Assessment by the Financial and Capital Market Commission of the intensity of cyclical systemic risk and the appropriateness of the applicable CCyB rate currently set at 0%

25 January 2022 assessment of the intensity of cyclical systemic risk and the appropriateness of maintaining the Countercyclical Capital Buffer (CCyB) rate of 0%. **The decision of 27 April 2021** to set the CCyB rate of **0%** for relevant exposures to residents of the Republic of Latvia **remains in force**. **Rationale for the assessment**: The Financial and Capital Market Commission (FCMC) as the designated authority in charge of the application of the CCyB according to Article 35.[5] of the Credit Institution Law quarterly analyses the intensity of cyclical systemic risk and the appropriateness of the applicable CCyB rate to set or adjust it, if necessary. The credit-to-GDP ratio as well as its deviation from the long-term trend and the additional indicators are used to justify the decision on the CCyB rate. Credit institutions will be required to start applying the respective CCyB rate of 0% (set by the 27 April 2021 decision of the FCMC Council) in the calculation of the institution specific CCyB rate **from 1 May 2022 onwards**, and it will be applicable until the next decision of the FCMC to change the respective rate. The FCMC will **continue to publish** quarterly cyclical systemic risk assessments on its homepage.

To decide upon the applicable CCyB rate, the FCMC in cooperation with the Bank of Latvia carries out the assessment of the financial cycle of Latvia and continues to monitor 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 (CSB), the growth of the economy has increased significantly in Q2 2021, compared to levels observed in previous year, and in Q3 2021 the GDP growth increased by 5.1% (year-on-year) mostly due to the low base effect. In Q3 2021 the most significant growth (production approach) observed in financial and insurance activities (by 41.7%), mostly from income of commissions and profit from financial instruments' transactions, and in human health and social work activities (by 19.8%), mostly from investments in healthcare in light of Covid-19 pandemic. On the contrary, negative growth rate (year-on-year) of GDP in Q3 2021 was observed in arts, entertainment and recreation activities (by -4.8%), mostly due to prolonged effects of Covid-19 pandemic, and in agriculture, forestry and fishing (by -4.5%) given unfavorable weather conditions. In autumn of 2021 the government imposed strict restrictions to contain the pandemic and it is expected that the growth rate of GDP in Q4 will slow down. In Q3 2021 the total expenditure of households rose by 9.0% that was promoted by reduction of unemployment and rather low Covid-19 restrictions in the summer. Household consumption was stimulated also by the growth of average wages, as the compensation of employees at current prices increased by 10.8% of which total wages and salaries rose by 11.3% (year-on-year).

In December 2021 the Bank of Latvia updated the forecast of Latvia's' GDP to account the effects of pandemic, predicting growth of 4.6% in 2021 (previous forecast of 5.3% made in September 2021 was updated), and 4.2% in 2022. These forecasts were made amidst high uncertainty and the main highlighted risks to positive economic growth were related to the effectiveness of containing the pandemic, including successful vaccine roll-out and new Covid-19 outbreaks as well as general growth of expenses such as energy prices. The recovery of Latvia's economy slowed down significantly in the autumn due to rise of infection rate and imposed strict restrictions such as lockdown to contain it.

The CCyB benchmark buffer rate data regarding the credit-to-GDP gap shows prolonged negative trend both for its broad (financial accounts) (-30 p.p. in Q2 2021) and narrow (bank) (-14.8 p.p. in Q3 2020) credit definition[1]. Domestic private nonfinancial client credit-to-GDP ratio also continues to gradually decrease both within the narrow (30% in Q3 2021) and broad (72% in Q2 2021) credit definition.

Domestic credit has been further negatively affected by the pandemic as the overall issuance of loans to the domestic private non-financial sector continued to decrease also in Q2 2021, falling by 3.5% (year-on-year). According to the Credit Register of the Bank of Latvia, steady downward trend has also been observed for the domestic credit for real estate purchase as its balance fell by 11.1% in Q3 2021 compared to the corresponding period of the previous year, and also for the financial leasing for which a decrease by 1.8% was observed (year-on-year). At the same time households' segment lending such as consumer credit and credit for house purchase in terms of balance in Q3 2021 displayed slight increase, compared to the same period in previous year – by 2.3% (for consumer credit) and by 1.4% (for credit for house purchase).

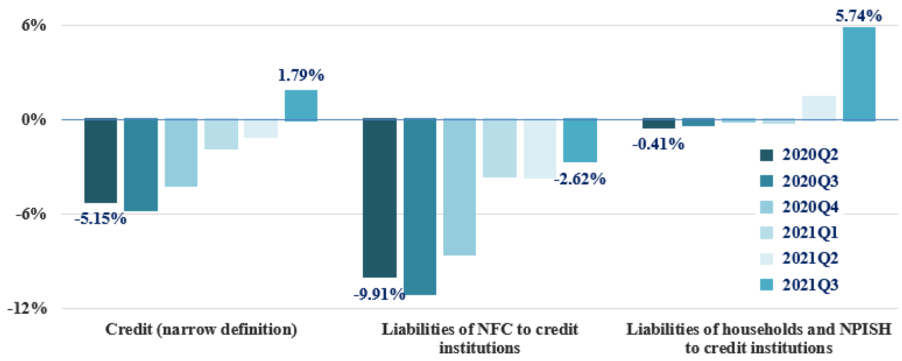

***Chart 1**. Credit (narrow definition) and its components quarterly changes (year-on-year)*

Loans issued by credit institutions and debt securities purchased by private non-financial sector showed signs of mild recovery in Q3 2021 compared to recent previous quarters, increasing by a mere 1.79% compared to the corresponding quarter of 2020. The decrease present in H1 2021 can be mostly explained by a fall in loans issued to non-financial corporations (decrease by 2.6% also observed in Q3 2021 (year-on-year)), which, however, still shows signs of growth rate recovery in the first three quarters of 2021 compared to decrease observed in 2020. Overall, these credit developments, albeit still in the negative territory, start to show more positive trend after the lowest point in Q3 2020 (Chart 1). The total domestic household and non-profit institutions serving households (NPISH) portfolio, on the other hand, remained more stable and resilient to economic demand-supply shock caused by

[1] Additional information regarding the definition of credit applicable in the CCyB methodology is available in FCMC homepage: https://www.fktk.lv/en/media-room/macroprudential-supervision/countercyclical-capital-buffer/

Covid-19 pandemic in both 2020 and first three quarters of 2021, increasing significantly by 5.7% in Q3 2021 (year-on-year).

House prices continued their rise in 2020, albeit the growth rate slowed down significantly due to the pandemic (Chart 2). Some early recovery signs of house price growth rate were already observed in the start of 2021, and in Q2 and Q3 of 2021 the house price growth rate started to increase significantly, returning to the level previously observed in 2019. According to unadjusted data in Q3 2021 the CSB housing price index increased by 12.7% (year-on-year) (in Q2 2021 - by 12.1%), wherein existing house prices increased slightly more by 15.9% (in Q2 2021 – by 15.8%), while on the other hand new house prices grew only by 3.7% (in Q2 2021 - by 0.6%) (year-on-year). The correlation between house prices and wages continues to be high.

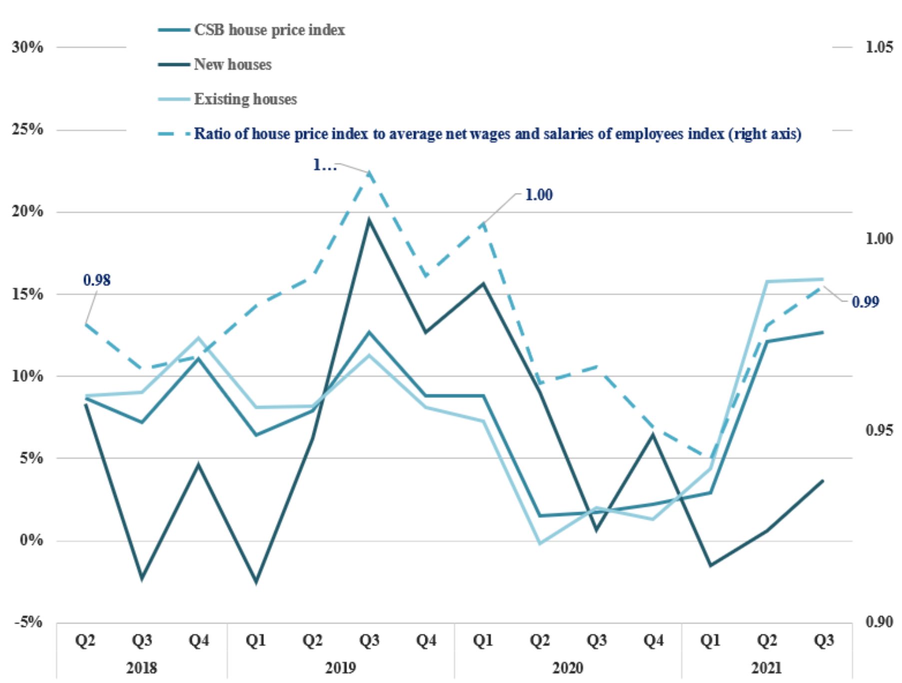

Chart 2. CSB housing price index and its components' quarterly changes (year-on-year) (left axis) and ratio of house prices and wages (right axis)

Overall, in 2020 the housing market remained resilient to the effects of Covid-19 pandemic, with the exception of Q2 2020 when restrictions to contain pandemic and high uncertainty resulted in significant drop of the purchase contracts. In Q1 2021 the activity in terms of the number of purchase contracts yet again decreased mainly due

Chart 3. Number of purchase contracts registered in the Land Registry – quarterly changes (year-on-year)

to decreased supply in the real estate market as well as pandemic containment measures that were tightened at the start of 2021 (Chart 3). In Q2 2021 the activity again surged, and the growth rate of purchase contracts rose mostly due to low base effect in the previous quarters, while in Q3 2021 the low base effect gradually decreased (growth in the country as a whole by 10.1% and in the capital by 23.1% (year-to-year) was observed). In absolute terms the number of purchase contracts in Q2 and Q3 2021 has returned to the average long-term level observed before the pandemic.

According to experts, banks are currently re-evaluating credit standards for mortgage loans thus potentially providing a further stimulus to already high demand for housing. Increase in the demand for housing drives the housing price, especially considering limited supply conditions. In recent quarters a general trend of rising house prices can be observed with the exception of rural regions, while the number of purchase contracts highly correlates with the severity of restrictions introduced to contain the pandemic. In 2021 the cost of new housing construction continued to rise which could have had a restraining effect on the availability of this housing segment. Various surveys indicate high housing consumer confidence regarding housing price increase in the near future along with the recovery of economy. The rent market in central districts of the capital has largely recovered in light of increasing demand.

Information publicly disclosed by Altum accounts for the growth rate of 19.2% in the first nine months of 2021 (compared to the same period in 2020) for natural persons portfolio that was stimulated mostly by growing demand for housing purchase guarantees and those guarantees relating to programs for improving energy efficiency of apartment buildings. State guarantees regarding housing purchase are actively used by families with children as those in the first nine months of 2021 have accounted for more than 65% growth compared to the same period in 2020 when economic activity decreased significantly resulting from restrictions to contain the pandemic. According to experts, housing market in the first nine months of 2021 was largely active and prices continued to rise as opposed to previous pessimistic future expectations. The pandemic also shaped the behavior of real estate buyers – people are seeking larger dwellings and the demand for land and summer houses is still high. One of the most dominant factors for high house prices are insufficient supply and high construction costs. As there are no expectations for a decrease in wage growth therefore it is not expected that housing prices will decrease as well. Rent market in H1 2021 slowly rebounded from the effects of pandemic that were present during 2020 when rent apartments rapidly become available and demand decreased. Currently higher demand is for rent apartments in new houses and the quality of the apartment is valued more than before. In commercial real estate segment in 2021 both in Latvia and in Baltics a several significant lease-back operations were performed in which owners sold their real estates and entered into a long-term lease with the new owners, leaving more available funds for higher elasticity to either reduce or widen the business and also to make additional investments if needed. According to experts, this type of financial instrument is not new, but pandemic sparked a new interest.

Adjusting to life in pandemic the non-bank financial institution credit portfolio recovered overall faster than bank lenders' portfolio. At the end of Q3 2021 non-banks' issuance of credit to domestic households and non-financial corporations increased by 7.1% (year-on-year), mostly due to the activities of other non-bank lenders (institutions outside the scope of consolidation of Latvian credit institutions). Non-bank lending demonstrated the same trend as in banking sector where the growth of household lending is more resilient to the effects of pandemic. According to the Credit Register of the Bank of Latvia leasing companies' loans to households in September of 2021 increased by 4.2%, compared to the same period in previous year, demanded by stable growth of net wages, created savings and adaptation to pandemic constraints. It is expected that in 2022 there will be changes regarding car leasing segment due to the grant introduced for electric (zero or low emission) car purchases and write offs regarding old cars. Loans issued by leasing companies to domestic non-financial corporations were mostly affected by negative effects of pandemic on overall economic situation and the disruption of supply chains. In Q3 2021 the growth rate of newly issued leasing loans to non-financial corporations slowly recovered, reaching pre-pandemic levels. Leasing companies' loans growth rate to domestic non-financial corporations recovered from -13.4% in September 2020 to -3.3% in September 2021 (annual change) according to the Credit Register of the Bank of Latvia data. Loans to domestic households by other non-bank financial institutions, such as "pay-day" lenders, grew by 6.0% in Q3 2021, largely explained by the rise in economic activity, changes in some of loan origination standards and active advertisements by lenders.

Overall, the assessment of relevant indicators in Q3 2021, and the uncertainty regarding future economic developments notwithstanding, suggest broadly unchanged dynamics of the financial cycle. Chart 4 depicts the Composite Cyclical Risk Indicator (CCRI)[2] – an additional cyclical systemic risk intensity assessment tool, developed by the Bank of Latvia that allows to account for the specificities of the Latvian financial system and to evaluate the state of the local

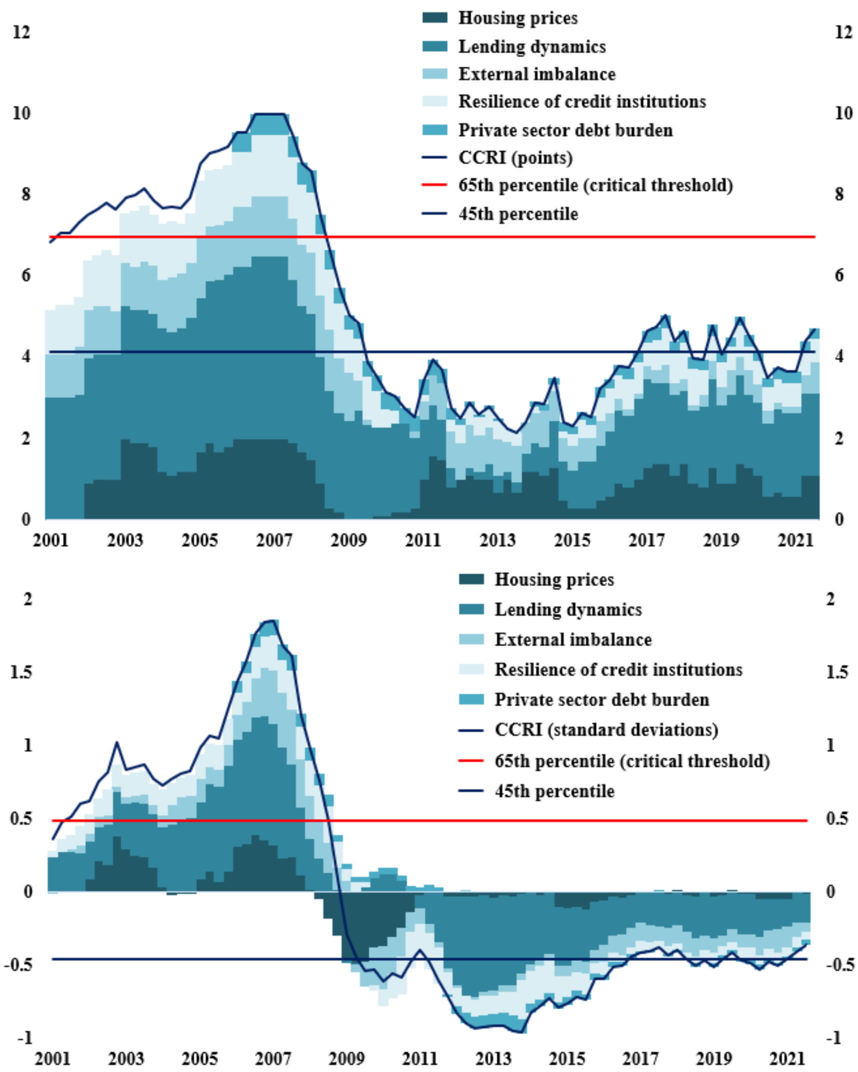

Chart 4. *CCRI and its underlying components (points in Graph 1, standard deviations in Graph 2)*

[2] Information regarding the Bank of Latvia developed CCRI is available in 2021 Financial Stability Report: https://datnes.latvijasbanka.lv/fsp/FSP_2021_en.pdf
Additional information regarding the methodology behind calculating CCRI is available in the Bank of Latvia 2020 Financial Stability Report: https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf

financial cycle. The CCRI assigns a relatively high weight to credit development indicators, therefore, due to weak lending trends observed during the pandemic, it currently signals a low cyclical systemic risk level both from the perspective of points (upper panel) and standard deviations (lower panel) methods. Higher CCRI in Q2 and Q3 2021 can be explained mostly by increased house price growth.

Overall, considering the effects of restrictions to contain Covid-19 pandemic that were enforced more strictly in the autumn of 2021, their negative impact on economic developments as well as uncertainty regarding future trends of the spread of pandemic is still reflected in weak lending and subdued values of other relevant indicators, thus the financial cycle is expected to remain subdued. Therefore, the current assessment of the appropriate CCyB rate remains unchanged at the level of 0%.

The FCMC in cooperation with the Bank of Latvia will continue to assess relevant indicators, the level of cyclical systemic risk and the appropriateness of the applicable CCyB rate.