BANK ĊENTRALI TA' MALTA

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CENTRAL BANK OF MALTA

The Countercyclical Capital Buffer Rate

December 2016

Financial Stability Department

The Countercyclical Capital Buffer (CCyB)

In accordance with Article 136(7) of EU Directive 2013/36/EU, transposed in the Central Bank of Malta Directive 11 "Macro-prudential Policy", the Central Bank of Malta is hereby notifying its decision on the applicable buffer rate for the first quarter of 2017.

Notification

- The applicable countercyclical capital buffer rate: 0%
- The relevant credit-to-GDP ratio: 87.2% and its deviation from the long-term trend: -25.2 percentage points.
- The buffer guide: 0%

Analysis

The aim of the countercyclical capital buffer is to protect the banking sector from losses that could stem from the build-up of excessive credit growth. The countercyclical capital buffer is built during the upswing of the financial cycle to absorb losses that may arise in a subsequent downturn, without interrupting the supply of credit to the real economy.

The Central Bank of Malta (CBM) assesses private credit variables and other banking sector indicators with the aim to decide on the need for activating the countercyclical capital buffer (CCyB). This note provides the rationale for the proposed buffer rate to be set at 0%.[1] The main indicator is the deviation of credit-to-GDP ratio from its long-term trend. The analysis is also supplemented by a sub-set of additional quantitative indicators and expert judgement.[2]

Indicators used in the assessment of the countercyclical capital buffer rate

Based on the Basel Committee on Banking Supervision (BCBS) Guidance for the calculation of the CCyB, Chart 1 illustrates the results of a one-sided Hodrick-Prescott (HP) filter of the credit-to-GDP ratio for Malta.[3] The trend represents the smoothed version of the actual

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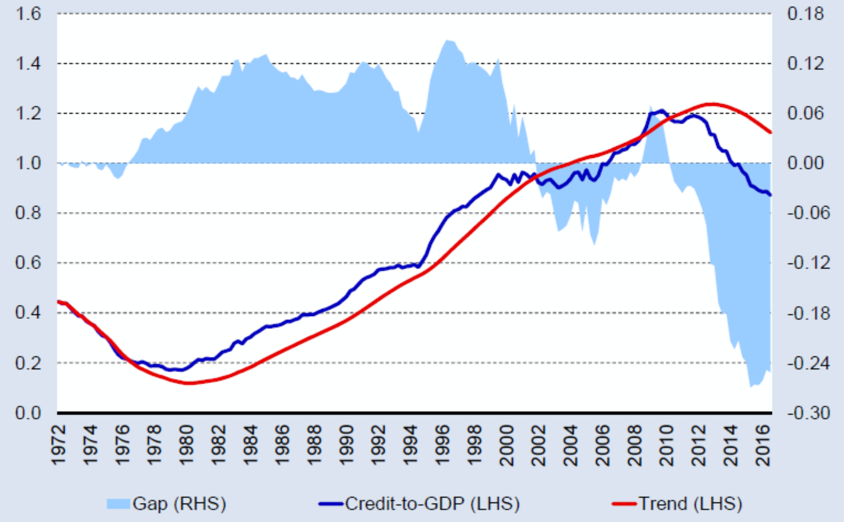
[1] The analysis is based on the guidelines issued by the European Systemic Risk Board (ESRB) and Bank of International Settlements (BIS) as well as the experience of relevant international and European authorities.

[2] ESRB/2014/1 - Recommendation on the Guidance for Setting Countercyclical Buffer Rates.

[3] Credit represents total bank credit. CRD IV Article 136 (2a) states that "an indicator of growth of levels of credit within that jurisdiction" shall be used by the authority. Even though Drehmann (2013) showed that the credit gaps based on total credit outperform the credit gaps based on bank credit as early warning indicators for banking crises this might be not so relevant for Malta because the domestic economy is strongly reliant on bank credit and therefore the use of total bank credit is highly appropriate for this purpose. Besides, total credit data revealed breaks in the series over time which could lead to reliability issues in the estimations that were undertaken.

series of the ratio of credit-to-GDP, both plotted on the left hand axis. The gap between the two is reflected in the light blue histogram which is plotted on the right-hand axis.

Chart 1
HODRICK-PRESCOTT FILTER (LAMBDA = 400,000) APPLIED TO THE CREDIT-TO-GDP RATIO
(per cent; percentage points)



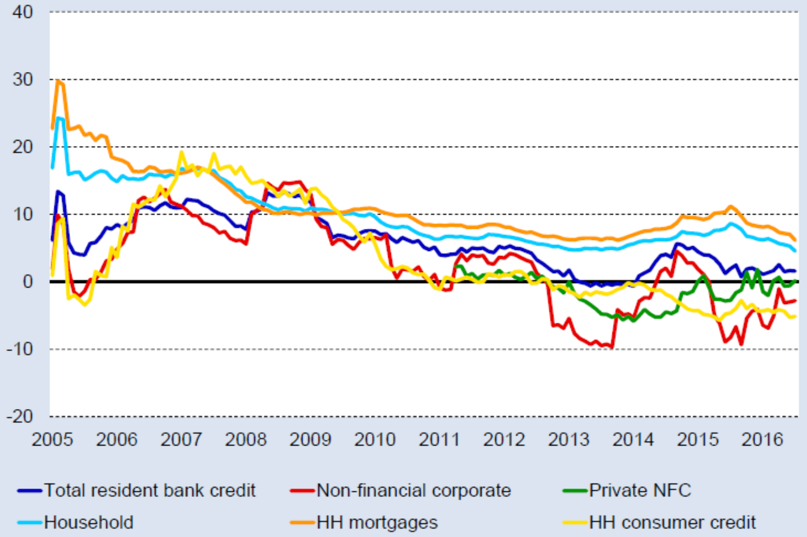
Source: Central Bank of Malta calculations.

It is observed that the current credit-to-GDP-ratio based on September 2016 data is 25.2pp below the trend and the cyclical component has been negative since 2010. In this regard, the negative gap means that a CCyB rate of zero is appropriate. Furthermore, previous cycles show that the most pronounced former downswing of almost 10pp took several quarters to return to positive territory. Therefore, it is unlikely that the credit-to-GDP ratio will exceed its long-term trend in the near future.

Credit Growth

Resident credit growth remained contained, with the annual growth rate standing at 1.6% in September 2016. This continued to reflect subdued developments in credit to NFCs which remain in the negative growth territory, albeit improving over the previous quarter thus contributing to the weak pick-up in overall credit growth. Indeed private NFC credit recovered, with the growth rate hovering around the 0%. The annual mortgage growth rate almost halved since the last quarter of 2015, growing by 6.2% in September 2016. Consumer credit contracted further throughout the third quarter of 2016 (see Chart 2).

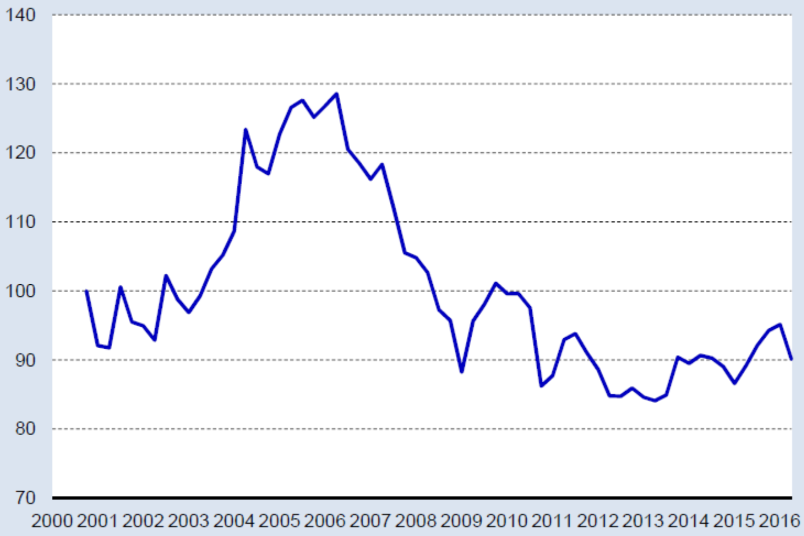
Chart 2
ANNUAL CREDIT GROWTH RATE
(per cent)



Source: Central Bank of Malta.

Although lending for house purchases remained buoyant, the strong economic performance coupled with very low unemployment and high home ownership rates sustained the growth in mortgages. In the third quarter of 2016 mortgage growth decelerated further. In 2015, the median advertised property price-to-income ratio resumed its upward trend, but reversed somewhat in Q2 2016, remaining well below its peak in 2006 (see Chart 3).

Chart 3
MEDIAN PROPERTY PRICE TO INCOME RATIO



Note: Based on the Central Bank of Malta advertised property prices.
Source: Central Bank of Malta calculations.

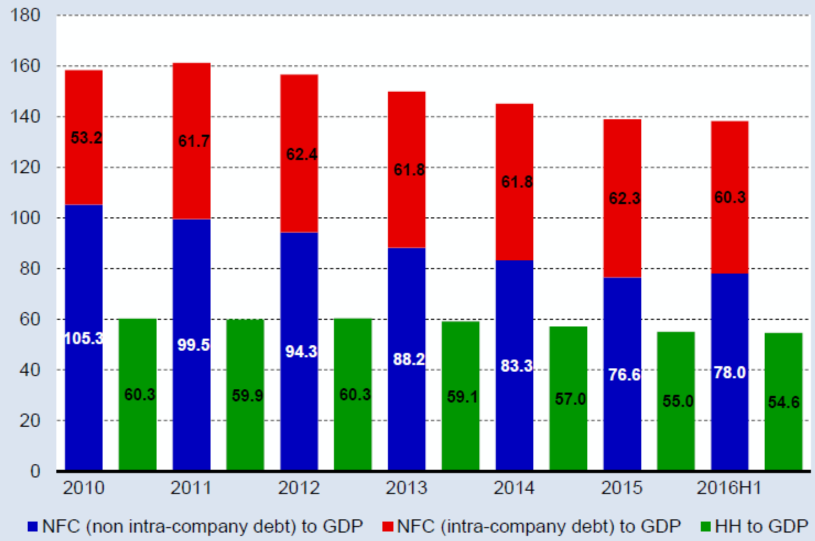
Property prices continued to recover. However, the conservative haircuts and relatively low loan-to-value ratios applied by banks mitigate potential vulnerabilities. Moreover, delinquency rates on mortgages have traditionally been low and household disposable income is growing at a healthy rate as economic activity remains strong. Overall risks stemming from the housing market remain contained.

Household and Corporate Debt

While both household and corporate indebtedness increased in absolute terms, these dropped when expressed as a percentage of GDP (see Chart 4). Household debt, as a percentage of GDP, stood at 54.6% in June 2016, below the euro area average notwithstanding the high home ownership rate which stands at around 80%. Furthermore, despite the increase in household debt in absolute terms, up by an annual rate of 5.1%, growth in households' net financial wealth was slightly stronger, up by 5.4% to 183.4% of GDP, mainly as a result of higher deposit holdings.

Corporate debt dropped to 138.3% of GDP in June 2016, as GDP grew at a faster pace. Furthermore, about 45% of NFC debt is characterised by intra-company debt, so that on a consolidated basis, NFC indebtedness stood at 78.0% of GDP, lower than that for the euro area. Furthermore, NFCs have a strong financial position with financial assets significantly exceeding indebtedness.

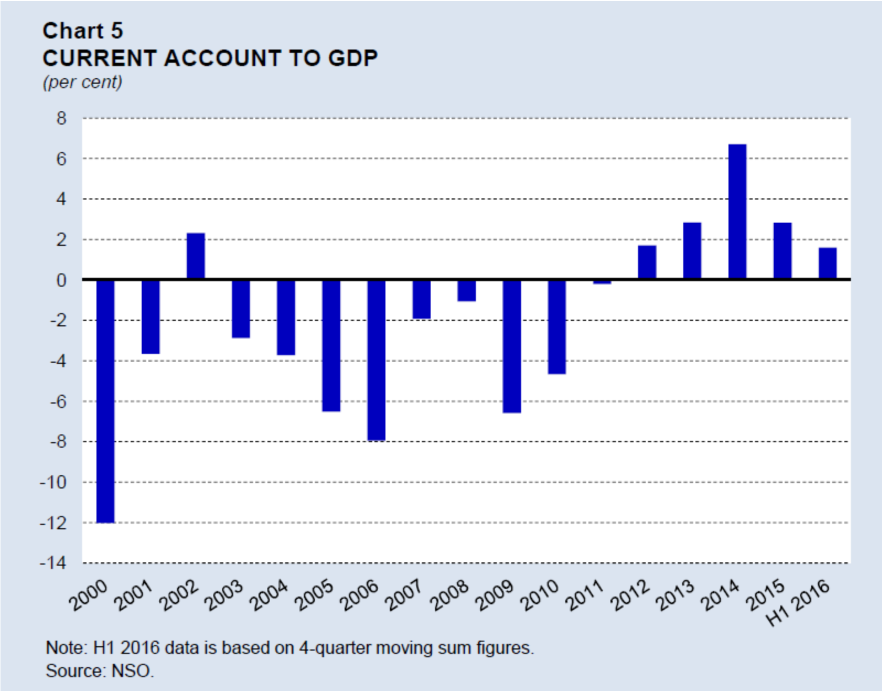
Chart 4
HOUSEHOLD AND CORPORATE DEBT TO GDP
(per cent)



Sources: Central Bank of Malta; NSO.

Current Account

On the external front, following several years of current account deficits prior to 2011, the current account surplus reached 1.6% of GDP in H1 2016 (see Chart 5). This shows that while the correction for past imbalances is still underway, Malta is not currently resorting to external debt financing.



The core domestic banks remained resilient and profitable, with robust capital ratios, backed by ample liquidity and stable funding. All the relevant quantitative and qualitative information assessed were judged to convey strong indications that the CCyB rate for Malta should continue to be set at zero at the current juncture. The standardised bank credit-to-GDP gap is currently negative at -25.2pp, which is well below the lower reference threshold of 2pp proposed in the BCBS guidance.