Macroprudential Recommendation within the legal framework of new credit relating to house purchase and consumer credit: change to the limit for personal credit maturity and to exceptions to the DSTI ratio

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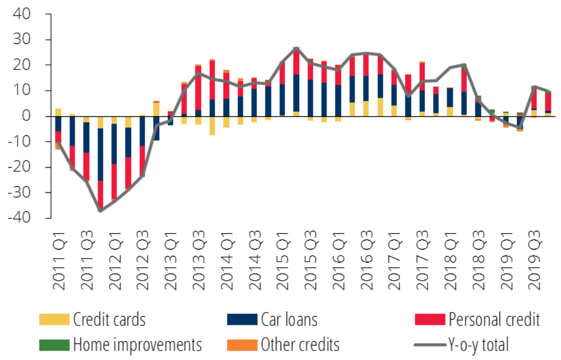
1 Background

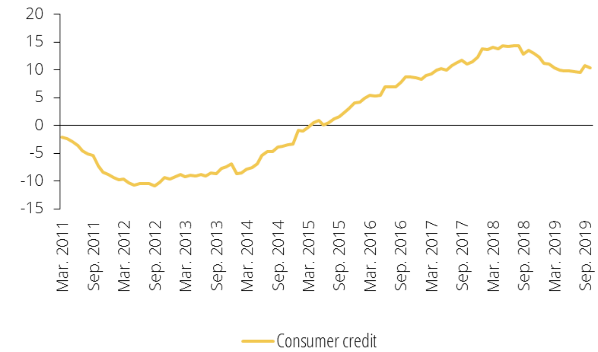
The slowdown in new consumer credit was reversed in the third quarter of 2019, mostly due to an acceleration in personal credit, whose year-on-year rate of change reached 22.2% (Chart 1). More recently, new personal credit continued to be quite dynamic, as confirmed by the year-on-year rate of change in the quarter ending November 2019, which reached 15.7%. In turn, after having declined by 4.4 p.p. to around 10% between August 2018 and April 2019, the annual rate of change (arc) in the stock of consumer credit stabilised at a high level, standing at 10.3% in October 2019 (Chart 2).

Chart 1 • Year-on-year rate of change in new consumer loans, including contribution by type of credit | Per cent and percentage points



Source: Banco de Portugal. | Note: Latest observation: quarter ending November 2019.

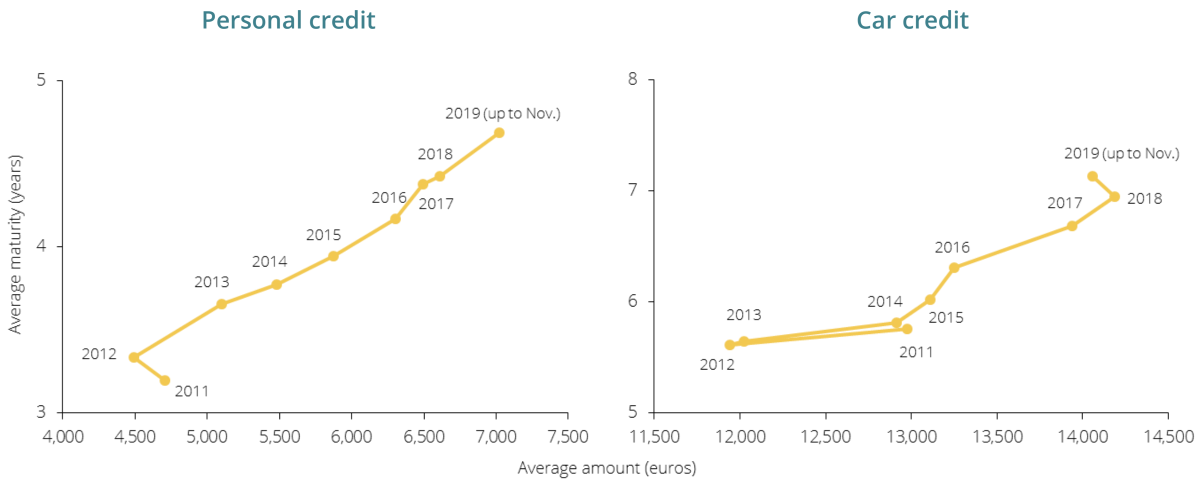
Chart 2 • Annual rate of change in the stock of consumer credit | Per cent



Source: Banco de Portugal | Notes: Annual rates of change are calculated on the basis of an index using adjusted transactions, i.e. changes in end-of-period outstanding amounts adjusted for reclassifications, write-offs, price and exchange rate revaluations and, where relevant, for the effect of securitisation and sales. Latest observation: October 2019.

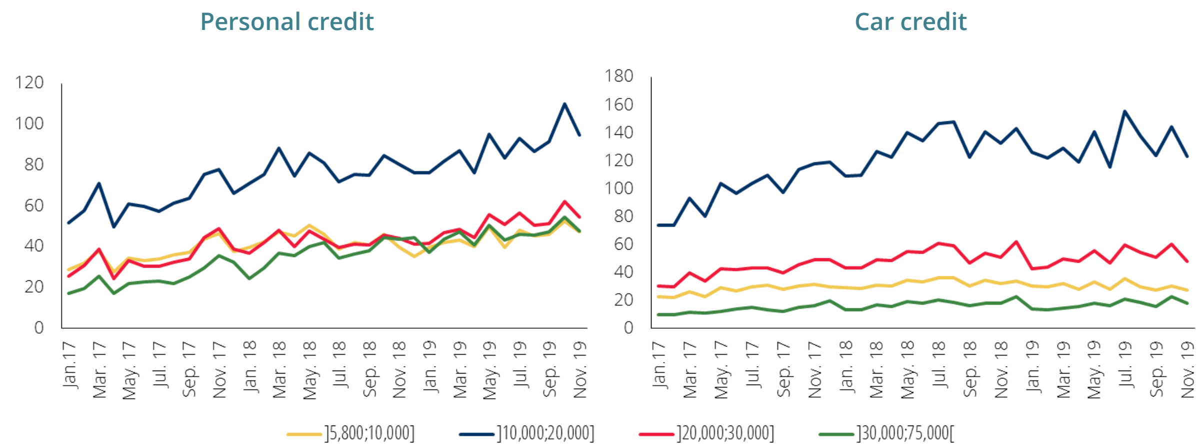
Since 2012 there has been an upward trend in the weight of new consumer credit (car and personal credit) with a maturity of over 7 years, as well as in the average maturity. Although the upward trend of the average maturity is common to personal and car credit, the dynamics underlying developments in the amount of new business in each segment is noticeably distinct. Indeed, the average amount of car credit declined somewhat in the most recent period, with the amount of new business increasing up to July 2018, and stabilising ever since (Chart 3). As far as new personal credit is concerned, from January 2017 to September 2019 there was an increase in all amount ranges (Chart 4).

Chart 3 • New consumer credit granted to households: personal credit and car credit | Average amount and average maturity of new agreements



Source: Banco de Portugal. | Notes: Excludes new consumer credit with no specified maturity. Personal credit includes home improvements purposes. Latest observation: November 2019.

Chart 4 • Evolution of new consumer credit, by amount range | EUR millions



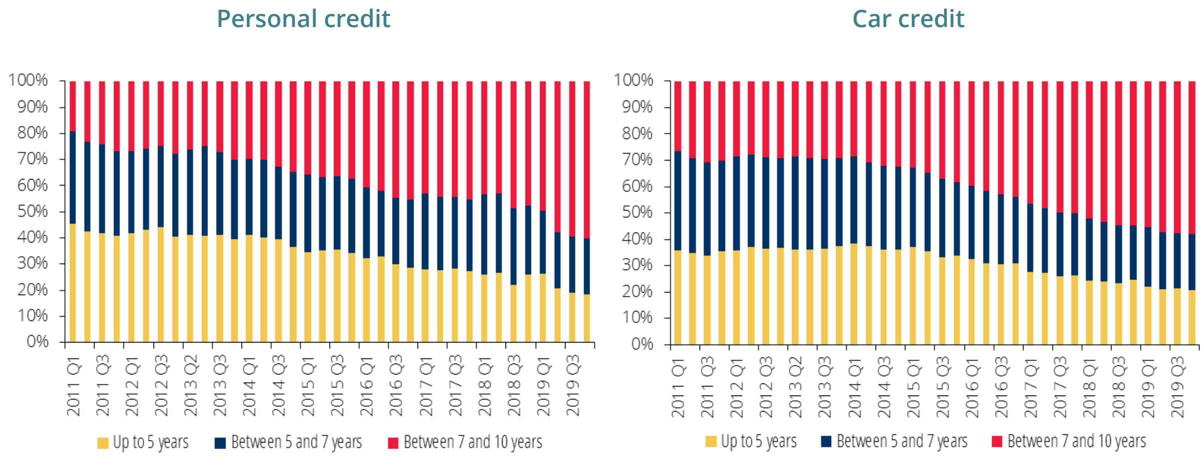
Source: Banco de Portugal. | Note: Excludes operations falling outside the scope of the Recommendation, namely lower than the equivalent to tenfold the guaranteed monthly minimum wage in 2018. Latest observation: November 2019.

From January 2017 to November 2019 both personal and car credit continued to predominantly involve amounts between €10,000 and €20,000.

In the quarter ending November 2019 the share of personal credit granted with a maturity of over 7 years accounted for around 60% of new personal credit (around 30% of total new consumer credit under the macroprudential Recommendation and 8% of total new credit to households), growing by 36 p.p. from the third quarter of 2012. This increase became more marked in the most recent period (Chart 5).

58% of new car credit was granted with a maturity of over 7 years in the quarter ending November 2019, while in the third quarter of 2012 credit in the maturity range of over 7 years had accounted for only approximately 29% of this type of credit (Chart 5).

Chart 5 • Total amount of new consumer credit, by maturity range | Per cent



Source: Banco de Portugal. | Note: Excludes operations falling outside the scope of the Recommendation, namely lower than the equivalent to tenfold the guaranteed monthly minimum wage in 2018. Personal credit includes home improvements purposes. Latest observation: quarter ending November 2019.

This increase in the average amount and maturity of new personal credit was accompanied by a reduction in interest rates, with the interest rate range up to 7% in the third quarter of 2019 playing a more relevant role vis-à-vis the 7%-9% rate range.

2 Risks and vulnerabilities

From July 2018 to November 2019 new consumer credit concentrated on borrowers within the €600-€1,200 and €1,200-€2,400 income brackets. There was a joint increase in the amounts of credit relating to house purchase and consumer credit granted to borrowers with net income from €1,200 to €2,400 between July and November 2019 (Charts 6 and 7).

Chart 6 • Consumer credit, by income range | EUR millions

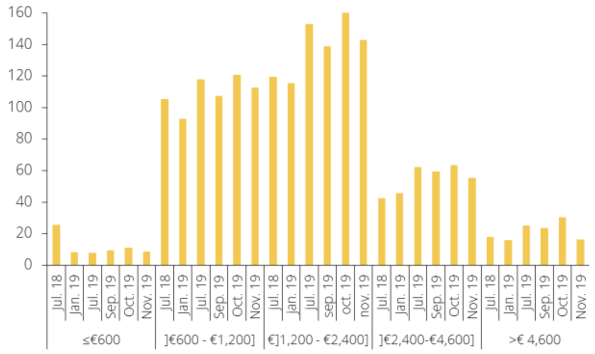
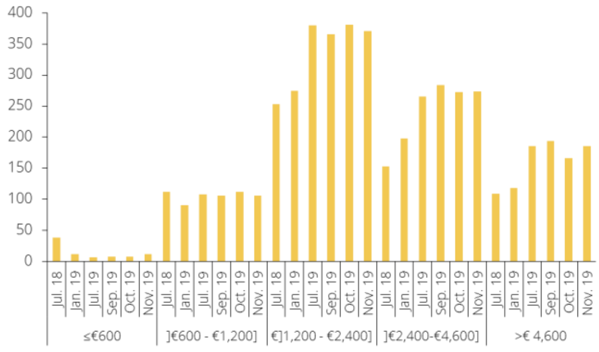


Chart 7 • Credit relating to house purchase, by income range | EUR millions



Source: Banco de Portugal. | Note: Based on the self-assessment reports of 13 institutions.

Since the entry into force of the macroprudential Recommendation, there has been an improvement in the borrowers' risk profile, partly reflected in an increase in credit relating to house purchase granted to borrowers with monthly net income above €1,200.

These developments occurred in the context of a still high indebtedness ratio, despite the downward trend seen since 2010, and a low household saving rate. The combination of these factors involves the households' low capacity to absorb adverse shocks on income, with a potential impact on financial stability.

The greater the risk of default on credit obligations, the higher (lower) the indebtedness level (net wealth) of borrowers. In November 2019 around 31% of personal credit was granted to borrowers with a DSTI ratio between 30% and 50% and a maturity of over 7 years. Furthermore, according to the latest Portuguese Household Finance and Consumption Survey,[1] 27% of households in the lowest net wealth group had loans that were not collateralised by real estate, the highest figure among all net wealth groups.

The expansion of consumer credit results in the banking system's increased exposure to borrowers who tend to be less resilient to a possible deterioration in labour market conditions. In particular, the increase in maturities may pose a further risk, as it implies that credit exposures, potentially without collateral or linked to less liquid assets and/or shorter depreciation periods than the loan maturity, will be exposed to fluctuations in the financial and business cycle for longer periods. This hinders the restructuring of loans and the reduction of default, in the event of borrowers' financial distress.

A protracted very low interest rate environment for a longer period of time (lower-for-longer environment) may encourage search-for-yield behaviour by institutions, materialised in an increase in exposure and competition in credit segments with higher profitability but also higher risk, namely in consumer credit. Increased competition may translate into misalignment between credit standards and risks taken, reflected in the extension of maturities and the reduction of interest rates, simultaneously leading to higher household indebtedness.

The high level of consumer confidence, supported by expectations of continued growth in disposable income, boosts credit demand. However, the current economic environment is characterised by high uncertainty and a slowdown in economic activity. In fact, projections for economic growth published by Banco de Portugal and the main international organisations have been revised downwards, with risks to economic activity mostly on the downside.

[1] *Inquérito à Situação Financeira das Famílias 2017*, available at https://www.bportugal.pt/page/inquerito-situacao-financeira-das-familias.

3 Amendment to the macroprudential Recommendation

Given that the Recommendation intends to promote (i) banking sector and household resilience, contributing to reduce the probability of credit default and minimise losses in case of default and (ii) access to sustainable funding by households, given the risks seen in the current environment, Banco de Portugal considers that the maximum maturity of new personal credit should be reduced to 7 years,[2] with a few exceptions.

Hence, with effect from 1 April 2020 onwards the following limits to the original maturity are recommended:

- 7 years for personal credit agreements;
- 10 years for personal credit for education, healthcare and renewable energy, provided that these purposes are duly evidenced; and
- 10 years for car credit agreements.

The definitions of personal credit and car credit and of personal credit purposes correspond to those provided for in Instruction of Banco de Portugal No 14/2013.[3]

In addition, the goal was to contain potential unwanted effects resulting from the introduction of an upper limit of 7 years to the personal credit maturity on the level of the ratio of the monthly instalment amount calculated with all the borrower's loans to his/her income (DSTI – debt service-to-income). In this sense, the exceptions provided for in the Recommendation for granting credit to borrowers with a DSTI ratio above 50% will be reduced to closer to the value currently used by institutions. Thus, up to 10% of the total amount of new credit granted by each institution may have a DSTI ratio of up to 60%, continuing to allow institutions to consider other important aspects for assessing the borrowers' creditworthiness that are risk mitigating factors. The 5% exception to the DSTI ratio limits will be maintained with regard to the total amount of credit granted by every institution covered by the Recommendation.

The assessment of the impact of the revision to the maximum maturity for personal credit and of the reduction of exceptions to the DSTI ratio suggests that the effect on new consumer credit is low, with a consequent residual pass-through to economic activity. In the medium term the changes introduced to the Recommendation foster the reduction of borrowers' probability of default, improving the quality of the institutions' credit portfolio. This effect is particularly significant given the borrowers' vulnerability to a potential deterioration in labour market conditions.

In its capacity as macroprudential authority, Banco de Portugal will continue to monitor developments in household indebtedness, as well as credit standards, and if necessary adopt any additional measures it deems appropriate.

[2] When the macroprudential Recommendation was introduced, international experience with macroprudential measures targeted at consumer credit was quite limited. More recently, other examples emerged in similar contexts. In particular, Banka Slovenije has introduced a 7-year limit to the personal credit maturity. Considering the European-wide experience, of the other four countries that have established limits to the consumer credit maturity, Portugal is the least restrictive (10 years), followed by Slovakia and the Czech Republic (8 years) and Romania (5 years).

[3] The following definitions apply: (i) personal credit – credit with repayment time schedule, amount and duration of the loan set out at the start of the agreement, with the exception of car credit; (ii) personal credit for education purposes – credit to finance education expenses; (iii) personal credit for healthcare purposes – credit to finance healthcare expenditure.; (v) personal credit for renewable energy – credit to finance renewable energy equipment; and (vi) car credit – credit for the purchase of a car or other vehicles, with repayment time schedule, amount and duration of the loan set out at the start of the agreement.