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The Countercyclical Capital Buffer Rate

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Financial Stability Department

The Countercyclical Capital Buffer (CCyB)

In line with Article 136(7) of EU Directive 2019/878, 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: 78.8% and its deviation from the long-term trend: -5.35 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 that are associated with of systemic risk. This enhances the resilience of the banking system and counter the pro-cyclicality of credit. 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 additional indicators and expert judgement.[1] The Central Bank of Malta assesses variables related to the current account balance, 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

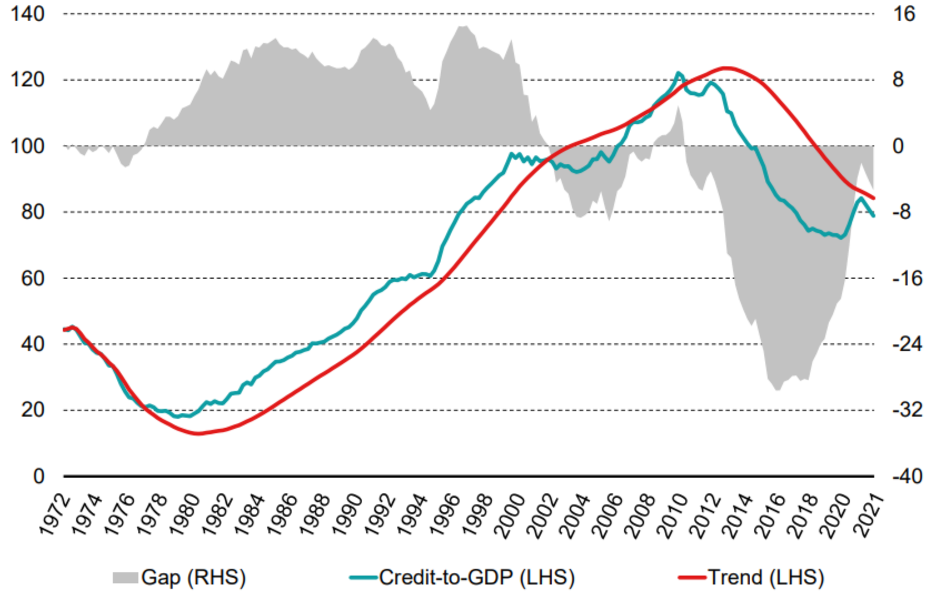
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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 fourth quarter of 2021, the credit-to-GDP gap widened to -5.35 percentage points from -4.34 in the previous quarter as the GDP continued to recover at a stronger pace than credit growth (see Chart 1). In line with this, projections by the Central Bank of Malta indicate that the GDP is expected to expand further although at a decelerating rate, up by 6.0% by the end of this year, 5.3% in 2023 and 3.8% in 2024.[4] How this transcripts to the developments within the gap depends however on numerous other factors include credit growth going forward The recent widening in the gap however follows a lengthy period of generally consistent narrowing from a trough of around -30 percentage points in the first quarter of 2016 which highlights the importance to continue monitoring developments pertaining to cyclical risks via the additional indicators.

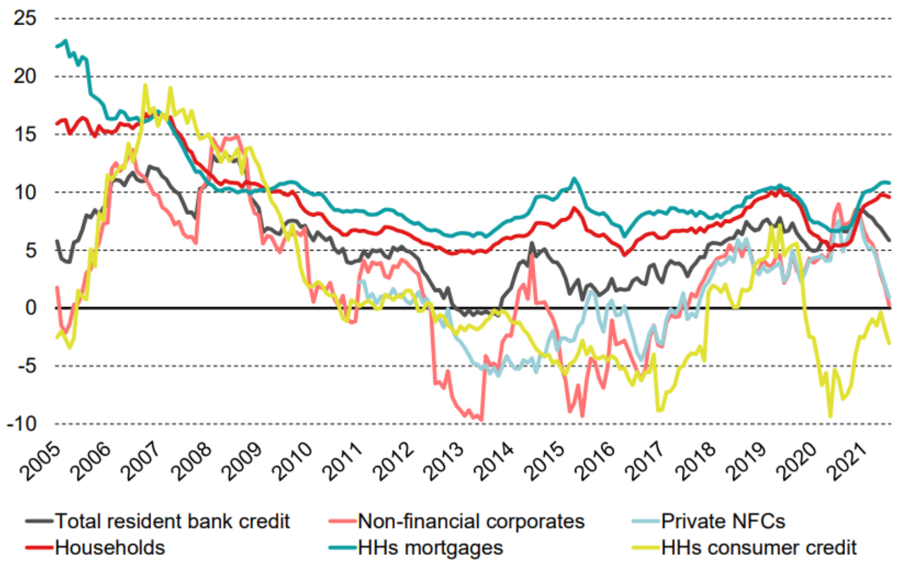
[3] Credit represents total bank credit. CRD IV Article 136 (2a) states that "*an indicator of growth of levels of credit within that jurisdiction*" shall be used by the Authority. Although Drehmann (2013) showed that credit gaps based on total credit outperform those based on bank credit as early warning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

Credit Growth

Resident credit growth decelerated to 5.8% as at December 2021, compared to 7.2% in September and 7.3% a year earlier. The growth continued to be largely driven by credit to households, which grew by 9.6% (see Chart 2). This reflected higher mortgages which increased by 10.8%, as this continued to increase and surpassing pre-pandemic growth rates. However anecdotal evidence indicates a possible slowdown going forward as the tax relief measures introduced during the pandemic were not extended, with data on new mortgage loans indicating a slowdown during 2021. Meanwhile, consumer lending remained in negative territory with growth declining by 3.0%. Turning to credit growth to NFCs, diverging developments could be observed to that of households, with growth decelerated to just 0.3%, significantly lower than the 4.5% of the previous quarter and the 9.0% a year earlier. The deceleration in the growth rate possibly reflects a slowdown in demand for both working capital loans and fixed investment, with a significant slowdown in the uptake of loan disbursed under the MDB COVID-19 Guarantee Scheme also reported. Lending to such scheme was important in the early stages of the pandemic, and indeed was the primary contributor to the pick-up in lending in 2020. Excluding such loans, NFC credit growth would currently be negative.

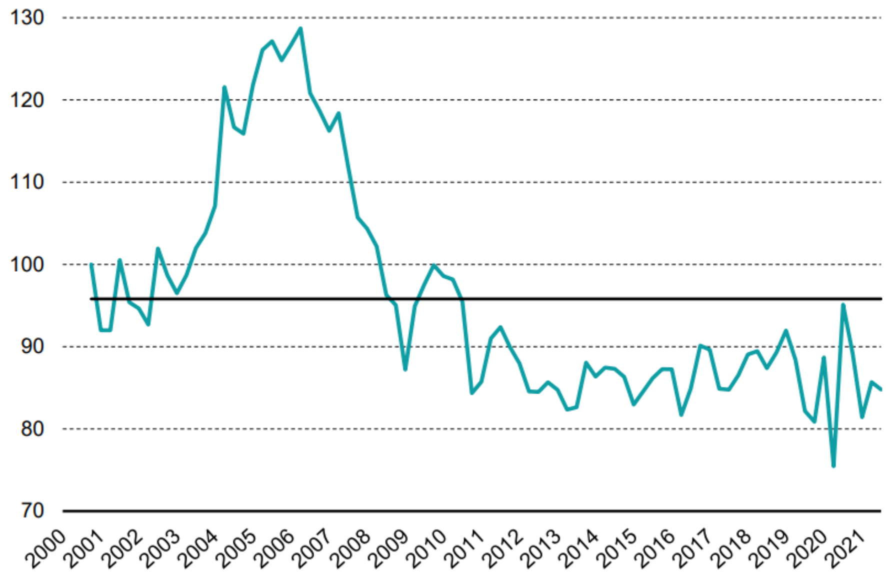
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



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 the slowdown reported up until 2020. the growth in property prices decelerated, this accelerated during 2021 to read 5.9% in 2021Q3. This however remains below the euro area average where a more pronounced pick-up was reported for the growth to read 8.8%. Such growth reflects the economic recovery which is also reflected in the rebound in mortgage lending. This is also supported by the consistent positive trend in the property sales during recent months. Despite such pick-up, the median advertised property price-to-income ratio remained well below the long-term average (see Chart 3).

Chart 3
MEDIAN PROPERTY PRICE TO INCOME RATIO
(per cent)



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

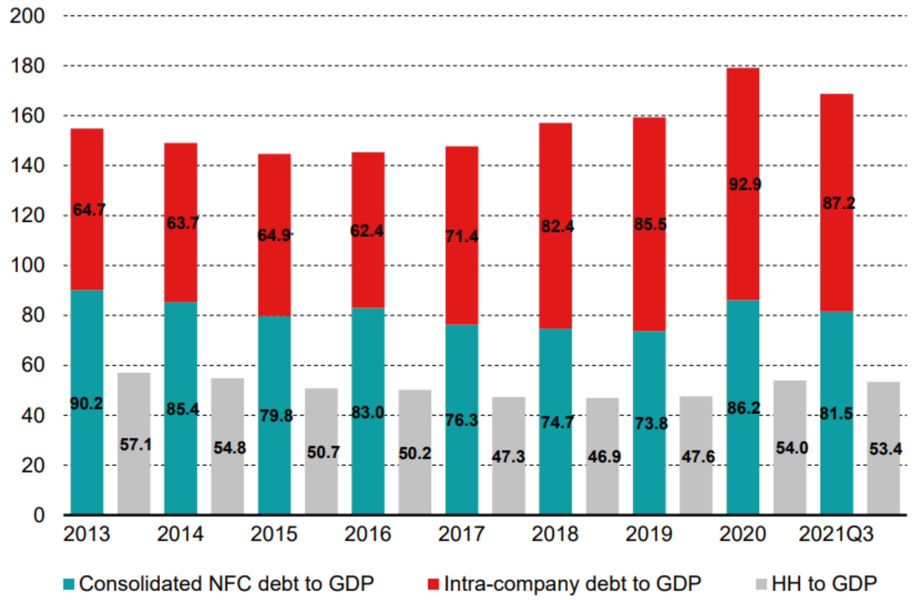
Meanwhile, the conservative haircuts and loan-to-value ratios applied by banks help to mitigate any potential vulnerabilities that could stem from the real estate market, safeguarding banks' and households' balance sheets. Conservative lending practices are also enforced through the borrower-based metrics which were introduced in 2019 through the Banks' Directive No. 16. Delinquency rates on resident mortgages remained low levels in the last 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 on one side, and the possible increase in demand should new fiscal measures be introduced. 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

As at the third quarter of 2021, private sector debt increased further reflecting both higher corporate indebtedness and household debt. However, expressed as a share of GDP, private sector debt decreased to 222.1% 2021Q3, 10 percentage points lower than the level as at end 2020 on account of the strong recovery in GDP.(see Chart 4). The household debt-to-GDP dropped by 0.6 percentage point to 53.4%, remaining somewat below the euro area average. Meanwhile, NFC debt to GDP fell by 9.4 percentage points to 168.7%. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 81.5% of GDP, below the euro area average. Furthermore, at 28.7%, NFCs consolidated leverage continued to decline and stood below that of the euro area. Moreover, households' net financial wealth increased further and stood at a healthy position, also consisting mainly in deposits.

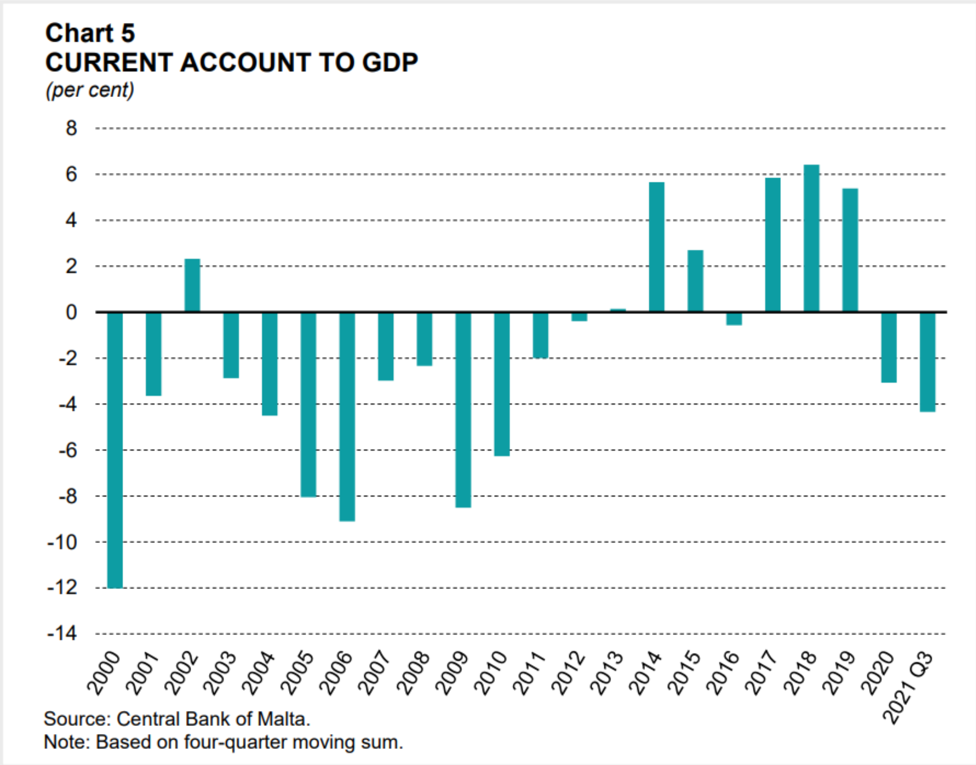
Chart 4
HOUSEHOLD AND CORPORATE DEBT TO GDP
(per cent)



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

Current Account

On the external front, the current account remained in deficit, standing at 4.3% of GDP as at 2021Q3 (see Chart 5). This was mostly due to a strong decline in net services receipts which however showed evident signs of recovery in 2021Q3.



The core domestic banks entered the COVID-19 outbreak on the back of healthy aggregate capital levels, liquidity and profits. The core domestic banks' Total Capital Ratio and Common Equity Tier 1 capital ratio stood at around 22.5% and 19.1%, respectively in December 2021. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at around 360% in December 2021, 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 -5.35 percentage points, which is still below the reference threshold of positive 2 percentage points as indicated in the BCBS guidance. The uncertainty arising from the current geopolitical situation should also be considered when deciding on the implementation of further macro-prudential measures, given the implications that these could have on the economy, and subsequently the banking sector. However, continued monitoring is warranted, with further analysis to assess possible diverging trend in cyclical contributors and credit growth, while assessing the importance of the transitory element in such developments