

Q1 2023 assessment of the cyclical systemic risk and the applicable countercyclical capital buffer rate

30 January 2023

Latvijas Banka, in its capacity as the designated authority for the application of the countercyclical capital buffer (hereinafter – CCyB) analyses the cyclical systemic risk on a quarterly basis pursuant to Section 35⁵ of the Credit Institution Law and, if necessary, sets or adjusts the CCyB rate applicable to risk exposures to residents of the Republic of Latvia. The CCyB aims to reduce excessive fluctuations of the financial cycle and strengthen credit institutions' resilience to the cyclical systemic risk.

Latvijas Banka publishes quarterly assessments of the cyclical systemic risk and the appropriateness of the applicable CCyB rate on its website. If the CCyB rate remains unchanged, the previous decision regarding the applicable CCyB rate remains in force. The previous decision on 0% CCyB rate was made on 27 April 2021 (applicable as of 1 May 2022) by the Financial and Capital Market Commission, which has been integrated into Latvijas Banka as of 1 January 2023. Credit institutions apply the respective CCyB rate to risk exposures to residents of the Republic of Latvia when calculating the institution-specific CCyB rate¹.

Latvijas Banka maintains the CCyB rate at 0%, taking into account the cyclical systemic risk assessment. The cyclical systemic risk is assessed as low considering the economic downturn, the cautious lending (including a slowdown in the growth rate of household lending), stricter credit standards and the rise in credit costs, as well as lower activity in the real estate market. Domestic private non-financial sector credit and GDP ratio is low and continues to decline.

In Q3 2022, the **credit-to-GDP gap** remained strongly negative both according to the standardised (broad) credit definition and additional (narrow) credit definition (see Table 1 and Charts 1 and 2). Therefore, the CCyB buffer guide is 0%.

Table 1. **Key variables of the CCyB rate assessment; Q3 2022²**

Variables	Standardised credit (wide) definition	Additional credit (narrow) definition
Credit-to-GDP ratio (%)	61.9	26.8
Credit-to-GDP gap (pp)	-28.0	-13.1
Benchmark buffer rate (% of risk weighted assets)	0	0 ³

The contribution of non-financial corporations (hereinafter – NFCs) to the growth of **domestic lending** in Latvia is increasing, whereas lending to households is slowing down (see Chart 3). In December 2022, the annual growth rate of domestic loans (excluding

¹ According to the Financial and Capital Market Commission's Regulation No 137 "Regulations on calculating the institution-specific countercyclical capital buffer rate" of 25 August 2020.

² The narrow credit definition includes credit institution loans to NFCs and households and the debt securities purchased by credit institutions, but the wide definition – liabilities of NFCs and households to credit institutions, as well as loans from non-bank financial institutions or other NFCs.

³ In Latvia, the narrow measure of credit provides better signalling properties therefore the benchmark buffer rate calculated according to the narrow credit definition serves as the buffer guide.

one-time effects relating to structural changes in the banking sector) reached 7.6%⁴ (inter alia loans to NFCs grew by 10.0%, but loans to households – by 4.3%; see Chart 4). A significant rise in prices, especially those of energy, increases costs for companies and the demand for short-term financing for the provision of working capital. Thus, overdraft loans and credit lines increased notably, especially in the energy sector.

In turn, lending to households has slowed down, given the deteriorating confidence, rising interest rates and the high inflation. The results of the bank lending survey show that household demand for loans is shrinking, bank credit standards are tightening and loans are becoming more expensive.

Private non-financial sector debt and its servicing burden is low. In Q3 2022, the household and NFC debt-to-GDP ratio was historically low due to the rapid growth of nominal GDP. The ratio of household and NFC interest payments-to-GDP is also low and continues to decline (see Chart 5).

Activity in the **real estate market** has contracted, taking into account the decrease in household purchasing power, the increase in the costs of loans and the weak supply of new housing. In H2 2022, the number of purchase transactions fell by 10% year on year. Growth of house prices is becoming more moderate – in Q3 2022, the annual growth rate of the Central Statistical Bureau house price index declined to 13.7% (see Chart 6).

The trends differ in various market segments – prices of standard apartments decrease, and their supply has increased in the market. In turn, in the new housing segment, a lack of supply and the rise in construction costs contribute to the continuous price hikes. Activity in the housing market as a whole continues to decline, reducing pressure on prices. At the same time, the risk of abrupt price correction is low considering the cautious lending, the low household debt level, the weak supply of the new housing and relatively low market imbalance.

The weakening of **macroeconomic development** in Latvia also suggests a low cyclical risk. According to the forecasts of Latvijas Banka, the recession expected in 2023 will be temporary and shallow, with real GDP shrinking by 0.3%, but inflation will remain high – 10.9%. Therefore, interest rates are likely to increase further. The rise in inflation reduces purchasing power and increases caution, with negative implications for consumption and investment development. Latvijas Banka forecasts that private consumption could decline by 5.6% in 2023.

The growth of **composite cyclical risk indicator** (hereinafter – **CCRI**) developed⁵ by Latvijas Banka has reversed, and in Q3 2022, it declined to 6.0 points, still below the critical threshold (i.e. below the above-average risk threshold; see Chart 10). When explaining the growth of CCRI in previous quarters, it should be noted that in the composition of CCRI the most significant weights are attributed to credit and house price variables, which have been primarily affected by the significant rise in prices and costs. The CCRI was also affected by the current account deficit component, which was increased by rising imports due to a leap in energy prices (see Chart 8). After deflating⁶ the credit and house price variables, the CCRI was only 4.45 points.

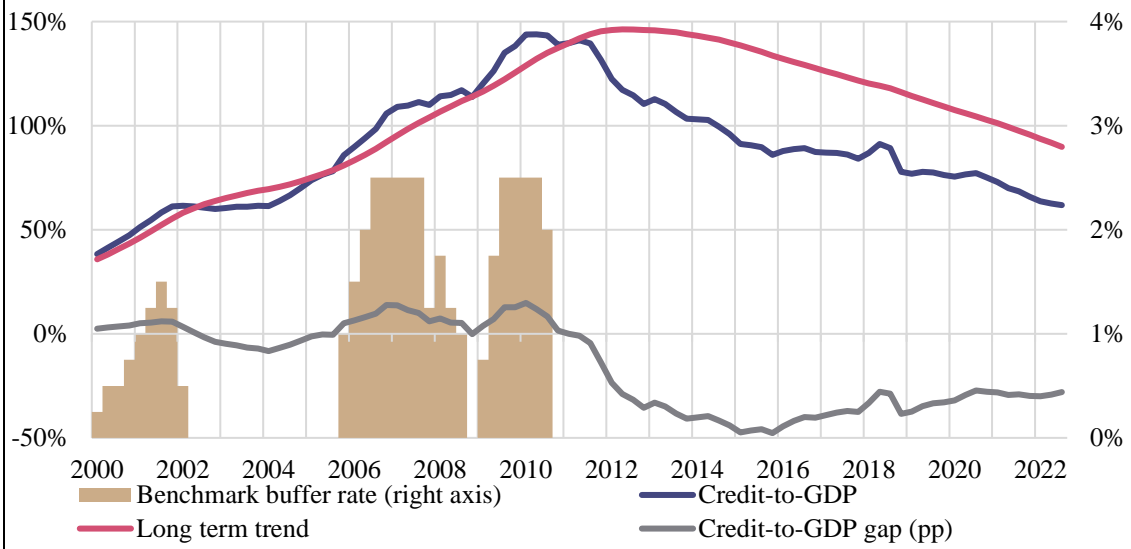
⁴ In real terms, deflating with the projected GDP deflator, the domestic loan portfolio continued to decrease notably – in December 2022, it shrank by 7.4% (annually).

⁵ Additional information on the CCRI methodology is available in Appendix 1 of the Financial Stability Report 2020 of Latvijas Banka https://datnes.latvijaskbanka.lv/fsp/FSP_2020_en.pdf. In 2021, the CCRI model was repeatedly tested, and the medium risk interval was widened to the 45th – the 65th percentiles (before it was set between the 50th and the 60th percentiles).

⁶ The house price index and the index of house prices-to-average net wages ratio are adjusted with the consumer price index, but the domestic loans – with the GDP deflator.

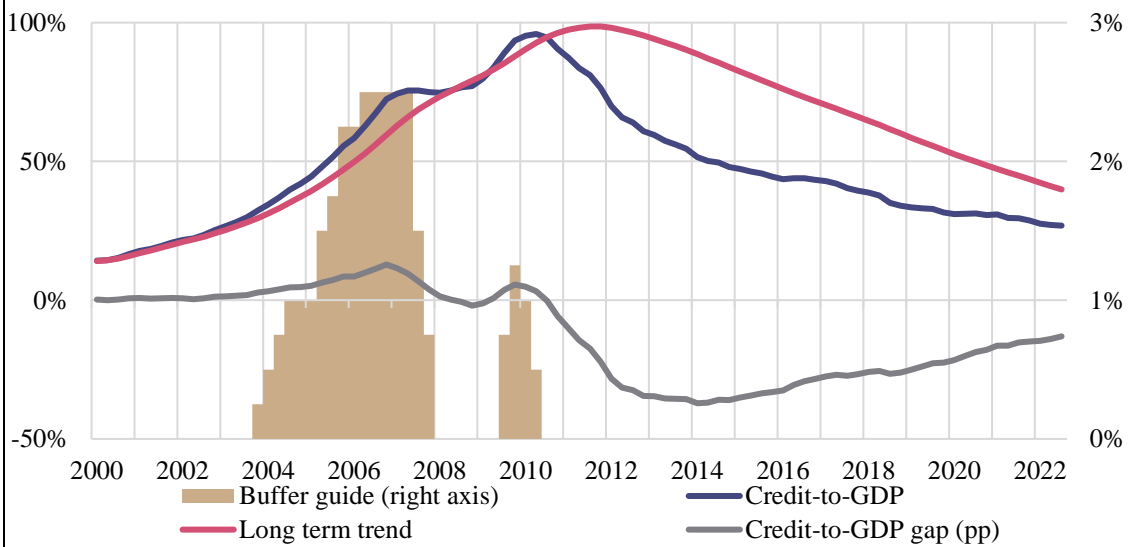
Annex 1. Key variables of the Financial Cycle

Chart 1. Standardised credit-to-GDP gap



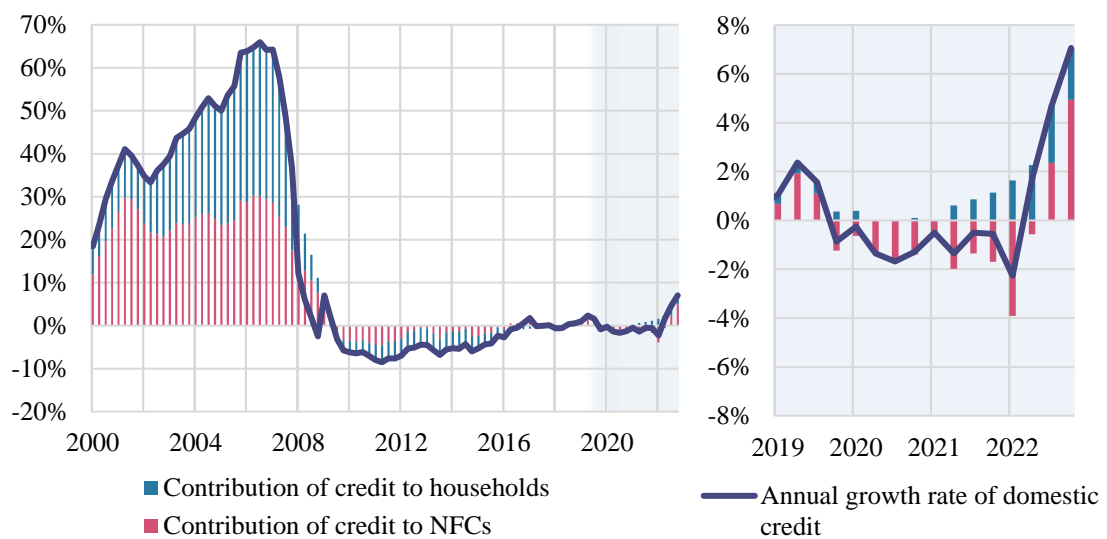
Source: Latvijas Banka, CSB

Chart 2. Additional credit-to-GDP gap



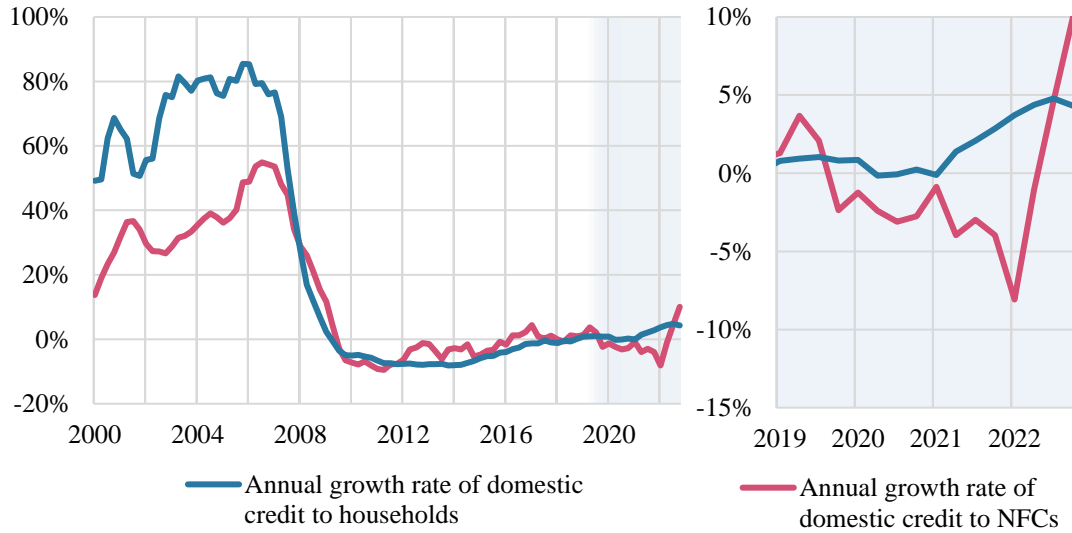
Source: Latvijas Banka, CSB

Chart 3. Credit developments



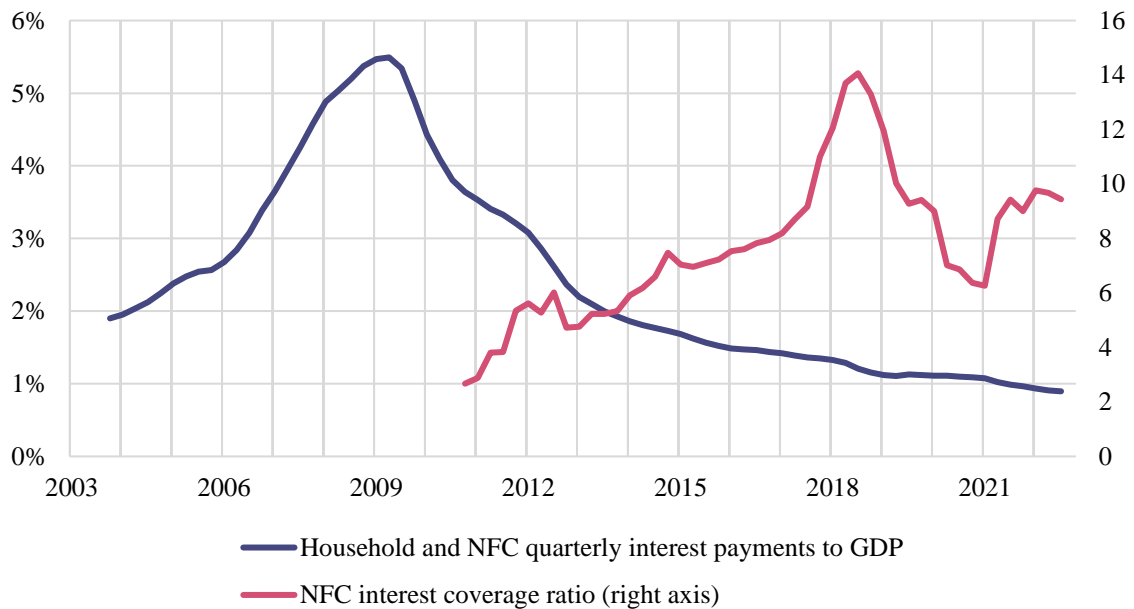
Source: Latvijas Banka, CSB. Note: From credit growth rate excluded overclassification and other one-time effects but including loan write-offs.

Chart 4. Credit developments – annual growth rates of credit to households and NFCs



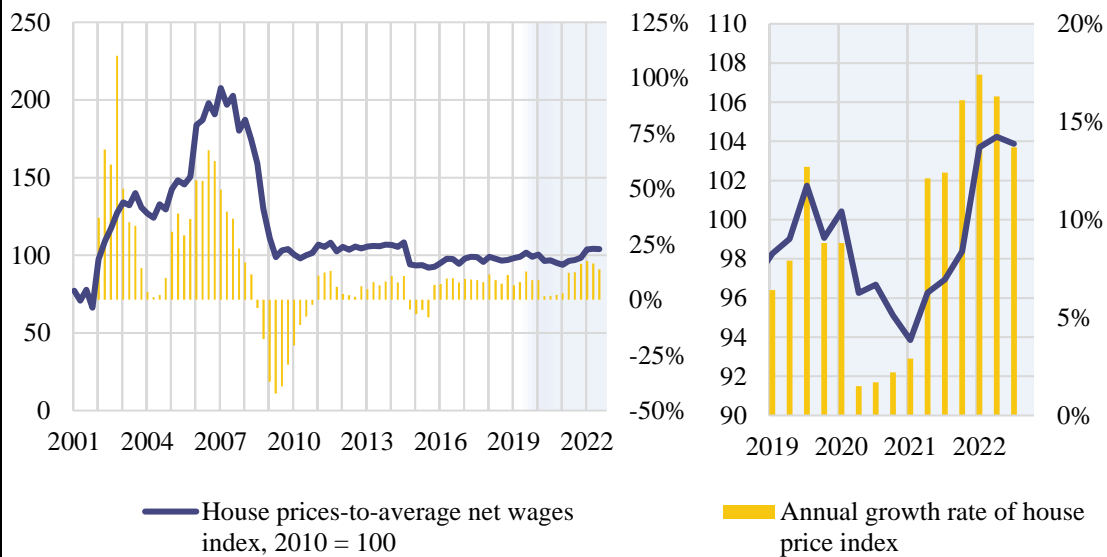
Source: Latvijas Banka, CSB. Note: From credit growth rate excluded overclassification and other one-time effects but including loan write-offs.

Chart 5. Private non-financial sector debt servicing burden

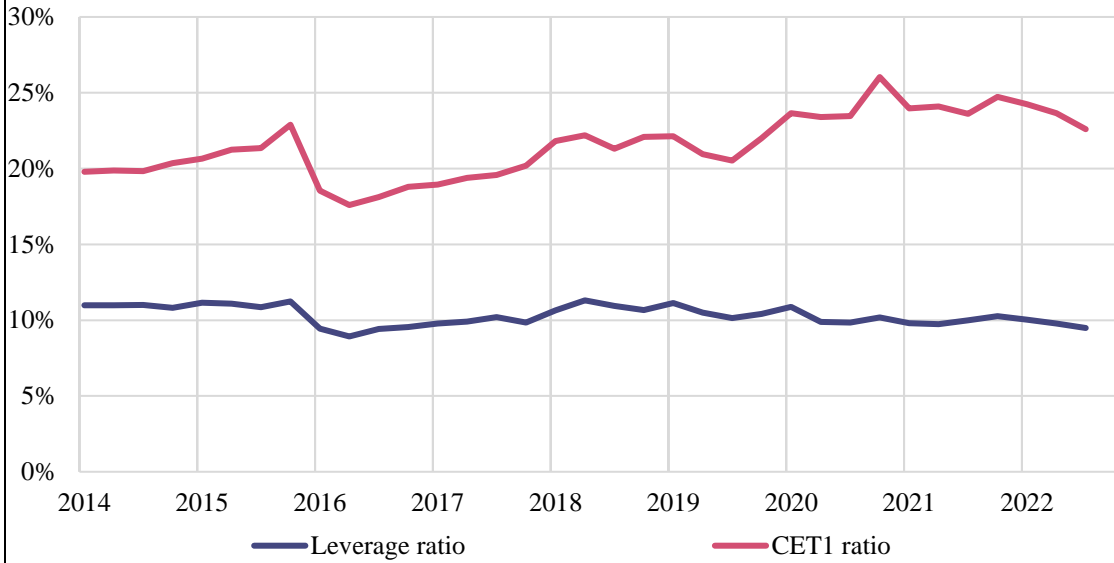


Source: Latvijas Banka, CSB. Note: NFC interest coverage ratio includes ratio of earnings before taxes and interest payments to interest payments.

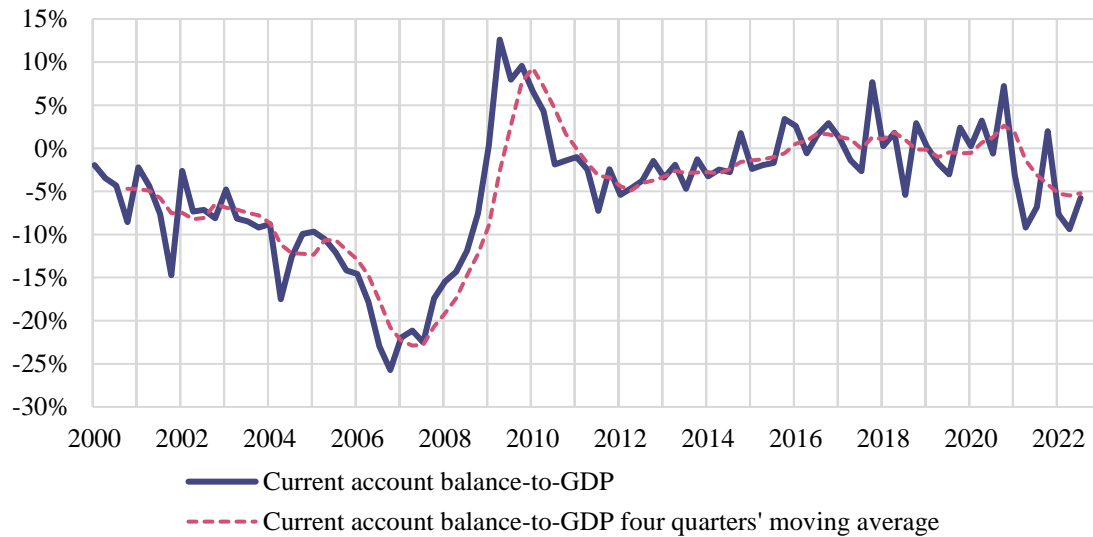
Chart 6. Potential overvaluation of property prices



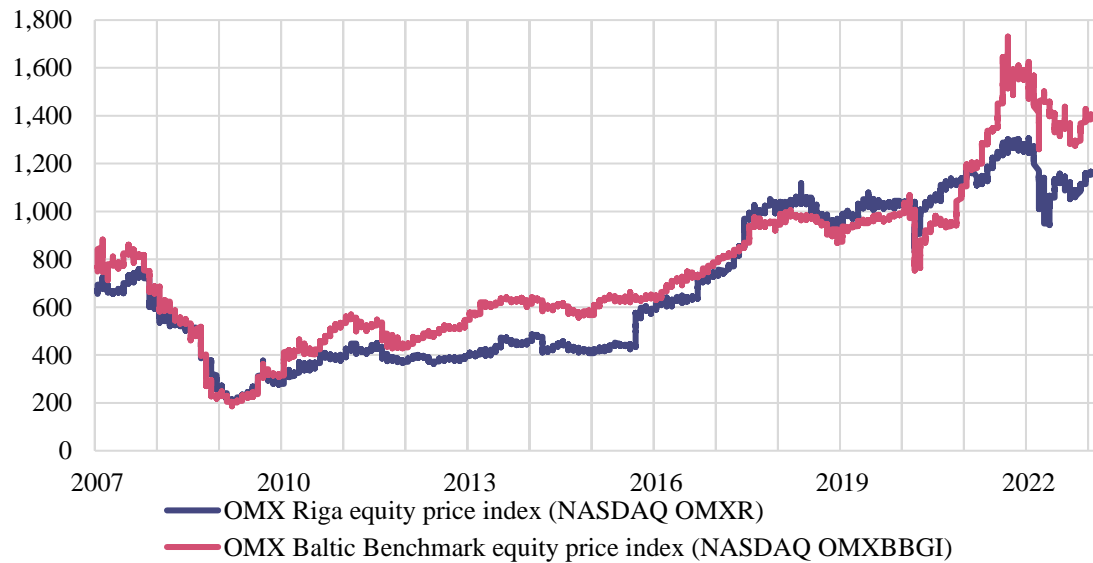
Source: CSB

Chart 7. Resilience of credit institutions

Source: Latvijas Banka. Note: Only credit institutions active at the end of 2022 are included.

Chart 8. External imbalances

Source: Latvijas Banka, CSB

Chart 9. Potential mispricing of risk

Source: Bloomberg

Chart 10. CCRI – Percentile method

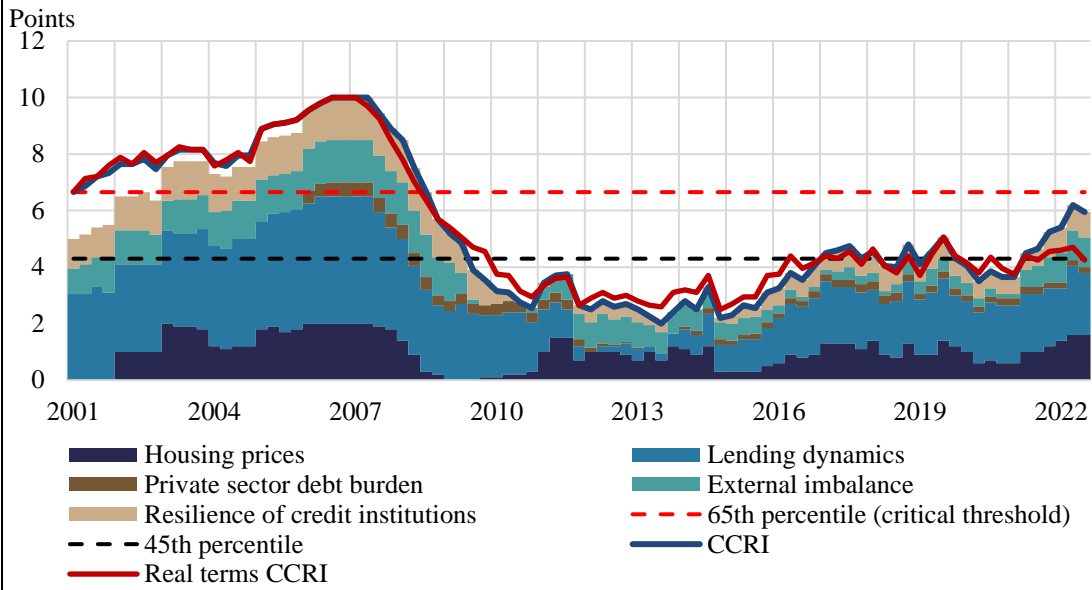


Chart 11. CCRI – Standardized method

