**The 24. 01.2017 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCB) rate for the exposures to Latvian residents has been set at 0%. The established CCB rate will be used to calculate a credit institution-specific countercyclical capital buffer rate** **from 1 February 2018 till 30 April 2018. Over the next two years, the need to increase the provision is not expected.**

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.

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).

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.

In Latvia, using the broad credit definition, the credit-to-GDP ratio was 99% in Q2 2016 while its standardized gap was -38%[[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 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 -38%, the benchmark buffer rate will be 0%.

Applying the narrow credit definition the credit-to-GDP ratio was 45%, but the additional gap was -29%[[4]](#footnote-4) in Q3 2016, 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. Overall, the decline in credit-to-GDP ratio, which had been observed since the end of 2010, has stopped in 2016. However, the credit-to-GDO gap remains deeply negative.

Since the beginning of 2016, explicit positive developments have been observed in credit dynamics. Although the housing loan portfolio has been still declining, reduction rates have been slowing down. As to non-financial corporations, their loan portfolio is already higher compared to its level a year ago. Overall, Q3 2016 data suggests that the banking sector credit portfolio to the private sector has still declined (-1.2%) on a y-o-y basis, while compared to the end of 2015 – it has already posted a slight increase (0.6%).

Since 2015, both – real estate prices and a number of transactions in real estate market continue to increase, with the rate of the increase accelerating in the second half of 2016. A vigorous increase in the real estate prices in 2016 partly can be explained by the base effect, i.e. decline in prices at the end of 2014 and the following low level of housing prices in 2015. However, the dynamics of housing prices have been also influenced by the improvement in the household financial position through a substantial reduction in their leverage and an increase in real wages, as well as by improved availability of loans due to the governmental support for the young families with children.

Annual interest payments by the private sector (households and non-financial corporations) since the end of 2015 have stabilised in relation to GDP at the historically lowest level (1.5%).

Latvia's economic growth in 2016 was the slowest since 2010 – the year which highlighted the end of financial crisis in Latvia. Weakening of the economic development was influenced by a number of negative external factors, as well as by the interruption in the use of the EU funding. The GDP forecast for 2017 is 3% on the background of increasing activity in investment projects financed by the EU funds. Still, high uncertainties and risks on account of external factors and weak bank lending activity will play their role.

Capital adequacy ratios continue to substantially exceed the required levels, and are high compared to the average EU level. At the end of Q3 2016, the banking sector's total and common equity tier 1 ratios were at 20.4 and 17.4%, respectively.

The banking sector profit for Q3 2016 was ~ 374 million euro, or by 19% more compared to the respective three quarters a year ago. However, it should be noted that the banking sector profit was positively influenced by one-off factor – the sale of the VISA EUROPE shares in line with requirement by the VISA Inc. In Q3 2016, the banking sector ROE was 15.7% and, excluding the impact of VISA transaction, it was 10.6%

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. It 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 Q2 2016. [↑](#footnote-ref-3)
4. Credit time series from Q1 1999 to Q3 2016. [↑](#footnote-ref-4)