**The 28.10.2015 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 November 2016. 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[[2]](#footnote-2) to the domestic private non-financial sector. 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 Q1 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 46%, but the additional gap was -34%[[5]](#footnote-5) in Q2 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.** The financial position of the Latvian banking sector has not changed significantly since the Commission's meeting on 29 July this year. Though first signs of lending revival have emerged this year, reduction in the total outstanding loan balance still continues. Geopolitical tensions and uncertainty regarding export opportunities to Russia and the EU member states are the most relevant factors that hamper credit recovery. The annual rate of decline in loan balance, though slowed down, still exceeds 4%. The balance of outstanding loans granted to the domestic private non-financial sector by credit institutions has decreased by 41% since Q4 2008 (when the loan portfolio had reached a peak). As the loan portfolio had shrunk, the loan balance to GDP ratio decreased from 49% in Q2 2014 to 46% in Q2 2015.

Uncertainty over the changes in the Insolvency Law as well as amendments made to the Immigration Law had an adverse impact on the real estate market at the beginning of 2015, and as a result the real estate market experienced a downturn. However, the situation stabilized in Q2 this year, and to a great extent it was due to implementation of thestate support programmefor mortgage loanguarantees and introduction of non-recourse loans on an optional basis. Nevertheless, overall housing prices are still significantly lower than before the crisis.

The Latvian economic growth forecast for 2015 was raised slightly to 2.3% level (vis-à-vis previously estimated 2%)[[6]](#footnote-6). The GDP growth in Latvia has been hampered by a sluggish euro area development, a low demand from Russia and depreciation of the rouble. The GDP growth is mainly ensured by domestic consumption, while investments and export volumes could be facilitated by the gradual improvement in external environment in 2016. Inflation rate has remained below 1%.

**8.** None of other additional ratios indicate that there would be the necessity to set a higher CCB rate as well. The current account balance, after major fluctuations (in 2007 and 2009), since the beginning of 2011 has stabilized at 0% to -5% corridor limits. The ratio of annual interest payments by the private sector to GDP has contracted from 5% to 1.6% (to a great extent it is due to the historically low level of EURIBOR interbank rates).

**9.** In general, the indicators show that the financial cycle in the national economy is at the stage of moderate recovery. Notwithstanding the GDP growth and low interest rates, the credit growth rates remain negative for the sixth year in a row. Risks related to the national economic development are balanced and excessive crediting risk is insignificant.

**10.** 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.

**11.** On 28 September 2015, 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.

**12.** On 14 October 2015, the Commission submitted to the ECB notification of intention to set the CCB rate at 0%; the ECB had no objections to that 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 to loans from non-bank financial institutions. [↑](#footnote-ref-2)
3. Credit time series from Q4 1995 to Q1 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 Q2 2015. [↑](#footnote-ref-5)
6. Bank of Latvia's forecast. [↑](#footnote-ref-6)