COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

31 December 2019

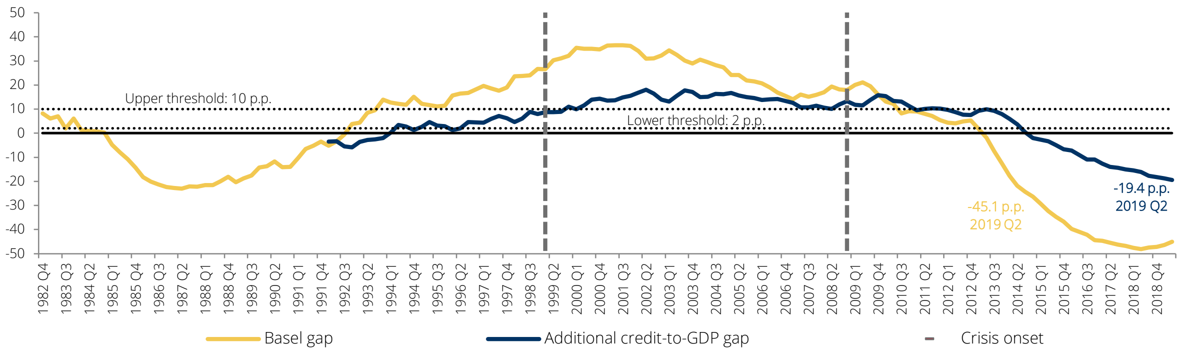
Pursuant to the decision of the Board of Directors of 20 December 2019, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 January 2020.

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

Credit-to-GDP gap became less negative

In the second quarter of 2019, the Basel gap reached -45.1 percentage points (p.p.) maintaining its upward path, while the additional credit-to-GDP gap became more negative reaching –19.4 p.p. (Chart 1).[2] The nominal output continued to increase at a higher rate than the total credit outstanding to the private non-financial sector (quarter on quarter), albeit at a slower rate, justifying the maintenance of the downward trajectory of the credit-to-GDP ratio, initiated in 2013.

Chart 1 Basel gap and additional credit-to-GDP gap[3] | In percentage points



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2019Q2. 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 30 October 2019. 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] Due to revisions inherent to the change of base and changes in methodology and underlying sources of national accounts, the credit gaps were revised backwards (see Box 5 of October 2019 *Economic Bulletin* of Banco de Portugal for more information on the impact of the national accounts revisions). Consequently, the value for the additional credit-to-GDP gap in the first quarter of 2019 was revised from -20.2 to -18.7, making the value of -19.4 of the second quarter of 2019 a further decline when compared to the revised value of the previous quarter.

[3] 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.

Since both credit-to-GDP gap measures are still negative and significantly below the 2 p.p. risk level threshold, the implied benchmark countercyclical buffer rate continues to be 0% of the total risk exposure amount.

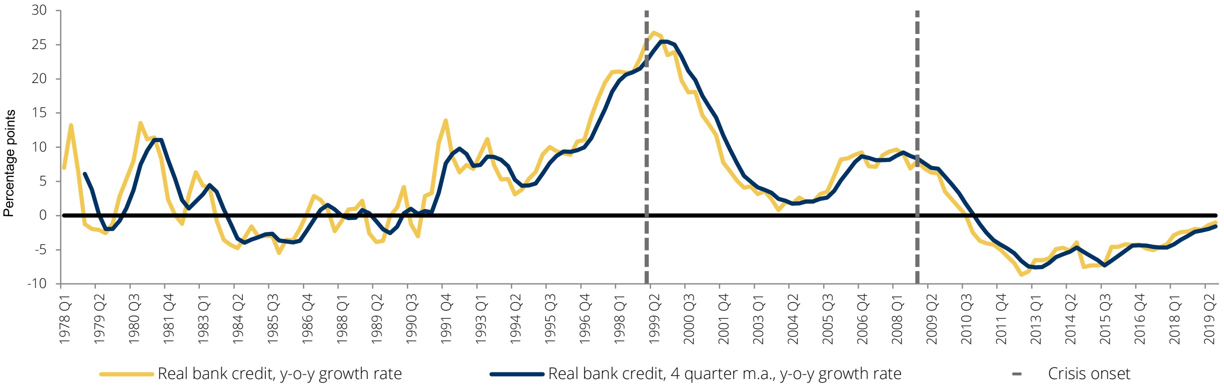
Despite the positive growth of the Basel gap in the first two quarters of 2019 (annual change), (i) the inertia underlying the trend estimate coupled with projections of GDP growth, published in the October 2019 *Economic Bulletin* of Banco de Portugal, and (ii) the expectations of ongoing deleveraging of the private non-financial sector[4] point to the maintenance of both gaps well below the risk level threshold for the period 2019-21.

Real total credit remained stable whereas real bank credit continued to recover at a slow pace

Total credit outstanding to the private non-financial sector, in real terms, remained virtually unchanged in the second quarter of 2019 (year on year), as a result of a decrease in real total credit outstanding to households (-0.5%) and of the first increase in real total credit outstanding to non-financial corporations (NFCs) (0.3%) since the first quarter of 2013. Nonetheless, according to the October 2019 *Economic Bulletin*, based on a micro level analysis, the Portuguese NFCs with the highest investment rate between the second quarter of 2018 and the first quarter of 2019, are those that have increased their leverage. This evidence suggests that the gradual recovery in corporate credit is associated to the growth in investment more recently observed in the Portuguese economy. Moreover, the analysis indicates that these NFCs face less financial constraints, lower interest expenses relative to operating income and have higher profitability, reflecting their lower risk level. This is in line with the analysis in the June 2019 *Financial Stability Report* of Banco de Portugal that reported that new bank loans have been preferably granted to NFCs with a lower risk of default. The same publication also highlights that systematically, until 2017, NFCs with lower indebtedness ratios were the ones recording higher investment rates.

Real bank credit outstanding to the private non-financial sector decreased by 1.0%[5] (year on year) (Chart 2) in the third quarter of 2019, as a result of a decline in real bank credit outstanding to non-financial corporations (-3.1%). In contrast, the year-on-year growth rate of real bank credit outstanding to households remained in positive territory (0.5%), reflecting the increase in both real bank credit for house purchase and for consumption (0.3% and 10.6%, respectively).

Chart 2 Real bank credit growth[6] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2019 Q3. 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 October 2019 *Bank Lending Survey* of Banco de Portugal the demand for housing loans slightly increased, in the third quarter of 2019, motivated by the low level of interest rates, and remained broadly unchanged for NFCs and

[4] Measured by non-financial corporations' debt in percentage of GDP and by households' debt in percentage of disposable income.
[5] Figures for the second and third quarters were adjusted of the effects of a statistical reclassification of a set of Portuguese branches of credit institutions located in other European Union countries that were previously registered outside the monetary and financial institutions sector and are now considered in the same sector as their parent institution.
[6] 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 Statistics Portugal.

consumer loans. Furthermore, for the fourth quarter of 2019, banks do not anticipate major changes in the demand for loans to NFCs and housing loans, but anticipate a slight increase in the demand for consumer credit and other lending to households.

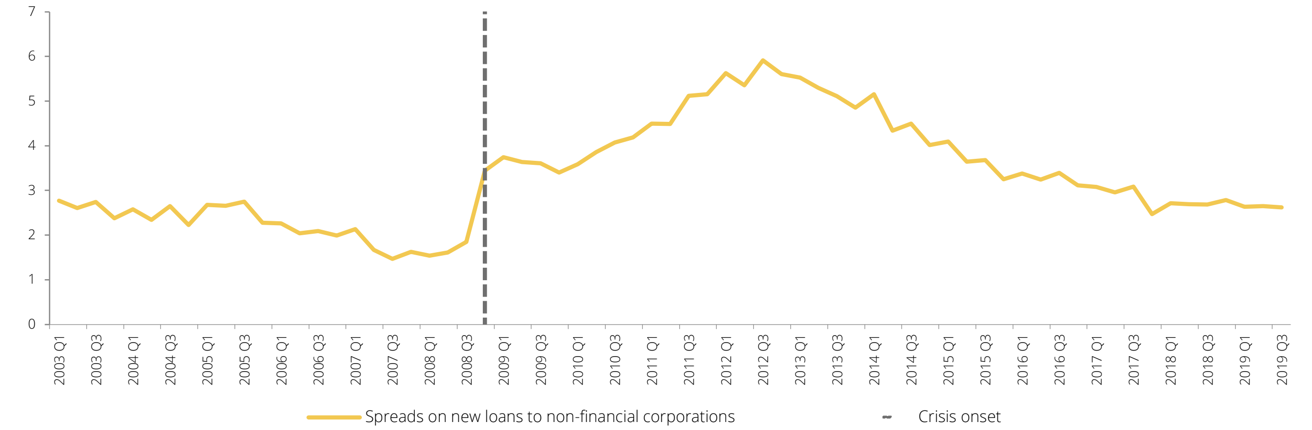
In the second quarter of 2019, the ratio between the annual change in bank credit to the private non-financial sector and the five year moving average of nominal GDP increased by 2.0 p.p., to -3.5% (quarter on quarter), mostly reflecting the evolution of real bank credit.

Lending spreads on new loans to households declined

In the third quarter of 2019, spreads on new lending granted to the non-financial sector followed different trajectories, in different segments, when compared with the levels observed in the previous quarter.

On the one hand, in the households' segment, new lending spreads for house purchase declined by 0.3 p.p., to 1.3 p.p., in the third quarter of 2019, in comparison with the previous quarter, and those related to new lending for consumption and other purposes reached 6.0 p.p., decreasing by 0.5 p.p..[7] On the other hand, new lending spreads (up to one year) to NFCs remained at 2.6 p.p., during the same period (Chart 3).

Chart 3 Spreads on new loans to non-financial corporations[8] | In percentage points



Sources: Banco de Portugal, Refinitiv and Banco de Portugal calculations.
Notes: The last observation refers to 2019 Q3. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The average interest rate on new lending to households for house purchase reached 0.9% in September 2019, decreasing by 0.4 p.p. when compared to June 2019, and that for consumption and other purposes declined by 0.5 p.p. to 5.6%. In what concerns NFCs, the average interest rate on new lending (up to one year) decreased slightly by 0.1 p.p. to 2.2%. According to the December 2019 *Financial Stability Report* of Banco de Portugal, new loans granted to NFCs are largely associated with lower risk classes, and lending policy reflects a greater spread differentiation by NFC risk profile than before the crisis.

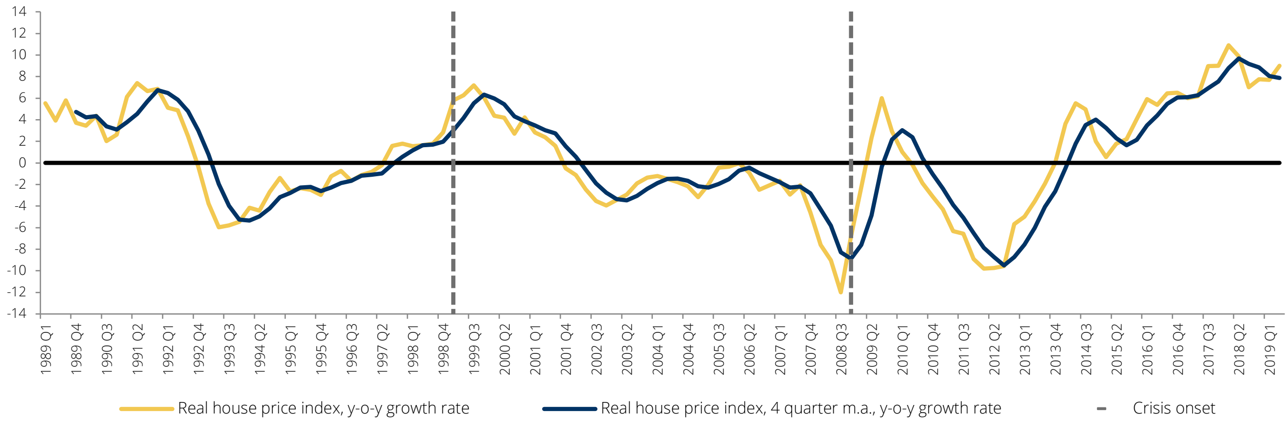
According to the October 2019 *Bank Lending Survey*, in the third quarter of 2019, credit standards and overall terms and conditions of loans granted to NFCs and households remained broadly unchanged, when compared with the previous quarter, and adjustments in credit standards applied on loans to both segments are not anticipated by banks in the short-term. Additionally, participating banks also reported that competitive pressures contributed to narrowing their margin on loans granted to NFCs with average risk.

[7] In the households' segment, the spread for house purchase is calculated against the six month Euribor rate, whereas that for consumption and other purposes is calculated against the three month Euribor rate.
[8] 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 Refinitiv. 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.

Residential house prices increased further

In the second quarter of 2019, real house prices increased by 9.0% (year on year), accelerating when compared to the year-on-year growth rate registered in the previous quarter (7.7%), and nearing the series' historical peak observed in the first quarter of 2018 (10.9%) (Chart 4).

Chart 4 Year-on-year growth rate of house prices, in real terms[9] | In percentage



Source: Organization for Economic Co-operation and Development.
Notes: The last observation refers to 2019 Q2. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

As highlighted in the December 2019 *Financial Stability Report*, the significant increase in house prices points to some evidence of overvaluation, at the aggregate level, in the Portuguese residential real estate market since the end of 2017[10].

According to the October 2019 *Economic Bulletin*, private residential gross fixed capital formation registered a year-on-year increase of 7.1%, accelerating when compared with the second half of 2018 (6.5%). Demand for housing continued to be driven by improving labour market conditions and favourable housing financing conditions. Additionally, demand from non-residents and the dynamism of tourism and related real estate activities have also continued to contribute to the evolution in residential investment. Moreover, in the second quarter of 2019, the number of building permits issued increased 0.5% (year on year), slowing down significantly vis-à-vis the previous quarter (13.3%),[11] which may weaken the curbing effect that housing supply is expected to have on house price dynamics, all else held constant.

Loan-to-deposits ratio reversed its downward trajectory but maintained a low level

In the second quarter of 2019, the loan-to-deposits ratio rose to 88.2%. Loans increased at a higher rate than deposits, leading to the slight increment of this ratio, by 0.4 p.p., when compared with the previous quarter.

The debt-service-to-income ratio[12] of the private non-financial sector maintained its downward trajectory in the first quarter of 2019, declining from 16.0% to 15.4% (year on year). According to the October 2019 *Economic Bulletin*, nominal wages are expected to accelerate, reflecting both the update of the minimum wage and the gradual unfreezing of careers

[9] 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.

[10] This evidence is based on three categories of methodologies, namely statistical indicators, models based on macroeconomic determinants and asset valuation methods. For a more in-depth analysis, see Special Issue [*Metodologias de avaliação dos preços da habitação: uma aplicação a Portugal*] published in the December 2019 *Financial Stability Report*.

[11] Data are available at Statistics Portugal website at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=354081353&DESTAQUESmodo=2.

[12] 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.

in the public administration sector. Accordingly, and considering the new round of monetary stimulus measures adopted by the European Central Bank in September,[13] which reinforced the commitment to keep interest rates low in the coming years, a material increase in the debt-service-to-income ratio is not expected in the near future.

In the second quarter of 2019, the seasonally adjusted current account[14] improved, reaching a surplus of 0.1% of GDP, recovering from a deficit of 1.5% in the previous quarter, largely driven by the reduction in the deficit of the goods and primary income accounts.

General assessment

The expansion in the residential real estate market has continued, with strong house price increases and signs of overvaluation. These developments stem partially from a search-for-yield behaviour, also from non-resident investors, in a context of a lower for longer interest rate environment.

The historically low bank lending interest rates, in the context of the lower for longer interest rate environment, coupled with the projected slowdown of the economic activity which also faces mostly downside risks stemming from external factors, reinforce the need to guarantee that credit standards are appropriate to the underlying risk. Moreover, despite the deleveraging of the Portuguese economy in the post-crisis period, it continues to record high levels of indebtedness in the European context, which warrants close monitoring, in particular given the still low level of the domestic saving.

Although not aimed at influencing directly the overall credit granted to households nor the developments in the real estate market per se, the macroprudential Recommendation, implemented in 2018, by limiting the flow of credit granted to borrowers with a higher risk profile may have a mitigating effect on the feedback loop risk between domestic credit and real estate prices.

Despite the context of high uncertainty, the countercyclical buffer rate is maintained at 0% over the first quarter of 2020. Nevertheless, Banco de Portugal will reinforce the monitoring of prospective developments in the risk assessment framework, given its potential to signal, in advance, cyclical systemic risks.

[13] For more details, see https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190912~08de50b4d2.en.html.

[14] The balance of payments was revised under the scope of the recent national accounts benchmark revision. For a more in-depth analysis on the impact of these revisions on the current account, see Box 5 in the October 2019 *Economic Bulletin*.