LATVIJAS BANKA

EIROSISTĒMA

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Q1 2024 assessment of the cyclical systemic risk and applicable countercyclical capital buffer rate

25 March 2024

The countercyclical capital buffer (hereinafter – the CCyB) is a macroprudential tool that aims at strengthening the capitalisation of credit institutions so that they are adequately equipped to absorb losses in times of crisis. When risks materialise, the CCyB rate is partially or fully released to help credit institutions continue to offer funding to the economy, thereby reducing the length of crises and their impact on the economy.

Latvijas Banka, in its capacity as the designated authority for the application of the CCyB requirement, evaluates the cyclical systemic risk on a quarterly basis pursuant to Section $35.^5$ of the Credit Institution Law and, if necessary, sets or adjusts the CCyB rate applicable to credit institution exposures to residents of the Republic of Latvia. Latvijas Banka publishes quarterly assessments of the cyclical systemic risk and the applicable CCyB rate. If the CCyB rate remains unchanged, the previous decision regarding the applicable CCyB rate remains in force.

On 18 December 2023, Latvijas Banka decided[1] to implement a positive neutral CCyB approach[2]. According to this approach the CCyB rate is set at positive basis level (above zero) already in a standard risk environment or at the neutral stage of the financial cycle when cyclical systemic risk is neither elevated nor subdued. Latvijas Banka has estimated 1% to be an appropriate base level of the CCyB rate. In the event of an increase in the cyclical systemic risk, the CCyB rate is raised proportionately to its intensity, starting from an already positive base rate, rather than from zero. Thereby the total CCyB requirement will comprise both the base rate and the cyclical rate components for which the level is determined every quarter. The CCyB rate may be partially or fully released in times of crisis as risks materialise and in the post-crisis recovery period.

To ensure gradual implementation of the positive neutral CCyB approach, the Council of Latvijas Banka determined that the 0.5% CCyB rate requirement takes effect on 18 December 2024 and the 1% CCyB rate requirement – on 18 June 2025. Credit institutions apply the respective CCyB rate to the risk exposures to residents of the Republic of Latvia when calculating the institution-specific CCyB rate[3].

Considering the Q1 2024 cyclical systemic risk assessment, Latvijas Banka has decided not to increase the cyclical component of the CCyB rate. Therefore the decision on the applicable CCyB rate taken on 18 December 2023 remains in force. The cyclical systemic risk is still assessed as low taking into account a slowdown in the pace of lending, increasing lending costs and continuously high lending standards, as well as lower activity in the real estate market. The ratio of domestic private non-financial sector credit to GDP continues to decline.

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[1] An administrative act No 444/10 of the Council of Latvijas Banka of 18 December 2023 (available only in Latvian) Par pretcikliskās kapitāla rezerves normas riska darījumiem, kuri noslēgti ar Latvijas Republikas rezidentiem, noteikšanu 1 procenta apmērā.

[2] For more information please see Latvijas Banka's approach to applying the countercyclical capital buffer.

[3] Pursuant to Regulation No 137 of the Financial and Capital Market Commission of 25 August 2020 on calculating the institution-specific countercyclical capital buffer rate.

The **credit-to-GDP gap** in the private non-financial sector is gradually narrowing but remains negative both according to the standardised (broad) credit definition and additional (narrow) credit definition (see Table 1 and Charts 1 and 2). Consequently, the CCyB buffer guide is 0%.

Table 1 **Key variables of the CCyB rate assessment**[4]

Variable	Standardised (broad) credit definition	Additional (narrow) credit definition
	Q3 2023	Q4 2023
Credit-to-GDP ratio (%)	61.0	26.3
Credit-to-GDP gap (pp)	–21.9	–8.4
Benchmark buffer rate (% of risk weighted assets)	0	0[5]

The growth rate of **domestic lending** to both non-financial corporations (hereinafter – NFCs) and households continues to decelerate (see Chart 3). In December 2023, the annual growth rate of domestic loans, excluding one-off structural effects in the banking sector, shrank to 1.5% (inter alia, the annual growth rate of the household loan portfolio increased by 2.9%, while that of the NFC loan portfolio declined by 1.4%; see Chart 4). A sharp rise in interest rates, uncertainty and weak economic growth continue to weigh on the willingness and ability of households and companies to borrow. Moreover, lending is still affected by several structural factors such as shortcomings in the business environment, weak construction sector, insufficient capital market, demographic factors.

The private non-financial sector debt and its servicing burden is low. Along with the interest rate increase, the ratio of household and NFC interest payments to GDP continues to grow (see Chart 5). The bank loan portfolios have shown no signs of deterioration so far, but in the fourth quarter of 2023 the share of Stage 2 loans has been slowly increasing (see Chart 8). Overall the financial resilience of borrowers remains strong.

The **real estate** market activity continues to shrink gradually, and in January-February 2024 the total number of real estate purchases was down by 2.2% compared to the same period in 2023. The annual growth of house prices continued to slow down: the annual growth rate of the house price index published by the Central Statistical Bureau (hereinafter - CSB) of Latvia was 1.0% in the fourth quarter of 2023 (see Chart 6), but quarterly change was -2.5%. The supply of energy-inefficient standard apartments remains at a historically high level, and their prices are on a slow and gradual downtrend, with their cumulative decline amounting to 12.8% between June 2022 and February 2024. Meanwhile, growth in prices on new housing remained persistently high (prices on new housing increased by 11.6% year on year in the fourth quarter of 2023) since their supply was still limited and the construction costs remained high.

The persistently weak **macroeconomic development** in Latvia also suggests that the cyclical risk is low. The monetary policy tightening has led to a decrease not only in inflation but also in external demand According to the estimates made by the CSB of Latvia the seasonally adjusted GDP of 2023 remained at the level of 2022. In the fourth quarter of 2023 the annual growth rate of GDP already was positive (0.4%), and the economic activity might recover gradually in 2024 and 2025 as the household purchasing power and investments as well as growing export possibilities are projected to follow an upward trend. The substantial decline in inflation and the rise in real wages are improving

[4] The narrow credit definition includes credit institution loans to NFCs and households and debt securities purchased by credit institutions, but the broad definition comprises liabilities of NFCs and households to credit institutions, as well as their loans from non-bank financial institutions or other NFCs.
[5] 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.

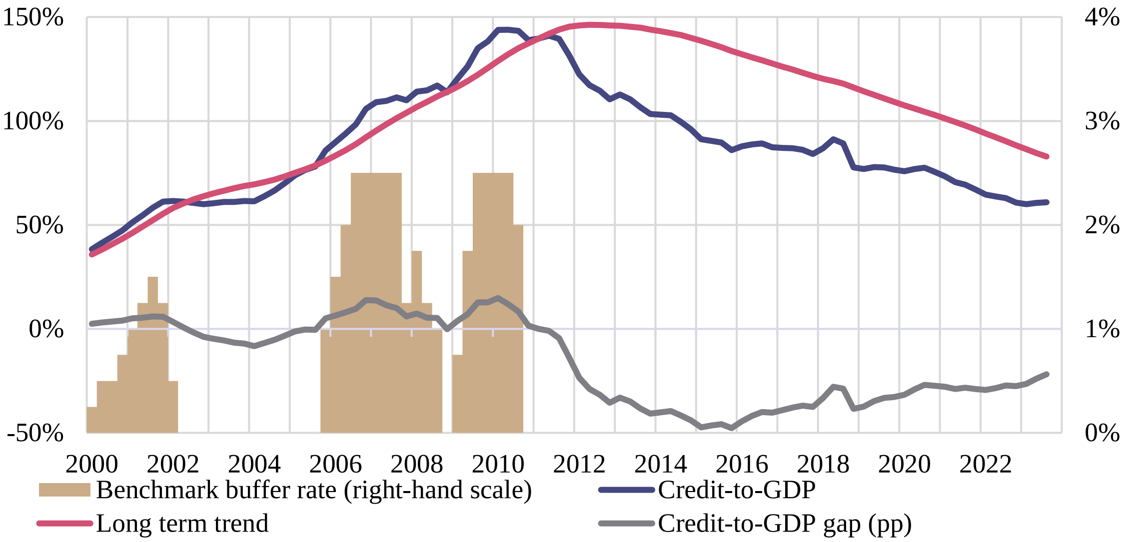
the financial situation of households. Meanwhile, investment activity is supported by absorption of EU funds. Changes in imported mineral products and slight improvement of the export performance has driven a decrease in the current account deficit to -1.6% of GDP in the fourth quarter of 2023 (see Chart 9).

Latvijas Banka's composite systemic cyclical risk indicator (hereinafter – the CCRI)[6] declined from 5.3 points in the third quarter of 2023 to 5.1 points in the fourth quarter of 2023. It is still below the risk level that is considered to be above average (see Chart 11).

[6] For further information on the CCRI methodology, see Appendix 1 to Latvijas Banka's Financial Stability Report 2020 (https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf).

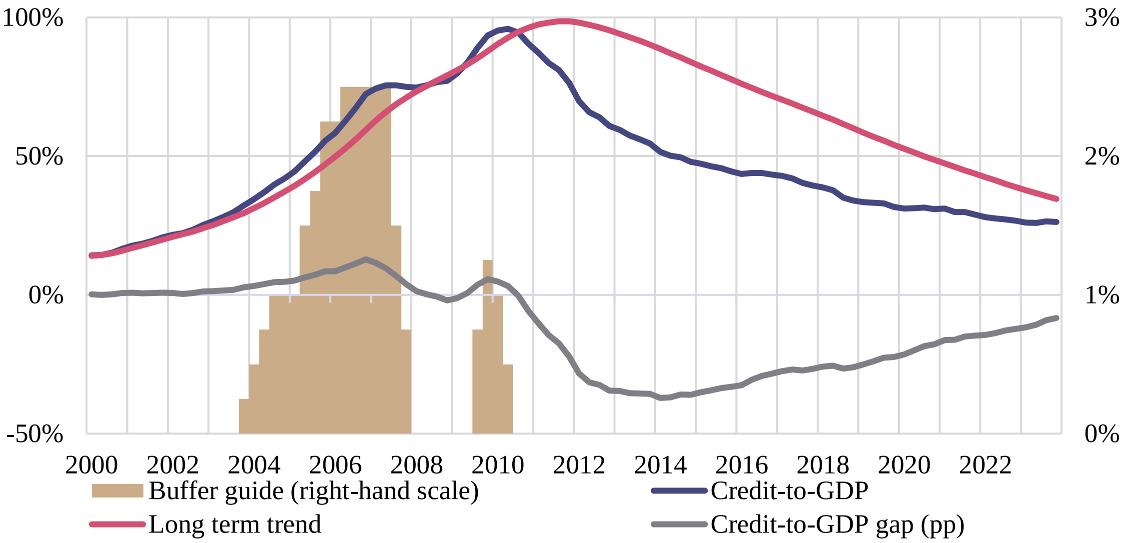
Annex 1. **Key variables of the Financial Cycle**

Chart 1. Standardised credit-to-GDP gap



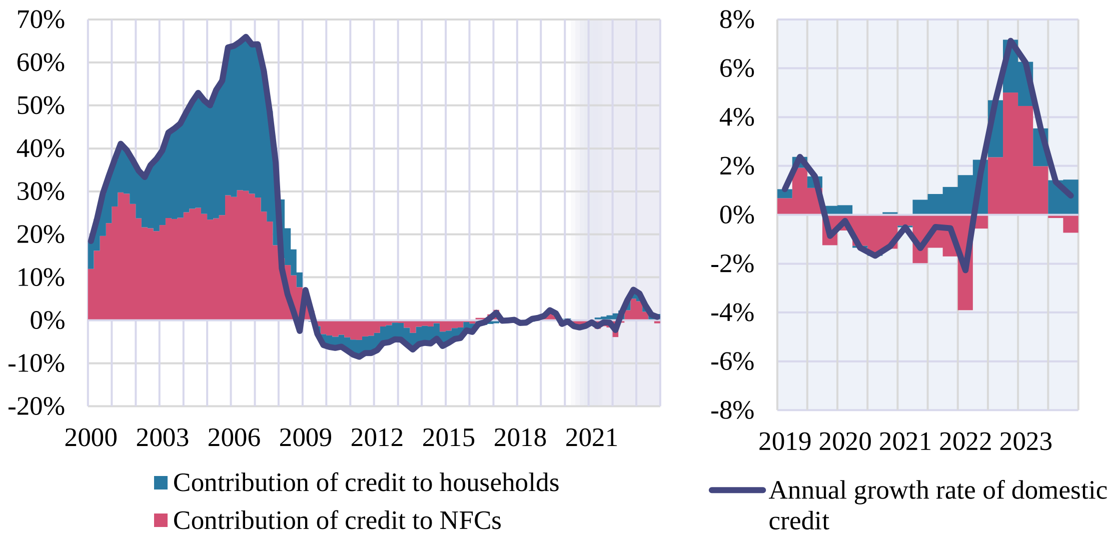
Source: Latvijas Banka, CSB.

Chart 2. Additional credit-to-GDP gap



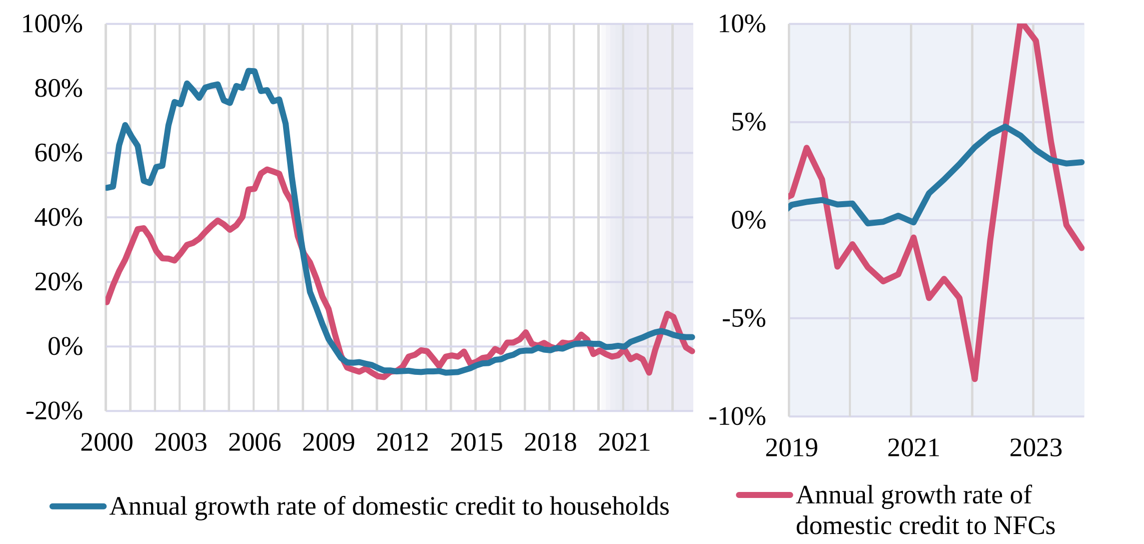
Source: Latvijas Banka, CSB.

Chart 3. Credit developments



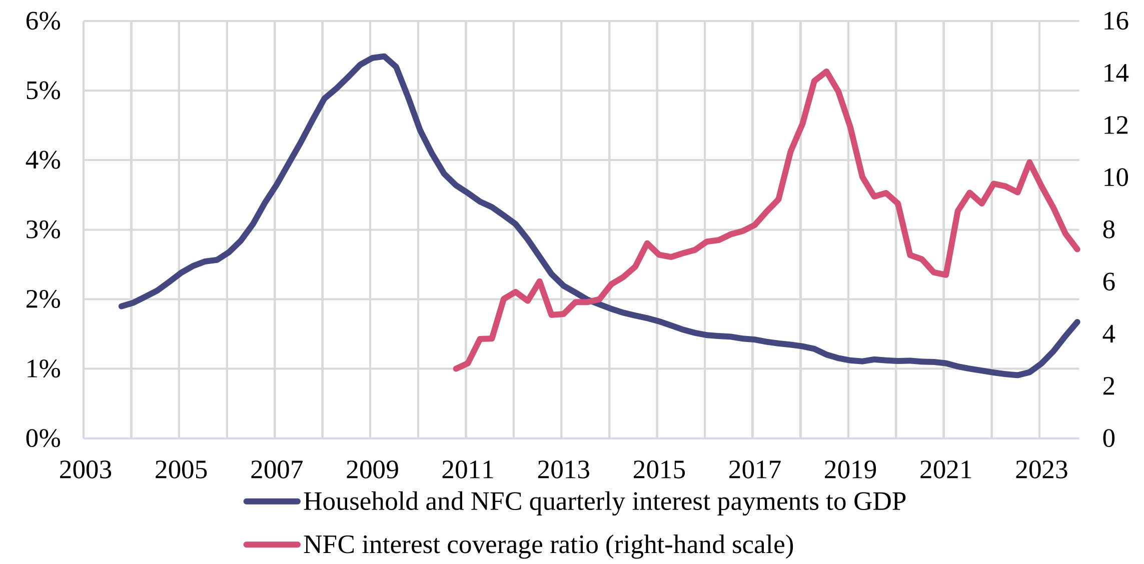
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

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



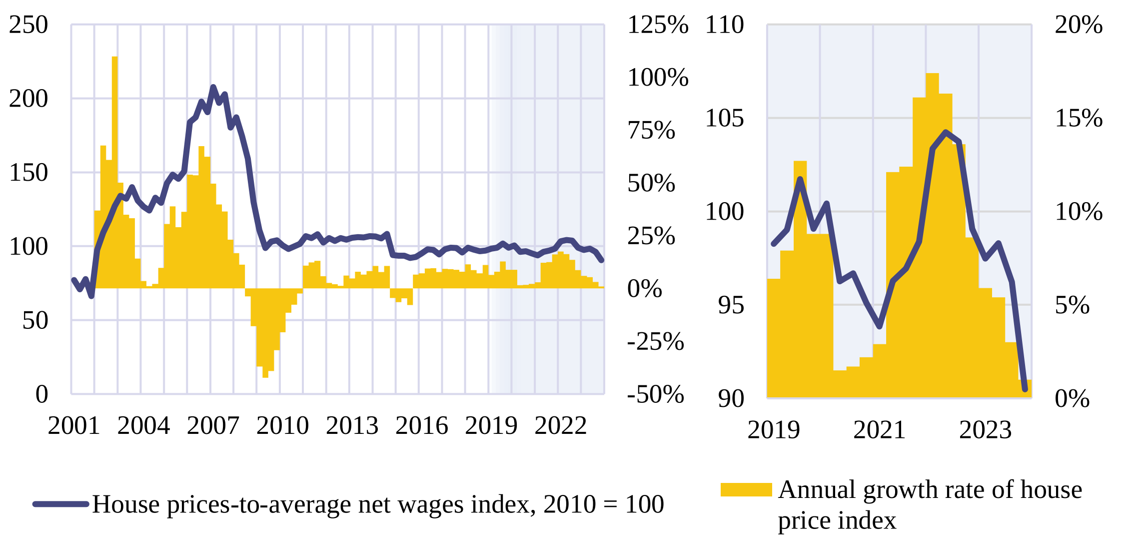
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

Chart 5. Private non-financial sector debt servicing burden



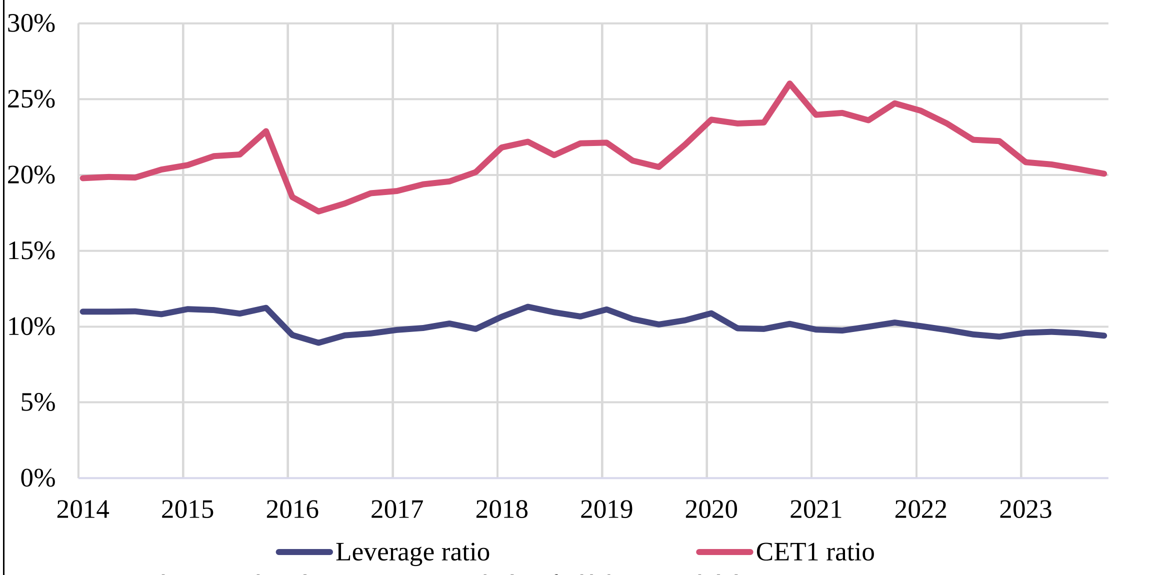
Source: Latvijas Banka, CSB. Note. The NFC interest coverage ratio includes the ratio of earnings before taxes and interest payments to interest payments.

Chart 6. Potential overvaluation of property prices



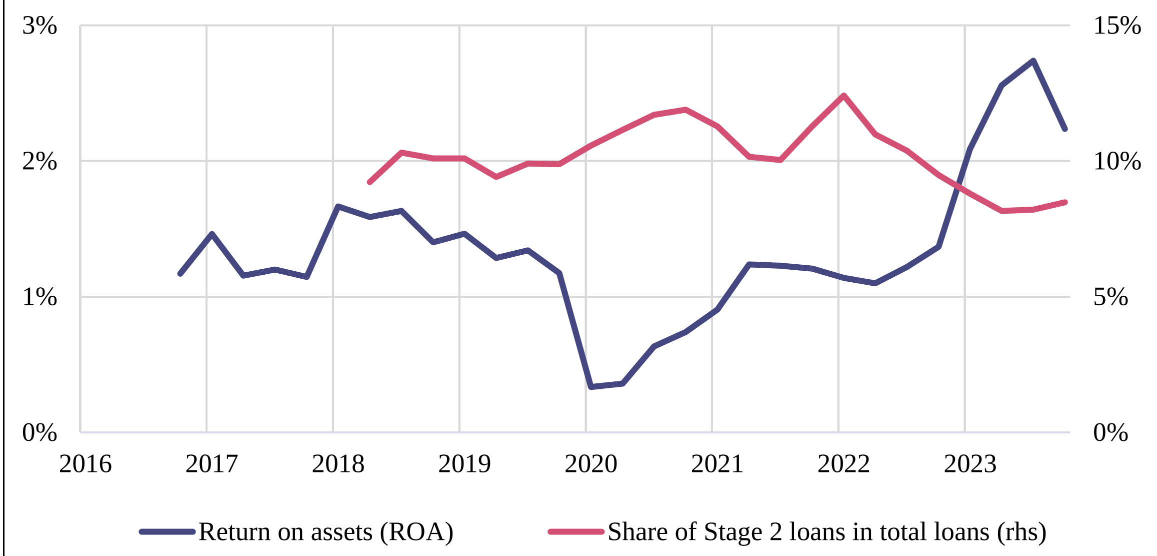
Source: CSB.

Chart 7. Resilience of credit institutions - capitalization



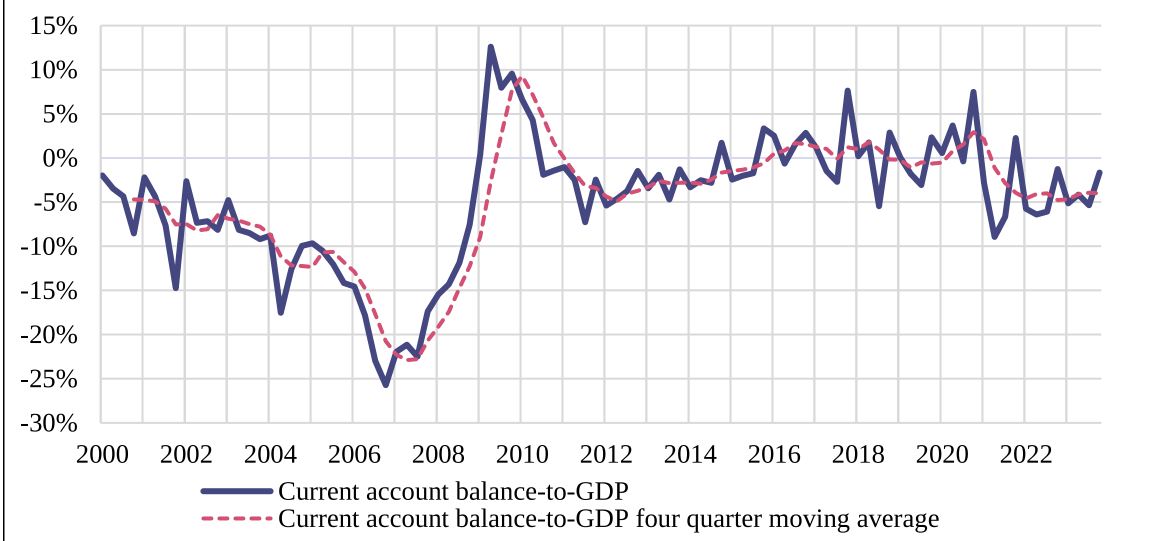
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 8. Resilience of credit institutions - profitability and asset quality



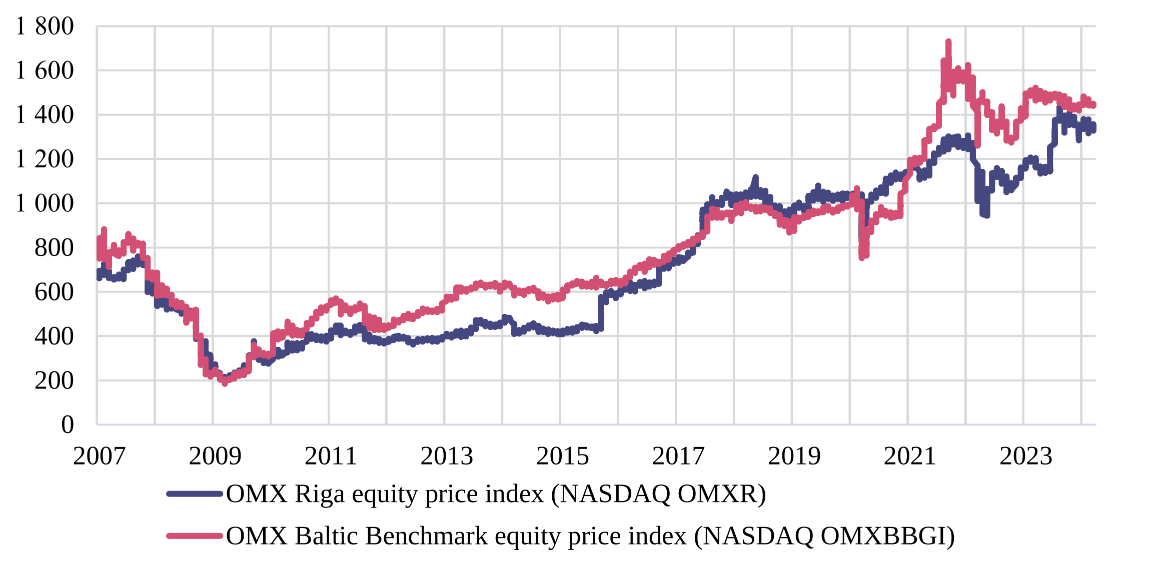
Source: Latvijas Banka. Note. Only credit institutions active at the date of publishing are included.

Chart 9. External imbalances



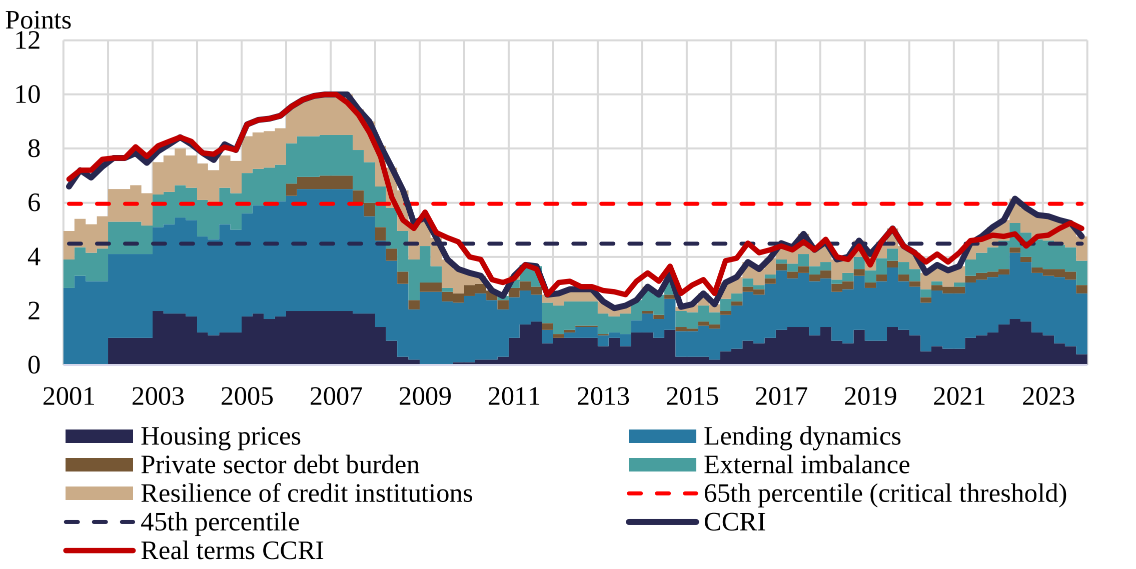
Source: Latvijas Banka, CSB.

Chart 10. Potential mispricing of risk



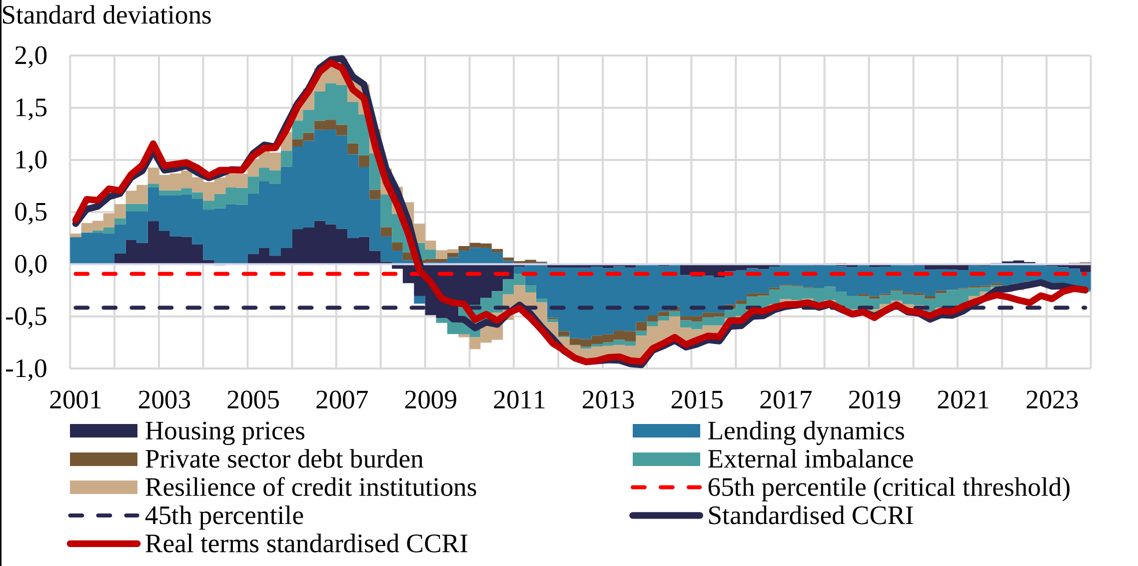
Source: Bloomberg.

Chart 11. CCRI – percentile method



Source: Latvijas Banka, CSB.

Chart 12. CCRI – standardised method



Source: Latvijas Banka, CSB.