BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

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Financial Stability Department

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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: 74.8% and its deviation from the long-term trend: -6.3 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.

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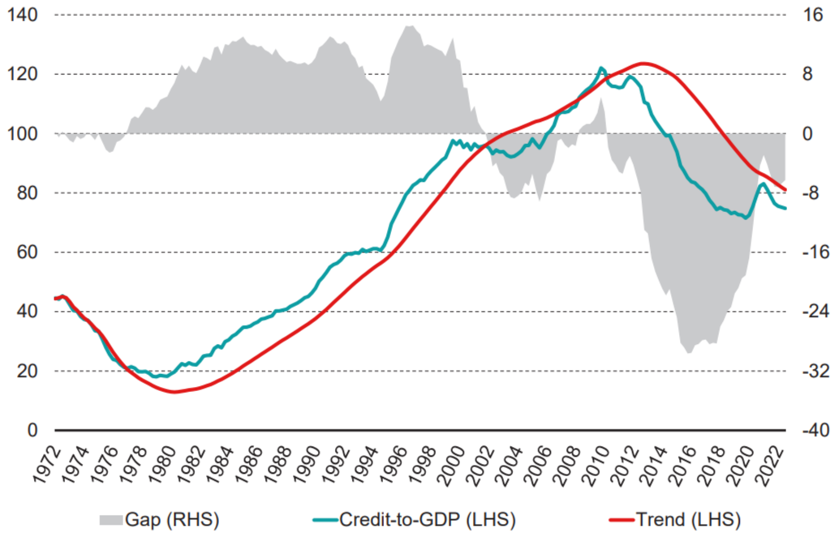
credit-to-GDP ratio for Malta.[3] The trend represents the smoothened credit-to-GDP plotted on the left-hand axis together with the actual series. The gap between the two is reflected in the light grey histogram which is plotted on the right-hand axis.

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 third quarter of 2022, the credit-to-GDP gap narrowed slightly to -6.3 percentage points while the credit-to-GDP ratio fell to 74.8% as economic activity continued to expand at a stronger pace than credit growth (see Chart 1).[4] In line with this, the Bank' latest forecast for GDP growth shows an upward revision of 1.6 percentage points to 6.8% in 2022, mainly reflecting stronger than expected growth in exports and private consumption during the first half of the year. However, amid a deteriorated international environment and high inflation, GDP growth for 2023 and 2024 was reassessed downward to 3.7% and 3.6% respectively. How this translates into the developments within the gap depends on a number of factors including the path of future credit growth. While the gap remains below the activation threshold of +2 percentage points, it is also significantly lower than the trough of around -30 percentage points in the first quarter of 2016 thus requiring continuous monitoring of developments. Furthermore, despite the recent pick up in private NFC credit, it is still comparatively weak and NFC leverage is still on a downward trend. This supplements the decision that at the current

[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

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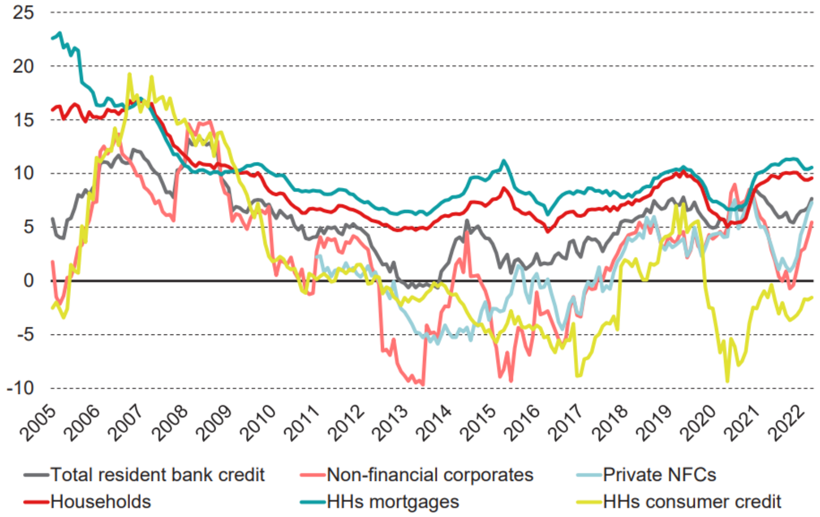
juncture, the decision is not to activate the CCyB buffer rate above 0%, also given that this macroprudential tool is perceived to impact all credit sectors, which at this stage is unwarranted.

Credit Growth

In September 2022, resident credit growth continued to accelerate to 7.7%, compared to 6.5% reported in the previous quarter, and of the 7.2% reported in the same period a year earlier. Growth continued to be largely driven by credit to households, which grew by 9.6% (see Chart 2), owing exclusively to mortgages which increased by 10.6%. Despite, tentative signs of weaker growth compared to recent observations, it remained above pre-pandemic growth rates in part, owing to the front loading of property sales experienced in the past quarters due to the tax relief scheme introduced during the pandemic. The transitory element could also be confirmed by looking at the strong number of promise of sales agreements signed during 2021, which subsequently fell by 16.4% in the first eleven months of 2022 when compared to the same period of the previous year. As these transitory elements fade, mortgage growth should slow down further, also in view of the current uncertain macroeconomic environment as evidenced by the recent declining trend of the Maltese Economic Sentiment Indicator (ESI), Consumer lending remained on a downward trend, declining by 1.6% in September 2022, though at a slower pace when compared to earlier periods. Meanwhile, NFC lending grew by almost 5.5% after some contractions reported earlier this year, with such growth recovering to exceed the rate of 4.5% 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.

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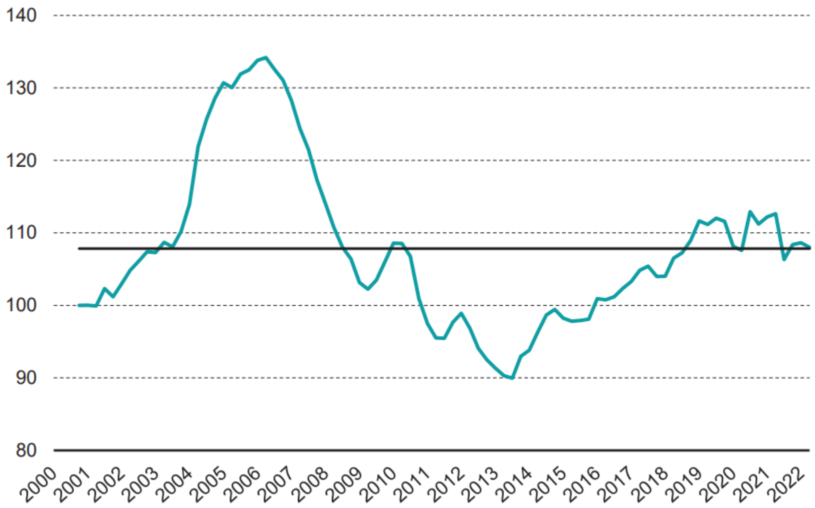
Property market

Turning on to the property market, transacted property prices grew by an annual 7.7% in the second quarter of 2022, up by almost a percentage point compared to the previous quarter, being somewhat above the average since 2009 but below the euro area average of 9.3%. Furthermore, housing affordability increased slightly compared to recent years as the ratio of the median advertised property price-to-per capita income ratio remained relatively stable at slightly lower levels following an increasing trend which had been persisted since 2013 (see Chart 3). As a result, the ratio stood in line with the long-term average and much 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 nine months of 2022, whereas compensation of employees continued to improve.

Household and Corporate Debt

During the second 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 203.8%, 8.7 percentage points lower than the level as at end 2021

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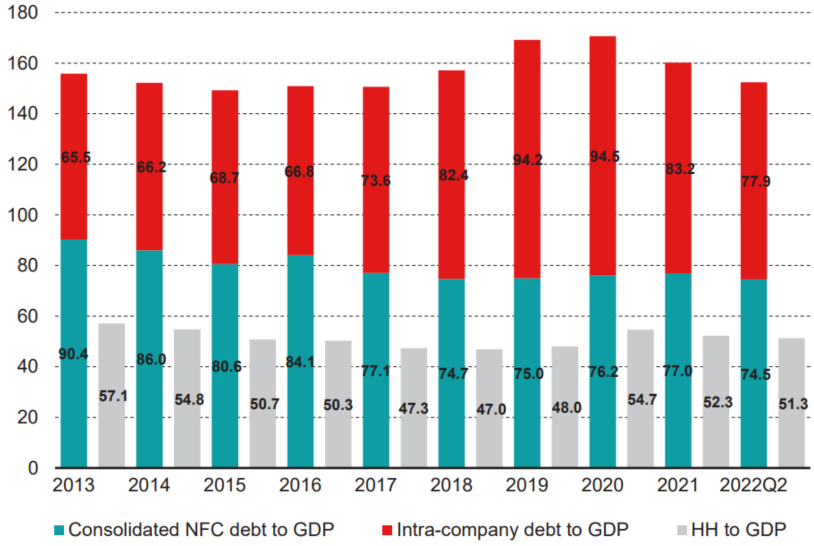
on account of the strong continued recovery in GDP (see Chart 4). In 2022 Q2, the household debt-to-GDP ratio fell by 1.0 percentage point to 51.3% when compared to December 2021, remaining below the euro area average. However, looking at household leverage, household debt-to-financial assets, and household debt-to disposable income both increased in June 2022 to reach 23.8% and 87.6%, respectively. Furthermore, households' net financial wealth decreased by 1.7% albeit it remained strong and mainly held in the form of deposits.

Meanwhile, NFC debt-to-GDP fell by 7.7 percentage points to 152.4%. Given that intra-group debt is an important element of NFC debt, on consolidated basis NFC indebtedness stood at a more contained rate of 74.5% of GDP, well below the euro area average. Meanwhile, the NFCs' leverage ratio on a consolidated basis, remained stable at 28.0% and thus still below the euro area average. This highlights the diverging trends between households and corporates also in terms of debt leverage.

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

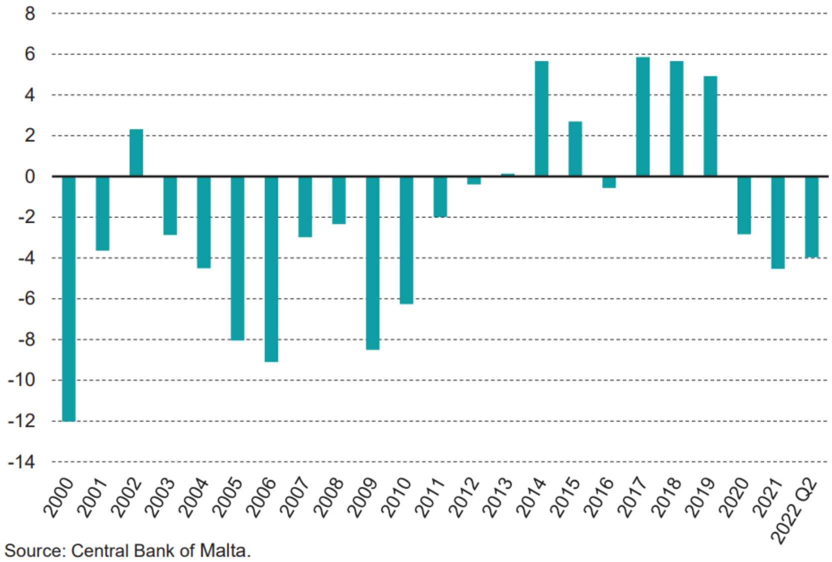


Sources: Central Bank of Malta; NSO.
Note: Based on 4-quarter moving sum.

Current Account

On the external front, despite improving somewhat over the last quarter of 2021, the current account remained in deficit during as at June 2022, standing at 4.0% of GDP (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 22.0% and 18.5%, respectively in September 2022. Liquidity remained ample with core domestic banks' Liquidity Coverage Ratio standing at 346.9%, 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 -6.3 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.