



## 2. FINANCIAL STABILITY

In its capacity as the Macprudential Authority in Malta, the Central Bank of Malta is entrusted with maintaining the stability of the financial system. The Financial Stability Surveillance & Research (FSSR) Department and the Policy, Crisis Management & Stress Testing (PCMST) Department are responsible for discharging the Bank's mandate to safeguard the stability of the financial system. This is primarily achieved through the continuous monitoring of potential financial stability risks, and the subsequent design and application of macroprudential policy tools to build resilience against emerging systemic risks. The assessments are supplemented by stress tests and sensitivity analyses to evaluate the impact of plausible tail-risk events which could challenge the resilience of the domestic financial system.

### Main developments

During 2022, the Bank published the *Financial Stability Report (FSR) 2021* and its *Interim*, which covers financial stability developments for the first half of 2022, in a bid to keep the public and stakeholders informed of the main financial stability conditions amidst the heightened uncertainty and challenging macro-economic environment. Towards the end of September, the Central Bank of Malta hosted its first-ever FSR launch event entitled *Financial Stability Report 2021 – Resilience in Uncertain Times*.

Staff also contributed to the Bank's publications in the form of two working papers documenting a stress testing framework for Maltese households and the estimation of one of the Bank's macroeconomic models, respectively. The latter also featured as an article in the fifth edition of the Bank's Research Bulletin. The Bank participated in the discussions on the 2022 European Commission (EC) Macroprudential Review, expressing its views and proposing targeted amendments to the current European macroprudential toolkit.

The newly set up Financial Stability Research Office launched its internal Research Seminar Series with a presentation to staff in November on a new systemic risk indicator for Malta. This indicator complements existing indicators developed earlier in the year. Its construction is part of a research project aimed at strengthening the Bank's analysis of cyclical risks. Economists from this office are also working on the development of other methods that further strengthen this toolkit.

In September, the Bank hosted a joint European Investment Bank and Central Bank of Malta Conference, entitled *Financing the Transition to a Carbon Neutral Economy* in which staff members from the Financial Stability Surveillance & Research and the Policy, Crisis Management and Stress Testing Departments took part. They presented a first assessment of the Maltese financial sector's direct exposure to economic sectors that may be affected by the transition to a less polluting economy.

Later in October, the Bank also hosted a series of ECB and ESRB meetings on matters relating to macroprudential policy, including a meeting for members of the ECB Macroprudential Policy Group (MPPG). The Bank and the ECB also jointly hosted the fifth annual MPPG research workshop, entitled *Macroprudential policy and real estate markets: objectives, effectiveness and new challenges*. The workshop's special focus was on real-estate oriented macroprudential policies, with contributions from the Bank's staff.

The Bank continued to monitor developments in AML related matters of different stakeholders, including the government, national authorities and market operators which continued their work in addressing the recommendations made by MONEYVAL and the Financial Action Task Force (FATF). In this regard, following the significant progress made in improving the AML/Combating the Financing of Terrorism (CFT) regime, and

after meeting the commitments identified in the action plan regarding the strategic deficiencies that the FATF highlighted in June 2021, Malta was officially removed from the FATF list of jurisdictions under increased monitoring in June 2022.

### Policy developments

In line with the ESRB recommendation (ESRB/2015/1), on recognising and setting CCyB rates for exposures to third countries, in 2022 the Bank carried out its annual exercise with the aim of identifying the material third countries to which the domestic banking sector is exposed.<sup>1</sup> The material third countries identified in 2021, which comprise the United States of America, United Kingdom and United Arab Emirates, were all also confirmed for the period Q2 2022 – Q2 2023.

As per the ESRB recommendation on the assessment of cross-border effects of, and voluntary reciprocity for macroprudential measures, the Bank reviews macroprudential policy measures recommended for reciprocation by other Member States.<sup>2</sup> During 2022, four countries recommended measures for reciprocation: Lithuania, The Netherlands, Belgium and Germany. After analysing the recommended policy measures, it was decided not to reciprocate on the basis of the immateriality of exposures in the local banking sector and/or inapplicability of the policy measure to the domestic financial system. The Bank also maintained its non-reciprocation stance unchanged, in relation to the previously activated measures recommended for reciprocation by other Member States.<sup>3</sup>

In consideration of the fact that 2021 was the third year of application of Directive No. 16 on BBMs, credit institutions were required to submit their external audit reports covering the 2021 financial year. Overall, the banks were found to be compliant with the provisions of Directive No. 16.

During 2022, the CCyB was kept unchanged at 0%, with the credit-to-GDP gap narrowing slightly on account of the faster recovery in GDP than growth in bank credit. Drawing also from an assessment of supplementary indicators, the Bank did not deem necessary to activate the CCyB, which is considered to be a broad-based policy tool. Meanwhile, the capital conservation buffer remained in force, with banks required to hold an additional capital of 2.5% of risk-weighted assets.

In addition, the Bank carried out quarterly rounds of the BLS in 2022 among four large core domestic banks, with the aim to gather qualitative information on developments in lending standards and credit demand of households and NFCs. The BLS results were published in a dedicated box in the Bank's *FSR 2021*, highlighting domestic developments and a comparison of these with the euro area.

The Bank together with the MFSA carries out a yearly exercise on the identification of the O-SIIs and the related applicable capital buffer. The same four credit institutions identified as O-SIIs in 2021 have been re-confirmed in 2022.

### Committee meetings at domestic and European levels

The Bank's Financial Stability Committee met four times in 2022 to discuss ongoing topics related to financial stability as well as the content of the *FSR*. In addition, other important topics discussed were the assessment of cyclical risks in Malta, a progress update on the design of the climate-related adverse scenario, the Bank's views on the revamp of the MFSA's banking rule BR/09 which relates to measures addressing non-performing and forborne exposures, and the results of the 2022 O-SII buffer exercise.

The Bank remained also active in the Joint Financial Stability Board as well as the Domestic Standing Committee and its Crisis Management Task Force.

<sup>1</sup> ESRB/2015/1: Recommendation of the ESRB of 11 December 2015 on recognising and setting countercyclical buffer rates for exposures to third countries.

<sup>2</sup> ESRB/2015/2: Recommendation of the ESRB of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (europa.eu)

<sup>3</sup> The latest information on the reciprocation stance taken by the Central Bank of Malta is available on the website at this [link](#).

The Forum for Financial Stability was held in February 2022 where cyclical and residential real estate risks, capital buffer usability and climate risks were discussed.

At a European level, senior Bank officials participated in a number of meetings of the ESRB, the European Banking Authority (EBA), the EFC, the ECB SSM, and the ECB meetings and their sub-structures. Furthermore, several meetings on financial stability issues were held with the IMF in terms of its Article IV Mission, the EC and with credit rating agencies.

### **Future developments**

In 2023, the Bank will continue updating its risk quantification and assessment toolkit to be in a better position to assess potential financial stability risks at an early stage. This should be complimented by further research initiatives especially in the field of cyclical risks. Similarly, the stress testing frameworks will be reviewed and refined as necessary to better capture any new or emerging risks, as well as the quantification of their impact.

The macro stress testing framework is being reviewed with the aim of incorporating balance sheet dynamics under prescribed paths in response to a stress test scenario. Research plans for 2023 include an assessment of the introduction of BBMs through Directive No. 16 in 2019, as well as the start of the development of a network model that captures financial interlinkages across Malta's financial sector. From the policy side the Bank will recommend the introduction of a sectoral systemic risk buffer to mitigate against concentration risk and rising cyclical vulnerabilities in the mortgage lending sector.