COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

29 March 2019

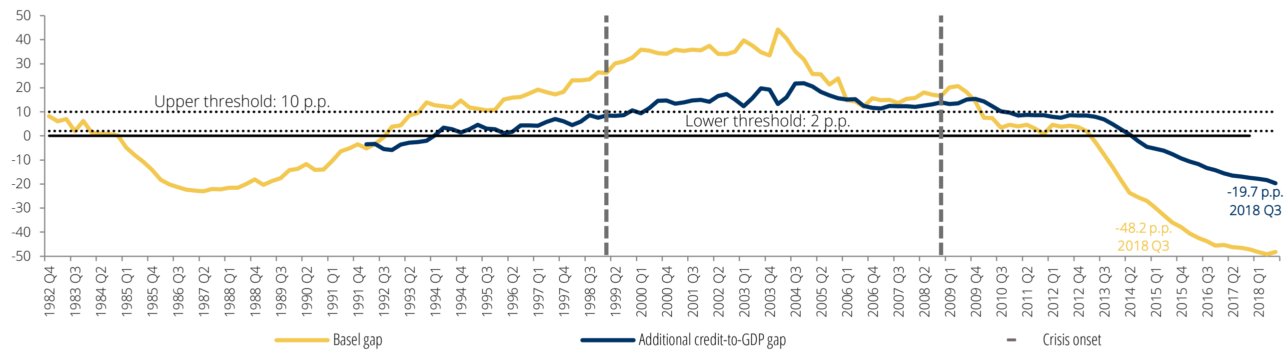
Pursuant to the decision of the Board of Directors of 26 March 2019, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 April 2019.

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

Basel gap became less negative

In the third quarter of 2018, the Basel gap changed slightly from -49.2 to -48.2 percentage points (p.p.) (Chart 1), as the decline of the credit-to-GDP ratio was more than compensated by the reduction of its long-term trend. On the other hand, the additional credit-to-GDP gap[2] decreased 1.3 p.p. to -19.7 p.p., as the fall in the credit-to-GDP ratio augmented with ARIMA forecasts offset a slight increase in its long-term trend. Furthermore, nominal output increased at a higher rate than total credit outstanding to the private non-financial sector (quarter-on-quarter), leading to the downward trajectory of the credit-to-GDP ratio, initiated in 2013.

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 refers to 2018Q3. 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 January 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] 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 by 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 by 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.

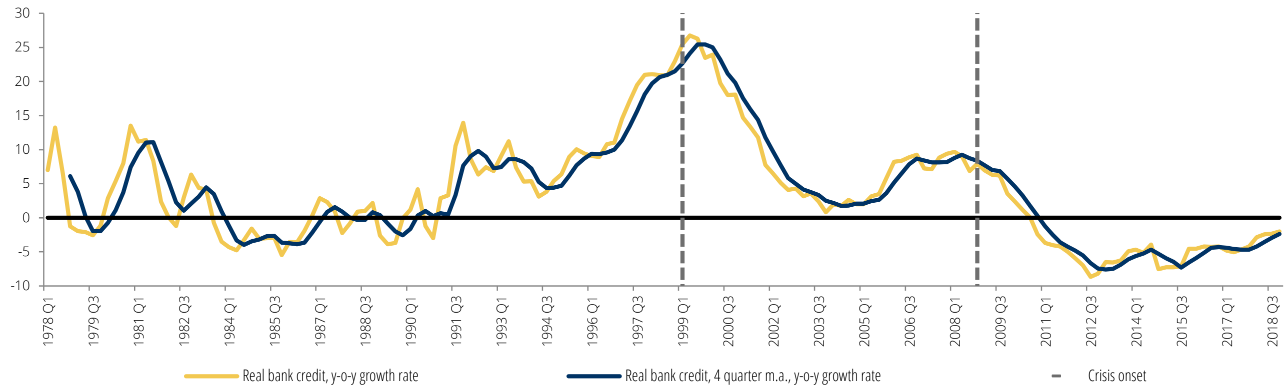
The implied benchmark countercyclical buffer rate remains at 0% of the total risk exposure amount, since both credit-to-GDP gap measures continue negative and significantly below the risk level threshold.

The projected GDP growth – despite the expected deceleration –, the reduction in the indebtedness ratios[3] of the private non-financial sector that is expected to continue[4], coupled with the inertia underlying the trend estimate, point to the maintenance of the sign of both gaps over the next quarters.

Real bank credit continues to decline but at a slower pace

In the fourth quarter of 2018, real bank credit outstanding to the private non-financial sector declined 2% (year-on-year) (Chart 2), mostly driven by the reduction of real bank credit outstanding to non-financial corporations (NFCs) (4.2%). The real bank credit outstanding to households decreased 0.3%, over the same period, reflecting the reduction in real bank credit for house purchase (-1%), whereas consumer loans registered a year-on-year increase (9.6%, in real terms). In December 2018, credit for house purchase represented 80.7% of real bank credit outstanding to households.

Chart 2 Real bank credit growth[5] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation refers to 2018 Q4. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

As reported in the December 2018 *Financial Stability Report* of Banco de Portugal, in the first semester of 2018, new loans granted by the banking sector to NFCs continued to mainly flow to low-risk NFCs, whose share in new bank loans granted to NFCs has been increasing since 2016.

The ratio between the annual change in bank credit to the private non-financial sector and the five-year moving average of nominal GDP continued the upward trajectory initiated in 2015, increasing 2.2 p.p. quarter-on-quarter, to -4.2% in the third quarter of 2018. This evolution reflects the joint effect of a gradual increase in nominal GDP and the fact that bank credit continued to decline but at a slower pace.

Real total credit outstanding to the private non-financial sector continued to contract in the third quarter of 2018 (-3.1%, year-on-year), as a result of a decrease in credit outstanding to both households and NFCs (-1% and -4.4%, respectively).

This notwithstanding, in the third quarter of 2018, the total credit net[6] flow to the private non-financial sector surpassed the negative contribution of other volume and price changes, namely loans repayments, write-offs and sales. Regarding households, the credit net flow remained positive, as observed in the previous quarter, whereas the credit net flow to NFCs became positive, chiefly driven by credit from abroad.

[3] Measured by NFC debt as a percentage of GDP and by household debt as a percentage of disposable income.

[4] According to the December 2018 *Economic Bulletin* of Banco de Portugal.

[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 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.

[6] Net of other volume and price changes.

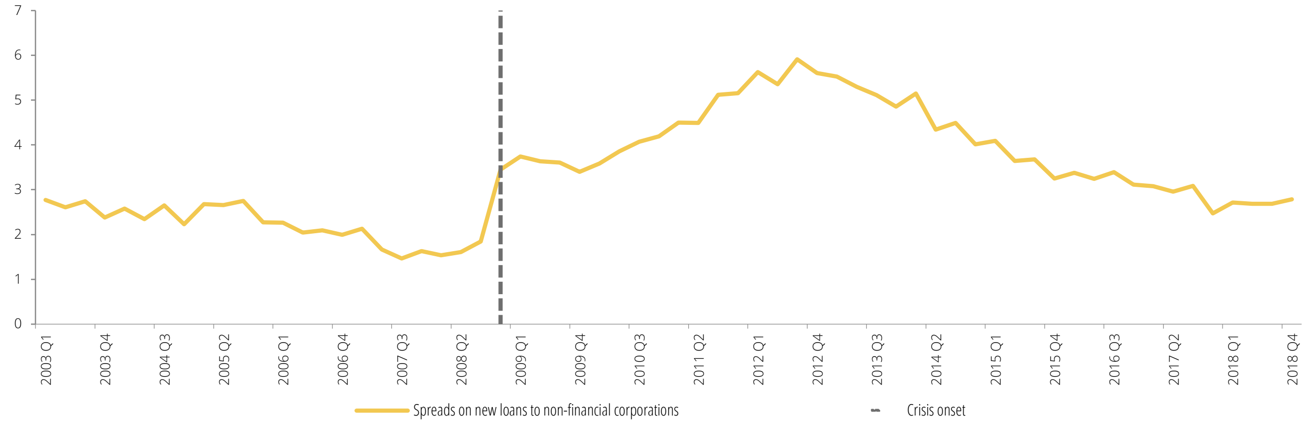
Lending spreads of new loans remained broadly stable

In the fourth quarter of 2018, lending spreads of new loans granted to the private non-financial sector remained broadly stable, when compared with those observed in the previous quarter.

Regarding households, in the fourth quarter of 2018, lending spreads of new loans for house purchase remained at 1.6 p.p., in comparison with the previous quarter, whereas for consumption and other purposes decreased 0.4 p.p. to 6.1 p.p.. Nonetheless, in line with the July and October 2018 *Bank Lending Surveys*, the majority of Portuguese credit institutions participating in the January 2019 *Bank Lending Survey* considered to have implemented tighter credit standards on loans for house purchase over the past six months, owing to new regulatory or supervisory actions. For credit for consumption and other purposes, some participating Portuguese credit institutions also reported tighter credit standards, also due to regulatory or supervisory actions.

Concerning NFCs, in the fourth quarter of 2018, lending spreads of new loans (up to one year) increased 0.1 p.p. to 2.8 p.p., when compared with the previous quarter (Chart 3). Moreover, according to the December 2018 *Financial Stability Report*, in the first half of 2018, lending spreads associated to new loans to NFCs continued to be differentiated according to credit risk. However, a slight leftward shift of the spread distributions was observed, especially for the higher risk classes, which is likely associated with (i) the improvement in the NFCs' financial position, arising from the more favourable macroeconomic and financial environment, and (ii) might also be related with the NPL reduction in the banks' balance sheets and their recomposition.

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 refers to 2018 Q4. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In December 2018, the average interest rate on new lending to households for house purchase remained at 1.4%, when compared to September 2018, whereas for consumption and other purposes it decreased 0.4 p.p. to 5.8%. Regarding NFCs, the average interest rate on new lending (up to one year) increased 0.1 p.p. to 2.5%, considering the same period.

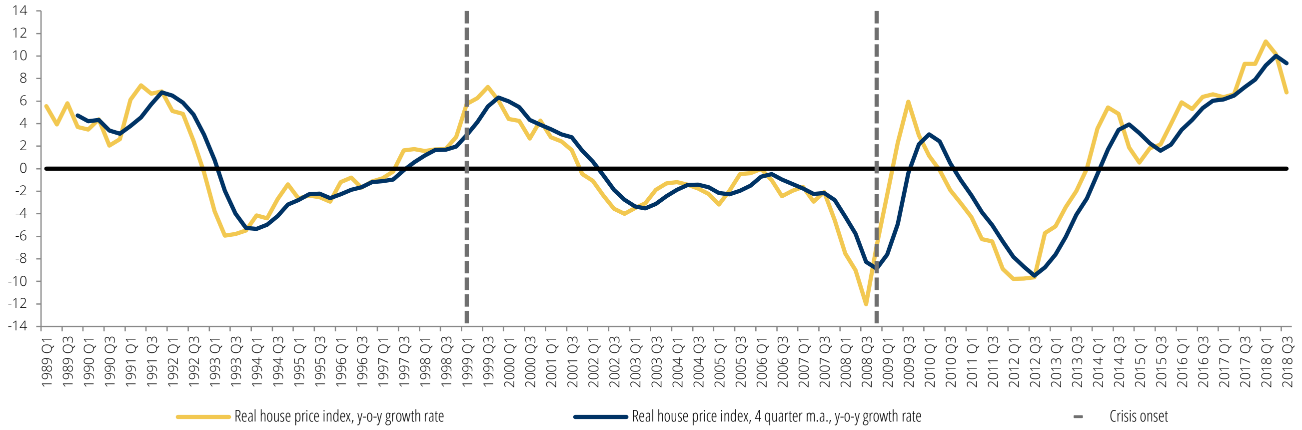
Overall, Portuguese credit institutions participating in the January 2019 *Bank Lending Survey* have not anticipated adjustments in credit standards applied on loans to firms and households in the first quarter of 2019. Nonetheless, Banco de Portugal will continue to monitor their dynamics, jointly with other credit terms and conditions underlying new loans granted to firms and households (the latter also in the context of the macroprudential Recommendation, issued by Banco de Portugal, which entered into force on 1 July 2018).[8]

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

Residential house prices decelerated further

In the third quarter of 2018, residential house prices increased 6.8% in real terms (year-on-year), slowing down since the series' peak in the first quarter of 2018 (11.3%, year-on-year) (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 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 third quarter of 2018, the ECB average residential real estate valuation measures[10] signalled a slight, although limited, misalignment of residential real estate prices with economic fundamentals, which suggests a slight overvaluation in aggregate terms.

Demand for real estate by non-residents continued to be an important factor behind the momentum in the Portuguese real estate market, as mentioned in the December 2018 *Financial Stability Report* of Banco de Portugal – non-resident investment has grown, since 2012, both in terms of number of properties and transaction amounts.[11] The recovery observed in the real estate market is also the result of buoyant tourism, which has boosted demand for real estate by investors, particularly for local accommodation. The latter has experienced significant growth since 2016 and is considered one of the main structural changes regarding supply capacity of tourism accommodation in Portugal.[12]

On the supply side, in the third quarter of 2018, the number of building permits increased 16.3% (year-on-year) and completed buildings increased 12.3%.[13] Taking into account the time lag between building permits and housing completions, the latter are expected to continue to increase significantly in the next few quarters, which may curb the upward pressure on prices.

Furthermore, as highlighted in the December 2018 *Financial Stability Report* of Banco de Portugal, the ratio between new domestic loans to households for house purchase and the total value of house sales stabilised in recent quarters at the level reached at the end of 2016 – close to 40% –, clearly below the level observed in 2010 (around 65%). This decline indicates that house sales growth is not being mainly fostered by credit granted by domestic banks.[14]

According to the December 2018 *Economic Bulletin* of Banco de Portugal, financing conditions are expected to continue to support housing investment, though in a progressively more mitigated way over the projection horizon 2018-21. Moreover, the labour market rebound and the incentives created by the rise in house prices, affected, among other

[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] For more details, see Box 3 in the *Financial Stability Review*, European Central Bank, June 2011.

[11] Statistics Portugal recently published data on the purchase of real estate by non-residents. Published data cover real estate property for housing, trade, manufacturing and other purposes and are grouped into three categories: urban, rural and mixed. Data are available on Statistics Portugal website at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=344337664&DESTAQUESmodo=2 and refer to the 2012-17 period.

[12] For more details see the Special issue – Tourism exports: recent developments and future prospects, *Economic Bulletin*, Banco de Portugal, December 2018.

[13] Data are available at Statistics Portugal website at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=316001477&DESTAQUESmodo=2&xlang=en

[14] For further details, see Box 5 "Recent developments in the sale of family dwellings and loans to households for house purchase: regional heterogeneity, *Economic Bulletin*, Banco de Portugal, October 2018.

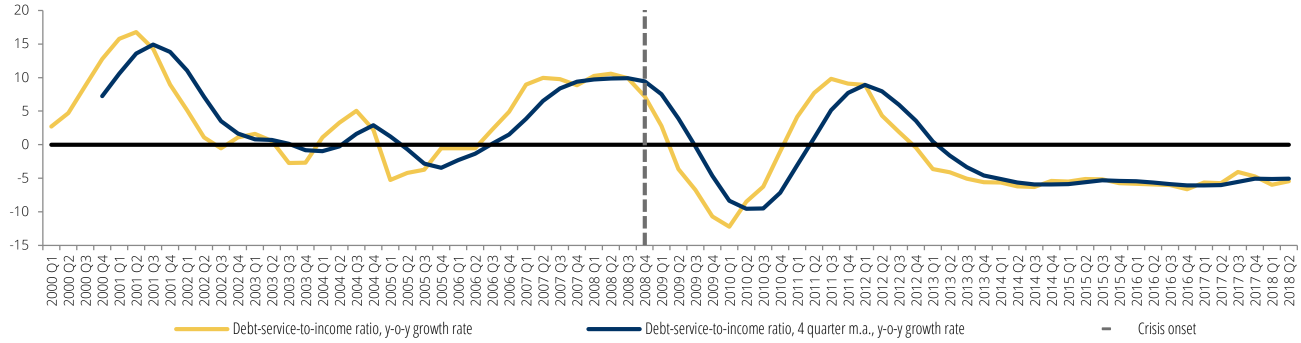
factors, by the impact of the buoyancy of tourism, also contribute to support the expected housing investment expansion trajectory, albeit at a lower growth rate than that of the other institutional sectors over the projection horizon. Banco de Portugal will continue to closely monitor further developments in the residential real estate market.

Additional indicators do not signal a build-up of imbalances

The loan-to-deposits ratio increased to 89.4% in the third quarter of 2018. The increase in loans and, to a smaller extent, the reduction in deposits, contributed to the slight increment of this ratio by 0.4 p.p., when compared with the previous quarter. This ratio thus remains well below the levels observed before the international financial crisis, indicating that banks are more resilient against shifts in wholesale debt markets' sentiment.

In the second quarter of 2018, the year-on-year growth rate of the debt-service-to-income ratio[15] of the private non-financial sector decreased 5.5%, maintaining its downward trajectory (Chart 5). This reduction is explained by (i) favourable funding conditions, stemming from the current scenario of low interest rates, and (ii) the real disposable income trajectory, largely determined by the acceleration in wages and by dynamic employment growth.

Chart 5 Year-on-year growth rate of debt-service-to-income ratio |In percentage



Sources: BIS and Banco de Portugal calculations.
Notes: The last observation refers to 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 December 2018 *Economic Bulletin* of Banco de Portugal, the indebtedness ratios of households and NFCs are expected to continue to decline over the projection horizon 2018-21, though at a progressively slower pace. Against this background, and despite the expected slight increase of interest rates, as a result of the progressive reduction of monetary policy stimulus, a material increase in the debt-service-to-income ratio is not expected in the near future.

In the third quarter of 2018, the seasonally adjusted current account deficit of the Portuguese economy, as a percentage of GDP, improved slightly, decreasing from 0.8% to 0.4%, when compared with the previous quarter. The current account deficit registered since the second quarter of 2018, was mostly due to (i) the increase of the goods account deficit, as a percentage of GDP, as a result of higher growth of imports than that of exports[16], and (ii) the increase of the primary income account deficit, as a percentage of GDP, explained by the combined effect of a decline in interest received from abroad and an increase in dividends paid to non-residents in Portugal.

This notwithstanding, as reported in the December 2018 *Economic Bulletin* of Banco de Portugal, current projections point to the maintenance of the Portuguese economy's net lending, as observed since 2012. The combined current and capital account balance is expected to stand at 1.3% of GDP, on average, in the 2018-20 period, broadly unchanged from 2017, increasing to 1.6% at the end of the projection horizon, in 2021. Nonetheless, this projection assumes a shift in the composition of the current and capital accounts, with a gradual reduction in the goods and services accounts surplus largely offset by an increase in the capital account balance and by a reduction of the primary income deficit.

[15] 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.

[16] Up to September, exports of goods and services grew by 6.9%, while imports increased by 7.9%, partially caused by a slowdown of tourism throughout the year. For more information, see the Special issue – Tourism exports: recent developments and future prospects, *Economic Bulletin*, Banco de Portugal, December 2018.

General assessment

Overall, the available quantitative and qualitative information does not signal the build-up of imbalances related to cyclical systemic risk in Portugal. Despite the residential real estate market dynamics, although slowing down, these developments do not seem to be directly related with domestic credit evolution. Thus, the countercyclical buffer rate is maintained at 0% over the second quarter of 2019.