**The 28.01.2020 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 February 2021. 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.

In 2019, the economic growth in Latvia slowed. In 2017 and 2018, GDP growth was 5.0%, while in the first half of 2019 (year-on-year) it declined to 3.0%. It is expected that in the coming years it will remain moderate (around 3% a year), as a negative impulse of external demand will reduce the growth rate.

In 2019 an overall slowdown of the economic growth in Latvia was observed. Compared to the 4% - 5% annual GDP growth rate maintained in 2017-2018, in Q3 2019 it dropped to a mere 2.9% and was mostly based on the growth of the industrial sector. In coming years, the annual GDP growth rate in Latvia is expected to remain moderate (around 3%), as being a small and open economy, Latvia is positioned to be disproportionally affected by the potential global slowdown.

Economic growth so far has not been driven by the bank lending and thus does not pose risks to financial stability. While the development of the EU co-financing projects continues, the availability of that funding is expected to decrease in the coming years. The uncertainty in external markets, including the weakening of the economic growth in the euro area countries, increases uncertainties for the export sector. Private consumption, supported mainly by wage growth and the development in sectors related to internal market, remains a key driver of the economic growth. However, high uncertainty of the external environment due to geopolitical and economic developments has gradually brought forward moderately slower investment activity and increased consumer caution.

Some credit institutions in Latvia are currently in the process of changing their business models by increasing the share of loans granted to the local residents; however, as they currently account for only a small portion of total credit portfolio of domestic non-financial sector (5.6% in Q3 2019), these changes do not significantly affect the trend of the financial cycle.

The issuance of loans to the domestic non-financial sector is growing steadily although viewed in proportion to the GDP it is still decreasing. In Q3 2019 lending to domestic households grew year-on-year by 1.0%, but to non-financial corporations – by 2.5% (compared to 3.6% in the previous quarter). Granting of state supported loans to residential households for house purchase contributes highly to the overall credit trend and volume growth – credit institutions’ residential mortgage portfolio has increased by 1.2% year-on-year as of Q3 2019. Consumer credit also factored significantly in the overall domestic loan growth rate, growing 8.6% year-on-year in Q3 2019. Net position of households’ remains positive (7.4% of the GDP in Q2 2019).

The role of the non-banking sector in domestic lending is still gradually increasing (albeit the growth rate itself has started to decrease) aided by rising salaries (real net salary year-on-year increase was 4.7% in Q3 2019) as well as strong economic growth in recent years and the absorption of EU structural funds which contributes to the growth of financial leasing volumes. Non-bank financial institutions’ credit portfolio grew by 5.3% year-on-year in Q2 2019, leasing companies being the largest contributor to the increase. Issuance of payday loans has also continued at a steady pace (13.9% year-on-year increase in Q3 2019). Amendments to the Consumer Rights Protection Law (CRPL) came into force on July 1 of 2019 aiming particularly at restricting certain activities of payday lenders. The overall impact of the amendments to CRPL on financial stability has been assessed as positive. Despite increased variety and volume of non-banking lending, there is currently no indication that it could pose risks to financial stability.

The assessment of risks related to the real estate market remains unchanged compared to the previous period. At the beginning of 2019, the housing price growth slowed as growing supply of economic class housing started to ease pressure on prices. The number of housing purchase transactions in Latvia has not noticeably changed in recent years, but higher activity has been observed in the residential market of the capital (number of transactions grew by 8.1% in the first nine months of 2019 compared to the same period in 2018) due to increase in the supply of new housing projects. In Q2 2019, the housing price index set by the Central Statistical Bureau increased by 9.0% year-on-year (existing house prices increased by 9.3% and new house prices increased by 6.8%). This growth rate remains in sync with the wage growth as the ratio between housing price index and real net salary index has been hovering around 1.00 since 2009.

Overall, the assessment of cyclical risks and the policy stance remains unchanged. The level of risks associated with lending and real estate market is estimated as low. Bank balance sheets are strong as leverage ratio hasn’t dropped below 8% since 2009. The level of household debt is low and mortgage lending dynamics remain slow. Housing prices are growing on a par with household income levels and the housing availability remains stable. The main risks to the stability of Latvia's financial sector remain unchanged compared to the previous quarter’s assessment. They mostly relate to the openness of the Latvian economy, weakening of the global (including the EU) macroeconomic environment as well as ongoing slowdown of external demand and lingering reputational risk. Geopolitical risks also play a significant role. Other financial stability risks such as unbalanced development of real estate market and high levels of household debts in the Nordic countries also remain on the agenda.

The FCMC in cooperation with the Bank of Latvia is continually analysing relevant indicators and trends and will update the setting of the CCB rate on a quarterly basis.