COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

30 JUN. 2020

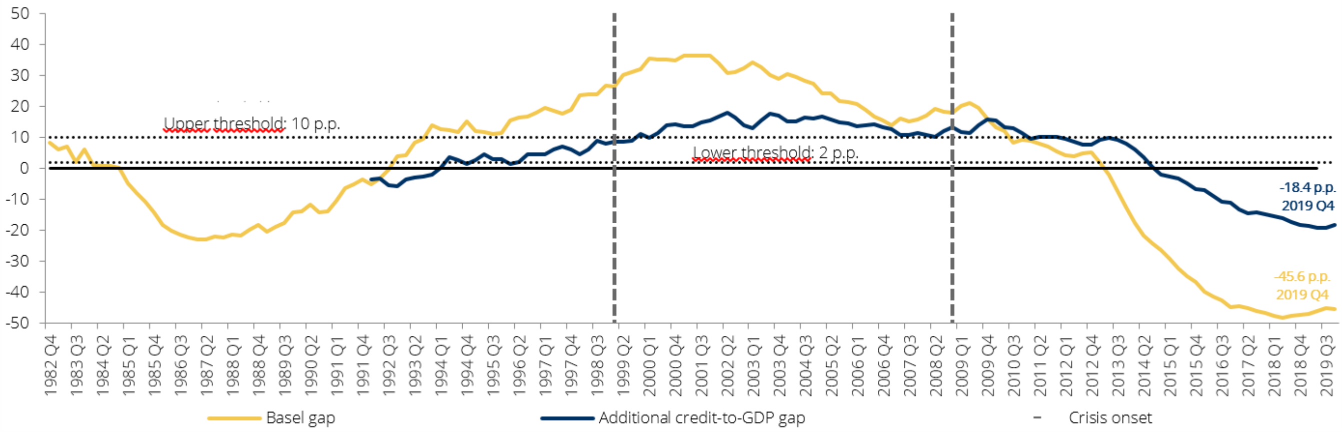
Pursuant to the decision of the Board of Directors of 23 June 2020, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 July 2020.

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 2019, the Basel gap reached -45.6 percentage points (p.p.) and the additional credit-to-GDP gap -18.4 p.p. (Chart 1), providing no evidence of excessive credit growth. While the additional credit-to-GDP gap became less negative (quarter-on-quarter), the Basel gap declined, in the same period, due to a larger decrease of the credit-to-GDP ratio than that of its long term trend.

Chart 1 • Basel gap and additional credit-to-GDP gap[2] | In percentage points



Sources: Banco de Portugal, Statistics Portugal (Banco de Portugal calculations).

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

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.

[1] The assessment is based on data available up to 29 April 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.

Notwithstanding, the outlook for the global economy has undergone a sudden change, as a result of the COVID-19 pandemic, which could actually lead to a slight increase of both gaps, in the short term, via increase of the credit-to-GDP ratio.

In fact, according to projections published in the March 2020 *Economic Bulletin* of Banco de Portugal, nominal GDP (i.e., the denominator of the credit-to-GDP ratio) is expected to decline in 2020, due to the shock in the economy underlying the COVID-19 outbreak. However, the current situation has no recent historical precedent, which exacerbates the uncertainty underlying the projection exercise, and that both gaps also depend on how lending to the private non-financial sector will evolve.

The most immediate effects of the pandemic on the activity of Portuguese non-financial corporations (NFCs) started to be assessed in April, through the weekly *Fast and Exceptional Business Survey* conducted by Banco de Portugal and Statistics Portugal. According to the most recent informative note,[3] published on 28 April 2020, with respect to the week of 20-24 April 2020, (i) 83% of NFCs were operating, even if partially, (ii) 80% of operating NFCs or NFCs temporarily closed reported reductions in the turnover, and half of them with a reduction over 50% and (iii) around 12% of operating NFCs or NFCs temporarily closed increased their borrowing amount from banks in the previous week.

Concerning the numerator of credit-to-GDP, it is foreseeable a slight increase, in the short run, due to the measures taken by the Portuguese government to minimise the impact of the expected effects underlying the Covid-19 outbreak on the Portuguese economy. In fact, policies focused on liquidity support and on credit to NFCs and households (notably the new NFC credit lines launched with public guarantees[4] and the moratoria applied to credit previously granted to NFC and households) will have an immediate impact on total credit outstanding to the private non-financial sector.

Concerning the macroprudential Recommendation on new credit agreements for consumers, Banco de Portugal has decided that new personal loans with maturities of up to 2 years, duly identified as intended to mitigate situations of temporary insufficient liquidity on the part of households, are exempted from complying with the limit on the DSTI ratio defined in the Recommendation and from complying with the Recommendation for regular payment of capital and interest.[5] This measure is applicable to new personal credits granted from April 1 until September 30, 2020, date in which a reassessment of the adequacy of this amendment will be carried out.

Having all this in consideration, an increase of the private non-financial sector indebtedness ratio[6] in 2020 is expected. This increase should be especially sharp in the second quarter, where it is projected the largest decrease in GDP. However, and albeit the uncertainty underlying the projection exercise, this effect should be of a temporary nature.

[3] More information is available on https://www.bportugal.pt/sites/default/files/anexos/documentos-relacionados/iree_20200428.pdf (Portuguese version only).

[4] More information is available on https://www.portugal.gov.pt/download-ficheiros/ficheiro.aspx?v=581ba684-4b80-47b1-a3cb-b8bb0c3e04f9 (Portuguese version only).

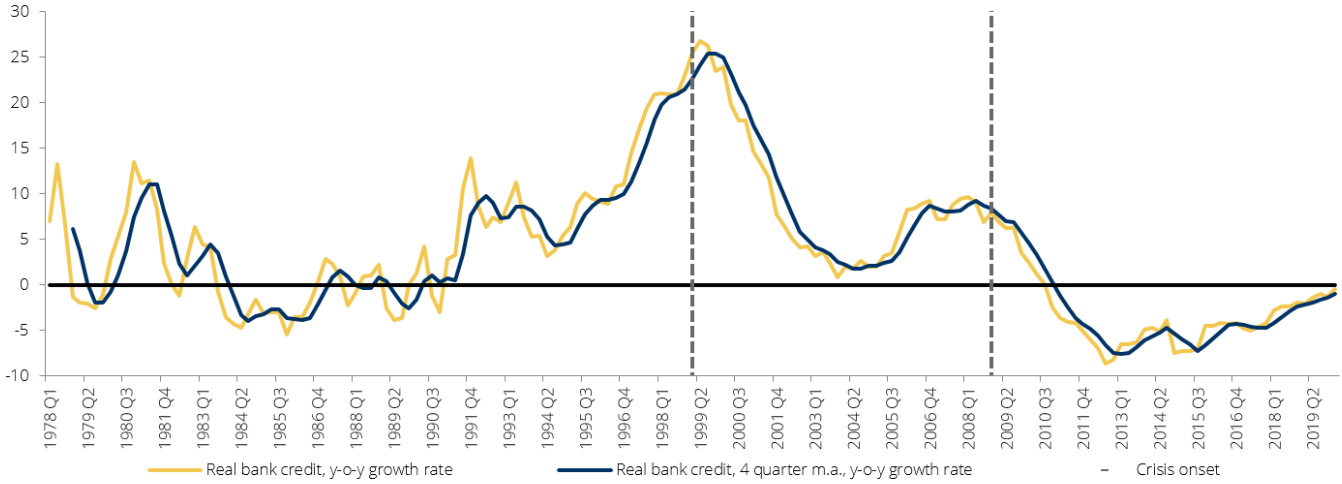
[5] As stated in https://www.bportugal.pt/sites/default/files/recomendacao_contratoscredito_consolidada_en.pdf.

[6] Measured by non-financial corporations and households debt as a percentage of GDP.

Real bank credit declined in the first quarter of 2020

In the first quarter of 2020, real bank credit outstanding to the private non-financial sector declined by 0.4%[7] (year-on-year) (Chart 2), mostly driven by the reduction of real bank credit outstanding to NFCs (-1.8%). Regarding households, real bank credit outstanding increased by 0.5%, over the same period, mainly reflecting the increase in consumer loans (11.8%), albeit slowing down from the peak observed in the previous quarter (13.3%), whereas loans for house purchase registered a year-on-year decrease of 0.2%, in real terms).

Chart 2 • Real bank credit growth[8] | In percentage



Sources: Banco de Portugal, Statistics Portugal (Banco de Portugal calculations).
Notes: The last observation refers to 2020 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 2019, the year-on-year decrease in real total credit[9] outstanding to the private non-financial sector (-0.6%) was chiefly driven by the decrease in real total credit outstanding to NFCs (-1.0%), while real total credit outstanding to households stayed constant on a year-on-year basis.

As previously mentioned, measures aiming at facilitating liquidity to both NFCs and households and at ensuring that banks continue to play their role in financing the real economy may have a substantial impact on the growth of bank credit to the private non-financial sector in the following quarters (especially to NFCs). Nevertheless, these are exceptional measures and of a temporary nature and may in fact be counteracted by other factors (such as the increase in the restrictiveness of the creditworthiness assessment by banks).

In fact, according to the April 2020 *Bank Lending Survey,* banks expect a strong increase in the demand for loans by NFCs for the second quarter of 2020, across different types of NFCs and loan maturities, in particular for short term loans. For households, in contrast, banks anticipate a strong contraction in the demand for loans, especially for house purchase. Regarding supply, banks foresee slightly tighter credit standards on loans to firms, in particular to large firms and long term loans. As regards households, credit standards are expected to become tighter in both types of credit (mortgages and consumer loans).

[7] Figures for the second, third and fourth quarters of 2019, and of the first quarter of 2020 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.

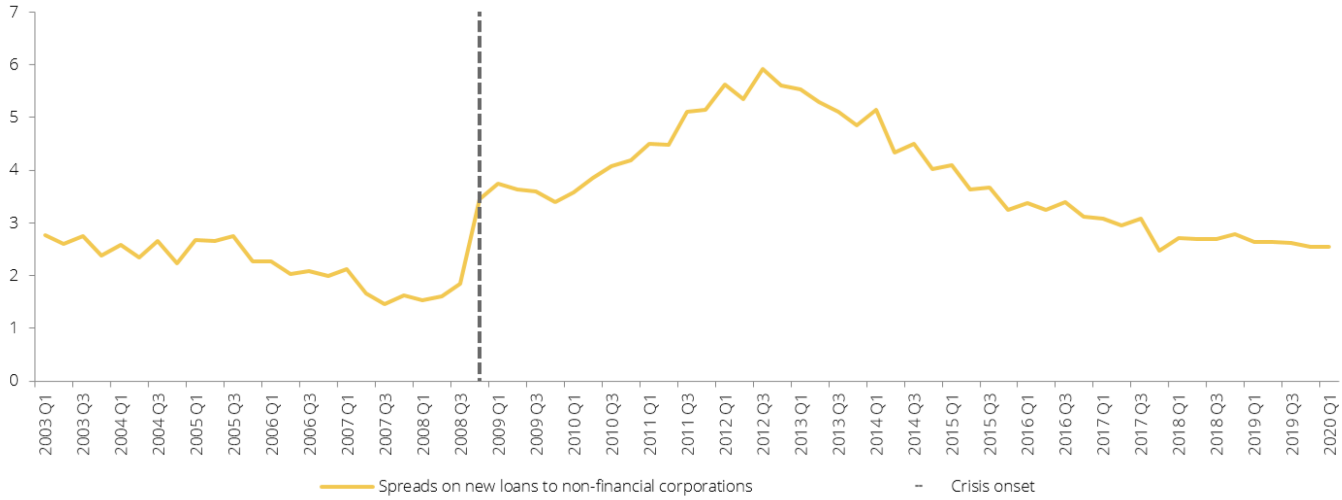
[8] Credit includes loans granted to the domestic private non-financial sector and debt securities issued by the domestic private non-financial sector. Bank credit granted by resident monetary financial institutions as available in Monetary and Financial Statistics published by Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by Statistics Portugal.

[9] 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.

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

In the first quarter of 2020, spreads on new lending granted to the private non-financial sector remained virtually unchanged, when compared to the levels observed in the previous quarter. Regarding the household segment, both new lending spreads for house purchase and for consumption and other purposes decreased by 0.1 p.p. (to 1.3 p.p. and to 5.9 p.p. respectively).[10] Conversely, new lending spreads to NFCs (up to one year) increased slightly by 0.1 p.p. to 2.6 p.p. (Chart 3).

Chart 3 • Spreads on new loans to non-financial corporations[11] | In percentage points



Sources: Banco de Portugal, Refinitiv (Banco de Portugal calculations).

Notes: The last observation refers to 2020 Q1. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

In March 2020, the average interest rate on new lending to households for house purchase reached 1.0%, declining by 0.1 p.p. when compared to December 2019, as well as the average interest rate on new loans for consumption and other purposes, which decreased by 0.1 p.p. to 5.6%. Concerning NFCs, the average interest rate on new lending (up to one year) remained unchanged at 2.2%, over the same period.

According to the April 2020 *Bank Lending Survey*, credit standards and terms and conditions applied on loans to NFCs and households remained, in overall terms, broadly unchanged in the first quarter of 2020, when compared with the previous period. This stabilisation was common to all credit types in both segments, namely loans to SME and to large firms, and loans for house purchase and consumer credit and other lending.

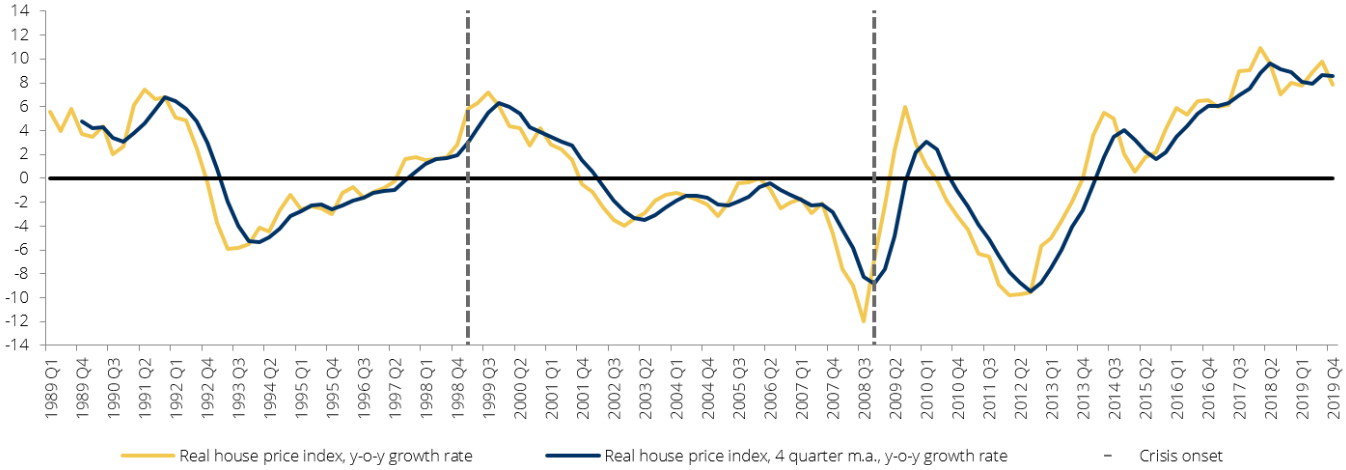
[10] In the case of households, the spread for house purchase is calculated against the six month Euribor rate, whereas that for consumption and other purposes is calculated against the three month Euribor rate.

[11] 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 continued to increase, but at a slower pace

In the fourth quarter of 2019, real house prices increased by 7.8% (year-on-year), slowing down when compared to the year-on-year growth rate registered in the previous quarter (9.8%) (Chart 4).

Chart 4 • Year-on-year growth rate of house prices, in real terms[12] | In percentage



Sources: Organization for Economic Co-operation and Development.

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.

Going forward, in the context of COVID-19 pandemic, it is expectable that house prices slowdown further. The fact that the pandemic is synchronised and broadly based across a great number of countries should tend to intensify the fall in economic activity, due to the collapse in world trade flows, part of it related to tourism, one of the main drivers of the recovery of house prices in Portugal since 2013. The non-resident investment in real estate should also be affected, at least in the short run, also contributing to the expected slowdown.

In this regard, the March 2020 *Portuguese Housing Market Survey*[13] points to (i) an abrupt deterioration in sentiment across the Portuguese residential real estate market, with measures put in place to tackle the spread of COVID-19 pandemic heavily restricting the outlook for sales activity, and (ii) negative price expectations at both the three and twelve-month time horizons, across all Portuguese regions.

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

In the fourth quarter of 2019, the loan-to-deposits ratio declined to 87.3%, reaching a new minimum since 2000. Loans decreased at a higher rate than deposits, leading to the slight reduction of this ratio, by 0.7 p.p., when compared with the previous quarter.

In the third quarter of 2019, the debt-service-to-income ratio[14] of the private non-financial sector declined from 14.9% to 14.4% (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. Nonetheless, and despite the current government measures to support the economy, the contraction of Portuguese economic activity, due to the COVID-19 outbreak and as projected in the March 2020 *Economic Bulletin*, is expected to carry negative consequences for the labour market, which might reduce household income and put pressure on their debt servicing capacity. This would, however, be mitigated by the maintenance of a low interest rate environment stemming from the monetary policy response to the aforementioned pandemic.

[12] 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.

[13] The Portuguese Housing Market Survey (PHMS), a joint initiative by Confidencial Imobiliário and the Royal Institution of Chartered Surveyors, provides a qualitative assessment of the sales and lettings markets, based on a monthly survey to a panel of real estate agents and developers.

[14] 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 turns into a surplus

In the fourth quarter of 2019, the seasonally adjusted current account balance of the Portuguese economy, as a percentage of GDP, turned into a small surplus of 0.2%, recovering from a deficit registered in the previous quarter (-0.6%). This surplus was mainly driven by the reduction in the deficit of the goods account. Moreover, according to the March 2020 *Economic Bulletin*, the projections for the Portuguese economy in both baseline and adverse scenarios point to (i) an improvement in the goods account deficit in 2020, reflecting the gains in terms of trade associated with the fall in oil prices, and (ii) a decrease in the services account surplus in the same period, driven by the particularly negative impact of the pandemic shock on tourism flows.

General assessment

Against the background of the COVID-19 pandemic, the micro and macroprudential authorities have taken measures regarding banks' capital requirements. In particular, both ECB and Banco de Portugal, as supervisors of significant and least significant institutions, respectively, will allow institutions to temporarily operate below the level of capital defined by the Pillar 2 Guidance (P2G), the combined buffer requirement, and the liquidity coverage ratio (LCR) requirement. This action taken by the supervisors aims at ensuring that banks continue to play their role in financing the real economy and, therefore, may contribute to the increase of new credit agreements in the private non-financial sector. Moreover, Banco de Portugal, as the national macroprudential authority, decided to postpone in one year the phase-in period of the O-SII buffers in Portugal, defined in 2017, to further contribute to the effort being done for banks to continue to fulfil their role in funding the real economy, as the economic effects of the pandemic become apparent. That said, one of the main objectives of capital is to absorb losses in times of stress and any use of the capital buffers, even with the capital relief measures announced, is a decision of banks, taking also into account the potential deterioration of borrowers' creditworthiness assessment and/or the need to absorb losses. Despite all the measures taken, banks need to keep adequate standards of credit underwriting.

Moreover, no time period was defined for banks to restore the required capitalisation levels observed before the COVID-19 outbreak. This should be articulated at European level, taking into account the period that will be necessary to stabilise the economy, the initial situation of banks in each Member State, and the different impact that this pandemic is expected to have on them.

Given the current context of a sudden and marked deterioration of the outlook for the Portuguese economy, reflecting the estimated negative consequences of the COVID-19 pandemic, which is surrounded by high uncertainty, the countercyclical capital buffer rate is maintained at 0% over the third quarter of 2020.

Banco de Portugal will continue to closely monitor the prospective developments in the risk assessment framework, arising particularly from the projected negative impact of the pandemic.