**The 25.07.2016 decision on setting the countercyclical capital buffer rate**

**The countercyclical capital buffer (CCB) rate for the exposures to Latvian residents has been set at 0%. The established CCB rate will be used to calculate a credit institution-specific countercyclical capital buffer rate** **from 1 August 2017 till 31 October 2017. Over the next two years, the need to increase the provision is not expected.**

**1.** In accordance with paragraph 1 of Article 355 of Credit Institution Law every quarter the Financial and Capital Market Commission (hereinafter, the Commission) sets the countercyclical capital buffer (CCB) rate applicable to exposures to the residents of the Republic of Latvia taking into account:

1) the CCB guide calculated for the appropriate quarter;

2) variables that the Commission considers significant for assessing significant cyclical systemic risk;

3) effective European Systemic Risk Board's (ESRB) recommendations on the setting of the CCB rate.

2. The calculation of the CCB guide shall be carried out taking into account the deviation of the credit (issued to the Latvian residents) to GDP ratio from its long-run trend (hereinafter, the credit-to-GDP gap).

3. In accordance with the ESRB Recommendation[[1]](#footnote-1) (hereinafter, the Recommendation), the CCB guide may be calculated using the data of broad and narrow definition time series. The broad credit definition covers banking loans and loans issued by non-bank financial institutions to the domestic private non-financial sector[[2]](#footnote-2). The standardized credit-to-GDP gap has been assessed using the broad definition time series. The narrow credit definition, in the case of Latvia covers the balance of outstanding loans granted to the domestic private non-financial sector by banks (it does not include loans from non-bank financial institutions). The additional credit-to-GDP gap was assessed based on the narrow credit definition time series.

4. In Latvia, using the broad credit definition, the credit-to-GDP ratio was 98% in Q4 2015 while its standardized gap was -42%[[3]](#footnote-3). In case the total credit-to-GDP gap exceeds the long-run trend by 2 percent points, the benchmark buffer rate will increase linearly from zero to the upper threshold of risk-weighted assets at 2.5%, where the credit-to-GDP gap reaches 10 percent points. Where the gap is at -42%, the benchmark buffer rate will be 0%.

5. Applying the narrow credit definition the credit-to-GDP ratio was 44%, but the additional gap was -32%[[4]](#footnote-4) in Q1 2016, as a result the benchmark buffer rate calculated under the additional credit-to-GDP gap was 0%. In accordance with the Recommendation the benchmark buffer rate that best reflects the specificities of the national economy shall be selected as the CCB guide. For Latvia, the results obtained from the calculations of the benchmark buffer rate under the narrow definition 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 become 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 CCB guide.

6. Additional indicators used as a guide for setting a countercyclical capital buffer rate do not point to the growing cyclical risks in the financial sector.

7. The Q1 2016 data suggests that the banking sector credit portfolio to private corporates and households continues to decline (-4.2% y-o-y). Along with a continuing decrease in total outstanding loans banking credit-to-GDP ratio declined from 47% to 44% (y-o-y).

8. Residential real estate prices rose modestly in 2015 with an RRE price index up by 6% at the end of 2015 (y-o-y), but still down about 36% from the peak in 2008. Residential real estate prices continued a moderate growth also in the first four months of 2016. A real wage growth, as well as governmental support for the young families with children facilitated the availability of loans.

9. Against the background of continuing deleveraging, the private sector indebtedness and debt service burden continued diminishing. Annual interest payments by the private sector (households and non-financial corporations) continued to decline in relation to GDP (from 5.5% in Q2 2009 to 1.5% in Q4 2015).

10. Latvia's economic growth remained moderate in 2015: GDP increased by 2.6%. The fourth quarter of 2015 and first quarter of 2016 saw a notable slowdown in the economic growth suggesting high uncertainty and risks on account of external factors and weak bank lending activity, going forward.

11. Continuing the previous year's trend, private consumption was the key growth engine also in 2015; it increased by 3.1% over the year and contributed 2.0 percentage points to GDP growth. Throughout the year, private consumption was supported by a rather steep increase in real net wages. Amid ongoing strengthening of purchasing power of the working population and stable consumer sentiment, private consumption is expected to be the driver of growth also in 2016.

12. In 2015, an unemployment rate continued to moderate, albeit at a decelerating pace. Average inflation (HICP) stood at 0.2%, and its year-on-year decline primarily was on account of commodity (e.g. oil and agricultural and food products) price falls on a global scale.

13. Banking sector strength measured in terms of solvency and profitability was high: at the end of Q1 2016 ROE was 11.5% and Common Equity Tier 1 ratio was at 17%.

14. Considering above, the Commission sets the CCB rate of 0%. In accordance with the current lending and GDP growth rate forecasts, no increase in the CCB rate would be required in the next two years.

15. On 11 June 2016, the Commission sent a letter to other members of the Macroprudential Council (the Bank of Latvia and the Ministry of Finance), notifying them of intention to set the CCB rate at 0%; both institutions responded that they did not object to such intention.

1. Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1). [↑](#footnote-ref-1)
2. It includes non-financial corporations, households and non-profit institutions serving households. Loan balance reflects not only the private sector liabilities to credit institutions, but also loans from non-bank financial institutions. [↑](#footnote-ref-2)
3. Credit time series from Q4 1995 to Q4 2015. [↑](#footnote-ref-3)
4. Credit time series from Q1 1999 to Q1 2016. [↑](#footnote-ref-4)