LATVIJAS BANKA

EIROSISTĒMA

K. VALDEMĀRA IELA 2A, RĪGA, LV-1050, LATVIJA. TĀLRUNIS +371 67022300, E-PASTS INFO@BANK.LV, WWW.BANK.LV

Q4 2023 assessment of the cyclical systemic risk and applicable countercyclical capital buffer rate

18 December 2023

The countercyclical capital buffer (hereinafter – the CCyB) aims at strengthening the capitalisation of credit institutions so that they are adequately equipped to absorb losses in times of crisis. When risks materialise, the CCyB rate is partially or fully released to help credit institutions continue to offer funding to the economy, thereby reducing the duration of crises and their impact on the economy.

Latvijas Banka, in its capacity as the designated authority for the application of the CCyB rate, evaluates the cyclical systemic risk on a quarterly basis pursuant to Section 35.[5] of the Credit Institution Law and, if necessary, sets or adjusts the CCyB rate applicable to credit institution exposures to residents of the Republic of Latvia. Latvijas Banka publishes quarterly assessments of the cyclical systemic risk and the applicable CCyB rate. If the CCyB rate remains unchanged, the previous decision regarding the applicable CCyB rate remains in force.

On 18 December 2023, Latvijas Banka decided to implement a positive neutral CCyB approach and determined that the 0.5% CCyB rate requirement takes effect on 18 December 2024 and the 1% CCyB rate requirement – on 18 June 2025. Credit institutions apply the respective CCyB rate to the risk exposures to residents of the Republic of Latvia when calculating the institution-specific CCyB rate[1].

Latvijas Banka has decided to implement the positive neutral approach to setting the CCyB. According to this approach, the CCyB rate is maintained at a certain base level above zero already in a standard risk environment or in the neutral phase of the financial cycle when the cyclical systemic risk is neither elevated nor significantly low. Latvijas Banka has determined 1% as an appropriate CCyB base rate. Latvijas Banka will continue to assess the intensity of the cyclical systemic risk on a quarterly basis. In the event of an increase of the cyclical systemic risk, the CCyB rate will be raised according to the risk intensity already from the positive base rate level, rather than from zero. The total CCyB requirement will, therefore, comprise both the base rate and the cyclical rate components. The CCyB rate can be partially or fully released in times of crisis as risks materialise and during the post crisis recovery phase.

This decision is based on the necessity to ensure a gradual and timely increase in the resilience of credit institutions against potential shocks in the future, also considering the long 12-month period of implementing the CCyB rate. A timely build-up of the capital buffer provides protection against large unexpected shocks, reduces uncertainty about timely identification of risks and their materialisation and ensures greater flexibility with respect to the macroprudential policy implementation throughout the financial cycle, since the CCyB is a macroprudential policy instrument that is most readily available in the event of a financial crisis.

[1]Pursuant to Regulation No 137 of the Financial and Capital Market Commission of 25 August 2020 on calculating the institution-specific countercyclical capital buffer rate.

To start the implementation of the positive neutral CCyB approach**, on 18 December 2023, the Council of Latvijas Banka decided that the CCyB rate of 0.5% would take effect on 18 December 2024 and 1% – on 18 June 2025.**

The current financial situation of Latvian credit institutions allows them to build up and maintain this buffer in full amount without raising additional capital and without negative pro-cyclical side effects. The financial situation of the credit institutions is sufficiently strong as their capitalisation and profitability is good and does not constrain lending, their asset quality remains good (see Charts 7 and 8).

Considering the Q4 2023 cyclical systemic risk assessment, Latvijas Banka has decided not to increase the cyclical component of the CCyB rate. The cyclical systemic risk is still assessed as low taking into account a slowdown in the pace of lending, increasing lending costs and continuously high lending standards, 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** in the private non-financial sector is gradually narrowing but remains negative both according to the standardised (broad) credit definition and additional (narrow) credit definition (see Table 1 and Charts 1 and 2). Consequently, the CCyB buffer guide is 0%.

Table 1 **Key variables of the CCyB rate assessment**[2]

Variable	**Standardised (broad) credit definition**	**Additional (narrow) credit definition**
	Q2 2023	Q3 2023
Credit-to-GDP ratio (%)	59.8	26.2
Credit-to-GDP gap (pp)	–24.6	–9.3
Benchmark buffer rate (% of risk weighted assets)	0	0[3]

The growth rate of **domestic lending** to both non-financial corporations (hereinafter – NFCs) and households continues to decelerate (see Chart 3). In September 2023, the annual growth rate of domestic loans, excluding one-off structural effects in the banking sector, shrank to 2.1%[4] (inter alia, the annual growth rate of the household loan portfolio decreased to 2.9%, while that of the NFC loan portfolio declined slightly by 0.2%; see Chart 4). A sharp rise in interest rates, inflation, weak economic growth and uncertainty continue to weigh on the willingness and ability of households and companies to borrow. Moreover, lending is still affected by several structural factors.

The private non-financial sector debt and its servicing burden is low. Along with the interest rate increase, the ratio of household and NFC interest payments to GDP continued to grow in the third quarter of 2023 (see Chart 5). The rise in costs, including that in loan interest payments, increases the credit risk of both households and NFCs. Nonetheless, the financial resilience of borrowers has been strong as the bank loan portfolios have shown no signs of deterioration so far. The share of Stage 2 loans has been on a steady downward trend since the beginning of 2022 (see Chart 8).

[2] The narrow credit definition includes credit institution loans to NFCs and households and debt securities purchased by credit institutions, but the broad definition comprises liabilities of NFCs and households to credit institutions, as well as their loans from non-bank financial institutions or other NFCs.
[3] 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.
[4] Deflated with the projected GDP deflator, the annual domestic loan portfolio remained unchanged in real terms in September 2023.

Following a weak recovery in June-August of 2023, the **real estate** market activity is once again gradually shrinking, and the total number of real estate purchases was down by 9.1% year on year in October. The annual growth in house prices continued moderating: the annual growth rate of the house price index published by the Central Statistical Bureau of Latvia was 5.6% in the second quarter of 2023 (see Chart 6). The supply of energy-inefficient standard apartments remains at a historically high level, and their prices are on a slow and gradual downtrend, with their cumulative decline amounting to 11.1% between June 2022 and September 2023. Meanwhile, growth in prices on new housing remained persistently high (prices on new housing increased by 15.0% year on year in the second quarter of 2023) since their supply was still limited and the construction costs kept surging in early 2023.

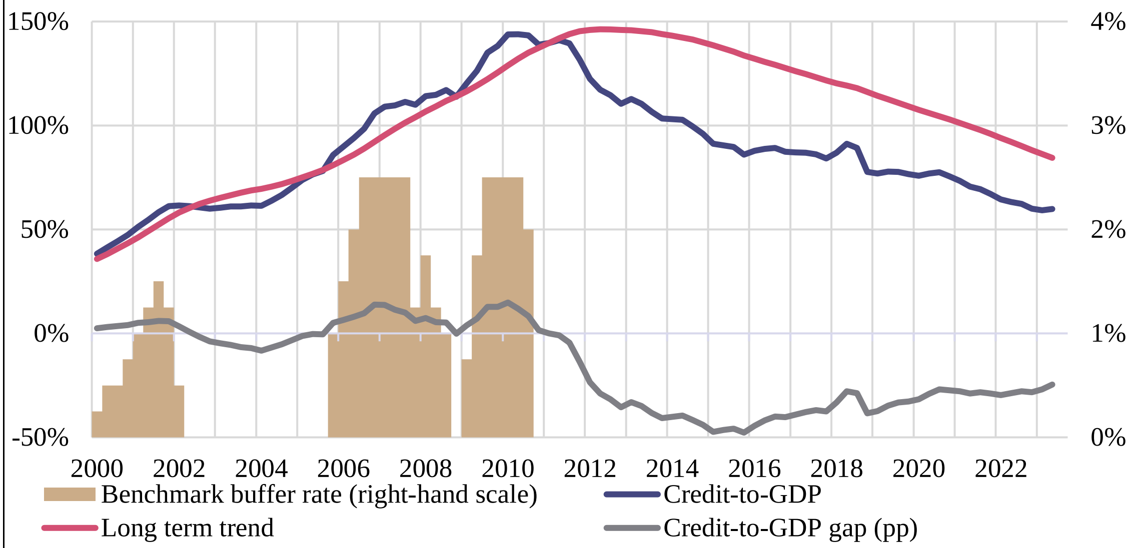
The persistently weak **macroeconomic development** in Latvia also suggests that the cyclical risk is low. The monetary policy tightening has led to a decrease in external demand, and the most recent forecast by Latvijas Banka suggests a 0.4% decline in Latvia's GDP for 2023. The economic activity might recover gradually in 2024 and 2025 as the household purchasing power and investments are projected to follow an upward trend. The substantial decline in inflation, the rise in real wages and the government support measures are all improving the financial situation of households. Meanwhile, investment activity is supported by absorption of EU funds. The weakening of external demand has driven an increase in the current account deficit to 5.3% of GDP in the third quarter of this year (see Chart 9).

Latvijas Banka's composite systemic cyclical risk indicator (hereinafter – the CCRI)[5] has been decreasing over the last few quarters. The CCRI declined from 5.4 points in the first quarter of 2023 and from 6.15 points in the second quarter of 2022 to 5.3 points in the second quarter of 2023. It is still below the risk level that is considered to be above average (see Chart 11).

[5] For further information on the CCRI methodology, see Appendix 1 to Latvijas Banka's Financial Stability Report 2020 (https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf). In 2021, the CCRI model was tested again by applying a broader average risk interval ranging between the 45th and the 65th percentiles (the previous interval ranged between the 50th and the 60th percentiles).

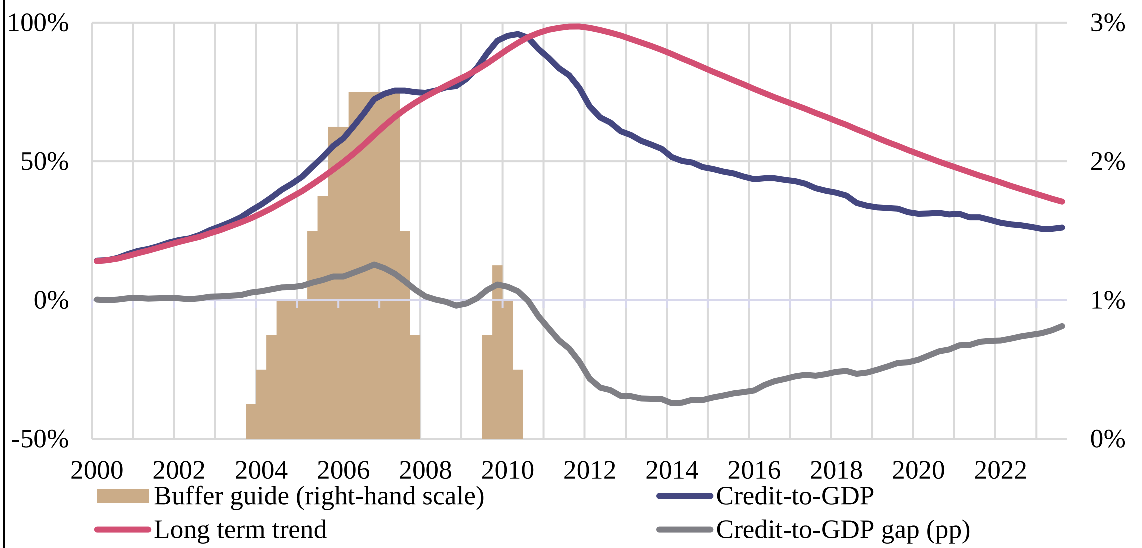
Annex 1. **Key variables of the Financial Cycle**

Chart 1. Standardised credit-to-GDP gap



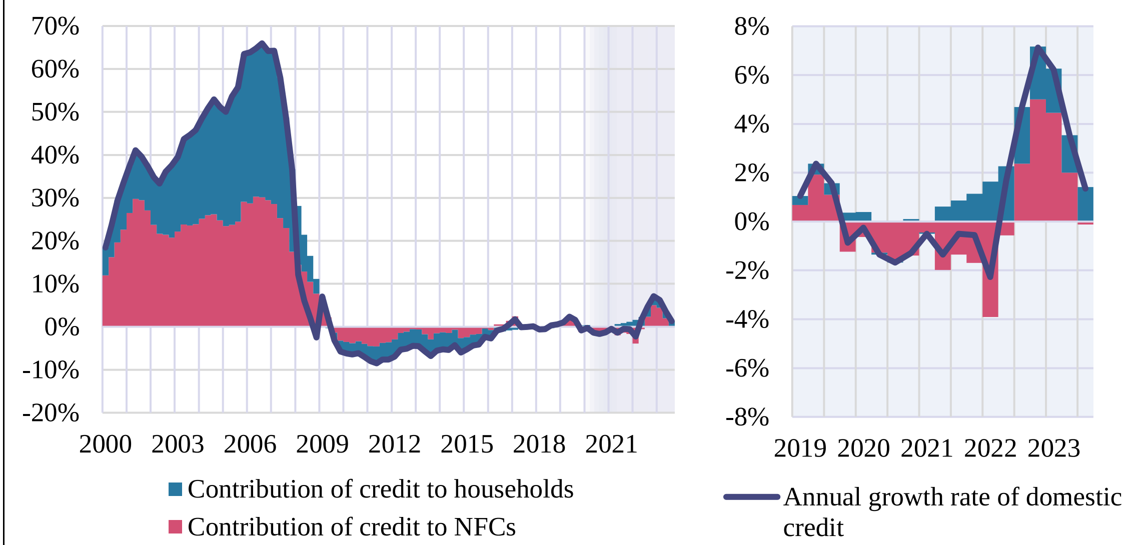
Source: Latvijas Banka, CSB.

Chart 2. Additional credit-to-GDP gap



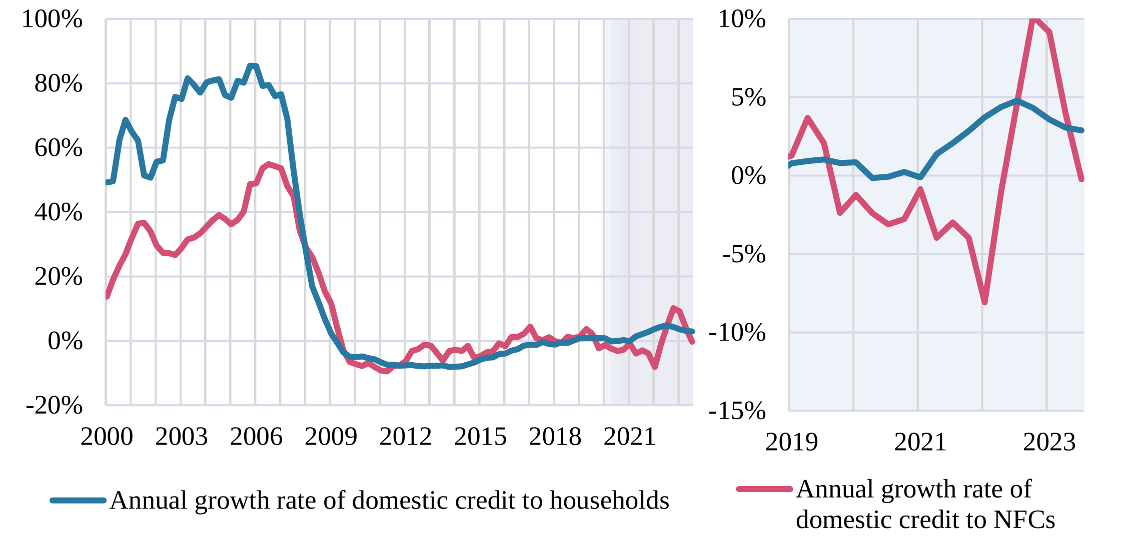
Source: Latvijas Banka, CSB.

Chart 3. Credit developments



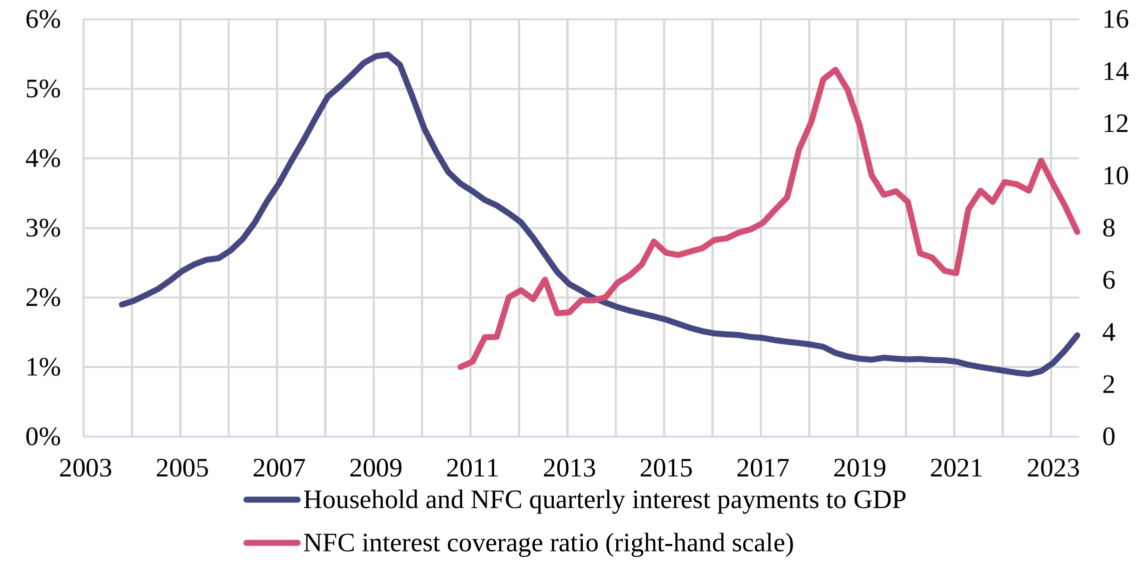
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

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



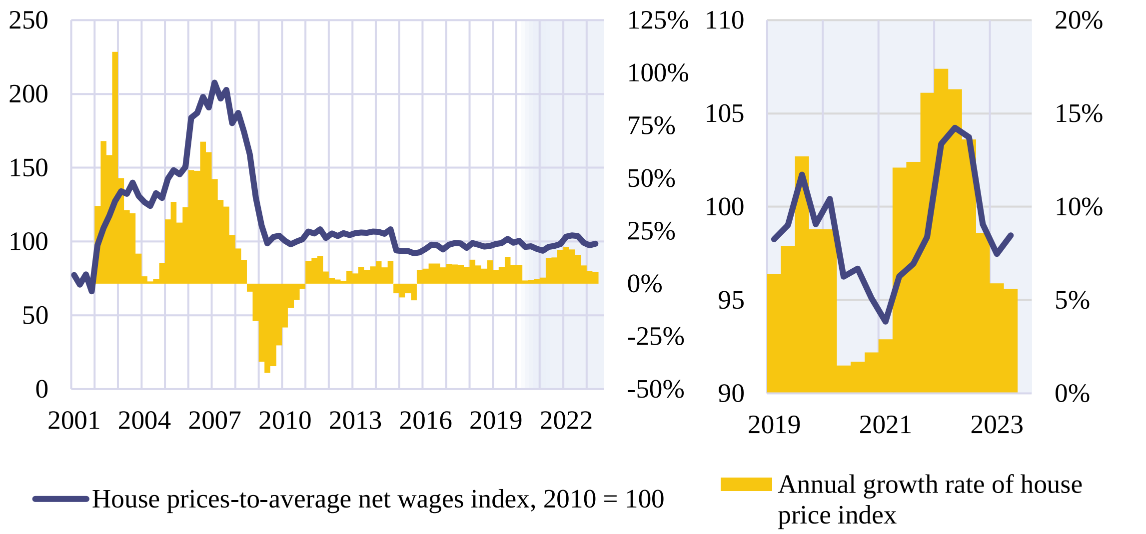
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

Chart 5. Private non-financial sector debt servicing burden



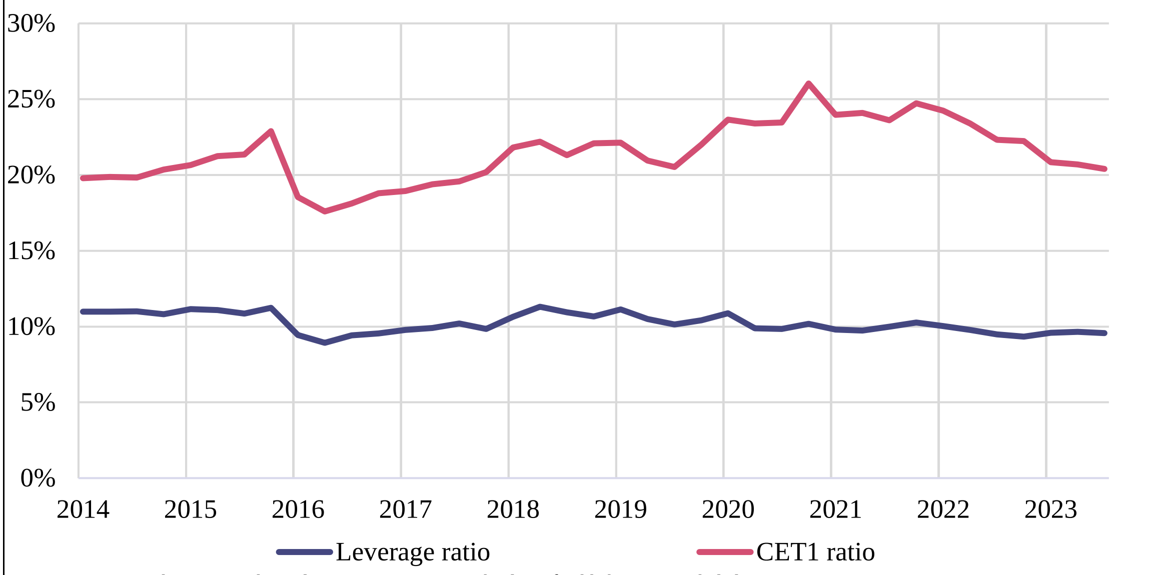
Source: Latvijas Banka, CSB. Note. The NFC interest coverage ratio includes the ratio of earnings before taxes and interest payments to interest payments.

Chart 6. Potential overvaluation of property prices



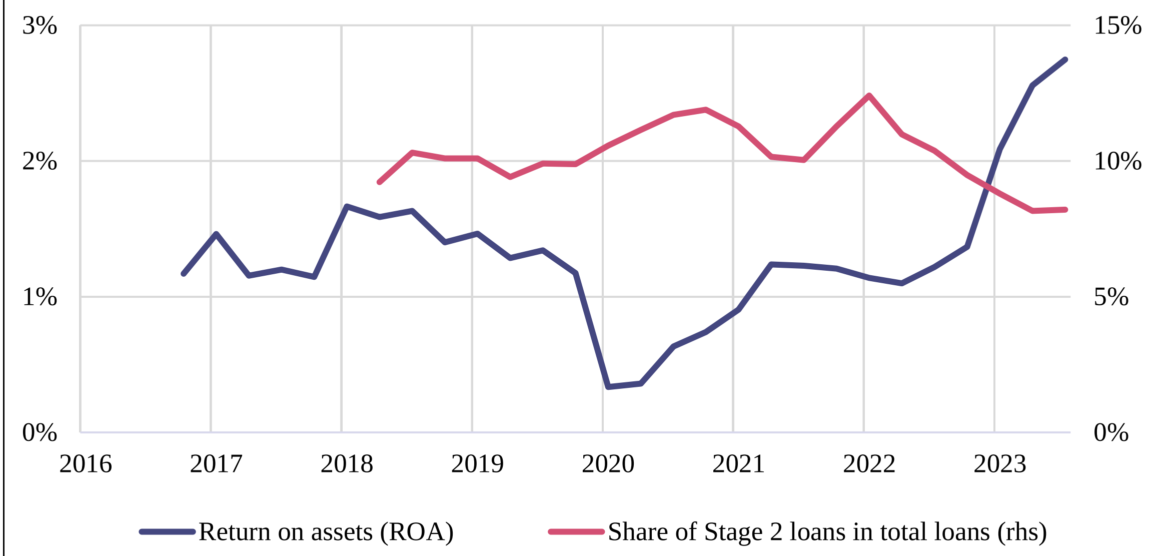
Source: CSB.

Chart 7. Resilience of credit institutions - capitalization



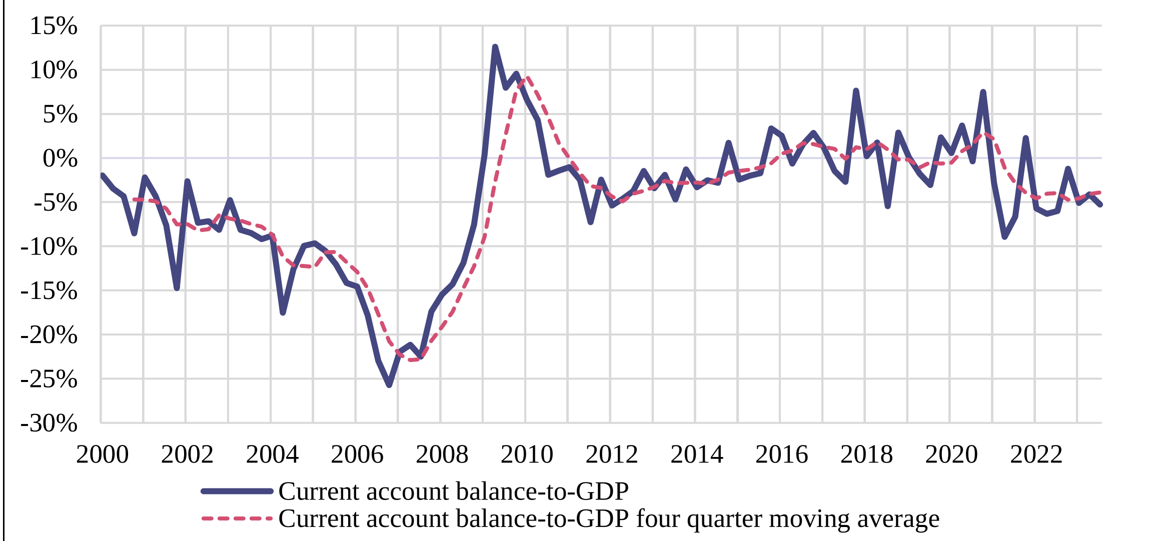
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 8. Resilience of credit institutions - profitability and asset quality



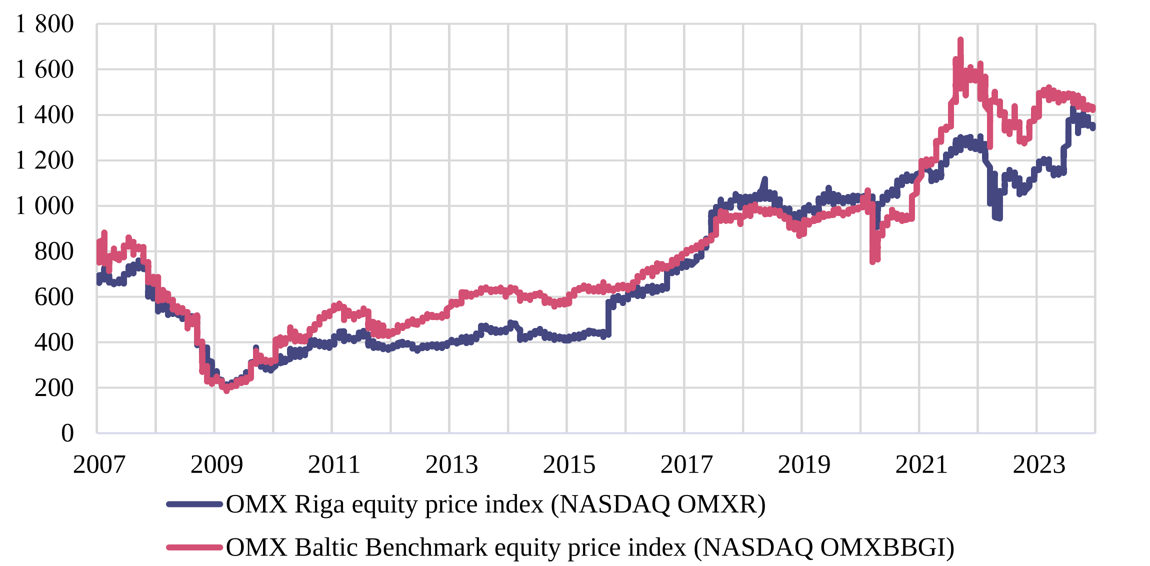
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 9. External imbalances



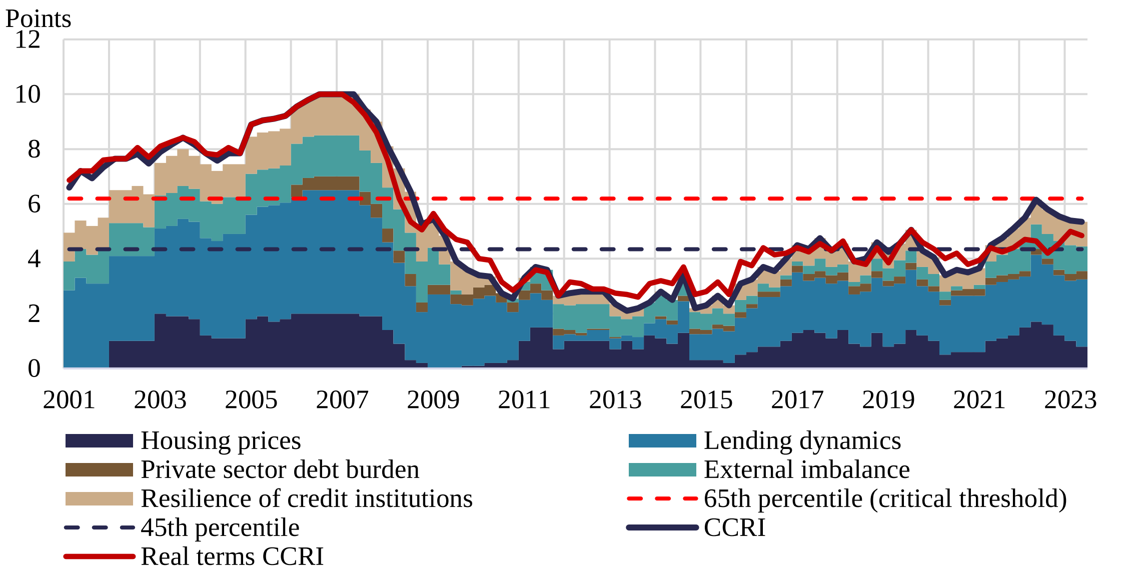
Source: Latvijas Banka, CSB.

Chart 10. Potential mispricing of risk



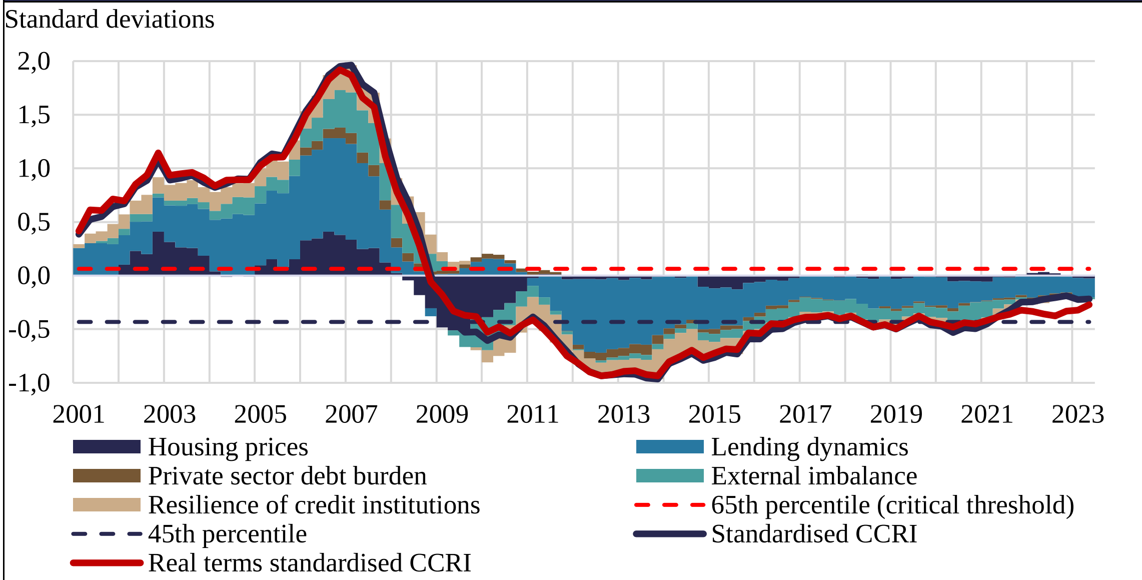
Source: Bloomberg.

Chart 11. CCRI – percentile method



Source: Latvijas Banka, CSB.

Chart 12. CCRI – standardised method



Source: Latvijas Banka, CSB.