BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

September 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: 75.2% and its deviation from the long-term trend: -7.0 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 traditional 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

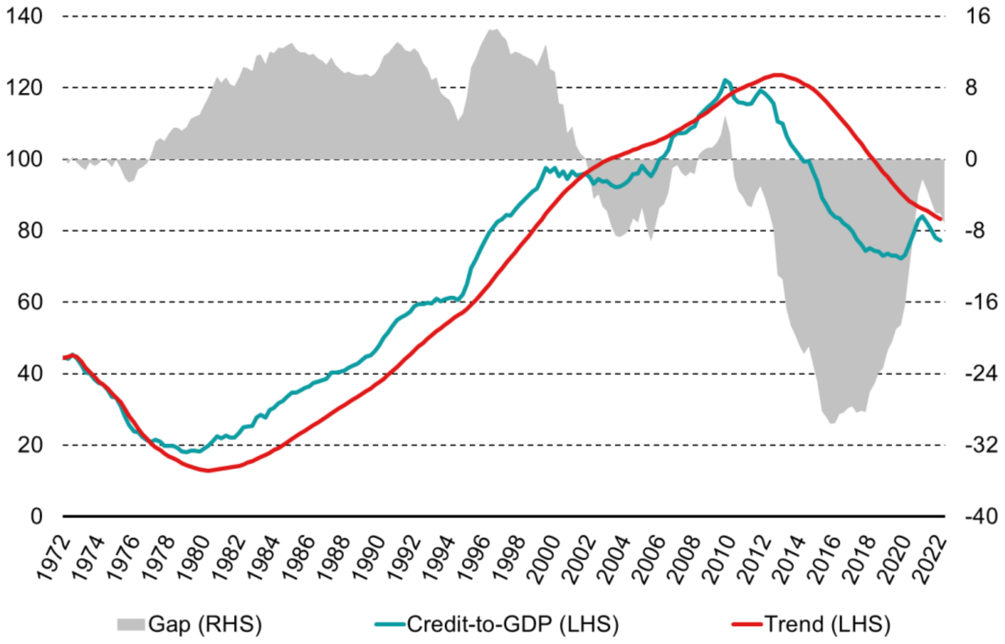
Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of the one-sided Hodrick-Prescott (HP) filter of the

[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 second quarter of 2022, the credit-to-GDP gap widened slightly to -7.0 percentage points while the credit-to-GDP ratio fell to 75.2% as economic activity continued to recover at a stronger pace than credit growth (see Chart 1).[4] However, the geopolitical risks which grew within the first half of the year impacted negatively GDP growth projections, with the Central Bank of Malta revising growth downwards, with the latest projections standing at 5.2% for this year and 4.5% and 3.7% for 2023 and 2024, respectively. 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 widened slightly to remain below the activation threshold of +2 percentage points, this still remains significantly lower than the trough of around -30 percentage points in the first quarter of 2016 thus requiring continuous monitoring

[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.

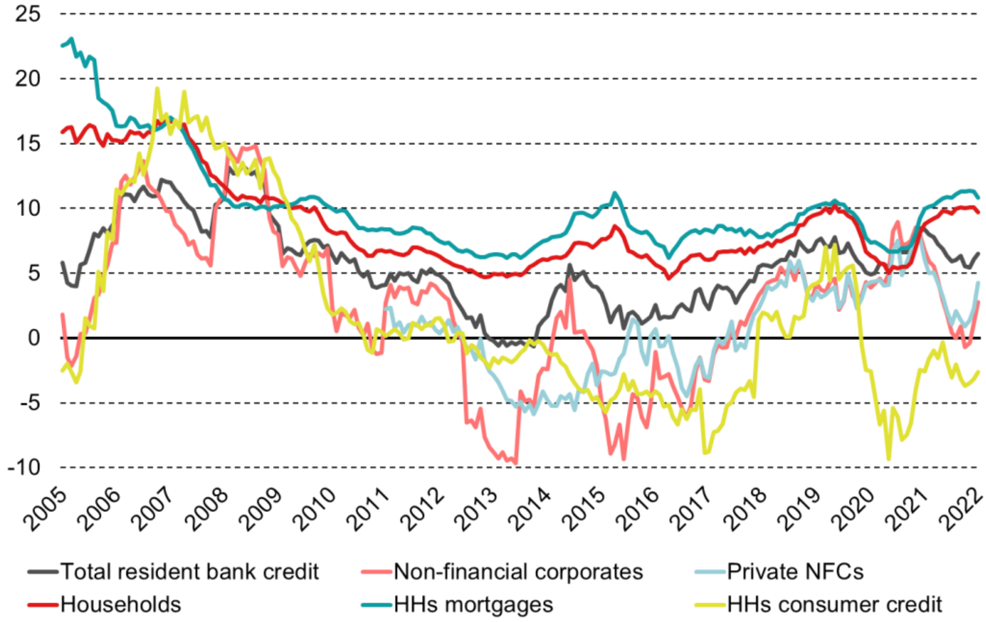
[4] https://www.centralbankmalta.org/economic-projections

of developments. Furthermore, as the additional indicators below indicate, credit growth, and private sector development do experience diverging trends which would indicate different sources of cyclical risks. This supplements the decision that at the current juncture, the decision is not to activate the CCyB buffer rate above 0%, also given that this macroprudential tool is perceived to impact all credit sectors, which at this stage is unwarranted.

Credit Growth

In June 2022, resident credit growth accelerated to 6.5%, compared to 5.6% reported in the previous quarter, albeit still at a lower extent than 8.4% a year earlier. Growth continued to be largely driven by credit to households, which grew by 9.7% (see Chart 2), owing exclusively to mortgages which increased by 10.9%, surpassing pre-pandemic growth rates. Such developments are deemed to be, in part, transitory owing 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 now till end June 2023 to sign the final deed for those promises of sale signed by end 2021, after the deadline was extended further. The transitory element could also be confirmed by looking at the strong number of promise of sales agreements signed during 2021, with such agreements falling by around 22% during the first eight months of 2022. In contrast, consumer lending remained in negative territory with growth declining further by 2.7%. Meanwhile, NFC lending grew by almost 3.0% after some contractions reported in March 2022, although such growth remains contained and much lower than 6.7% reported a year earlier.

Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)

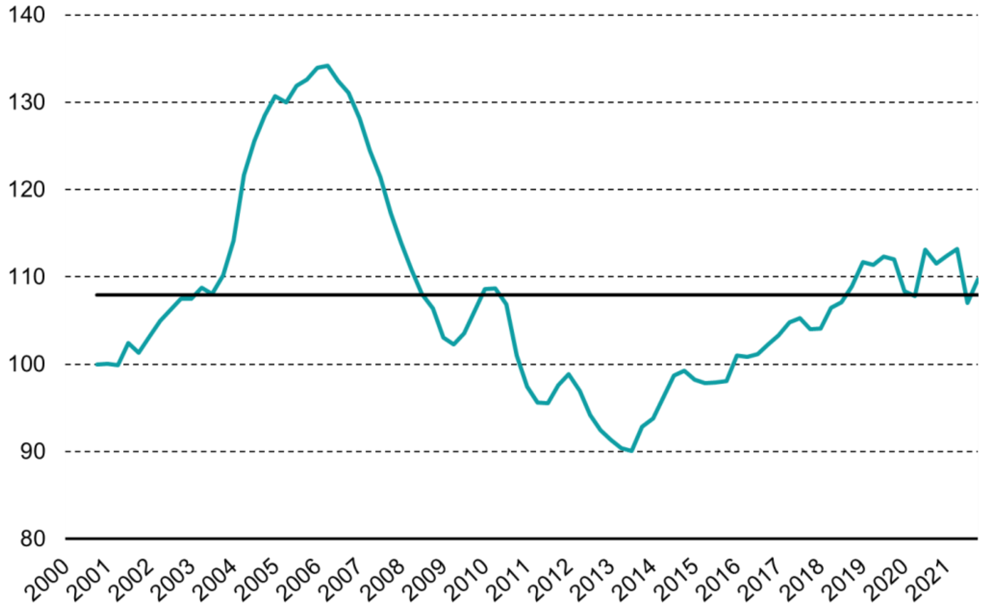


Source: Central Bank of Malta.
Note: A break in series was reported in May 2017 with regards to HH consumer credit due to a reclassification exercise.

Property market

Turning on to the property market, transacted property prices grew by an annual 6.7% in the first quarter of 2022, up by 2.2 percentage points compared to the last quarter of 2021, being somewhat above the average since 2009 but below the euro area average of 9.8%. Furthermore, housing affordability measured as the ratio of the median advertised property price-to-per capita income ratio stood above the long-term average, after enbarking on an increasing trend since 2013 (see Chart 3). Still, this remained below the peaks reported during the global financial crisis.

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



Source: Central Bank of Malta.
Note: Based on the Central Bank of Malta advertised property prices. Refers to 4-quarter moving average with 2000Q4 = 100.

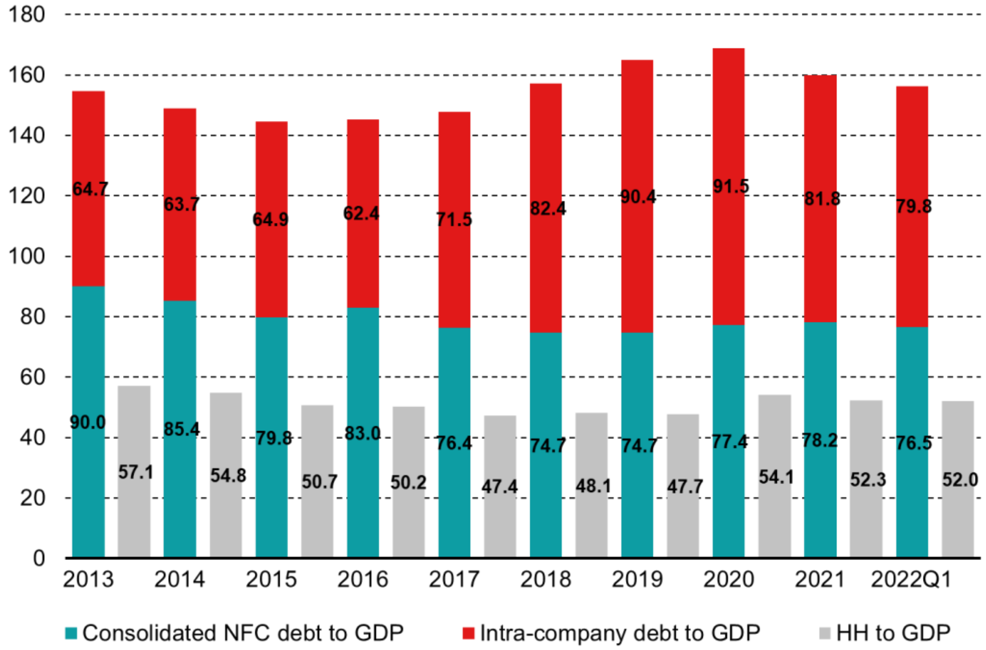
Meanwhile, the conservative haircuts and loan-to-value ratios applied by banks continue to mitigate any potential vulnerabilities that could stem from the real estate market, safeguarding banks and households' balance sheets. Conservative lending practices are also enforced through the borrower-based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

Household and Corporate Debt

During the first quarter of 2022, 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 208.3%, 3.9 percentage points lower than the level as at end 2021 on account of the strong recovery in GDP (see Chart 4). In 2022 Q1, the household debt-to-GDP ratio fell slightly by just 0.3 percentage point to 52.0% as compared to December 2021, remaining below the euro area average. However, looking at household leverage, household debt-to-financial assets, and household debt-to disposable income both increased slightly in March 2022 to reach 22.2% and 86.6%, respectively. Furthermore, households' net financial wealth decreased by almost 2% albeit it remained strong mainly held in the form of deposits.

Meanwhile, NFC debt-to-GDP fell by 3.6 percentage points to 156.3%. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 76.5% of GDP, below the euro area average. Furthermore, the consolidated leverage ratio of NFCs continued to decline to 28.5%, remaining below that of the euro area. The above highlights the diverging trends between households and corporates also in terms of debt leverage.

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

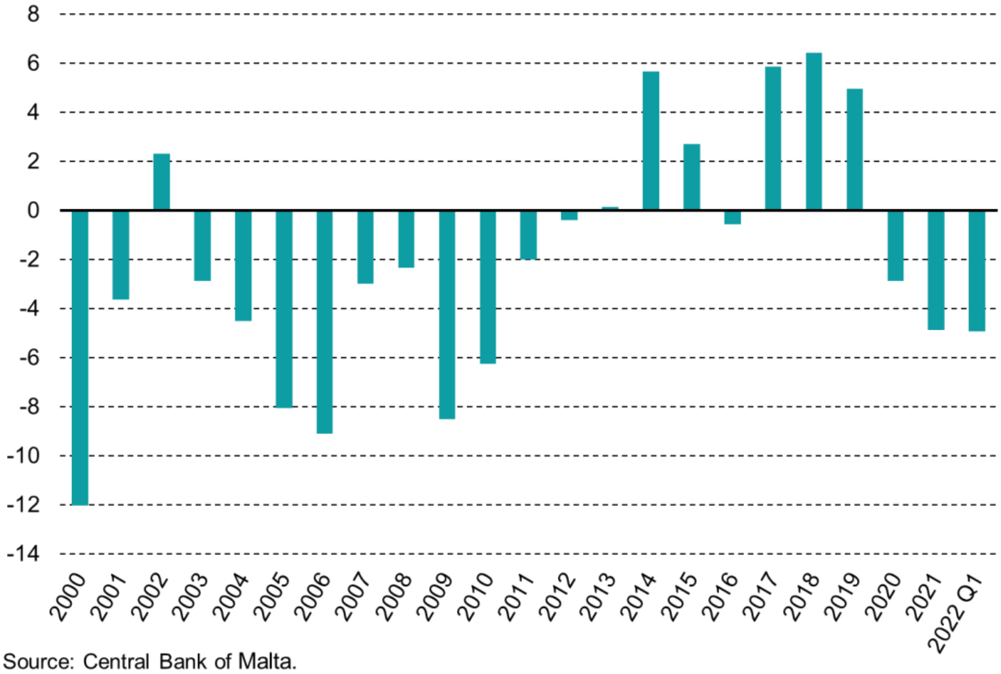


Sources: Central Bank of Malta; NSO.
Note: Based on 4-quarter moving sum.

Current Account

On the external front, the current account remained in deficit during the first quarter of 2022, standing at 4.9% of GDP, similar to the position held in the last quarter of 2021 (see Chart 5).

Chart 5
CURRENT ACCOUNT BALANCE
(per cent)



Source: Central Bank of Malta.
Note: Based on 4-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% and 19%, respectively in June 2022. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at 374.0%, 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 -7.0 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.