COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

31 DEC. 2020

Pursuant to the decision of the Board of Directors of 22 December 2020, 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 2021.

The current financial and macroeconomic context is characterized by the severe economic contraction in the first half of 2020, related with the COVID-19 pandemic and the underlying strict lockdown measures. The initial shock was subsequently tempered by the rapid policy response and by the gradual relaxation of the lockdown measures, promoting a recovery of economic activity in the third quarter of 2020. Indeed the projection for the Portuguese economy growth in 2020 was revised upwards and, so far, the recovery is in line with the central scenario of a relatively fast recovery. However, the degree of economic recovery by the end of the year is still associated to a high level of uncertainty, being dependent on the implementation of a medical solution for the COVID-19 pandemic. In this setting, it is important to ensure that financial institutions have the capacity to absorb losses while continuing to provide credit to the economy.

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

The Basel gap has increased but remains below its long-term trend

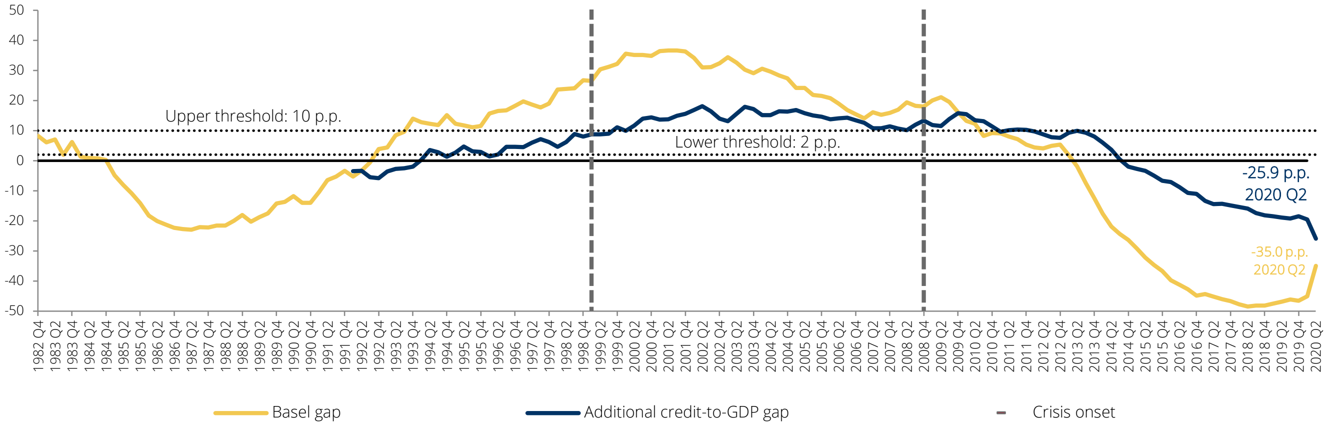
In the second quarter of 2020, the Basel gap reached -35.0 percentage points (p.p.) while the additional credit-to-GDP gap reached -25.9 p.p. (Chart 1), indicating that the credit-to-GDP ratio remains below its long-term trend. These figures are well below the threshold of 2 p.p. that would trigger a positive benchmark buffer rate. The credit-to-GDP ratio increased from 159.0% in the first quarter of 2020 to 167.3% in the second quarter of 2020, reflecting the increase in total credit to non-financial private sector (1.9%, quarter-on-quarter), mainly due to the issuance of debt securities by non-financial corporations´ (NFCs), and the fall in nominal GDP (-12.6%, year-on-year).

The latest projections published in the December 2020 *Economic Bulletin* of the Banco de Portugal point to a reduction in GDP of 8.1% in 2020, initiating in 2021 a recovery path that will continue until 2023. The current projections maintain the estimate for GDP in 2020 released in the October *Economic Bulletin*, due to the combination of two opposing factors: the upturn in the third quarter was higher than anticipated (13.3% quarter-on-quarter), but the evolution of the pandemic and related containment measures have led to a downward revision in activity in the fourth quarter. The economic outlook remains highly uncertain and is conditional on the evolution of the pandemic and the swiftness of large-scale vaccination.

Overall, the credit-to-GDP ratio is expected to increase in the first quarter of 2021, as the increase in credit to non-financial private sector (numerator effect) would only be partly offset by the projected economic recovery (denominator effect). The expected evolution of credit is positively affected by the extension, until September 2021, of the public loan moratorium: by postponing debt service, the moratorium leads to a higher outstanding amount of credit.

[1] The assessment is based on data available up to 28 October 2020. Any differences in figures from previous assessments are due to revisions in underlying data.

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



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2020Q2. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Real bank credit granted to the non-financial private sector increased for the second consecutive quarter

In the third quarter of 2020, real bank credit outstanding to the private non-financial sector increased 2.6% (year-on-year), as a result of an increase in real bank credit outstanding both to NFCs and households of 4.3% and 1.4% (year-on-year), respectively. Regarding households, the increase in real bank credit reflects a year-on-year increase in credit for consumption and other purposes and credit for house purchase of 2.1% and 1.2%, respectively. Real bank credit outstanding to the non-financial sector has also increased, for the second consecutive quarter, thus interrupting the downward trend observed since 2010.

The increase in real bank credit outstanding to the private non-financial sector is related to the introduction of measures by the national authorities in response to the COVID-19 pandemic, notably the credit lines with public guarantees and moratorium granted to NFCs and households' loans. According to the December 2020 *Financial Stability Report* of the Banco de Portugal, credit lines with public guarantee represented approximately 40% of the new loans granted to NFCs between March and September 2020, whereas loan moratorium covered around 32% of credit to NFCs and 17% of credit to households. It is worth mentioning that the growth of the private non-financial sector's indebtedness due to the measures taken in response to the COVID-19 pandemic occurs in the aftermath of a relevant deleveraging adjustment made by this sector.[3]

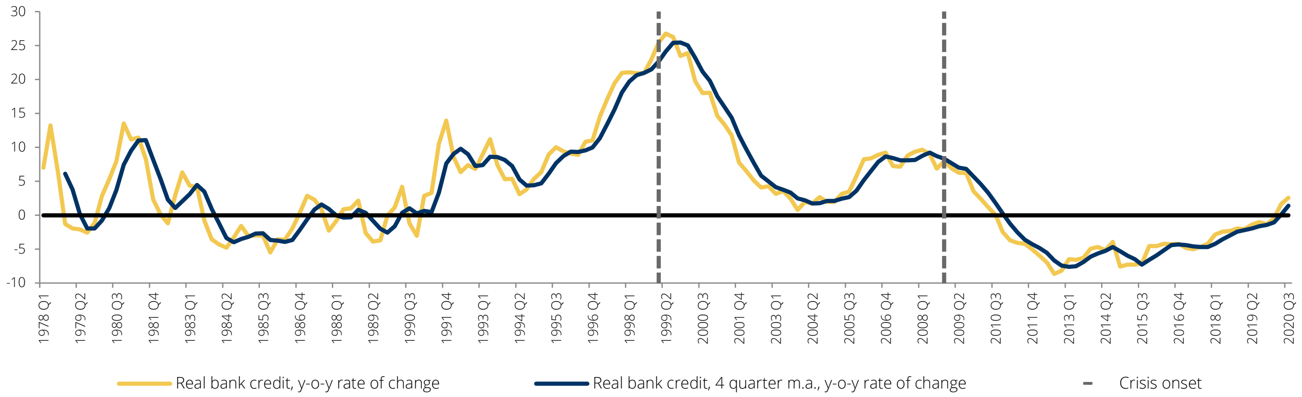
Regarding the evolution of financing conditions, spreads on new lending to NFCs increased from 2.2%, in June 2020, to 2.5%, in September 2020 (the same value as the one observed in the first quarter of 2020). This reflects the significant percentage of credit lines granted with public guarantee, which have attached a relatively small spread that has had a more significant impact on the second quarter of the year. The spreads on new lending for house purchase reached 1.4%, in September 2020, decreasing by 0.1 p.p. when compared to June 2020, while the spreads on new lending for consumption and other purposes reached 6.0%, in September 2020, which compares to 5.7% in June 2020. In general, and despite the magnitude of the negative shock associated with the COVID-19 pandemic, the financing costs for the private non-financial sector remained relatively unchanged, also reflecting the accommodative monetary policy stance.

As expected, and according to the October 2020 *Bank Lending Survey*[4], banks' perception of higher risks and banks' lower risk tolerance contributed to a slight tightening of the credit standards on loans to firms and households. In new loans to NFCs, the perception of risks associated to industry or firm-specific situation, the general economic situation and the collateral demanded stands out as the main factors affecting credit standards. Going forward, banks anticipate slightly tighter

[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. 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.
[3] For more details please see Box 3 and Box 4 of June 2020 *Financial Stability Report* of the Banco de Portugal.
[4] More information is available on https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/results_oct2020_en.pdf

(unchanged) credit standards on credit to NFCs (households). A decrease in credit demand by NFCs and for consumer credit and a stabilization in the demand for housing loans is also expected.

Chart 2 • Year-on-year rate of change of real bank credit[5] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2020 Q3. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Real house prices decelerated in the second quarter of 2020

Due to the drop in the economic activity and in international tourism flows associated to the COVID-19 pandemic, real house prices increased at a slower pace in the second quarter of 2020 (6.7% year-on-year) compared to the first quarter of 2020 (9.2% year-on-year). The amount of house dwellings transactions was also negatively impacted, decreasing 15.2% (year-on-year).

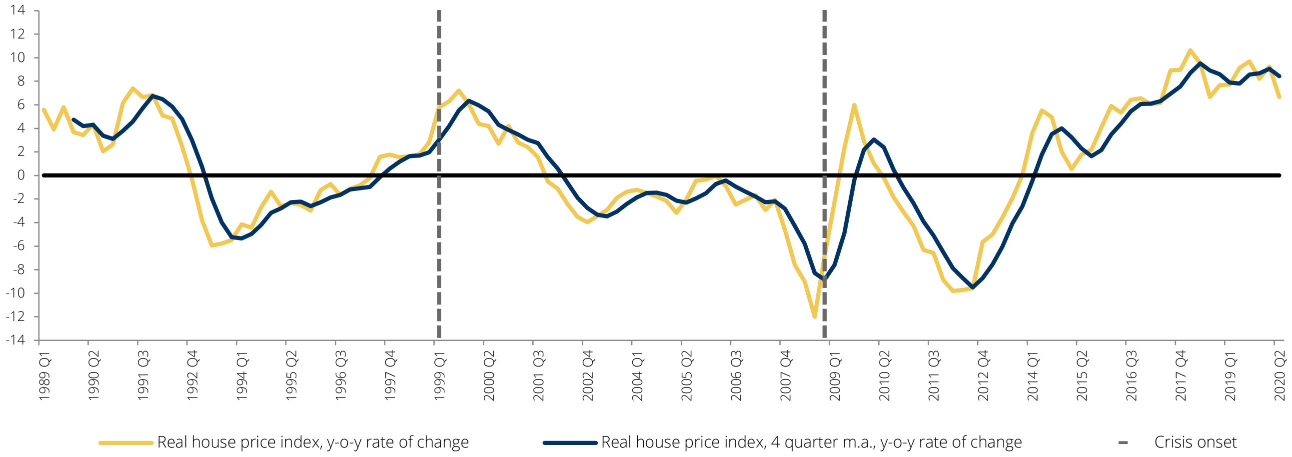
Going forward, and depending on the evolution of economic activity and of labour market conditions, a correction in real estate prices might take place. Notwithstanding, the magnitude of this potential correction could be mitigated by the accommodative monetary policy in place, which results in a low interest rate environment and thus contributes to a higher relative return rate of real estate.

In this vein, the national confidence index (a combined measure capturing near term price and sales expectations) published in the August 2020 *Portuguese Housing Market Survey*[6] fell back to -12 in August (despite the recovery observed from June to July), reflecting the negative view of the participants in the housing market.

[5] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Bank credit granted by resident monetary financial institutions as available in Monetary and Financial Statistics published by the Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by Statistics Portugal.

[6] The Portuguese Housing Market Survey (PHMS), a joint initiative by Confidencial Imobiliário and the Royal Institution of Chartered Surveyors, provides a qualitative assessment of the sales and lettings markets, based on a monthly survey to a panel of real estate agents and developers.

Chart 3 • Year-on-year rate of change of house prices, in real terms[7] | In percentage

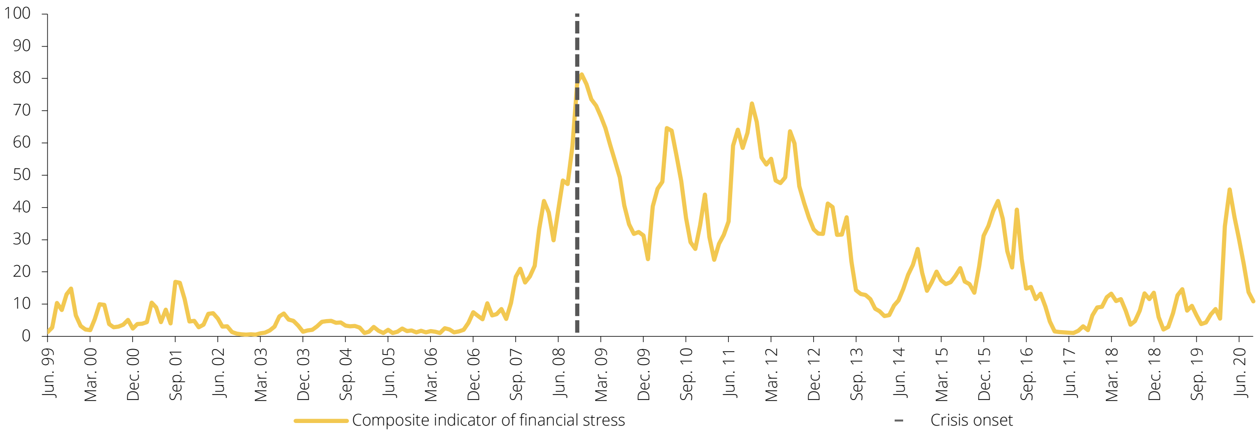


Sources: Organization for Economic Co-operation and Development.
Notes: The last observation refers to 2020 Q2 m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The composite indicator of financial stress for Portugal has decreased to pre-crisis levels

After recording its highest value since September 2012, a period associated with the sovereign debt crisis, in April 2020 (45.6), the composite indicator of financial stress for Portugal reached 10.9 in September 2020, decreasing to a level close to that observed in the period before the beginning of the COVID-19 crisis. This evolution reflects a stabilization of financial conditions after a period of high volatility in financial markets and a strong increase in risk aversion by investors associated to the propagation of the COVID-19 pandemic to global proportions. The rapid economic policy response from the international and domestic authorities to support both the financial system and the real economy has contributed to containing the level of stress in the financial markets.

Chart 4 • Composite indicator of financial stress for Portugal[8] | Quantile rank



Source: Banco de Portugal.
Notes: The last observation refers to September 2020. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

[7] 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 (2016=100) taken from the National Accounts (ESA2010, base 2016) published by Statistics Portugal.

[8] For more information on the composite indicator of financial stress see Braga, J. et.al (2014), "Composite Indicator of Financial Stress", *Financial Stability Papers*, Banco de Portugal, available on https://www.bportugal.pt/sites/default/files/anexos/papers/paper_1_en_0.pdf.

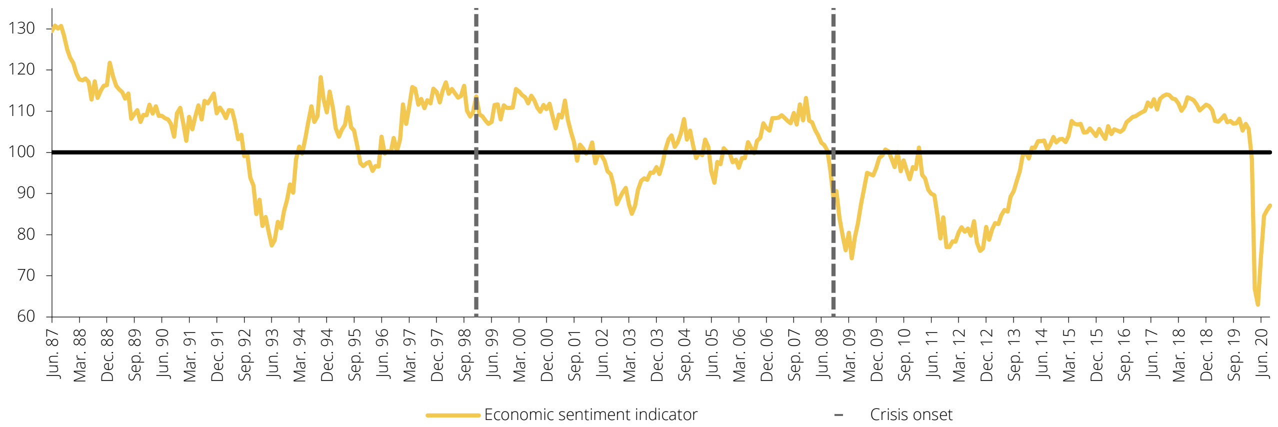
The economic sentiment indicator for Portugal has recovered

The European Commission economic sentiment indicator for Portugal has been recovering after having reached its lowest ever value (63) in May 2020, standing, in September of 2020, at 87.1 (Chart 5). This composite indicator measures the confidence level among manufacturers, service providers, consumers, retailers and constructors and provides an overview of the current conditions of economic activity and near future perspectives. According to this indicator, the most affected sector by the COVID-19 pandemic and the underlying lockdown measures was the services' sector, which includes tourism, restaurants and entertainment.

The observed recovery in the economic sentiment indicator, which started in July 2020, should be associated to the coordinated policy response to the pandemic including monetary, fiscal and regulatory/supervisory measures.[9] This recovery is driven, at least in part, by the services' sector, which evolved from -51.2, in May 2020 (its lowest recorded value), to -24.4, in September 2020.

Despite the recovery in the European Commission economic sentiment indicator, both manufacturers and the consumer confidence indicators have decreased from August to September 2020.

Chart 5 • Economic sentiment indicator for Portugal | Index (2000-2019 average = 100)



Source: European Commission
Notes: The last observation refers to September 2020. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

General assessment

Given the materialization of risks due to the COVID-19 pandemic, along with the uncertainty regarding the economic recovery, it is important to ensure that financial institutions have the ability to absorb losses while continuing to provide credit to the economy. Therefore, the countercyclical capital buffer rate is maintained at 0% over the first quarter of 2021.

Banks should take advantage of the flexibility they have been granted by micro and macro-prudential authorities to use their capital buffers to absorb losses and finance viable households and NFCs. Banks should have sufficient time to replenish these buffers and only when there is evidence of a sustained recovery in the economy and normalization of financial conditions. This should also take into account the specific circumstances of each financial institution.

The Banco de Portugal will continue to closely monitor the developments in cyclical systemic risk, arising particularly from the current and the projected impact of the pandemic.

[9] For a more detailed analysis please see the Special Issue "Policy measures in response to the COVID 19 pandemic of relevance to financial Stability" published in the June 2020 Financial Stability Report.