BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

September 2021
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: 83.2% and its deviation from the long-term trend: -2.42 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 supporting 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

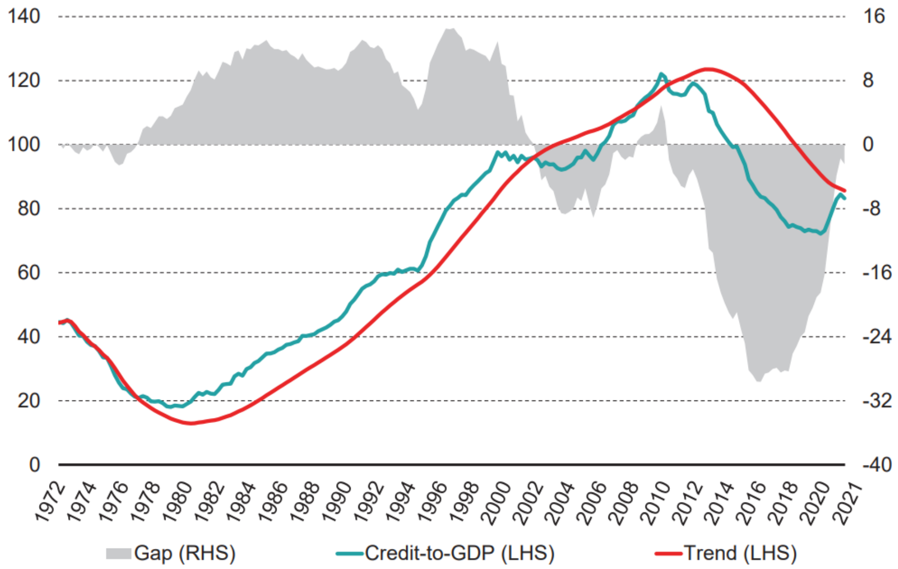
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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 grey 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 second quarter of 2021, the credit-to-GDP gap widened marginally to -2.42 percentage points from -1.71 in the previous quarter, following a lengthy period of generally consistent narrowing from a trough of around -30 percentage points in the first quarter of 2016 (see Chart 1). The slight widening of the gap in the second quarter mainly reflected the recovery in GDP, which grew by 3.4% over previous quarter, amid a normalising economy as uncertainty in relation to the COVID-19 pandemic started to dwindle. In line with this, projections by the Central Bank of Malta indicate that the GDP is expected to expand by 5.1% by the end of this year, 5.9% in 2022, and by 4.7% in 2023.[4] This could possibly cause the gap to widen further going forward. Following such developments, the decision that at the current juncture the CCyB rate should be zero remains appropriate. Such decision is further corroborated by additional indicators.

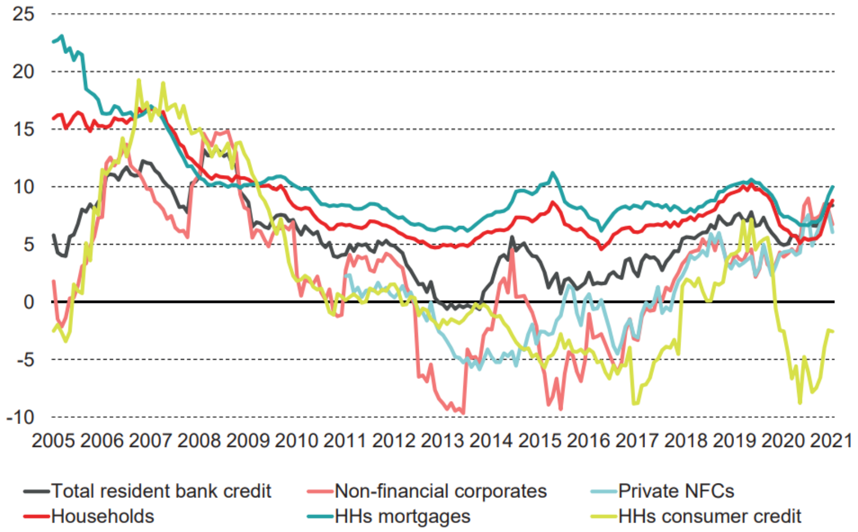
[3] Credit represents total bank credit. CRD IV Article 136 (2a) states that "*an indicator of growth of levels of credit within that jurisdiction*" shall be used by the Authority. Although Drehmann (2013) showed that credit gaps based on total credit outperform those based on bank credit as early warning 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.

[4] https://www.centralbankmalta.org/site/Publications/Projections-2021-3.pdf?revcount=6710

Credit Growth

Resident credit grew annually by 8.4% as at June 2021, largely driven by credit to households, which grew by 8.8% in 2021Q2 (see Chart 2). This reflected higher mortgages which increased by 10.0%, as this recovered following the slowdown reported during the initial stages of the pandemic. Otherwise, consumer lending remained in negative territory, contracting by a less pronounced 2.6%. Meanwhile, although credit growth to NFCs decelerated slightly, such lending still increased by 6.7% in 2021Q2. The deceleration in the growth rate possibly reflects a slowdown in demand for working capital loans following the significant amount disbursed in the initial period of the MDB COVID-19 Guarantee Scheme.

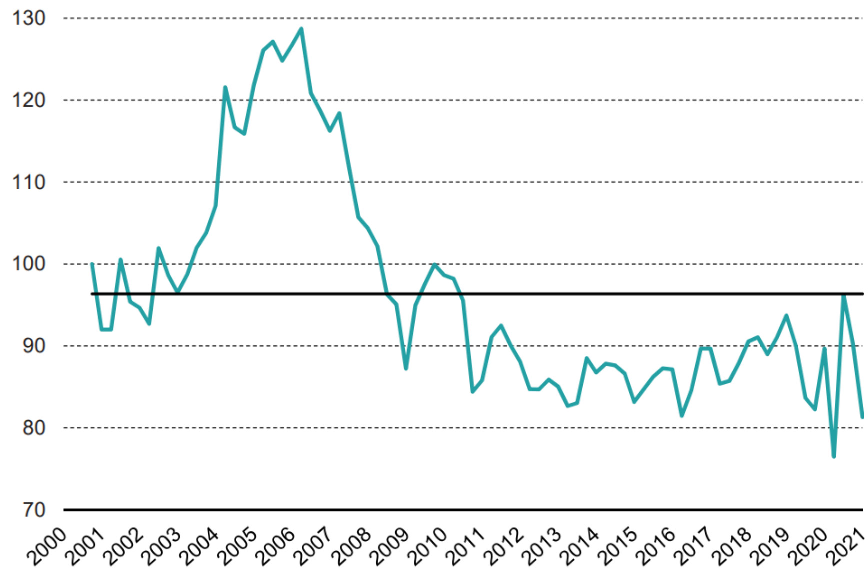
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



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.

Following a number of quarters where the growth in property prices decelerated, this accelerated once again, rising by 4.7%, although remaining below pre-pandemic levels. Such growth reflects a normalising economy as the pandemic became more controlled, collaborated by a rebound in mortgage lending. This is also supported by the consistent positive trend in the property sales during recent months. Notwithstanding, the median advertised property price-to-income ratio continued to decline in 2021Q1 over the previous quarter and stands well below the long-term average (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.

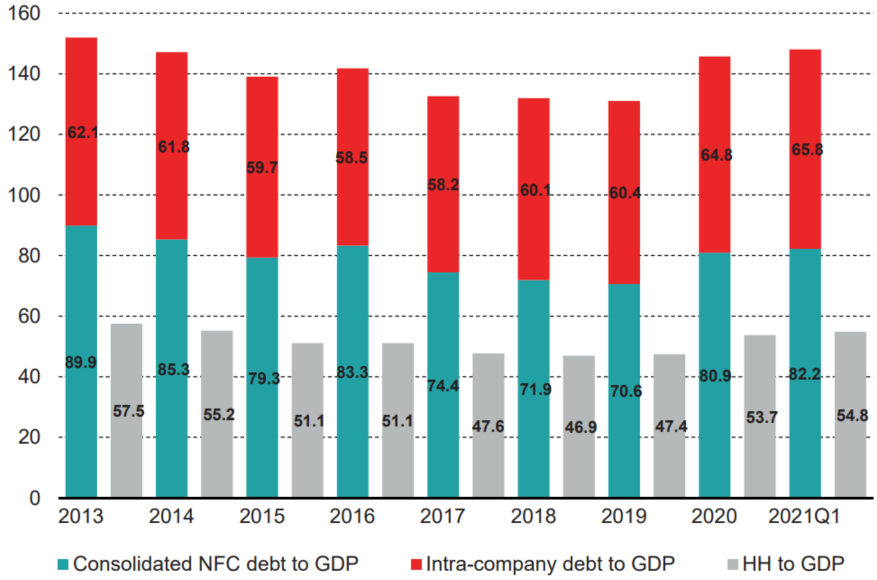
Meanwhile, the conservative haircuts and loan-to-value ratios applied by banks help to mitigate any potential vulnerabilities that could stem from the real estate market, safeguarding banks' and households' balance sheets. Delinquency rates on resident mortgages remained stable at low levels in the second quarter of 2021, whereas compensation of employees continued to improve, exceeding pre-pandemic levels.

Although financial stability risks stemming from the housing market seem to have remained contained, one should still consider the potential aftermath of lifted government support measures and expiration of moratoria in relation to NPL levels. Therefore, looking ahead it is important from a financial stability perspective that banks continue to maintain adequate capital and liquidity buffers.

Household and Corporate Debt

During the first quarter of 2021, private sector debt increased owing to higher corporate indebtedness and to a lower extent higher household debt. Expressed as a share of GDP, private sector debt rose by 3.4 percentage points compared to the previous quarter to 202.8% (see Chart 4). The household debt-to-GDP increased by 1.1 percentage points to 54.8%, remaining well below the euro area average. Similarly, corporate debt-to-GDP increased by 2.3 percentage points to 148.0%, also remaining slightly below the euro area average. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 82.2% of GDP. Furthermore, at just over 168%, NFCs have a strong financial position with financial assets significantly exceeding their debt. Also, the leverage ratio of NFCs remained quite stable in 2021 Q1 at 33.0% being in line with the euro area average of 32.6% in March 2021. Moreover, households' net financial wealth remained strong mainly held in the form of deposits.

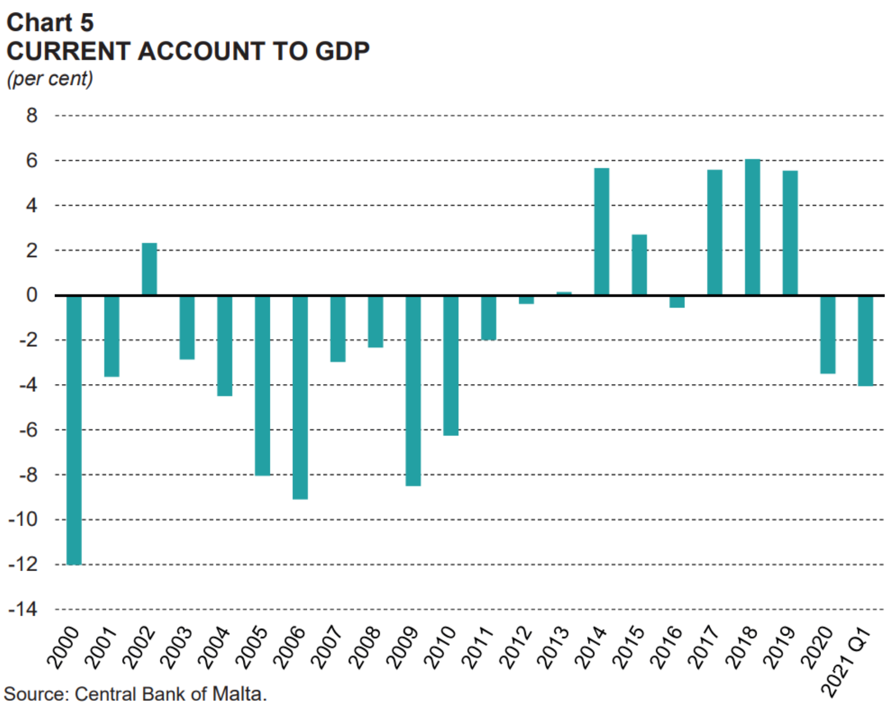
Chart 4
HOUSEHOLD AND CORPORATE DEBT TO GDP
(per cent)



Sources: Central Bank of Malta; NSO.
Note: Based on four-quarter moving sum.

Current Account

On the external front, the current account remained quite stable, deteriorating only marginally in the first quarter of the year, posting a deficit of 4.1% of GDP as at March 2021. (see Chart 5).



Source: Central Bank of Malta.
Note: Based on four-quarter moving sum.

The core domestic banks entered the COVID-19 outbreak on the back of healthy capital levels, liquidity and profits. The Total Capital Ratio and Common Equity Tier 1 capital ratio stood at around 21.7% and 18.4%, respectively in June 2021. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at around 420% in June 2021 and thus exceeding the regulatory requirement of 100%, indicating abundant liquidity and stable funding as deposits continued to flow in, further building up banks' liquidity buffers. This is buttressing further banks' resilience to the medical crisis and in their role in providing credit to the economy.

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 slight re-widening credit-to-GDP gap amid a recovering GDP as a result of the normalising economic situation. The standardised bank credit-to-GDP gap is currently negative at -2.42 percentage points, which is still below the reference threshold of positive 2 percentage points as indicated in the BCBS guidance.