LATVIJAS BANKA
EIROSISTĒMA

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Macroprudential policy framework of Latvijas Banka

1. General information

Latvijas Banka's task is to determine and implement macroprudential policy[1]. **The objective of the macroprudential policy framework of Latvijas Banka** is to explain how the institution implements this task. The framework sets the ultimate objective and intermediate objectives of macroprudential policy, delineates the instruments for their attainment, as well as specifies the most important elements and principles underpinning the implementation of macroprudential policy.

Macroprudential policy is the policy through which Latvijas Banka promotes the stability of the financial system as a whole – by strengthening its resilience and limiting the build-up of systemic risks. The implementation of macroprudential policy encompasses the identification, analysis, and assessment of systemic risks and vulnerabilities, as well as the application of macroprudential policy measures.

Financial system means all financial institutions, markets, products, and market infrastructures[2].

Financial stability means a condition of the financial system enabling it to withstand shocks, thereby mitigating the likelihood of significant disruptions in the financial intermediation process.

Systemic risk means a risk of disruption in the financial system with the potential to have serious negative consequences for the financial system and the real economy[3]. The materialisation of such systemic risk typically manifests as a financial crisis, which can have profound effects on the economy and long-term growth.

When defining and implementing macroprudential policy, Latvijas Banka is guided by the legal framework established by the European Union (hereinafter the "EU") and Latvia,

[1] Section 45 of the Law on Latvijas Banka.
[2] The term is used within the meaning of Regulation (EU) No 1092/2010 of the European Parliament and of the Council (24 November 2010) on European Union macroprudential oversight of the financial system and establishing a European Systemic Risk Board (Article 2(b)).
[3] This term is used within the meaning of Directive 2013/36/EU of the European Union and the Council (26 June 2013) on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Article 3(10)).

for instance, the CRD[4], the CRR[5], the Law on Latvijas Banka, the Credit Institution Law, and regulations issued by Latvijas Banka. Additionally, Latvijas Banka considers recommendations and warnings issued by the European Systemic Risk Board (hereinafter the "ESRB"), statements from the European Central Bank (hereinafter the "ECB"), and guidelines from the European Banking Authority (hereinafter the "EBA").

2. Ultimate objective and intermediate objectives

The ultimate objective of Latvijas Banka's macroprudential policy[6] is to contribute to the overall stability of the financial system, including strengthening the resilience of the financial system to shocks and restricting the build-up of systemic risks, thus ensuring sustainable contribution of the financial system to the economy.

The achievement of the ultimate objective is supported by subordinated **intermediate objectives**:

1) to limit **excessive indebtedness risks**, which manifest, for instance, as heightened borrower solvency risk, disproportionate leverage, accelerated credit growth, and the emergence of asset-price bubbles;
2) to limit **systemic liquidity and funding risks** across the financial system, such as those stemming from an excessive loan-to-deposit ratio or composition of the raised funding;
3) to limit **the direct and indirect exposure concentration**;
4) to limit systemic risks to financial stability arising from **excessive risk-taking by systemically important financial institutions and wrong incentives** (too-big-to-fail; moral hazard).

The ultimate objective and intermediate objectives were set based on Recommendation of the ESRB of 22 December 2011 on the macroprudential mandate of national authorities (ESRB/2011/3) and Recommendation of the ESRB of 4 April 2013 on intermediate objectives and instruments of macroprudential policy (ESRB/2013/1), as well as considering the structural features of the Latvian financial system. These objectives are defined in qualitative rather than quantitative terms, as macroprudential supervision simultaneously manages multiple risks, and, unlike monetary policy, it is difficult to establish a universal, medium-term stable quantitative target in this domain.

Latvijas Banka periodically assesses the appropriateness of its established intermediate objectives, in light of its practical experience in macroprudential policy implementation, the evolution of Latvia's financial system, and changes in EU and national regulatory frameworks.

In reviewing its intermediate objectives and implementing macroprudential policy, Latvijas Banka also monitors EU-level initiatives concerning the potential contribution of macroprudential policy to managing emerging risks, such as those posed by

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[4] Directive 2013/36/EU of the European Parliament and of the Council (26 June 2013) on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV) and their supplementary versions.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council (26 June 2013) on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 and its supplementary versions.

[6] Section 44 of the Law on Latvijas Banka.

technological development[7], global geopolitical risks[8] and cyber threats[9], climate risks[10], and the non-bank financial sector[11]. Latvijas Banka takes into account that these risks are best addressed primarily through other policy instruments. Therefore, the use of macroprudential measures to mitigate such risks is considered in conjunction with other policies, serving as a potentially complementary or corrective mechanism.

3. Formulation and implementation of macroprudential policy

When formulating and implementing macroprudential policy, Latvijas Banka carries out the following activities:

1) analyses and assesses the stability of the Latvian financial system – it identifies, assesses, and monitors systemic risks and vulnerabilities that may threaten financial stability, and assesses whether the financial system can withstand shocks;
2) implements macroprudential measures aimed at mitigating systemic risks and enhancing the resilience of financial institutions – it selects appropriate instruments, determines the scope and specifications of the requirements, assesses the suitability and effectiveness of the adopted macroprudential measures.

3.1. Analysis and assessment of the financial system stability

Timely and appropriate identification, analysis, and assessment of systemic risks and vulnerabilities are essential prerequisites for the effective implementation of macroprudential policy.

Latvijas Banka monitors and analyses risks and vulnerabilities within the financial sector – including trends in banking and non-banking lending, credit, liquidity, funding, market, profitability, and solvency risks in the banking sector, as well as the developments of the non-banking financial sector. Stress tests assess banks' resilience to adverse scenarios encompassing credit, market, liquidity, and climate-related risks. Risk assessment also involves an analysis of risks within the external and internal macro-financial environments, the real estate market, the solvency of households and non-financial corporations, the financial sector's interconnectedness with the economy, as well as the interrelations among financial institutions. The assessment also takes into account the cyclical and structural dimensions of systemic risks[12].

The assessment of the financial stability is based on extensive quantitative and qualitative data and involves the application of various analytical methods. Expert judgement plays a crucial role in the assessment of systemic risks and vulnerabilities, as well as in decision-making regarding macroprudential measures.

The financial stability assessment is reflected in the Financial Stability Report published by Latvijas Banka and in other related publications and internal reports submitted to the

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[7] ECB (2024) Technology as a new frontier for macro-prudential policy.
[8] ECB (2024) Global rifts and financial shifts: supervising banks in an era of geopolitical instability.
[9] ESRB (2023) Advancing macro-prudential tools for cyber resilience – Operational policy tools.
[10] ESRB (2023) Towards macro-prudential frameworks for managing climate risk.
[11] EC (2024) Macro-prudential policies for non-bank financial intermediation (NBFI).
[12] Cyclical systemic risks and vulnerabilities tend to accumulate and evolve as a result of the procyclical behaviour of financial institutions or their customers (during the upswing of the financial cycle, financial institutions are inclined to take on excessive risks, whereas in periods of downturn, they typically exhibit heightened risk aversion). Structural systemic risks and vulnerabilities in the financial system emerge, for example, from an increasing concentration of risk exposures or from heightened interconnectedness among financial institutions – particularly those deemed systemically important – and the adverse effects of such interlinkages.

Council of Latvijas Banka. These reports are prepared on a regular basis within the framework of a process for identifying and assessing risks and vulnerabilities that could threaten financial stability.

3.2. Implementation of macroprudential measures

Latvijas Banka assesses the need to implement macroprudential measures and selects the most appropriate ones from the **range of macroprudential measures** at its disposal.

1) Latvijas Banka holds the responsibility for the application of macroprudential **instruments mandated by EU regulations**, such as the CRR and CRD (see Table 1), in Latvia. Some of these instruments, such as the additional capital buffer requirements for other systemically important institutions (hereinafter "O-SIIs") and the countercyclical capital buffer, must be applied in accordance with the requirements of the Credit Institution Law and are subject to regular review. Other instruments, such as the general or sectoral systemic risk buffer, the higher risk weight requirement, or the stricter national macroprudential measures under Article 458 of the CRR, are predominantly applied in specific cases;
2) to promote the sustainability of the financial system, Latvijas Banka may also implement **other measures**[13], such as borrower-based instruments aimed at influencing lending standards, enhancing the resilience of borrowers and lenders, and fostering responsible borrowing and lending practices (see Table 1).
3) Latvijas Banka may issue **recommendations**[14] to other public authorities or financial market participants regarding measures, desired practices, or actions necessary to promote financial stability;
4) Latvijas Banka may also apply public **communication tools** (such as press releases, interviews, presentations, and articles) to influence the risk perception and behaviour of financial market participants, or to encourage other authorities to undertake measures within their remit, with the aim of promoting financial stability.

Table 1. Macroprudential instruments at the disposal of Latvijas Banka

Macroprudential instrument	Aim
Instruments prescribed by the EU regulatory framework (CRD)	
Capital conservation buffer (CCoB).	To enhance credit institutions' ability to absorb losses and maintain capital adequacy.
Countercyclical capital buffer (CCyB).	To reduce the procyclicality of the financial system. To strengthen the capitalisation of credit institutions during the neutral and upward phases of the financial cycle, enabling them to absorb losses in times of crisis.
Systemic risk buffer (SyRB).	To mitigate systemic risks not covered by the CCyB, O-SII, or other CRR macroprudential measures. To increase the resilience of credit institutions.
Sectoral systemic risk buffer (sSyRB).	To mitigate systemic risks not covered by the CCyB, O-SII, or other CRR macroprudential measures. To increase the resilience of credit institutions. Applicable to risk-weighted exposures of a specific sector.
Capital buffers of other systemically important institutions (O-SIIs).	To reinforce the resilience of systemically important institutions against financial shocks and to mitigate the potential spillover effects of their distress on the stability of the financial system and the economy.

[13] Paragraph three of Section 46 of the Law on Latvijas Banka.
[14] Paragraph two of Section 46 of the Law on Latvijas Banka.

Instruments prescribed by the EU regulatory framework (CRR)	
Higher risk weights (Article 124 of the CRR) or higher minimum loss given default (LGD) values (Article 164 of the CRR) for exposures secured by real estate.	To reduce incentives to increase the relevant exposures, limit potential losses of credit institutions, and enhance their capacity to absorb such losses should risks materialise in the real estate market.
Stricter national macroprudential measures (Article 458 of the CRR).	To mitigate systemic risk when other measures prescribed by the CRR and CRD are insufficient to contain the relevant risk.
Instruments not specified in the EU regulatory framework	
Instruments related to financed properties – the loan-to-value (LTV) ratio.	To increase the borrower's initial involvement in real estate financing, thereby decreasing the borrower's debt burden and indirectly reducing the likelihood of default, while also mitigating the lender's potential losses. The LTV ratio can also be differentiated, for example, by applying it to buy-to-let housing loans.
Borrower income-related instruments – the debt service-to-income ratio (DSTI) and the debt-to-income ratio (DTI), representing the ratio of debt servicing costs to the borrower's net monthly income and the ratio of the total debt to the borrower's net annual income, respectively.	To limit the borrower's capacity to incur excessive debt obligations.
Maximum loan repayment term.	To limit the amount of the loan granted and restrict the ability to extend the loan repayment term disproportionately, thereby reducing credit risk.

Note: the list of macroprudential policy measures presented in the table is not exhaustive and may be supplemented with additional instruments.

Latvijas Banka primarily applies macroprudential measures to credit institutions providing financial services in Latvia. Although the role of non-bank financial institutions in the Latvian financial system is gradually increasing, along with their impact on financial stability, they are currently supervised through microprudential measures (supervision of individual financial market participants). This is due to the fact that, at the EU level, a framework of macroprudential instruments for non-bank financial institutions is still under development. Latvijas Banka will decide on the application of macroprudential instruments to non-bank financial institutions, taking into account the development of the EU regulatory framework in this area as well as the need to promote financial stability.

Macroprudential measures are predominantly preventive and restrictive in nature. They are implemented or tightened with the aim of timely containing the build-up of systemic risks and strengthening the resilience of financial institutions before such risks materialise. At the same time, macroprudential measures may be withdrawn or eased if the relevant systemic risks and vulnerabilities diminish or disappear, or if the resilience of the financial system to such risks increases, as well as in cases where the impact of an already materialised financial shock needs to be mitigated.

In deciding on the need to apply macroprudential measures, consideration is given to the extent to which existing measures already address the identified systemic risks and vulnerabilities, and whether financial institutions possess sufficient resilience to absorb the impact of those risks materialising.

Macroprudential measures often entail short-term costs; therefore, their long-term impact is carefully assessed. As they curb the build-up of vulnerabilities and reduce the likelihood of financial crises, while also enhancing the resilience of the financial sector during periods of financial crises, the long-term benefits of effectively implemented macroprudential measures generally outweigh their short-term costs.

When selecting macroprudential measures and calibrating their requirements, Latvijas Banka considers a range of **principles**:

- clarity – a clear and understandable objective of the measure, the source of the risk or vulnerability being addressed, the likelihood and consequences of the risk materialising;
- effectiveness – the measure is useful and effective in achieving its objective; the magnitude of the requirement is sufficient to mitigate the risk or vulnerability in the financial system.
- proportionality – the scale of the measure corresponds to the level of systemic risks, while also taking into account macroprudential policy in other countries.
- efficiency – the measure achieves its objective with minimal costs and limited negative side effects. Consideration is also given to the potential for regulatory arbitrage and adverse cross-border effects of the measure.

Latvijas Banka also takes into account the **interaction** of macroprudential measures **with other policies**, including monetary policy and micro-prudential policy. The primary goal of Latvijas Banka is to maintain price stability. Price stability is a prerequisite for fostering financial stability, while financial stability, in turn, is essential for the effective transmission of monetary policy. Meanwhile, although several requirements within microprudential regulation also contribute to achieving intermediate macroprudential policy objectives to some extent, the focus of microprudential and macroprudential supervision differs: microprudential supervision focuses on the resilience of individual institutions and the protection of their customers, whereas macroprudential supervision refers to the financial system as a whole. At the same time, it is essential to ensure that microprudential and macroprudential requirements do not overlap, so as to avoid imposing excessive requirements that are inappropriate for mitigating a given risk.

Within the framework of international cooperation, Latvijas Banka also recognises **macroprudential measures adopted in other countries**. To ensure the effectiveness of macroprudential measures, it is crucial that branches or subsidiaries of credit institutions registered in other countries, as well as cross-border service providers, comply with these measures in the implementing country whenever their operations have a material impact on that country's financial stability. In accordance with the EU regulatory framework, some instruments are subject to mandatory reciprocity across the European Economic Area (EEA), while other macroprudential measures may be voluntarily requested by Member States for recognition by their counterparts. When deciding on the voluntary reciprocity of macroprudential policy measures adopted by other Member States, Latvijas Banka applies its general position[15] on the matter and takes into account the measures and materiality thresholds established in the ESRB Recommendation of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2). Latvijas Banka may also request other Member States to voluntarily recognise its macroprudential measures when deemed necessary.

Decision-making. Decisions on macroprudential measures are taken by the Council of Latvijas Banka. Latvijas Banka is independent in making and implementing decisions[16].

When making decisions in accordance with the procedures established by the EU regulatory framework, Latvijas Banka cooperates with the ECB, the ESRB, and, in certain

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[15] Decision No 174 of the Board of the Financial and Capital Market Commission of 27 September 2022 "On the general approach regarding the voluntary reciprocity of macro-prudential policy measures".
[16] Paragraph one of Section 3 of the Law on Latvijas Banka.

cases, also with the EBA and the EC, including informing them of both planned and adopted decisions.

Latvijas Banka and the Ministry of Finance jointly discuss macroprudential measures within the advisory Macroprudential Council, while each party retains independent decision-making authority within its respective remit.

Where appropriate, prior to decision-making, Latvijas Banka informs financial market participants about the planned macroprudential measure, facilitates the exchange of views, and, if necessary, conducts a public consultation process in accordance with the procedures established by laws and regulations. Following the adoption of a decision, Latvijas Banka provides comprehensive information to financial market participants regarding the decision taken.

Supervision. Latvijas Banka supervises financial market participants' compliance with the established requirements and provides support in their implementation when necessary. If the requirements are not met, Latvijas Banka assesses the reasons for non-compliance and decides on the application of restrictions and penalties as stipulated in laws and regulations.

Assessment of implemented macroprudential measures. Latvijas Banka conducts periodic assessments of the effectiveness of the implemented macroprudential measures and their alignment with the defined objectives. The assessment is carried out in line with the principles originally applied by Latvijas Banka in selecting the respective macroprudential measure and determining the magnitude of the requirement. At the same time, the current assessment of the relevant systemic risk or vulnerability is taken into account. The assessment also highlights the interaction with other policies and the consistency with the positions of EU institutions (such as the ECB, ESRB, and EBA) on systemic risks and macroprudential policies at the EU level.

4. Communication

In the area of macroprudential supervision, Latvijas Banka engages in communication with financial market participants, the public, relevant public authorities, and EU institutions regarding the assessment of systemic risks and vulnerabilities, as well as macroprudential policy decisions.

The purpose of communication is to enhance understanding of the financial system's development and to raise awareness of systemic risks and vulnerabilities, inform financial market participants and other stakeholders about the macroprudential decisions made, their rationale and impact, and provide an overview of Latvijas Banka's activities. Effective communication fosters trust in the implemented policy and the achievement of its objectives.

Communication in the field of macroprudential supervision is based on **the following key principles**:

1) transparency and openness – timely and open communication of macroprudential policy decisions and their explanations, except in cases when it may be detrimental to the financial stability;
2) comprehensibility – communication must be clear, understandable and well-argued, tailored to the target audience;
3) proportionality – communication regarding the policy decisions taken and systemic risks must be proportionate to the significance of the decision made and the systemic risks involved;
4) consistency – consistent publication of macroprudential analysis and decisions enhances the predictability and credibility of the policy under implementation.

The analysis of financial stability, including the assessment of systemic risks and vulnerabilities, as well as information on the implementation of macroprudential policy, is presented in the Financial Stability Report of Latvijas Banka published on Latvijas Banka's website.

The implementation of macroprudential policy is also reported in the Annual Report of Latvijas Banka, which is published on Latvijas Banka's website and submitted annually to the Saeima of the Republic of Latvia.

Decisions and regulations issued by Latvijas Banka in the field of macroprudential supervision are published on Latvijas Banka's website, in the official gazette of the Republic of Latvia *Latvijas Vēstnesis*, and on the website of legal acts of the Republic of Latvia.

The Financial Stability Section of Latvijas Banka's website explains the macroprudential policy implemented by Latvijas Banka and publishes as well as updates, on a regular basis, detailed information on macroprudential instruments, including measures requested for voluntary reciprocity by other countries, as well as analysis of financial stability.

Where appropriate, Latvijas Banka provides supplementary information on its financial stability assessment and the implementation of macroprudential policy. It organises meetings and engages in information exchanges with financial market participants or other relevant stakeholders to explain planned or adopted macroprudential decisions and to discuss emerging issues in financial stability.

5. Cooperation with other institutions

Latvijas Banka formulates and implements macroprudential policy in cooperation with various domestic and foreign institutions[17].

5.1. Cooperation at the national level

Latvijas Banka cooperates with the Ministry of Finance, which serves as the leading public administration authority responsible for implementing the financial sector policy. Latvijas Banka and the Ministry of Finance have signed a cooperation agreement and established the **Macroprudential Council**[18] – a permanent collegial advisory body fostering mutual cooperation with the aim of promoting the overall stability of Latvia's financial system, including by strengthening the resilience of the financial system to shocks and by limiting the build-up of systemic risks.

Latvijas Banka and the Ministry of Finance engage in the exchange of necessary information, hold consultations concerning the systemic risk assessment and the measures to mitigate the financial stability risks, assess the effectiveness and efficiency of the implemented measures, while fully understanding and respecting the institutional independence of Latvijas Banka and the Ministry of Finance in decision-making within their respective mandates.

In implementing macroprudential policy, Latvijas Banka cooperates not only with a range of public institutions but also with financial market participants.

[17] Section 47 of the Law on Latvijas Banka.

[18] The members of the Macroprudential Council comprise the Governor of Latvijas Banka, a member of the Council of Latvijas Banka who is responsible for macroprudential policy issues, a member of the Council of Latvijas Banka who is responsible for issues related to regulation and supervision of the operation of the financial market and its participants, the Minister for Finance and the Deputy State Secretary of the Ministry of Finance responsible for financial policy issues.

5.2. International cooperation

In implementing macroprudential policy, Latvijas Banka cooperates with the ECB, the ESRB, as well as other international and EEA institutions, such as the EBA, the organisational structures of the European Parliament, the Council and the European Commission (e.g. the Economic and Financial Committee), the Organisation for Economic Co-operation and Development, the International Monetary Fund, and institutions of the Nordic and Baltic countries.

Latvijas Banka participates in the ECB and ESRB assessments of the financial stability of the euro area and the EU financial system, as well as in the formulation of financial stability policy documents produced by both institutions. Latvijas Banka assesses and takes into full account the ECB's statements[19] on macroprudential issues, alongside the recommendations and warnings issued by the ESRB. Under the Single Supervisory Mechanism (SSM) regulation, the ECB is authorised to adopt macroprudential decisions prescribed by the EU regulatory framework for the SSM participating Member States, including Latvia[20].

Latvijas Banka also takes part in the development of EU-level regulatory frameworks and other binding documents in the field of macroprudential policy.

Latvijas Banka also cooperates with **institutions of the Nordic and Baltic countries** having a significant impact on financial stability. Within the Nordic-Baltic Macroprudential Forum, the central banks and national supervisory authorities of the region engage in cooperation on macroprudential policy matters. This includes discussions on the assessment of systemic risks to financial stability, measures for their prevention, and other financial stability issues. The central banks of the Nordic and Baltic countries have signed a Memorandum of Understanding on cooperation and information exchange concerning credit institutions operating in more than one country within the region. As part of this cooperation, the Stability Group was established to broaden collaboration and the exchange of information among central banks, supervisory and resolution authorities, as well as ministries of finance within the region to enhance the financial stability across the region.

[19] ECB statement on the methodology for setting the minimum capital requirement for O-SIIs Governing Council statement on macro-prudential policies. ECB statement on enhancing the resilience of the banking system Governing Council statement on macro-prudential policies.
[20] Council Regulation (EU) No 1024/2013 (15 October 2013) conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.