2. FINANCIAL STABILITY

The Central Bank of Malta is the national macroprudential authority responsible for maintaining the stability of the domestic financial system. The Bank monitors and assesses systemic risk and carries out macroprudential research. In addition, the Bank develops and maintains stress testing frameworks and sensitivity analyses, as well as introduces new macroprudential tools as the need arises.

Main developments

Following the publication of the *Financial Stability Report* (FSR) 2022, the Bank presented the key messages of this Report in a seminar, entitled *Stability in a Changing Financial Landscape*. Staff highlighted the main takeaways of the Report in the form of a Strength, Weaknesses, Opportunities and Threats analysis for the sector and participated in a panel discussion titled *The Role of Macroprudential Policy in a Tighter Monetary Policy Environment*. The panel discussion included officials from the Bank, the Head of the Macroprudential Policy and Financial Stability Division of the ECB and a representative from the banking industry. Discussions revolved around the interaction of these policy frameworks and the way authorities balance the two to minimise unintended consequences. In the last quarter of the year, the Bank also published the Interim FSR 2023 which gave an update of the developments for the first half of the year.

These publications contained several special features and articles on various topics of interest, including additional indicators of cyclical risk, namely a domestic cyclical systemic risk indicator and a semi-structural credit gap. During the year, the Bank published a refined assessment of the financial sector exposure to climate-sensitive sectors and a box on climate change experimental indicators for Malta in line with research conducted by the ECB. The Bank enhanced further its suite of stress testing models particularly its macro stress testing framework. The amended framework's credit risk module now facilitates the projection of loan loss provisions in accordance with the IFRS9 three-stage provisioning, as well as in alignment with both baseline and adverse macroeconomic scenario. Furthermore, the Bank refined the Interest Rate Risk in the Banking Book (IRRBB) framework and liquidity risk stress tests to address specific shocks. Similarly, the Bank improved the vulnerability assessment framework of Maltese indebted households to inflation and interest rate shocks based on the fourth wave of the Household Finance and Consumption Survey (HFCS).

The Bank organised a series of internal research seminars focused on macroprudential research where staff presented their research to colleagues to share expertise and solicit feedback. Staff also presented their research in international conferences. One staff member published research on macroprudential policy in two international peer-reviewed journals, and an additional paper in the Bank's Working Paper series. The Bank also hosted an online research seminar delivered by an external speaker and a staff member provided training on econometrics to some of the Bank's economists.

The annual Forum for Financial Stability was held on the 6 December 2023 where the Governor, in his opening remarks, highlighted the need to keep an open dialogue with stakeholders and the cross fertilization of ideas for the benefit of our industry. Discussions focused on the Bank's new measure of a semi-structural credit gap for Malta, central bank digital currencies and the banking sector's journey towards Environmental, Social, and Governance (ESG) compliance.

Macroprudential Policy developments

As per the European Systemic Risk Board's (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 European Union Member States. Sweden and Belgium recommended measures for reciprocation during 2023. The Bank did not reciprocate based on the lack of materiality 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.[1]

In addition, the Bank carried out its annual exercise for the identification of material third countries to which the Bank is exposed, in line with the ESRB recommendation (ESRB/2015/1), on recognising and setting countercyclical capital buffer (CCyB) rates for exposures to third countries. The material countries identified during 2023 remained the same as those identified in the previous year, namely, the United States of America, United Kingdom and United Arab Emirates.

In line with Article 19 of Directive No. 16 on borrower-based measures, lenders are required to submit internal audit reports on an annual basis, as a verification of compliance with the Directive. In 2023, the Bank analysed the reports for the financial year 2022 where all banks were deemed compliant with the requirements of the Directive.

During 2023, the CCyB was kept unchanged at 0%, with the credit-to-GDP gap remaining in negative territory. However, drawing from the assessment of supplementary indicators and other metrics, the Bank identified budding cyclical risks driven by the real estate and household sectors. For this reason, the Central Bank of Malta, in consultation with the Malta Financial Services Authority (MFSA) and following recommendation by the Joint FSB, introduced a sectoral systemic risk buffer on domestic residential real estate (RRE) mortgage exposures to natural persons, secured by RRE, in Malta. The buffer is a macroprudential tool emanating from Article 133 of the Capital Requirements Directive (CRD) framework and has the aim of preventing and mitigating systemic risks that may potentially have serious adverse repercussions on the financial system and the real economy. The buffer became effective in March 2023 and is applicable from end September 2023 at a rate of 1.0%, with a fully phased-in rate of 1.5% applicable at the end of March 2024.

The Bank together with the MFSA carried out the yearly exercise on the identification of the Other Systemically Important Institutions (O-SIIs) and the related applicable capital buffer rates; whereby the same O-SIIs identified during 2022 continued to be classified as such during 2023.

During 2023, the Bank continued to carry out quarterly rounds of the BLS among the larger four core domestic banks. The aim is to gather qualitative information on developments in lending standards and credit demand from households and NFCs. The BLS results were published in a dedicated box in the Bank's FSR 2022, highlighting how domestic developments compared to the euro area.

Committee meetings at domestic and European levels

The Bank's Financial Stability Committee continued to discuss ongoing matters related to financial stability as well as the content of the FSR and its Interim. In addition, other important topics considered included the construction of a domestic cyclical systemic risk indicator and a semi-structural credit gap, the setting up of a framework to assess the adequacy of risk-weights in line with CRR Article 124 and the results of the 2023 O-SII capital buffer exercise. During these meetings, the members also considered a new methodology for the classification of domestically-relevant insurance companies and a revised methodology underpinning the Bank's dashboard for the banking sector. The Bank remained active in the Joint FSB as well as the Domestic Standing Committee and its Crisis Management Task Force. The Bank held bilateral discussions with the Ministry for Finance on matters related to the Crisis Management Deposit Insurance.

At a European level, senior Bank officials participated in several meetings of the ESRB, the European Banking Authority, the Economic and Financial Committee (EFC), the Single Supervisory Mechanism and the

[1] Central Bank of Malta note on reciprocity: https://www.centralbankmalta.org/reciprocity.

ECB. Furthermore, meetings on financial stability matters were held with the IMF in terms of its Article IV Mission, the European Commission and with credit rating agencies.

Future developments

The Bank endeavours to further its efforts on maintaining its internal system-wide risk dashboards and its suite of stress testing frameworks. In addition, it will keep abreast of developments relating to financial stability matters with a specific focus on emerging risks such as climate change. The Bank will also conduct further research on topics related to financial stability and macroprudential policy. Together with the MFSA, the Bank will keep up with cyber-resilience related analyses and work conducted by the ECB particularly on the design of a cyber-resilience stress test. The exercise will be launched in early 2024 to assess participating banks' ability to respond to and recover from cyberattacks.