BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

June 2020
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: 78.0% and its deviation from the long-term trend: -12.6 percentage points
- The buffer guide: 0%

Analysis

The aim of the countercyclical capital buffer (CCyB) is to strengthen banks’ capital buffers during periods of excessive credit growth in a bid to enhance the resilience of the banking system and counter pro-cyclicality in the financial system. 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 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.[1] The Central Bank of Malta assesses variables related to private sector credit 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%.[2]

Indicators used in the assessment of the countercyclical capital buffer rate

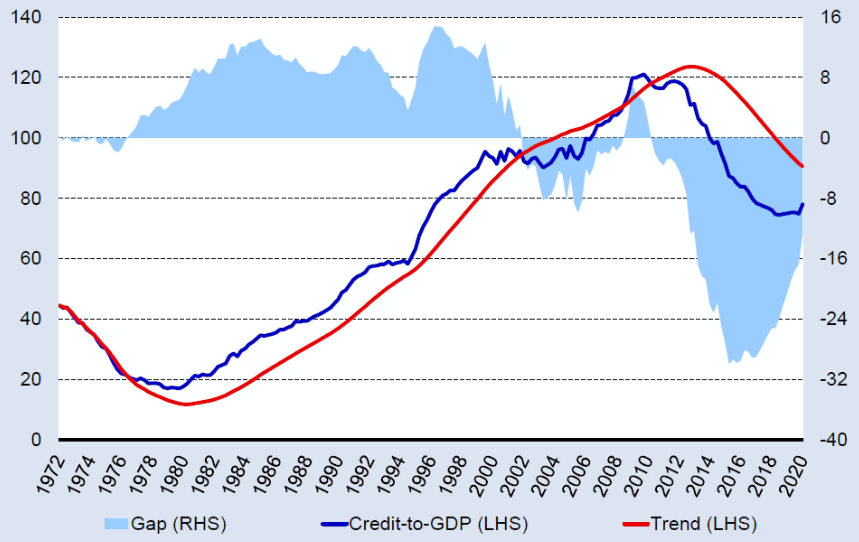
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

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

[2] 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.

credit-to-GDP ratio for Malta.[3] The trend represents the smoothened credit-to-GDP plotted on the left-hand axis together with the actual series. 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.

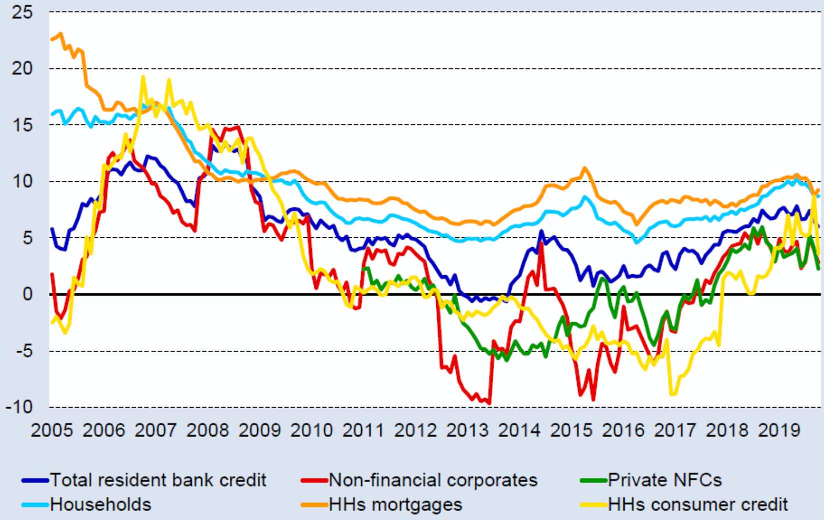
In the first quarter of 2020, the credit-to-GDP gap narrowed to -12.6 percentage points from a trough of -30 percentage points in the second quarter of 2015. Still, the gap remained in negative territory. Historical developments indicate that the closing of the gap would take some quarters before it returns to positive territory. Owing to the COVID-19 spread, uncertainty surrounding credit developments increased largely on the back of the economic slowdown which could have negatively affected firms' capital expenditure plans, coupled with a virtual halt of business in real estate with implications on mortgage growth. On the other hand, lending for working capital is expected to increase. On balance, such developments have reinforced the decision that at the current juncture the CCyB rate of zero remains appropriate. Such decision is further corroborated by additional indicators to the headline indicator - the credit-to-GDP gap.

[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.

Credit Growth

During the first quarter of 2020, resident credit growth decelerated slightly to 6.0% on the back of a slowdown in both credit to households and NFCs. Overall lending to households rose by 8.7%, 1.1 percentage points lower than in the previous quarter but the pace of growth was largely in line with the same quarter in 2019. Mortgage lending increased by 9.3%, down by around 1 percentage point compared to the previous quarter. Moreover, growth in consumer credit decelerated to 3.6% in 2020Q1, 1.5 percentage points lower when compared to December 2019 (see Chart 2). Meanwhile, NFC lending increased by 2.8% in March 2020 in line with the previous quarter. Going forward, lending to households is expected to slow down on the back of lower demand for house purchases owing to the pandemic coupled with lower consumer credit. On the upside, banks are expecting higher short-term demand for NFC loans to finance working capital requirements, offsetting to some extent the expected drop in demand for funding of capital expenditure.

Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)

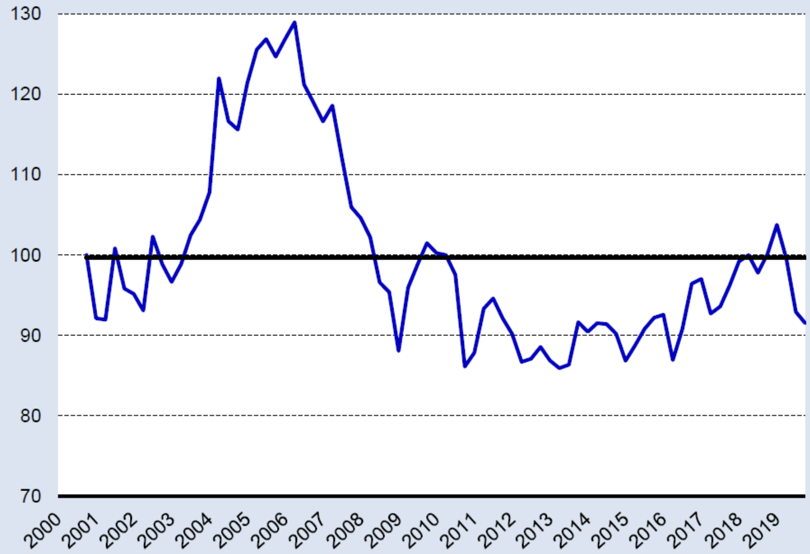


Source: Central Bank of Malta.
Note: A break in series was reported in May 2017 with regards to HH consumer credit due to a reclassification exercise.

During the last quarter of 2019, property prices rose by 5.6% slowing down marginally compared to the previous quarters and still at a slower pace compared to the growth rates recorded in 2015. Such price developments reflected increased demand on the back of robust job-rich economic growth reported in 2019, increased disposable income, a higher female participation rate, inward migration, and budgetary measures aimed at first-time and second-time buyers. Supply had also responded to such demand pressures as dwelling permits have risen significantly in the past few years aiding in attenuating property price pressures, although in 2019 these declined by 3.1% when compared to 2018. The COVID-

19 pandemic resulted in a further slowdown in permits which fell by around 30% during the first four months of 2020. Although the median advertised property price-to-income ratio increased since mid-2015, it remained well-below its peak in 2006 and its long-term average since 2000 (see Chart 3).

Chart 3
MEDIAN PROPERTY PRICE TO INCOME RATIO



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

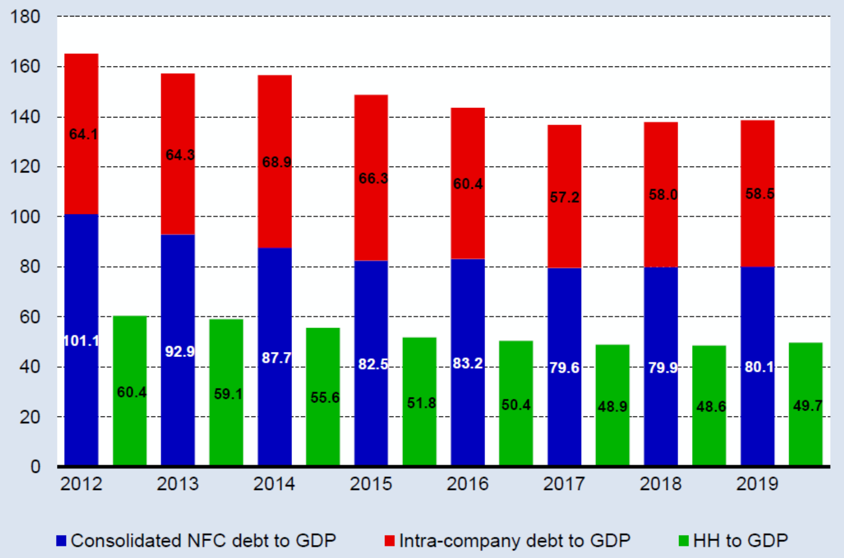
The conservative haircuts and loan-to-value ratios applied by banks help to mitigate any potential vulnerability that could stem from the real estate market, safeguarding both the banks' and households' balance sheet. Moreover, delinquency rates on resident mortgages have traditionally been low at 2.1% in March 2020, whereas compensation of employees is growing at a healthy pace as economic activity remains strong. However, going forward, compensation of employees may dwindle as result of lower demand for labour, especially in sectors mostly hit by the COVID-19 spread. Overall, on balance, financial stability risks stemming from the housing market remain contained.

Nevertheless, asset quality may deteriorate as some corporates mostly affected by the pandemic, together with some households, may find it difficult to meet their financial obligations. However, the latest policy measures including the implementation of moratoria and government guarantee schemes are expected to ease some of the pressures on corporates and households alike.

Household and Corporate Debt

During the fourth quarter of 2019, private sector debt increased owing to higher corporate indebtedness and to a lower extent household debt. Expressed as a share of GDP, private sector debt rose by 1.8 percentage points to 188.3%. The household debt-to-GDP increased by 1.1 percentage points to 49.7% during December 2019, remaining slightly below the euro area average (see Chart 4). Meanwhile corporate debt-to-GDP edged slightly higher to 138.6%. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 80.6% of GDP, in line with the euro area average. Furthermore, at about 183%, NFCs have a strong financial position with financial assets significantly exceeding their debt. Also, the leverage ratio of NFCs declined by 1.5 percentage point to 31.5% sustaining the downward trend reported for a number of years, to now stand just below the euro area average of 31.8% in December 2019. Moreover, households' net financial wealth remained strong at about 160% of GDP, mainly held in the form of cash and deposits.

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

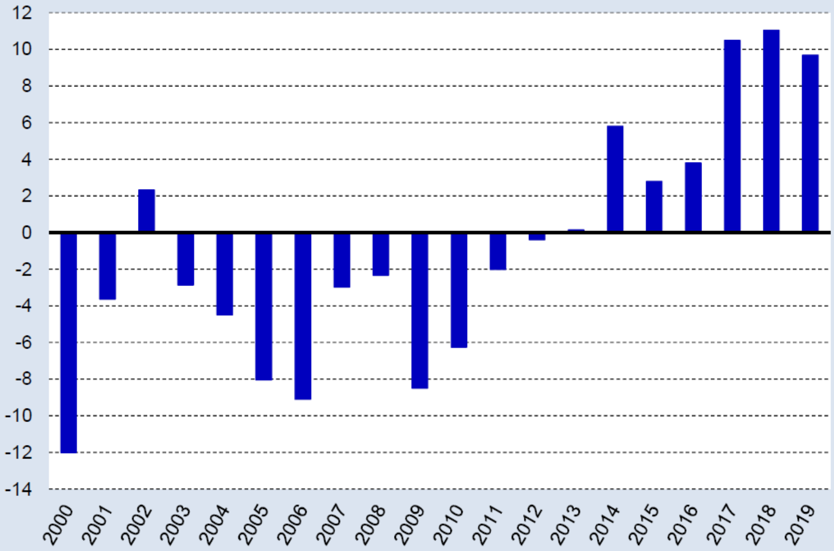


Sources: Central Bank of Malta; NSO.

Current Account

On the external front, the current account remained in significant surplus at 9.7% of GDP in December 2019, although 1.4 percentage points lower than in 2018. However, the current account surplus still indicates 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 the Total Capital Ratio and Common Equity Tier 1 capital ratio standing at 19.7% and 17.2%, respectively in March 2020. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at 357.4% in March 2020 and thus exceeding the regulatory requirement of 100%, indicating ample liquidity and stable funding as deposits continued to flow further building up the liquidity buffer. 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. This is also in view of the current developments and the economic slowdown envisaged due to COVID-19. The standardised bank credit-to-GDP gap is currently negative at -12.6 pp, which is well below the reference threshold of 2 percentage points as indicated in the BCBS guidance.