COUNTERCYCLICAL CAPITAL BUFFER

30 March 2016

> Banco de Portugal decided that the countercyclical buffer rate for credit exposures to the domestic private non-financial sector remains at 0 per cent of the total risk exposure amount, with effect from 1 April 2016.
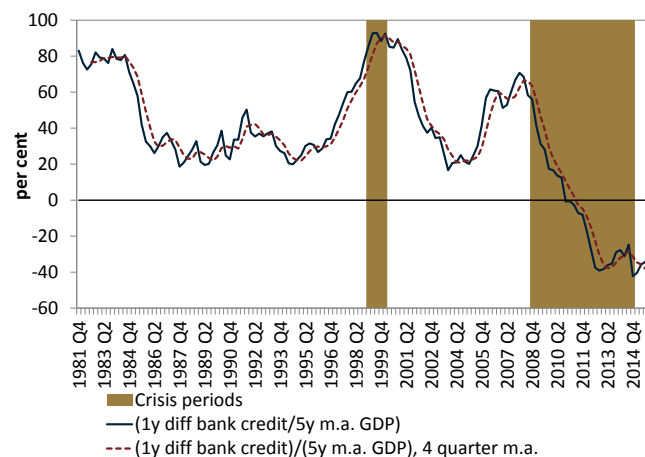
This decision is based on the overall assessment of a set of financial and macroeconomic indicators[1]:

Chart 1 – Basel gap and additional credit-to-GDP gap[3]
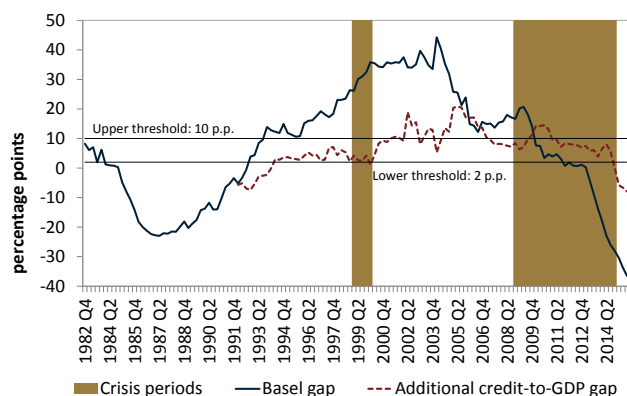
Sources: BdP, INE and BdP's calculations. **Last observation:** 2015 Q3.

Chart 2 – Ratio between the one year difference in bank credit and the five year moving average of GDP[4]

Sources: BdP, INE and BdP's calculations. **Last observation:** 2015 Q3.

Credit-to-GDP gap has further declined

Both measures of the credit-to-GDP gap (Basel gap and additional credit-to-GDP gap) decreased further in the third quarter of 2015, thus remaining in negative territory. This means that the credit-to-GDP ratio is still below its long-term trend, providing no evidence of excessive credit growth. **The additional credit-to-GDP gap is presently at a level of -7.9 p.p.,** which compares to -6.7 p.p. in the second quarter of 2015. In addition, the Basel gap decreased from -33.7 p.p. to -36.6 p.p. since the previous quarter. For these values of the gap, the BCBS methodology suggests that **the benchmark buffer rate should be set at 0 per cent of the total risk exposure amount**[2].

The decrease in the credit-to-GDP gap has been driven by a decrease in the credit-to-GDP ratio, due to both declining outstanding credit to the private non-financial sector and increasing nominal GDP.

Better prospects for bank credit

Another early indicator of credit imbalances is the ratio between the one year absolute difference in bank credit and the five year moving average of GDP. This ratio has been in negative territory since 2010, reflecting the contraction in bank credit. Still, in the third quarter of 2015, real bank credit growth was -7.1 per cent, representing an increase of 0.2 p.p. when compared to the previous quarter.

It is expected that bank credit continues to recover over the upcoming quarters due to developments in both supply of and demand for credit. On the one hand, more favourable

Chart 3 – Spreads on new loans granted to non-financial corporations[5]
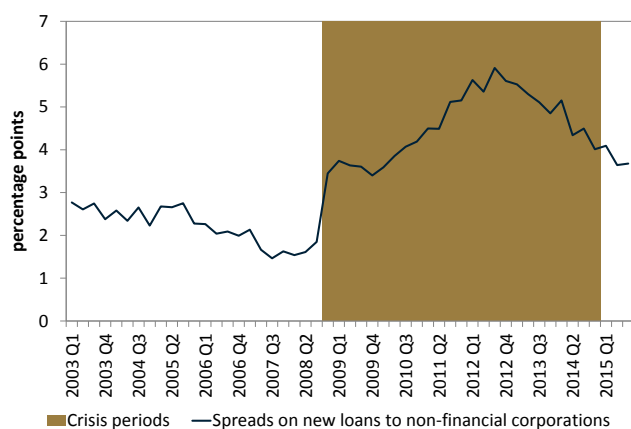
Sources: BdP, Reuters and BdP's calculations. **Last observation:** 2015 Q3.

Chart 4 – Current account deficit as a percentage of GDP[6]
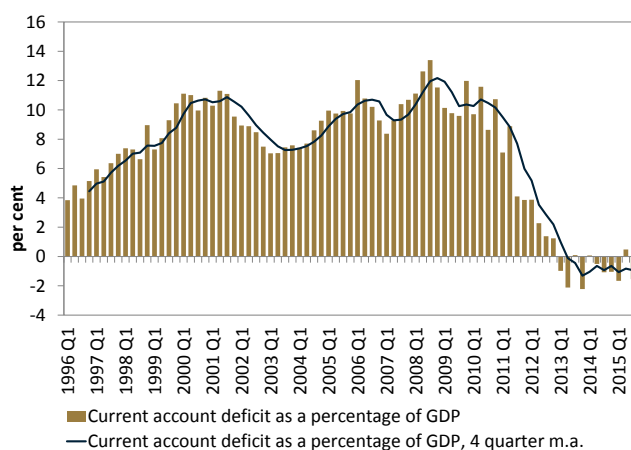
Sources: BdP, INE and BdP's calculations. **Last observation:** 2015 Q3.

prospects for the Portuguese economy - in particular, for the housing market - and the improvement in bank's financial position should contribute to an increase in the supply of credit.

On the other hand, credit demand may benefit from a recovery in consumer confidence and investment, related to, among other factors, a reduction in households' debt service and non-financial corporations' financing costs as a result of low interest rates.

Banks' spreads are still above the historical average

The narrowing of banks' spreads on new loans granted to non-financial corporations since late 2012 entails the possibility of

a renewed pick-up in the credit market, especially if accompanied by a similar evolution in banks' spreads applied in lending to households. However, the spread to non-financial corporations for the third quarter of 2015 (3.7 p.p.) still stands well above the historical and pre-crisis averages and, in particular, the minimum value observed around 2007-end. Moreover, the results of the January 2016 Bank Lending Survey show that the largest banking groups are not lowering spreads for high risk loans. In addition, banks have continued to adjust their balance sheets as shown by the constant improvements in the loan-to-deposit ratio, and the private non-financial sector continues to deleverage. **Therefore, there is no evidence pointing to excessively loose bank credit conditions.**

The current account was positive in the third quarter of 2015

In the third quarter of 2015, the current account as a percentage of GDP registered a positive value in line with the adjustment observed during the crisis, standing at 1.5 per cent. This recent development is also aligned with the still negative growth in total lending to households and non-financial corporations. **Against this background, current account developments do not point to an acceleration in the credit market in the near future.**

General assessment

The assessment regarding the need to implement the countercyclical capital buffer in Portugal has not changed significantly since December 2015. From a macroprudential perspective, financial market conditions are still in a post crisis phase and, accordingly, there is no reason for changing the current countercyclical buffer rate.

Notes

1 The assessment is based on available data up to 18 January 2016. This set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

2 In case the gap exceeds 2 p.p., the benchmark buffer rate will increase linearly from 0 per cent to the upper threshold of 2.5 per cent of the total risk exposure amount, which is associated with a gap of 10 p.p.. See Recommendation ESRB/2014/1 Annex Part II available at http://www.esrb.europa.eu/pub/pdf/recommendations/2014/140630_ESRB_Recommendation.en.pdf?03a7c5c908620b34673b6f290b54c13d.
   BCBS thresholds of 2 p.p. and 10 p.p. were determined using the Basel gap. Nevertheless, they are used as an approximation to map the additional credit-to-GDP gap into a benchmark buffer rate.

3 Credit to the domestic private non-financial sector, comprising all lending (loans and debt securities) extended by domestic and foreign banks, non-banks and debt markets. The credit-to-GDP ratio is computed using a four-quarter moving sum of nominal GDP. Credit is obtained from National Financial Accounts Statistics published by BdP and nominal GDP from National Accounts (ESA2010, base 2011) published by INE.
   The credit-to-GDP gap is calculated as the percentage point difference between the observed credit-to-GDP ratio and its long-term trend, where the trend is estimated employing a one-sided HP filter with a smoothing parameter set to 400,000.
   The additional credit-to-GDP gap is computed as the percentage point difference between the observed credit-to-GDP ratio augmented with ARIMA(p,1,0) forecasts, using a maximum forecast horizon of 28 quarters, and its long-term trend, where the trend is estimated employing a one-sided HP filter with a smoothing parameter set to 400,000. Until the first quarter of 2015, the optimal lag order (p) of the forecasting model is recursively determined. From the second quarter of 2015 onwards, p is set to three quarters, which is the optimal lag length when data until the first quarter of 2015 is used.
   Crisis periods as identified for the ESCB Heads of Research Group's banking crises database.

4 Calculated as the ratio between the one year absolute difference of bank credit and the five year m.a. of GDP, as proposed in Kalatie *et al*. (2015), "Indicators used in setting the countercyclical capital buffer", Bank of Finland Research, Discussion Papers, No. 8/2015. Bank credit extended by resident monetary financial institutions as available in Monetary and Financial Statistics published by BdP. Nominal GDP is obtained from National Accounts, ESA2010, base 2011, published by INE.
   Crisis periods as identified for the ESCB Heads of Research Group's banking crises database.

5 Average of spreads weighted by the corresponding outstanding loan amounts at the end of the quarter. Spread is calculated against the three month Euribor rate as available in Reuters. Only interest rates on new loans granted by other monetary financial institutions to residents with initial rate fixation up to one year are considered. Interest rates on new loans as available in Monetary and Financial Statistics published by BdP.

6 Current account deficit seasonally adjusted as available in the Balance of Payments Statistics published by BdP.

Abbreviations

ARIMA   Autoregressive Integrated Moving Average
BCBS   Basel Committee on Banking Supervision
BdP   Banco de Portugal
ESA   European System of Accounts
ESCB   European System of Central Banks
ESRB   European Systemic Risk Board
GDP   Gross domestic product
HP   Hodrick and Prescott
INE   *Instituto Nacional de Estatística* (Statistics Portugal)
m.a.   Moving average
p.p.   Percentage points
1y diff   1 year absolute difference