COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

30 June 2017

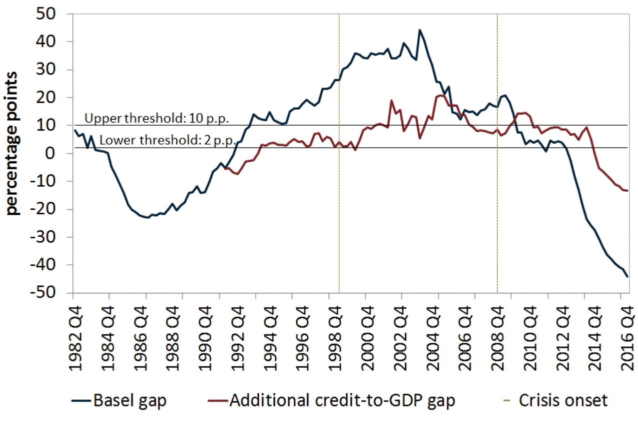
Pursuant to a decision of the Board of Directors of 20 June 2017, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at zero per cent of the total risk exposure amount, with effect from 1 July 2017.

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

The two measures of the credit-to-GDP gap quarterly computed by Banco de Portugal continued to depict negative values in the last quarter of 2016 further below those observed in the previous quarter. In the fourth quarter of 2016, the Basel gap was -44.1 p.p., while, in the previous quarter, it stood at -41.5 p.p.. The alternative gap measure developed by Banco de Portugal moved from -13.0 p.p., in the third quarter of 2016, to -13.4 p.p., in the last quarter of that year (see Chart 1). The values of these indicators continue to be well below the 2 p.p. threshold that could trigger a positive countercyclical benchmark buffer rate.

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



Sources: BdP, INE and BdP's calculations. **Last observation:** 2016 Q4.

The evolution of the credit-to-GDP gap measures reflects the continued reduction in the outstanding amount of credit granted to the private non-financial sector, as well as the positive growth rate of the nominal GDP.

Given that the GDP growth rate is expected to increase to 2.5% in 2017, while banks' credit outstanding amount is not expected to augment, there is no indication that the credit-to-GDP gap will revert in the next quarter.

Real credit growth rates remain negative

The year-on-year growth rates of both real bank credit and its four-quarter moving average remained negative in the first quarter of 2017, further decreasing since the last quarter of 2016 and standing at -4.8 per cent and -4.4 per cent, respectively. Also in this regard, the ratio between the one year difference in bank credit and the five year moving average of GDP continued to be negative (-17.0 per cent) in the fourth quarter of 2016, albeit less negative than in the previous quarter (-18.2 per cent). Since credit growth remains negative both in nominal and real terms, in contrast to the GDP growth rates, there is no evidence of excessive aggregate credit growth.

In the last quarter of 2016, the evolution of the stock of credit granted to households and to non-financial corporations (in real terms) has shown a similar pattern, with year-on-year growth rates of, respectively, -3.2 per cent and -3.3 per cent, both decreasing from the previous quarter.

The outstanding amount of bank credit granted to households for house purchase has been steadily decreasing in the last years, which is also explained by the volume of redemptions in this segment. In the first quarter of 2017, new lending for house purchase augmented, in line with the reported increase in credit demand by the households, triggered by the low level of interest rates and the increased consumer confidence, as highlighted in the April 2017 Bank Lending Survey. This trend is perceived to continue further in the second quarter of 2017, as institutions also expect a slight increase of demand for this credit segment.

The stock of consumer credit is the only component of credit to the household sector that increased in the first quarter of 2017, although its share in the total outstanding amount of credit granted remained quite low (around eight per cent).

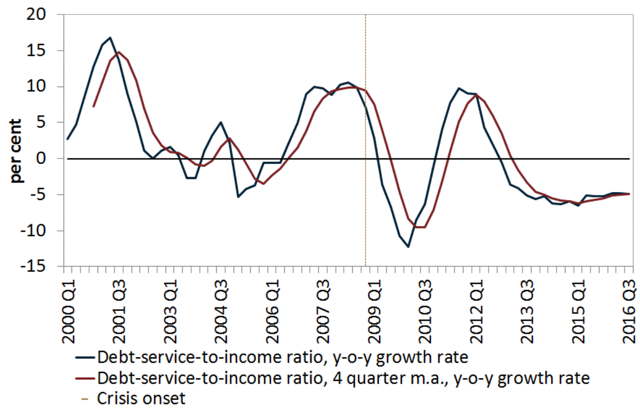
Also in regard to banks' intermediation activity, the ratio of credit to deposits increased slightly in the fourth quarter of 2016, to 95.5 per cent, from its lowest level of 94.2 per cent, observed in the previous quarter. Bank funding continued to rely on retail deposits, a funding source that is less vulnerable to a market sentiment shift, hence this indicator remains at very low levels and does not signal the building up of risks.

Deleveraging process of the private non-financial sector at a more moderate pace

The debt-service-to-income ratio continued to decrease, to 17.4 per cent in the third quarter of 2016, signaling a continued improvement in the ability of the private non-financial sector to service the debt. The year-on-year growth rate and the four quarter moving average of the debt-service-to-income ratio remained at around minus five per cent during 2016 (Chart 2).

This development was mainly due to the deleveraging process of both households and non-financial corporations and was also fostered by the low interest rate environment.

Chart 2 – Debt-service-to-income ratio[3]



Source: BIS. **Last observation:** 2016 Q3.

The improvement in the debt ratio of non-financial corporations is common to all activity sectors, although with some heterogeneity within those sectors. The reduction of the stock of credit was much more significant in construction and real estate sectors, which was also triggered by the exit of some firms from the market.

House prices are picking up

House prices continued to rise, as evidenced by the year-on-year growth rate – by the end of 2016, house prices were *circa* six per cent higher than in the same period of 2015, in real terms. Nonetheless, there is no evidence that the increase in house prices is being fuelled by domestic credit, since the outstanding amount of bank credit granted to households for house purchase is still decreasing. All reporting banks to the April 2017 Bank Lending Survey indicated the maintenance of credit standards applied to loans for house purposes in the first quarter of the year. However, it is also referred that factors such as competition from other banks, improvement on banks' funding costs or reduced balance sheet constraints may motivate the easing of credit standards by some banks in this credit segment. This may take different forms, which need to be carefully monitored.

There is also evidence that credit conditions, reflected in the loan-to-value and loan-to-income ratios at origination, have slightly eased in 2014 and 2015 (see June 2017 Financial Stability Report, for further details). Additional information also indicates the lengthening of maturities. Finally, interest rates on new lending for house purchase have decreased further in March 2017, reaching a new historical minimum of this series.

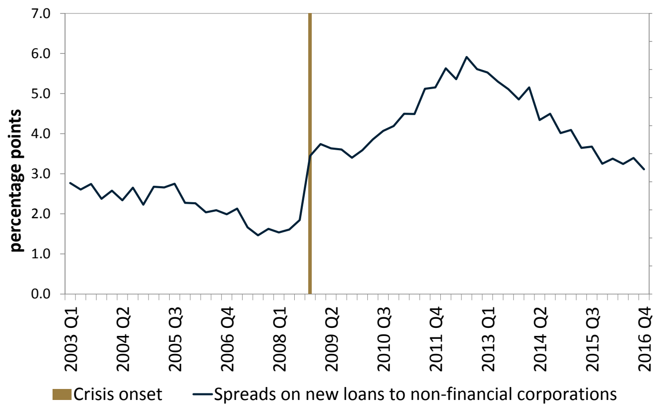
Stable lending conditions for non-financial corporations

In 2016, banks' spreads on new lending to non-financial corporations continued to decrease, standing at 3.1 p.p. in the fourth quarter (Chart 3). In March 2017 the interest rates on new loans to non-financial corporations have reached a new historical minimum of this series.

An analysis of the distribution of interest rates by risk categories shows risk differentiation across non-financial corporations (May 2017 Economic Bulletin). For example, the distribution of interest rates on new lending to low risk non-financial corporations has been moving to lower rates, while new loans to high risk non-financial corporations display relatively higher interest rates and a significant dispersion.

A detailed analysis of credit granted to non-financial corporations, published in the June 2017 Financial Stability Report, shows that credit institutions have mainly reduced credit to counterparties with worse credit risk profiles. On the other hand, non-financial corporations with the best credit risk profiles have presented a positive contribution to credit aggregates since 2014.

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



Sources: BdP, Reuters and BdP's calculations. **Last observation:** 2016 Q4.

According to the April 2017 Bank Lending Survey, credit standards remained stable, in general, in the first quarter of 2017 and further reductions in interest rates are not expected.

Current account continued to present a surplus

No additional evidence points to the accumulation of cyclical systemic risk fuelled by credit. In particular, the current account continued to present a surplus in the last quarter of 2016, having increased from 0.4 to 1.2 per cent of GDP *vis-à-vis* the fourth quarter of 2015.

General assessment

The recent economic recovery observed in Portugal has been accompanied by a decrease in the outstanding amount of credit granted to the non-financial private sector, which translates into negative and decreasing credit-to-GDP gap measures. Despite the recent developments in consumer credit and the increase in the amount of new lending granted for house purchase, the stock of credit has continued to decrease.

Accordingly with the available quantitative and qualitative information, Banco de Portugal has decided to maintain the current macroprudential policy stance, keeping the countercyclical buffer rate at zero per cent of total risk exposure amount.

Notes

1 The assessment is based on available data up to 24 April 2017. 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 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 BdP and nominal GDP from National Accounts (ESA2010, base 2011) published by 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 zero per cent to the upper threshold of 2.5 per cent 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 Debt-service-to-income ratio estimates published by the BIS 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.

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 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 produced by BdP.

Abbreviations

ARIMA	Autoregressive Integrated Moving Average
BCBS	Basel Committee on Banking Supervision
BdP	Banco de Portugal
BIS	Bank for International Settlements
ESA	European System of Accounts
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)
OECD	Organisation for Economic Cooperation and Development
p.p.	Percentage points