

## Q2 2023 assessment of the cyclical systemic risk and the applicable countercyclical capital buffer rate

12 June 2023

Latvian Banka, in its capacity as the designated authority for the application of the countercyclical capital buffer (hereinafter – CCyB), analyses the cyclical systemic risk on a quarterly basis pursuant to Section 35.<sup>5</sup> of the Credit Institution Law and, if necessary, sets or adjusts the CCyB rate applicable to risk exposures to residents of the Republic of Latvia. The CCyB aims to reduce excessive fluctuations of the financial cycle and strengthen credit institutions' resilience to the cyclical systemic risk.

Latvian Banka publishes quarterly assessments of the cyclical systemic risk and the appropriateness of the applicable CCyB rate on its website. If the CCyB rate remains unchanged, the previous decision regarding the applicable CCyB rate remains in force. The previous decision on 0% CCyB rate was made on 27 April 2021 (applicable as of 1 May 2022) by the Financial and Capital Market Commission, which has been integrated into Latvian Banka as of 1 January 2023. Credit institutions apply the respective CCyB rate to risk exposures to residents of the Republic of Latvia when calculating the institution-specific CCyB rate<sup>1</sup>.

**Latvian Banka maintains the CCyB rate at 0%, taking into account the cyclical systemic risk assessment carried out in Q2 2023. The cyclical systemic risk is still assessed as low considering the cautious lending and a slowdown in its growth rate, stricter credit standards and the rise in credit costs, as well as lower activity in the real estate market. The ratio of domestic private non-financial sector credit to GDP continues to decline.**

The **credit-to-GDP gap** still remained negative both according to the standardised (broad) credit definition and additional (narrow) credit definition (see Table 1 and Charts 1 and 2). Therefore, the CCyB buffer guide is 0%.

Table 1. **Key variables of the CCyB rate assessment**<sup>2</sup>

Variables	Standardised credit (wide) definition	Additional credit (narrow) definition
	Q4 2022	Q1 2023
Credit-to-GDP ratio (%)	59.5	25.7
Credit-to-GDP gap (pp)	-28.4	-11.9
Benchmark buffer rate (% of risk weighted assets)	0	0 <sup>3</sup>

The growth rate of **domestic lending** to non-financial corporations (hereinafter – NFCs) and households in Latvia is slowing down (see Chart 3). In March 2023, the annual

<sup>1</sup> According to the Financial and Capital Market Commission's Regulation No 137 "Regulation on Calculating the Institution-Specific Countercyclical Capital Buffer Rate" of 25 August 2020.

<sup>2</sup> The narrow credit definition includes credit institution loans to NFCs and households and the debt securities purchased by credit institutions, but the wide definition – liabilities of NFCs and households to credit institutions, as well as loans from non-bank financial institutions or other NFCs.

<sup>3</sup> In Latvia, the narrow measure of credit provides better signalling properties; therefore, the benchmark buffer rate calculated according to the narrow credit definition serves as the buffer guide.

growth rate of domestic loans (excluding one-time structural effects in the banking sector) decreased to 6.3%<sup>4</sup> (inter alia, loans to NFCs grew by 9.0%, but loans to households – by 3.6%; see Chart 4). Rise in interest rates, high inflation, drop of purchasing power, weak economic outlook and uncertainty weaken the willingness and ability to borrow by companies and households. Lending is also affected by various structural factors. The volume of financing to the economy and investments overall is still insufficient.

**Private non-financial sector debt and its servicing burden** is very low. In Q1 2023, due to the rise in interest rates, the ratio of household and NFC interest payments to GDP slightly increased as opposed to a downward trend observed in the recent years (see Chart 5). A prolonged and rapid growth in costs as well as a rise in loan interest rates increase credit risk for both households and NFCs. Currently, the deterioration of loan portfolio is not observed.

Activity in the **real estate market** continues to contract, taking into account the decrease in household purchasing power, the increase in the costs of loans and the weak supply of new housing. In April 2023, the number of purchase transactions fell by 15.2% (year on year). Growth in house prices is becoming more moderate – in Q4 2022, the annual growth rate of the Central Statistical Bureau (hereinafter – CSB) house price index declined to 9.1% (see Chart 6). Increase in supply of less energy-efficient housing has facilitated the downward trend of their respective prices. In turn, in the new housing segment, a lack of supply and the rise in construction costs contribute to the continuous price hikes. Therefore, the price trends differ in these real estate segments.

Persistent weakening of **macroeconomic development** in Latvia also suggests a low cyclical risk. In 2023, the growth rate of GDP will continue to be low, but the inflation – high. Taking into account that the inflation in the euro area remains significantly above the target level set by the central bank (2% in the medium term), a further increase in interest rates can be expected. According to the forecasts of Latvijas Banka, in 2024, the macroeconomic outlook might improve – annual inflation is expected to drop below 3%, but the economic growth will rise above 3%.

The growth in **composite cyclical risk indicator** (hereinafter – **CCRI**) developed<sup>5</sup> by Latvijas Banka decreased from 6.0 points in Q3 2022 to 5.7 points in Q4 2022, remaining below the critical threshold (i.e. below the above-average risk threshold; see Chart 10). It should be noted that in the composition of CCRI the most significant weights are attributed to credit and house price variables, which have been primarily affected by the significant rise in prices and costs. The CCRI was also affected by the current account deficit component, which was increased by rising prices of imported energy resources (see Chart 8). Therefore, it is important to look at the deflated CCRI as well. After deflating<sup>6</sup> the credit and house price variables, the CCRI was only 4.6 points.

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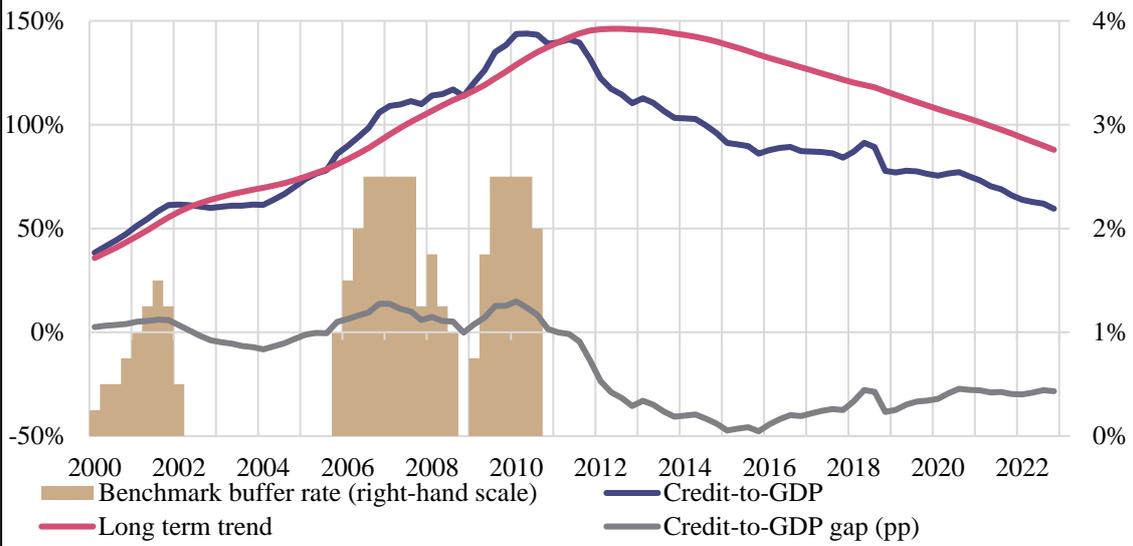
<sup>4</sup> In real terms, deflating with the projected GDP deflator, the domestic loan portfolio continued to decrease notably – in March 2023, it shrank by 4.7% (annually).

<sup>5</sup> Additional information on the CCRI methodology is available in Appendix 1 of the Financial Stability Report 2020 of Latvijas Banka ([https://datnes.latvijasbanka.lv/fsp/FSP\\_2020\\_en.pdf](https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf)). In 2021, the CCRI model was repeatedly tested, and the medium risk interval was widened to the 45<sup>th</sup>–the 65<sup>th</sup> percentiles (before it was set between the 50<sup>th</sup> and the 60<sup>th</sup> percentiles).

<sup>6</sup> The house price index and the index of house prices-to-average net wages ratio are adjusted with the consumer price index, but the domestic private non-financial sector loans – with the GDP deflator.

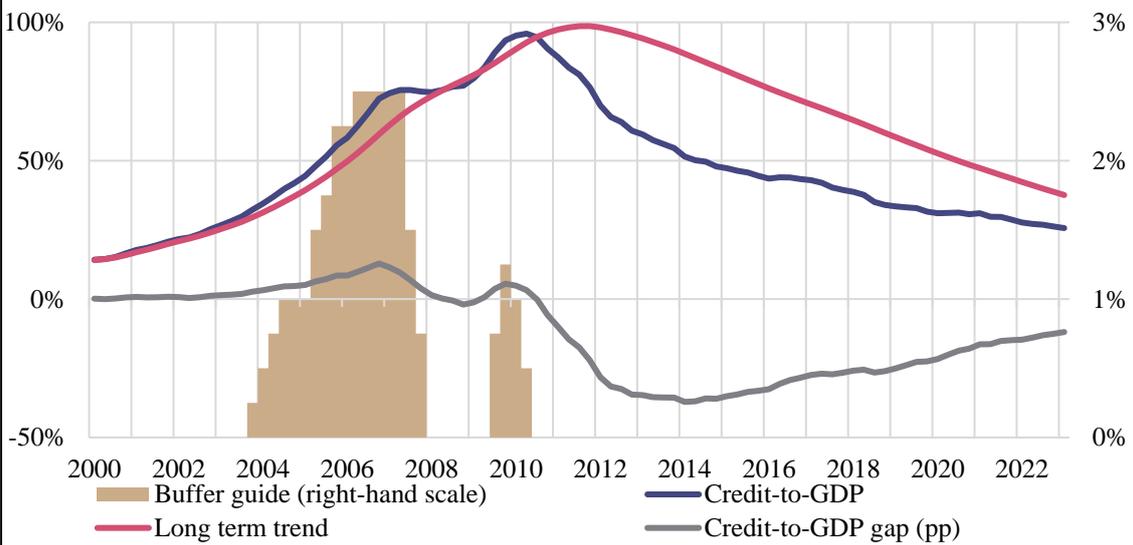
Annex 1. Key variables of the Financial Cycle

Chart 1. Standardised credit-to-GDP gap



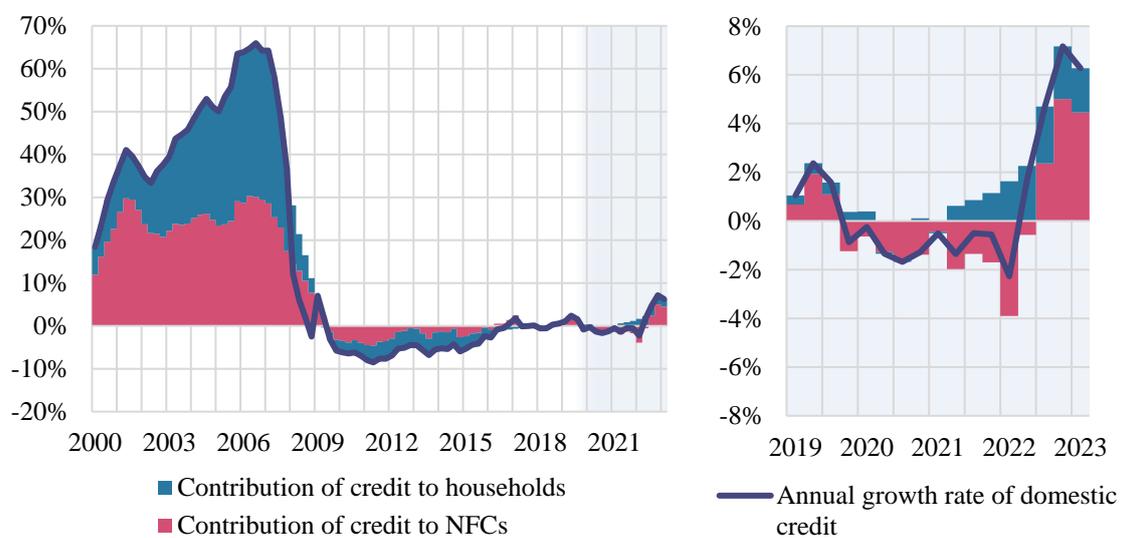
Source: Latvijas Banka, CSB.

Chart 2. Additional credit-to-GDP gap



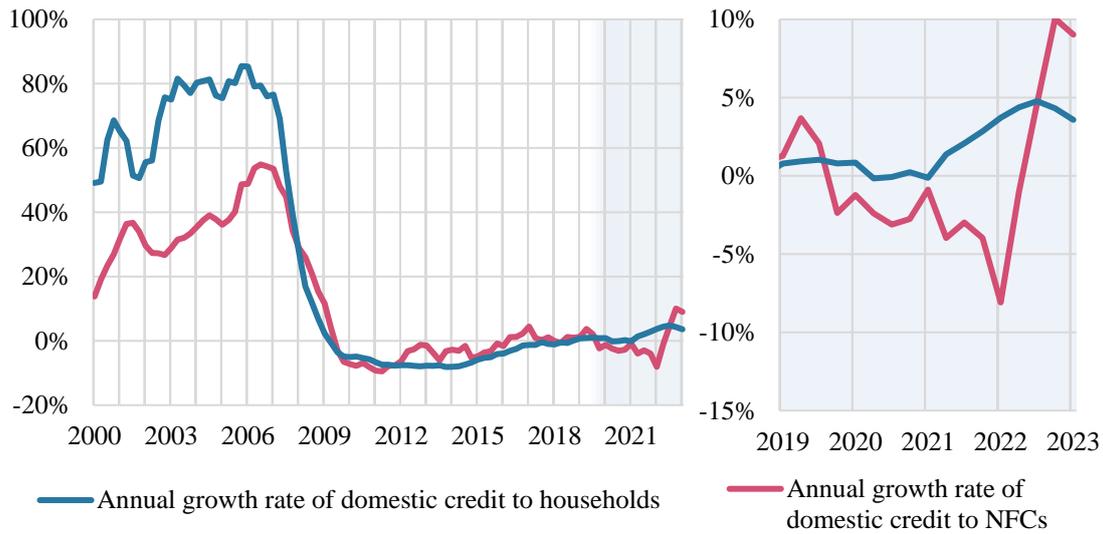
Source: Latvijas Banka, CSB.

Chart 3. Credit developments



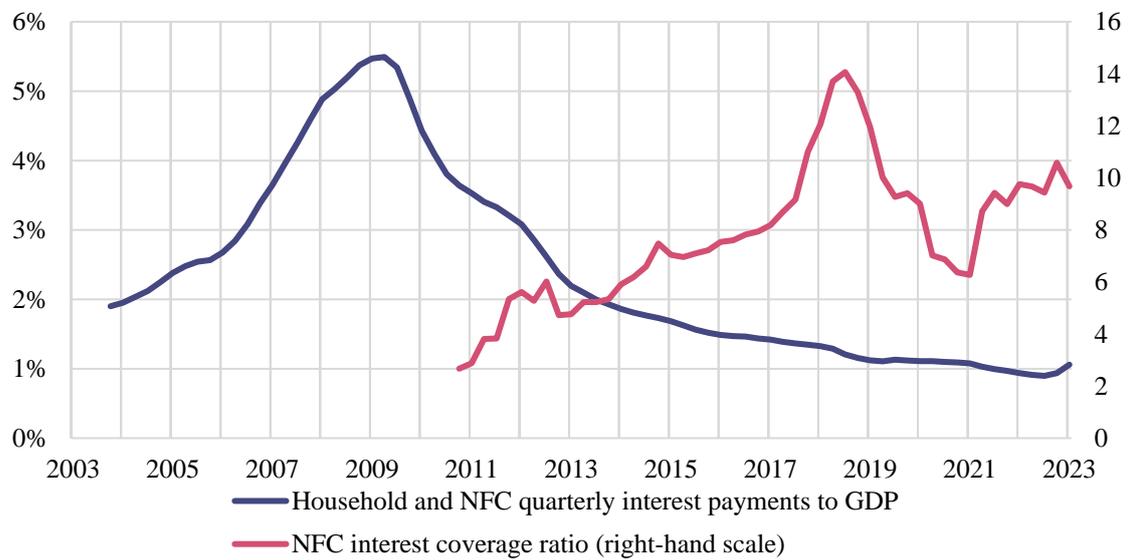
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

**Chart 4. Credit developments – annual growth rates of credit to households and NFCs**



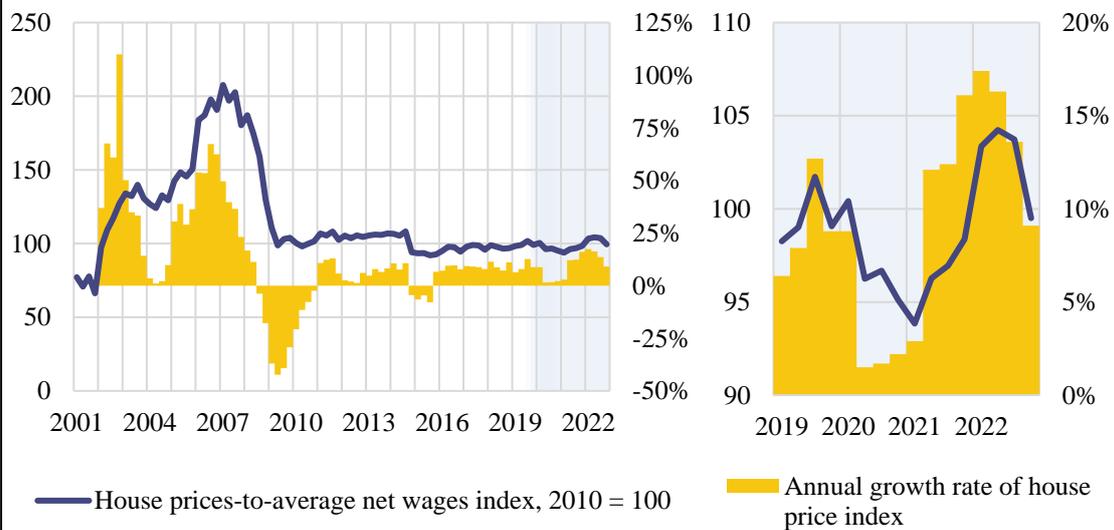
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

**Chart 5. Private non-financial sector debt servicing burden**



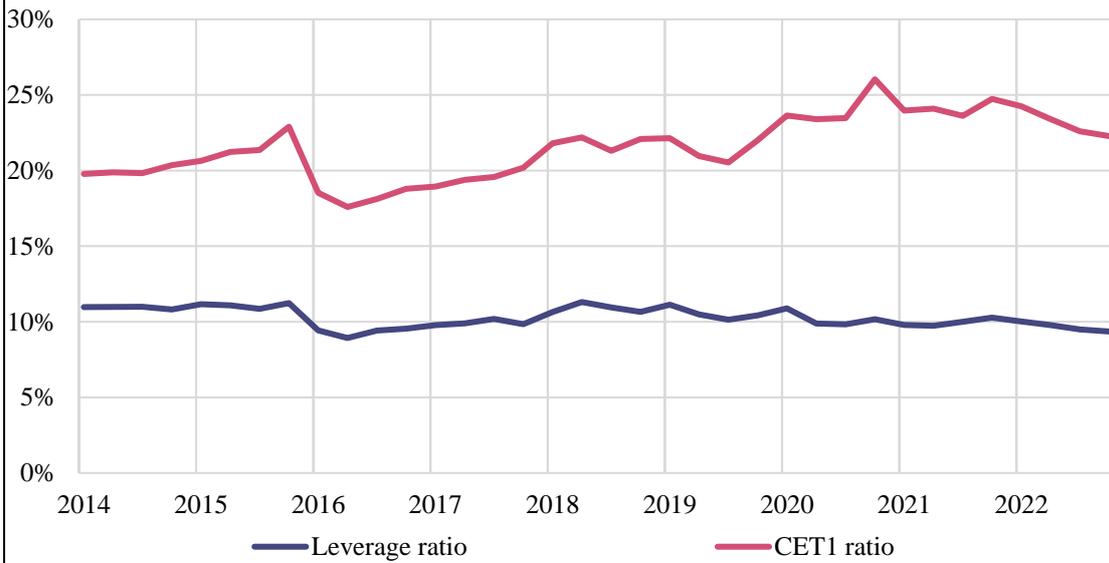
Source: Latvijas Banka, CSB. Note. The NFC interest coverage ratio includes the ratio of earnings before taxes and interest payments to interest payments.

**Chart 6. Potential overvaluation of property prices**



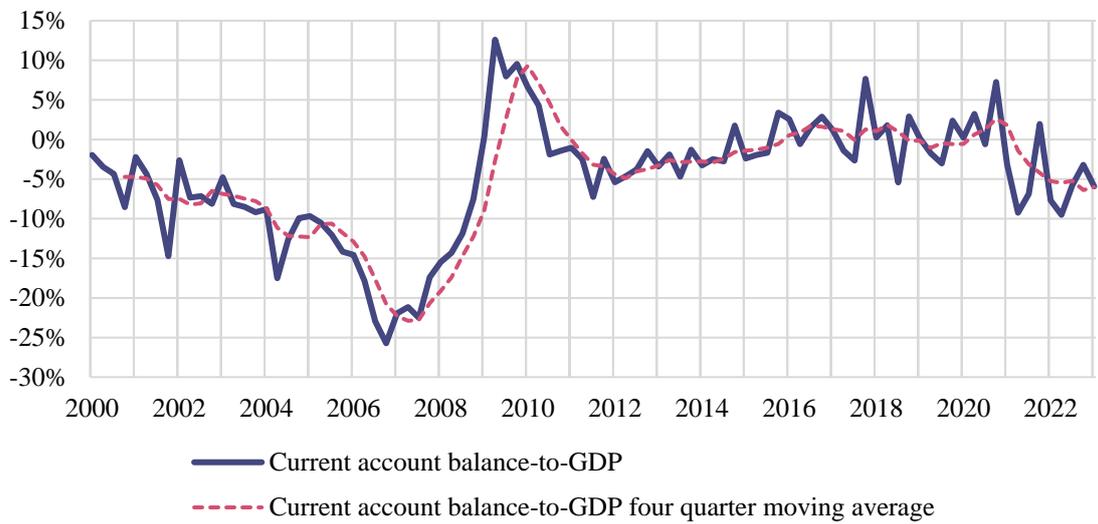
Source: CSB.

**Chart 7. Resilience of credit institutions**



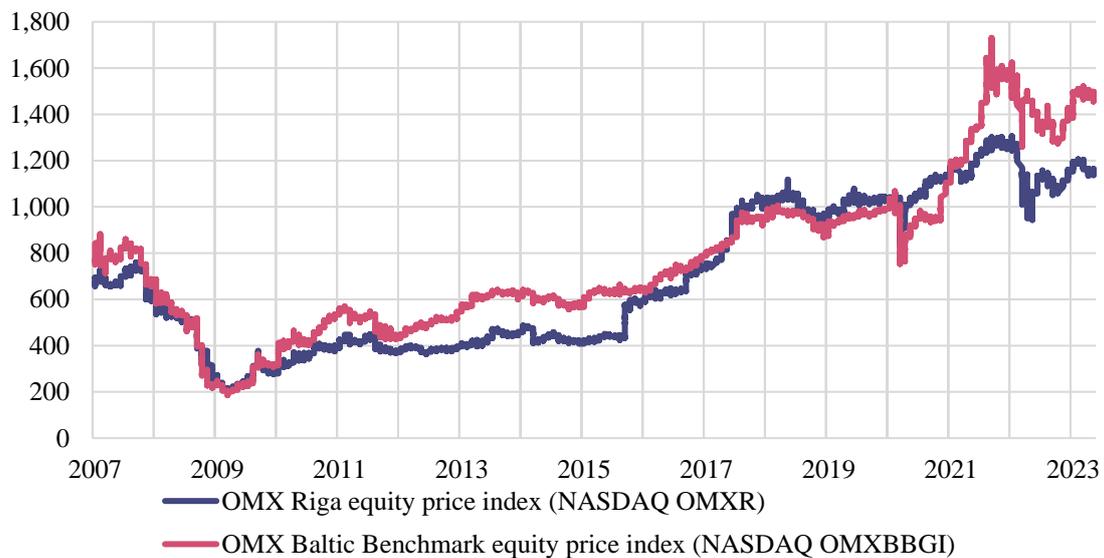
Source: Latvijas Banka. Note. Only credit institutions active at the end of 2022 are included.

**Chart 8. External imbalances**



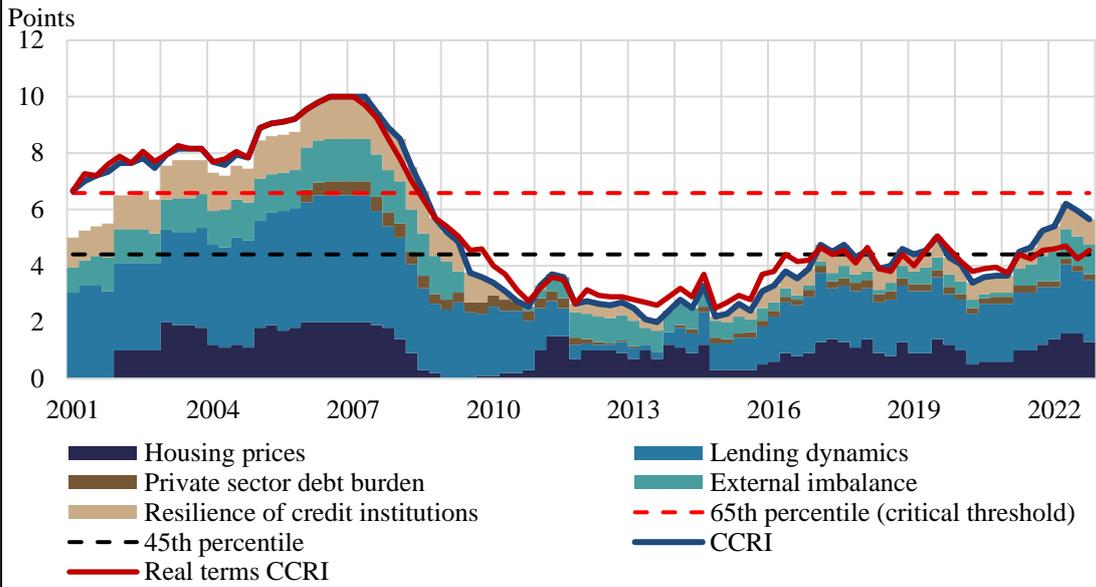
Source: Latvijas Banka, CSB.

**Chart 9. Potential mispricing of risk**



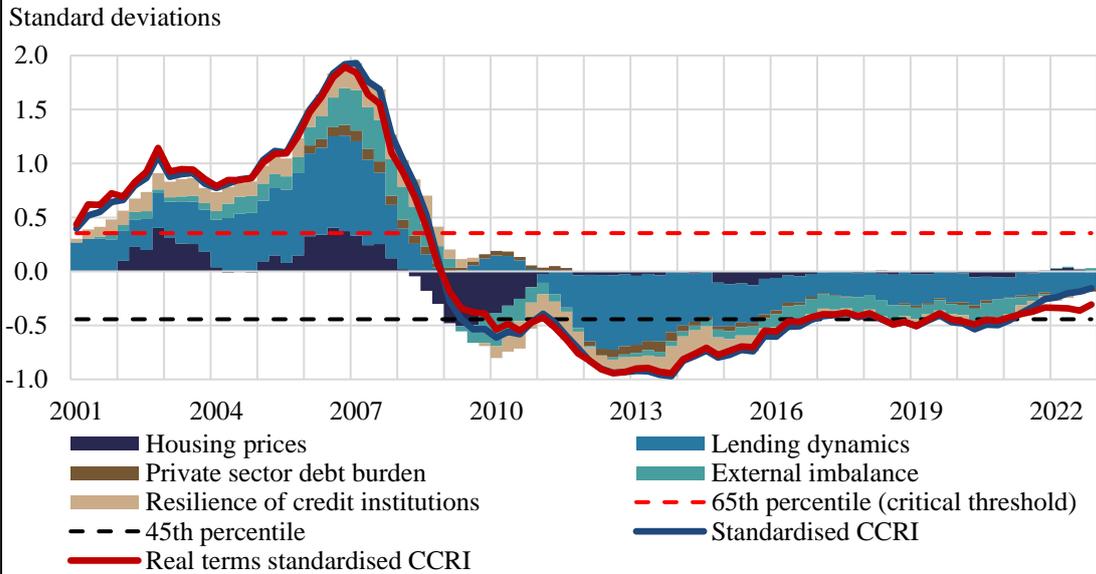
Source: Bloomberg.

**Chart 10. CCRI – percentile method**



Source: Latvijas Banka, CSB.

**Chart 11. CCRI – standardised method**



Source: Latvijas Banka, CSB.