**The 25.10.2016 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 November 2017 till 31 January 2018. 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 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).

3. 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.

4. In Latvia, using the broad credit definition, the credit-to-GDP ratio was 100% in Q1 2016 while its standardized gap was -39%[[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 -39%, the benchmark buffer rate will be 0%.

5. Applying the narrow credit definition the credit-to-GDP ratio was 45%, but the additional gap was -30%[[4]](#footnote-4) in Q2 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.

6. Indicators used as a guide for setting a countercyclical capital buffer rate do not point to the growing cyclical risks in the financial sector.

7. Since 2016, positive developments have been observed in credit dynamics, especially in lending to the non-financial corporations. However, Q2 2016 data suggests that the banking sector credit portfolio to the private sector continues to decline, albeit at a slower pace (-1.8% y-o-y).

8. Residential real estate prices are still about 34% lower compared to the peak in 2008. However, since 2015, housing prices, as well as number of transactions in the RE market have been growing moderately, at the speed of the growth accelerating somewhat in first half of 2016. An improvement in the household financial position through substantial reduction in their leverage and increase in real wages, as well as the governmental support for the young families with children improved the availability of loans.

9. Against the background of continuing deleveraging, the private sector indebtedness and debt service burden continue shrinking. Annual interest payments by the private sector (households and non-financial corporations) continue to decline in relation to GDP (reaching 1.5% in Q1 2016).

10. Given weak economic data for the first half of 2016, the Bank of Latvia reduced the GDP forecast for 2016: from 2% to 1.4%. The GDP forecast for 2017 is 3% on the background of increasing activity in investments projects financed by the EU funds. Still, high uncertainty and risks on account of external factors and weak bank lending activity will play their role.

11. The banking sector strength measured in terms of solvency and profitability remains high. Capital adequacy ratios substantially exceed both – minimal and total capital requirements, as well as an average EU level. At the end of Q2 2016, the banking sector's ROE was 16.9% and common equity tier 1 ratio was at 16.5%..

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.

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