**The 26.01.2021 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCyB) rate for the exposures to Latvian residents has been set at 0%. The established CCyB rate will be used to calculate a credit institution-specific CCyB rate from 1 February 2022. The Financial and Capital Market Commission (FCMC) will decide about the necessity to set the CCyB rate above 0% if significant rise in cyclical systemic risks is recorded in Latvia's financial sector.**

The FCMC, as an institution responsible for the application of the CCyB according to Article 35.5 of the Credit Institution Law, analyses the credit-to-GDP ratio every quarter, as well as its deviation from the trend and the additional indicators to justify the decision on the CCyB rate.

The FCMC has been monitoring coronavirus (Covid-19) outbreak developments and the effects of the resulting global supply-demand shock on Latvia’s economy. According to the Central Statistical Bureau in Q3 2020 the economy contracted moderately by 2.6% (year-on-year), in comparison to a more significant drop of 8.6% in Q2 2020 (year-on-year).

The annual GDP growth forecast for 2020 has been updated in December to -4.7% (previously also estimated at -4.7% in September). During the period of high uncertainty the forecast of the annual GDP growth for 2021 has been adjusted in December to a modest 2.8% compared to a more optimistic figure of 5.1% forecasted in September.

Restrictions to contain the Covid-19 pandemic (in particular, quarantine, self-isolation and also distancing requirements) have significantly affected business operations leading to losses of various degree depending on the sector of the economy. In Q3 2020 (year-on-year) the most affected segments were accommodation and food service activities (decreased by 28.6%, wherein provision of accommodations dropped by 44.5%), arts, entertainment and recreation (22.4%) and transportation and storage (14.7%, wherein provision of passenger traffic services still contributed the most also in third quarter and dropped by 57.6%) largely as a result of restrictions imposed by governments of Latvia and other countries. However, contrary to the general trend, agriculture, forestry and fishing grew by 6.3% due to favourable weather conditions and also a significant increase was observed in manufacture of computer, electronic and optical products (growth of 16.1 %) and manufacture of wood and of products of wood (growth of 8.2 %). The overall demand in both internal and external markets has been decreasing and this has negatively affected both export and import levels – the volume of goods and services in Q3 2020 (year-on-year) decreased by 3.7% (export – wherein drop in transport and tourism services affected by the pandemic was the key driver for reduction in exports of services of 26.9 %) and 2.6% (import – wherein a decline of 23.1% in imports of services was mainly determined by drop in imports of transport and tourism services in light of pandemic). The high uncertainty in external markets and potential further reduction in consumption can result in a further weakening of the economic growth in Latvia.

The overall economic slowdown was also reflected in household consumption which in Q3 2020 fell by 7.4% compared to the corresponding period in 2019 as households spent less on transport (drop of 10.7%). Likewise, the spending on accommodation and catering services dropped noticeably by 31.2% (year-on-year).

According to real estate experts the worst-case scenario of a significant fall of housing prices did not materialize and the real estate market displayed resilience in the first three quarters of 2020 as the volume of transactions remained steady – the price level therefore did not experience significant changes although the previously observed growth rate of prices has now slowed down. Along with the second wave of pandemics the caution of consumers has returned, but according to statistical data the activity level is slowly returning to that of before Covid-19 crisis and the highest activity is observed in the new housing segment. Overall, house prices are still growing, but at a slower rate than before the pandemic - the housing price index as calculated by the CSB (unadjusted data) increased by a mere 2.1% in Q3 2020 compared to the same period in 2019 (existing house prices increased slightly faster by 2.4% and new house prices increased by 0.6%).

Notwithstanding the economic slowdown, issuance of state supported housing loans to resident households’ still factors significantly in the overall credit growth as almost half of all bank issued housing loans are issued using one or another of established state support programmes. In Q3 2020 domestic housing loans grew by 2.3% in terms of transactions, while there was a slight decrease (of 0.9%) in terms of volume (year-on-year). The support package was updated in summer of 2020 allowing more families to apply for certain support programmes – and more additional support measures are on the way such as subsidy program for large families.

Domestic credit has been negatively affected by the pandemic as the overall issuance of loans to the domestic non-financial sector continued to decrease also in Q2 2020, falling by 1.2% (year-on-year). The domestic consumer credit balance also continue to decrease in Q2 and Q3 compared to the corresponding periods in previous year - by 13.1% (Q2) and by 14.4% (Q3).

Loans issued by credit institutions to private non-financial sector in Q3 2020 decreased by 5.7% compared to the same quarter in 2019, mostly due to a fall in loans issued to non-financial corporations which dropped by 11.0%. The total domestic household portfolio, however, grew (though by a mere 0.4%) in the same period, due to increase in loans collateralized by residential immovable property (by 1.0%).

The overall decrease in economic activity has also left its impact on lending by non-bank financial institutions, as their issuance of credit to domestic households and non-financial corporations decreased even more in Q3 2020 (year-on-year) by 6.2% (compared to decrease by 4.1% in Q2 2020 (year-on-year)), while leasing companies’ loans in the same period also exhibited a similar trend, dropping by 5.1% (year-on-year). Highest drop in Q3 2020 (year-on-year) was observed in leasing companies’ loans to non-financial corporations (decrease by 8.5%). The tightening of credit standards, negative effect of the economic shock on income levels and continuously high uncertainty are among the main contributing factors explaining the decrease. Following this trend, in Q3 2020 (year-on-year) a subsector of non-bank lenders mainly comprising of payday loan issuers endured a large drop in their household lending of 8.2% (compared to a decrease by 3.7% in Q2 2020 (year-on-year)).

Overall, the assessment of cyclical risks and the policy stance at this stage is cautious. Taking into account the shock to the economy from the coronavirus outbreak, signals of increased financial stability risks can be observed while the financial cycle is expected to shift further downwards. The second wave of pandemic and a rise in infection cases following tightening of restrictions can significantly affect the risk outlook in the near future.

The FCMC in cooperation with the Bank of Latvia continue to analyse relevant indicators and trends and will update the setting of the CCB rate on a quarterly basis.