**The 29.10.2019 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 November 2020. The Financial and Capital Market Commission (FCMC) will decide about the necessity to set the CCyB rate above 0%, as soon as a significant rise in cyclical systemic risks is recorded in Latvia's financial sector.**

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.

In 2019, the economic growth in Latvia slowed. In 2017 and 2018, GDP growth was 5.0%, while in the first half of 2019 (year-on-year) it declined to 3.0%. It is expected that in the coming years it will remain moderate (around 3% a year), as a negative impulse of external demand will reduce the growth rate.

Currently, the economic growth does not pose risks to financial stability, continuing without an active lending effect. The deviation of credit-to-GDP ratio from the long-term trend remains negative for a long time, using both the broad (-36% at the end of Q1 2019) and narrow (-24% at the end of Q2 2019) definitions. The ratio of credit (by narrow definition)- to- GDP continued to decline and was 33% at the end of the Q2 2019. This level of the credit-to-GDP ratio was observed in Latvia in 2003-2004.

The development of the EU co-financing projects continues; however, the availability of that funding will gradually decrease in the coming years. The uncertainty in external markets, including the weakening of the economic growth in the euro area countries, results in a cautious approach to export opportunities. Private consumption, supported by employment and wage growth, remains a driver of growth. However, the high uncertainty of the external environment due to geopolitical and economic developments is also gradually resulting in the more moderate investment activity and could increase consumer caution.

According to unadjusted data, the annual growth rate of loans to the domestic non-financial sector was gradually increasing, reaching 2.4% in July 2019. Household lending increased by 1.0% compared with the previous year (including mortgage loans by 2.1% compared to the previous year). The credit portfolio of non-financial corporations grew by 3.6% compared to the corresponding period of the previous year and it was supported by the issuance of some large long-term loans.

The role of the non-banking sector in domestic lending gradually rises, however, the growth rates of non-bank lending have slowed and the credit portfolio issued by non-bank financial institutions increased by 5.3% (y-o-y) in Q2 2019 (including leasing and factoring – by 8.2%). The stock of loans issued to households and non-financial corporations increased by 11.9% and 2.2%, accordingly (y-o-y). Payday loans consistently show double digits annual growth (17%), and due to recent amendments to the Consumer Rights Protection Law (CRPL), the consumer credit sector modifies some of its products into credit lines. Although there may be certain effect on some banking products, the overall impact of the amendments to CRPL on financial stability has been assessed as positive.

Regardless of increasing varieties and volumes of non-bank lending, there is no indication that non-bank lending poses a risk to financial stability. The growth in non-bank lending is linked to a steady increase in salaries (net annual salary increased by 7.5% in Q2 2019), as well as the strong economic growth in recent years and the absorption of EU structural funds. The majority of the non-bank loan portfolio (76%) is allocated by leasing companies, which in most cases are banking subsidiaries and which are subject to consolidated supervision. Therefore, the structural increase in non-bank lending is largely supported by bank group strategies and growing demand for bank group services provided by the leasing sub-structure. In the current situation, a wider overview of lending (including non-bank lending) does not change the risk assessment associated with overall lending development.

The change in business models of credit institutions serving mainly foreign customers has not affected the dynamics of the financial cycle, since the involvement of these credit institutions in dealing with domestic customers remains negligible – the share of deposits in total domestic deposits was around 6% in August 2019, but the share of domestic loans issued by these credit institutions – around 7% (9% and 12% respectively at the end of 2017). Consequently, the business model change is important at the level of individual credit institutions, but no systemic impact is observed at the moment.

There are no changes in the assessment of risks related to the real estate market. At the beginning of 2019, the housing price growth slowed, as a growing supply of economic class housing started to ease pressure on housing prices. The number of housing purchase transactions has not changed essentially in recent years. In Q1 2019, the housing price index set by the Central Statistical Bureau increased by 7.1% (compared to 11.1% in Q4 2018).

Overall, the assessment of cyclical risks and the policy stance remains unchanged. The level of risks associated with lending and the real estate market is estimated as low. The level of household debts is low, mortgage lending dynamics remain slow. Household income grows at a similar rate as housing prices, so housing availability generally does not change significantly and the ratio of the housing price index to the average net salary index is close to the long-term average ratio.

The main risks to the stability of Latvia's financial sector remain unchanged compared to the previous quarter assessment. They relate to the openness of the Latvian economy, worsening of the global (including the EU) macroeconomic environment as well as ongoing slowdown of external demand and retaining reputational risk. Risks associated with the unbalanced development of real estate market and high levels of household debts in the Nordic countries remain actual. Overall, the uncertainty surrounding the future economic development forecasts is growing.

The FCMC, in cooperation with the Bank of Latvia, will continue to analyse the relevant indicators and trends when deciding on the determination of the CCyB rate in the following quarters. The FCMC will decide on the need to set the CCyB rate above 0% if a significant increase in cyclical systemic risks is observed in the Latvian financial sector.