5. MACROPRUDENTIAL POLICY RESPONSE

This chapter highlights the main policy measures implemented by the Bank during 2022. It also provides an overview of the regulatory actions and developments taken by other authorities in this regard, both at a Domestic and European level.

5.1 Central Bank of Malta measures

Sectoral Systemic Risk Buffer

During 2022, risk assessments carried out by the Bank indicated vulnerabilities in the domestic RRE sector, particularly those emanating from a significant increase in the share of mortgage loans in banks' loan portfolios, thus amplifying concentration risk. In view of these observed vulnerabilities, the Central Bank of Malta together with the MFSA decided to implement in 2023 a sSyRB on domestic RRE mortgages secured by domestic RRE collateral. For further details on the scope, design and calibration of the buffer please refer to Box 7.

Countercyclical capital buffer

As per the CCyB rate decision notification, applicable for the first quarter of 2023, a CCyB rate at 0% remains appropriate for the domestic financial system.[1] The relevant credit-to-GDP ratio was recorded at 73.9%, and its deviation from the long-term trend stood at -6.2 percentage points. The analysis is also supplemented by other relevant indicators of credit developments and expert judgement confirming that, at the current juncture, the CCyB rate for Malta should continue to be set at zero.[2]

Voluntary reciprocation of macroprudential measures

In line with the ESRB Recommendation, on voluntary reciprocity for macroprudential measures, the Bank annually reviews newly implemented measures recommended for reciprocation by other EU Member States.[3] During 2022, the Bank decided not to reciprocate the Lithuanian, Dutch, Belgian, and German measures, on the basis of a lack of applicability to the Maltese banking sector. Moreover, the Bank maintained its non-reciprocity stance unchanged in relation to the previous measures recommended for reciprocation by other Member States in past years; namely Finland, Belgium, France, Sweden, Luxembourg, and Norway.[4,5]

Material third countries

The Bank carries out an annual exercise for the identification of those third countries which are deemed to be material to the Maltese banking sector.[6,7] The extent of materiality is based on three exposure metrics; namely, original exposures, RWAs, and defaulted exposures for the Maltese banking sector in relation to third countries.[8] In line with the methodology stipulated in Article 4 of the ESRB Decision 2015/3, the material third countries for the domestic banking sector during the period Q2 2023 until Q2 2024 remain unchanged from those identified last year namely, the United States, the United Kingdom and the United Arab Emirates.

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[1] Refer to https://www.centralbankmalta.org/site/Financial-Stability/CCyB/CCyB-assessment-2023-Q2.pdf.

[2] The other relevant indicators of credit developments that further supplemented this analysis include credit growth, household and corporate debt to GDP ratio, median property price to income ratio and ratio of current account to GDP.

[3] ESRB/2020/9: Recommendation of the ESRB of 2 June 2020 amending Recommendation ESRB/2015/2 on the assessment of cross border effects of and voluntary reciprocity for macroprudential policy measures.

[4] For further information on these measures refer to the reciprocity on the Central Bank of Malta website. Link: https://www.centralbankmalta.org/reciprocity.

[5] For further information on reciprocity adopted in the first half of 2022, kindly refer to the *Interim Financial Stability Report* 2022.

[6] ESRB/2015/3: Decision of the ESRB of 11 December 2015 on the assessment of materiality of third countries for the Union's banking system in relation to the recognition and setting of countercyclical buffer rates. Source: https://www.esrb.europa.eu/pub/pdf/other/Decision_ESRB_2015_3.pdf.

[7] ESRB 2015/1: Recommendation of the ESRB of 11 December 2015 on recognising and setting countercyclical buffer rates for exposures to third countries. Source: https://www.esrb.europa.eu/pub/pdf/recommendations/ESRB_2015_1.en.pdf.

[8] A third country is identified as material, when exposures of the Maltese banking system to that third country are at least 1% for at least one of the above three metrics for a set period of time, and for both steps, as prescribed by the ESRB Decision 2015/3.

Borrower-Based Measures

The Directive on BBMs has entered into its fourth year of implementation since July 2019. The policy stance on BBMs had remained unchanged during 2022, as it continues to be effective in safeguarding the financial resilience of both obligors and lenders in the current scenario.

During 2022, the banks submitted external audit reports requested by the Bank in line with Paragraph 19 of the Directive, relating to a detailed assessment of the banks' compliance with such Directive. In preparation for the internal audit reports expected to be received during 2023, a set of guidelines has been communicated to each credit institution. The aim of the guidelines is to ensure consistency among the checks applied by the respective banks' auditors in their internal assessments, and to standardise the processes across the reporting banks.

Identification of other systemically important institutions

The same four credit institutions identified as O-SIIs during the 2021 exercise have been re-confirmed in the 2022 O-SII iteration.[9] Consequently, the Bank in conjunction with the MFSA, (hereinafter referred to as 'the Authorities'), confirmed APS Bank plc, MDB Group Limited, HSBC Bank Malta p.l.c. and Bank of Valletta plc as O-SIIs, with an O-SII buffer rate ranging from 0.50% to 2.00%.[10]

In the latest O-SII statement of decision, the Authorities announced changes in the O-SII buffer rates for two designated O-SIIs. APS Bank plc registered a higher O-SII score, leading to an increase in its O-SII buffer rate from 0.25% to 0.50%. This increase is to be phased-in over a four-year period. In the course of 2022, HSBC Bank Malta p.l.c. was subject to a corporate restructuring process. This restructuring made HSBC Bank Malta p.l.c. eligible for the O-SII buffer cap foreseen in Article 131(8) of the Capital Requirements Directive, which caps the bank's 1.50% O-SII buffer rate to 1.25%.[11] The O-SII buffer requirement for each identified bank and the applicable transitory provisions are outlined in the Authorities' statement of decision and are applicable from the date of publication of this decision.[12]

5.2 Other domestic regulatory developments

Update on the implementation of revised MFSA BR/09

During the course of 2022, the MFSA consulted the Bank on a number of updates to the MFSA's BR 09.[13] These updates to the Rule reflect a number of EU regulatory developments, including the:

- *Implementation of EBA Guidelines related to the field of NPEs;* namely the EBA Guidelines on the management of NPEs and Forborne Exposures (FBEs) (EBA/GL/2018/06) which amends the threshold for a high NPE bank from 6% to 5%;[14]
- *Removal of 'General Reserve for banking risk'* and 'Excessive NPLs reserve' and replaced by a *revised 'Regulatory Allocation*.[15] The new Regulatory Allocation sets out quantitative requirements for minimum amount of coverage expectations against both the flow and stock levels of NPEs.

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9 CBM-MFSA Policy document on the revised methodology for the identification of other systemically important institutions (O-SIIs) and the related capital buffer calibration: https://www.centralbankmalta.org/site/Financial-Stability/O-SII/o-sii-policy-document.pdf.

10 MeDirect Bank Malta is the parent of MeDirect Bank Belgium, which collectively make up MDB Group Limited, i.e., the consolidated entity that is subject to the O-SII exercise.

11 Directive 2013/36/EU of the European Parliament and of the Council, as amended by Directive (EU) 2019/878 of the European Parliament and of the Council (CRD V).

12 The CBM-MFSA O-SII Statement of Decision was published on 16 January 2023 and is accessible from the following link: https://www.centralbankmalta.org/site/Financial-Stability/O-SII/2023-O-SII-Statement-of-Decision.pdf.

13 MFSA BR No. 9 – Measures addressing credit risks arising from the assessment of the quality of asset portfolios of credit institutions authorised under the Banking Act 1994.

14 The revised Rule also reflects the EBA Guidelines on the definition of default (EBA/GL/2017/07), the EBA Guidelines on credit risk management practices and accounting for expected credit losses (EBA/GL/2017/06) and the EBA Guidelines on disclosures of NPEs and FBEs (EBA/GL/2018/10).

15 Two types of reserves were embedded in the previous BR/09: (i) Allocation of a 'general banking risk reserve' which comprised of a capital buffer in the form of a Pillar II measure allocated from the profits for the year (CET1 deductions) and (ii) Allocation of a 'Reserve for excessive NPLs' which was applied to banks deviating from NPL Reduction Plans.

These amendments ensure a more level playing field between the NPE supervisory expectations applied to SIs and less significant institutions (LSIs). By reflecting a fairer economic cost of NPEs, the amendments foster greater bank balance sheet transparency. A final version of the revised BR/09 that reflects the above considerations was published on 19 January 2023.[16]

5.3 European regulatory developments

Introduction of the Daisy Chain Regulation

On 14 November 2022, Regulation (EU) 2022/2036 of the European Parliament and of the Council came into force (the Daisy Chain Regulation). The Regulation amended the Capital Requirements Regulation (EU) No 575/2013 (CRR) and the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD). The aim of the Daisy Chain Regulation is to introduce targeted adjustments to improve the resolvability of banks in a way that banks remain resilient and capable of withstanding shocks. In this regard, revisions are made to the MREL regime, and to align the resolution treatment of global systemically important institutions (G-SII) in the prudential regulatory framework. Such amendments were necessary to implement in the European Union the international 'Total Loss-absorbing Capacity (TLAC) Term Sheet' for G-SII groups as published by the Financial Stability Board on 9 November 2015, as well as to enhance the application of the MREL for all banks.

Single Resolution Board (SRB) publishes updated 2022 MREL policy

On 8 June 2022, the SRB published the updated approach to setting MREL. The approach results from the experience gained during past resolution planning cycles, feedback received from stakeholders, as well as the consideration of new regulatory developments arising from the revised Banking Package. MREL is a crucial tool in ensuring that banks have sufficient eligible instruments to support the implementation of the institutions' preferred resolution strategy. Additionally, MREL internalizes the cost of failure of the respective bank and thus ensures that the shareholders and the creditors are the ones that contribute to the absorption of losses and subsequent recapitalisation, thereby preventing the provision of public financial support. The developments considered in the new updated policy include the end of the supervisory leverage relief measures of the ECB, the changes to the CRR on the indirect holding of internal MREL (iMREL), and the MREL calibration for banks with a multiple point-of-entry resolution strategy.

Digital Operational Resilience Act (DORA)

On 27 December 2022, Regulation (EU) 2022/2554 on Digital Operational Resilience for the Financial Sector was published in the EU Official Journal, and entered into force on 16 January 2023. DORA entered into force with a two-year implementation period, with financial entities being expected to be compliant by January 2025. The aim of this new regulation is to create a framework that strengthens the financial sector's resilience towards ICT related incidents and threats.

Markets in crypto-assets (MiCA) Regulation

In June 2022, the European Parliament and the Council reached a provisional agreement on the MiCA regulation, which is part of a wider digital finance package that is intended to stimulate technological growth, while ensuring financial stability and consumer protection. The Regulation is expected to enter into force in 2023, with a transitional period for its application. The aim of the regulation is to create provisions on the prevention of market abuse within the crypto-asset market and regulate specific areas such as client information, fund protection and outsourcing. Following the publication of MiCA, the European Supervisory Authorities (ESAs) will develop regulatory technical standards for the content and methodologies included in the regulation.

ESRB Recommendation on the vulnerabilities in the Commercial Real Estate Sector

On 25 January 2023, the ESRB published a recommendation on vulnerabilities in the CRE sector in the European Economic Area. The aim of the recommendation is to urge the European Union and national authorities to

[16] The final amended BR/09 text may be accessible from the following link: https://www.mfsa.mt/wp-content/uploads/2023/01/BR-09-Measures-Addressing-Non-Performing-Exposures-and-Forborne-Exposures.pdf.

enhance the monitoring of systemic risks emanating from the CRE sector, whilst ensuring that financial institutions participating in CRE lending are resilient and engage in sound and prudent risk management practices.

The EBA publishes its Report on the first mandatory exercise on Basel III full implementation impact

On 30 September 2022, the EBA published a report on the first mandatory exercise on the impact of the full implementation of Basel III in 2028.[17] This project was launched at the end of January 2022, with the sample of EU banks participating in this exercise determined by the relevant NCAs in line with Articles 4 and 8 of the EBA Decision on the mandatory Basel III monitoring exercise. The data submitted in scope for this exercise has a reference date as of December 2021, and covers a total of 163 banks from all EU countries with the four MT O-SIIs also forming part of the sample.[18] The results of this exercise revealed that the full Basel III implementation would result in an average increase of 15.0% of the current Tier 1 minimum required capital (T1 MRC) of EU banks, with the main drivers of this impact being the 'Output floor' (6.3%) and 'credit risk' (4.4%).[19]

[17] The Basel III monitoring exercise aims to assess the impact of the latest regulatory developments at BCBS level with regard to: i) the global regulatory framework to enhance resilience for banks and banking systems; ii) leverage ratios; iii) liquidity ratios; iv) the NSFR; v) the post-crisis reforms.

[18] Namely APS Bank plc, MDB Group Limited, HSBC Bank Malta p.l.c. and Bank of Valletta plc.

[19] The output floor aims at reducing inconsistencies in the calculation of RWAs between banks using the Standardised Approach (SA) and those using the Internal-Rating Based (IRB) approach to calculate their capital requirements. IRB-based banks are to hold RWAs equivalent to at least 72.5% of the RWA that would have had to be held under the SA approach.

BOX 7: IMPLEMENTATION OF A SECTORAL SYSTEMIC RISK BUFFER FOR MALTA[1]

Introduction

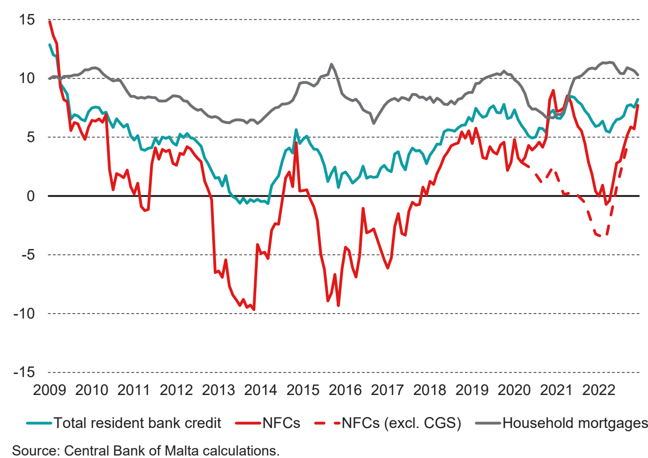
As outlined in 'Special Feature 1: Assessing Cyclical Risks in Malta,' risk assessments indicate that cyclical risk has been rising, driven by the household and property stretches.[2] More recent assessments indicate that, vulnerabilities persisted within the RRE sector, stemming from heightened mortgage loan activity. While growth in mortgages decelerated slightly in 2022, this remains at significantly strong levels, close to 10% (see Chart 1).

Vulnerabilities within the RRE sector have to be seen in the context of higher household leverage which, given the prevailing increasing interest rate environment, could lead to a strain on debt repayments, particularly for the more indebted borrowers.

From the banks' perspective, persistently high mortgage growth continued to manifest itself in increasing concentration risk. As can be seen in Chart 2, the share of resident mortgage lending rose significantly, from just 26% in 2004, to around 53% in 2022. Given the vast majority of the banks' collateral is immovable property related, the performance of the immovable property sector may also expose the banking sector to indirect vulnerabilities. Also, in the event of a sharp correction in residential property prices, banks' asset quality may be weakened via the wealth effect channel.

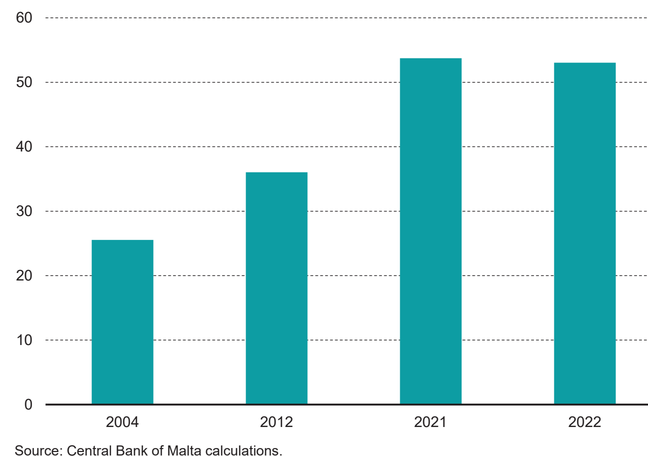
Regarding the corporate sector, the above-mentioned special feature highlights

Chart 1
ANNUAL CREDIT GROWTH RATE
(per cent)



Source: Central Bank of Malta calculations.

Chart 2
MORTGAGE LENDING AS A SHARE OF TOTAL LENDING
(per cent)



Source: Central Bank of Malta calculations.

[1] Prepared by Ms Dominique Tanti Executive within the Policy, Crisis Management and Stress Testing Department. The author would like to thank Ms Christine Balzan, Manager and Mr Stephen Attard Head of Department within the Policy, Crisis Management and Stress Testing Department for their valuable suggestions.

[2] Refer to https://www.centralbankmalta.org/site/Financial-Stability/WP-Other-Studies/special-feature1-fsr-2021.pdf.

that the NFC stretch was in negative territory, indicating that risks from within the sector were contained. Chart 1 shows that the growth rate of resident NFC loans generally exhibited a strong downward trend in 2021, following the temporary pick-up reported during the COVID-19 pandemic, on the back of the MDB CGS, introduced in April 2020, to meet new working capital requirements. A strong pick-up in growth rate was again observed throughout 2022, owing to pent-up demand following the pandemic, as projects were coming onstream. Furthermore, such growth was almost entirely driven by lending towards real estate, rather than from a broad-based pick-up in bank lending to NFCs.

Against this backdrop, Maltese authorities assessed which macroprudential tools could be implemented that could best safeguard the financial system against the above-mentioned risks. In this regard, the Central Bank of Malta, in collaboration with the MFSA, and under the auspices of the Joint Financial Stability Board (JFSB), agreed to implement a sSyRB. This is in view of its targeted nature, which makes it the most effective tool for Malta to address the prevailing risks stemming from the RRE sector, particularly with respect to domestic mortgage exposures to natural persons. In contrast to a CCyB, which adopts a more blanket approach, the systemic risk buffer (SyRB) targets existing or emerging vulnerabilities in specific sectors and credit institutions.

Scope and characteristics of the sSyRB for Malta

As per Article 133 of the CRD, the SyRB can address risks which are not covered by other tools, such as the CCyB and O-SII/G-SI buffer. This makes the SyRB a very flexible tool to address risks of both cyclical and structural nature. Furthermore, the SyRB can also be applied on a sectoral basis, as well as to a subset of institutions only. These characteristics enhance the effectiveness of the tool, particularly when the tool is intended to target risk stemming from a particular sector. Such risk targeting also leads to a price signalling effect, by incentivising banks to diversify their loan portfolio, thereby reducing concentration risk to the sector. Indeed, the sSyRB is designed to operate in a proportionate manner, whereby those institutions with a higher share of the targeted exposures (i.e. domestic mortgage exposures) to total exposures, are impacted more. In other words, banks could control the impact of this measure according to their targeted level of exposure to the real estate sector. In this regard, the SyRB differs from the aim and features pertaining to the CCyB, which is designed to target overall credit dynamics, as opposed to specific sources thereof.

Calibration of the sSyRB

The calibration of the sSyRB rate was based on house price sensitivity tests. The standard house price sensitivity test applies exogenous shocks to house prices and assesses the corresponding impact on the core domestic banks' balance sheet, which are the main mortgage providers in Malta, via collateral values. The assumed magnitude of shocks to house prices is based on the historical standard deviations of the annual rate of change in the house price index and relates to the magnitude of shocks applied in similar stress test exercises. The calibration method employed assumes that a drop in house prices fully translates into a drop in property related collateral values, which corresponds to the main type of collateral backing loans for core domestic banks.

Shocks to house prices lead to increases in loan loss provisions; given that, as collateral values decline, loan loss provisions would have to increase accordingly to fulfil the requirement of full NPL coverage by either provisions or collateral. The hypothetical increase in provisions is charged to capital, which feeds into changes in the Tier 1 capital ratio held by banks. The changes in Tier 1 capital arising from diverse shocks to house prices are then assessed against the loss absorption capacity of banks, based on different sSyRB rates.

Drawing from the results of these sensitivity tests, and the banks' capacity to absorb the increase in capital via management buffers, the Central Bank of Malta's policy decision was to set the sSyRB rate at 1.5% to be implemented in a phased-in approach.

Applicability and review of the measure

The sSyRB is effective from 28 March 2023, with its first phase of implementation taking place in end-September 2023, with a sSyRB of 1%, and fully phased-in at 1.5% as of end-March 2024.

The 1.5% sSyRB is applicable on the amount of RWAs held against domestic mortgage exposures to natural persons, secured by RRE. Exposures also include BTL loans (for residential purposes) secured by RRE, granted to natural persons. Furthermore, the 1.5% sSyRB is applicable to credit institutions, at the highest level of consolidation in Malta.

Moreover, the review of the measure, including its scope and applicability, will take place at least every two years, in accordance with the provisions of CRDV, and as transposed in CBM Directive No. 11. The Bank plans to conduct regular reviews of the underlying risks being addressed by the sSyRB to assess the adequacy of the buffer, also in the context of the evolving market developments and risk landscape.