BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

June 2022
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: 77.3% and its deviation from the long-term trend: -6.0 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 the build-up 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

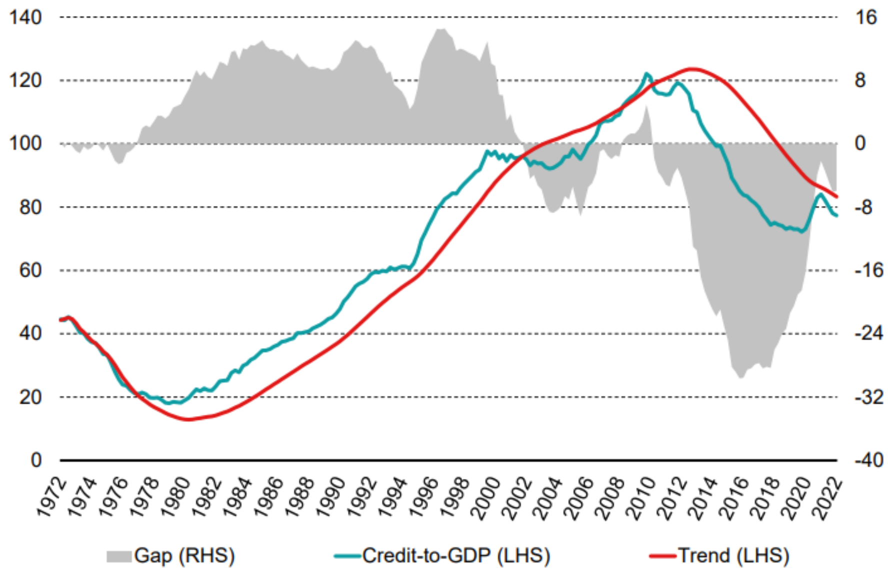
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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 first quarter of 2022, the credit-to-GDP gap remained largely unchanged at -6.0 percentage points while the credit-to-GDP ratio fell to 77.3% as economic activity 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 5.4% by the end of this year, 4.9% in 2023 and 3.8% in 2024.[4] How this translates into the developments within the gap depends on a number of factors including the path of credit growth going forward. Although the gap remains below the activation threshold of +2 percentage points, this had narrowed significantly from a trough of around -30 percentage points in the first quarter of 2016, to -2.2 percentage points in the first quarter of 2021, to widen somewhat thereafter, though continuous monitoring of developments is still

[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

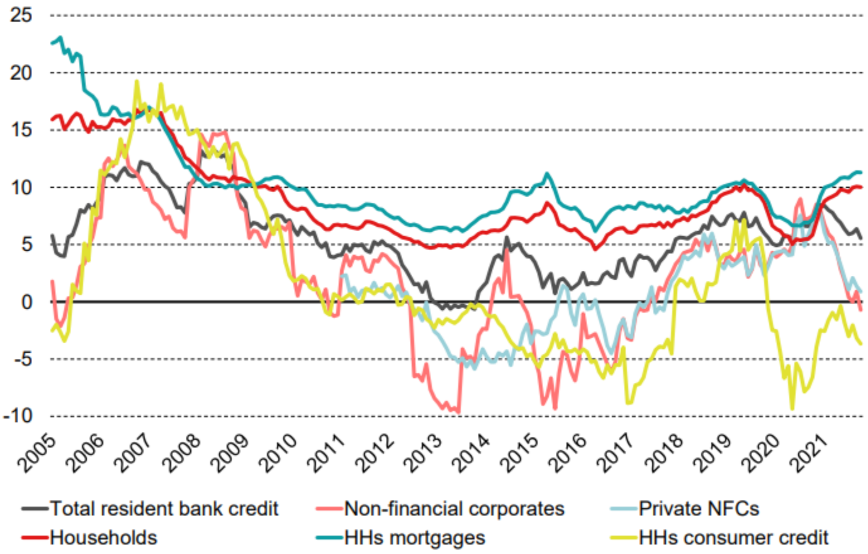
warranted. At the current juncture, the decision not to activate the CCyB buffer rate above 0% is supplemented by other supplementary indicators.

Credit Growth

Resident credit growth decelerated to 5.6% as at March 2022, compared to 5.9% in December 2021 and 7.0% a year earlier. Growth continued to be largely driven by credit to households, which grew by 10.0% (see Chart 2). This reflected higher mortgages which increased by 11.3%, surpassing pre-pandemic growth rates. Such developments are deemed to be transitory, owing in part to the front loading of the decision by buyers and sellers to buy/sell their property to take advantage of the tax relief scheme introduced during the pandemic. Buyers and sellers eligible for these tax benefits have till end September 2022 to sign the final deed for those promises of sale signed by end 2021. Furthermore, the impact of the scheme on mortgage lending is clearly visible by assessing new loans where these declined briefly in the first quarter of 2020 to increase significantly thereafter. Towards the end of 2021 the amount of new loans granted decreased indicating a possible slowdown in mortgages. This is corroborated with off balance sheet commitments of banks which also slowed down during the initial stages of the pandemic to later resume their upward trend in early 2021 with a slight drop towards the end of the year. In light of these transitory developments, the CBM is currently carrying out in-depth assessments to ascertain the evolution and impact of these transitory elements on resident credit growth.

In contrast, consumer lending remained in negative territory with growth declining by 3.7%. Meanwhile, NFC lending contracted by 0.7% compared to a growth of 0.4% in the previous quarter and 7.5% a year earlier. This reflects a slowdown in the uptake of loan disbursed under the MDB COVID-19 Guarantee Scheme, which was the primary contributor to the pick-up in lending in 2020.

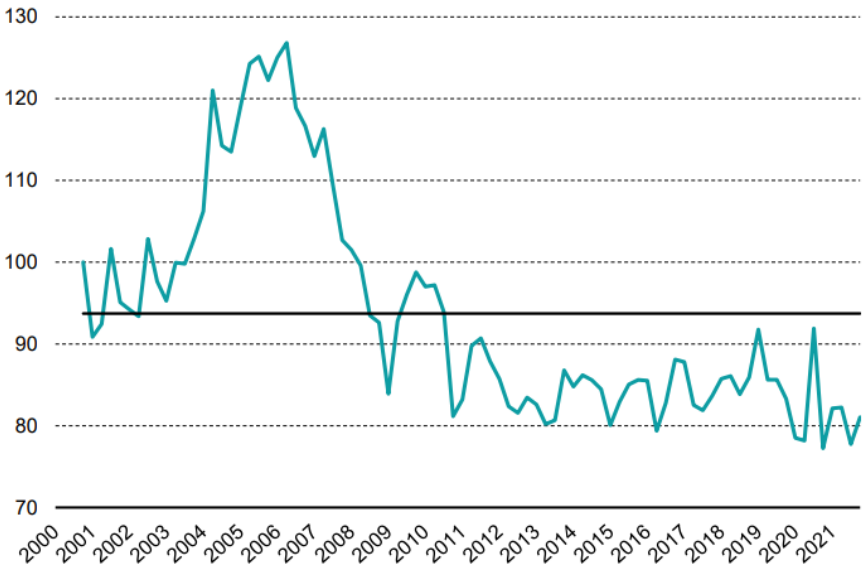
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



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.

After a pick-up in the first three quarters of 2021, transacted property prices decelerated in the fourth quarter of 2021 to grow by 4.5%, remaining below the average since 2014 and significantly below the euro area average of 9.4%. Furthermore, housing affordability measured as the ratio of 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.

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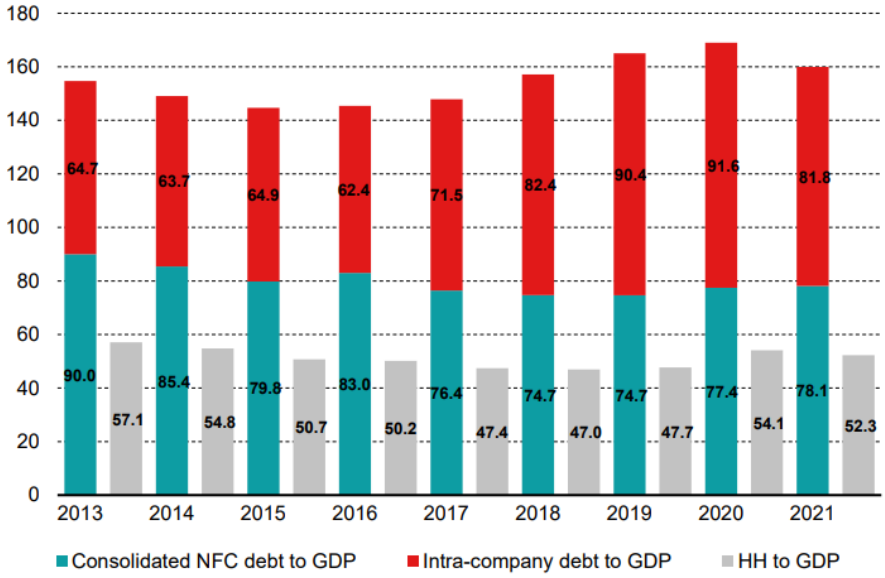
Meanwhile, the conservative haircuts and loan-to-value ratios applied by banks continue to mitigate any potential vulnerabilities that could stem from the real estate market, safeguarding banks and households' balance sheets. Conservative lending practices are also enforced through the borrower-based metrics which were introduced in 2019 through the Banks' Directive No. 16. Delinquency rates on resident mortgages decreased further in the first quarter of 2022, whereas compensation of employees continued to improve, exceeding pre-pandemic levels.

Household and Corporate Debt

As at the end 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 212.2%, 16.5 percentage points lower than the level as at end 2020 on account of the strong recovery in GDP (see Chart 4). In 2021, household debt resumed momentum, up by 8.6% (which corroborates with the increase in mortgages in part due to the advantageous tax scheme which is temporary in nature), but since GDP recovered strongly, the household debt-to-GDP ratio fell to 52.3% from 54.1% a year earlier, remaining below the euro area average. However, household debt to financial assets increased slightly in 2021 to reach 21.6%, up by just 0.4 percentage points from the previous year. Meanwhile, NFC debt to GDP fell by 14.7 percentage points to 160.0%. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 78.1% 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)

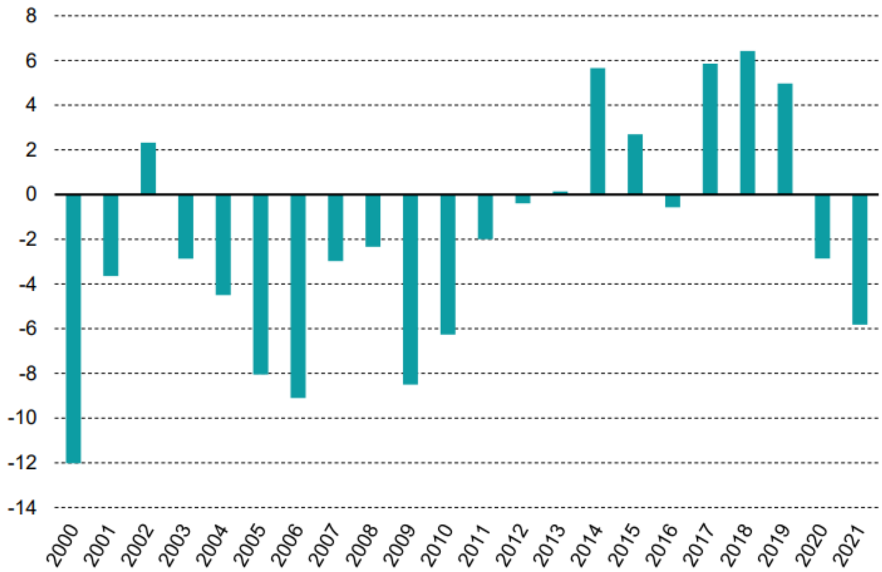


Sources: Central Bank of Malta; NSO.
Note: Based on four-quarter moving sum.

Current Account

On the external front, the current account remained in deficit, standing at 5.8% of GDP as at end 2021 (see Chart 5). In 2020 this was mostly due to a strong decline in net services receipts, which although showed evident signs of recovery in 2021 reflecting the increased tourism activity this remained below pre-pandemic levels. Furthermore, higher merchandise trade deficit was reported in 2021, also affected by extraordinary investment in the aviation sector.

Chart 5
CURRENT ACCOUNT BALANCE
(per cent)



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

The core domestic banks continued to report healthy aggregate capital levels, liquidity, and profits. The core domestic banks' Total Capital Ratio and Common Equity Tier 1 capital ratio stood at around 22.4% and 19.0%, respectively in March 2022. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at around 350%, 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. The standardised bank credit-to-GDP gap is currently negative at -6.0 percentage points, which is still below the reference threshold of positive 2 percentage points as indicated in the BCBS guidance. More importantly additional indicators show diverging trends in the underlying credit growth, impacted also through transitory effects.