COUNTERCYCLICAL CAPITAL BUFFER

31 December 2018

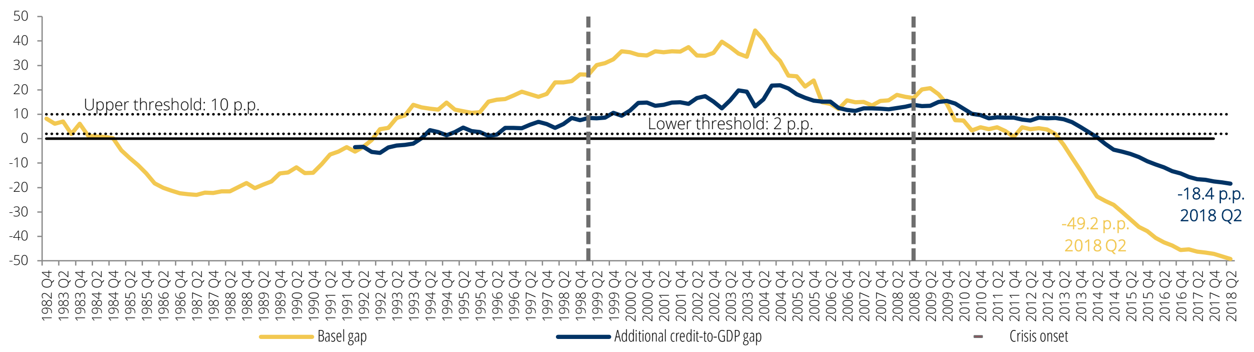
Pursuant to a decision of the Board of Directors of 20 December 2018, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 January 2019.

This decision is based on the overall assessment of a set of financial and macroeconomic indicators.[1]

Credit-to-GDP gap measures have further declined

Both credit-to-GDP gap measures reported in Chart 1 maintained their downward path in the second quarter of 2018, indicating that the credit-to-GDP ratio remains below its long-term trend. Accordingly, the Basel gap reached -49.2 percentage points (p.p.) and the additional credit-to-GDP gap -18.4 p.p., providing no evidence of excessive credit growth. The credit-to-GDP ratio has been declining since 2013, reflecting the positive developments observed in the business cycle coupled with the decrease in the total credit outstanding to the private non-financial sector.

Chart 1 Basel gap and additional credit-to-GDP gap[2] | In percentage points



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation is dated 2018Q2. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

[1] The assessment is based on data available up to 26 October 2018. Any differences in figures from previous assessments are due to revisions in underlying data. The set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

[2] 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 *Hodrick–Prescott* 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. In case the gap exceeds 2 p.p., the benchmark buffer rate will increase linearly from 0% to the upper threshold of 2.5% 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. Basel Committee on Banking Supervision 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.

The inertia underlying the trend estimate coupled with the projections published in the June 2018 *Economic Bulletin* of Banco de Portugal, pointing to continued GDP growth and an expected private non-financial sector deleveraging[3], are expected to result in the maintenance of the negative sign of both gaps for the period 2018-20.

As both measures of the credit cycle continue to be well below the 2 p.p. risk level threshold, the implied benchmark countercyclical buffer rate continues to be 0% of the total risk exposure amount.

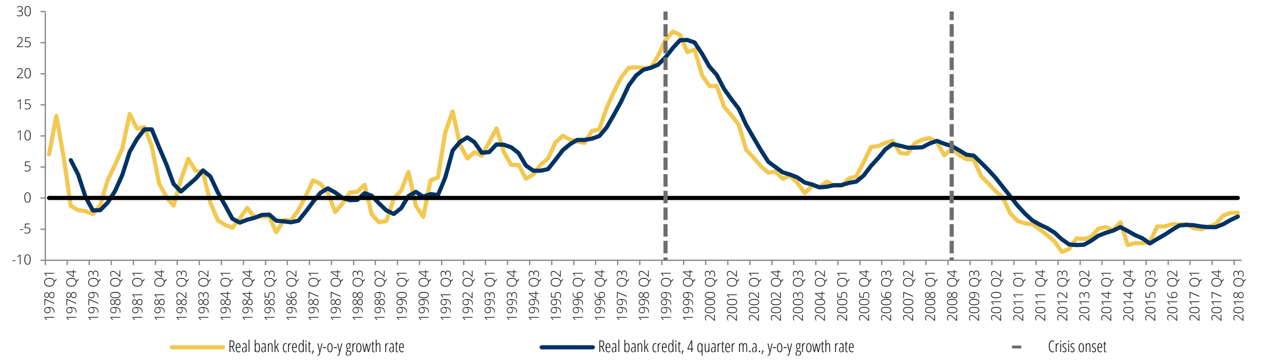
Real bank credit growth is still negative

In the third quarter of 2018, real bank credit outstanding to the private non-financial sector declined 2.3% (year-on-year) (Chart 2). This reduction was mostly driven by the real bank credit outstanding to non-financial corporations, which contracted 4.2% over the same period. Regarding households, real bank credit outstanding decreased 0.9% (year-on-year), reflecting the combined effect of the decrease of the credit for house purchase (-2%) and the increase in credit for consumption (9%). The latter is associated with the private consumption dynamics, reflecting households' real disposable income increase and consumer confidence at historical high levels, as highlighted in the October 2018 *Economic Bulletin* of Banco de Portugal. However, credit for consumption still represents a small share of the total real bank credit outstanding to households (12.9% in September 2018).

In the second quarter of 2018, the ratio between the one year absolute difference in bank credit and the five year moving average of nominal GDP increased 3 p.p. to -6.3%, when compared with the previous quarter, continuing the upward trajectory initiated in 2015. This evolution reflects the combined effect of the gradual output increase and the deceleration in credit's downward path.

All things considered, the year-on-year increase in new loans granted by the banking sector remained below the volume of repayments, write-offs and sales, providing evidence that the private non-financial sector deleveraging process continues, albeit at a slower pace than the one observed in the last periods.

Chart 2 Real bank credit growth[4] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation is dated 2018 Q3. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In the second quarter of 2018, total credit outstanding to the private non-financial sector, in real terms, declined 3% (year-on-year), reflecting a reduction in credit granted to both non-financial corporations and households (of -4.4% and -0.7%, respectively). The credit net[5] flow to non-financial corporations remained negative, in the second quarter of 2018 (as observed in the previous quarter), partly offset by debt securities issued (mainly placed with the resident financial institutions). Regarding households, the credit net flow to households became positive, unlike what was observed in the previous quarter. However, the positive contribution from resident financial institutions was not enough to offset the

[3] Measured by non-financial corporations debt in percentage of GDP and by households debt in percentage of disposable income.
[4] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Bank credit extended by resident monetary financial institutions as available in Monetary and Financial Statistics published by Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by INE.
[5] Net of other volume and price changes.

negative contribution of loan repayments, write-offs and sales, resulting in the above-mentioned total credit outstanding decrease.

Spreads on new lending broadly unchanged

In the third quarter of 2018, spreads on new lending granted to the private non-financial sector stood stable, when compared with the levels observed in the previous quarter.

Regarding households, spreads associated with new loans for consumption and other purposes reached 6.5 p.p. in the third quarter of 2018, increasing 0.1 p.p., in comparison with the previous quarter. Moreover, new lending spreads for house purchase declined 0.1 p.p. to 1.6 p.p., in the same period. According to the October 2018 *Bank Lending Survey*, participating Portuguese credit institutions, in general, reported more restrictive criteria applied on loans to households in both segments in the third quarter of 2018 as a result of the implementation of the macroprudential Recommendation applied by Banco de Portugal on new loans to households, which entered into force on 1 July 2018.[6] Additionally, participating Portuguese credit institutions, in general, expect tighter credit standards for households in the near future.

Concerning non-financial corporations, spreads on new loans (up to one year) decreased 0.1 p.p. to 2.6 p.p., in the third quarter of 2018, when compared with the previous period (Chart 3). Furthermore, participating Portuguese credit institutions in the October 2018 *Bank Lending Survey* do not anticipate, in a short-term period, changes in lending criteria for non-financial corporations.

Chart 3 Spreads on new loans to non-financial corporations[7] | In percentage points

Sources: Banco de Portugal, Thomson Reuters and Banco de Portugal calculations.
Notes: The last observation is dated 2018 Q3. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The above analysis points to the absence of a significant decrease of lending spreads, whose levels, on average, continue to remain above the pre-financial crisis average level.

In September 2018, the average interest rate on new lending to households for house purchase decreased 0.1 p.p. to 1.4%, when compared to June 2018, whereas for consumption and other purposes it increased 0.1 p.p. to 6.2%, over the same period. Regarding non-financial corporations, the average interest rate on new lending to non-financial corporations (up to one year) contracted 0.1 p.p. to 2.3%, considering the same period. It should be mentioned that, according to the October 2018 *Economic Bulletin*, banks continue to clearly differentiate the counterparty risk by charging higher average interest rates on riskier non-financial corporations compared with the ones showing lower risk, although a noticeable decline is observed from mid-2017 to mid-2018 for both risk levels.

[6] More information on this macroprudential Recommendation is available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

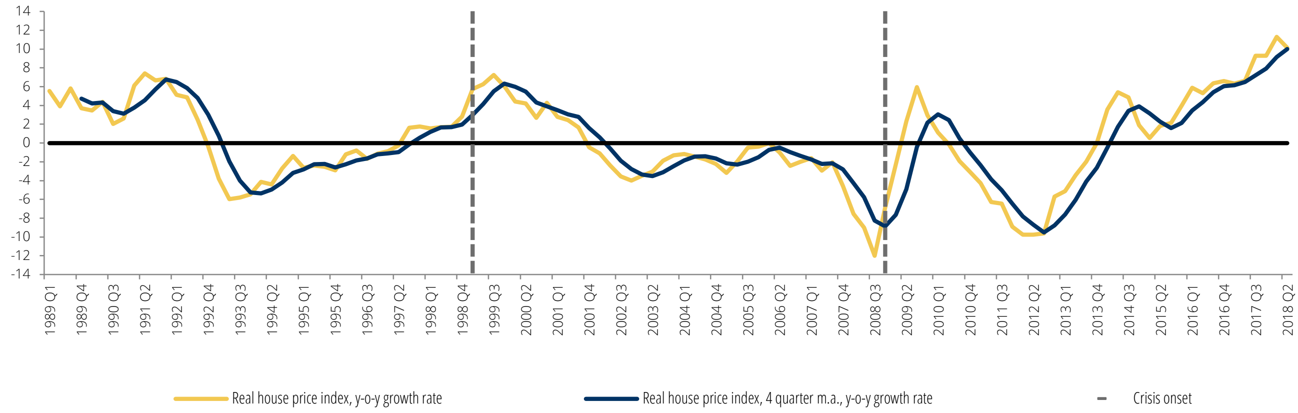
[7] Average of spreads weighted by the corresponding outstanding loan amounts at the end of the quarter. The spread is calculated against the three month Euribor rate, as available in Thomson Reuters. Only interest rates on new loans granted by other monetary financial institutions to residents with initial rate fixation up to one year (as available in Monetary and Financial Statistics published by Banco de Portugal) are considered.

In the first quarter of 2018, debt-service-to-income ratio[8] of the private non-financial sector kept the downward trajectory, decreasing 0.3 p.p. to 15.8%. According to the October 2018 *Economic Bulletin* of Banco de Portugal, this reduction is mainly explained by the current scenario of historically low interest rates, which is reflected in more favourable funding conditions, and by the real disposable income upward trajectory, associated to an acceleration of wages, explained by the continuing labour market improvement. In accordance with the previous quarterly assessment, despite the anticipation of an increase of interest rates, as a result of the gradual phasing out of the current non-conventional monetary policy, a material increase in the debt-service-to-income ratio, in the near future, is not expected.

The residential house prices increase has slightly decelerated

In the second quarter of 2018, house prices increased, in real terms, 10.1% (year-on-year), decelerating slightly when compared to the first quarter of 2018 (11.3%).[9] However, real house prices continue to exhibit an upward trend since the end of 2015 (Chart 4). According to the October 2018 *Economic Bulletin* of Banco de Portugal, the upward trajectory of the house sales' total value reflects an increase in both house sales average value and house sales volume.

Chart 4 Year-on-year growth rate of house prices, in real terms[10] | In percentage



Sources: Organization for Economic Co-operation and Development.
Notes: The last observation is dated 2018 Q2. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

According to the ECB average valuation measures and consistently with the previous quarterly analyses, house prices remain slightly above their economic fundamentals, at the aggregate level, in the second quarter of 2018.

Housing demand is expected to remain strong in a context of the current disposable income recovery, low interest rates and increased demand by non-residents. On the other hand, an increase in building permits has been contributing to a gradual recovery of housing supply, which, in the future, might moderate the house prices growth, all else held constant.

The October 2018 *Economic Bulletin* of Banco de Portugal reports that, in June 2018, the ratio between new domestic loans to households for house purchase and the total value of house sales is 32 p.p. below the one observed in June 2010. The ratio reduction has been mainly caused by an increase of the number of purchased dwellings that was not financed by domestic banks.[11] Consequently, the credit granted by resident financial institutions does not seem to be the main driver of the real house prices current dynamics. In fact, the strong dynamics in the tourism sector and the non-resident investment in real estate are also pushing prices up, as highlighted in the June 2018 *Financial Stability Report* of Banco de Portugal.

[8] Debt-service-to-income ratio estimates published by the Bank for International Settlements for the private non-financial sector, which uses gross disposable income as a proxy for income. Available at http://www.bis.org/statistics/dsr.htm.

[9] Regarding data on real house price indexes, published by the OECD, the base year has changed from 2010 to 2015.

[10] Real house price index (2015=100) published by the Organization for Economic Co-operation and Development. The house price index is adjusted for inflation using the private consumption deflator (2010=100) taken from the National Accounts (ESA2010, base 2011) published by Statistics Portugal.

[11] Special issue "Recent developments in the sale of family dwellings and loans to households for house purchase: regional heterogeneity", Banco de Portugal, *Economic Bulletin*, October 2018.

Current account deficit slightly deteriorates

The loan-to-deposits ratio reached a new minimum since the last quarter of 2000, decreasing to 89.1% in the second quarter of 2018. Loans reduction and, mainly, deposits increase contributed to the contraction of this ratio by 3.4 p.p., when compared to the previous quarter.

In the second quarter of 2018, the Portuguese economy registered a slight deterioration of the seasonally adjusted current account deficit, which increased 0.2 p.p. to 0.3%, in percentage of GDP, when compared with the previous quarter. According to the October 2018 *Economic Bulletin* of Banco de Portugal, the year-on-year negative change of the current account in the first semester of 2018 was essentially due to (i) the increase of the goods account deficit by 0.9 p.p., in percentage of GDP, as a result of a relatively higher growth of imports, in volume, than that of exports, and (ii) the increase of the primary income account deficit by 0.4 p.p., in percentage of GDP, which was essentially driven by a higher direct investment income deficit, associated with the increase of dividends paid abroad and the reduction of dividends received from the rest of the world. Additionally, the tourism sector dynamics was behind the services account surplus increase, in the same period, which mitigated the two above-mentioned negative effects on the current account balance.

It is worth noticing that this negative trajectory has only been observed since the first quarter of 2018, which translates into a positive four quarter moving average of the current account balance in percentage of GDP (0.3 p.p.).

Furthermore, current projections point to the maintenance of the Portuguese economy's net lending, as measured by the current and capital account surplus, equivalent to 1.4% of GDP in 2018, similar to the figure for 2017, as reported in the October 2018 *Economic Bulletin* of Banco de Portugal.

General assessment

In accordance with the previous risk analysis, there is no evidence of emerging cyclical systemic risk in Portugal, despite the developments in the current account balance and the trajectory observed in the residential real estate market. Hence, the countercyclical buffer rate is maintained at 0% over the first quarter of 2019. Nevertheless, Banco de Portugal will continue to closely monitor the developments in the different areas assessed in this note, given their interlinkages with financial stability risks.