

# COUNTERCYCLICAL CAPITAL BUFFER



28 September 2018

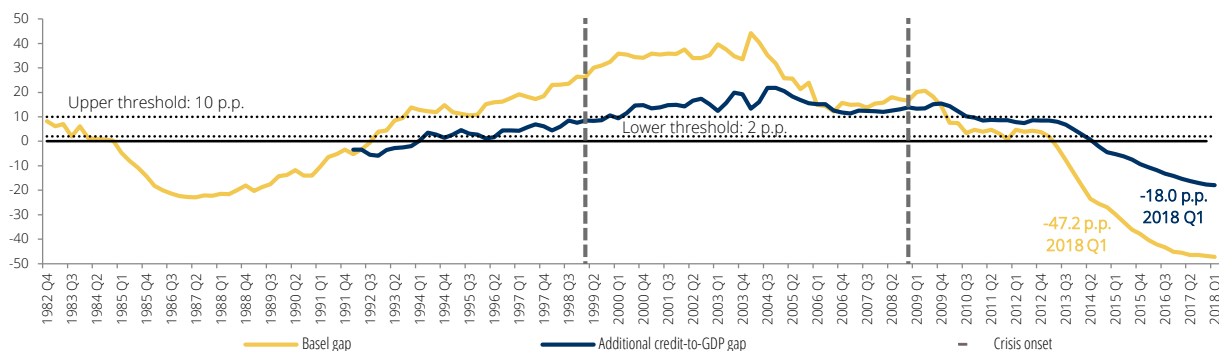
Pursuant to a decision of the Board of Directors of 24 September 2018, the countercyclical buffer rate for credit exposures to the domestic private non-financial sector will remain at 0% of the total risk exposure amount, with effect from 1 October 2018.

This decision is based on the overall assessment of a set of financial and macroeconomic indicators.<sup>1</sup>

## Credit-to-GDP gap measures remain at negative levels

In the first quarter of 2018, the Basel gap reached -47.2 percentage points (p.p.) and the additional credit-to-GDP gap -18.0 p.p. (Chart 1). The credit-to-GDP ratio continued its downward trajectory, initiated in 2013, driven by both GDP growth and the decline in the total credit outstanding amount to the private non-financial sector.

**Chart 1** Basel gap and additional credit-to-GDP gap<sup>2</sup> | In percentage points



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

Notes: The last observation is dated 2018Q1. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

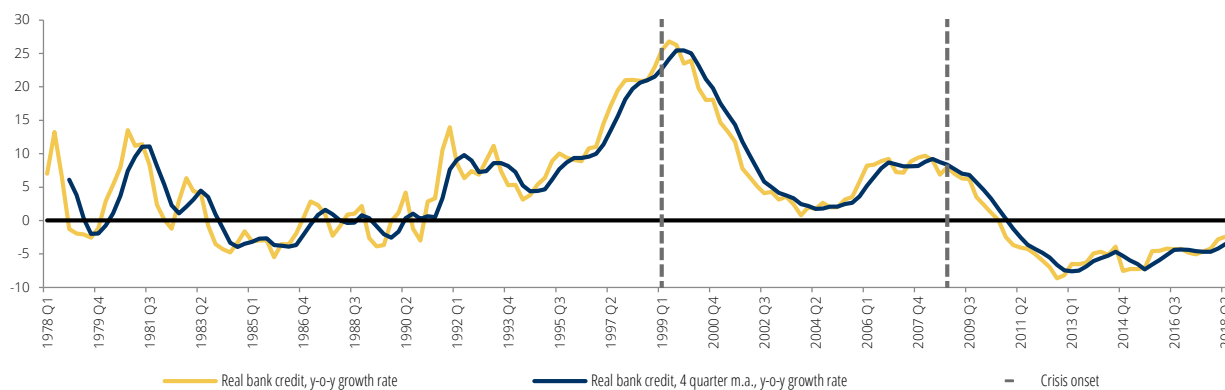
<sup>1</sup> The assessment is based on data available up to 26 July 2018. Any differences in figures from previous assessments are due to revisions in underlying data. The set of indicators covers the six categories set out in Recommendation ESRB/2014/1.

<sup>2</sup> 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](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.

According to the projections published in the June 2018 *Economic Bulletin* of Banco de Portugal, this trend may persist in the near future (2018-20), driven by the projected GDP growth, reaping the benefits of a favourable economic and financial environment. Furthermore, households and non-financial corporations are expected to maintain their deleveraging<sup>3</sup> path, albeit at a slower pace than the observed in the last periods.

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

**Chart 2** Real bank credit growth<sup>4</sup> | In percentage



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

Notes: The last observation is dated 2018 Q2. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

The real bank credit outstanding amount to the private non-financial sector contracted 2.4% (year-on-year) in the second quarter of 2018 (Chart 2). Regarding households, the observed decline (-1%) reflects the combined effect of a slight decrease of credit for house purchase (-1.9%) and the continuing momentum in credit for consumption (increase of 12.9%), mainly due to the labour market recovery, the increase in consumer confidence and the continued private consumption growth. However, credit for consumption only accounts for 12.6% of the total real bank credit stock granted to households (as of the second quarter of 2018). Concerning non-financial corporations, real bank credit decreased 4.3%, in the second quarter of 2018 (year-on-year). All in all, the year-on-year increase in new loans granted by the banking sector remained below the volume of repayments and write-offs.

In what concerns total credit granted to the private non-financial sector, it continued to decline, in the first quarter of 2018 (-1.6%, in real terms, when compared with the first quarter of 2017), resulting from the decrease in the outstanding credit to households and non-financial corporations. The growth of new credit granted to non-financial corporations remained negative, in the first quarter of 2018 (as observed in the previous quarter), due to a sharp reduction of debt securities issued (mainly placed with non-residents investors), which was only partly offset by the positive flow of loans from the resident banking system. As to households, a slightly negative flow of credit was observed in the first quarter of 2018, interrupting the positive flows observed in the two previous quarters.

Despite the continued downward trajectory, both in total credit and in real bank credit, the decline has been decelerating in recent periods.

The ratio between the one year absolute difference in bank credit and the five year moving average of nominal GDP remained negative (-9.4%), in the first quarter of 2018, above the ratio observed in the previous quarter (-12.8%) mirroring the aforementioned deceleration in credit's downward trajectory.

Taking into account the analysis above, there are no signs of a cyclical systemic risk regarding credit growth which would justify an adjustment of the countercyclical buffer rate.

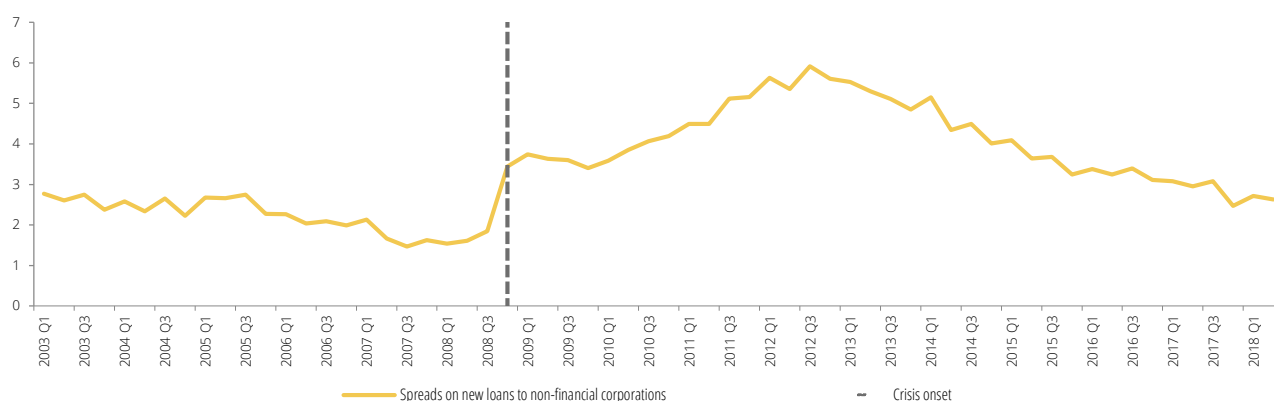
<sup>3</sup> Measured by non-financial corporation debt in percentage of GDP and by household debt in percentage of disposable income.

<sup>4</sup> 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.

## Slightly less restrictive lending spreads

In the second quarter of 2018, new lending conditions to the private non-financial sector revealed slightly less restrictive lending spreads when compared to those observed in the previous quarter. In the case of non-financial corporations, banks' spreads on new lending up to one year decreased 0.1 p.p. to 2.6 p.p., in the second quarter of 2018, when compared with the previous quarter (Chart 3). On average, spreads in this segment are already close to the pre-crisis average, despite the existing differentiation in spreads on new loans according to the firms' risk profile.<sup>5</sup> Additionally, according to the information provided in the *Bank Lending Survey* of July 2018, the participating Portuguese credit institutions, in general, do not foresee adjustments in credit terms and conditions as well as in spreads applied on loans to non-financial corporations, over the next six months.

**Chart 3** Spreads on new loans to non-financial corporations<sup>6</sup> | In percentage points



Sources: Banco de Portugal, Thomson Reuters and Banco de Portugal calculations.

Notes: The last observation is dated 2018 Q2. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Spreads on new lending for house purchase decreased 0.1 p.p. to 1.7 p.p., in the second quarter of 2018, when compared with the previous quarter, whereas those related to credit for consumption and other purposes decreased 0.1 p.p. to 6.4 p.p., in the same period. These spreads remain above the pre-financial crisis average in both credit segments. According to the information provided in the *Bank Lending Survey* of July 2018, the participating Portuguese credit institutions do not anticipate significant changes in spreads for credit granted to households, over the next six months. But, in what concerns credit terms and conditions, the majority of the participating credit institutions foresee slightly tighter credit standards applied on loans to households in both segments.

In June 2018, the average interest rate on new lending to non-financial corporations decreased 0.1 p.p. to 2.3%, in comparison with the level observed in March 2018, whereas the average interest rate on new lending to households reached 3.2%, in June 2018, decreasing 0.2 p.p. when compared with March 2018.

The analysis above points to the absence of a significant decrease of lending spreads, whose levels remain above those observed before the crisis. Nonetheless, Banco de Portugal will continue monitoring their evolution, jointly with other credit terms and conditions underlying new loans granted to firms and households (also in the context of the recent Recommendation, issued by Banco de Portugal, which entered into force on 1 July 2018).<sup>7</sup>

In the fourth quarter of 2017, the debt-service-to-income ratio<sup>8</sup> of the private non-financial sector continued its downward path, reaching 16.1% (representing a year-on-year decrease of 0.8 p.p.). This reduction is explained by the improvement in households' disposable income and firms' profitability, coupled with the more favourable funding

<sup>5</sup> Special issue "Risk segmentation on the interest rate spreads of new bank loans to non-financial corporations", Banco de Portugal, Financial Stability Report, December 2017.

<sup>6</sup> 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 Thomson Reuters. 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.

<sup>7</sup> More information on this macroprudential measure is available at <https://www.bportugal.pt/en/page/ltv-dsti-and-maturity-limits>.

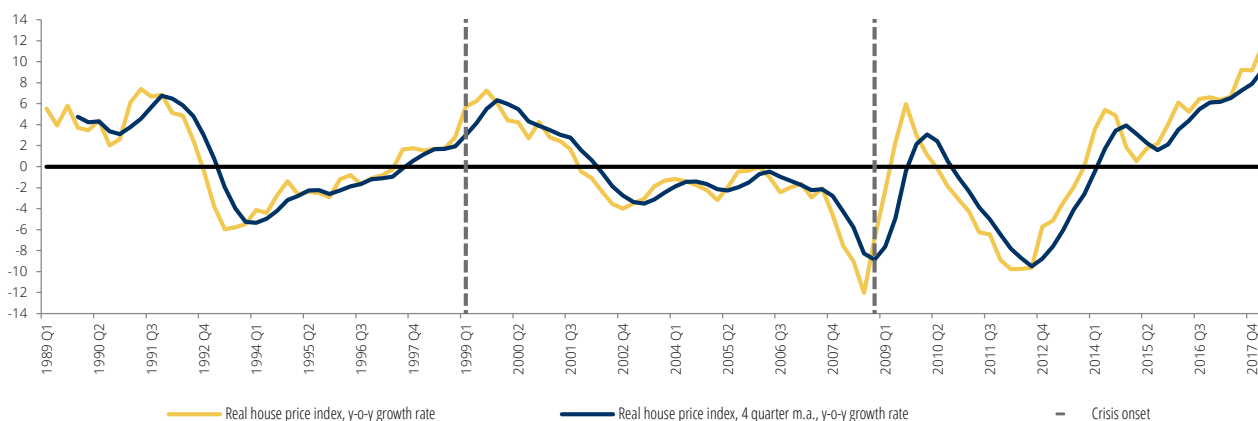
<sup>8</sup> Debt-service-to-income ratio estimates published by the Bank for International Settlements for the private non-financial sector, which uses gross disposable income as a proxy for income. Available at <http://www.bis.org/statistics/dsr.htm>.

conditions, as a result of the current low interest rates. According to the June 2018 *Economic Bulletin* of Banco de Portugal, households' real disposable income is expected to maintain its growing path in the projected horizon (2018-20), which, coupled with the expected exports growth, can result in a continued improvement of firms' profitability. Moreover, household and corporate indebtedness are expected to continue their downward path over the projection horizon, albeit at a slower pace than in the past few years. Against this background, and despite the expected increase of the short-term interest rate, stemming from the gradual withdrawal of monetary stimulus, which should occur at a gradual pace and in a context of economic recovery, we do not expect a significant increase in the debt-service-to-income ratio in the short-run.

## House prices maintain an upward trend

Real house prices maintained an upward trend in the first quarter of 2018, in line with the previous assessment reports. After a significant price reduction in real terms between 2010 and 2013, house prices recorded robust and increasing growth rates in the past few years. The year-on-year growth rate for the first quarter of 2018 rose to 11.5% (Chart 4).

**Chart 4** Year-on-year growth rate of house prices, in real terms<sup>9</sup> | In percentage



Sources: Organization for Economic Co-operation and Development.

Notes: The last observation is dated 2018 Q1. m.a. stands for moving average. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Price dynamics of the residential real estate market seems to be mainly driven by demand by non-residents, caused by the strong dynamics of the tourism sector, in particular local accommodation, and foreign investment in this market. The rebound of households' disposable income, their preference for home ownership, the favourable funding conditions and the declining unemployment should also contribute to the current evolution of house prices. As to housing supply, the number of building permits and completed buildings for family housing has been gradually recovering. This may have, in the future, a potential effect in dampening house prices growth.

In line with what was mentioned in the previous quarterly assessment, house prices, in aggregate terms, remain, in the first quarter of 2018, slightly above their economic fundamentals (according to the ECB average valuation measure). Additionally, there is still no evidence that domestic credit developments are the main driver underlying the residential real estate price dynamics in Portugal. Nonetheless, Banco de Portugal will continue to closely monitor further developments in this market.

<sup>9</sup> Real house price index (2010=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.

## Additional indicators do not signal the emergence of imbalances

The loan-to-deposits ratio remained at 92.5%, in the first quarter of 2018, when compared with the previous quarter. The narrowing of this ratio from its peak, in June 2010, points to a substantial adjustment towards funding sources less sensitive to changes in the risk perception of international investors.

The Portuguese economy continued to present a seasonally adjusted current account surplus (0.02% of GDP in the first quarter of 2018), decreasing 0.94 p.p. when compared with the previous quarter. The seasonally adjusted current account was also positive in April and May 2018, as reported in the July 2018 *Statistical Bulletin* of Banco de Portugal. According to the June 2018 *Economic Bulletin* of Banco de Portugal, the current account is expected to remain positive over the period 2018-20, explained by the favourable economic and financial environment, albeit some different dynamics might be observed in goods and services balance, reflecting a rise of goods deficit and an increase of services surplus.

## General assessment

In line with the previous risk assessment, and despite the developments in the residential real estate market, the current outlook does not provide evidence of emerging cyclical systemic risk in Portugal which would justify an adjustment of the countercyclical buffer rate, over the fourth quarter of 2018.