**The 29.04.2015 decision on setting the countercyclical capital buffer rate**

The countercyclical capital buffer (CCB) rate has been set at**0 percent.** The set CCB rate will be used to calculate a credit institution-specific countercyclical capital buffer rate **from 1 May 2016**. No need for increasing the CCB rate is expected in the next two years.

**Justification for setting the rate**

1. In accordance with paragraph 1 of Article 355 of Credit Institution Law, the FCMC sets the countercyclical capital buffer (CCB) rate on a quarterly basis applicable to exposures to the residents of the Republic of Latvia, taking into account:  
1) the CCB guide calculated for appropriate quarter;  
2) variables that the FCMC considers relevant for assessing cyclical systemic risk;  
3) effective recommendations issued by the European Systemic Risk Board (ESRB) on the setting of the CCB rate.

2. The CCB shall be set to ensure that credit institutions accumulate, during periods of economic growth, a sufficient capital base to absorb losses in stressed periods.

3. The calculation of the CCB guide shall be based on the deviation of the ratio of credit (issued to the Latvian residents)-to-GDP from its long-term trend, taking into account:  
1) an indicator of growth of levels of credit and, in particular, an indicator reflective of the changes in the ratio of credit granted in the Republic of Latvia;  
2) current guidance and recommendations issued by the ESRB on the calculation of the CCB guide, and the measurement and calculation of the deviation of ratio of credit to gross domestic product (GDP) from its long term trend.

4. Pursuant to the ESRB Recommendation1 (hereinafter – the Recommendation), real total credit is outstanding credit to the domestic private non-financial sector1 (loans and issued securities). Using the time series from Q4 1995 to Q3 20143 the benchmark buffer rate4was calculated under the standardised credit-to-GDP gap in accordance with the Basel Committee on Banking Supervision (BCBS) guidance.

In Q2 2014, the ratio of credit-to-GDP was 104%, but its deviation from the long-term trend was -40%. Where the ratio of credit-to-GDP exceeds the long term trend by 2 percent points, the benchmark buffer rate will increase linearly5 from zero to the upper threshold of 2.5%. Where the deviation is at -40%, the benchmark buffer rate will be 0%.

5. For the period from Q1 1999 6to Q4 2014, the benchmark buffer rate was calculated under the additional credit-to-GDP gap. Unlike the standardised (proposed by BCBS or "broad") credit definition, the credit definition used in the additional ("narrow") credit-to-GDP gap does not include borrowing from non-banking financial institutions. This credit definition is narrower than the definition proposed initially by the BCBS, however, the results obtained from the calculations of the benchmark buffer rate under the "narrow" definition are more justified than using the "broad" credit definition. Compared with the "broad" credit time series, the data of the "narrow" credit series are more stable (they are not retrospectively adjusted) and they become available sooner. The ratio of credit-to-GDP in Q4 2014 was 47%, but its deviation from a long term trend was -36%, and as a result the benchmark buffer rate based on the additional credit-to-GDP gap was 0%. In accordance with Recommendations B (4)   
the benchmark buffer rate that best reflects the specificities of the national economy shall be selected as a CCB guide. Therefore the benchmark buffer rate that is calculated based on the additional credit-to-GDP gap is selected as the CCB guide.

6. The overall macroeconomic and financial sector situation is described as stable. After a decrease of 17% since Q4 2008, the total loan balance in the domestic private non-financial sector grew by 2% during Q2 2014 and remained at the same level during Q3 2014 (the balance of loans granted to the domestic private non-financial sector by credit institutions has decreased by 38% as from Q4 2008). Following a 40% decrease in 2009, housing price index annual growth rate has not substantially exceeded 10% since 2011 (11.7% in Q3 2014). The GDP has been increasing moderately over the past years, within 3%-5% annually and the inflation rate remains low.

7. None of the other additional ratios indicates 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 become stable ranging from 0% to -5%. Annual interest payments by the private sector to GDP have shrunk from 5% to less than 2% from the beginning of 2010 (to a great extent it is due to the historically low level of EURIBOR interbank rates).

8. In general, the CCB guide and additional indicators show that the national financial cycle is at the stage of moderate recovery. Notwithstanding the GDP growth and low interest rates, the credit growth rates are close to zero, and the borrowers' vision of the future is not rather optimistic. At the current stage of the cycle, excessive crediting risk is low; and therefore the FCMC 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.

9. On the 19 February 2015, FCMC sent the letters to other participants of the Macroprudential Council (the Bank of Latvia and the Ministry of Finance), where it informed about its intention to set the CCB rate at 0%; both institutions responded that they do no object such intention.

1 Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical capital buffer rates (ESRB/2014/1).  
2 Non-financial corporations, households and non-profit institutions serving households.  
3 Quarterly data till the end of 2000 are linearly interpolated from the available annual EUROSTAT data. As from Q1 2001, the quarterly data from the financial account statistics of the Bank of Latvia have been used (data on earlier periods are not available). Using combination of above both data sources, the longest available time series are obtained for analysis as from the end of 1995 to reflect the development of private sector crediting and consequent amount of  benchmark buffer rate.  
4 In accordance with references of Annex to Recommendations, Part 1 the one-sided Hodrick-Prescott filter with the smoothing parameter lambda = 400 000 was used.   
5 In accordance with references of Annex to Recommendations, Part 2.  
6 With this starting point, historical simulation of buffer requirement determination most closely matches the expert assessment on the lending cycle (namely, the CCB rate should have been introduced from Q4 2003 to Q4 2007).