**Justification for the 09.05.2017 decision by the FCMC Board on countercyclical capital buffer (CCyB) for exposures to residents of Latvia**

**The FCMC sets the CCyB rate at 0%. The established CCyB rate will be used to calculate the credit institution-specific countercyclical capital buffer rate from 1 May 2018.**

Since the beginning of 2016 a credit growth has started to pick up again after a break of several years. Though the loan portfolio to households still has been declining, the pace of decline has slowed down substantially. As to non-financial corporations, their loan portfolio is already higher compared to its level a year ago. Overall, by the end of 2016 the banking sector credit portfolio to the private non-financial sector already posted a slight increase (0.5%) compared to the end of 2015. A number of factors, including an increase in real estate prices, the state support for the programme for mortgage loan guarantees for families with children, low interest rates, more active EU funds inflow will have a positive impact on lending dynamics in 2017. The banks themselves are also optimistic regarding an expansion of resident lending.[[1]](#footnote-1)

A decline in credit-to-GDP ratio that had been observed since the end of 2010 has come to a halt in 2016. A deviation of this ratio from a long-term trend still remains clearly negative though it narrows gradually.

According to the "broad credit" definition, the credit-to-GDP ratio was 99% in Q3 2016, while the standardised gap was -38%.[[2]](#footnote-2) If the credit-to-GDP ratio exceeds a long-term trend by 2 percentage points, the benchmark buffer rate increases linearly from zero to 2.5% of risk-weighted assets. In case of the credit-to-GDP gap of -38%, the benchmark buffer rate is 0%.

According to the "narrow credit" definition, the credit-to-GDP ratio was 45% by the end of 2016, but its additional gap was -27%[[3]](#footnote-3), as a result the benchmark buffer rate based on the additional credit-to-GDP gap was at 0%. The benchmark that best reflects the specificities of the national economy is selected as a countercyclical capital buffer guide. For Latvia, the results obtained from the calculations of the benchmark buffer rate under the narrow definition (additional benchmark buffer rate) are more justified than using the broad credit definition results. The data of the "narrow credit" time series are more stable (they are not retrospectively adjusted) and they are available sooner. Therefore, in Latvia the benchmark buffer rate that is calculated based on the additional credit-to-GDP gap has been selected as the countercyclical capital buffer guide.

It should be noted that according to experience of other countries, the deviation of credit-to-GDP ratio from its long-term trend may not always be a reliable signal. In order to assess an increase in cyclical systemic risk and determine the CCyB rate, other quantitative indicators and constrained judgement should be considered as well, placing a great deal of emphasis on the qualitative assessment. Where necessary, FCMC may set the CCyB rate that is higher than 2.5% of risk-weighted assets.

Since 2015, both – real estate prices and a number of transactions in real estate market – continue to climb with the rate of the increase accelerating in the second half of 2016. Enlivening of the real estate market is a positive trend; however, this market segment should be closely monitored in view of relatively higher pace of housing price growth over past quarters. Housing price dynamics are influenced by improvements in the household financial situation, with a declining debt burden and increasing wages, as well as better availability of credits in the context of the state support for the programme for mortgage loan guarantees for families with children. The amount of mortgage loans granted within this programme constitute approximately one-third of all new housing credits granted. At the same time, non-financial corporations' and households' debt service expenditure since the end of 2015 have stabilised at the historically lowest level of 1.5% of GDP.

In 2016, Latvia's economic growth of 1.3% (in comparable prices according to the seasonally adjusted data) was the slowest one since 2010. Weakening of the national economic development was due to a number of negative external factors, slow economic growth in main trading partners of Latvia, decline in investments, in particular in the construction sector, as well as disruption in the use of the EU funding. Whereas in 2017, the GDP growth is expected at 3.0% on the background of impact of external economic environment improvements, increasing activity in investment projects financed by the EU funds, as well as increase in export and investment volumes and private consumption growth. Major risks for economic growth are related to external uncertainty factors and global political situation[[4]](#footnote-4).

Capital adequacy ratios continue to substantially exceed both – minimum and total capital requirements, as well as an average EU level. At the end of 2016, the banking sector's total and common equity Tier 1 (CET1) ratios were at 21.2% and 18.0%, respectively. The banking sector in general in 2016 generated the profit of ~454 million euro, i.e. by 9.1% more than a year ago. However, it should be noted that the banking sector profit was positively influenced by one-off factor – the sale of the VISA EUROPE shares in line with requirements by the VISA Inc. At the end of 2016, the banking sector ROE was 14.3%, but excluding the impact of VISA transaction, it was lower, i.e. 10.4%.

**The above considerations demonstrate that an impact of cyclical systemic risk on the Latvia's banking sector is minimal therefore the FCMC sets the CCB rate at 0%. In view of the current economic and lending development trends, and provided there will be not notable increase in cyclical systemic risks, the FCMC is not planning to increase the CCyB rate over the coming two years.**

1. FCMC annual banking survey on financial ratios, risks and strategic forecast for 2017. [↑](#footnote-ref-1)
2. Credit time series from Q4 1995 to Q3 2016 [↑](#footnote-ref-2)
3. Credit time series from Q4 1995 to Q4 2016 [↑](#footnote-ref-3)
4. Macroeconomic report for December 2016 by the Bank of Latvia [↑](#footnote-ref-4)