COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

29 March 2018

Pursuant to a decision of the Board of Directors of 27 March 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 April 2018.

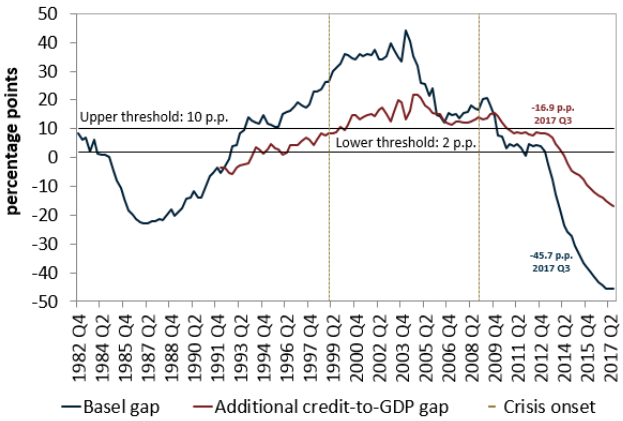
This decision is based on the overall assessment of a set of financial and macroeconomic indicators[1]:

Gap measures remain significantly below the low risk level threshold

In the third quarter of 2017, both the Basel gap and the additional credit-to-GDP gap remained negative and significantly below the risk level threshold of 2 p.p., reaching -45.7 p.p. and -16.9 p.p. respectively (Chart 1). Consequently, the countercyclical buffer guide equals 0% of the total risk exposure amount. The evolution of the gaps mainly reflects the positive developments observed in the business cycle coupled with the still negative credit growth. Projections published in the December 2017 *Economic Bulletin* of Banco de Portugal indicate that a change in the sign of the gaps is unlikely to occur in the 2018-2020 period given that the credit recovery is projected to take place at a slower pace than growth in disposable income and GDP.

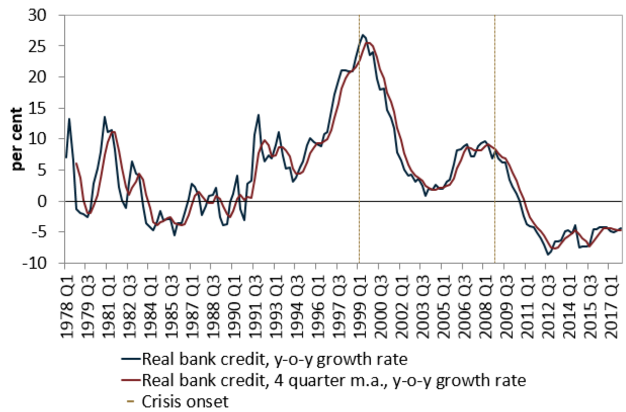
The year-on-year growth rate of real bank credit to the private non-financial sector was -4.3% in the fourth quarter of 2017 (Chart 2). This reduction in the outstanding amount of bank credit was mostly driven by the behaviour of lending to non-financial corporations, which contracted 6.8% over the same period. In what regards households, real bank credit fell 2.4%, year-on-year, in the fourth quarter of 2017. This behaviour was mostly driven by the fall in real bank credit for housing purposes as the year-on-year growth rate of real consumer credit was positive in the fourth quarter of 2017, keeping the upward trajectory observed since the start of 2012.

Chart 1 – Basel gap and additional credit-to-GDP gap[2]



Sources: Banco de Portugal, Statistics Portugal (INE) and Banco de Portugal calculations. Last observation: 2017 Q3.

Chart 2 – Real bank credit growth[3]



Sources: Banco de Portugal, Statistics Portugal (INE) and Banco de Portugal calculations. Last observation: 2017 Q4.

The outstanding amount of total credit decreased 0.9%, year-on-year, in the third quarter of 2017. This reduction results from the decline in outstanding credit related to non-financial corporations and households. In the case of non-financial corporations, the reduction reflects the net effect of an increase of issued debt securities, mostly placed with non-residents, a decrease of the amount of loans, mostly driven by the negative contribution from loans granted by residents, and a significant amount of write-offs. In what concerns households, the reduction mainly results from the effect of loan redemptions and loans maturing.

The path of the ratio between the one year absolute difference in bank credit and the five year moving average of nominal GDP is in line with the other credit indicators. In particular, this ratio continued to be negative in the third quarter of 2017 (-16.6%) slightly above the value observed in the previous quarter (-17.4%).

Despite the downward trend recorded in outstanding credit amounts, the Portuguese private non-financial sector still presents a high indebtedness level, and it is of utmost importance that the current process of deleveraging undertaken by the sector continues.

Taking into account this information, there are no signs of overheating in the credit market in Portugal.

Some relaxation of the credit standards applied to mortgage loans

In the first three quarters of 2017, bank spreads on new lending to non-financial corporations, up to one year, have been hovering around 3.0 p.p., but in the fourth quarter of 2017 narrowed to 2.5 p.p., a value still above those observed prior to the financial crisis (Chart 3). In addition, the average interest rate on new loans granted to non-financial corporations decreased further to 2.2% in December 2017, 42 b.p. less than the rate observed in November, setting a new historical low. However, as discussed in the Special Issue of the December 2017 *Financial Stability Report* of Banco de Portugal – "The risk segmentation on the interest rate spreads of new bank loans to non-financial corporations" - there is evidence pointing to banks differentiation in spreads according to firms' risk profile (evidence on risk differentiation based on quantities was already reported in previous editions of the *Financial Stability Report* of Banco de Portugal). Going forward, and according to the January 2018 *Bank Lending Survey*, banks do not anticipate significant adjustments in credit standards applied on loans to firms.

There are signs of some relaxation in the credit standards applied to loans to households, in particular for house purchase, despite being tighter than in the period before the financial crisis. This evolution reflects, to a large extent, the competition pressures, the low level of interest rates, economic recovery and the improving housing market prospects. Taking into consideration these developments and the fact that households' indebtedness is still high when compared with other euro area countries, Banco de Portugal adopted a preventive macroprudential measure to ensure that credit institutions and financial companies do not take on excessive risks in granting new loans and that borrowers have access to sustainable financing.[5]

Chart 3 – Spreads on new loans to non-financial corporations[4]

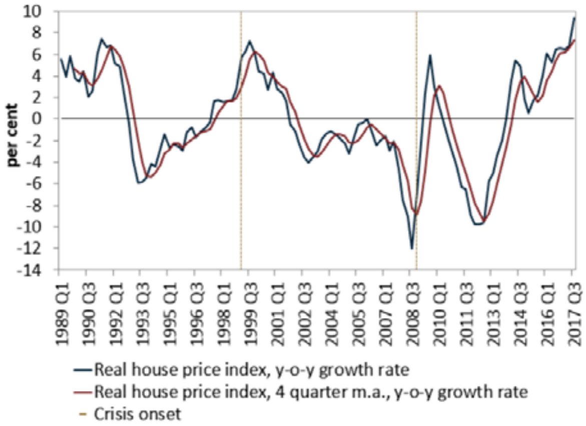
Sources: Banco de Portugal, *Thomson Reuters* and Banco de Portugal calculations. Last observation: 2017 Q4.

Linked with the improvement in households' disposable income and firms' profitability, coupled with the favourable funding conditions, the debt-service-to-income ratio for the private non-financial sector continued to decline (-0.9 p.p. in the third quarter of 2017 in comparison with the ratio one year ago). The latest economic projections published in the December 2017 *Economic Bulletin* of Banco de Portugal anticipate favourable developments in consumption and investment. Despite their potential negative impact on the debt-service-to-income ratio due to the underlying potential increase in financial debt, this is unlikely to occur given that the projection exercise also foresees a higher growth rate for disposable income and GDP than for credit, as highlighted above.

House prices continue to increase

House prices dynamics kept the marked growth as described in the previous quarter risk analysis under the countercyclical capital buffer's framework. The real growth rate of house prices accelerated to 9.3% in the third quarter of 2017, vis-à-vis the same quarter of 2016, and prices seem to be closer to the level consistent with fundamentals, according to the ECB average valuation measure (Chart 4).

Chart 4 – Real House Prices[6]



Sources: OECD. Last observation: 2017 Q3.

Housing demand, by residents and non-residents, is expected to keep increasing in the short-term - against the background of a still loose monetary policy stance, the economic recovery and the attractiveness of investment in residential real estate -, further stimulating house prices. Banks that participated in the *Bank Lending Survey* of January 2018 anticipate an increase in the demand for loans for house purchase. The potential rebound in housing supply, as indicated by the increase in building permits, may contribute to reduce the growth in house prices going forward.

Banco de Portugal will continue monitoring the progress in the Portuguese residential real estate market, which, at this point, does not seem to be predominantly driven by domestic credit.

Other indicators included in the risk assessment framework do not signal the emergence of imbalances

In the third quarter of 2017, the loan-to-deposits ratio was 94.0%, slightly above the ratio observed in the previous quarter (93.5%) but well below the values reached in the past. This slight increase in the ratio in the third quarter is driven both by an increase in loans and a decrease in deposits. However, the overall decreasing trend of this ratio, since end-2010, indicates that banks are more resilient against shifts in wholesale debt markets sentiment.

Finally, the current account continues to present a surplus, reaching 0.7% of GDP in the third quarter of 2017. Prospectively, and according to the December 2017 *Economic Bulletin* of Banco de Portugal, the financing capacity, measured by the current account as a percentage of GDP, is expected to moderately increase in the 2018-2020 period.

General assessment

The risk assessment does not provide evidence of emerging cyclical systemic risk driven by credit growth that would justify the change in the macroprudential policy stance regarding the countercyclical capital buffer. Hence, the countercyclical buffer rate is maintained at 0% of total risk exposure amounts during the second quarter of 2018.

Notes

1 The assessment is based on available data up to 7 February 2018. Any differences in figures from previous assessments are due to revisions in underlying data. This set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

2 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 Banco de Portugal and nominal GDP from National Accounts (ESA2010, base 2011) published by Statistics Portugal (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.
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.
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.
Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

3 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 (INE).

4 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 *Thomson 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 Banco de Portugal.

5 More information on the adopted recommendation available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

6 Real house price index (2010=100) produced by the OECD. 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 (INE).

Abbreviations

ARIMA	Autoregressive Integrated Moving Average
BCBS	Basel Committee on Banking Supervision
ESA	European System of Accounts
b.p.	basis points
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
OECD	Organisation for Economic Co-operation and Development
p.p.	percentage points
y-o-y	year on year