# COUNTERCYCLICAL CAPITAL BUFFER

30 SEP. 2020

Pursuant to the decision of the Board of Directors of 22 September 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 October 2020.

The current financial and macroeconomic context is characterised by the severe negative shock caused by the COVID-19 pandemic and the uncertainty associated to the pace of the subsequent economic recovery. In this setting, it is important to promote that financial institutions have the ability to absorb losses and maintain a stable flow of credit to the economy.

This decision is based on the overall assessment of a set of financial and macroeconomic indicators.[1] However, in the current context of severe and abrupt materialization of risks, it is important to complement the analysis with additional indicators that can signal contemporaneously stress in the financial system and the economy. To this end, the current assessment includes the Banco de Portugal composite indicator of financial stress and an economic sentiment indicator along with some of the indicators used in previous analyses of cyclical systemic risk.

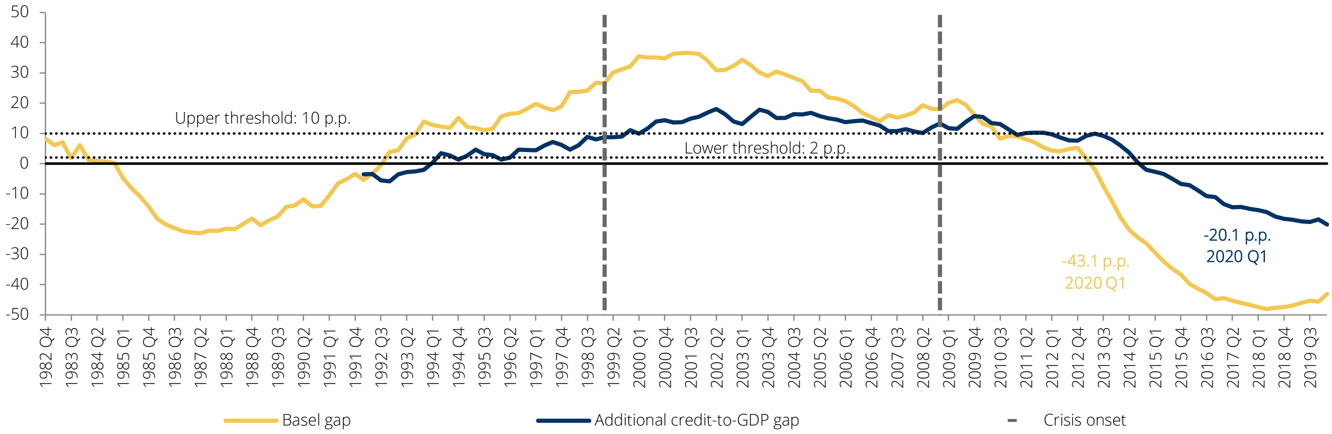
## Credit-to-GDP gap measures remain at negative levels

Credit-to-GDP gap measures remain at negative levels. In the first quarter of 2020, the Basel gap reached -43.1 percentage points (p.p.), still well below the threshold of 2 p.p. that would trigger a positive benchmark buffer rate, while the additional credit-to-GDP gap fell to -20.1 p.p. (Chart 1). These figures indicate that the credit-to-GDP ratio remains below its long-term trend. The credit-to-GDP ratio increased from 160.8 p.p., in the fourth quarter of 2019, to 161.1 p.p., in the first quarter of 2020, thus interrupting its downward trajectory observed since 2013. The observed increase in the credit-to-GDP ratio is attributed to the fall of 0.7% in nominal GDP in the first quarter of 2020, year-on-year, while total credit to the private non-financial sector remained relatively stable.

According to the projections published in the June 2020 *Economic Bulletin* of the Banco de Portugal, GDP is expected to drop by 9.5% in 2020, mainly due to the negative impact of the pandemic in the first half of the year. In the first quarter of 2020, the Portuguese economy recorded a significant contraction, as GDP decreased by 3.8% quarter-on-quarter, the largest decline since quarterly series are published. As for the second quarter of 2020, the preliminary estimate, published by Statistics Portugal, points to a quarter-on-quarter GDP rate of change of -14.1%, reflecting the more severe impact of the pandemic in this period. The main risks underlying the Banco de Portugal's projections are on the downward side, as a new wave of infections may require the reintroduction of containment measures, implying a more severe and persistent effect on economic activity. In fact, the projections for the Portuguese economy under the adverse scenario, characterised by a more intense spread of the virus in Portugal and in the rest of the world, point to a decrease in GDP of 13.1% in 2020.

[1] The assessment is based on data available up to 23 July 2020. Any differences in figures from previous assessments are due to revisions in underlying data.

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




Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2020Q1. p.p. stands for percentage points. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

Overall, the credit-to-GDP ratio is expected to increase in 2020 considering the severe impact of the COVID-19 pandemic on economic activity, given that GDP is expected to fall sharply, and the measures taken by European and national authorities with the objective of providing liquidity to non-financial corporations (NFCs) and households that are likely to contribute to an increase, at least in the short-term, of total credit granted to the private non-financial sector.

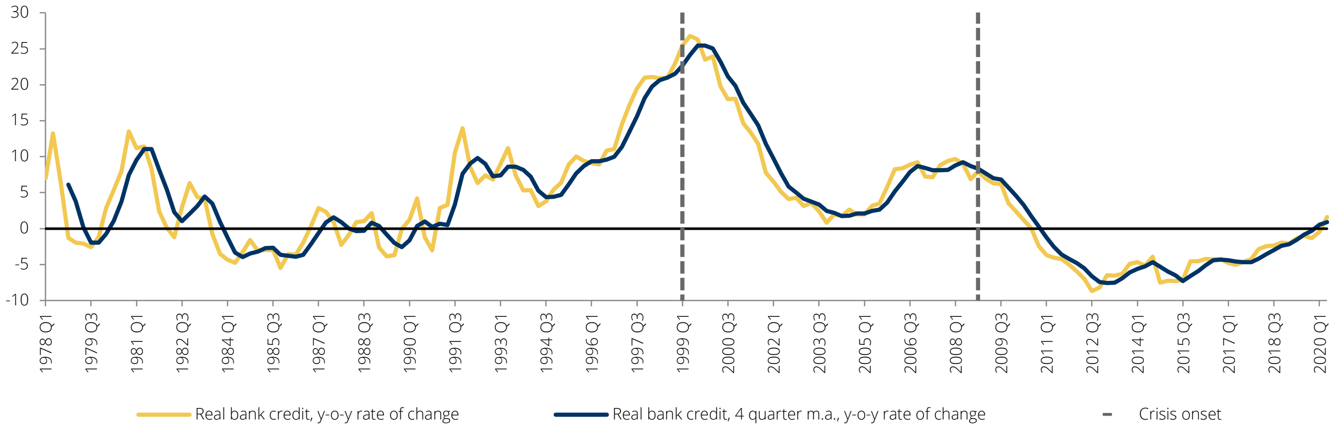
## In the second quarter of 2020, real bank credit granted to the non-financial private sector increased for the first time since the fourth quarter of 2010

In the second quarter of 2020, real bank credit outstanding to the private non-financial sector increased 1.6% (year-on-year), interrupting the downward trend observed since 2010. This dynamic reflects a year-on-year increase in real bank credit outstanding to NFCs of 2.2% and to households of 1.2%, which compares to -1.8% and 0.5% in the previous quarter, respectively. Regarding NFCs, this is the first increase observed since the second quarter of 2010. As for households, the increase in the real bank credit results from an increase of 0.8% in credit for house purchase and 2.6% in credit for consumption and other purposes, which compare to a year-on-year growth rate of -0.2% and 3.5% in the previous quarter, respectively.

In this period, the year-on-year growth rate of new loans to NFCs reached 47.9%, which represents a significant increase relative to previous quarters (11.3% in the first quarter of 2020). Regarding households, new loans decreased 14.3% in the second quarter of 2020, thereby contrasting with the upward momentum observed since the fourth quarter of 2013. The reduction in new loans to households reflects a reduction in both segments: house purchase (-3.3%) and consumption and other purposes (-30.7%).

[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.

**Chart 2** • Year-on-year rate of change of real bank credit[3] | In percentage




Sources: Banco de Portugal, Statistics Portugal and Banco de Portugal calculations.
Notes: The last observation refers to 2020 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 measures taken by the Portuguese government in response to the COVID-19 crisis aimed at providing liquidity to NFCs and households contributed to the increase of real bank credit in the second quarter of 2020. New credit lines with public guarantees were launched, while previously contracted credit lines were prohibited from being revoked, facilitating the access to liquidity by NFCs. Similarly, loan moratoria (both public and private) were applied to credit previously granted to households and NFC, thus enabling the temporary suspension of payments associated with the debt service.

The reported data is in line with the July 2020 *Bank Lending Survey*[4], which indicates a significant increase in the demand for new loans by NFCs in the second quarter of 2020, mainly motivated by inventories or working capital financing and, to a lesser extent, debt refinancing. In contrast, the demand for new loans by households in the same period decreased, according to the *Bank Lending Survey*, especially in the segment of credit for consumption, in response to the deterioration in consumer confidence. Regarding the supply of credit in the second quarter of 2020, banks reported a tightening of credit standards on loans to both NFCs and households when compared to the previous quarter, as a result of a lower risk tolerance and an increase in risks related to the economic outlook. In the previous quarter, banks had reported a tightening of credit standards on new loans to households whereas in the case of NFCs credit standards remained unchanged. For the third quarter of 2020, banks anticipate that credit demand from NFCs will tend to increase and that credit demand from households will stabilize. Credit standards are expected to tighten further for NFCs, mainly for SMEs, and for credit for consumption.

In June 2020, the average interest rate on new lending to households was 1.2% for house purchase and 5.3% for consumption and other purposes, which compare to 1.0% and 5.6%, respectively, in March 2020, thus remaining relatively stable. Regarding NFCs, the average interest rate on new lending decreased from 2.1%, in March 2020, to 1.7%, in June 2020. This reduction was driven by the interest rates of loans up to 1 million euros, which decreased from 2.4%, in March 2020, to 1.8%, in June 2020, possibly reflecting the introduction of the new credit lines with public guarantees. The interest rates for loans above 1 million euros remained stable in this period, standing at 1.6% in June 2020.

The amount of deposits and deposit-like instruments held by households increased by 6.2% (year-on-year) in June 2020, whereas the amount of NFCs' deposits increased by 19.0% in the same period. These dynamics indicate that households and NFCs continue to provide the banking sector a stable source of funding. The increase in deposits by NFCs should be associated with the increase of short-term borrowing by firms to prevent liquidity shortages.

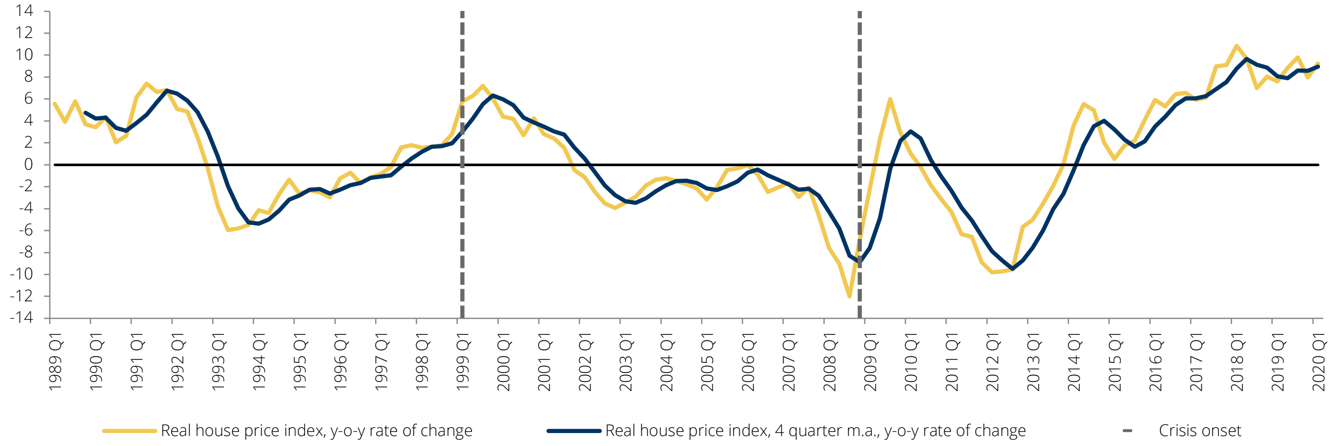
[3] Bank credit granted by resident monetary financial institutions as available in the Statistical Bulletin published by the Banco de Portugal. The credit variable is adjusted for inflation using the consumer price index (2012=100) published by Statistics Portugal.

[4] More information is available on https://www.bportugal.pt/sites/default/files/anexos/pdf-boletim/results_jul2020_en.pdf

## The growth rate of real house prices remained high, in the first quarter of 2020, but some downward correction in prices is expected going forward

In the first quarter of 2020, real house prices increased 9.3% (year-on-year), which compares to 8.0% in the previous quarter (Chart 3), while the number of transactions decreased 0.7% (year-on-year). Going forward, house prices are expected to slowdown considering the drop in economic activity and international trade flows, and, in particular, in tourism, associated with the COVID-19 pandemic.

**Chart 3 • Year-on-year rate of change of house prices, in real terms[5] | In percentage**




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

According to the results from the June 2020 *Portuguese Housing Market Survey*[6], the housing market sentiment remains cautious as the survey's respondents reported a decrease in buyer enquiries, sales and prices. Going forward, the majority of survey respondents expects house prices to fall. In addition, the results from the June 2020 *Survey on bank evaluation on housing*[7] indicate that the year-on-year growth rate of the median value of bank appraisals has been decreasing since the beginning of 2020, reaching, in June 2020, 8.3%, the lowest value since April 2018. The number of bank appraisals also decreased sharply in June 2020 (27.5% lower than in June 2019).

As detailed in the June 2020 *Financial Stability Report*, the above mentioned factors related to the pandemic crisis (drop in economic activity and a deterioration in housing market sentiment) exert a negative pressure in house prices with possibly persistent effects. However, the low interest rate environment and the high return rate of real estate in comparison to other assets might lessen the negative impact on house prices, at least in the short-run.

## After having increased abruptly, the composite indicator of financial stress for Portugal has, more recently, started to decline

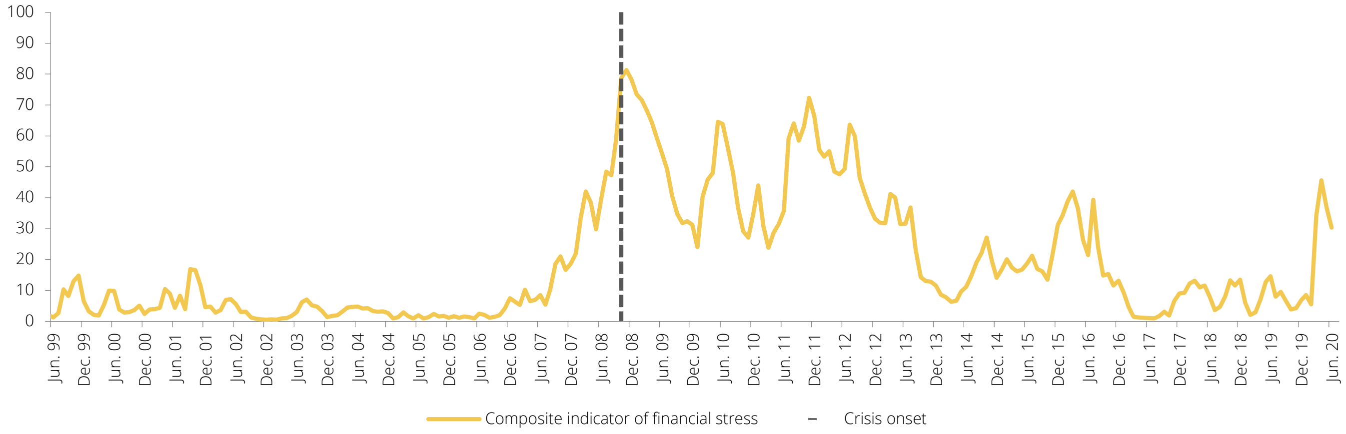
In April 2020, the Banco de Portugal composite indicator of financial stress for Portugal (Chart 4) recorded its highest value (45.6) since September 2012, during the sovereign debt crisis. In the following months, the indicator fell slightly, reaching 30.3 in June 2020, a value still indicating a high degree of financial stress and still well above the figures recorded between 2017 and the beginning of 2020 (a period characterised by relative economic and financial stability in Portugal). The relatively high financial stress signalled by the indicator reflects the increase in uncertainty and intense search for liquidity as the propagation of the COVID-19 virus achieved global proportions. The reduction of the indicator since April 2020 may come as a result of the measures taken by European and national authorities to support of both the financial system and the real economy.

[5] 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 (2016=100) taken from the National Accounts (ESA2010, base 2016) published by Statistics Portugal.

[6] 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.

[7] More information is available on https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=415140902&DESTAQUESmodo=2

**Chart 4 • Composite indicator of financial stress[8] | Quantile rank**



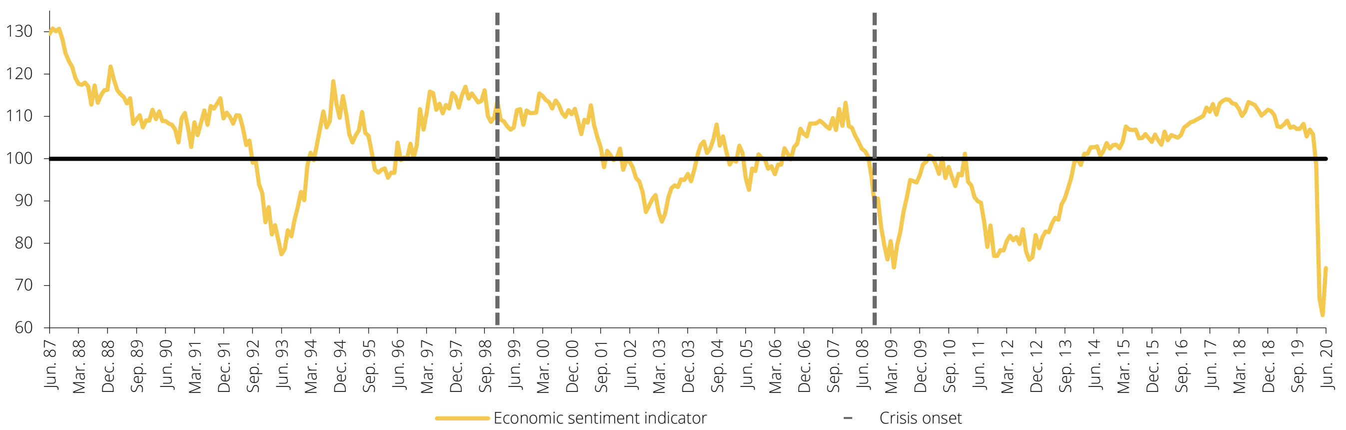

Source: Banco de Portugal.
Notes: The last observation refers to June 2020. Dates for crises onset as defined in the ESCB Heads of Research Group's banking crises database.

## The economic sentiment indicator for Portugal recorded its lowest ever value

The European Commission economic sentiment indicator for Portugal has recorded its lowest ever value in May 2020 (63), subsequently recovering to 74.1 in June (Chart 5). This indicator provides a broad overview of the current conditions of economic activity and near future perspectives regarding the private non-financial sector on a monthly basis, by combining survey data encompassing industry, services, retail, construction and consumer confidence.

The sharp reduction of this indicator is another sign of a severe downturn in the Portuguese economy as a consequence of the lockdown measures enacted amid the COVID-19 pandemic. The most affected sector in this period has been the services sector, which includes tourism, restaurants and entertainment, with the services confidence indicator also recording a record low value of -51.2 in May 2020. Additionally, in April 2020 the consumer confidence indicator recorded its lowest value (-36.3) since September 2013.

**Chart 5 • Economic sentiment indicator | Index (2000-2019 average = 100)**




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

[8] For more information on the Composite indicator of financial stress see Braga, J. et.al (2014), "Composite Indicator of Financial Stress", *Financial Stability Papers*, Banco de Portugal, available on https://www.bportugal.pt/sites/default/files/anexos/papers/paper_1_en_0.pdf

According to the results of the *Fast and Exceptional Enterprise Survey,* published on 29 July 2020[9], with respect to the first fortnight of July 2020, (i) 99% of the responding NFCs were operating, even if partially, (ii) 58% reported a decrease in activity in relation to the expected situation without a pandemic and (iii) 24% of NFCs reported a reduction in the number of effectively working versus the expected scenario without pandemic. These results suggest an improvement in the situation of NFCs in relation to the second quarter of 2020[10] where 90% of the responding NFCs were operating even if partially, 74% of NFCs reported a decrease in activity and 48% of NFCs reported a reduction in the staff effectively working, relative to the expected situation without the pandemic.

# General assessment

The countercyclical capital buffer is a macroprudential instrument designed for improving the resilience of the financial system against negative shocks. Banks accumulate capital during the upward phase of the financial cycle that is released during crisis/stress events, allowing the absorption of potential losses coming from exposures to the private non-financial sector. Its purpose is then to prevent a credit crunch during crisis/stress periods characterised by elevated financial stress and thus contribute to the stable financing of the real economy during such periods.

Given the current negative outlook for both the Portuguese and the world economy, reflecting the negative consequences of the COVID-19 pandemic, along with high uncertainty surrounding the recovery, the countercyclical capital buffer rate is maintained at 0% over the fourth quarter of 2020.

The Banco de Portugal will continue to closely monitor the developments in cyclical systemic risk, arising particularly from the current and the projected negative impact of the pandemic.

[9] More information is available on https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=442426360&DESTAQUESmodo=2&xlang=en

[10] More information is available on https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=440671964&DESTAQUESmodo=2&xlang=en