MACROPRUDENTIAL RECOMMENDATION ON NEW CREDIT AGREEMENTS FOR CONSUMERS – PROGRESS REPORT

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Macroprudential Recommendation on new credit agreements for consumers – progress report • Banco de Portugal
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Contents

Executive summary

In its capacity as the national macroprudential authority, the Banco de Portugal announced in February 2018 the entry into force of a macroprudential measure on the criteria used by the institutions in borrowers' creditworthiness assessments. This Recommendation is targeted at mitigating the build-up of systemic risk, increasing financial sector resilience, while promoting households' access to sustainable financing.

Not all new credit agreements concluded with consumers are covered by the Recommendation. Credit agreements for an amount equal to or lower than the equivalent to tenfold the guaranteed monthly minimum wage fall outside the scope of the Recommendation. In addition, credit intended to prevent or address arrears situations is also excluded, thus giving greater flexibility to the design of these agreements. Also excluded are credit agreements in the form of an overdraft facility and other credit with no defined repayment schedule (including credit cards and credit lines).

In May 2019 the first *Macroprudential Recommendation on new credit agreements for consumers – progress report* was published, with a cut-off date of March 2019, and concluded that the institutions were converging considerably towards the limits considered in the Recommendation. This Report presents the results of the monitoring of the macroprudential Recommendation since then. The Recommendation monitoring process by the Banco de Portugal is targeted at preventing actions that jeopardise the Recommendation's effectiveness and/or potential distortions of competition.

Such monitoring of the degree of implementation of the Recommendation continued to be based on the monthly reporting by 13 institutions with a market share of 95% of new credit to consumers. The Banco de Portugal has also been assessing the measures taken by all institutions in view of the Recommendation, taking into account the data reported through the Central Credit Register.

As explained in the first progress report in May 2019, which includes data up to March 2019, the first few months of implementation of the Recommendation were affected by credit business for which the borrower's creditworthiness assessment was carried out prior to its entry into force, and thus credit agreements were mostly based on solvency criteria that did not coincide with those established in the Recommendation. Hence, data for July 2018 were used as a starting point to assess the evolution of the borrowers' risk profiles.

From July 2018 to March 2019 there was a considerable convergence towards the limits established in the Recommendation, while from March to December 2019 there were virtually no cases of non-compliance with the limits recommended in new credit granted.

With regard to the LTV (loan-to-value) ratio limits, there was a change in the distribution of new credit by range of this ratio: agreements with an LTV ratio of more than 90%, which accounted for 22% in July 2018 and 4% in March 2019, became insignificant in December 2019 (2%). By contrast, there was an increase in new credit with an LTV ratio between 80% and 90%, which accounted for around 50% of new business in December 2019.

This convergence was also seen in the DSTI (debt service-to-income) ratio. In fact, in December 2019 around 92% of new credit for house purchase and new consumer credit was granted to borrowers with a DSTI ratio of 50% or less[1]. The share of new business regarding consumer credit

[1] The DSTI ratio is calculated taking into account interest rate rises according to maturity and shocks on income when borrowers are aged 70 and over at the maturity of the agreement and not yet retired.

and credit for house purchase with a DSTI ratio between 50% and 60% underwent few changes from July 2018 to December 2019, standing at around 7%, i.e. much lower than the 20% limit provided for in the Recommendation in this period. New business regarding credit for house purchase and consumer credit with a DSTI ratio of over 60% accounted for 3% of new credit in December 2019, thus being within the 5% limit established in the Recommendation.

Limits to maturity have also been complied with for credit for house purchase from October 2018 onwards and for consumer credit since the entry into force of the Recommendation. As at December 2019 over 90% of credit for house purchase had a maturity of 20 to 40 years, with the weighted average maturity per credit amount declining by about a year between July 2018 and December 2019, from 33.4 years to 32.6 years. The dispersion of the average maturity of new credit for house purchase across institutions implies their distinct needs, in order to ensure convergence, as set out in the Recommendation, towards an average maturity of 30 years by 2022. The average maturities of consumer credit increased: from around 6 years in July 2018 to around 8 years in March 2019, a figure that was maintained in December 2019.

Finally, the regular payments requirement continued to show a high degree of compliance with the Recommendation, with most of the explanations for non-compliance presented by institutions involving the granting of bridging loans (loans with only capital drawdowns, e.g. for down payments).

There was a gradual improvement in the risk profile of borrowers with credit for house purchase since the entry into force of the Recommendation, considering the combination of the DSTI and LTV ratios. This improvement is evident from the analysis of the share of credit granted to higher-risk borrowers. In July 2018 this share reached 35%, declining to 9% in March 2019 and to 4% in December 2019.

Upon monitoring the Recommendation, the Banco de Portugal has concluded that the maintenance of the upward trend of the average maturity and average amount of new personal credit might pose an increased risk to the financial system. Hence, by deliberation of the Board of Directors of 29 January 2020, the Banco de Portugal decided to reduce the maximum maturity of new personal credit to 7 years. This excludes credit for education, healthcare and renewable energy – which will continue to have a maximum maturity of 10 years –, provided that these purposes are duly evidenced. The exceptions provided for in the Recommendation for granting credit to borrowers with a DSTI ratio between 50% and 60% have been reduced by up to 10% of the total amount of new credit granted by each institution. In addition, the 5% exception to the DSTI ratio limits will be maintained with regard to the total amount of credit granted by each institution covered by the Recommendation.

The analysis in the Report now published shows that the limits considered in the Recommendation are overall appropriate and effective in complying with the objectives set: to promote the resilience of financial institutions by applying suitable credit standards for households in addition to households' access to sustainable financing.

More recently, with the spread of COVID-19 economic and financial conditions have deteriorated considerably. In this context, the Banco de Portugal will continue in the pursuit of its financial stability objective, promoting the flow of funds into the economy through the instruments it considers suitable.

1 Macroprudential Recommendation within the legal framework of new credit agreements for consumers

In February 2018, in its capacity as national macroprudential authority,[2] the Banco de Portugal announced a recommendation targeted at new credit agreements for consumers,[3] which acted on the credit standards used by institutions when assessing the borrower's creditworthiness. As of 1 July 2018 the limits provided for in the Recommendation apply to agreements for credit for house purchase, credit secured by a mortgage or equivalent guarantee and consumer credit concluded by credit institutions and financial companies having their head office or branch in Portugal.

With this Recommendation, the Banco de Portugal intended, on the one hand, to prevent the build-up of systemic risk in the financial system, given an environment of low interest rates, continued high indebtedness and a low household savings rate, economic recovery and house price increases – conducive to an easing of credit standards. On the other hand, it also aimed at promoting borrowers' access to sustainable financing. In this respect, the Banco de Portugal's actions were of a preventive nature at an early stage of economic recovery and, taking into account the need to reduce non-performing assets in banks' balance sheets, had the ultimate purpose of reinforcing banking sector resilience.

Similarly to other macroprudential authorities in the European Union, the Banco de Portugal has chosen to implement the limits to credit standards in the form of a Recommendation, to avoid market disturbances, which are difficult to forecast given the measure's innovative and complex nature. This notwithstanding, the Recommendation is subject to the 'comply or explain' principle, which means that the institutions concerned should comply with the set requirements and state the reasons if they do not do so. In the event that the explanation is considered inadequate, the Banco de Portugal may take other measures.

This is part of several initiatives at European and national level establishing principles and rules to be observed by institutions when assessing creditworthiness and setting out the standards applicable to borrowers when granting new credit. Within this framework, institutions should only conclude a credit agreement when the result of a borrower's creditworthiness assessment shows that the obligations of the credit agreement can be complied with under the proposed terms and conditions.

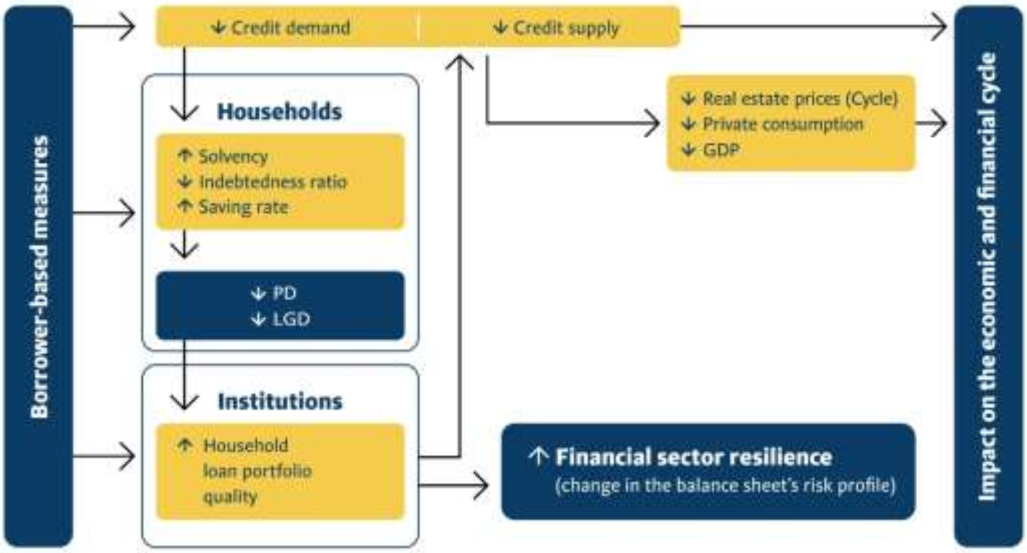
The Recommendation is of a type of macroprudential measures that act directly on the borrower (the so-called borrower-based measures), in contrast to measures that promote the increase of minimum capital requirements, applied at institution level (the so-called capital-based measures). Both borrower-based and capital-based macroprudential measures are ultimately targeted at improving resilience in financial institutions. While capital-based measures raise institutions' resilience in an immediate and direct manner, and may influence the composition of the credit portfolio, borrower-based measures improve institutions' resilience indirectly and over the

[2] Pursuant to its Statute, approved by Law No 5/98 of 31 January 1998, in its current version.

[3] Consumer means a natural person acting with purposes other than those of his or her commercial or professional activity in the credit agreements covered by the provisions of Decree-Law No 133/2009 and Decree-Law No 74-A/2017.

medium term, i.e. by improving the risk level of new credit, resulting from the enhanced resilience of borrowers. Hence, the macroprudential measures targeted at borrowers, in particular the limits related to their income and the value of collateral, will tend to result in a reduction of expected losses associated with new credit granted by institutions, due to the decline in both the probability of default and loss given default (Figure 1.1).

Figure 1.1 • Transmission mechanism of instruments applied to the granting of consumer credit



Notes: Adapted from: Committee on the Global Financial System (2012), Operationalizing the selection and application of macro-prudential instruments, *CGFS papers* No 48, December. PD – Probability of Default, LGD – Loss Given Default.

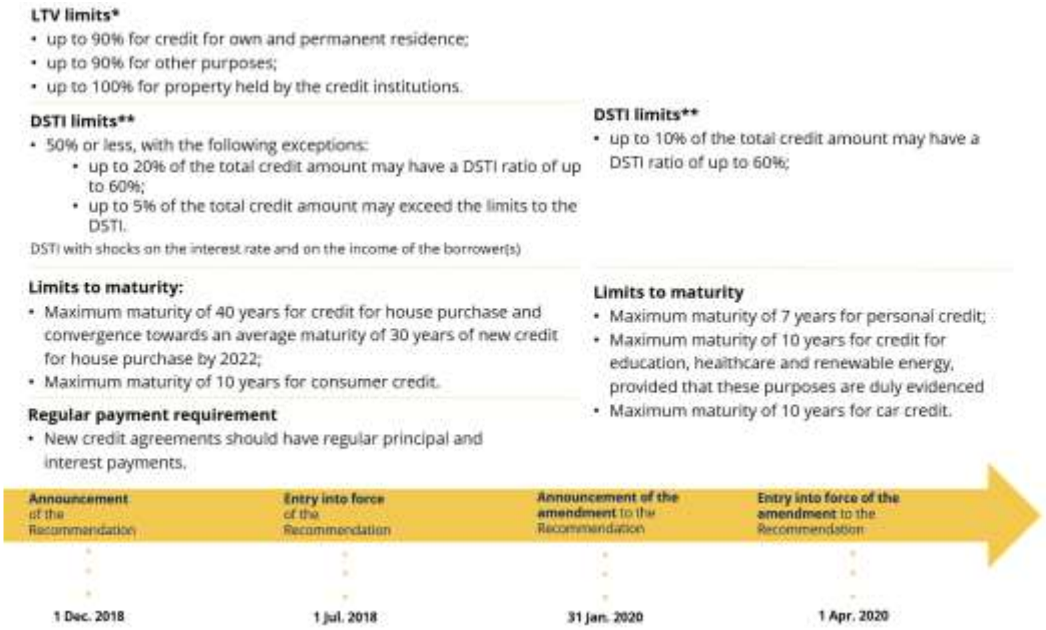
Borrower-based measures are usually implemented at the beginning of financial cycle recovery periods, with the purpose of maintaining credit standards at prudent levels. Often the interaction involves anchoring credit standards to the practice followed, on average, by credit institutions, while in other cases it is necessary to correct institutions' current practices.

The microeconomic impacts on the probability of default and loss given default can be complemented by impacts on macroeconomic variables, particularly on the degree of household indebtedness, the level of private consumption and real estate market prices. With regard to the latter, this type of measures does not intend, at an initial level, to influence developments in the real estate market per se. However, it may have a mitigating effect on the potential feedback loop risk between credit granted at domestic level and real estate prices.

The Recommendation sets forth a series of limits for credit standards

The Recommendation introduced limits to some of the criteria used in the consumers' creditworthiness assessment (Figure 1.2).

Figure 1.2 • Summary of the recommendation on new credit agreements for consumers



Notes: *The LTV (loan-to-value) ratio is the ratio of the total amount of credit agreements secured by immovable property to the minimum between the purchase value and the appraisal value of the immovable property pledged as collateral.[4] ** The DSTI (debt service-to-income) ratio is the ratio of the total amount of monthly instalments of a borrower's total debt to his/her monthly income less taxes and compulsory social security contributions. The calculation of the DSTI ratio should assume that the instalments of the new credit agreement are constant and consider the impact of an interest rate rise according to maturity in the case of variable and mixed interest rate agreements and a reduction of the income in the case of a borrower aged 70 and over at the planned expiry of the agreement, except if at the time of the creditworthiness assessment the borrower is already retired.

The limits correspond to the applicable caps and as such do not replace these institutions' compulsory assessment of whether levels of the different indicators are suited for assessing each borrower's creditworthiness.

The Recommendation provides for exceptions to the DSTI ratio limit, which were introduced so that other factors can be considered when the borrower's creditworthiness is assessed, such as: the borrower's level of wealth, the existence of a guarantor, or the amount of the borrower's other regular expenses. The value of the actual DSTI ratio for consumers will be lower than recommended, as it is calculated based on the interest rates in force and the level of current net monthly income.[5]

The other limits (LTV ratio, original maturity of agreements and regular payments requirement), although different depending on the purpose of the agreement, do not foresee exceptions.

[4] For further details, see Article 3 of the Recommendation within the legal framework of new credit agreements for consumers.

[5] As an illustration, assuming a 35-year-old borrower with a monthly income less taxes and compulsory social security contributions of €1,500 and no prior loans, for a credit agreement with a maturity of 40 years, a variable interest rate, -0.25% index and fixed spread throughout the agreement's lifetime at 2.25 p.p., the DSTI ratio that is actually borne by the borrower is 31%, equivalent to the DSTI ratio of 50%, taking into account a 3 p.p. increase in the index for agreements with a maturity of over 10 years.

Not all new credit agreements concluded with consumers are covered by the Recommendation

In accordance with Notice of the Banco de Portugal No 4/2017 of 22 September 2017, credit agreements for a total amount equal to or lower than the equivalent to tenfold the guaranteed monthly minimum wage fall outside the scope of the Recommendation, since it was considered that in such cases institutions may estimate the borrower's income based on information they deem sufficient. Thus the consumer's income may be estimated.

Also excluded was credit intended to prevent or address arrears situations, corresponding to situations in which credit risk has materialised or is about to and, as such, greater flexibility in the design of these agreements is deemed acceptable.

Finally, credit agreements in the form of an overdraft facility and other credit with no defined repayment schedule (including credit cards and credit lines) were also excluded, given the difficulty in applying some of the measures envisaged in the Recommendation to these agreements.

The instalments of agreements excluded from the scope of the Recommendation should nevertheless be considered in the calculation of the DSTI ratio, provided that they present a defined repayment schedule.

However, the Banco de Portugal will continue to scrutinise the evolution of credit agreements for consumers excluded from the scope of the Recommendation.

In 2019 the Banco de Portugal continued to interact closely with the institutions

In accordance with the Recommendation, the Banco de Portugal will monitor the implementation of the established limits as well as the evolution of credit excluded from the scope of the measure.

Hence, in the months following the entry into force of the Recommendation and to date, the Banco de Portugal and the Portuguese financial system's most representative institutions, including institutions specialising in consumer credit, interacted closely via telephone, email and bilateral meetings (80 meetings have been held since July 2018). The purpose of these contacts with institutions was to gauge the degree of implementation of the Recommendation, clarify the information to be reported, check compliance of advertising campaigns with the Recommendation, understand the institutions' lending strategies, as well as the involvement of their boards in the monitoring of implementation of this macroprudential measure. In addition, over these 18 months the Banco de Portugal provided a number of clarifications on issues raised by these institutions and their customers.

In May 2019 the Banco de Portugal published the first *Macroprudential Recommendation on new credit agreements for consumers – progress report*,[6] with March 2019 as the cut-off date. The analysis in this Report showed that the limits to the LTV ratio, to the DSTI ratio and to the maturity established in the Recommendation were appropriate and effective in reaching their objectives,

[6] Further details on the *Macroprudential Recommendation on new credit agreements for consumers – progress report* available at: https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/acompanhamento_recomendacao_macroprudencial_2019_en.pdf.

and considerable convergence towards the limits established was observed. The same was true for the regular payments requirement. This showed an improvement in the borrowers' risk profile, with the exceptions having been scrutinised by the Banco de Portugal. Subsequently, institutions intensified compliance with the limits set in the Recommendation.

The European Systemic Risk Board considered the macroprudential Recommendation to be appropriate and sufficient

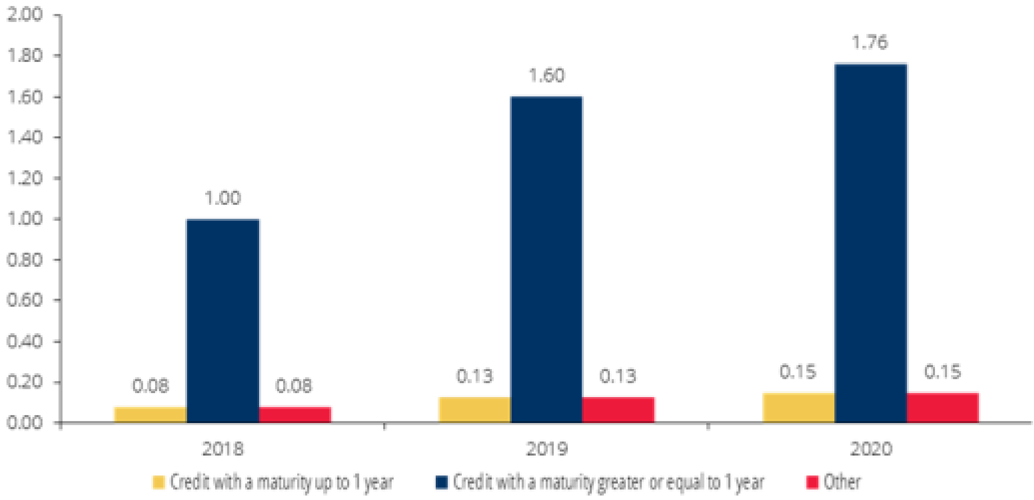
This assessment was supported by the European Systemic Risk Board (ESRB) in its *assessment report on European residential real estate markets* published in September 2019. Portugal was assessed as medium risk. However, Portugal was not the subject of an ESRB warning or recommendation, contrary to 11 European countries, precisely because the measures taken to address risk were considered to be appropriate and sufficient. Some features of this macroprudential measure were indeed pioneering, namely as regards the involvement of institutions' governance in the assessment of the degree of implementation of the measure, and the measure was a benchmark for other macroprudential authorities from European countries.

National legislative amendments and international guidelines may impact on the effectiveness of the Recommendation

Recently, there have been legislative amendments that might have some impact on credit granted to consumers.

The State Budget for 2020 provides for an increase of 10% in stamp duty rates applied to consumer credit with a maturity equal to or over 1 year and of 15% in stamp duty rates applied to consumer credit with a maturity of less than 1 year and other maturities. Hence, the upward trend already seen in 2019 was maintained. In addition, stamp duty rates were raised taking into account the maturity of the agreement (Chart 1.1).

Chart 1.1 • Stamp duty rate applied to consumer credit | Per cent



Sources: *Stamp Duty Code* and State Budget for 2018, 2019 and 2020.

The increase in stamp duty based on the consumer credit maturity may be considered to be an enabler of the Recommendation's effectiveness. In fact, the upward trend of the maturity and average amounts of the agreements for this type of credit may pose an increased risk to financial stability, as it implies that institutions have greater exposure to credit potentially without collateral and for a longer maturity. The latter aspect may hinder the restructuring of loans in the event of borrowers' financial difficulties, through the extension of the agreement's maturity and consequent reduction of the monthly instalment. Finally, agreements with longer maturities increase the probability of borrowers being exposed to income shocks resulting from a deterioration in labour market conditions.

In 2019 the Basic Housing Law was approved, setting forth that borrowers may terminate their debt upon surrender of the property to the bank, thus terminating their obligations regardless of the value assigned to the property for that purpose. However, this must be established in the credit agreement, and the credit institution is responsible for providing such information prior to conclusion of the agreement.

The fact that this possibility applies only to new agreements and must be contractually established, thus requiring prior agreement between banks and borrowers, mitigates the associated risks considerably. However, to actually mitigate risks, this type of agreement would need to have a considerably lower LTV ratio than the maximum ratios currently set out in the macroprudential Recommendation.

The Banco de Portugal decided to monitor the evolution and characteristics of this type of agreement. For this, as of 1 October 2019 it started to collect information from the 13 previously scrutinised institutions on the amounts of new credit agreements with the option of surrendering the property to service debt. To date there is no evidence of lending with these characteristics.

Amendment to the macroprudential Recommendation within the legal framework of new credit agreements for consumers

As aforementioned, the Recommendation aims to prevent the build-up of systemic risk in the financial system and promote borrowers' access to sustainable financing.

Hence, and in the light of the risks observed, the Banco de Portugal, in its capacity as macroprudential authority and by deliberation of the Board of Directors of 29 January 2020, decided to reduce the maximum maturity of new personal credit to 7 years. This excludes credit for education, healthcare and renewable energy – which will continue to have a maximum maturity of 10 years –, provided that these purposes are duly evidenced.[7]

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 DSTI ratio level. 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 actually used by institutions. Thus, up to 10% of the total amount of new credit granted by each institution may have a DSTI ratio higher than 50% and lower than 60%, thus continuing to allow institutions to consider other important aspects for assessing the borrowers' creditworthiness that are risk mitigating factors. In addition, the 5% exception to the DSTI ratio limits is maintained with regard to the total amount of new credit covered by the Recommendation.[8]

As with the process followed when defining the Recommendation, with regard to this revision of the Recommendation, the Banco de Portugal consulted the Associação Portuguesa de Bancos (APB), Associação Portuguesa de Leasing, Renting e Factoring (ALF), Associação de Instituições de Crédito Especializado (ASFAC) and Associação Portuguesa para a Defesa do Consumidor (DECO). The National Council of Financial Supervisors (CNSF) was also consulted in accordance with the applicable law.

The Banco de Portugal decided that the entry into force (1 April 2020) of this amendment would take place two months after its announcement, taking into account the time needed to prepare its operational implementation by the institutions.

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

[8] For further details on the amendment to the Recommendation, as well as the reasons behind it, see https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits and https://www.bportugal.pt/sites/default/files/2020_doclimites_en.pdf.

2 Background

In 2019 the economic and financial environment was characterised by (i) a still high household indebtedness level, despite the reduction in recent years; (ii) a low household savings rate; (iii) a protracted very low interest rate environment, which might encourage search-for-yield behaviour and a consequent easing of credit standards; and (iv) a high consumer confidence level, supported by expectations of continued growth in disposable income that strengthened credit demand. The economic environment was also 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. More recently, with the spread of COVID-19 economic and financial prospects have deteriorated considerably.

In the third quarter of 2019, total household debt as a percentage of disposable income was 96.4%, maintaining the downward trend hitherto seen, albeit still very high by international standards. Moreover, in the year ending in the third quarter of 2019 the household savings rate was one of the lowest by historical standards, i.e. around 6% of disposable income, continuing the downward trend observed since 2013.

> New credit for house purchase slowed down compared to the second quarter of 2018, but accelerated further from the third quarter of 2019 onwards

In more recent quarters, residential real estate prices in Portugal remained on an upward path, which continued to translate into an overvaluation of the market in aggregate terms.[9] However, the momentum observed in this market was not boosted, to a large extent, by domestic bank credit, but rather by high demand by non-residents, in a context of buoyant tourism, high consumer confidence levels, as well as from the prolonged low interest rate and high liquidity environment, which reinforces economic agents' search-for-yield behaviour.

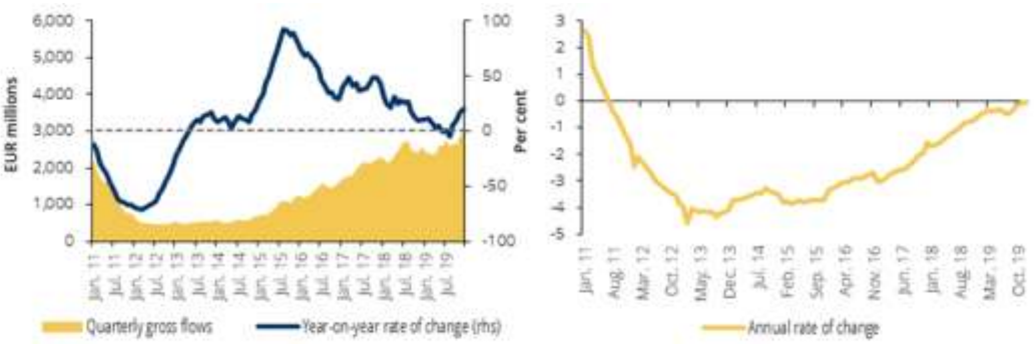
From mid-2018 to mid-2019 new credit for house purchase slowed down, reversing the growth trend observed since mid-2013. In the second half of 2019, however, new business accelerated, particularly in the last quarter of 2019, growing by about 20% year on year (Chart 2.1). This coexisted with a reduction of the stock of credit for house purchase, which recorded an annual rate of change of -0.1% in December 2019 compared to the same period a year earlier.

[9] For further details, see the Special Issue "Housing price assessment methodologies applied to Portugal" in the December 2019 issue of the *Financial Stability Report*.

Chart 2.1 • Credit for house purchase

New credit – quarterly flows

Annual rate of change in stock | Per cent

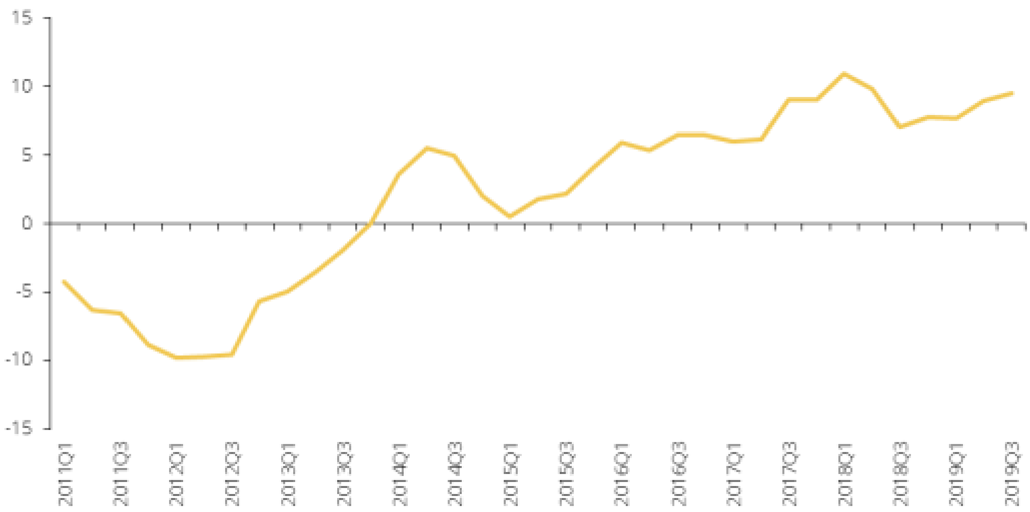


Source: Banco de Portugal. | Notes: Latest observation: December 2019. Flows of new business conducted by monetary financial institutions resident in Portugal. Activity on an individual basis.

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

In the third quarter of 2019 housing prices increased by 9.5% in real terms from the same period in 2018, against a 9.0% increase in the second quarter of 2019 in comparison to the same period a year earlier (Chart 2.2).

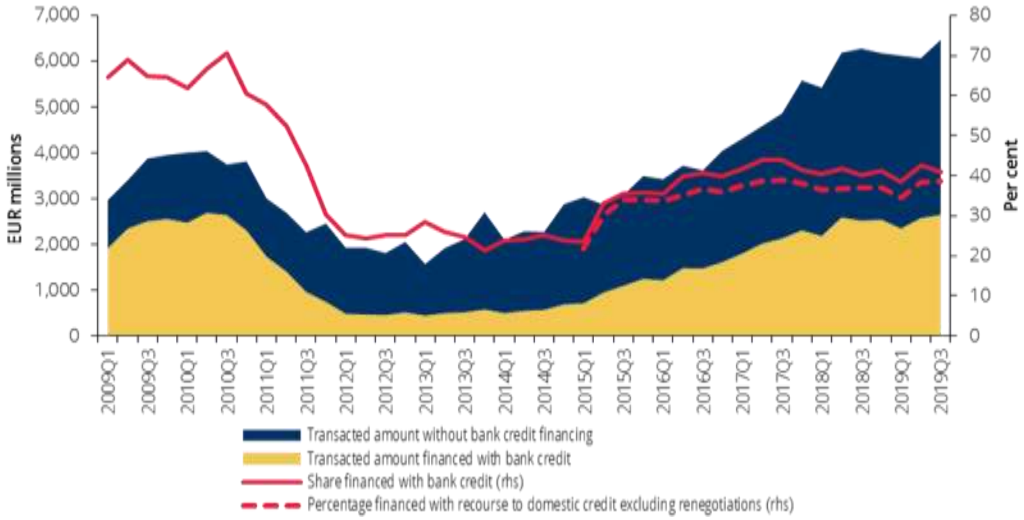
Chart 2.2 • Year-on-year rate of change in house prices | Per cent



Source: Organisation for Economic Co-operation and Development.

This notwithstanding, the share of residential real estate market transactions financed using domestic bank credit remained stable at around 40%, compared to around 65% in the period before the sovereign debt crisis (Chart 2.3).

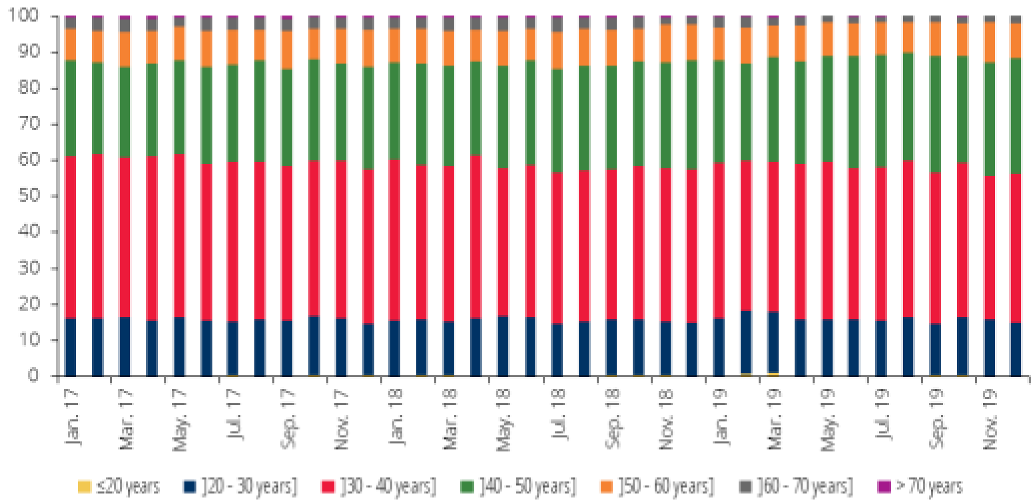
Chart 2.3 • Dwelling transactions versus new credit for house purchase



Sources: INE and Banco de Portugal. | Note: The dashed series corresponds to the share financed using domestic bank credit excluding renegotiations in agreements for credit for house purchase. Renegotiations are a residual component of new credit for house purchase and, with the exception of one-off situations, have no material impact on new business. However, this business is not as a general rule associated with transactions occurred in the period.

From January 2017 to December 2019 no significant changes were seen in the distribution of new credit for house purchase by borrower age. Credit for house purchase remained in general more concentrated in the 30-40 age range and residual below 20 years and over 70 (Chart 2.4).

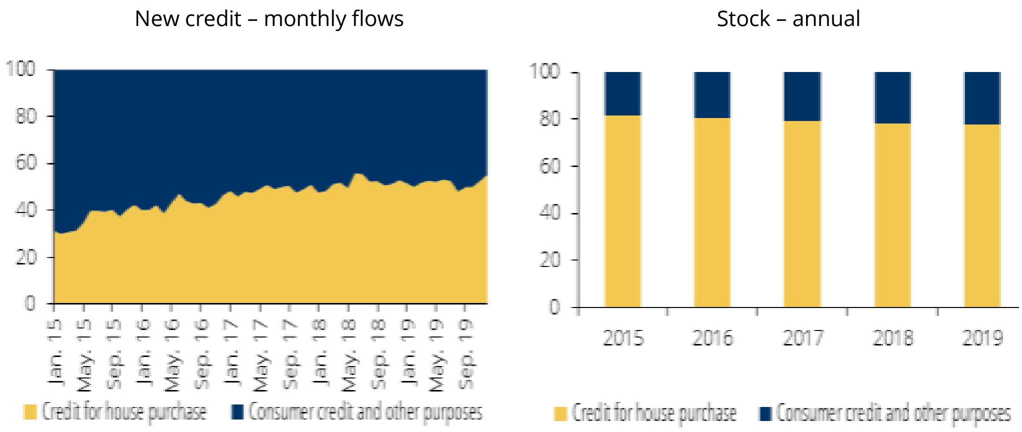
Chart 2.4 • New credit for house purchase by borrower age range | Per cent



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

In December 2019 the share of new credit for house purchase in total credit granted to households was 55%. However, in terms of credit stock, it accounted for around 80% (Chart 2.5).

Chart 2.5 • Evolution of stock and new credit to households by type of credit | Per cent

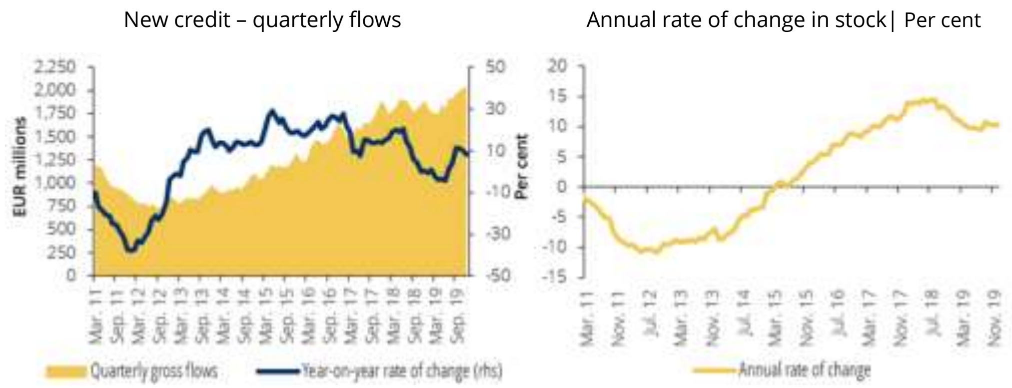


Source: Banco de Portugal. | Note: Latest observation for new business: December 2019.

Following a slowdown, new consumer credit accelerated in the second half of 2019

The quarterly year-on-year rate of change in new consumer credit declined by 4.5% from the second quarter of 2018 to the second quarter of 2019. Nevertheless, it reaccelerated in the third quarter of 2019, reaching growth of around 11.5%, mostly due to an acceleration in personal credit, whose year-on-year rate of change reached 22.2%. In the fourth quarter of 2019 new consumer credit maintained high growth, i.e. about 8.2% (with a 6.5% contribution from personal credit). After having declined by about 5 p.p. between August 2018 and April 2019, the annual rate of change in the stock of consumer credit stabilised at a high level, standing at around 10% in December (Charts 2.6 and 2.7).

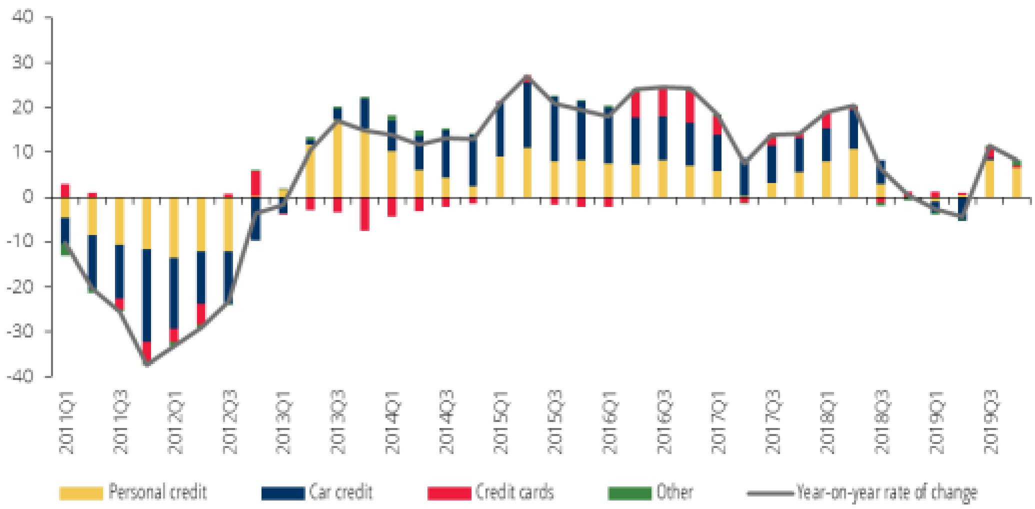
Chart 2.6 • Consumer credit granted to households



Source: Banco de Portugal. | Notes: Latest observation: December 2019.

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

Chart 2.7 • Year-on-year rate of change in new consumer loans including contribution by type of credit | Per cent and percentage points



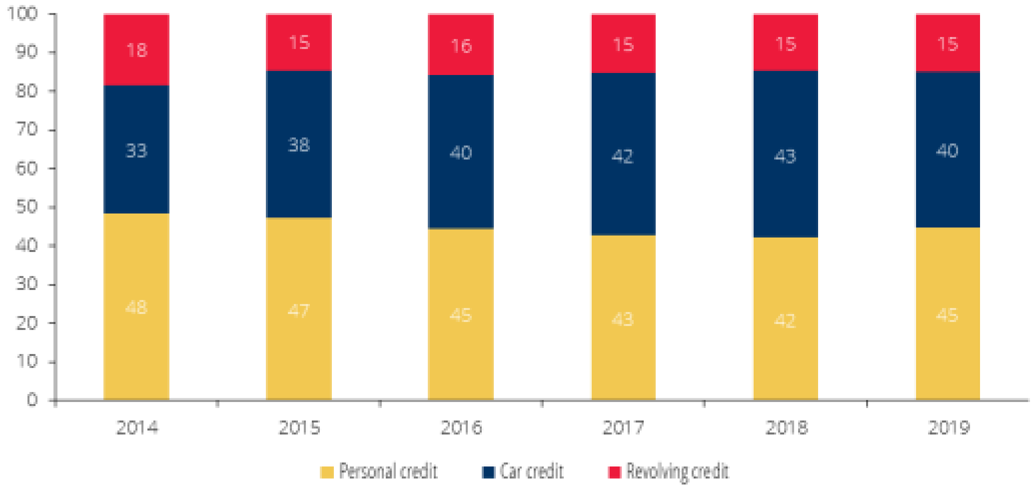
Source: Banco de Portugal. | Notes: Latest observation for the fourth quarter of 2019. Car credit is aimed at the purchase of new and second-hand cars or other vehicles, with repayment time schedule, amount and duration of the loan set out at the start of the agreement. Personal credit is aimed at financing the acquisition of goods and services, such as household equipment or education and health services, renewable energy, equipment leasing and consolidated credit or credit with no specific purpose.

According to the information available, in December 2019 around 4% of new personal credit was for 'education, health or renewable energy'. The other categories of new personal credit included 'other purposes', 'with no specific purpose', 'other purposes', 'for household equipment', 'consolidated credit', and 'financial leasing of equipment'.

According to information reported in the *Bank Lending Survey* for the third and fourth quarters of 2019, although the policy for granting credit to households remained virtually unchanged, the demand for credit increased in both quarters in the segment of credit for house purchase and in the last quarter of 2019 in the consumer credit segment. In addition, for the first quarter of 2020 institutions did not anticipate relevant changes in demand, nor in the supply of loans in the segments of credit granted to households.

Developments in 2019 in the different segments of new consumer credit translated into an increase in the relative importance of personal credit. Hence, the share of personal credit in new consumer credit rose from 42% in 2018 to 45% in 2019. This appears to be related with the fact that, in a protracted low interest rate environment, institutions adopted strategies to raise credit in segments with higher yields, but also greater risk, in particular personal credit. In this sense, some institutions seem to have adjusted their business models by adapting their offering to products that include credit previously granted in a single transaction with a higher amount and maturity, the so-called consolidated credit. The risk associated with this type of credit chiefly results from its greater sensitivity to a deteriorating economic environment, particularly in the labour market. In contrast, the relative weight of car credit declined by 3 p.p. in 2019, partly reflecting the anticipation in 2018 of car purchases following the announcement of a rise in related taxes in 2019. In turn, the committed amount of revolving credit, which includes credit cards, credit lines, current accounts and overdraft facilities, maintained the share observed in mid-2018, i.e. much lower than in 2014 (Chart 2.8).

Chart 2.8 • Distribution of the credit amount granted | Per cent



Source: Banco de Portugal. | Note: Revolving credit includes credit cards, credit lines, current accounts and overdraft facilities, to the committed amount.

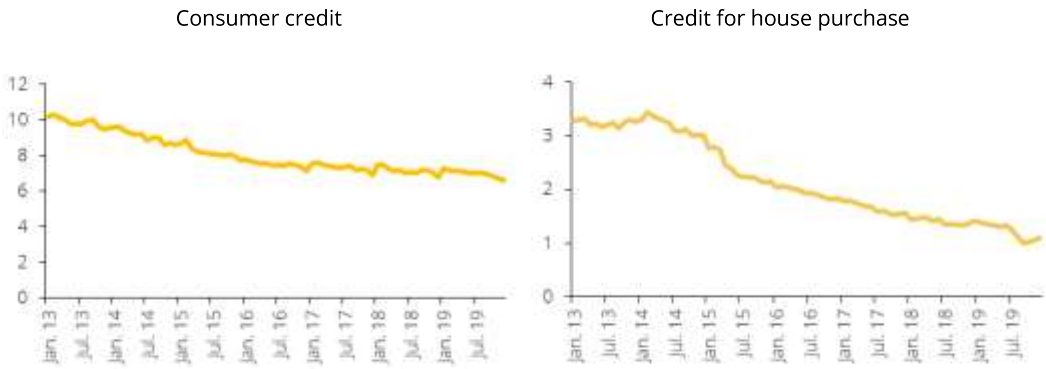
According to the *Portuguese Household Finance and Consumption Survey* for 2017, 27% of households in the lowest net wealth group had loans that were not collateralised by real estate, the highest figure among all net wealth groups considered. The Box "Characterisation of the distribution of personal credit by Portuguese households according to the *Portuguese Household Finance and Consumption Survey in 2017*" describes the main features of borrowers who have entered into personal credit. This survey concludes that borrowers with a lower income profile who have a median personal credit value of €5,000 are mostly the youngest, with greater job insecurity and a higher debt service ratio. This renders them more sensitive to adverse shocks to both income and interest rates.

Interest rates on credit for house purchase remained low

The interest rate on new consumer credit stood at around 7% in December 2019, i.e. slightly below the value observed in 2018, but much higher than the interest rate on new credit for house purchase, which reached 1% in December 2019 (Chart 2.9). This difference between the interest rates applied to credit for house purchase and to consumer credit results from a higher risk level in consumer credit as shown by a historically much higher default rate.

The Banco de Portugal's interaction with financial institutions shows that it is possible to conclude that the decline in interest rates on new credit may partly reflect an increase in competition among institutions, including credit intermediaries entering the market in an ancillary capacity. Whereas in consumer credit the role played by intermediaries is historically relevant (accounting for around 46% of the amount of credit granted to consumers in 2018), in the case of credit for house purchase they recently started to become relevant.[10] In fact, amid low interest rates, increased competition may have become more important, boosted by the role played by credit intermediaries in an ancillary capacity in credit for house purchase , and would have stimulated the renegotiation of housing credit agreements, which tripled from 2015 to 2018.[11]

Chart 2.9 • Interest rates on new credit | Per cent



Source: Banco de Portugal. | Notes: Latest observation: December 2019.

The market for new credit for house purchase continued to comprise predominantly variable-rate agreements. In the case of consumer credit, the share of loans with a rate fixation period of less than one year has been declining since 2017, while the proportion of loans with a rate fixation period of over five years rose considerably.

[10] For further details, see *Retail Banking Markets Monitoring Report* https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/retail_banking_markets_monitoring_report_2018.pdf.

[11] For further details see the December 2019 *Financial Stability Report* https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/ref_12_2019_en.pdf.

3 Assessment of the degree of implementation of the Recommendation

During 2019 the Banco de Portugal continued to assess the Recommendation's degree of implementation through monthly reporting by 13 previously scrutinised institutions, representing around 95% of new credit to households. In addition, each institution is asked to present a self-assessment report on an annual basis, which is subject to the approval of the respective management board. The Banco de Portugal has also been assessing the measures taken by all institutions in view of the Recommendation, based on the data reported through the Central Credit Register.

As explained in the first progress report, the first few months of implementation of the Recommendation were affected by credit business for which the borrower's creditworthiness assessment was carried out prior to its entry into force. This was particularly evident in credit for house purchase, for which the period between the creditworthiness assessment and the release of funds is longer than for consumer credit. Hence, as at July 2018, also due to some difficulties involved in the Recommendation's operational implementation by the institutions, credit agreements were mostly based on solvency criteria that did not coincide with those established in the Recommendation. Therefore, data for July 2018 were used as a starting point to assess the evolution of the borrower's risk profile throughout the period under review.

The first *Macroprudential Recommendation on new credit agreements for consumers – progress report* analysed the period from July 2018 to March 2019. In turn, this Report scrutinised the months from July 2018 to December 2019, especially developments from March 2019 onwards.

Institutions reinforced compliance with the limits set out in the Recommendation

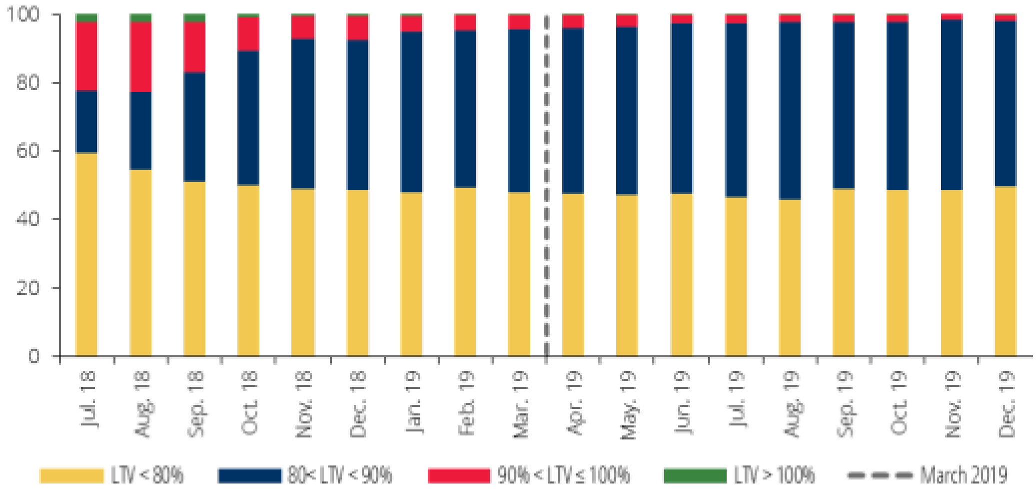
In accordance with the Recommendation, new credit agreements should observe an LTV ratio limit of:

- up to 90% for credit for own and permanent residence;
- up to 80% for other new credit for house purchase ;
- up to 100% for new credit for house purchase and credit for purchasing property held by the credit institutions and for property financial leasing agreements.

The calculation of the LTV ratio denominator should use the minimum between the purchase price and the appraisal value. In fact, prior to the entry into force of the Recommendation, banks privileged the use of the appraisal value.

The definition of LTV ratio limits translated into a change in the distribution of new credit for house purchase by range of this ratio. Hence, this credit's agreements with an LTV ratio of more than 90% became insignificant: in July 2018, 22% of new credit had an LTV ratio of more than 90%, compared to only 4% in March 2019 and declining to 2% in December 2019. In July 2018, 18% of new credit for house purchase had an LTV ratio of between 80% and 90%. This share increased consistently over the second half of 2018, stabilising at around 50% of new business over the course of 2019 (Chart 3.1). However, the average ratio of new credit for the purchase of own permanent residence within the 80%-90% range was about 88% in December 2019, i.e. very close to the upper limit of the range. The change in the distribution of the LTV ratio shows a decline in the risk assumed by institutions, given that the borrower should have at least 10% of own capital when purchasing an own permanent residence. The amount of new business with an LTV ratio above 100% was nil as at December 2019, which translated into a decline in credit granted for purchasing property held by the institutions.

Chart 3.1 • Distribution of new credit for house purchase by LTV ratio | Per cent

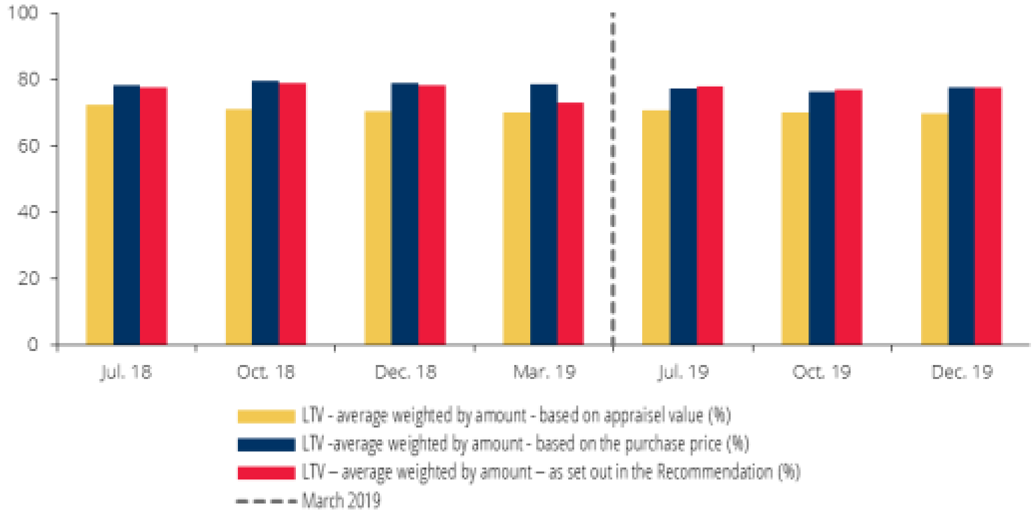


Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

In a context of sharp growth in residential real estate market prices, setting limits only to the LTV ratio tends to lose its effect, given that as the collateral value increases for a given credit amount the ratio tends to decline, thus becoming less tight. Alternatively, for a given LTV ratio a rise in the collateral value in itself enables the amount of credit granted to be raised. It is therefore important to set out limits to the DSTI ratio and the maturity simultaneously. Overall, the macroprudential Recommendation contributes to the reduction of the feedback loop between credit for house purchase and real estate prices.

In addition, the definition of the LTV ratio considered in the macroprudential Recommendation, having as denominator the minimum between the purchase value and the appraisal value of the property and taking into account that the appraisal value has been standing on average systematically above the purchase value, makes it possible to avoid financing 100% of the housing purchase price. Indeed, the minimum between the property's purchase price and appraisal value moved closer, on average, to the purchase price than to the appraisal value (Chart 3.2). The average LTV ratio calculated on the basis of the appraisal value declined by about 2 p.p. from 72% to 70% between July 2018 and December 2019, while the average LTV ratio based on the purchase price remained constant at around 77%.

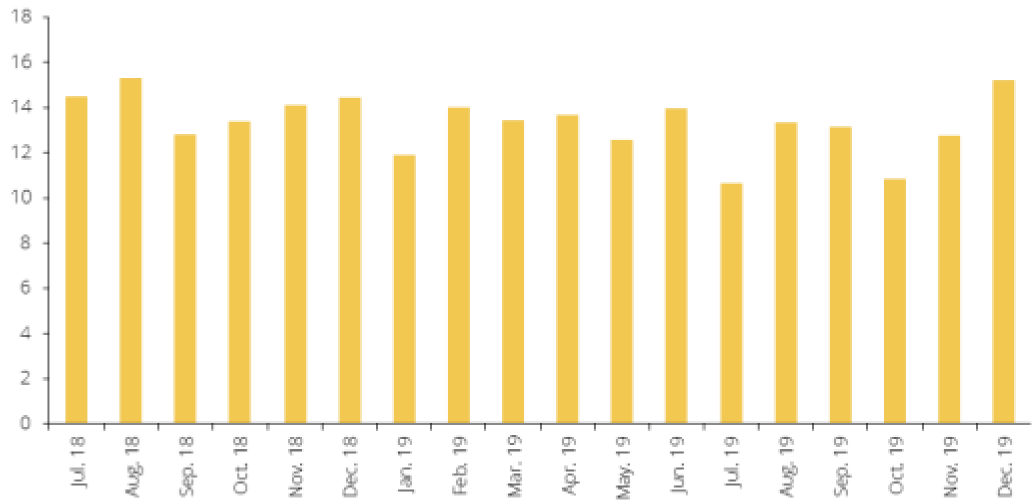
Chart 3.2 • Evolution of the LTV ratio for new credit for own permanent residence | Per cent



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions. In some periods the value of the average LTV ratio weighted by the credit amount is different from the minimum between the value of the average LTV ratio weighted by the credit amount based on the purchase price and based on the appraisal value. This is due to the fact that in some cases the minimum is the purchase price and in others the appraisal value.

Furthermore, from July 2018 to December 2019 the average purchase prices and the average appraisal value grew 6% and 7% respectively in annual average terms. In turn, the average value of agreements in the period under review rose by 5% (Chart 3.3). In this period disposable income in Portugal recorded an (estimated) annual average rate of change of 4%, i.e. below the change in housing prices, with the DSTI ratio limit, jointly with the limit to maturity, acting as "automatic stabiliser".

Chart 3.3 • Difference between the appraisal value and the purchase price over the purchase price | Per cent



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

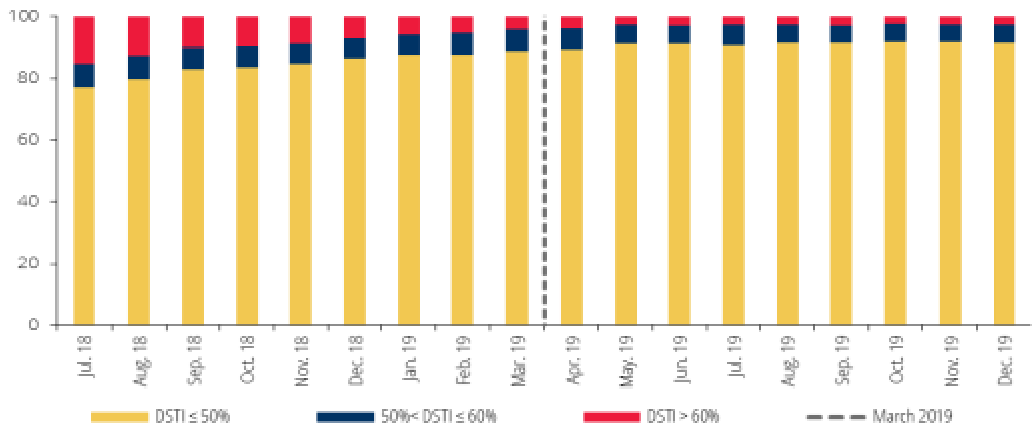
In accordance with the Recommendation, and even before the latest adjustment,[12] the DSTI ratio should not exceed 50%, with the following exceptions:

- up to 20% of the total amount of credit granted by each institution in each year may be granted with a DSTI ratio of up to 60%;
- up to 5% of the total amount of credit granted by each institution in each year may exceed the limits to the DSTI.

The calculation of the DSTI ratio assumes that the monthly instalment of new business is constant throughout the agreement's lifetime and considers the impact of a rise in the interest rate applied, which varies according to the original maturity of the agreement and the interest rate scheme. Hence, it is possible to assess whether borrowers are able to bear the effects on the debt service of a rise in interest rates.[13] A reduction in income when the borrower is aged 70 and over at the expiry of the agreement was also considered. The requirement of calculating the DSTI assuming a constant instalment scheme aims to avoid considering the lowest-value instalments, which would imply a more favourable DSTI for consumers in the short term, possibly creating the illusion of ability to service debt over the whole lifetime of the agreement.

In December 2019 around 92% of new credit for house purchase and new consumer credit was granted to borrowers with a DSTI ratio of 50% or less, compared to 77% in July 2018 and 89% in March 2019. The share of new business regarding consumer credit and credit for house purchase with a DSTI ratio between 50% and 60% underwent few changes from July 2018 and December 2019, standing at around 7%, i.e. much lower than the 20% limit provided for in the Recommendation in this period. New credit for house purchase and new consumer credit with a DSTI ratio of over 60% in July 2018 accounted for 15% of new business, and in March 2019 for around 4%, being within the 5% limit established in the Recommendation. This share continued to show a downward trend, reaching around 3% in December 2019 (Chart 3.4).

Chart 3.4 • Distribution of new credit by limit to the DSTI ratio | As a percentage of total credit



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

[12] The amendment to these exceptions will only enter into force on 1 April 2020.

[13] In the case of a borrower aged 70 and over at the planned expiry of the agreement, a reduction in income of at least 20% of current annual income shall be considered, weighted by the ratio of the number of years of the agreement in which a borrower is aged 70 and over to the total maturity of the agreement. This reduction in income shall not be considered if at the time of the creditworthiness assessment the borrower is already retired.
https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/acompanhamento_recomendacao_macroprudencial_2019_en.pdf.

With regard to the maturity, the Recommendation establishes an upper limit of 40 years for new credit for house purchase and 10 years for new consumer credit. Also, for new credit for house purchase it sets convergence towards an average maturity of 30 years by 2022.

Limits to maturity have been complied with, for new credit for house purchase from October 2018 onwards and for consumer credit since the entry into force of the Recommendation.

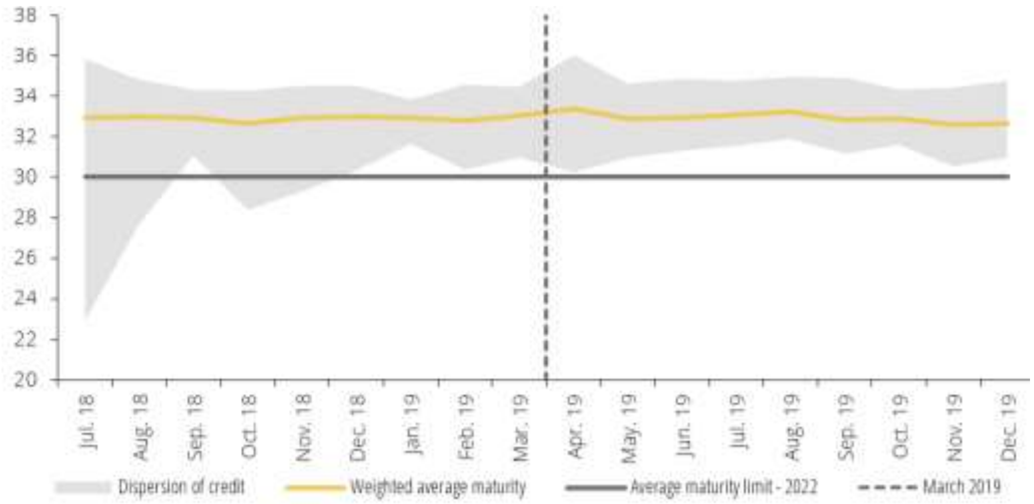
Taking into consideration the distribution of credit by maturity range, in December 2019 over 90% of new credit for house purchase had a maturity of 20 to 40 years, while credit with a maturity of over 40 years was immaterial. The maturities of consumer credit increased following a growth trend, since the share of credit with a maturity of 5 to 10 years was 81% in July 2018, 84% in March 2019 and 85% in December 2019 (Chart 3.5).

Chart 3.5 • Distribution of new credit by maturity range

Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

The weighted average maturity per credit amount declined from 33.4 years in July 2018 to 33 years in March 2019 and 32.6 years in December 2019. The minimum weighted average maturity observed was 30.9 years and the maximum was 34.7 years in December 2019. This dispersion implies distinct convergence needs across institutions (Chart 3.6).

Chart 3.6 • Maturity of new credit for house purchase | In years



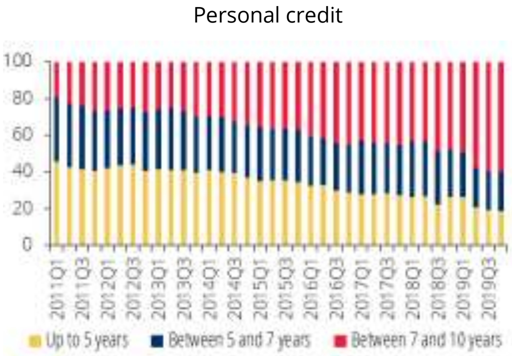
Source: Banco de Portugal.

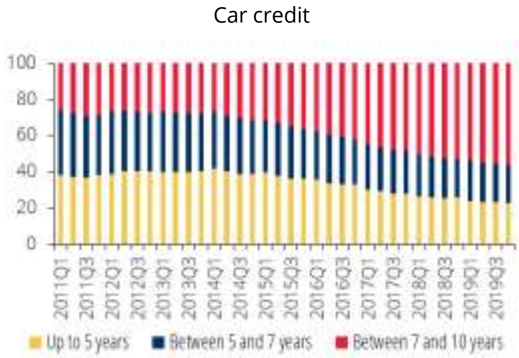
The weighted average maturity of consumer credit was about 6.4 years in July 2018, increasing to around 8 years in March 2019, a figure that was maintained in December 2019.

To review in greater detail the increase in the maturity of consumer credit in the 5-10 year range, the evolution of personal and car credit maturities is subject to a disaggregated analysis.

In the fourth quarter of 2019 the share of personal credit granted with a maturity of 7 to 10 years accounted for around 60% of new personal credit, growing by about 10 p.p. from the first quarter of 2019. This increase became more marked in the most recent period. 56% of new car credit was granted with a maturity of 7 to 10 years in the last quarter of 2019, compared to around 53% in the first quarter of 2019 (Chart 3.7).

Chart 3.7 • Total amount of new consumer credit, by maturity range | Per cent





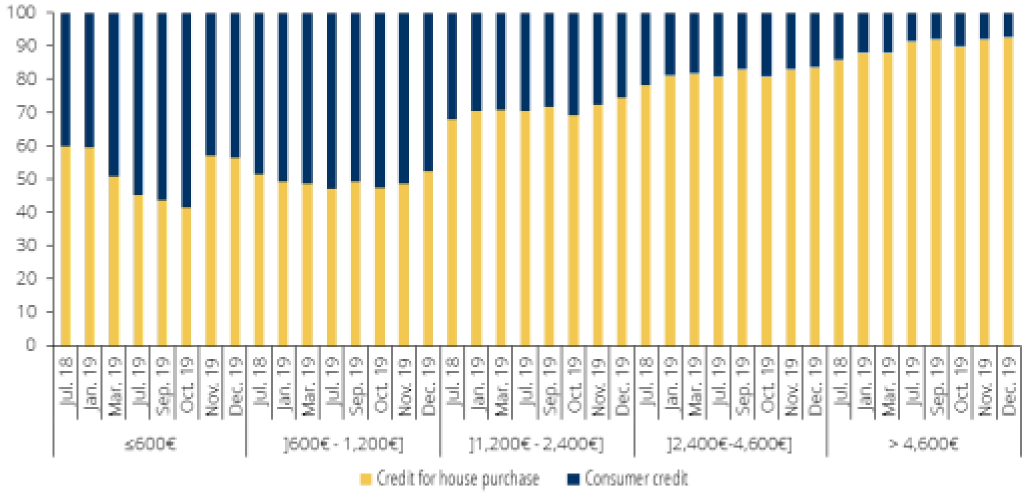
Source: Banco de Portugal. | Note: Excludes operations falling outside the scope of the Recommendation, namely lower than the equivalent to tenfold the guaranteed monthly minimum wage in 2018. Personal credit includes home improvements purposes. Latest observation: fourth quarter of 2019.

Finally, a high degree of compliance with the Recommendation continues to be observed with regard to the regular payments requirement, as in December 2019 only around 4% of total new credit did not comply with this requirement. As in March 2019, most of the explanations presented by institutions for not complying with this requirement involves the granting of bridging loans (loans with only capital drawdowns, e.g. for down payments).

The borrowers' risk profile continued to improve

According to the distribution of new credit by income range, the share of credit for house purchase is higher in the case of borrowers with higher monthly net income. In contrast, new consumer credit has a higher weight in credit granted to borrowers with lower monthly net income (Chart 3.8).

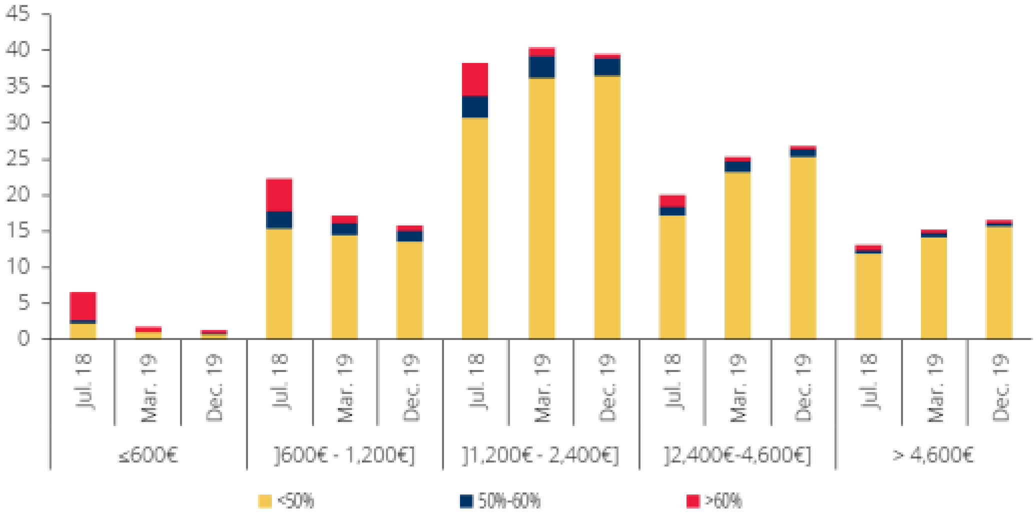
Chart 3.8 • New credit regarding consumer credit and credit for house purchase by income range | Per cent



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

Between July 2018 and December 2019 there was a considerable decline in the concentration of credit for house purchase and consumer credit granted with a DSTI ratio of over 60% in all brackets of the net monthly income of borrowers (Chart 3.9). This largely reflects the evolution of new credit for house purchase and seems to mirror a change in credit standards, reducing the share of credit granted to borrowers combining a DSTI ratio above 50% with lower monthly net income. In turn, there was an increase in credit granted to borrowers with a net monthly income of more than €1,200 and a DSTI ratio of 50% or less.

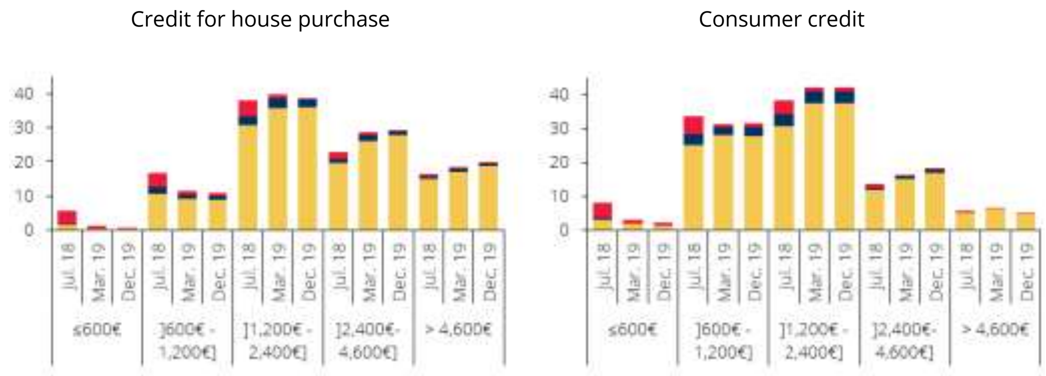
Chart 3.9 • New credit for house purchase and new consumer credit by interval of DSTI ratio and net monthly income of borrowers | Per cent



Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

Borrowers with a net monthly income of €600 or less and a DSTI ratio higher than 50% show a residual value of new credit for house purchase (0.4%) and new consumer credit (0.9%) (Chart 3.10).

Chart 3.10 • New credit by interval of DSTI ratio and net monthly income of borrowers | Per cent



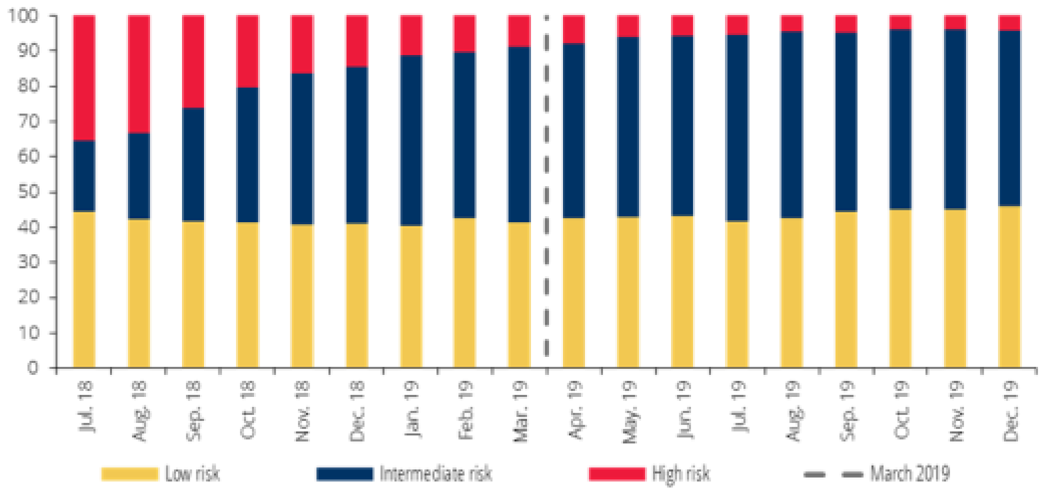
Source: Banco de Portugal. | Note: Based on information reported by a sample of 13 institutions.

From July 2018 to December 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 for house purchase and consumer credit granted to borrowers with net income from €1,200 to €2,400 between July and December 2019.

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 for house purchase y granted to borrowers with monthly net income above €1,200.

There was also an improvement in the risk profile of borrowers with credit for house purchase since the entry into force of the Recommendation, considering the combination of the DSTI and LTV ratios. This improvement is evident from the analysis of the share of credit granted to higher-risk borrowers. In July 2018 the share of loans with a high risk profile was 35%, declining to 9% in March 2019 and standing at only 4% in December 2019. This was offset by an increase in the share of credit for house purchase granted to borrowers with an intermediate risk profile, which stood at around 20% in July 2018 and at around 50% in March 2019 and December 2019. In turn, credit granted to borrowers with a low risk profile remained stable in the period under review (Chart 3.11).

Chart 3.11 • Borrowers' risk profile in new credit for house purchase | Per cent



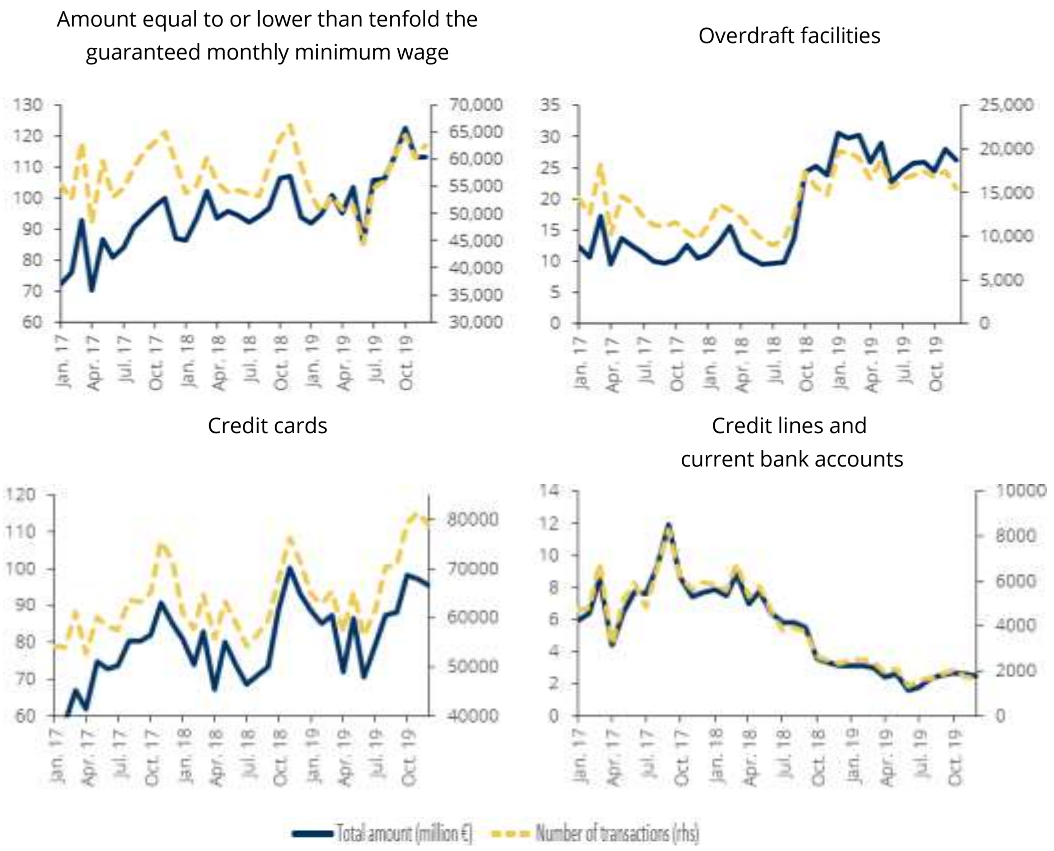
Source: Banco de Portugal. | Notes: Based on information reported by a sample of 13 institutions. Low risk: DSTI≤50% and LTV≤80%; High risk: DSTI≤60 % and/or LTV≤90 %; Intermediate risk: other cases.

The fact that a lower share of credit is granted to borrowers with a high risk profile, considering the combination of the DSTI ratio and the LTV ratio, will tend to increase institutions' resilience to a possible deterioration of economic conditions. Hence, there is evidence that institutions have implemented more appropriate practices when granting credit for house purchase, reducing credit granted to borrowers with a higher risk profile, thus decreasing the probability of default. In turn, compliance with the limits established in the Recommendation appears to have improved borrowers' ability to service debt, making them less sensitive to interest rate rises and income reductions.

No significant changes were identified in the pattern of credit granted outside the scope of the Recommendation

With regard to credit for an amount equal to or lower than the equivalent to tenfold the guaranteed monthly minimum wage, credit in the form of credit cards and credit in the form of overdraft facilities, no significant changes were identified in the pattern of credit granted since the entry into force of the Recommendation. There was a very significant increase in credit in the form of overdraft facilities in October 2018, but it was due to a correction in the reporting of an institution, and not a result of the entry into force of the Recommendation (Chart 3.12).

Chart 3.12 • New credit outside the scope of the Recommendation



Source: Banco de Portugal. | Notes: Based on information reported by a sample of 13 institutions. With regard to overdraft facilities, credit cards, credit lines and current accounts, this refers to the committed amount.

Box 1 • Characterisation of the distribution of personal credit by Portuguese households according to the Portuguese *Household Finance and Consumption Survey* in 2017

The financial situation of households is important for the resilience of the financial system. The greater the risk of default on credit obligations, the higher the indebtedness level of borrowers and/or the lower the net wealth.[14] The debt servicing ability of obligors with a high risk profile is particularly sensitive to interest rate rises and income reductions. This risk is more significant with a variable interest rate scheme and/or when households' indebtedness level is high or their liquid assets buffer is lower.

In the event of financial difficulties, it is more likely that households comply with the obligations of credit agreements for the purchase of or secured by own and permanent residence, because they value the safeguarding of their house. Hence, households with a high share of monthly income allocated to the payment of housing credit-related expenses and low levels of saving, when faced with an unanticipated negative shock on their income and/or a rise in their debt burden, will tend to substantially adjust their consumption level, also affecting residential investment decisions, with an impact on economic activity. On the other hand, given adverse shocks on their income level and/or a rise in the debt burden, a higher level of consumer credit default is expected.

The purpose of this box is to characterise borrowers who have entered into personal credit, based on the data collected through the Portuguese *Household Finance and Consumption Survey* (Portuguese acronym: ISFF) for 2017. Data from this Survey make it possible to characterise households according to their income percentile, education level, labour status, age, number of household members, among others. The ISFF was held on a sample of 5,924 households representative of the Portuguese population.

In 2017 almost half of the surveyed households (46%) held debt, and the median value of the ratio of debt service to the monthly income for indebted households was 14%.[15] Of total households, 9% held personal credit,[16] with a median value of €4,500 and a median value for the original maturity of loans of 4 years. For these households the median of the ratio of debt service (referring not only to personal credit but also to other loans households may have) to income stood at 16%.

Furthermore, income below the 20th and above the 90th percentiles refers to a lower number of households holding personal credit. In particular, only about 5% of households with income below the 20th percentile hold personal credit.

However, the behaviour of the median amount per household is slightly different, with households with income below the 20th, between the 40th and the 60th and above the 80th percentiles having a higher median amount of personal credit. Specifically, households with income below the 20th percentile show a median value of personal credit of around €5,000, while households with income in the 40th-60th, 80th-90th and above 90th percentiles show values amounting to €4,800, €5,000 and €15,300 respectively.

With regard to maturity, households with income below the 20th and between the 40th and the 60th percentiles entered into personal credit with a (median) maturity above the other income brackets. The median of the debt service ratio followed a downward trend based on the

[14] For further details see Costa, S. (2012). "Households' default probability: an analysis based on the results of the HFCS". Banco de Portugal, *Financial Stability Report*, November.

[15] For further details see Costa, Farinha, Martins and Mesquita (2020), *Banco de Portugal Economic Studies*, Vol. VI No 1, p. 25 to 52.

[16] Personal credit means loans not secured by immovable property, except for loans for purchasing a vehicle or another means of transport.

households' income percentile. In fact, this ratio ranges from 39.8% to 9.7% for below the 20th or above the 90th percentiles respectively (Chart C1.1).

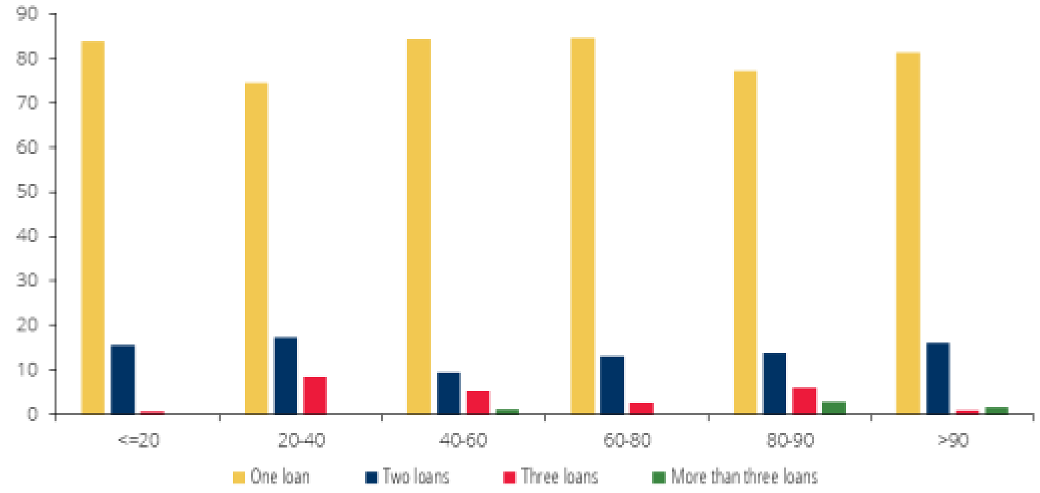
Chart C1.1 • Characterisation of personal credit

Source: Portuguese *Household Finance and Consumption Survey* 2017.

A breakdown of personal credit by purpose shows that this type of credit is chiefly intended for consumer spending (53%), home improvements or décor (16.5%) and debt consolidation (12.7%).

81% of households holding personal credit have only one personal loan. Households with income below the 40th percentile hold three personal loans at most, and only 0.6% of those below the 20th percentiles hold three personal loans. The total number of households with more than three personal loans is also low, and this is only observed in households with income over the 40th percentile (Chart C1.2).

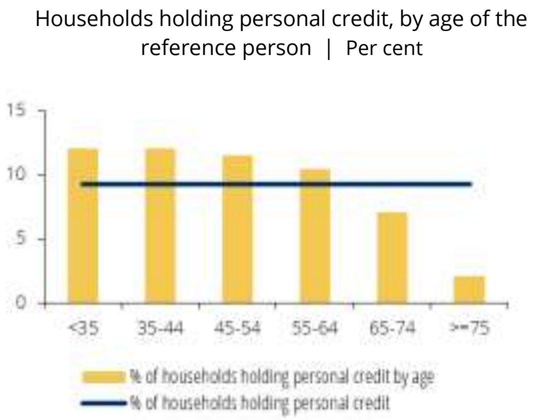
Chart C1.2 • Number of personal loans, by household and income percentile | Per cent

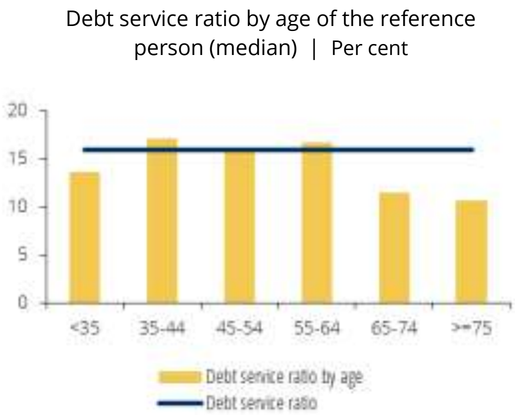


Source: Portuguese *Household Finance and Consumption Survey* 2017.

Overall, the share of households holding personal credit stands at around 12% in households whose reference person is aged under 55 and decreases with age from then onwards (Chart C1.3). In this context, the share of households with personal credit whose reference person is aged under 35 stands 10 p.p. above the share of those whose reference person is part of the older age group. In turn, as regards the debt service ratio, households whose reference person is aged 35-64 tend to record a median debt service ratio higher than that of the other age groups. Indeed, households whose reference person is aged 35-64 show a median of the debt service ratio of about 17%, while those whose reference person is part of the older age group record a median of the debt service ratio of about 11% (Chart C1.3).

Chart C1.3 • Personal credit by age



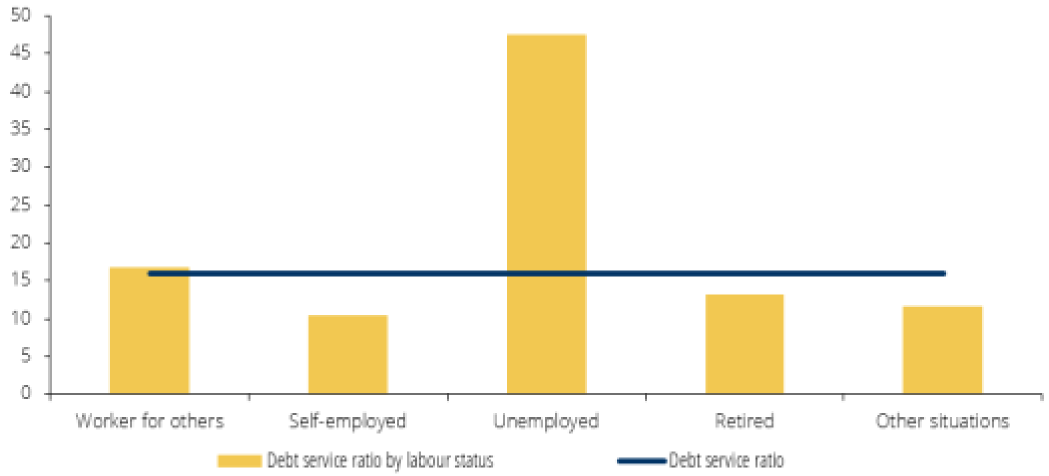


Source: Portuguese *Household Finance and Consumption Survey* 2017.

The ISFF also allows for an analysis of the households' financial position by their labour status, i.e. self-employed person, employee, unemployed, retired, etc. This disaggregation shows that 12.1% of employees and 12.6% of self-employed persons have entered into personal credit. 7.6% of the unemployed hold this type of credit, in contrast to only 5% of the retired. In turn, the median of the debt service ratio is 47.5% for the unemployed, compared to 16.9% and 10.4% for employees and self-employed persons respectively. Finally, retired persons show a debt service ratio of 13.2% (Chart C1.4).

With regard to education level, households whose reference person did not complete secondary education show a debt service ratio of 17.4%. This value declines as the education level increases.[17]

Chart C1.4 • Debt service ratio by labour status (median) | Per cent



Source: Portuguese *Household Finance and Consumption Survey* 2017.

The analysis shows that borrowers with a lower income profile who have a median personal credit value of €5,000 are mostly the youngest, with greater job insecurity and a higher debt service ratio. This renders them more sensitive to adverse shocks to both income and interest rates. The median value of personal credit increases according to the surveyed households' income percentile. With regard to maturity, households with an income below the 20th and above the 90th percentiles entered into personal credit with a maturity above the other income brackets. The debt service ratio followed a downward trend based on households' income percentile. As regards the age group, the share of households holding personal credit declines as the age of the reference person increases.

Finally, as far as the classification of households according to their labour status is concerned, the debt service ratio of the unemployed is much higher than in other professional statuses.

[17] See Costa (2016), *Banco de Portugal Economic Studies*, Vol. II No 4, p.15 to 60, for details on households that are characterised by their number of members and education level.

4 Conclusion

The analysis in this Report shows that the limits considered in the Recommendation are overall appropriate and effective in complying with the objectives set: to promote the resilience of financial institutions by applying suitable credit standards for households in addition to households' access to sustainable financing.

In the past two years the Banco de Portugal has been monitoring developments in credit granting activity, to boost the effectiveness of the Recommendation. As at December 2019 the various limits established in the Recommendation, as well as the regular payments requirement, were observed by institutions.

However, an analysis showed an upward trend of the average amount and average maturity of new personal credit, which may pose an increased risk to the financial system, as it implies that borrowers will be exposed to fluctuations in the business cycle for longer periods. In the light of this scenario, the Banco de Portugal has decided to reduce the maximum maturity of new personal credit to seven years. This excludes credit for education, healthcare and renewable energy – which will continue to have a maximum maturity of 10 years –, provided that these purposes are duly evidenced. Also, the exceptions provided for in the Recommendation for granting credit to borrowers with a DSTI ratio of up to 60% have been reduced by up to 10% of the total amount of new credit granted by each institution. In addition, 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.

Since the entry into force of the Recommendation, there has been an improvement in the risk profile of borrowers with credit for house purchase, considering the combination of DSTI and LTV ratios. In fact, in July 2018 the share of borrowers with a high risk profile was 35%, declining to 9% in March 2019 and standing at only 4% in December 2019.

In a context of sharp growth in residential real estate market prices, setting limits only to the LTV ratio tends to lose its effect, given that as the collateral value increases for a given credit amount the ratio tends to decline, thus becoming less tight. Alternatively, for a given LTV ratio a rise in the collateral value in itself enables the amount of credit granted to be raised. It is therefore important to set out limits to the DSTI ratio and the maturity simultaneously. However the calculation of the LTV ratio denominator should use the minimum between the purchase price and the appraisal value.

The Banco de Portugal will continue to monitor compliance with the Recommendation by the institutions covered, so as to prevent potential distortions of competition or actions that may jeopardise the Recommendation's effectiveness, as well as to scrutinise any possible overrunning.

The analysis in the Report now published shows that the limits considered in the Recommendation are overall appropriate and effective in complying with the objectives set: to promote the resilience of financial institutions by applying suitable credit standards for households in addition to households' access to sustainable financing.

More recently, with the spread of COVID-19 economic and financial conditions have deteriorated considerably. In this context, the Banco de Portugal will continue in the pursuit of its financial stability objective, promoting the flow of funds into the economy through the instruments it considers suitable.