COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

31 MAR. 2020

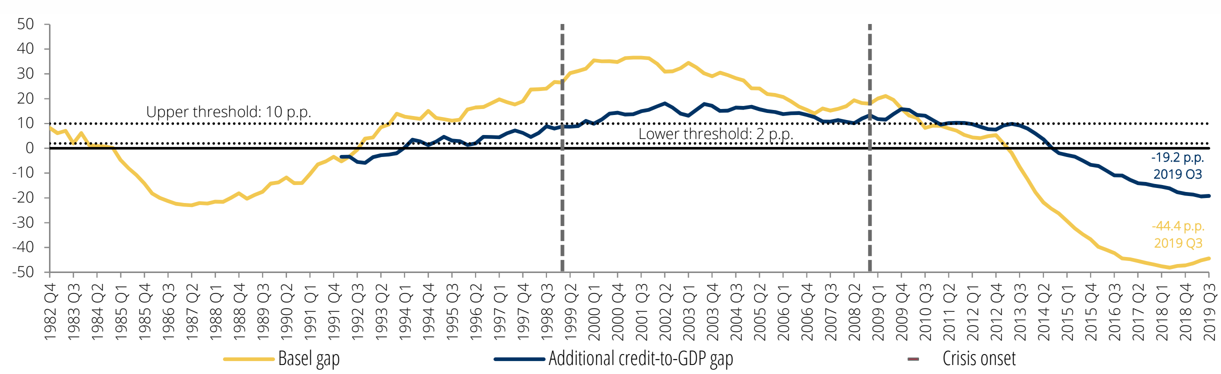
Pursuant to the decision of the Board of Directors of 24 March 2020, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 April 2020.

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

Credit-to-GDP gap remains in negative territory

In the third quarter of 2019, the Basel gap increased slightly from -45.2 to -44.4 percentage points (p.p.), as the decline of the credit-to-GDP ratio was more than offset by the reduction of its long-term trend. The additional credit-to-GDP gap also became slightly less negative, reaching -19.2 p.p. (Chart 1). Since 2013, nominal output has 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.

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 2019Q3. 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 29 January 2020. 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. 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.

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

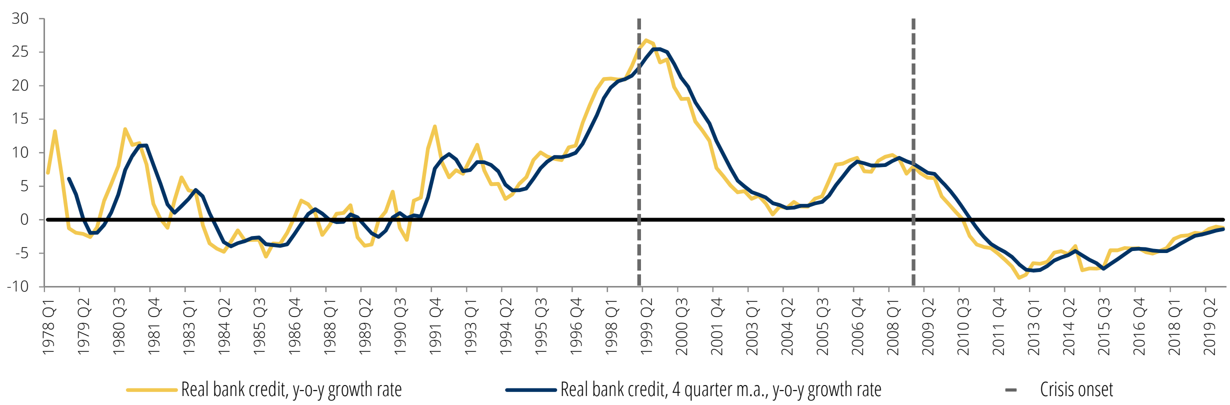
Moreover, according to the projections published in the December 2019 *Economic Bulletin* of Banco de Portugal, for the 2019-2022 period, a change in the sign of both gaps is unlikely to occur in the next quarters, given the expected continued decline of the private non-financial sector indebtedness ratio.[3]

Real bank credit growth remained negative, whereas real total credit growth returned to positive territory

In the fourth quarter of 2019, real bank credit outstanding to the private non-financial sector declined by 1.2%[4] (year-on-year) (Chart 2), mostly driven by the reduction of real bank credit outstanding to non-financial corporations (NFCs) (-3.7%). The real bank credit outstanding to households rose by 0.6%, over the same period, reflecting the increase in both consumer loans (10.2%), and loans for house purchase (0.2%), with the latter representing, by large, the highest share of total real bank credit outstanding to households (80.2% in December 2019).

In light of the developments observed in the credit market for consumption purposes, Banco de Portugal issued, on 31 January 2020, an amendment to the macroprudential Recommendation on new credit agreements for consumers. This amendment envisages a reduction of the maximum maturity to 7 years for new personal credit loans, excluding loans for education, healthcare and renewable energy, provided that these purposes are duly evidenced. For car loans, the 10 years maximum maturity will continue to apply. In addition, the 20% level of exceptions considered in the Recommendation for loans with a debt service-to-income (DSTI) ratio[5] above 50% was reduced to 10% (which is closer to the value currently used by institutions)[6]. These adjustments aim at further reinforcing the objective of the Recommendation of promoting (i) banking sector and household resilience, contributing to reduce the probability of default and minimise losses in case of default, and (ii) access to sustainable funding by households.

Chart 2 • Real bank credit growth[7] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.

Notes: The last observation refers to 2019 Q4. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

3 Measured by non-financial corporations and households debt as a percentage of GDP.

4 Figures for the second, third and fourth quarters of 2019 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.

5 Debt service-to-income ratio is the ratio of the monthly amount of instalments calculated considering the borrowers' total debt to their net monthly income. For the purposes of this calculation, the instalments of the new credit agreement are assumed to be constant, and the impact of an interest rate rise should be considered for this agreement, in accordance with the provisions of an Instruction of Banco de Portugal. In the case of a borrower aged 70 and over at the planned expiry of the agreement and not retired yet, a reduction of income of at least 20% of current annual income should be considered, weighted by the ratio of the number of years of the agreement in which a borrower is aged 70 and over to the total maturity of the agreement. See Article 4 of the Recommendation for further details.

6 More detailed information is available on https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

7 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 Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by Statistics Portugal.

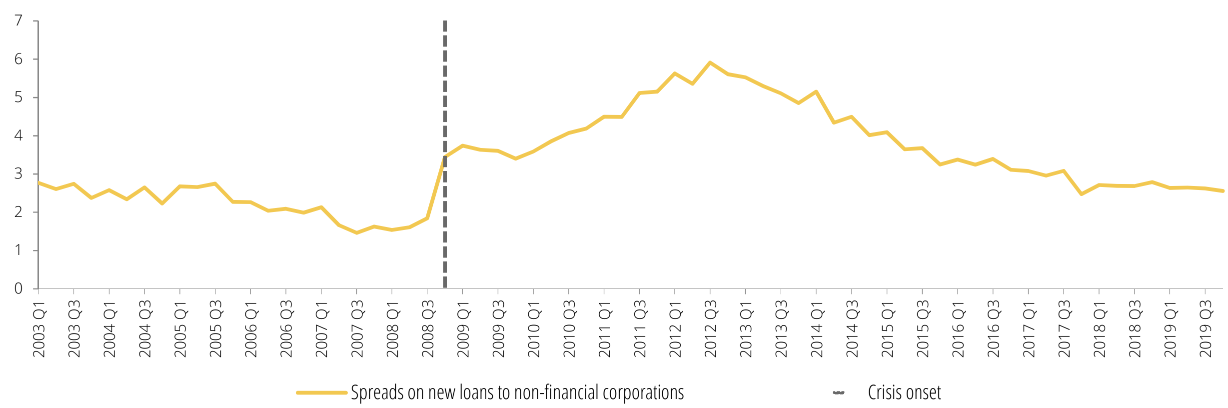
According to the January 2020 *Bank Lending Survey*, demand for loans to NFCs, in the fourth quarter of 2019, remained broadly unchanged, while it has increased in the case of households, when compared with the previous quarter. According to the survey, the low levels of interest rates drove the increase in the demand for both housing and consumer loans, with the latter also being motivated by consumer confidence. Moreover, banks do not anticipate major changes in the demand for loans from firms and households for the first quarter of 2020.

In the third quarter of 2019, the year-on-year rise in real total credit[8] outstanding to NFCs (0.6%) and to households (0.3%), the latter for the first time since the second quarter of 2010, led to the expansion of real total credit outstanding to the private non-financial sector (0.5%), whose year-on-year growth rate also returned to positive territory for the first time since the third quarter of 2011. According to the December 2019 *Financial Stability Report* of Banco de Portugal the developments in total credit to NFCs, in June 2019, were essentially driven by (i) the increase in debt securities, as loans decreased over the same period and (ii) accelerating annual rates of change in total credit to most sectors of activity, particularly to the construction and real estate sectors, when compared with the annual rate of change registered at the end of 2018.

Spreads on new loans to the private non-financial sector remained stable

In the fourth quarter of 2019, spreads on new lending granted to the private non-financial sector remained stable when compared to the levels observed in the previous quarter. For the household segment, new lending spreads for house purchase remained at 1.4 p.p. and those related to new lending for consumption and other purposes remained at 6.0 p.p.[9] Regarding the NFCs' segment, and despite a small overall decrease, new lending spreads (up to one year) remained unchanged at 2.6 p.p. (Chart 3).

Chart 3 • Spreads on new loans to non-financial corporations[10] | In percentage points



Sources: Banco de Portugal, Refinitiv and Banco de Portugal calculations.

Notes: The last observation refers to 2019 Q4. 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 1.1% in December 2019, increasing by 0.1 p.p. when compared to September 2019, whereas the average interest rate on new loans for consumption and other purposes increased by 0.1 p.p. to 5.6%. With regard to NFCs, the average interest rate on new lending (up to one year) remained unchanged at 2.2%.

According to the January 2020 *Bank Lending Survey*, credit standards and the overall terms and conditions of loans granted to households and NFCs remained broadly unchanged, in the fourth quarter of 2019, when compared with the previous quarter. Furthermore, banks do not anticipate adjustments in credit standards applied to loans to households and NFCs in the short-term. Participating banks also reported that pressure from competition contributed to narrowing their margin on average risk loans granted to households for house purchase.

[8] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Total credit granted by domestic and non-resident banks and non-banks.

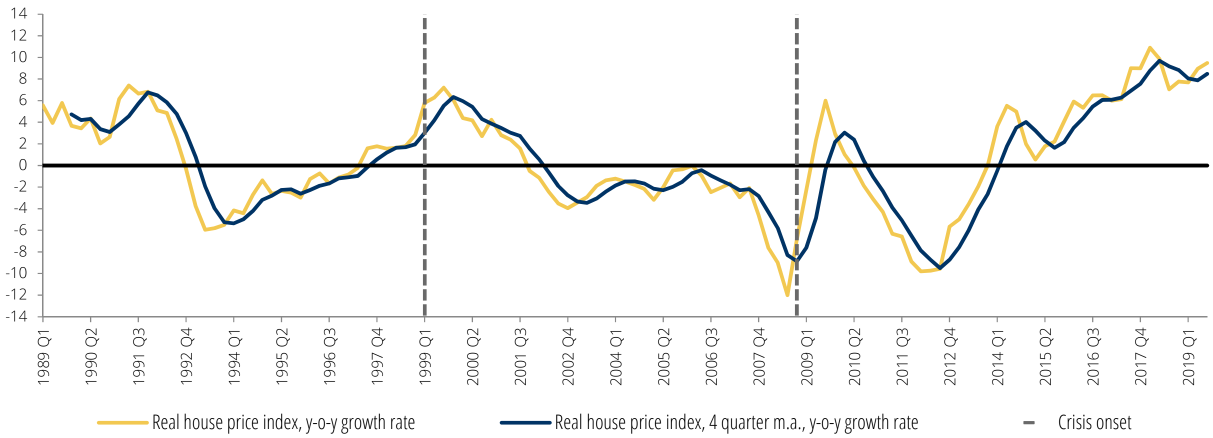
[9] In the case of households, the spread for house purchase is calculated against the six month Euribor rate, whereas that for consumption and other purposes is calculated against the three month Euribor rate.

[10] Average of spreads weighted by the corresponding new lending 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 third quarter of 2019, real house prices increased by 9.5% (year-on-year), accelerating when compared to the year-on-year growth rate registered in the previous quarter (9.0%), 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[11] | In percentage



Sources: Organization for Economic Co-operation and Development.

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.

As put forward in the December 2019 *Financial Stability Report*, the main drivers of the strong house prices growth have been (i) the continued growth of economic activity, reflected in the improvement of labour market conditions and high levels of consumer confidence, (ii) the continued low financing costs, (iii) the increase in the foreign population residing in Portugal and (iv) the search-for-yield behaviour of private and institutional investors, both resident and non-resident. Moreover, according to several measures of overvaluation presented in the same publication, house prices are above the level consistent with fundamentals which can generate potential risks to the banking system arising from price correction in this market. The increase in non-residents' participation in the real estate market in Portugal, reflecting investors' search-for-yield behaviour in a low interest rate environment, continued to significantly drive demand. Notwithstanding, the persistence of a gap between the number of permits and completions and the recovery of the construction sector should continue to translate into an increase in the supply of new housing, which could contribute to moderate growth in house prices going forward.

The loan-to-deposit ratio remained stable and the indebtedness ratio of the private non-financial sector decreased

The loan-to-deposits ratio has remained relatively stable (88.0% in the third quarter of 2019): the increase in deposits and the maintenance of loans contributed to the slight decrease of this ratio, by 0.2 p.p., when compared with the previous quarter. This indicator thus continues to be much below the levels observed before the financial crisis, indicating that banks are more resilient against shifts in wholesale debt markets' sentiment.

In the second quarter of 2019, the debt-service-to-income ratio[12] of the private non-financial sector declined from 15.1% to 14.7% (year-on-year), maintaining its downward trajectory. Borrowers' responsibilities associated with debt servicing continued to benefit from the low interest rate environment, paired with an increase, albeit at an increasingly slower pace, in income. Additionally, according to the December 2019 *Economic Bulletin* of Banco de Portugal, the indebtedness ratios of households and NFCs are expected to continue to decline over the projection horizon 2019-2022. Consequently, considering the expected scenario of low interest rate levels, a material increase in the debt-service-to-income ratio is not foreseen in the near future.

[11] 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.

[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.

Current account balance slightly deteriorated and turns into a deficit

In the third quarter of 2019, the seasonally adjusted current account balance of the Portuguese economy, as a percentage of GDP, slightly deteriorated (from 0.0% to -0.3%), when compared with the previous quarter. Moreover, according to the projections for the Portuguese economy published in the December 2019 *Economic Bulletin* of Banco de Portugal, the developments in the goods account – strongly related to the robust real growth in imports, notably associated to imports of capital goods over the past two years – are likely to continue, contributing to the deficit trajectory over the projection period 2019-2022.

General assessment

The sustained increase of prices in the residential real estate market, coupled with signs of overvaluation, continue to justify a close monitoring of developments in this market, given, in particular, the potential impact that a price correction could have on the banking system.

Additionally, the current context of competitive pressures across banks, of very low interest rates and of still high levels of indebtedness, reinforces the need to guarantee that credit standards set by banks are appropriate to the underlying risk of loans.

The recent amendment to the macroprudential Recommendation on new credit agreements for consumers that reduced (i) the maximum maturity of new personal credit loans from 10 to 7 years, with some exceptions, and (ii) the level of exceptions for loans with DSTI ratio above 50% from 20% to 10%, aim at ensuring that institutions do not take excessive risks when granting credit and at promoting borrowers' access to sustainable funding.

Therefore, and despite the context of high uncertainty, as in the previous quarterly assessment, the countercyclical buffer rate is maintained at 0% over the second 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 risk.