**The 08.08.2019 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCyB) rate for the exposures to Latvian residents has been set at 0%. The established CCyB rate will be used to calculate a credit institution-specific CCyB rate from 1 August 2020. The Financial and Capital Market Commission (FCMC) will decide about the necessity to set the CCyB rate above 0%, as soon as a significant rise in cyclical systemic risks is recorded in Latvia's financial sector.**

FCMC, as an institution responsible for the application of the CCyB according to Article 35.5 of the Credit Institution Law, analyses the credit-to-GDP ratio every quarter, as well as its deviation from the trend and the additional indicators to justify the decision on the CCyB rate.

Economic growth, like in previous periods, was not driven by bank lending. The deviation of credit-to-GDP ratio from the long-term trend remained negative, with both the broad (-37% at the end of Q4 2018) and the narrow (-25% at the end of Q1 2019) credit definition remaining at this level for approximately two years. The level of credit-to-GDP ratio (by narrow credit definition) continued to decline and reached 33% at the end of Q1 2019. Similar levels of credit-to-GDP ratio in Latvia were observed in 2003-2004.

In 2018, Latvia's economic growth reached 4.8%. At the same time, according to experts, economic growth is already above the peak of the economic cycle and gradual slowdown in growth is expected. In Q1 of this year, the annual growth rate of GDP declined to 3.2%, with a drop of 0.1% compared to Q4 2018. Under the impact of those trends the Bank of Latvia adjusted the economic growth forecast for 2019 – it has been reduced to 2.9%. The development of projects co-financed by the European Union (EU) is continuing; however, the availability of this funding will gradually decrease in coming years. The uncertainty in external markets, including the weakening of economic growth of euro area countries, requires caution with regard to export prospects. Private consumption, supported by employment and salary increases, remains a driver of growth. However, the high uncertainty of the external environment is gradually reverberating to more moderate domestic investment activity and could increase consumer caution. The problem of labour shortages remains. The inflation rate (around 3%) corresponds to the economic situation and the gradual convergence of the economy with other countries in the euro area.

There is no increasing trend in lending rates, in Q1 2019 the change is stock of banks' loans to non-financial corporations and households was close to zero.

As regards the non-bank credit portfolio, at the end of Q1 2019 it was 7.0% higher compared to end of Q1 2018. The greater part (78%) is lease transactions, where the loans are mainly used for purchases of cars, commercial transport and agricultural machinery. On 1 July 2019, the amendments to the Law on the Consumer Rights Protection (interest rate ceilings (0.07% daily) and restrictions on advertising) will take effect, which will slow down the growth of pay day consumer credit.

The change in business models of credit institutions servicing mainly foreign customers has not affected the dynamics of the financial cycle, since the involvement of these credit institutions in transactions with domestic customers remains low, the share of deposits in total domestic deposits in April 2019 was around 7%, while the share of domestic loans of these credit institutions in total domestic loans was around 6% (9% and 12% at the end of 2017, respectively). As regards forecasts implied by these credit institutions' business plans in the short and medium-term, their share of domestic loans will not exceed 7% by 2020, because large credit institutions, which make up the largest share of the domestic loan portfolio, are also planning an increase in their loan portfolio along with the development of the economy. Consequently, the change of the business models is an important process at the level of individual credit institutions, but systemic impacts are not currently expected.

In Q1 2019, the housing price index increased by 7.1% (y-o-y). The structure of apartment transactions is gradually changing with a higher proportion of transactions with new and therefore more expensive apartments. Increases in housing prices continue to be driven by shortage of supply, rising income and employment, low interest rates and state guarantee programme for mortgage loans. At the same time, the growing supply of economy-class housing is starting to ease pressure on housing prices. The number of housing purchase transactions has not changed significantly in recent years.

Overall, the level of risks associated with the real estate market is considered to be low. The household debt level is low (one of the lowest among the Eurozone countries), mortgage lending dynamics remain sluggish. The role of the state guarantee programme for mortgage loans remains high, in Q1 2019 approximately half of new loans for the purchase of housing were issued with state guarantees. Household incomes are rising at a similar rate as housing prices, so housing availability generally does not change significantly and the ratio of housing price index to the average net wage index is close to the long-term average index.

The main risks to the stability of Latvia's financial sector have remained unchanged compared to the assessment of the previous quarter. They relate to the openness of Latvia's economy, the deterioration of the global macroeconomic environment, including in the EU, as well as still existing reputational risk. Risks associated with the unbalanced development of the real estate market and high levels of household debt in the Nordic countries also remain high.

The FCMC, in cooperation with the Bank of Latvia, will continue to analyse the relevant indicators and trends when deciding on the determination of the CCyB rate in the following quarters. The FCMC will decide on the need to set the CCyB rate above 0% if a significant increase in cyclical systemic risks is observed in the Latvian financial sector.