LATVIJAS BANKA
EIROSISTĒMA

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Q3 2024 assessment of the cyclical systemic risk and applicable countercyclical capital buffer rate

23 September 2024

The countercyclical capital buffer (hereinafter – the CCyB) is a macroprudential tool that aims at strengthening the capitalisation of credit institutions so that they are adequately equipped to absorb losses in times of crisis. When risks materialise, the CCyB rate is partially or fully released to help credit institutions continue to offer funding to the economy, thereby reducing the length of crises and their impact on the economy.

Latvijas Banka, in its capacity as the designated authority for the application of the CCyB requirement, evaluates the cyclical systemic risk on a quarterly basis pursuant to Section 35.[5] of the Credit Institution Law and, if necessary, sets or adjusts the CCyB rate applicable to credit institution exposures to residents of the Republic of Latvia. Latvijas Banka publishes quarterly assessments of the cyclical systemic risk and the applicable CCyB rate. If the CCyB rate remains unchanged, the previous decision regarding the applicable CCyB rate remains in force.

On 18 December 2023, the Council of Latvijas Banka decided[1] to implement a positive neutral CCyB approach[2]. According to this approach the CCyB rate is set at positive basis level (above zero) already in a standard risk environment or at the neutral stage of the financial cycle when cyclical systemic risk is neither elevated nor subdued. Latvijas Banka has estimated 1% to be an appropriate base level of the CCyB rate. In the event of an increase in the cyclical systemic risk, the CCyB rate is raised proportionately to its intensity, starting from an already positive base rate, rather than from zero. Thereby the total CCyB requirement will comprise both the base rate and the cyclical rate components for which the level is determined every quarter. The CCyB rate may be partially or fully released in times of crisis as risks materialise and in the post-crisis recovery period.

To ensure gradual implementation of the positive neutral CCyB approach, the Council of Latvijas Banka determined that the 0.5% CCyB rate requirement takes effect on 18 December 2024 and the 1% CCyB rate requirement – on 18 June 2025. Credit institutions apply the respective CCyB rate to the risk exposures to residents of the Republic of Latvia when calculating the institution-specific CCyB rate[3].

Considering the Q3 2024 cyclical systemic risk assessment, Latvijas Banka has decided not to increase the cyclical component of the CCyB rate. Therefore the decision on the applicable CCyB rate taken on 18 December 2023 remains in force. The cyclical systemic risk is still assessed as low taking into account sluggish lending, continuously high interest rates, moderate activity in the real estate market as well as

[1] An administrative act No 444/10 of the Council of Latvijas Banka of 18 December 2023 (available only in Latvian) Par pretcikliskās kapitāla rezerves normas riska darījumiem, kuri noslēgti ar Latvijas Republikas rezidentiem, noteikšanu 1 procenta apmērā.
[2] For more information please see Latvijas Banka's approach to applying the countercyclical capital buffer.
[3] Pursuant to Regulation No 137 of the Financial and Capital Market Commission of 25 August 2020 on calculating the institution-specific countercyclical capital buffer rate.

weak growth of the economy. The ratio of domestic private non-financial sector credit to GDP remains at a low level.

The **credit-to-GDP gap** of the private non-financial sector continues to gradually narrow but remains negative both according to the standardised (broad) credit definition and additional (narrow) credit definition (see Table 1 and Charts 1 and 2). Consequently, the CCyB buffer guide is 0%.

Table 1 **Key variables of the CCyB rate assessment**[4]

Variable	Standardised (broad) credit definition	Additional (narrow) credit definition
	Q1 2024	Q2 2024
Credit-to-GDP ratio (%)	59.7	26.4
Credit-to-GDP gap (pp)	–19.7	–6.3
Benchmark buffer rate (% of risk weighted assets)	0	0[5]

The growth rate of **domestic lending** to both non-financial corporations (hereinafter – NFCs) and households in the second quarter of 2024 (see Chart 3 and 4) and in July overall remains weak. In July 2024, the annual growth rate of domestic loans slightly increased up to 3.1% (inter alia, the annual growth rate of the household loan portfolio increased by 4.6%, while that of the NFC loan portfolio - by 3.2%). High interest rates, uncertainty and weak economic growth lessen the willingness and ability of private non-financial sector to borrow. Moreover, lending is still affected by several structural factors such as shortcomings in the business environment, weak construction sector, insufficient capital market, demographic factors.

The level or **private non-financial sector debt** is low **and its servicing burden** - moderate. Along with the high interest rates, the ratio of household and NFC interest payments to GDP has increased (see Chart 5). Going forward the burden of servicing debt will be alleviated by gradual decrease of interest rates, taking into account that costs of variable interest rate debt displays current changes in interest rates with a lag. The quality of the loan portfolio remains stable in the second quarter of 2024. The share of Stage 2 loans is at historically low levels and overall the financial resilience of borrowers remains strong. The ability for households to service their mortgage loans continues to be supported by the interest rate compensation that is paid-out from the mortgage borrower protection fee[6].

The **real estate** market activity is moderate – in July-August 2024 the total number of real estate purchases increased by 3.7% compared to the same period in 2023. The Central Statistical Bureau of Latvia (hereinafter – CSB) data on house price index shows that in the second quarter of 2024 the annual growth rate of house prices increased by mere 1.1% compared to the same period in 2023 (see Chart 6), while the quarterly change was 2.3%. Inter alia the growth rate of prices for the new housing sustained high also in the second quarter of 2024 – they grew by 11.1% year on year and by 8.6% compared to the previous quarter of 2024. The prices for standard apartments has somewhat stabilised and in June-August 2024 their monthly changes were close to zero. Overall between mid-2022 and the start of 2024 the price level of the standard apartments declined and in August 2024

[4] The narrow credit definition includes credit institution loans to NFCs and households and debt securities purchased by credit institutions, but the broad definition comprises liabilities of NFCs and households to credit institutions, as well as their loans from non-bank financial institutions or other NFCs.
[5] In Latvia, the narrow measure of credit provides better signalling properties; therefore, the benchmark buffer rate calculated according to the narrow credit definition serves as the buffer guide.
[6] The amendments to the Consumer Rights Protection Law of 06 December 2023 (available only in Latvian).

they were lover by 12.9% compared to June 2022. The supply of these apartments remains at a historically high level.

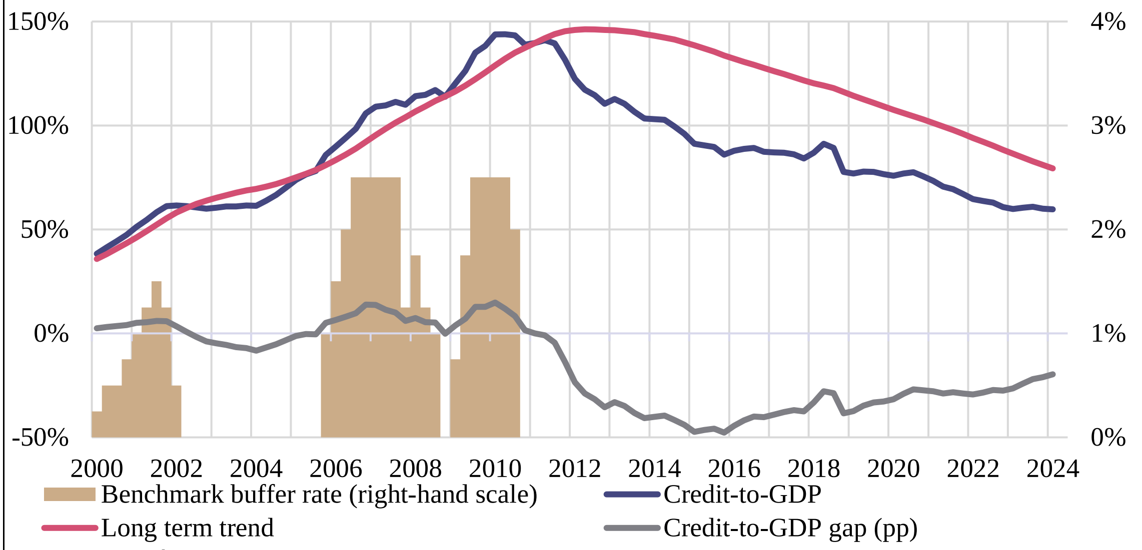
Weak **macroeconomic development** in Latvia also suggests that the cyclical risk is low. The GDP declined by 0.1% in the second quarter of 2024 year on year, but by 0.9% compared to the previous quarter of 2024. This decline was mostly affected by the weak export and cautious private consumption (regardless of improved purchasing power). According to the forecast made by Latvijas Banka the economic activity will gradually improve – albeit slower than previously expected, taking into account the uncertainty and continuously high interest rates. The inflation rate in Latvia is currently one of the lowest in the euro area and it is projected that it will remain low overall in 2024 and 2025. The current account deficit in the second quarter of 2024 grew up to 3.9% of GDP (see Chart 9).

Latvijas Banka's composite systemic cyclical risk indicator (hereinafter – the CCRI)[7] has declined from 5 points in the second quarter of 2023 to 4.5 points in the second quarter of 2024. It is still below the risk level that is considered to be above average (see Chart 11).

[7] For further information on the CCRI methodology, see Appendix 1 to Latvijas Banka's Financial Stability Report 2020 (https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf).

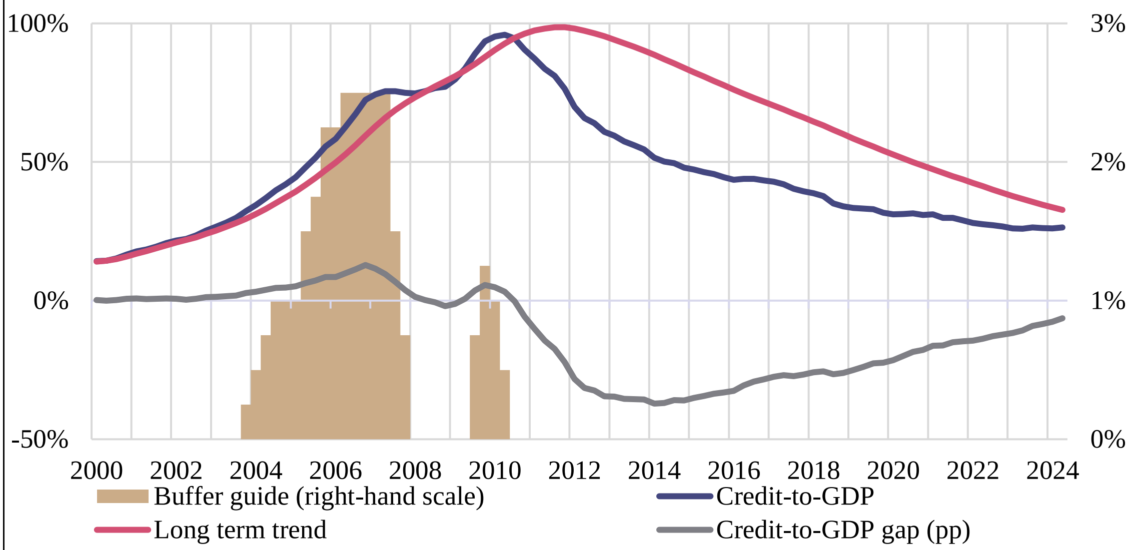
Annex 1. **Key variables of the Financial Cycle**

Chart 1. Standardised credit-to-GDP gap



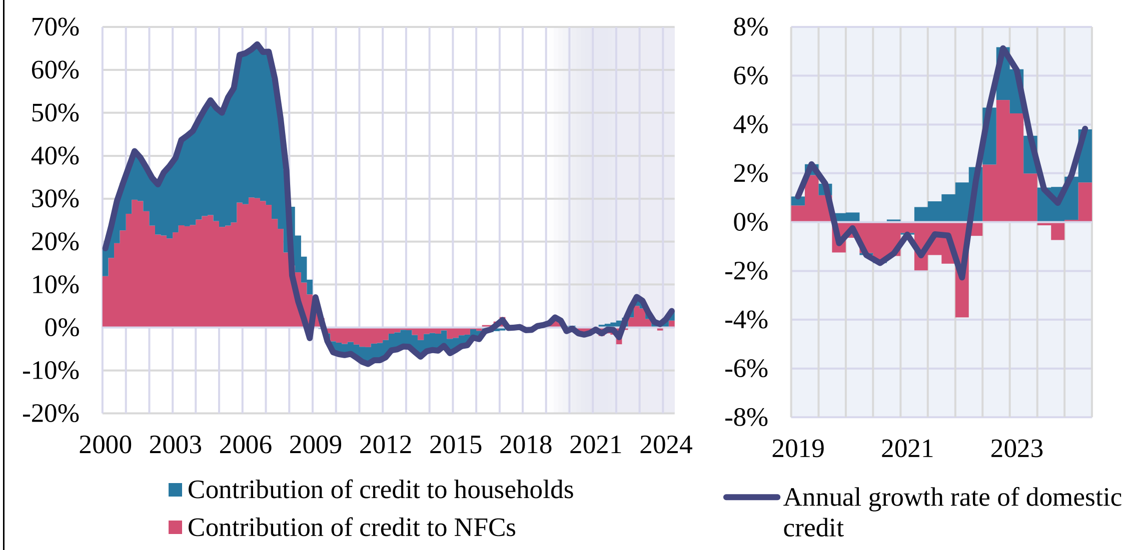
Source: Latvijas Banka, CSB.

Chart 2. Additional credit-to-GDP gap



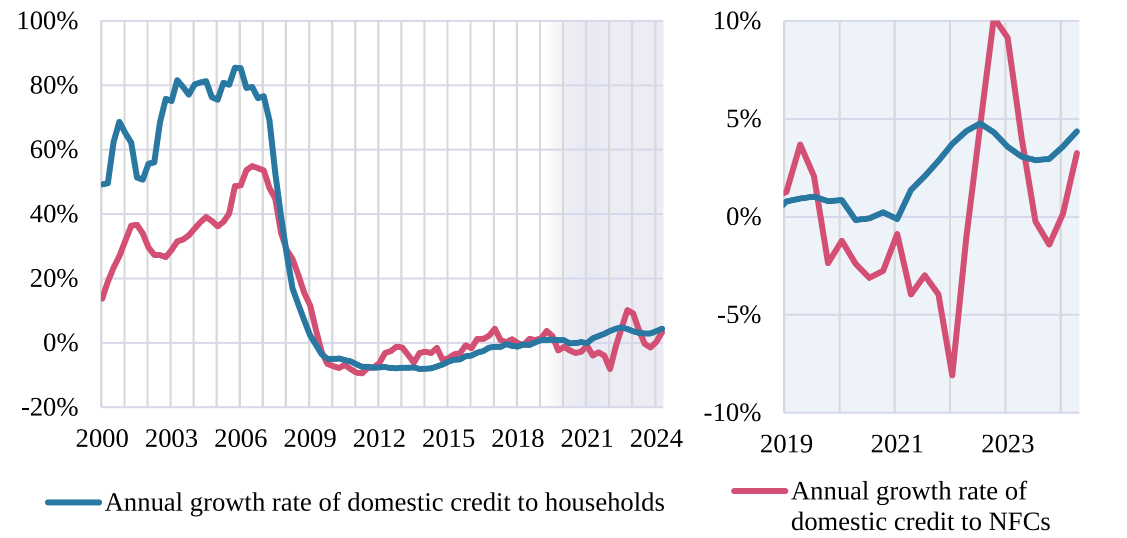
Source: Latvijas Banka, CSB.

Chart 3. Credit developments



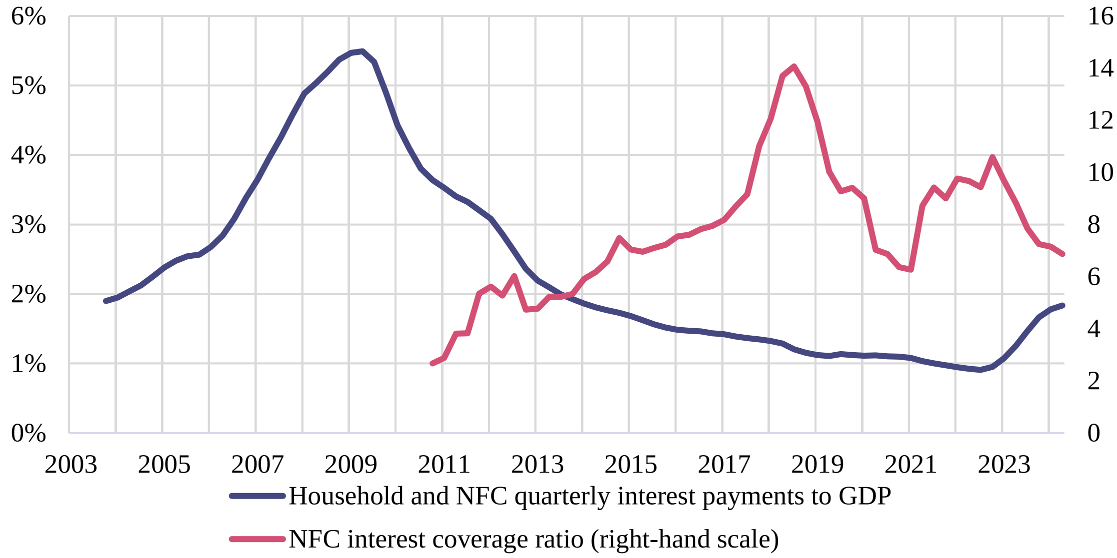
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

Chart 4. Credit developments – annual growth rates of credit to households and NFCs



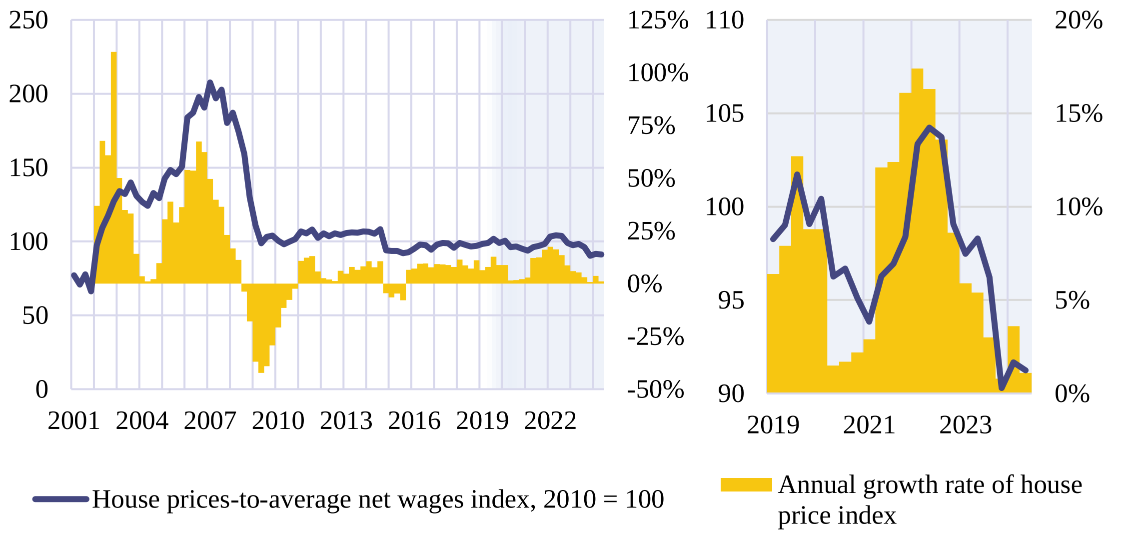
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

Chart 5. Private non-financial sector debt servicing burden



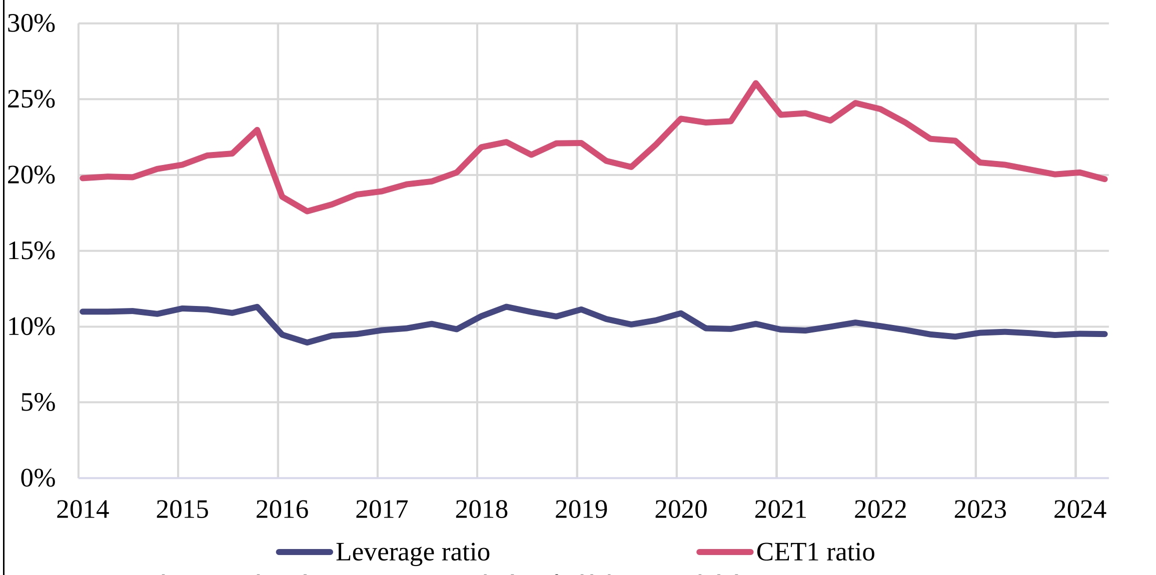
Source: Latvijas Banka, CSB. Note. The NFC interest coverage ratio includes the ratio of earnings before taxes and interest payments to interest payments.

Chart 6. Potential overvaluation of property prices



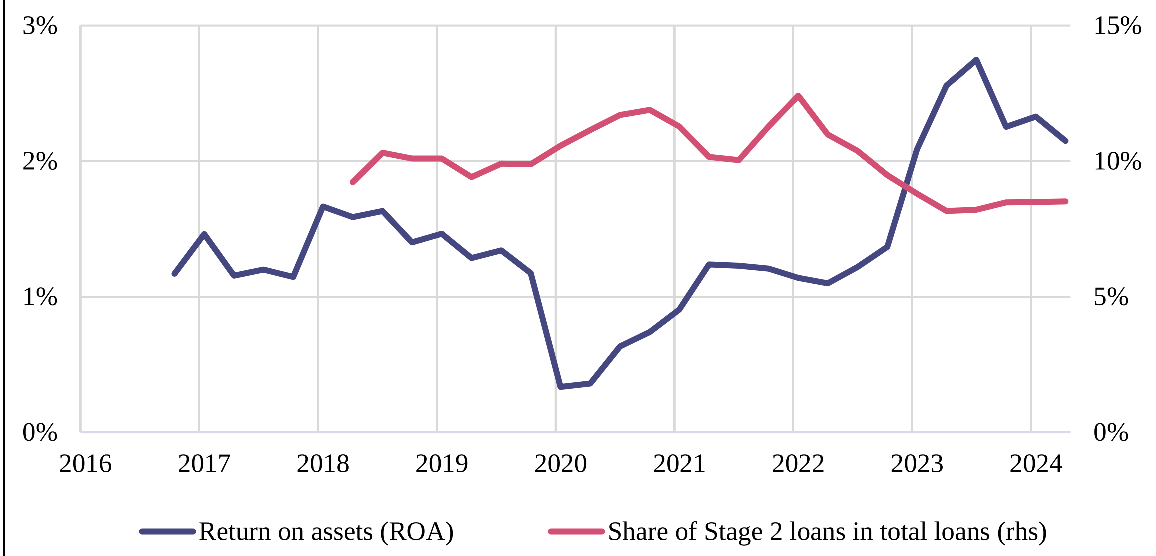
Source: CSB.

Chart 7. Resilience of credit institutions - capitalization



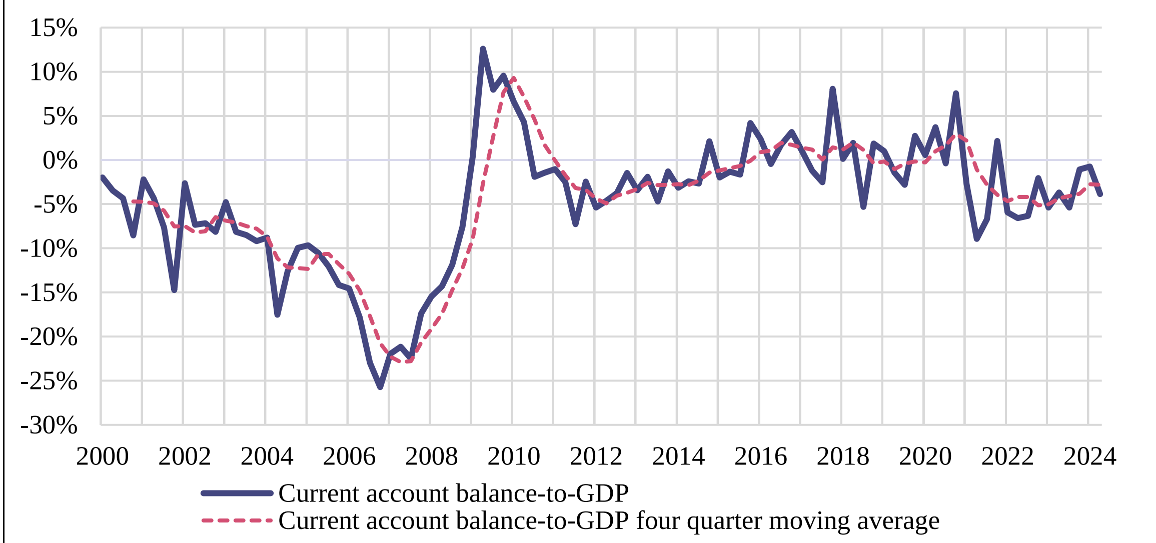
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 8. Resilience of credit institutions - profitability and asset quality



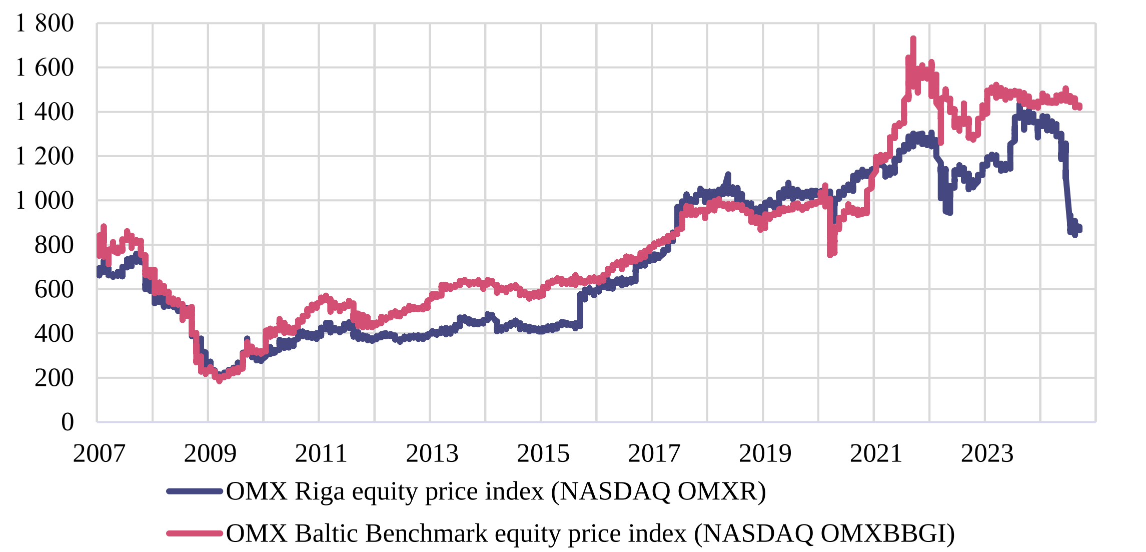
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 9. External imbalances



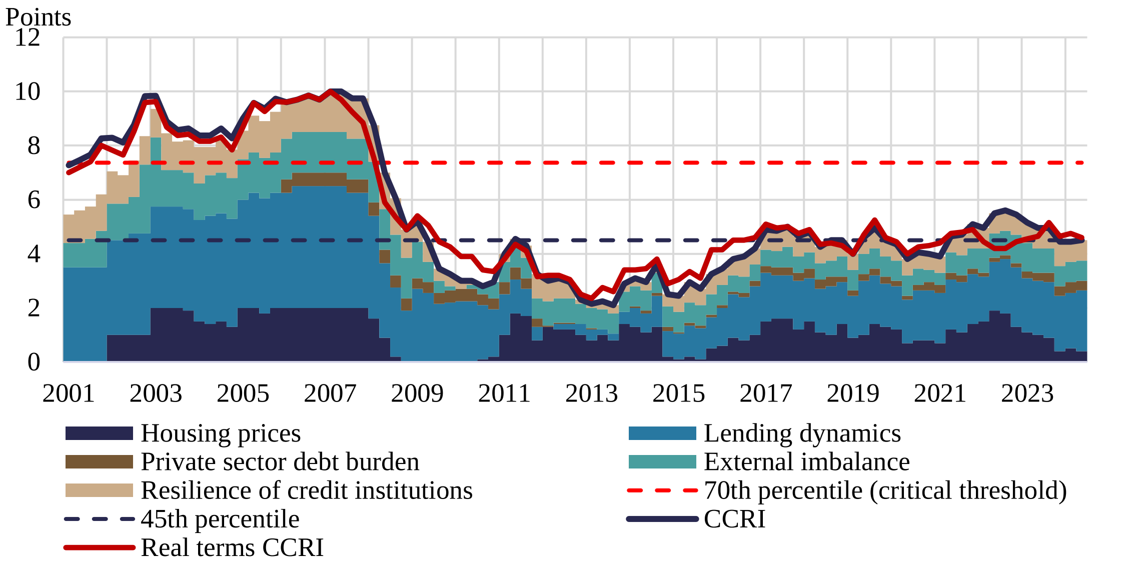
Source: Latvijas Banka, CSB.

Chart 10. Potential mispricing of risk



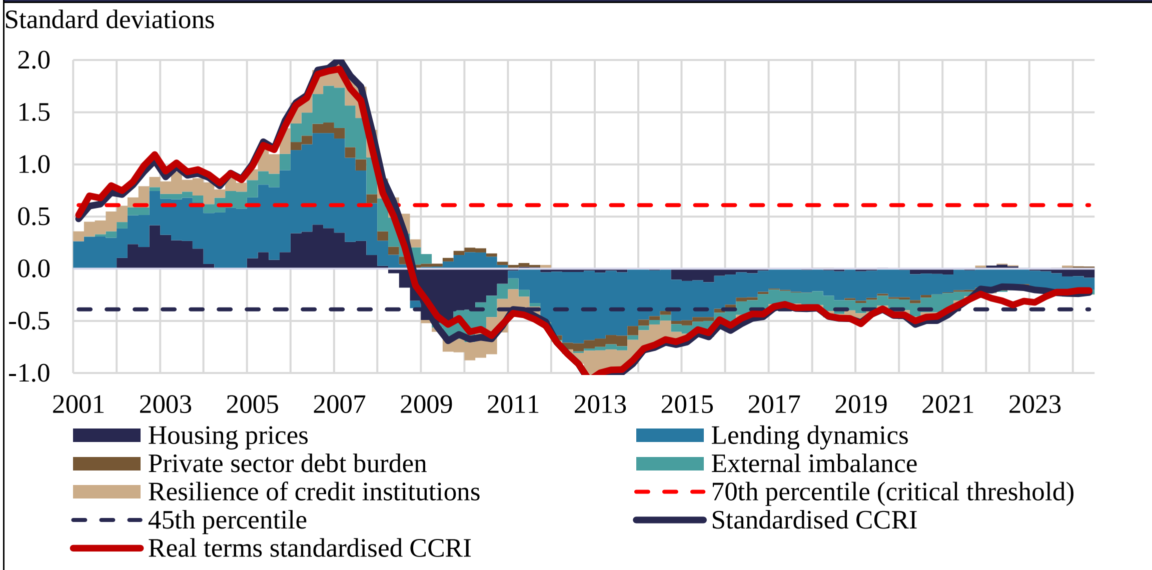
Source: Bloomberg.

Chart 11. CCRI – percentile method



Source: Latvijas Banka, CSB.

Chart 12. CCRI – standardised method



Source: Latvijas Banka, CSB.