



Assessment Team on national macroprudential measures

Assessment of a Portuguese notification in accordance with Article 133 of Directive (EU) 2013/36/EU concerning the application of a systemic risk buffer set between 3% and 5%

Introduction

On 4 October 2023 the European Systemic Risk Board (ESRB) Secretariat received a formal notification from the Banco de Portugal on the activation of a new sectoral systemic risk buffer (sSyRB), pursuant to Article 133 of the Capital Requirements Directive (CRD)¹. The proposal is to introduce a sSyRB of 4%, for banks using the internal ratings-based (IRB) approach, on retail exposures secured by residential immovable property for which the collateral is located in Portugal. The proposed measure is to be in place from 1 October 2024 and also be applicable to two subsidiaries whose parents are established in another Member State.

The ESRB must, within six weeks of receipt of the notification, issue a recommendation as to whether the sSyRB is appropriate, pursuant to Article 133(11) of the CRD. An ESRB recommendation is required by Article 133(11) of the CRD as the sSyRB rate is set at a level higher than 3% and up to 5% and it applies to two institutions that are subsidiaries of parents established in another Member State. The European Commission must also provide its recommendation on the measure within six weeks of receipt of the notification.²

In order to avoid leakages and regulatory arbitrage following the introduction of the proposed measure, the Banco de Portugal also on 4 October 2023 asked the ESRB to issue a recommendation to other Member States to reciprocate the measure under Article 133 of the CRD, in line with Article 134(5) of the CRD. The reciprocation request will be dealt with in a separate note referring to cross-border and internal market effects.

The role of the Assessment Team is to prepare a recommendation on the appropriateness of the macroprudential policy measure of which the ESRB has been notified, with regard to relevant requirements under the CRD, from a macroprudential and financial stability perspective. Pursuant to Article 133(8) of the CRD, the systemic risk buffer should not entail disproportionate adverse effects on the financial system in other Member States, or the EU as a whole, that form or create an obstacle to the proper functioning of the internal market. It should be reviewed at least every second year and it should not address risks covered by Article 130 or Article 131 of the CRD.

¹ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

² The European Commission is also required to issue an opinion on the measure regardless of the fact that it applies to subsidiaries whose parents are established in other Member States as the rate is between 3% and 5%.

The assessment draws extensively on quantitative and qualitative information provided by the Banco de Portugal and on discussions within the Assessment Team and with staff of the Banco de Portugal.

Description of the proposed measure

The proposed measure is the activation of a new sSyRB of 4% on IRB retail exposures secured by residential immovable property located in Portugal. The measure applies to retail exposures secured by residential immovable property located in Portugal irrespective of where the borrowers have their place of residence. It applies to the four domestically established Portuguese banks that use the IRB approach for the relevant exposure class, of which two are subsidiaries of entities established in another EU Member State. Furthermore, one of these banking groups will also apply the buffer at the sub-consolidation level. In the second quarter of 2023 the share of the IRB banking groups was 61% in total lending for house purchase in the Portuguese banking system. The two subsidiaries of parents in other EU Member States represented 31% of the stock of housing loans of the Portuguese banking system in the second quarter of 2023.

The proposed sSyRB would complement the existing borrower-based measures by making banks more resilient to vulnerabilities accumulated in the stock of mortgage loans in the event of a potential economic downturn and/or unexpected significant drop in residential real estate (RRE) prices. According to the Banco de Portugal, monitoring of the RRE market and the quality of banks' loan portfolios indicates that, in the event of a strongly adverse scenario, banks could suffer significant credit losses on their mortgage portfolios. The aim of the measure is to increase the banking sector's ability to absorb potential losses. The activation of the proposed measure is based on indicators such as house prices; average probability of default, loss given default and risk weights under the IRB approach of RRE exposures; and expected RRE losses under an adverse macroeconomic scenario. The proposed measure would complement the borrower-based measures in place since 2018 and introduced via a recommendation, comprising limits on the loan-to-value ratio, the debt service-to-income ratio and the maturity of loans, and a requirement of regular payments of interest and principal.

The new sSyRB is to be activated on 1 October 2024. The measure is expected to remain in place until targeted risks materialise or disappear. The Banco de Portugal intends to review the level of the buffer in the future on the basis of observed changes in the risk levels in the stock of targeted exposures, while also considering the impact of the existing borrower-based measures on the credit quality of new mortgage loans. The Banco de Portugal is closely monitoring any signs of the targeted risks materialising and will consider the release of the measure if warranted by specific markets developments.

Risks addressed through the proposed measure

The sSyRB is aimed at making Portuguese IRB banks more resilient to the systemic risk present in RRE markets. The Banco de Portugal has identified three main sources of vulnerabilities in the relevant portfolio: (i) rising interest rates; (ii) downside risks in housing prices; (iii) the lower risk weights applied by IRB banks than by banks using the standardised approach to exposures to mortgage lending in Portugal.

First, risks to financial stability remain high as the cycle of rising interest rates continues, and the transmission of monetary policy tightening to the economy takes time.

The prevalence of floating interest rates in housing loans granted in Portugal is particularly relevant in this regard. In August 2023 floating rate loans accounted for 85% of housing loans in terms of stocks and 56% in terms of flows, according to data provided by the Banco de Portugal. In the event of an economic downturn and persistently high inflation, coupled with additional increases in market interest rates, the financial situation of households may worsen, especially among those already more vulnerable, thereby increasing their default risk. However, the Banco de Portugal assesses that some factors mitigate this, such as: a reduction in the household indebtedness ratio, in particular for lower-income households, to a level below the euro area average; a concentration of credit for house purchase among higher-income households; an improvement in the risk profile of new borrowers as a result of borrower-based measures; labour market shortages, which would tend to limit the increase in unemployment in the event of a sharper slowdown in economic activity; an accumulation of deposits during the pandemic period, partly explained by credit moratoria as well as by precautionary motives; and the adoption of government measures to support households.

Second, there are downside risks to housing prices in Portugal.

While year-on-year nominal house price growth had started to moderate in the third quarter of 2022, the second quarter of 2023 saw an end to this moderation and growth was robust at 8.7%. Quarterly house price growth decreased from rates of around 3% in 2020-22 to close to 1% in the first quarter of 2023 and fourth quarter of 2022, but it rose to 3.1% in the second quarter of 2023. The number of housing transactions declined by 3% in the second quarter of 2023 compared with the previous quarter (-10% in the first quarter). In terms of value, transactions increased by 0.7% in the second quarter of 2023, interrupting the downward trend seen since the third quarter of 2022. As for house price overvaluation, the Banco de Portugal considers two different approaches, namely (i) statistical indicators; and (ii) models that take into account structural factors determining housing prices. According to its May 2023 Financial Stability Report, of the three models available, one pointed to overvaluation in the RRE market.³ However, the results of these models are subject to uncertainty. In particular, the models do not consider factors such as demand from non-residents and resident foreign citizens and demand for tourism activities, which have materially contributed to this development in the house market in Portugal.

Third, risk weights applied by IRB banks to exposures to mortgage lending in Portugal are lower than those applied by banks using the standardised approach.

For IRB banks, the average risk weight of RRE exposures was 18.5% in June 2023, which compares with an average of 35.4% under the standardised approach. The average IRB risk weights in Portugal are also slightly below the EU average, which was 19.3% at the end of 2022 according to ECB data. The level of risk weights for IRB banks appears to reflect the low rates of default in the RRE segment in the most recent period. However, given the current level of medium-term vulnerabilities, a downturn in the Portuguese RRE market cannot be excluded. The implementation of an sSyRB is aimed at increasing the resilience of IRB banks for a potential materialisation of an adverse scenario. Regarding the appropriateness of IRB parameters, the Banco de Portugal considers the measure to be aimed at addressing systemic risk and not at the correction of specific risk weights of individual institutions, which is the competence of microprudential authorities.

³ See "Financial Stability Report", Banco de Portugal, May 2023.

A number of vulnerabilities were also identified in the Portuguese RRE sector by the ESRB in its latest assessment in 2021.⁴ The key vulnerabilities identified in 2021 were related to elevated house price growth, high household indebtedness and loose lending standards for new housing loans in terms of low interest rate spreads. House prices in Portugal had been rising steadily and significantly in the previous few years. Although mortgage credit was not the main driver of house price increases, it had been picking up together with household indebtedness despite the introduction of borrower-based measures in 2018. The share of mortgage loans in banks' loan portfolios was among the highest in the EU and so were the mortgage loan charges paid by borrowers.⁵

These vulnerabilities could lead to a significant downturn in the Portuguese RRE market, which could have a substantial impact on the solvency positions of Portuguese credit institutions. The Banco de Portugal assesses that the size of the exposures targeted by the sSyRB could give rise to a risk to the financial system and the real economy in Portugal as loans to households secured by real estate accounted for 26% of banks' assets at the end of 2022. The Banco de Portugal is also of the view that unexpected losses might be significant under an adverse macroeconomic scenario, and that this could lead to negative spillover effects to other exposures (including commercial real estate exposures). Banks' capital headroom, i.e. capital surplus above requirements, and improving profitability suggest that they have capacity to retain earnings as additional capital buffers.

Effectiveness and proportionality

The total impact of the sSyRB on IRB banks' CET1 capital is estimated by the Banco de Portugal to be €402 million. According to the assessment of the Banco de Portugal, the 4% sSyRB is equivalent to an average risk weight add-on of 5.15 percentage points for the IRB banks concerned, as a whole. The implementation of an sSyRB is aimed at increasing the resilience of IRB banks for a potential materialisation of an adverse scenario. Regarding the appropriateness of IRB parameters, the Banco de Portugal considers the measure to be aimed at addressing systemic risk and not at the correction of specific risk weights of individual institutions, which is the competence of microprudential authorities. To avoid potential overlaps, Banco de Portugal considers that the measure should be taken into account when setting microprudential requirements.

The Banco de Portugal plans to reassess the adequacy of the sSyRB once the Basel III output floor becomes binding and, if necessary, will make adjustments to avoid duplication in capital requirements. The output floor is aimed at limiting the unwarranted variability of risk-weighted assets produced by internal models and the excessive reduction in capital that an institution using the IRB approach can derive relative to an institution using the standardised approach. It is also thus intended to improve the comparability of risk-weighted capital ratios between banks using internal models to determine risk weights. The output floor defines a lower limit on the total risk exposure amount of an IRB bank, not on an individual portfolio. The Banco de Portugal intends to reassess the calibration of the sSyRB at

⁴ See "**Vulnerabilities in the residential real estate sectors of the EEA countries**", ESRB, February 2022.

⁵ Mortgage lending accelerated during the pandemic crisis, from slightly negative year-on-year rates of change in mid-2019 to a peak of 4.5% growth in mid-2022, according to information provided by the Banco de Portugal. Since then a significant deceleration has been observed, with the year-on-year rate of change recently turning negative (-0.9% in September 2023). Household indebtedness as a percentage of disposable income has been below the euro area average since the third quarter of 2019.

least every two years, and the impact of the output floor on the required sSyRB in nominal terms will, where relevant, be one of the factors considered.

In the current environment, increases in capital buffers could lead to procyclicality, but banks' capital headroom and profitability mitigate this concern. The measure would be procyclical if it amplified bank deleveraging beyond what would occur solely as a result of changes in the financial cycle. Procyclicality is a relevant concern, but, according to the Banco de Portugal, the quantitative impact is likely to be limited in practice given banks' capital headroom and improving profitability. Considering the still high uncertainty surrounding the economic outlook, mostly in relation to inflation and interest rate developments, there is at present a window of opportunity to build up capital buffers. Banks' capital headroom seems to be sufficient to meet the proposed sSyRB requirements. The minimum requirement for own funds and eligible liabilities (MREL) has also been taken into account. This suggests that the level of management buffers should not be a binding constraint when considering strengthening bank resilience through higher macroprudential capital buffers.

The ESRB is of the view that the new sSyRB is effective and proportionate. It acts on the objective of making Portuguese IRB banks more resilient to potential severe downward corrections in RRE markets by increasing their CET1 capital in relation to exposures to these markets. A sSyRB of 4% is considered commensurate with the intensity of, and potential losses stemming from, the above-mentioned risks in the Portuguese financial system. This is also confirmed by the ESRB's assessment of vulnerabilities in RRE markets in 2021⁶, which considered the macroprudential stance appropriate and sufficient to address vulnerabilities of the RRE sector in Portugal. The 2021 assessment suggested that if vulnerabilities continued increasing, Portugal could consider introducing a sSyRB and/or measures to increase risk weights for RRE exposures for IRB institutions when the economic recovery was seen to be on a solid footing and taking into account potential procyclical effects. In the current environment procyclicality is a relevant concern, but as mentioned before, the quantitative impact of the measure on credit is likely to be limited in practice given the level of banks' capital headroom and improving profitability, and there is at present a window of opportunity to build up capital buffers. Thus the measure is in line with this ESRB assessment.

Other measures in the CRD and the Capital Requirements Regulation (CRR)⁷

The proposed measure does not cover risks covered by Article 130 of the CRD. The countercyclical capital buffer (CCyB) has never been activated in Portugal. The proposed measure specifically targets risks stemming from the RRE market, whereas a potential activation of the CCyB would also affect exposures to other sectors, where systemic risks have not been identified. The sSyRB would therefore avoid unintended consequences and be more proportionate to the systemic risk.

The global systemically important institutions (G-SII)/other systemically important institutions (O-SII) buffer and sSyRB rates are cumulative and clearly target different risks. The sSyRB covers risks of exposures to the

⁶ See footnote 4.

⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

Portuguese RRE market only, whereas the O-SII buffer addresses the systemic footprint of specific banks in the domestic market. The objectives of the two buffers are clearly different and there is no meaningful overlap between them. Pursuant to Article of the 131(15), an authorisation by the European Commission will not be required, as the sum of the sSyRB and O-SII buffer rates on the relevant exposures do not exceed 5% for any of the banks.

As the measure is applicable to IRB banks, an alternative measure could have been to adjust the IRB risk weights on the basis of Article 164 or 458 of the CRR. The Banco de Portugal assessed the sSyRB to be more appropriate, owing mainly to three factors: i) increased risk weights would have an impact as regards several other regulatory requirements, ii) adjusting risk weights is not as transparent as increasing capital buffers, and iii) the release of a sSyRB is more transparent as well and the buffer can be dipped into, and therefore corresponds better to a macroprudential perspective. In addition, according to the “pecking order” of measures in EU legislation, the sSyRB should be considered before measures based on Article 458 of the CRR.

Conclusions

The ESRB is of the view that the proposed sSyRB is appropriate to address the identified risks to IRB banks' RRE mortgage portfolios. It does not entail disproportionate adverse effects on financial stability in Portugal or the EU. The sSyRB is not expected to form or create an obstacle to the proper functioning of the internal market. Applying the measure also to subsidiaries of institutions established in other Member States is necessary to provide a level playing field in the domestic market and to avoid leakages given the importance of these two institutions in the Portuguese housing lending market. The focus of the measure is Portuguese RRE exposures of IRB banks and it does not address risks which could be covered by Articles 130 or 131 of the CRD. However, the ESRB encourages the Banco de Portugal to make sure, to the greatest possible extent and also through cooperation with microprudential supervisors, that overlaps with microprudential requirements are avoided. In addition, the ESRB supports the Banco de Portugal's intention to reassess the adequacy of the sSyRB when the Basel III output floor is introduced, to avoid overlaps and to maintain the effectiveness and appropriateness of the measures. The reciprocation request in the notification will be dealt with in a separate note.