**The 29.07.2015 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 August 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 (recommended by the Basel Committee on Banking Supervision (BCBS)) covers banking loans and loans issued by non-bank financial institutions 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, which is allowed by the Recommendation, in the case of Latvia 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 Q4 2014 while its standardized gap was -43%.[[2]](#footnote-2) In case the total credit-to-GDP gap exceeds the long-run trend by 2 percent points, the benchmark buffer rate will increase linearly[[3]](#footnote-3) 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 -43%, 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 -35%[[4]](#footnote-4) in Q1 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.** Credit dynamics in Latvia remain sluggish and reduction in the total outstanding loan balance continues. The annual rate of decline, 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 40% since Q4 2008 (when the loan portfolio had reached a peak). Following a 40% decrease in 2009, housing prices continue gradual recovering; however, they are still substantially lower than before the crisis. As the loan portfolio had shrunk, the loan balance to GDP ratio decreased from 51% in Q1 2014 to 46% in Q1 2015. The Latvian economic growth has been affected by adverse external factors and it is demonstrated by a slightly moderate GDP annual growth (2% in Q1 2015). Inflation rate is 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 (-25% in Q1 2007 and 13% in Q2 2009), since the beginning of 2011 has been levelled off ranging from 0% to -5%. The ratio of annual interest payments by the private sector to GDP has contracted from 5% to less than 2% since the beginning of 2010 (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, and the borrowers' vision of the future is not rather optimistic. At the current stage of the cycle, excessive crediting risk is low.

**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 11 June 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 15 July 2015, the Commission submitted to the ECB notification of intention to set the CCB rate at 0%; the ECB's reply was that it 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. Credit time series from Q4 1995 to Q4 2014. [↑](#footnote-ref-2)
3. In accordance with references in Annex 2 to the Recommendation. [↑](#footnote-ref-3)
4. Credit time series from Q1 1999 to Q1 2015. [↑](#footnote-ref-4)