Malta Bankers' Association

The Changing Regulatory Environment and its Impact on Bank Lending

Earlier this year, I gave a presentation on this topic at a Banking and Finance Law Seminar organised by Ganado Advocates in collaboration with the Malta Bankers' Association. For long, banks had been coming under undue criticism over their approach to lending, particularly lending to SMEs, and I felt it was important to explain how, following the financial crisis in 2007, the banking regulatory environment had drastically changed, and that inevitably, the banks' lending criteria also had to change in line with this new reality.

Maltese banks have always adopted prudent lending norms, but following the crisis, all lending must now be considered within the framework of much more stringent regulatory measures and standards, which have been introduced to reduce, as far as possible, the chances of such a crisis recurring. Tight supervision of banks is now conducted or overseen by the European Central Bank under the Single Supervisory Mechanism. The new measures are aimed at making banks more resilient, and to increase their loss-absorbing capacity so as to rule out any further bail-outs using taxpayers' money. To achieve these aims, new directives and regulations were introduced to enhance both the quantity and the quality of banks' capital, as well as their liquidity and leverage ratios.

In this new environment, banks have to focus more strongly on risk management and on the quality of their assets, a substantial portion of which consist of loans to individuals and businesses. This focus is essential because assets need to be supported by a certain level of capital, and riskier assets require more capital to back them. All assets on a bank's balance sheet are risk-weighted, and different capital requirements are mandated on the basis of these risk-weights. For example, loans for house purchase are amongst the less risky categories of lending. So on a scale of 100, a home loan which does not exceed 70% of the value of the property being purchased may currently be risk-weighted at 35. So if the bank has to maintain a capital ratio of (say) 12% of its risk-weighted assets, such a home loan for (say) € 300,000 would require a capital allocation of **€ 12,600** (35% of € 300,000 x 12%). On the other hand, a riskier speculative property loan could be risk-weighted at 120, which translates into a capital allocation of **€ 43,200** for a loan of € 300,000 for that purpose (120% of € 300,000 x 12%). The difference is significant. And capital requirements become more punitive if a loan is classified as 'non-performing' i.e. repayments are more than 90 days in arrears. Banks have therefore raised their lending standards across the board to ensure a better quality of loans, and are more inclined to shy away from riskier lending which would absorb much more of their capital at a time when higher capital requirements have been imposed on them.

To meet these higher capital requirements, banks must either retain more of their earnings as reserves, which could result in a lower dividend distribution, and possibly have an impact on their share price. Or raise fresh capital, which might result in a lower dividend per share (possibly also impacting their share price) if a corresponding increase in earnings is not also achieved. Capital therefore needs to be judiciously managed and allocated. In other countries, many banks which were hard hit by the crisis have been unable to meet the higher capital requirements now mandated, and have had to resort to “deleveraging”, in other words reducing their lending, thereby shrinking their balance sheet to “fit” the amount of capital available. Thankfully, this has not occurred in Malta.

Despite this new and more restrictive regulatory regime, banks in Malta remain committed to ensure the proper financing of the economy. During 2016, credit to residents (excluding Government) increased by 2.9% net of repayments, and stood at € 8.73 billion at the year end. However, all economic agents also need to adapt to the new realities and adopt measures which will improve their chances of accessing bank finance. In particular, SMEs need to address inherent weaknesses resulting from low levels of capital and key man risks. They also need to continue adopting a more professional approach by seeking appropriate advice and support that prepares them for the increasingly competitive environment in which they have to operate.

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