Assessment by the Financial and Capital Market Commission of the intensity of cyclical systemic risk and the appropriateness of the applicable CCyB rate currently set at 0%

26 October 2021 assessment of the intensity of cyclical systemic risk and the appropriateness of maintaining the Countercyclical Capital Buffer (CCyB) rate of 0%.

The decision of 27 April 2021 to set the CCyB rate of **0%** for relevant exposures to residents of the Republic of Latvia **remains in force**.

Rationale for the assessment: The Financial and Capital Market Commission (FCMC) as the designated authority in charge of the application of the CCyB according to Article 35.[5] of the Credit Institution Law quarterly analyses the intensity of cyclical systemic risk and the appropriateness of the applicable CCyB rate to set or adjust it, if necessary. The credit-to-GDP ratio as well as its deviation from the long-term trend and the additional indicators are used to justify the decision on the CCyB rate.

Credit institutions will be required to start applying the respective CCyB rate of 0% (set by the 27 April 2021 decision of the FCMC Council) in the calculation of the institution specific CCyB rate **from 1 May 2022 onwards**, and it will be applicable until the next decision of the FCMC to change the respective rate.

The FCMC will **continue to publish** quarterly cyclical systemic risk assessments on its homepage.

To decide upon the applicable CCyB rate, the FCMC, accompanied by the Bank of Latvia, carries out the assessment of the financial cycle of Latvia and continues to monitor coronavirus (Covid-19) outbreak developments and the effects of the resulting global supply-demand shock on Latvia's economy. According to the Central Statistical Bureau (CSB), the growth of the economy has increased significantly in Q2 2021 - by 11.1% (year-on-year) mostly due to the low base effect. This compares positively to GDP growth figures in 2020 and at the start of 2021 where quarterly growth was negative reflecting the shock to the economy associated with the pandemic and the associated restrictions. Looking forward, the Ministry of Economics forecasts a decrease in GDP growth rate in H2 2021 due to a gradual decrease of the base effect. Further economic recovery remains surrounded by high uncertainty.

In September 2021 Bank of Latvia updated the forecast of Latvia's' GDP predicting growth of 5.3% in 2021 (previous forecast of 3.3% made in June 2021 was updated), and 5.1% in 2022. These forecasts were made amidst high uncertainty and the main highlighted risks to positive economic growth were related to the effectiveness of containing the pandemic, including successful vaccine roll-out. Albeit the recovery of Latvia's economy was faster than expected the economic activity in various sectors still lags significantly compared to levels observed before the pandemic.

The CCyB benchmark buffer rate data regarding the credit-to-GDP gap shows prolonged negative trend both for its broad (financial accounts) (-27 p.p. in Q1 2021) and narrow (bank)

(-15.7 p.p. in Q2 2020) credit definition[1]. Domestic private nonfinancial client credit-to-GDP ratio also continues to gradually decrease both within the narrow (31% in Q2 2021) and broad (75% in Q1 2021) credit definition.

Domestic credit has been further negatively affected by the pandemic as the overall issuance of loans to the domestic private non-financial sector continued to decrease also in Q1 2021, falling by 3.4% (year-on-year). Steady downward trend has also been observed for the domestic consumer credit as its balance fell by 1.8% in Q2 2021 compared to the corresponding period of the previous year, and also for the domestic credit for house purchase which decreased by 0.6% in terms of total amount and by 1.4% in terms of transactions (year-on-year). Domestic private sector indebtedness continues to gradually decrease, while private sector annual interest payments to GDP decreased to 1.06% in Q2 2021, slightly lower than the stable rate of 1.1% observed since 2019.

Loans issued by credit institutions and debt securities purchased by private non-financial sector showed signs of recovery in Q2 2021 compared to recent previous quarters, decreasing by a mere 1.0% compared to the corresponding quarter of 2020. The decrease present in H1 2021 can be mostly explained by a fall in loans issued to non-financial corporations (decrease by 3.7% in Q2 2021 (year-on-year)), which, however, is a notable improvement compared to decrease observed in 2020 by around 8% on average. These credit developments, albeit still in the negative territory, start to show a more positive trend after the lowest point in Q3 2020 (Chart 1). The total domestic household and non-profit institutions serving households (NPISH) portfolio, on the other hand, remained more stable and resilient to economic demand-supply shock caused by Covid-19 pandemic in both 2020 and H1 2021, increasing by 1.4% in Q2 2021 (year-on-year).

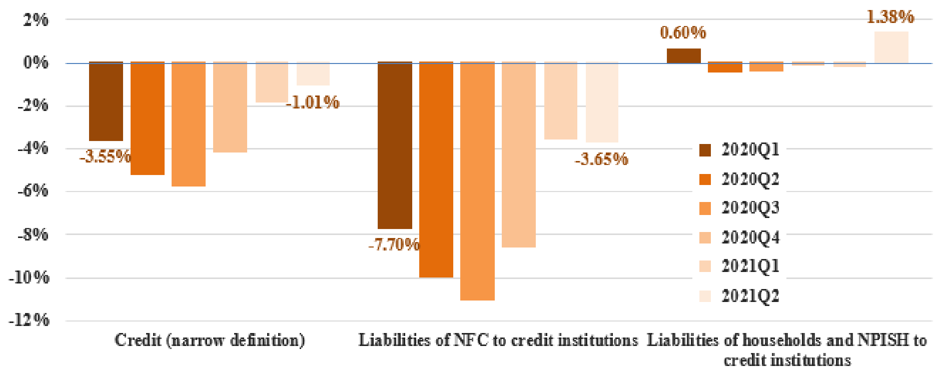

Chart 1*. Credit (narrow definition) and its components quarterly changes (year-on-year)*

Notwithstanding the economic slowdown and high uncertainty, issuance of state supported housing loans to resident households still factors significantly in the overall credit growth as significant part of all bank housing loans are issued using one or another of established state support programs. These support programs as well as availability of financial services from banks ensures that many households are now presented with increasing viable options for house purchase.

[1] Additional information regarding the definition of credit applicable in the CCyB methodology is available in FCMC homepage: https://www.fktk.lv/en/media-room/macroprudential-supervision/countercyclical-capital-buffer/

House prices continued their rise in 2020, albeit the growth rate slowed down significantly due to the pandemic (Chart 2). Some early recovery signs of house price growth rate were already observed in Q1 2021, and in Q2 2021 the house price growth rate has started to increase significantly, returning to the level previously observed in 2019. According to unadjusted data in Q2 2021 the CSB housing price index increased by 12.4% (year-on-year) (in Q1 2021 - by 2.2%), wherein existing house prices increased slightly more by 16.3% (in Q1 2021 – by 4.4%), while on the other hand new house prices grew only by 0.4% (in Q1 2021 decrease of 1.5% was observed) (year-on-year). The correlation between house prices and wages continues to be high.

Chart 2. *CSB housing price index and its components' quarterly changes (year-on-year) (left axis) and ratio of house prices and wages (right axis)*

Overall, in 2020 the housing market remained resilient to the effects of Covid-19 pandemic, with the exception of Q2 2020 when restrictions to contain pandemic and high uncertainty resulted in significant drop of the purchase contracts. In Q1 2021 the activity in terms of the number of purchase contracts yet again decreased mainly due to decreased supply in the real estate market as well as pandemic containment measures that were tightened at the start of 2021 (Chart 3). In Q2 2021 the activity again surged, and the growth rate of purchase contracts rose both in the country as a whole (by 47.6%) and in the

Chart 3. *Number of purchase contracts registered in the Land Registry – quarterly changes (year-on-year)*

capital (by 58.9%) (year-on-year) mostly due to low base effect in the previous quarters. In absolute terms the number of purchase contracts in Q2 2021 has returned to the average long-term level observed before the pandemic.

According to experts, banks are currently re-evaluating the credit standards for mortgage loans thus potentially providing a further stimulus to the already high demand for housing. Increase in the demand for housing drives the housing price, especially considering limited supply conditions. In recent quarters a general trend of rising house prices can be observed with the exception of rural regions, while the number of purchase contracts highly correlates with the severity of restrictions introduced to contain the pandemic. In 2021 the cost of new housing construction continued to rise which could have had a restraining effect on the availability of this housing segment. Various surveys indicate high housing consumer confidence regarding housing price increase in the near future along with the recovery of economy. The rent market in central districts of the capital has largely recovered in light of increasing demand.

Adjusting to life in pandemic the non-bank financial institution credit portfolio recovered overall faster than bank lenders' portfolio. At the end of Q2 2021 non-banks' issuance of credit to domestic households and non-financial corporations increased by 6.1% (year-on-year), while leasing companies' loans in the same period also exhibited a similar trend, increasing by 1.5% (year-on-year).[2] Loans to households by leasing companies in August 2021 grew by 2.6% compared to the same period in 2020. This increase was motivated mostly by stable net wage increase and savings made from 2020 when mobility restrictions to contain pandemic were introduced. The loan growth was affected by various aspects, including, for instance, by constrained developments in the (passenger) car production. It is expected that in 2022 there will be changes regarding car leasing segment due to the grant introduced for electric car purchases and write offs regarding old cars. Loans to domestic non-financial corporations, including loans issued by leasing companies, were mostly affected by negative effects of pandemic on income channel and the disruption of supply chains. In Q2 2021 these effects decreased, and the growth of newly issued loans can be observed, reaching pre-pandemic levels. Leasing companies' loans growth rate to domestic non-financial corporations recovered from -12.9% in August 2020 to -3.2% in August 2021 (annual change) according to the Bank of Latvia Credit Registry data. Loans to domestic households by other non-bank financial institutions, such as "pay-day" lenders, grew by 8% in Q2 2021, largely explained by the rise in economic activity, changes in some of loan origination standards and active advertisements by lenders.

Overall, the assessment of relevant indicators in Q2 2021, the uncertainty regarding future economic developments notwithstanding, suggest broadly unchanged dynamics of the financial cycle. Chart 4 depicts the Composite Cyclical Risk Indicator (CCRI)[3] – an additional cyclical systemic risk intensity assessment tool, developed by the Bank of Latvia that allows to account for the specificities of the Latvian financial system and to evaluate the state of the local financial cycle. The CCRI assigns a relatively high weight to credit development indicators, therefore,

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[2] This years' data in the Bank of Latvia Credit Registry on non-bank financial institutions credit portfolio is available only for H1 period, but data regarding leasing companies' loans is available for eight-month period.

[3] Information regarding the Bank of Latvia developed CCRI is available in 2021 Financial Stability Report: https://datnes.latvijasbanka.lv/fsp/FSP_2021_en.pdf

Additional information regarding the methodology behind calculating CCRI is available in the Bank of Latvia 2020 Financial Stability Report: https://datnes.latvijasbanka.lv/fsp/FSP_2020_en.pdf due to weak lending trends observed during the pandemic, it currently signals a low cyclical systemic risk level both from the perspective of points (upper panel) and standard deviations (lower panel) methods. Higher CCRI in Q2 2021 can be explained mostly by increased house price growth.

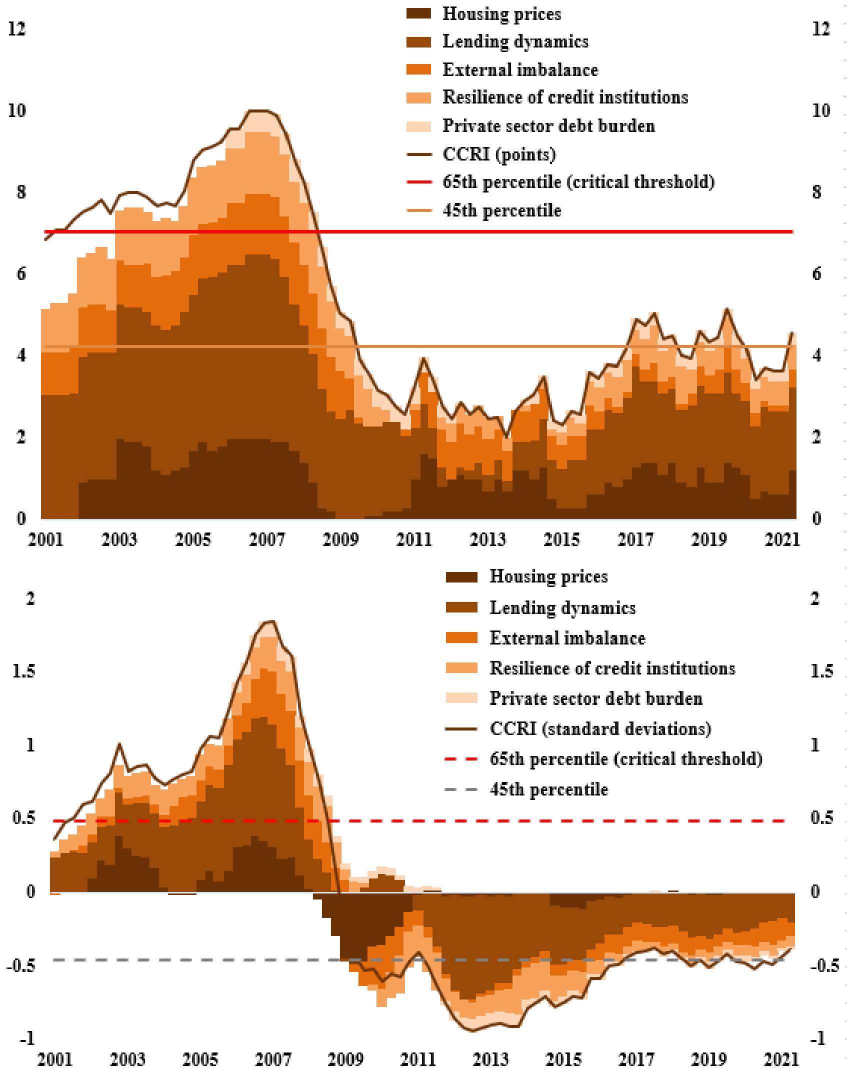

Chart 4. CCRI and its underlying components (points in Graph 1, standard deviations in Graph 2)

Overall, considering the assessment of relevant indicators and the uncertainty regarding future economic developments, the financial cycle is expected to remain subdued. The effects of pandemic are reflected in weak lending trends and subdued values of other relevant indicators that characterize the financial cycle. Therefore, the current assessment of the appropriate CCyB rate level remains at 0%.

The FCMC in cooperation with the Bank of Latvia will continue to assess relevant indicators, the level of cyclical systemic risk and the appropriateness of the applicable CCyB rate.