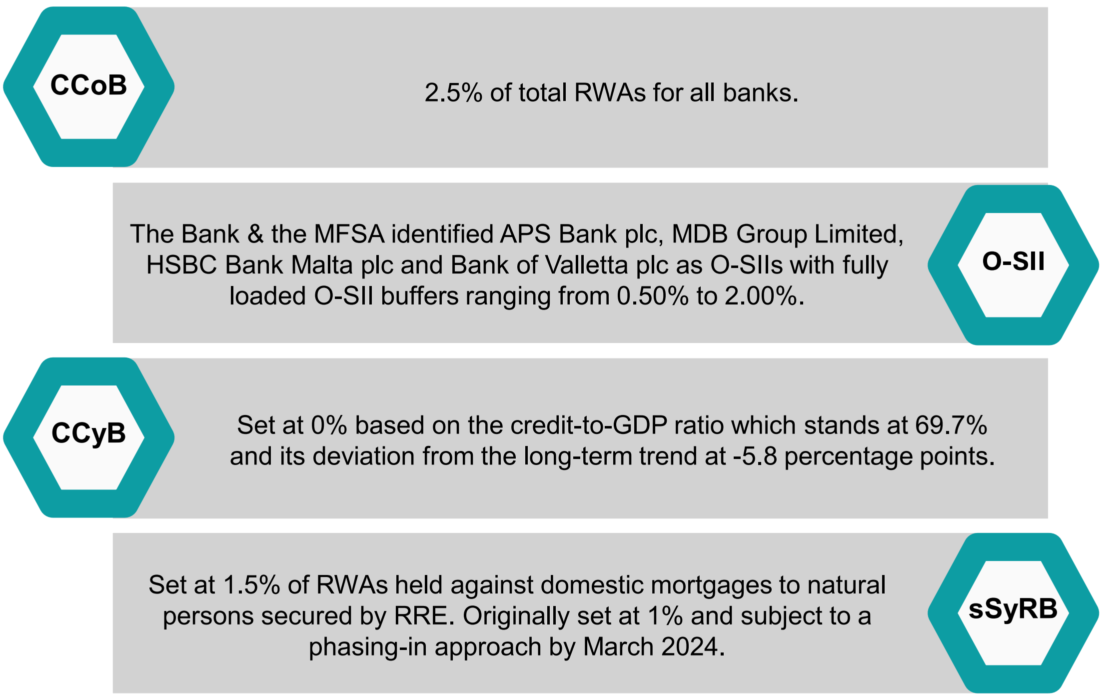
5. MACROPRUDENTIAL POLICY RESPONSE

This chapter highlights the key macroprudential policy initiatives that were in place during 2023, and seeks to identify the major contributions of these measures to the Bank's financial stability objectives. Additionally, this chapter also provides an overview of other main developments of a macroprudential nature both at the domestic and European levels.

5.1 Capital-based macroprudential measures

Capital-based macroprudential measures are integral components of the regulatory framework aimed at safeguarding the stability of the financial system. Through these capital-based measures, the Bank seeks to foster resilience within the financial system, mitigate or prevent the unfolding of systemic risks, and ensure adequate capital buffers against potential losses from economic shocks. Figure 5.1 depicts the capital-based buffers that are applicable to domestic banks. These buffers form the respective bank's CBR, and act as a line of defence against respective sources of risk. The CBR is made up of the Capital Conservation Buffer (CCoB), the Other Systemically Important Institutions (O-SII) Buffer, the CCyB and the sSyRB which are reproduced in Figure 5.1.

Figure 5.1
CAPITAL-BASED MEASURES IN MALTA



Source: Central Bank of Malta.

5.1.1 O-SII Buffers

On a yearly basis, the Central Bank of Malta, together with the Malta Financial Services Authority (MFSA), conducts an assessment to identify and apply a capital buffer to domestic O-SIIs. This assessment is carried out in line with the published CBM-MFSA O-SII policy document and the provisions under CBM

Table 5.1
LIST OF IDENTIFIED O-SIIs FOR 2024 AND CORRESPONDING O-SII SCORES

Institution	Size	Importance	Complexity	Intercon-nectedness	Total
APS Bank plc	163	462	26	46	698
Bank of Valletta plc	678	1675	191	334	2,878
HSBC Bank Malta plc	319	961	74	134	1,488
MDB Group Limited	233	196	527	380	1,335

Source: Central Bank of Malta.

Table 5.2
2024 APPLICABLE O-SII BUFFER RATES AND PHASING-IN ARRANGEMENTS

Institution	2024 Applicable O-SII buffer rate	Fully phased-in buffer rate	End of phasing-in period
APS Bank plc	0.375%	0.50%	2026
Bank of Valletta plc	2.00%	2.00%	N/A
HSBC Bank Malta plc	1.25%	1.25%	N/A
MDB Group Limited	0.875%	1.00%	2025

Source: Central Bank of Malta.

Directive No. 11.[1,2] Table 5.1 presents the O-SII scores of the four credit institutions identified as O-SIIs for 2024. Table 5.2 reports the applicable O-SII buffer rates for the four identified institutions which remained unchanged during the period under review. The rates are set in line with the current O-SII buffer calibration methodology, and an exercise of expert judgement where applicable.

The O-SII buffer requirement for the identified banks and the relevant transitory provisions are applicable from January 2024, as stipulated in the Statement of Decision.[3] An in-depth assessment on the O-SII buffer policy as applied in Malta can be found in Box 6.

5.2 Borrower-based measures

This section focuses on the BBMs enacted by the Bank. By targeting borrower behaviour and credit practices, the bank aims to mitigate the build-up of systemic risks, enhance the resilience of financial institutions, and foster sustainable lending practices.

The year 2023 marked the fifth year since the implementation of CBM Directive 16, which introduced BBMs domestically. Domestic banks submit their yearly internal audit reports which include an assessment of the banks' compliance with this Directive. In this regard, in 2023 the banks were provided with a set of guidelines to ensure homogeneous depth of analysis by internal auditors, including a deep dive into the usage of speed limits where applicable, and the homogenous reporting of audit findings. Compliance with the Directive is also analysed through loan-level data submitted by banks on newly issued loans on a quarterly basis.

In 2023 banks issued a total of 5,369 loans in line with the provisions of Directive 16. The majority of these loans (81%) were issued to Category I borrowers purchasing their primary residence, with

[1] The CBM-MFSA O-SII policy document can be accessed via the following link: https://www.centralbankmalta.org/site/Financial-Stability/O-SII/o-sii-policy-document.pdf?revcount=4986.

[2] The provisions in CBM Directive 11 for O-SIIs can be found in paragraphs 33-50 in the following link: https://www.centralbankmalta.org/site/About-Us/Legislation/Directive-11.pdf?revcount=5684.

[3] The 2024 statement of decision on the identification of O-SIIs and the related capital buffer calibration can be accessed via the following link: https://www.centralbankmalta.org/site/Financial-Stability/O-SII/2024-O-SII-Statement-of-Decision.pdf?revcount=5210.

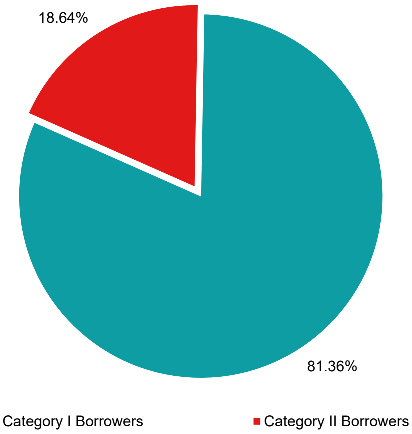
the remaining 19% of loans were issued to Category II borrowers purchasing secondary or buy-to-let residence (see Chart 5.1).

The average loan-to-value at origination (LTV-O) ratio, for loans sanctioned throughout 2023 was below the limits stipulated in the Directive namely of 90% and 75% for Category I and II borrowers respectively. Indeed, for Category I borrowers, the average LTV-O ratio has been rather stable throughout 2023 ranging between 68% and 70%, which is in line with the trend seen since 2021 Q1, and well below the limit stipulated for such borrowers. On the other hand, the LTV-O ratio for Category II borrowers was lower than that of Category I, ranging from 54% to 58%. This indicates a slight decrease compared to the peak levels recorded in the initial two quarters of 2021, where LTV-O had surpassed 62%, notably staying well below the threshold mandated in the Directive for such borrowers (see Chart 5.2).[4]

Regarding the debt service-to-income at origination (DSTI-O) metric which measures a borrower's repayment capacity, it remained consistent throughout 2023, aligning with the trend observed since Q1 2021. Notably for both borrower categories, it fluctuated between 29% and 32%, comfortably below the 40% limit prescribed in the Directive (see Chart 5.3). The DSTI is subject to a shock to the interest rate of 150 basis points (stressed). The aim of such shock is to act as a cushion against a period of rising interest rates over the life of a loan.[5]

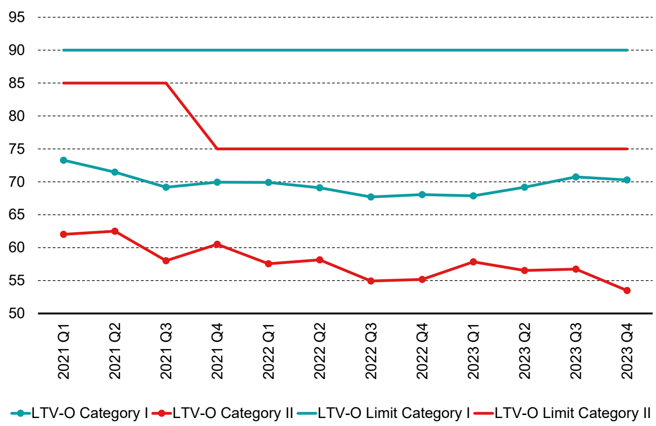
In terms of maturity, throughout 2023, similar observations were seen compared to previous periods whereby on average, loans to Category I borrowers have a term

Chart 5.1
SHARE OF LOANS ISSUED IN 2023 BY BORROWER CATEGORY



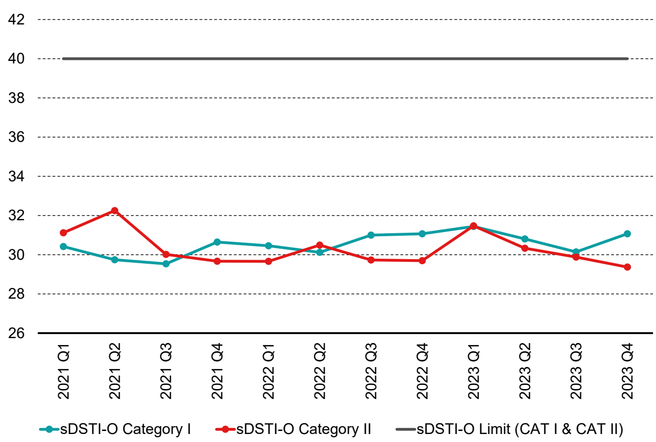
Source: Central Bank of Malta calculations.

Chart 5.2
AVERAGE LTV-O
(per cent)



Source: Central Bank of Malta calculations.

Chart 5.3
AVERAGE STRESSED DSTI-O
(per cent)

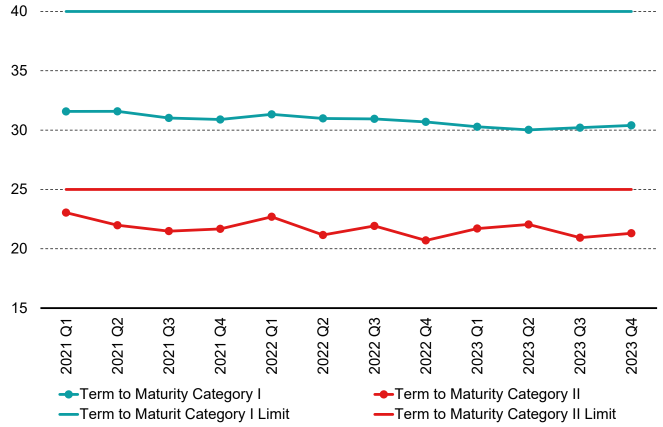


Source: Central Bank of Malta calculations.

[4] The fully phased-in LTV-O limit of 75% for Category II borrowers became applicable as from July 2021. Previously this was set at 85%.
[5] Between July 2022 (when key ECB interest rates turned back into positive territory for the first time since 2011) and December 2023, banks' interest rates for loans to households for house purchase in the euro area (annual percentage rate of charge) increased around 200 basis points (from 2.36% to 4.33%).

to maturity of around 30 years and loans to Category II borrowers have a term to maturity of around 22 years, both being below the 40 years and 25 years upper bound limit allowed by the Directive respectively (see Chart 5.4).[6]

Chart 5.4
AVERAGE TERM TO MATURITY
(years)



Source: Central Bank of Malta calculations.

5.3 Other domestic measures

As per the Recommendation of the ESRB on recognising and setting countercyclical buffer rates for exposures to third countries (ESRB/2015/1), the Bank carries out an annual exercise to identify the list of material third countries towards which the local banking sector is exposed. Similarly, in accordance with the Recommendation of the ESRB on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2), the Bank continuously reviews requests for reciprocation by other macroprudential authorities.

Voluntary Reciprocation

Reciprocation requests received in 2023:

Sweden – Risk Floor Weights for corporate exposures secured by CRE (35%) and RRE (25%) for institutions using internal ratings-based (IRB) approach.

Belgium – 9% systemic risk buffer (declined to 6% as from 1 April 2024) on retail exposures to natural persons secured by RRE for institutions using the IRB approach.

Non-reciprocation decision taken given inapplicability due to immaterial exposures towards each market and given that MT banks follow standardised approach for capital allocation.

No other changes were affected on the reciprocation stance of the Bank with respect to previously communicated measures recommended for reciprocation by other Member States. These remain currently active.

Material Third Countries

The criteria on which a third country is identified material is based on: (i) Risk-Weighted Exposures, (ii) Original Exposures and (iii) Defaulted Exposures as set in Article 4 of the Decision of the ESRB on the assessment of materiality of third countries (ESRB/2015/3).

For the period Q2 2024 till Q2 2025, the Bank identified the **United Kingdom** and the **United Arab Emirates** as material third countries for Malta and concluded that the CCyB rates set for the afore-mentioned third countries by their respective authorities are appropriate. The ESRB and the banks operating domestically have been notified accordingly.

[6] Directive 16 stipulates a maturity term of 40 years (Category I borrowers) and 25 years (Category II borrowers), or the official retirement age – whichever occurs first.

5.4 European regulatory developments

ESRB Recommendation on vulnerabilities in CRE in the EEA	Published on 25 January 2023, this recommendation requires Authorities to submit to the ESRB a first follow-up report on the actions taken to comply with Recommendation A – Improving the monitoring of systemic risks stemming from the CRE market, by 31 March 2024. The Recommendation provides the Authorities with adequate time to take policy decisions in response to identified risks in the CRE sector. Reporting on micro or macroprudential measures (Recommendations B and C) is not foreseen until 31 March 2026.
Single Resolution Board (SRB) MREL Policy	In May 2023, the SRB published the updated approach to setting MREL. The new updated MREL policy includes reference to the introduction of the Daisy Chain Regulation (Regulation (EU) 2022/2036) which improves the resolvability of banks within bank resolution groups. In addition, an update is made to the scope of entities subject to internal MREL whereby the asset size threshold for credit institutions considered as Relevant Legal Entities was reduced from EUR 10bn to EUR 5bn.
Crisis Management and Deposit Insurance (CMDI) framework	In April 2023, the European Commission put forward the CMDI proposal with the aim to enhance the current framework, particularly with regards to small and medium-sized banks. Overall, the proposal leverages on the current framework that is primarily aimed at a small subset of large banks by ensuring that failing banks can have an orderly market exit irrespective of their size and business model. In this regard, the proposal has three primary objectives: i. To preserve financial stability and protect depositors from bearing losses, by internalizing costs thus avoiding contagion risk. Additionally, taxpayers would also be safeguarded as reliance is made on industry-funded safety nets such as deposit guarantee schemes and resolution funds. ii. To shield the real economy from the effects of bank failure given that resolution is less disorderly than liquidation. In turn, clients can still have access to their bank accounts during a resolution period, whilst the critical functions of a bank are still preserved. iii. Wider coverage of protected deposits whereby the €100,000 coverage level for each depositor at each bank would still apply for all EU eligible depositors and, in addition, the proposal extends depositor protection to public entities and certain types of client funds such as investment companies, payment institutions and e-money institutions.

The new banking package: CRR III & CRD VI

The finalized texts of the EU banking package comprising of CRD VI and CRR III have been published on 6 December 2023, following finalization of discussions and negotiations which took place among the EU co-legislators. The next step is for the Council and the Parliament to formally adopt the texts envisaged in the course of 2024. An overview of the main changes which feature in the updated legal texts can be found in Figure 5.2.

Figure 5.2
THE NEW BANKING PACKAGE: CRR III AND CRD VI

CRR III

- Introduction of an output floor for IRB models and increase in risk sensitivity for standardized approach.
- Single non-model-based approach to be used for calculating operational risk.
- Three new approaches to calculate own funds requirements for CVA risk.
- BCBS Fundamental Review of the trading book becomes binding for calculating own funds for market risk.

CRD VI

- Widened use of the systemic risk buffer to be used for climate risks and ESG risks.
- Introduction of new harmonized regulations for third country branches, with strengthened supervisory powers and systemic risk assessments.
- FAP assessments are harmonized with the suitability assessment for bank managers.
- New requirements for ESG considerations when evaluating internal capital needs and governance.

BOX 6: THE SYSTEMIC IMPORTANCE OF O-SIIs IN MALTA[1]

1. Background

The CBM jointly with the MFSA annually identify O-SIIs, which are domestic credit institutions that, due to their systemic importance, could potentially create risks to financial stability. The identified O-SIIs are to maintain an O-SII capital buffer rate that enhances the resilience of these institutions by providing an additional layer of loss absorbing capital. A higher capital requirement acknowledges the greater impact that such banks could potentially have on the domestic financial system in case of failure.

The O-SII methodology is outlined in the CBM-MFSA policy document which is based on a set of EBA O-SII identification criteria guidelines, with some modifications to reflect national characteristics.[2,3] In line with the EBA guidelines, CBM and MFSA calculate the O-SII score by determining the weighted average market share for each indicator – this is a proxy of overall importance of a given credit institution for the Maltese financial system. The score is then multiplied by 10,000 to be expressed in terms of basis points. If the final O-SII score exceeds the threshold of 425 basis points, that credit institution is identified as an O-SII, and depending on the magnitude of the score, it will be classified into one of five buckets that correspond to an O-SII buffer.

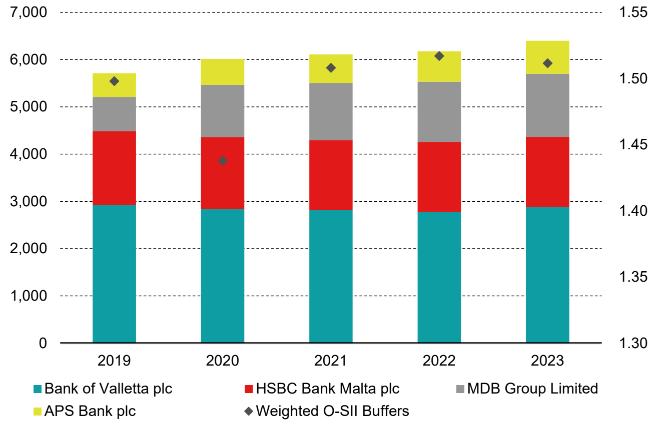
Against this background, section 2 delves into the relevance and coverage of this buffer in Malta. The box in section 3 compares MT O-SII buffers with other O-SII buffers applied in other European countries, while section 4 concludes.

2. O-SIIs significance to the Maltese banking sector

To investigate the relevance and coverage of this methodology, the CBM monitors a number of standard metrics. These help the Bank to gauge the extent of domestic systemic risk as measured by O-SII scores and the appropriateness of the 425 basis points O-SII identification threshold.

As can be observed from Chart 1, looking at the past five yearly assessments, a rising cumulative O-SII score can be observed. This highlights a trend of growing systemic importance of these institutions, reflecting potential higher risks to financial stability in case of failure. This increase can be attributed to the growth of APS Bank plc (39% increase in O-SII score since 2019) and MDB

Chart 1
EVOLUTION OF O-SII SCORES
(basis points; per cent)



Source: Central Bank of Malta calculations.

1 Written by Ms Mariah Dimech, Senior Economist and Mr Brendon Cassar, Principal Economist within the Policy, Crisis Management and Stress Testing Department. The authors would like to thank Ms Christine Balzan, Manager; Mr Stephen Attard, Head within the Policy, Crisis Management and Stress Testing Department; and Mr Alan Cassar, Chief Officer Financial Stability and Statistics Division, for their valuable suggestions.

2 The CBM-MFSA O-SII policy document is available on the following link.

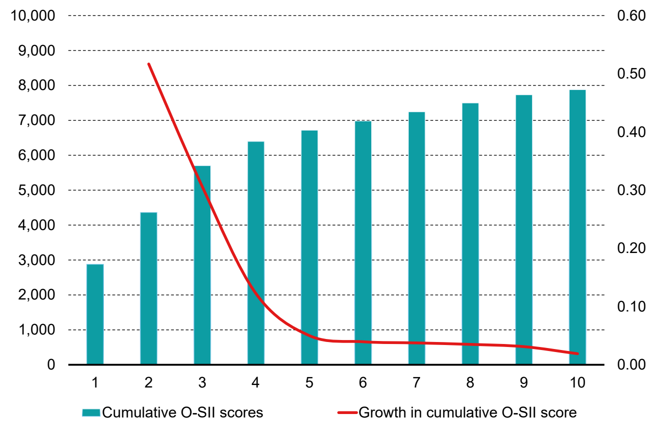
3 EBA Guidelines on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs) (EBA/GL/2014/10).

Group Ltd (85% increase in O-SII score since 2019). The increased potential risk to the domestic financial system, has been reflected in the application of higher O-SII buffers. In fact, the weighted average O-SII buffers in Malta hovered around 1.5% between 2020 and 2023.[4] MDB Group Ltd and APS Bank plc were also requested to hold higher O-SII buffer rates through the years to reflect their growth and the related risk.

In a methodology based on weighted market shares, the total sum of all O-SII scores amount to 10,000 basis points, equivalent to a 100% share in all the risk categories captured in the O-SII methodology. Out of a maximum of 10,000 basis points, the latest assessment captured a total of 6,398 basis points of O-SII score through the identified four O-SIIs (see Chart 2). This is equivalent to around 64% of the total O-SII score of all credit institutions in Malta.[5]

When considering the O-SIIs on a scale of representativeness as seen in Chart 2, if a fifth institution is added to the list, the growth in cumulative O-SII score would only increase marginally by 5% and continue to decrease thereafter, tending to zero. This indicates that the current identification threshold of 425 basis points capturing four credit institutions is appropriate to address the Maltese banking sector's specificities, and adding further institutions adds little value.

Chart 2
CUMULATIVE O-SII SCORES
(basis points; per cent)

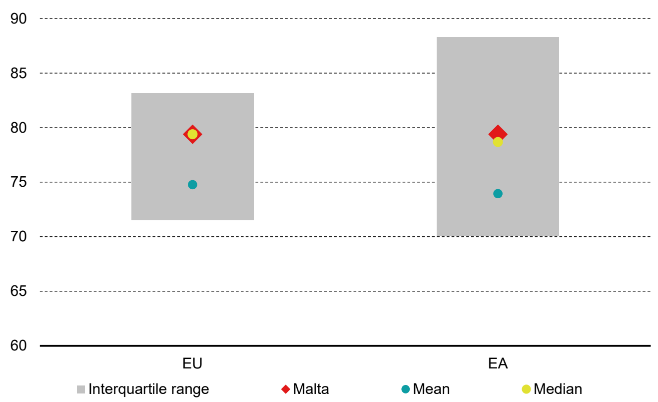


Source: Central Bank of Malta calculations.

3. Comparison of MT O-SII buffer rates with EU counterparts

It is important to assess whether the applied O-SII buffers adequately align with the elevated risk that the macro financial system is potentially exposed to by O-SIIs. This is a combined function of the number of O-SIIs being identified, their relative importance within the domestic economy, and the applied O-SII buffer rates. On average, EU Member States identify five

Chart 3
CUMULATIVE O-SII TOTAL ASSETS
(per cent of domestic total assets)



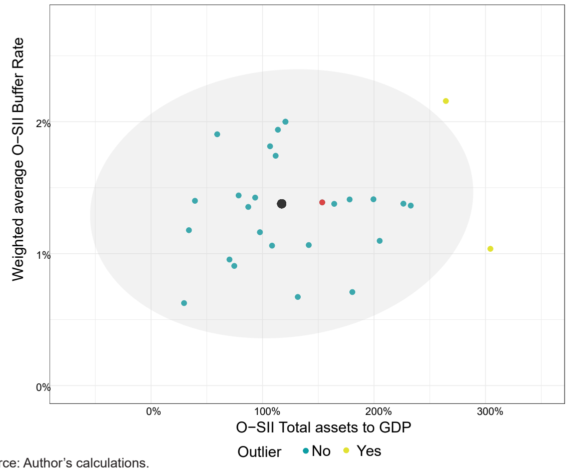
Sources: National O-SII reporting templates; Central Bank of Malta; author's calculations.
Note: Data based on latest reporting templates. Total Assets figure for Malta excludes branches.

[4] O-SII buffers are weighted by respective O-SII scores.
[5] A total of 21 credit institutions (including four branches of credit institutions exercising the right of establishment in Malta) comprise 10,000 basis points. For the purpose of Chart 2, only ten out of 21 credit institutions are taken into consideration.

O-SIIs within their jurisdiction. In Malta, four institutions are identified as O-SIIs. However, together they capture 79.4% of domestic total assets. As shown in Chart 3, this is in line with the EU median, and above the EU mean of 74.8%.[6] Compared with the euro area, Maltese O-SIIs capture a higher share of total assets than the euro area median (78.7%) and higher than euro area average (74.0%). This also indicates that the O-SII measure captures a substantial level of the domestic banking sector's core activities.

The range of buffer rates under the CBM-MFSA methodology reaches a maximum of 2.00%, which is below the 3% maximum allowed under the CRD. Some euro area countries revised their policies, with O-SII buffers in some jurisdictions reaching a maximum of 2.50%. These national variations can be compared by examining the relationship between applied O-SII buffer rates vis-à-vis the activity of the O-SII banking sector relative to GDP. In Chart 4, the weighted average O-SII buffer rate is compared with O-SII total assets as a percent of GDP, to capture the relevance of O-SIIs within domestic economies.[7]

Chart 4
RELATIONSHIP BETWEEN O–SII BUFFER RATES AND COUNTRY GDP
(outlier detection using Mahalanobis distance)



Source: Author's calculations.

Countries to the upper left-hand side of the graph have high O-SII buffer rates despite the smaller size of O-SIIs relative to GDP. Conversely, countries to the bottom-right set low O-SII buffers despite the larger size of total assets relative to GDP. Malta, depicted by the red point, has a weighted average rate for O-SIIs of 1.53%, which is close to the centre of the distribution.[8] When compared to other European peers, this could indicate that given their importance, Maltese O-SII have well balanced O-SII buffer rates.

4. Concluding remarks

O-SII buffers continue to play a crucial role in the resilience of the domestic banking sector. In fact, O-SII buffers account for 34.6% of total CBR, and the 2024 O-SII buffers added 0.97% worth of resilience to the domestic banking system's total capital ratios, a 0.027 percentage-point increase from last year. This buffer increases the loss absorption capacity of credit institutions through the increased availability of capital, thereby making them more resilient to financial stress. Upon evaluating the degree of importance of O-SIIs for the financial system, and following a comparison with other EU peers, the applicable buffer rates in Malta are reflective of the importance of such institutions to the domestic financial system.

[6] EU mean and median derived by estimating O-SII total assets to domestic total assets at the individual country level.
[7] Respective O-SII buffer rates are weighted by O-SII total assets.
[8] The large black dot represents the centroid of the distribution, based on the median. This point is a relative measure that could indicate a proxy for O-SII buffer rates which are appropriate given O-SII importance relative to GDP.