BANK ĊENTRALI TA' MALTA
EUROSISTEMA
CENTRAL BANK OF MALTA

Macro-prudential Policy Strategy
of the
Central Bank of Malta

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Financial Stability Department

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1. Objectives of the strategy

The Macro-prudential Policy Strategy sets out an operational framework for macro-prudential policy and its application with the aim of fostering the necessary transparency and accountability. More specifically this Policy Strategy aims to:

a) link the ultimate objective of macro-prudential policy with the intermediate objectives and macro-prudential instruments;
b) establish a sound framework for the application of instruments, including appropriate indicators that monitor the emergence of systemic risks and to guide decisions on the application, deactivation or calibration of macro-prudential instruments over time;
c) explain the coordination mechanism between the relevant national authorities involved in the decision-making process; and
d) foster transparency and accountability.

2. Legal Framework

In terms of Article 5 of the Central Bank of Malta Act (Cap. 204) (hereinafter referred to as "the Act"), the Central Bank of Malta (hereinafter referred to as "the Bank"), is responsible to formulate and implement macro-prudential policy to ensure the stability of the financial system. In terms of Article 17A of the Act, the Bank is empowered to issue, amend or revoke directives in order to implement macro-prudential policy and instruments. Article 17B of the Act, established a Joint Financial Stability Board with the purpose of ensuring effective cooperation between the Bank and the Malta Financial Services Authority (MFSA) in the area of financial stability.

The Bank's Directive No 11 on Macro-prudential Policy (hereinafter referred to as "the Directive") establishes the domestic legal framework for the implementation of macro-prudential policy and the application of macro-prudential instruments.

3. Governance of macro-prudential policy

To ensure stability in the financial system, the Bank has been designated as the macro-prudential authority and following consultation with the Joint Financial Stability Board (JFSB), it can issue Directives to implement macro-prudential policy and activate instruments in terms of Article 17A of the Central Bank of Malta Act. The JFSB guides the Bank and the MFSA in developing a common understanding of the situation in the financial sector, through an appropriate sharing of information and analyses, while recognising that each policy has a specific field of responsibilities with its own primary objectives.

In order to fulfil its financial stability responsibilities effectively, the Bank co-ordinates policy proposals through its internal Financial Stability Committee (FSC). The Committee mainly acts as a co-ordination forum with the task of discussing and endorsing the Bank's Financial Stability Report with the objective of formulating the Bank's opinion on the stability of the financial system and recommendations to preserve and enhance the resilience of the financial system.

To fulfil its international obligations in relation to macro-prudential oversight, the Bank cooperates with the European Systemic Risk Board, the European Central Bank (ECB) and other national or international micro and macro-prudential authorities in the exchange of information to ensure effective oversight.

The Bank has also to take into account the relevant provisions of European legislative instruments dealing with the operationalisation of macro-prudential instruments. It also has to consider the economic impact on other Member States and on the single market as contemplated in the Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR). In addition, to fulfil its obligations towards the European Systemic Risk Board (ESRB), the Bank assesses the warnings and recommendations issued by the ESRB with the objective of implementing such recommendations domestically, where applicable.

4. Financial Stability

At law, the objective of the Bank is to ensure the stability of the financial system as a whole since only a stable financial system can effectively make a contribution to sustainable economic growth.

Financial stability reflects the ability of the financial system, comprising institutions, markets and infrastructures, to efficiently supply the necessary credit intermediation and payment services to the real economy to enable it achieve sustainable growth. It also exhibits the ability to allocate savings into investment opportunities and to facilitate the efficient settlement of payments. Financial stability also allows the system to absorb shocks and thus manage risks that could harm its performance and, consequently, that of the economy.

To reach the goal of financial stability the Bank employs a macro-prudential assessment framework to identify, monitor and assess systemic risks to financial stability. The re-assessment of the risk assessment methodology being applied is undertaken on an annual basis. The re-assessment of the risk assessment methodology also depends on advice provided by the ESRB, BCBS and other players. Experience gained and current economic conditions play an important role in reviewing the usefulness of the risk assessment methodology. Macro-prudential policy, together with micro-prudential supervision, increases the resilience of the banks, limit contagion effects, and avoid excessive accumulation of risk over time.

5. Macro-Prudential Policy

The objective of macro-prudential policy is to mitigate systemic risk. CBM Directive No 11 on Macro-prudential Policy defines systemic risk as the risk of widespread disruptions to the provision of financial services that could potentially have serious negative consequences for the economy. In other words, systemic risk refers to the risk that financial instability becomes so widespread that it impairs the functioning of the financial system to the point where economic growth and welfare are significantly adversely affected.

Thus, macro-prudential policy aims to promote financial stability in Malta by strengthening the resilience of the financial system. Macro-prudential policy instruments can be distinguished along the cyclical and structural dimensions, namely:

a) those that mainly target the build-up of risk over time. During upturns in financial cycles, banks tend to take on exposures to similar credit and liquidity risks, including maturity mismatches. Similarly, during downturns banks tend to reduce their balance sheets by selling off similar exposures or stop lending. These lead to the accumulation of financial imbalances during expansionary phases, while in downturns they can produce fire sales of assets, with the result of a decline in asset prices, weakening of balance sheets, funding stress, and credit crunches.

b) those that mainly address the structural dimension. These refer to banks' direct and indirect interconnections, such as holdings of each other's assets, interbank lending and widespread adoption of misaligned incentives and moral hazard. Systemically important credit institutions and financial networks are crucial determinants of the cross sectional dimension.

Initially, the focus of macro-prudential policy will be on the banking sector given its prominent role in the intermediation process in Malta and given that new European legislation on macro-prudential instruments is mainly targeted towards this sector.

6. Intermediate objectives of macro-prudential policy

To operationalise macro-prudential policy, the Bank recognises the following intermediate objectives:

a) Mitigate and prevent excessive credit growth and leverage;
b) Mitigate and prevent excessive maturity mismatch and market illiquidity;
c) Limit direct and indirect exposure concentrations;
d) Limit the systemic impact of misaligned incentives with a view to reducing moral hazard; and
e) Strengthen the resilience of financial infrastructures.

The Bank will assess the need for further intermediate objectives on the basis of underlying market failures and the specific structural characteristics of the country and/or European Union financial system that could give rise to systemic risk.

7. Intermediate objectives linked to macro-prudential instruments

To pursue the intermediate objectives of macro-prudential policy, the Bank shall consider the use of the instruments referred to in the Directive, which adopts the instruments regulated in CRR and CRD IV in national legislation, and other instruments in accordance with the Act based on the assessment of risks observed in the financial system.

8. Implementation of macro-prudential policy by the Bank

The implementation of macro-prudential policy by the Bank follows a four-step cycle, namely:

a) Identification and evaluation of systemic risks;
b) Selection and calibration of the macro-prudential instrument;
c) Implementation of the macro-prudential instrument; and
d) Evaluation of the macro-prudential instrument.

The identification and evaluation of systemic risks is carried out through the analysis and monitoring of developments in macro-prudential indicators and other financial data as part of the early warning system. Assessment of risks also includes model-based analysis. In addition, top-down stress tests and scenario analysis complements the assessment framework by testing the resilience of banks to the materialisation of extreme, yet plausible, shocks to the macro-economy and to financial markets. The Bank makes use of risk models and carries out top-down stress tests mainly focused on domestically-oriented institutions in order to quantify potential losses that could arise from the materialisation of a number of risk events.

Market intelligence, conducted through a number of surveys and interviews, also provides essential input to the analysis. The latter, helps to detect vulnerabilities (to domestic or international developments) in the structure and functions of the domestic financial system, which could lead to systemic instability. This process could trigger policy recommendations designed to safeguard the stability of the financial system, thereby ensuring a sustainable contribution of the financial sector to economic growth.

The evaluation of systemic risks together with the outcome of a number of stress tests is regularly published in the *Financial Stability Report* and its half yearly *Update*.

Once potential vulnerabilities and risks are identified, relevant macro-prudential instruments are selected and calibrated. Initial discussion on the selected macro-prudential instruments and their calibration is undertaken by the Bank's Financial Stability Committee. The Bank then proposes the policy measure/s to the JFSB, which in turn provides its recommendations. The JFSB's decision is based on a number of principles in order to ensure that:

a) the instruments are effective;
b) negative cross-border spill-overs are avoided; and
c) national specificities are considered.

The decision making process might involve early interaction with the ECB/ESRB in order to obtain technical advice/opinions and/or speed up any required approval procedures. The final official decision is communicated to the ESRB Secretariat, the ECB, the EBA and other institutions according to EU legislation.

Once the relevant institutions (namely, the ECB, ESRB, and EBA) have been duly notified and provided feedback the macro-prudential instrument is implemented or deactivated.

The effectiveness to mitigate the systemic risk as well as the side effects of the measure will be evaluated on a continuous basis. The impact of instruments shall be assessed against their stated objectives. Such an assessment will take into consideration the domestic and cross-border effects, as well as the extent to which these measures were effective.

Furthermore, the Bank will study the transmission mechanism of the instruments so as to better understand their impact and to assure better selection and more precise calibration of the instruments.

9. External communication

Reliable communication guiding expectations in a rapidly changing environment is important to foster transparency and accountability of macro-prudential policy. Article 69 of the Bank's Directive stipulates that *"any macro-prudential decision, its motivation, and any statements on systemic risk shall be made public on the Bank's website in a timely manner, unless there are risks to financial stability in doing so. Furthermore, the Bank shall set out and publish any relevant macro-prudential strategies. The Bank shall make private statements by communicating directly with any institution on any macro-prudential decision, any statement on systemic risk or any matter affecting financial stability which is related to that institution where necessary."*

In practice this would lead, for example, to a quarterly announcement of the countercyclical capital buffer rate on the Bank's website and other specific information including a justification for that buffer rate once it is implemented.[1] Moreover, through the Bank's Financial Stability Forum, banks are invited to participate and debate relevant macro-prudential issues.

The Bank's External Communications function is a central component of its macro-prudential strategy. The financial media are crucial intermediaries for the Bank's Communication Department seeking to explain the changes in the regulatory framework. The Bank's tasks include ensuring accountability, explaining its macro-prudential measures, and providing information to the public.

There are five main components that make up the content of macro-prudential communication:

a) The institutional framework – by communicating the Bank's objective, governance, decision-making processes and instruments, it increases accountability and manages expectations.

b) Macro-prudential strategy – the Bank explains the idea behind macro-prudential policy, its objectives and how this is organised and conducted at the national level.

[1] CBM Directive no 11 article 58

c) Risk assessments – the Bank to regularly communicate on risk assessments and the policy stance.

d) Activation of macro-prudential measures - the Bank to disclose the operational features of activated instruments and how the identified objectives are to be attained. The communication of potential future actions may also be considered.

Follow up – The Bank will publish information on ex-post assessment of adopted measures and their effectiveness as well as impact on the financial system and the real economy. The target audience of such communication of macro-prudential policy includes regulated institutions, markets, legislators, the general public, and other relevant authorities. Communication tools include publications (e.g. FSR, quarterly and annual reports), internet-based tools (e.g. web sites), media relations (e.g. press releases and conferences) or events (e.g. speeches).