**Assessment by the Financial and Capital Market Commission of the cyclical systemic risk and the appropriateness of the applicable CCyB rate**

**Decision on 27 April 2021**: to set the Countercyclical Capital Buffer (CCyB) rate of **0%** to relevant exposures to residents of the Republic of Latvia.

**Rationale behind formal decision**: The Financial and Capital Market Commission (FCMC) as an institution responsible for the application of the CCyB according to Article 35.[5] of the Credit Institution Law, quarterly analyses the credit-to-GDP ratio as well as its deviation from the long term trend and the additional indicators to justify the decision on the CCyB rate.

***Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019*** *amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures* amends the procedure by which the EU Member States decide on setting the CCyB rate. As these amendments are implemented in the Credit Institution Law, the FCMC will continue as before to assess on a quarterly basis the intensity of cyclical systemic risk and the appropriateness of the applicable CCyB rate. A decision on a new CCyB rate will be taken not on a quarterly basis (as up until now), but only in cases when the CCyB rate is changed.

Credit institutions will have to start applying the respective CCyB rate of 0% 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.

The FCMC will **continue to publish** quarterly cyclical systemic risk assessments on its homepage.

To decide upon the applicable CCyB rate, the FCMC carries out 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 in Q4 2020 the economy contracted moderately by 1.5% (year-on-year), in comparison to a more significant drop observed in other quarters of 2020 – drop of 8.6% in Q2 and 2.8% in Q3 2020 (year-on-year). The annual GDP in 2020 decreased by 3.6% (year-on-year).

Year 2020 can be characterized as overall highly uncertain. Specific economic sectors (accommodation, tourism, arts, entertainment and recreation, transportation, and commercial real estate) were significantly negatively affected by the economic shock due to pandemic and restrictions to contain it. These restrictions to contain the pandemic and prolonged extraordinary circumstances burdened business activities, sometimes resulting in complete cessation of activity. They were also reflected in the income level of employees in respective economic sectors as restrictive measures significantly limited the possibilities for households to spend income on certain activities and goods thus resulting in the overall household consumption decrease of 10.3% in 2020 (year-on-year).

In March 2021 Bank of Latvia updated the forecast of Latvia's' GDP assuming growth of 3.3% in 2021 (previous forecast made in December 2020 provided for a more modest growth of

2.8%).The CCyB benchmark buffer rate data regarding credit-to-GDP gap shows prolonged negative trend both for its broad (-28 p.p. in 2020 Q3) and narrow (-17 p.p. in 2020Q4) credit definition[1]. Domestic private nonfinancial client credit-to-GDP ratio continues to decrease both within the narrow (32% in 2020 Q4) and broad (77% in 2020 Q3) credit definition.

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 Q3 2020, falling by 1.8% (year-on-year). A more pronounced decrease has been observed for the domestic consumer credit as its balance fell by 12.8% in Q4 2020 compared to the corresponding period in previous year. Domestic private sector indebtedness continues to gradually decrease, while private sector annual interest payments to GDP remain broadly unchanged in Q4 2020 at 1.1% (Chart 1).

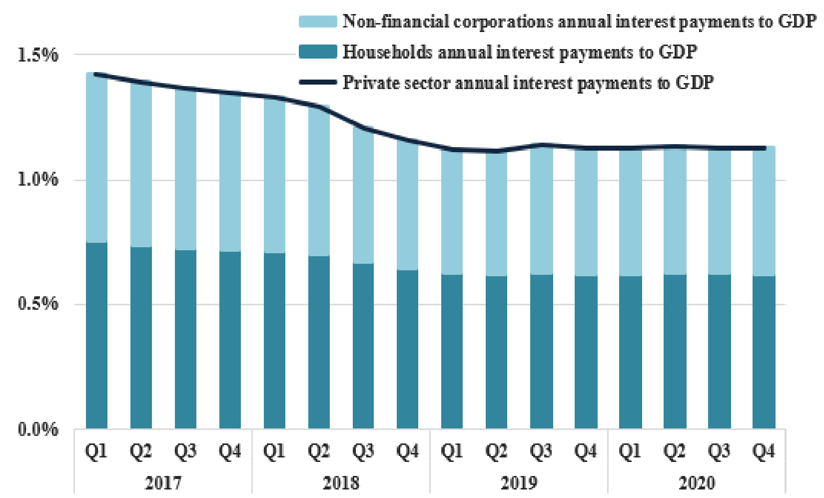


***Chart 1.*** *Domestic private sector indebtedness*

Amount of newly issued loans to domestic households remains relatively stable over time, but lending to non-financial corporations has proven to be more volatile (both before and since the start of pandemic). Most significant drop of loan issuance to non-financial corporations was observed in Q2 2020, however in the second half of 2020 signs of some recovery were already visible. As the pandemic surged in 2020, a significant rise of interest capitalization (especially in the household segment) and credit holidays (or similar corrections of liabilities) of domestic private non-financial clients was observed.

Loans issued by credit institutions to private non-financial sector in Q4 2020 decreased by 4.1% compared to the same quarter in 2019, mostly due to a

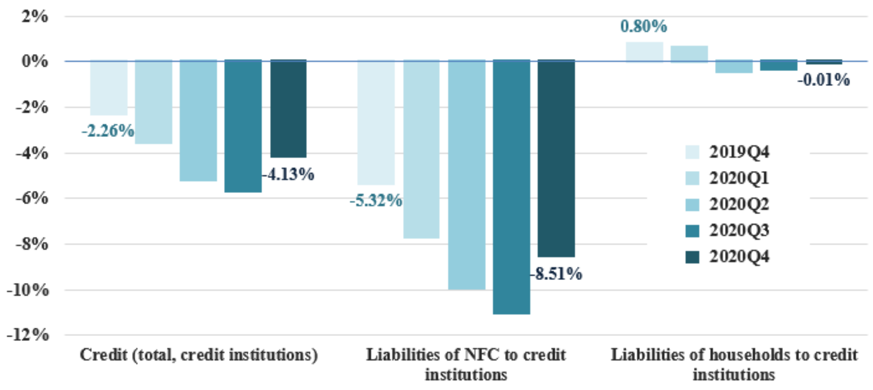


***Chart 2****. Credit (narrow definition) and its components quarterly changes (year-on-year)*

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

fall in loans issued to non-financial corporations which dropped by 8.5% in the same period. These credit developments, albeit still in the negative territory, start to show a more positive trend after the lowest point in Q3 2020 (Chart 2). The total domestic household portfolio, on the other hand, has remained stable, dropping just by 0.01% in Q4 2020 (year-on-year). This was supported by a moderate but stable increase in loans collateralized by residential immovable property (by 1.0% and 1.7% in, respectively, Q3 and Q4 of 2020).

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 housing loans are issued using one or another of established state support programs.  In Q4 2020 domestic housing loans grew by 2.0% in terms of transactions, while there was a slight decrease (of 2.0%) in terms of volume (year-on-year).

House prices continued to rise also in 2020 albeit the growth rate slowed down significantly due to the pandemic (Chart 3). According to unadjusted data the CSB housing price index Q4 2020 increased by a mere 3.1% (year-on-year), wherein existing house prices increased slightly lower by 2.3%, while new house prices increased more significantly by 6.4% (year-on-year). The correlation between house prices and wages continues to be high.

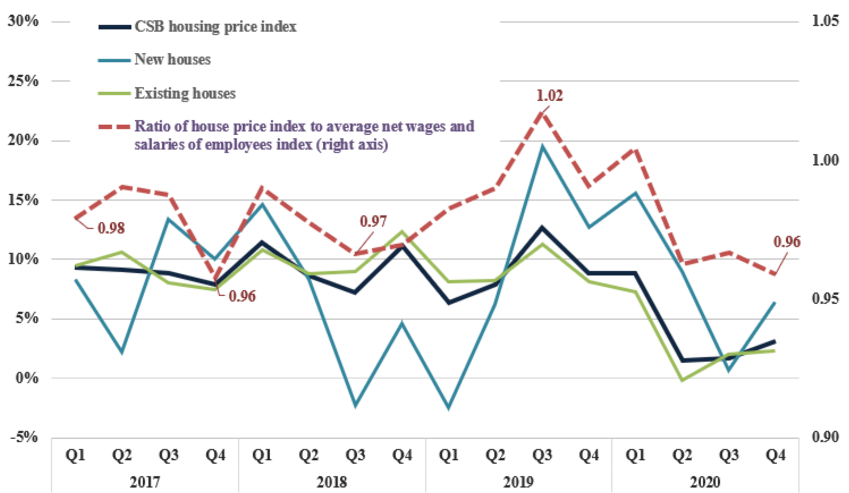


***Chart 3.*** *CSB housing price index and its components quarterly changes (year-on-year) (left axis) and ratio of house prices and wages (right axis)*

In spring 2020 when the effects of pandemic became pronounced there arose many obstacles in the real estate purchase process which were amplified by a sentiment of an overall caution in the market - in Q2 2020 the number of purchase contracts registered in the Land Register dropped significantly compared to the same period in 2019 – by 23.3% (in the capital the drop was even more severe – by 38.8%) (Chart 4).  However, the activity returned in the summer and remained high throughout the autumn as

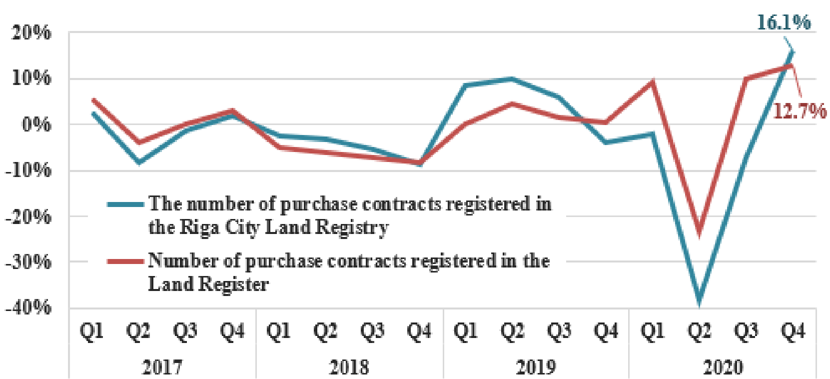


***Chart 4.*** *Number of purchase contracts registered in the Land Registry – quarterly changes (year-on-year)*

the number of purchase contracts rose by 12.7% in whole country (16.1% in the capital). According to experts the pandemic has highlighted issues of the housing availability in regions and the future of office spaces, while also negatively affecting trade centers due to restrictions related to social distancing.

The overall decrease in economic activity has also left its mark on lending by non-bank financial institutions, as their issuance of credit to domestic households and non-financial corporations continued to decrease also in Q4 2020 (year-on-year) by 6%, while leasing companies' loans in the same period also exhibited a similar trend, dropping by 7.1% (year-on-year). Highest drop in Q4 2020 (year-on-year) was observed in leasing companies' loans to non-financial corporations (decrease by 13.5%) while loans to households endured smaller decrease by 2%.

The Bank of Latvia has developed the Composite Cyclical Risk Indicator (CCRI)[2] that can serve as an additional cyclical systemic risk intensity measure that allows to account for the specificities of the Latvian financial system and to evaluate the state of the 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 (Chart 5).

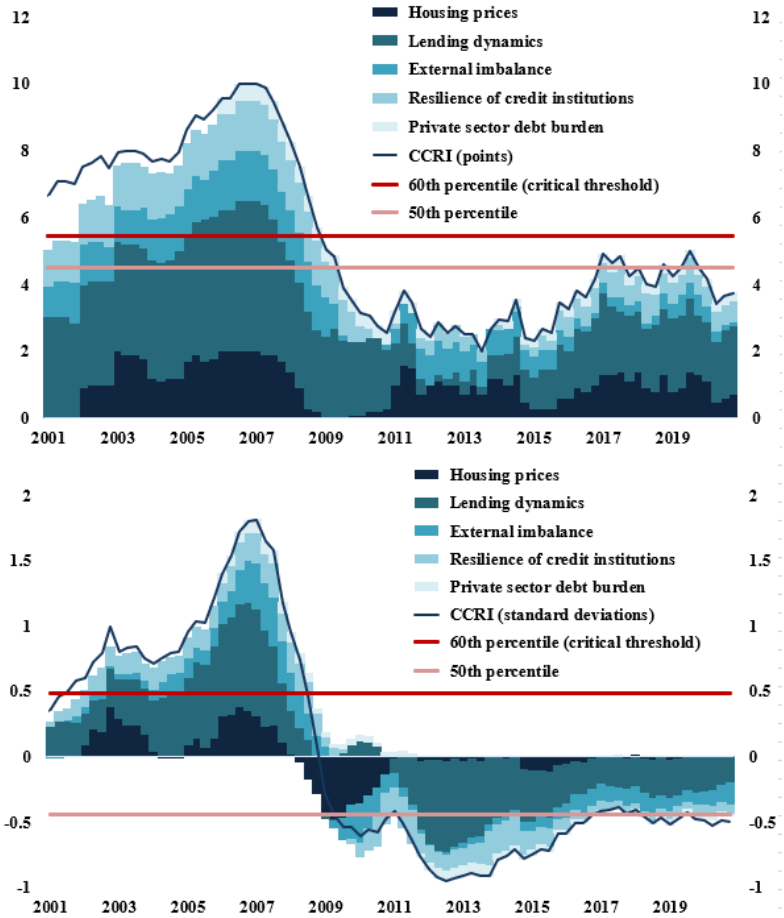


***Chart 5.*** *CCRI and its underlying components (points in Graph 1, standard deviations in Graph 2)*

Overall, considering the assessment of relevant indicators at the end of 2020 and the uncertainty towards future economic development in 2021, the financial cycle is expected to remain subdued. The effects of pandemic are reflected in weak lending trends and also by other relevant indicators that overall characterize the financial cycle. Therefore, the current assessment of the appropriate CCyB rate level remains at 0%.

[2] Bank of Latvia. Financial Stability Report (2020). Available: https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf

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