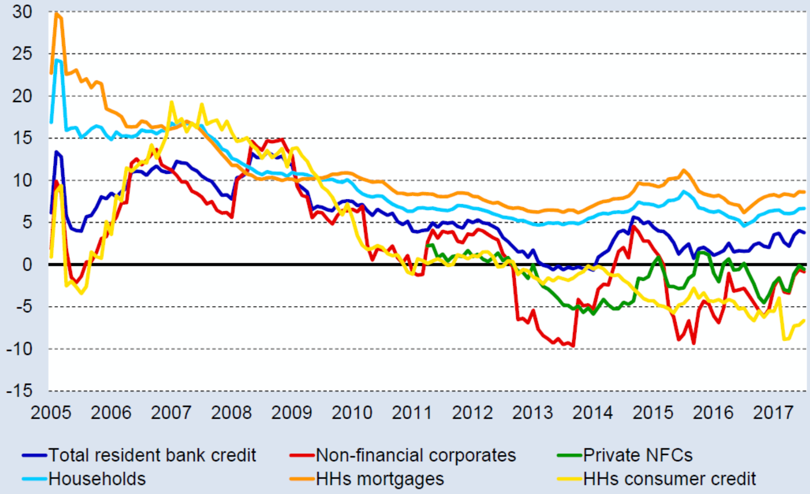
In the third quarter of 2017, the credit-to-GDP ratio narrowed slightly to 26.0 pp below the trend. Nevertheless the gap remains significantly negative with the CCyB rate of zero still remaining appropriate. Furthermore, based on historical developments, the narrowing of the gap is expected to take several quarters before it returns to positive territory.

Credit Growth

Resident credit grew by 3.8% in September 2017, largely driven by mortgages, as otherwise lending to NFCs remained subdued, down by -0.8% year-on-year in September 2017. Lending to private NFC also fell, albeit at a lower rate of -0.5%. Such contraction also reflects an element of disintermediation, whereby some NFCs tapped the capital market for their funding requirements. Consumer credit growth also remained in negative territory since 2013, falling by 6.6% (see Chart 2).

[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. Although Drehmann (2013) showed that credit gaps based on total credit outperform those based on bank credit as early warning indicators for banking crises, this might be not so relevant for Malta given that the domestic economy is strongly reliant on bank credit and therefore the use of total bank credit is highly appropriate for this purpose. Furthermore, the time series for total credit contains breaks in the data over time, which could lead to unreliable estimations.

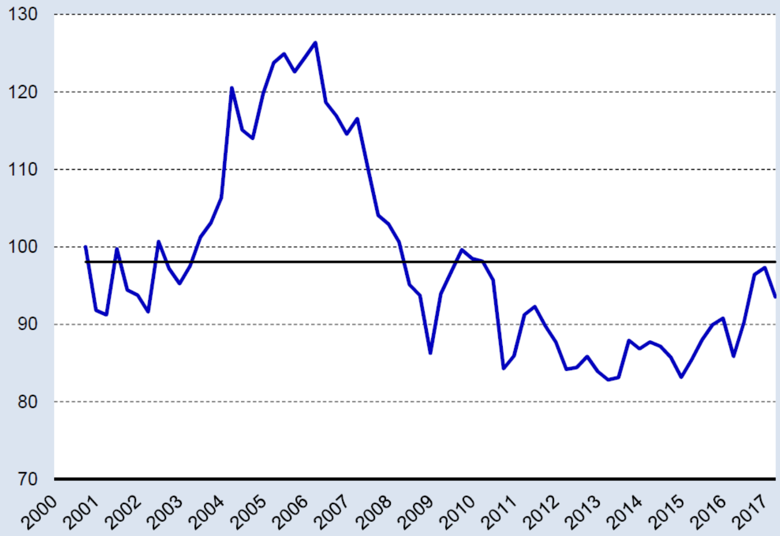
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



Note: A break in series was reported in May 2017 with regards to HH consumer credit due to a reclassification exercise.
Source: Central Bank of Malta.

Growth in mortgages continued to gain momentum, growing annually by 8.6% in September 2017. Such growth was sustained on the back of a strong economic performance coupled with a low unemployment rate and high home ownership rates. Although the median advertised property price-to-income ratio increased since mid-2015, it remained well below its peak in 2006 and lower than 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.

Property prices in Malta rose in recent years reflecting the robust economic activity. The growth in transacted property prices peaked in the third quarter of 2015 at 8.6% compared to a year earlier, but decelerated thereafter reaching 5.5% in the second quarter of 2017. Such increase in house prices remain more contained compared to the growth in GDP which rose by 10% in nominal terms in the second quarter of 2017.

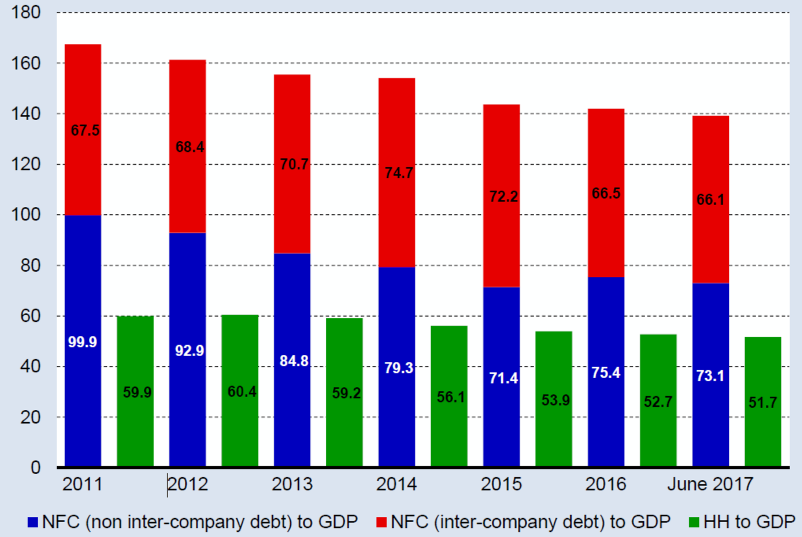
The conservative haircuts and relatively low loan-to-value ratios applied by banks help to mitigate potential vulnerabilities that could stem from the real estate market. Moreover, delinquency rates on mortgages have traditionally been low and on a decreasing path, whereas household disposable income 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 decreased to 51.7% of GDP in June 2017, below the euro area average notwithstanding the high home-ownership rate which stands at around 80%. Furthermore, despite household debt growing by 4.8% on an annual basis in June 2017, households continued to accumulate wealth, with their net financial wealth expanding by 1.7% in Q2 2017 to 168.8% of GDP. The increase in net financial wealth mainly stemmed from higher holdings of cash and deposits, which remained the largest share of the households' financial wealth.

In June 2017, corporate debt-to-GDP dropped marginally to 139.2% compared to end-2016. Given that about 47.5% of NFC debt consists of inter-company debt, on a consolidated basis, NFC indebtedness stood at 73.1% of GDP - lower than the euro area average. Furthermore, NFCs have a strong financial position with financial assets significantly exceeding their debt.

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

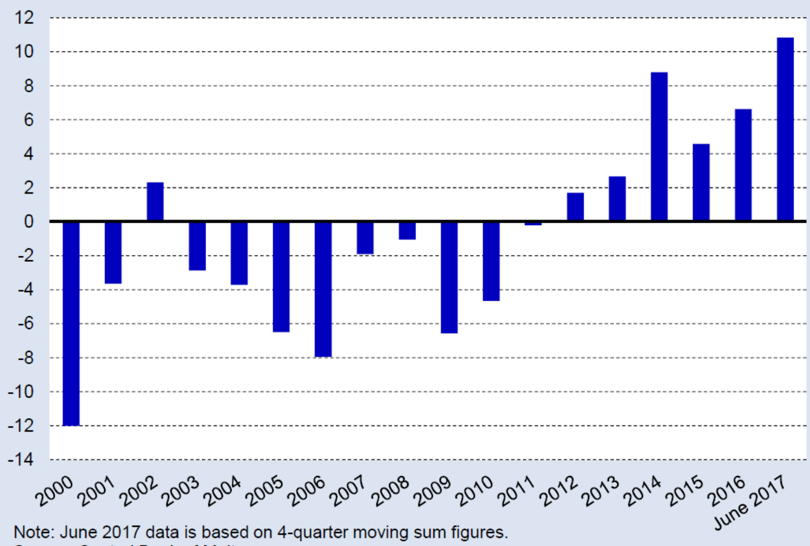


Sources: Central Bank of Malta; NSO.

Current Account

On the external front, the current account surplus widened further to reach 10.8% of GDP in June 2017, indicating that Malta is not currently resorting to external debt financing (see Chart 5).

Chart 5
CURRENT ACCOUNT TO GDP
(per cent)



Note: June 2017 data is based on 4-quarter moving sum figures.
Source: Central Bank of Malta.

The core domestic banks remained resilient and profitable with capital ratios above their regulatory requirements together with 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 -26.0pp, which is well below the lower reference threshold of 2pp proposed in the BCBS guidance.