BANK ĊENTRALI TA' MALTA
EUROSISTEMA
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The Countercyclical Capital Buffer Rate

December 2018
Financial Stability Department

The Countercyclical Capital Buffer (CCyB)

In line 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.

Notification

- The applicable countercyclical capital buffer rate: 0%
- The relevant credit-to-GDP ratio: 74.8% and its deviation from the long-term trend: -23.8 percentage points
- The buffer guide: 0%

Analysis

The aim of the countercyclical capital buffer (CCyB) is to strengthen capital buffers during periods when cyclical risks are thought to be on the increase, in a bid to enhance the resilience of the banking system against losses that could stem from excessive credit growth. In this regard, the CCyB is built during the upswing of the financial cycle and is released in a downturn to absorb any losses that may arise, 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 to activate this buffer. This note provides the rationale for the proposed buffer rate to be maintained at 0%.[1] The main indicator backing this proposal is the deviation of credit-to-GDP from its long-term trend. 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

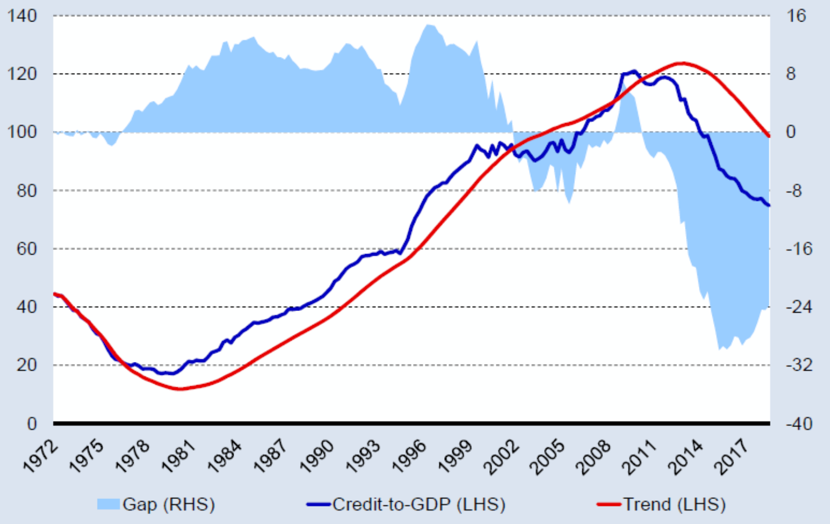
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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 2018, the credit-to-GDP ratio narrowed further to 23.8 pp below the trend, from a trough level of almost 30 pp recorded in the second quarter of 2015. Nevertheless, the gap remains significantly in negative territory with the CCyB rate of zero still remaining appropriate. Estimates based on historical developments also indicate that the narrowing of the gap is expected to take several quarters before it returns to positive territory.

Credit Growth

Resident credit grew by 5.8% in September 2018 on the back of positive growth rates in both households and NFC lending. Mortgage lending rose by 8.2%, increasing by 0.5 pp compared to the previous quarter, while consumer credit growth also remained positive, increasing by an annual growth rate of 2.1% in September 2018 (see Chart 2). Growth in NFC credit also accelerated further, up by 4.6% year-on-year, compared to the 3.9%

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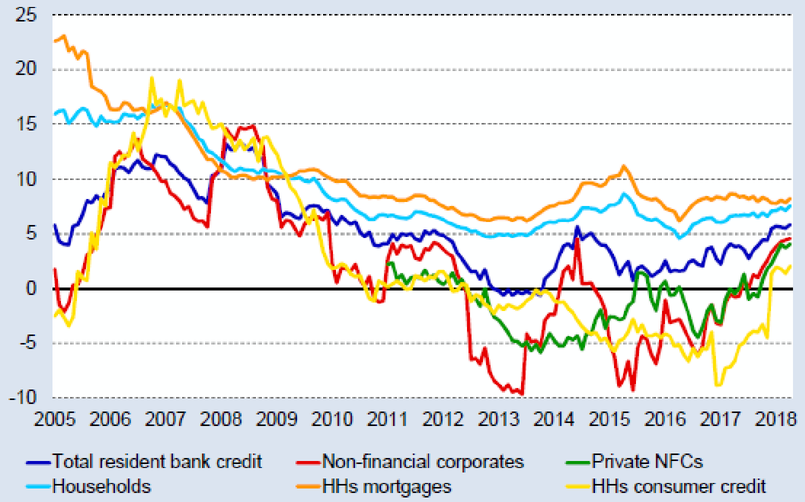
[3] Credit represents total bank credit. CRD IV Article 136 (2a) states that "*an indicator of growth of levels of credit within that jurisdiction*" shall be used by the Authority. Although Drehmann (2013) showed that credit gaps based on total credit outperform those based on bank credit as early warning indicators for banking crises, this might not be 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.

reported in June 2018. Such growth rates are however commensurate with the robust economic growth.

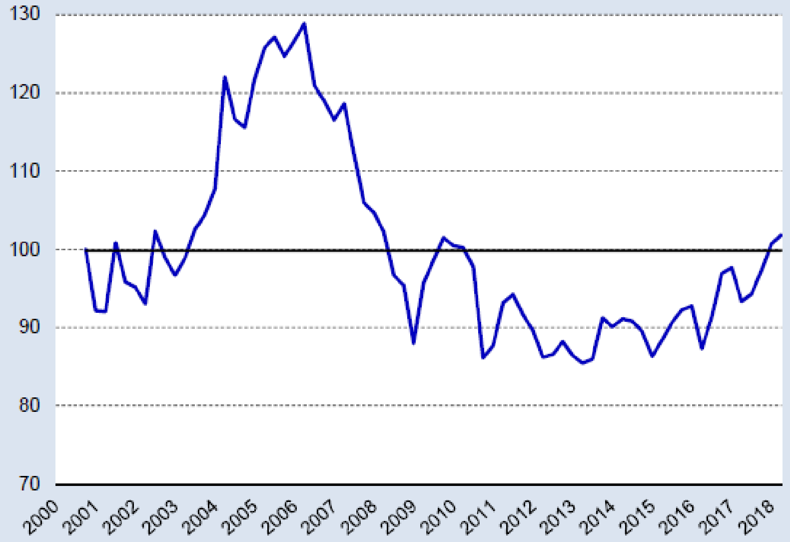
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



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.

In recent years, property prices in Malta rose reflecting the pick-up in economic activity. At 8.6% growth in transacted property prices peaked in the third quarter of 2015 but decelerated thereafter to 5.7% by the second quarter of 2018. House prices grew at a more modest rate than nominal GDP which rose by 9.5% in the third quarter of 2018. Although the median advertised property price-to-income ratio increased since mid-2015, it remained well-below its peak in 2006, but slightly above its long-term 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.

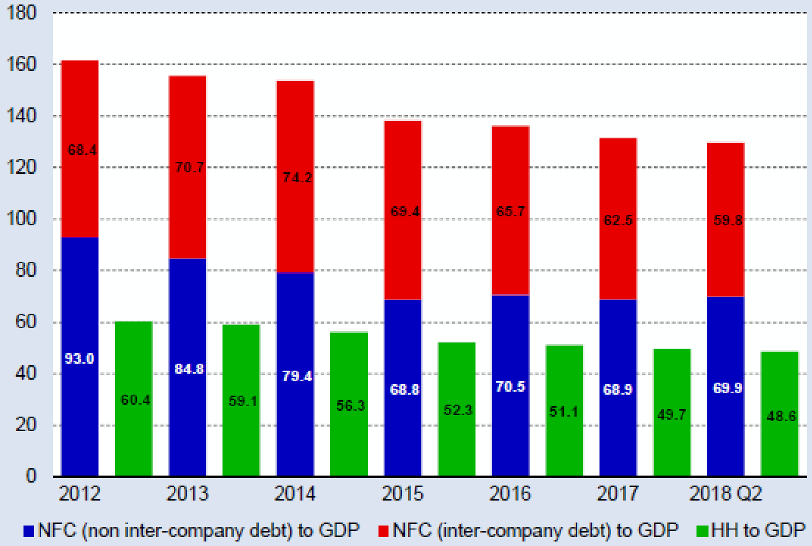
The conservative haircuts and loan-to-value ratios applied by banks help to mitigate any potential vulnerabilities that could stem from the real estate market. Moreover, delinquency rates on mortgages have traditionally been low, whereas households' disposable income is growing at a healthy pace as economic activity remains strong. Overall, financial stability risks stemming from the housing market remain low and contained.

Household and Corporate Debt

While both households' and corporate indebtedness increased in absolute terms, up by 5.2% and 5.5%, respectively, these dropped somewhat when expressed in terms of GDP (see Chart 4). Household debt decreased to 48.6% of GDP in June 2018, below the euro area average notwithstanding the high home-ownership rate which stands at around 84%. Households continued to accumulate wealth, with their net financial wealth expanding by 3.2% in June 2018 to 156.6% of GDP. The increase in net financial wealth mainly stemmed from higher holdings of cash and deposits, which remained the largest share of their financial wealth.

In June 2018, corporate debt-to-GDP dropped to 129.7% compared to the 131.4% in end-2017. Given that almost half of NFC debt consists of inter-company debt, on a consolidated basis, NFC indebtedness stood at about 70% of GDP, below the euro area average. Furthermore, NFCs have a strong financial position with financial assets significantly exceeding their debt, with such ratio standing at about 155%.

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

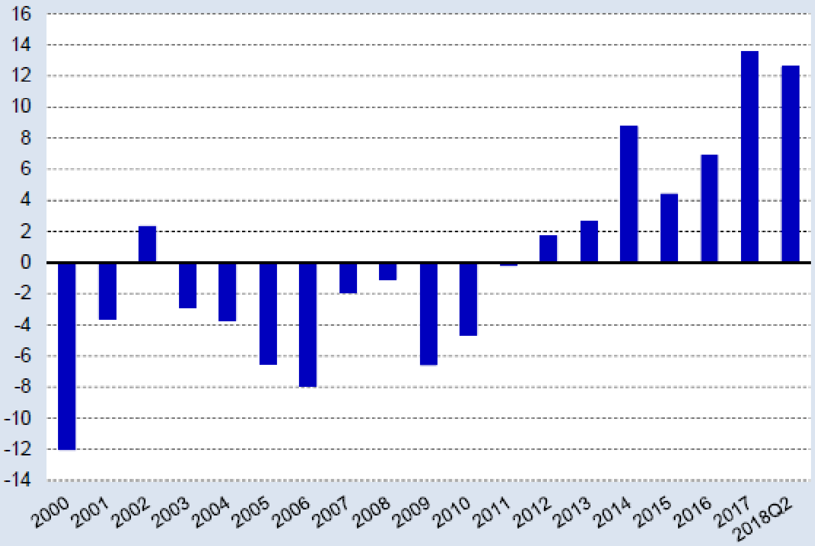


Sources: Central Bank of Malta; NSO.

Current Account

On the external front, the current account remained in significant surplus at 12.6% of GDP in June 2018, indicating that Malta is not currently resorting to external debt financing (see Chart 5).

Chart 5
CURRENT ACCOUNT TO GDP
(per cent)



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 -23.8pp, which is well below the reference threshold of 2 percentage points as indicated in the BCBS guidance.