**The 28.04.2020 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 May 2021. The Financial and Capital Market Commission (FCMC) will decide about the necessity to set the CCyB rate above 0% if significant rise in cyclical systemic risks is recorded in Latvia's financial sector.**

The 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.

The FCMC monitors latest developments regarding the global supply-demand shock resulting from coronavirus (COVID-19)[[1]](#footnote-1) outbreak. The effects related to this shock are already slowing down global economies and also the financial cycle of Latvia’s economy is expected to shift downwards during the following months. Specific domestic sectors such as tourism, hospitality and air transportation are already experiencing moderate or severe business disruptions. Various government support mechanisms have already been activated or are being considered to limit further damage to economy. The uncertainty surrounding future developments leads to cautious cyclical policy and setting of CCyB rate.

In 2019 the overall slowdown of the economic growth in Latvia was observed. The GDP growth rate in the fourth quarter of 2019 dropped to mere 1.0% (year-on-year) and was also the lowest since 2016. Small growth in previous year was due to non-favourable conditions in various domestic sectors, but mostly in transportation, industry and financial services. In contrast to positive forecast for GDP growth in 2020 made in previous year (2.6%), current forecasts, reflecting uncertainty and struggles to contain the coronavirus, have dropped in negative territory - it is estimated that Latvia’s GDP will decrease by 6.5% in 2020.

The uncertainty in external markets, including the weakening of the economic growth in the euro area countries, increases uncertainties for the export sector. Private domestic consumption, supported mainly by steady wage growth (average monthly gross wage increased by 7.2% in 2019 (year-on-year)), and decreasing unemployment rate, remained a key drivers of the economic growth in 2019. Other domestic sectors such as agriculture and trade and accommodations also positively contributed to the overall growth of the economy in 2019.

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 (5.9% in the fourth quarter of 2019), these changes do not significantly affect the trend of the financial cycle.

Even though the economic growth in previous periods was not driven by bank lending, the issuance of loans to the domestic non-financial sector is growing steadily – although, if viewed in proportion to the GDP, it is still decreasing. Furthermore, the overall private sector debt burden is decreasing as total interest payments to GDP plummeted to 1.1% (lowest they have been since 2003). In the fourth quarter of 2019 the growth rate of total lending to domestic households increased by mere 1.5%, but to non-financial corporations a decrease by 3.3% was observed. Consumer credits, which grew by 7.2% (year-on-year) in the fourth quarter of 2019, factored significantly in the overall domestic loan growth rate.

Issuance of state supported housing loans to resident households’ factors strongly in the overall credit growth. In the fourth quarter of 2019 domestic housing loans grew by 0.7% (volumes) and by 2.2% (transactions).

In 2019 he FCMC in collaboration with the Bank of Latvia, the Consumer Rights Protection Centre and the Finance Latvia Association developed a proposal for quantitative requirements with regard to borrowers-based measures - DTI (debt-to-income ratio), DSTI (debt-service-to-income ratio) and maximum maturity for residential mortgages and consumer loans. The measures are of a precautionary nature – their purpose is to strengthen the resilience of credit institutions and protect borrowers from potential future shocks, thus contributing to the financial stability. The proposal was adopted in FCMC regulations on 27 November 2019 and will apply to loans issued after 1 June 2020.

Despite moderate growth rates of domestic lending, the role of the non-banking sector is continuing to gradually increase aided by steady increase in salaries as well as strong economic growth in recent years and the absorption of EU structural funds. Loans issued by non-bank financial institutions to private non-financial sector grew by 4.4% in the fourth quarter of 2019 (year-on-year) which is slower than previous growth rates due to decreasing assets of individual non-bank lenders. Overall in 2019 the issuance of payday loans to domestic households has continued at a steady growth rate, but in the fourth quarter the growth was modest (3.3% (year-on-year)) comparing to previous period (13.9% growth in the third quarter of 2019 (year-on-year)). This change was mostly due to one large company exiting domestic market. Despite stable growth of non-banking lending volumes, currently there is no indication that it could pose risks to financial stability. Future developments in the non-bank lending sector are also likely to be significantly affected by the coronavirus outbreak.

The assessment of risks related to the real estate market remained unchanged in the late 2019, but recent observations (as of March 2020) already signals that coronavirus outbreak is starting to have a negative impact on housing market operations. Unadjusted data for the fourth quarter of 2019 show that the housing price index set by the Central Statistical Bureau increased by 9.4% compared to the same period in 2018 (existing house prices increased by 8.7% and new house prices increased by 12.7%). 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 (reaching 1.02 in the third quarter of 2019). While some seasonality can be observed, the number of housing purchase transactions in the twelve months of 2019 increased by 1.6% comparing to the same period of 2018. Similar to previous periods higher activity has been observed in the residential market of the capital (number of transactions grew by 5.0% in the twelve months of 2019 compared to the same period in 2018) due to increase in the supply of new housing projects.

Overall, the assessment of cyclical risks and the policy stance at this time is cautious. Available information[[2]](#footnote-2) regarding international reaction towards the novel coronavirus outbreak signals the collective release of previously build-up positive CCyB rates. In the view of coronavirus outbreak related shock to local economies, increased financial stability risks can be observed as financial cycles are expected to overall shift downwards in all European Union countries. This is also the case in Latvia where some of major risks are related to the solvency of enterprises as it is expected that some firms will have difficulties in short term to repay their liabilities. At this stage government support mechanisms play a crucial role in diminishing the depth of the crisis.

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

1. Topical information regarding COVID-19 outbreak is available in the World Health Organization home page: <https://www.who.int/emergencies/diseases/novel-coronavirus-2019> [↑](#footnote-ref-1)
2. Information from European Systemic Risk Board homepage and also publicly available publications on homepages from designated authorities of other European Union member states (including countries of the Schengen area) as of 24 April 2020 reveals complete release (or close to it) of CCyB in respective countries – Belgium, Denmark, France, Germany, Iceland, Ireland, Norway, Sweden, United Kingdom, Lithuania, Bulgaria, Czech Republic. [↑](#footnote-ref-2)