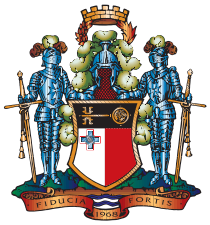

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IMPLEMENTATION OF A SECTORAL SYSTEMIC RISK BUFFER FOR MALTA

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

Introduction

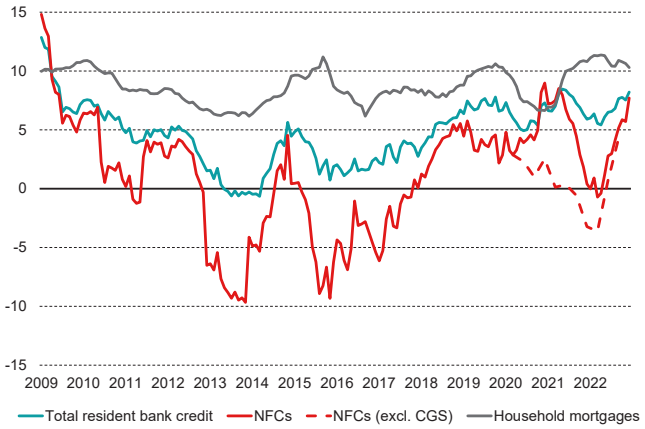
As outlined in 'Special Feature 1: Assessing Cyclical Risks in Malta,' risk assessments indicate that cyclical risk has been rising, driven by the household and property stretches.[2] More recent assessments indicate that, vulnerabilities persisted within the RRE sector, stemming from heightened mortgage 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.

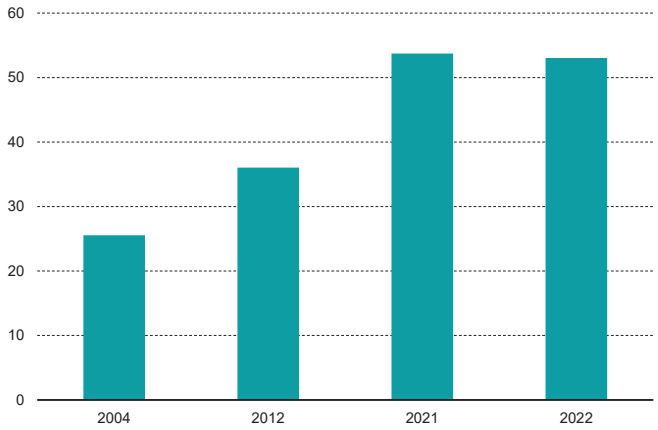
Regarding the corporate sector, the above-mentioned special feature highlights

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.