COUNTERCYCLICAL CAPITAL BUFFER

BANCO DE PORTUGAL
EUROSYSTEM

29 September 2017

Pursuant to a decision of the Board of Directors of 26 September 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 2 October 2017.

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

Credit-to-GDP gap measures decreased further in the first quarter of 2017

Both the Basel gap and the additional credit-to-GDP gap maintained their downward path in the first quarter of 2017, remaining negative and well below the threshold that would trigger a positive benchmark buffer rate. The Basel gap stood at -44.8 p.p. in the first quarter of 2017, which compares to -44.1 p.p. in the previous quarter, while the additional gap measure decreased from -13.4 p.p. in the end of 2016 to -14.4 p.p. in the first quarter of 2017 (Chart 1).

Chart 1 – Basel gap and additional credit-to-GDP gap[2]
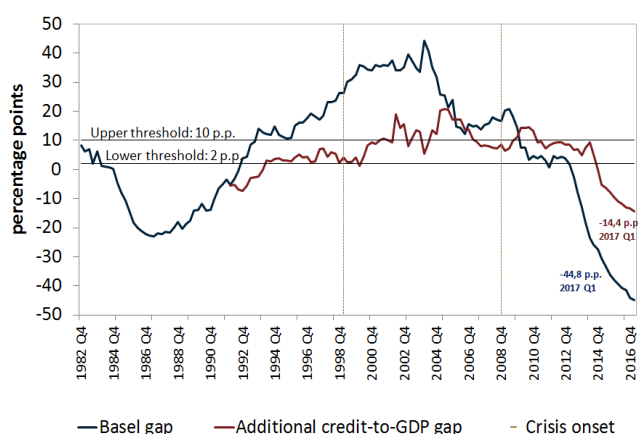
Sources: BdP, INE and BdP's calculations. Last observation: 2017 Q1.

The evolution of the credit-to-GDP gap measures reflects the diverging paths of nominal GDP and of the outstanding amount of credit granted to the private non-financial sector. In fact, while the former is expected to continue increasing during 2017, at a rate of 2.5%, according to Banco de Portugal's projections, the latter is expected to present negative growth rates.

The deleveraging process of the private non-financial sector continues

Bank credit to the private non-financial sector has continually depicted negative growth rates from the fourth quarter of 2010 until the second quarter of 2017.

The ratio between the one year absolute difference in bank credit and the five year moving average of nominal GDP is another early indicator of credit imbalances. As Chart 2 shows, this ratio continued to be negative in the first quarter of 2017 (-17.7 per cent), despite the more recent upward trend (from -18.7 per cent in the previous quarter).

Chart 2 – Ratio of the 1y difference in bank credit and the 5y m.a. of GDP[3]
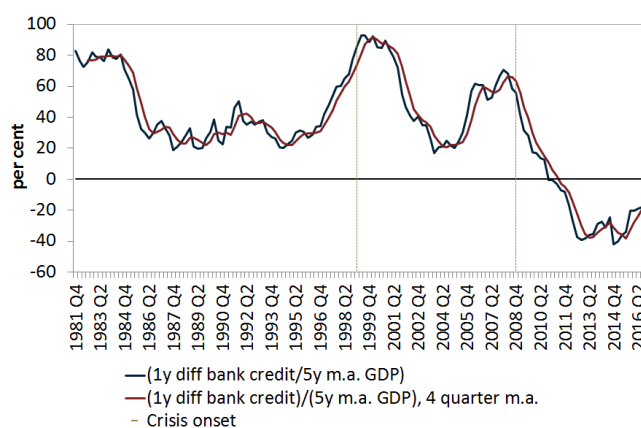
Sources: BdP, INE and BdP's calculations. Last observation: 2017 Q1.

Bank credit granted to households for house purchase has been steadily decreasing over the last years and this trend has continued in the second quarter of 2017.

On the other hand, consumer credit has increased, in the second quarter of 2017, in consonance with the upward trend observed in last years. Notwithstanding, its share in the total outstanding amount of credit granted to the non-financial sector remains quite low, albeit increasing to seven per cent in the first quarter of 2017.

The outstanding amount of total credit granted to non-financial corporations has decreased in the first quarter of 2017 (year-on-year growth rate of real credit of -3.9%). However, this path may reflect some heterogeneity regarding the sources of firms' financing. In fact, the reduction in credit granted by resident banks seems to be partially compensated by cross-border financing. This trend has been observed during 2016 and also in the first five months of 2017, being related to intragroup financing.

Overall, the ratio of credit-to-deposits of Portuguese banks diminished in the first quarter of 2017 vis-à-vis the last quarter of 2016, remaining below 100% (94.3%), reflecting banks' more stable funding sources.

Signs of less restrictive lending conditions

In May 2017, the average interest rate on new loans to non-financial corporations has reached a new historical minimum of this series, while banks' spreads on new lending to non-financial corporations, in the first quarter of 2017, remained at 3.1 p.p., as in the previous quarter. Despite the decline observed in recent years, banks' spreads are still above the pre-crisis levels. Moreover, the evidence available continues to show that lending continues to be mainly channeled to the less risky firms (June 2017 Financial Stability Report).

According to the July 2017 Bank Lending Survey, credit demand by non-financial corporations has slightly increased, mainly in the SME's segment and centered in long term loans. Similarly, for the households segment, banks reported a slight increase in demand for loans for house purchase, with some institutions referring a slight increase in demand for loans for consumption and other purposes.

In the July 2017 Bank Lending Survey, banks have reported that credit conditions remained stable in the second quarter of the current year, both for non-financial corporations and households. However, credit standards applied by banks in new credit operations seem to become less restrictive, at least in some segments. This tendency is observed in the households' segment, in particular, where some metrics, such as maturities and loan-to-value ratios at origination, are loosening. Moreover, spreads applied to mortgages continued to register a steady decline and average interest rates have reached a new historical minimum of the series in May 2017 (1.7%). To the extent that these practices may indicate a potential mispricing of risk in bank lending markets, they must be closely monitored.

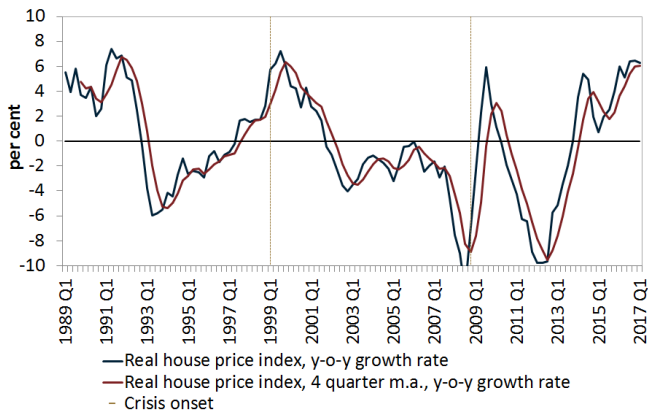## Indicators of debt sustainability of the private non-financial sector continue to improve

The debt-service-to-income ratio of the non-financial private sector continued to decrease, from 17.3% in the third quarter of 2016 to 16.9% by the end of the year. This trend reflects both households and non-financial corporations' improvement of debt servicing capacity.

The reduction in the outstanding amount of credit granted to these sectors, the continued decrease in interest rates and the improvement in general economic conditions (including the increase in available income) have contributed to a further reduction in the year-on-year growth rate of this indicator.

House prices maintain an upward trend

One risk underlying the current low interest rate environment relates to the potential search-for-yield behavior and price misalignments (in the real estate market, for instance).

The year-on-year growth rate of the real house prices index and its four quarter moving average increased 6.3 and 6.1 per cent, respectively, in the first quarter of 2017 (Chart 3). Despite the steady upward trajectory of house prices, which are already close to the historical maximum in nominal terms, there is no straightforward link with domestic credit. In fact, despite the acceleration of the flow of new credits for house purchase in the first semester of 2017, the outstanding amount of bank credit granted to households for house purchase is still decreasing, though at a slower pace. In any case, these recent developments in the real estate markets and the drivers behind them need to the closely monitored.

Chart 3 – Real House Prices[4]

- Real house price index, y-o-y growth rate
- Real house price index, 4 quarter m.a., y-o-y growth rate
- Crisis onset

Sources: BdP, Reuters and BdP's calculations. **Last observation:** 2017 Q1.

Current account continues to present a surplus

The seasonally adjusted current account has improved from 1.3 per cent in the last quarter of 2016 to 1.8 per cent of GDP in the first quarter of 2017. The four quarter moving average of the seasonally adjusted current account has also improved, from 1 per cent of GDP in the last quarter of 2016 to 1.1 per cent in the first quarter of 2017.

The current account has also improved on a year-on-year basis, driven by an improvement in the balance of Services surplus - albeit not enough to offset the deterioration in the Goods balance -, and an improvement in the Income(s) balance net account.

As such, the correction of the external imbalances at the aggregate level continues to progress.

General assessment

Overall, the available quantitative and qualitative information does not signal the build-up of imbalances related to cyclical systemic risk. Still, there is some evidence of a loosening of credit standards in lending operations, mainly in the households segment. In addition, house prices growth in real terms is accelerating, though these developments do not seem to be directly related with domestic credit dynamics.

The further reduction in the outstanding amount of credit granted to the non-financial private sector, in the second quarter of 2017, together with the positive GDP growth, led to a negative and decreasing credit-to-GDP gap measures. Taking into account recent credit developments and

prospects of negative gap measures over the next quarters, Banco de Portugal decided to keep the countercyclical buffer rate at zero per cent of total risk exposure amount as of 2 October 2017.

Notes

1   The assessment is based on available data up to 26 July 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?03a7c5c908620b34673b6f290b5 4c13d.

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   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 BdP. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by INE.

4   Real house price index (2010=100) produced by the OECD. The house price index is adjusted for inflation using the private consumption deflator (2010=100) taken from the National Accounts. The OECD has identified one main nominal index for each country that covers the prices for the sale of newly-built and existing dwellings.

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
SME	Small and Medium Enterprises