**The 26.04.2016 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCB) rate has been set at 0%. The established CCB rate will be used to calculate a credit institution-specific countercyclical capital buffer rate** **from 1 May 2017. Over the next two years, the need to increase the provision is not expected.**

**1.** In accordance with paragraph 1 of Article 355 of Credit Institution Law every quarter the Financial and Capital Market Commission (hereinafter, the Commission) sets the countercyclical capital buffer (CCB) rate applicable to exposures to the residents of the Republic of Latvia taking into account:

1) the CCB guide calculated for the appropriate quarter;

2) variables that the Commission considers significant for assessing significant cyclical systemic risk;

3) effective European Systemic Risk Board's (ESRB) recommendations on the setting of the CCB rate.

**2.** The CCB rate shall be established to ensure that credit institutions accumulate, during periods of economic growth, an additional capital base to absorb losses in economic downturn and/or stressed periods.

**3.** The calculation of the CCB guide shall be carried out taking into account the deviation of the credit (issued to the Latvian residents) to GDP ratio from its long-run trend (hereinafter, the credit-to-GDP gap).

**4**. In accordance with the ESRB Recommendation[[1]](#footnote-1) (hereinafter, the Recommendation), the CCB guide may be calculated using the data of broad and narrow definition time series. The broad credit definition covers banking loans and loans issued by non-bank financial institutions to the domestic private non-financial sector[[2]](#footnote-2). The **standardized credit-to-GDP gap** has been assessed using the broad definition time series. The narrow credit definition, in the case of Latvia covers the balance of outstanding loans granted to the domestic private non-financial sector by banks (it does not include loans from non-bank financial institutions). The **additional credit-to-GDP gap** was assessed based on the narrow credit definition time series.

**5.** In Latvia, using the broad credit definition, the credit-to-GDP ratio was 100% in Q2 2015 while its standardized gap was -42%[[3]](#footnote-3). In case the total credit-to-GDP gap exceeds the long-run trend by 2 percent points, the benchmark buffer rate will increase linearly[[4]](#footnote-4) from zero to the upper threshold of risk-weighted assets at 2.5%, where the credit-to-GDP gap reaches 10 percent points. Where the gap is at -42%, the benchmark buffer rate will be 0%.

**6.** Applying the narrow credit definition the credit-to-GDP ratio was 45%, but the additional gap was -33%[[5]](#footnote-5) in Q4 2015, as a result the benchmark buffer rate calculated under the additional credit-to-GDP gap was 0%. In accordance with the Recommendation the benchmark buffer rate that best reflects the specificities of the national economy shall be selected as the CCB guide. For Latvia, the results obtained from the calculations of the benchmark buffer rate under the narrow definition are more justified than using the broad credit definition results. The data of the narrow credit time series are more stable (they are not retrospectively adjusted) and they become available sooner. Therefore, in Latvia the benchmark buffer rate that is calculated based on the additional credit-to-GDP gap has been selected as the CCB guide.

**7**. Notwithstanding the GDP growth and low interest rates, the credit growth rates remain weak and cyclical systemic risks related to the Latvian banking sector's excessive lending risk are negligible.

**8**. The balance of loans granted to the domestic private non-financial sector by credit institutions has decreased by 42% as from Q4 2008 (when loan portfolio reached maximum). Along with reduction in lending activity, banking credit-to-GDP ratio over the last year (Q4 2015 to Q4 2014) declined from 48 to 45%.

**9.** In 2015 the market situation was influenced by a number of factors that limited investments in real estate. After the rapid decline in real estate market activity in the beginning of 2015, during the second half of the year the market activity stabilized while housing prices experienced modest growth.

**10.** The economic growth in 2015 was 2.6%, notably slowing down in Q4 2015. Economic growth in Latvia is limited by the weak growth of the euro area and by the weaker demand in Russia and depreciation of the Russian rouble. GDP growth remains mostly consumption-driven, but exports and investments are subject to developments in the external environment, which in turn display high uncertainty and risks. The GDP forecast for 2016 is 2.3% with the annual inflation rate around zero.

**11**. The current account balance, after major fluctuations in 2007 and 2009, has stabilised since 2011 in the range from 0% to -5%. Annual interest payments by the private sector (households and non-financial corporations) to GDP have gradually shrunk from 5.5% in Q2 2009 to 1.5% in Q4 2015 (not least due to historically low level of EURIBOR interbank rates).

**12.** Considering above, the Commission sets the CCB rate of 0%. In accordance with the current lending and GDP growth rate forecasts, no increase in the CCB rate would be required in the next two years.

**13.** On 14 March 2016, the Commission sent a letter to other members of the Macroprudential Council (the Bank of Latvia and the Ministry of Finance), notifying them of intention to set the CCB rate at 0%; both institutions responded that they did not object to such intention.

**14.** On 8 April 2016, the Commission submitted to the ECB notification of its intention to set the CCB rate at 0%. The ECB responded that they did not object to such intention.

1. Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1). [↑](#footnote-ref-1)
2. Includes non-financial corporations, households and non-profit institutions serving households. Loan balance reflects not only the private sector liabilities to credit institutions, but also loans from non-bank financial institutions. [↑](#footnote-ref-2)
3. Credit time series from Q4 1995 to Q3 2015. [↑](#footnote-ref-3)
4. In accordance with references in Annex 2 to the Recommendation. [↑](#footnote-ref-4)
5. Credit time series from Q1 1999 to Q4 2015. [↑](#footnote-ref-5)