COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

28 June 2019

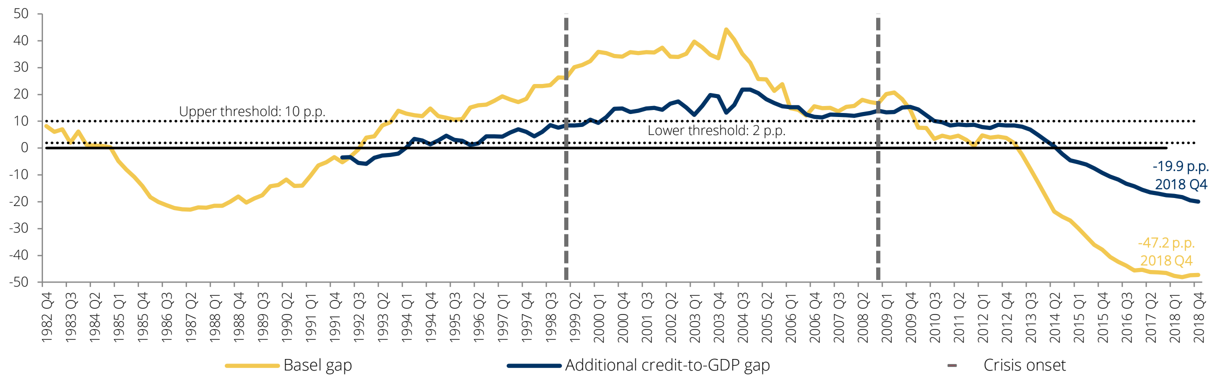
Pursuant to the decision of the Board of Directors of 25 June 2019, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 July 2019.

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

Credit-to-GDP gap measures remained negative

In the fourth quarter of 2018, the Basel gap reached -47.2 percentage points (p.p.) and the additional credit-to-GDP gap[2] -19.9 p.p. (Chart 1), providing no evidence of excessive credit growth. Moreover, credit-to-GDP ratio maintained its downward path, initiated in 2013, driven by both an increase in nominal GDP and a decline in total credit outstanding to the private non-financial sector. According to the projections published in the March 2019 *Economic Bulletin* of Banco de Portugal, regarding, in particular, the developments in GDP, both gaps should remain in negative over the next quarters.

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 2018Q4. 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 April 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.

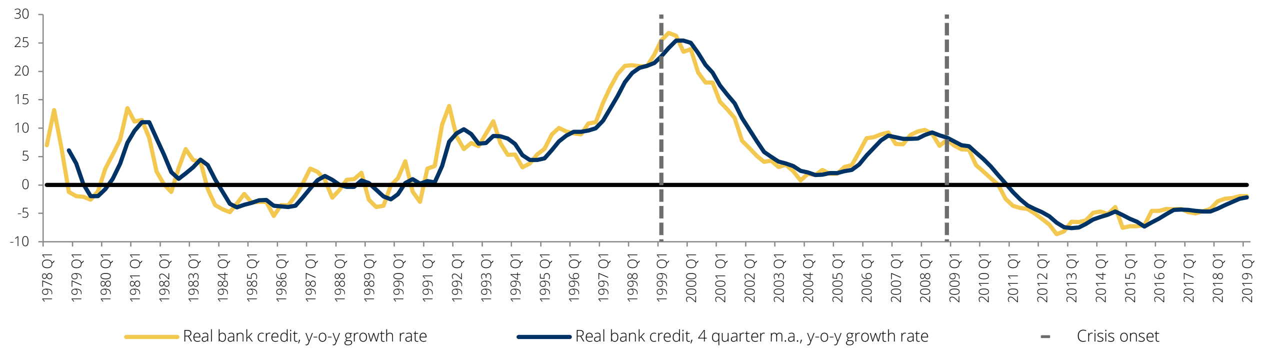
[2] The credit-to-GDP gap is calculated as the percentage point difference between the observed credit-to-GDP ratio and its long-term trend, where the trend is estimated employing a one sided HP filter with a smoothing parameter set to 400,000. The additional credit-to-GDP gap is computed as the percentage 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?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.

As both gaps remain negative and significantly below the risk level threshold, the implied benchmark countercyclical buffer rate remains at 0% of the total risk exposure amount.

Real bank credit continued to decline

In the first quarter of 2019, real bank credit outstanding to the private non-financial sector contracted by 2% (year-on-year) (Chart 2), mostly driven by the reduction of real bank credit outstanding to non-financial corporations (NFCs) (4.1%). Regarding households, real bank credit outstanding decreased by 0.4%, over the same period, reflecting mainly the decrease in real bank credit for house purchase (-0.8%), whereas consumer loans registered a year-on-year increase (7.9%, in real terms), albeit slowing down from the peak observed in the first quarter of 2018 (13.1%). The latter is associated with the increase in private consumption, related to (i) favourable developments in real household disposable income, reflecting the increase in employment and nominal wages – including the minimum wage in 2019 -, (ii) maintenance of high consumer confidence, albeit below the levels recorded in the recent past, and (iii) maintenance of positive expectations of households regarding developments in their financial situation, as highlighted in the March 2019 *Economic Bulletin* of Banco de Portugal. Nonetheless, in March 2019, credit for consumption still represents a small share of the total real bank credit outstanding to households (13.4%).

Chart 2 Real bank credit growth[3] | In percentage



Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal's calculations.
Notes: The last observation refers to 2019 Q1. 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 fourth quarter of 2018, the ratio between the annual change in bank credit to the private non-financial sector and the five year moving average of nominal GDP – another early indicator used to assess potential credit imbalances – decreased by 0.7 p.p. to -4.9% (quarter-on-quarter). This evolution reflects the joint effect of the gradual increase in nominal GDP and of the bank credit further decline.

Real total credit outstanding to the private non-financial sector continued to decrease in the fourth quarter of 2018 (-2.4%, year-on-year), reflecting a reduction in credit outstanding to both non-financial corporations and households (-3.7% and -0.5%, respectively).

Total credit net[4] flow to the private non-financial sector, in the fourth quarter of 2018, did not surpass the negative contribution of other volume and price changes, namely loans repayments, write-offs and sales, mostly due to the NFCs' segment, resulting in a decrease of real total credit outstanding to the private non-financial sector, when compared to the third quarter of 2018.

The analysis above shows that there are no signs of a cyclical systemic risk regarding credit growth.

[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 INE.

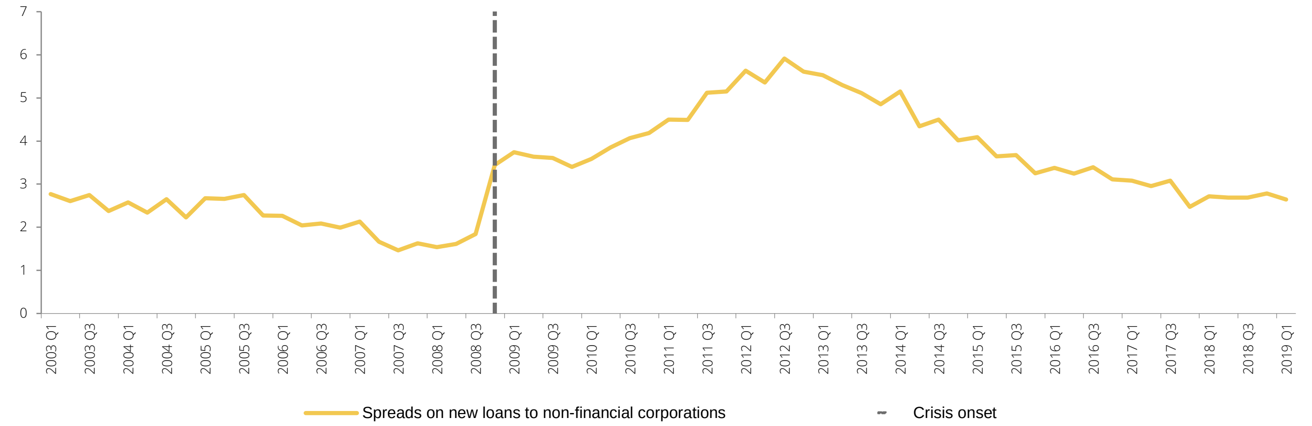
[4] Net of other volume and price changes.

Spreads of new loans stood broadly stable

In the first quarter of 2019, spreads on new lending granted to the private non-financial sector stood stable, when compared with the levels observed in the previous quarter.

Regarding households, spreads associated with new loans for house purchase remained at 1.6 p.p. in the first quarter of 2019, in comparison with the previous quarter. Moreover, spreads of new lending for consumption and other purposes reached 6.3 p.p., increasing by 0.2 p.p. in the same period. Concerning non-financial corporations, spreads on new loans (up to one year) reduced by 0.2 p.p., to 2.6 p.p., in the first quarter of 2019, when compared with the previous quarter (Chart 3).

Chart 3 Spreads on new loans to non-financial corporations[5] | In percentage points



Sources: Banco de Portugal, Refinitiv and Banco de Portugal calculations.
Notes: The last observation refers to 2019 Q1. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In March 2019, the average interest rate on new lending to households for house purchase stood at 1.4%, when compared to December 2018, whereas for consumption and other purposes it increased by 0.2 p.p. to 6.0%, over the same period. Regarding non-financial corporations, the average interest rate on new lending to non-financial corporations (up to one year) decreased by 0.2 p.p., to 2.3%, considering the same period.

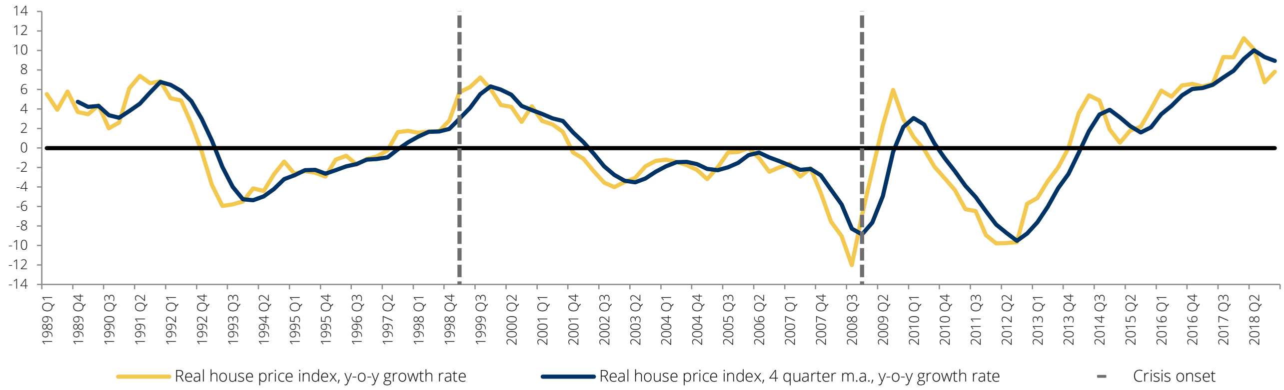
According to the April 2019 Bank Lending Survey, demand for all credit segments was virtually unchanged, except for credit for house purchase, which registered a slight decrease in the first quarter of 2019, when compared with the previous quarter, reflecting, according to the institutions, Banco de Portugal's macroprudential Recommendation on new loans to households, which entered into force on 1 July 2018.[6] Additionally, and according to the same source, new lending criteria for non-financial corporations and households remained broadly unchanged in the same period, and significant adjustments in credit standards applied on loans to both segments are not anticipated in the short-term.

[5] 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 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.
[6] More information on this macroprudential measure is available at https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits.

Residential house prices accelerated slightly

In the fourth quarter of 2018, real house prices increased by 7.8% (year-on-year), accelerating slightly in comparison with the previous period (6.8%), but remaining below the series' peak in the first quarter of 2018 (11.3%).

Chart 4 Year-on-year growth rate of house prices, in real terms[7] | In percentage



Sources: Organization for Economic Co-operation and Development.
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.

In the fourth quarter of 2018, according to the ECB average valuation measures for detecting residential property price misalignments from fundamentals[8], and in line with the previous quarterly reports, house prices remained slightly above their economic fundamentals, at the aggregate level.

Housing investment is expected to remain strong over the period 2019-21, in a context of increase in demand from residents and non-residents, and access to financing with low interest rates, as reported in the March 2019 *Economic Bulletin* of Banco de Portugal. Additionally, in the fourth quarter of 2018, the number of both building permits and completion buildings increased by respectively 28.8% and 18.8% (year-on-year).[9] Thereby, the gradual recovery of housing supply is expected to continue, considering the lagged impact of the rise in building permits issued, which may help curbing the ongoing demand pressure effect on house price growth.

Furthermore, the housing market is expected to gradually decelerate, as the economic cycle matures, reflected in the projected slower economic growth. Nonetheless, Banco de Portugal will continue to closely monitor further developments in the real estate market.

Additional indicators do not point to significant ongoing cyclical risks

In the fourth quarter of 2018, the loan-to-deposits ratio decreased to 88.9%, reaching a new minimum since the last quarter of 2000. Deposits increase explain the reduction of this ratio by 0.5 p.p., when compared with the previous period.

In the third quarter of 2018, debt-service-to-income ratio[10] of the private non-financial sector contracted from 16.4% to 15.7% (year-on-year) (Chart 5). According to the March 2019 *Economic Bulletin* of Banco de Portugal, a gradual acceleration in nominal wages in the private sector is expected to continue, over the projection horizon 2019-21, with wage developments in 2019 being influenced by the update of the minimum wage and by expectations of moderate price

[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 (2010=100) taken from the National Accounts (ESA2010, base 2011) published by Statistics Portugal.

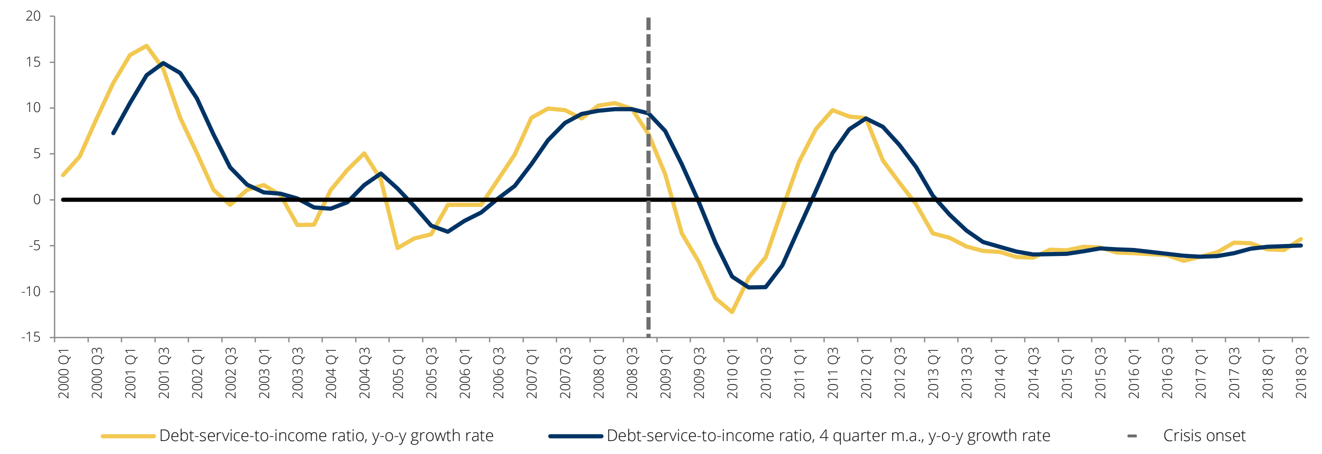
[8] For more details, see Box 3 in the *Financial Stability Review*, European Central Bank, June 2011.

[9] Data are available at Statistics Portugal website at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=348829804&DESTAQUESmodo=2&xlang=en

[10] 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.

developments. In what concerns the public sector, expected developments in wages encompass the impact of career revisions in general government, as well as the assumption of wage updates, in line with inflation, in the second half of the projection horizon. Accordingly, and considering the announced postponement of the gradual phasing-out of the current non-conventional monetary policy[11], a material increase in the debt-service-to-income ratio, in the near future, is not expected.

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 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 fourth quarter of 2018, the seasonally adjusted current account deficit remained at 0.4%, in percentage of GDP, when compared with the previous quarter. According to the March 2019 *Economic Bulletin* of Banco de Portugal, the year-on-year negative change of the current account in 2018 was chiefly due to a more pronounced increase in imports of goods and services in real terms, compared with exports. Moreover, as in 2017, the goods and services accounts moved in opposite directions in 2018, with the tourism sector dynamics driving the year-on-year increase in the services account surplus. The primary income account deficit rise, in the same period, was essentially driven by a higher direct investment income deficit, associated with the increase of dividends paid to non-residents.

Furthermore, although the gradual decline in the goods and services account balance is expected to continue over the projection horizon 2019-21, the estimates also point to the maintenance of the Portuguese economy's net lending capacity, as measured by the current and capital account surplus, largely due to the expected increase in European Union funds during this period, and to a one-off effect in 2021, associated with the reimbursement, by the European Financial Stability Facility, of amounts paid by Portugal under the Economic and Financial Assistance Programme.

General assessment

In line with the previous risk analysis, there is no evidence of emerging cyclical systemic risk in Portugal, despite the trajectory observed in the residential real estate market. Hence, the countercyclical buffer rate is maintained at 0% over the third quarter of 2019. Nevertheless, Banco de Portugal will continue to closely monitor the financial stability risks, which are reflected in the different indicators assessed in this analysis.

[11] For more details, see https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190410~3df2ed8a4c.en.html.