

Q2 2024 assessment of the cyclical systemic risk and applicable countercyclical capital buffer rate

10 June 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, the Council of Latvijas Banka decided¹ to implement a positive neutral CCyB approach². 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 rate³.

Considering the Q2 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 sluggish lending, continuously high interest rates, muted activity in the real estate market as well as slow

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.](#)

GDP growth rate. The ratio of domestic private non-financial sector credit to GDP continues to decline.

The **credit-to-GDP gap** of 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
	Q4 2023	Q1 2024
Credit-to-GDP ratio (%)	60.1	26.1
Credit-to-GDP gap (pp)	-21.0	-7.5
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 remains weak, albeit it somewhat increased in the first quarter and in April of 2024 compared to a significant slowdown observed at the end of 2023 (see Chart 4). In April 2024, the annual growth rate of domestic loans increased up to 2.8% (inter alia, the annual growth rate of the household loan portfolio increased by 4.0%, while that of the NFC loan portfolio - by 1.0%). High interest rates, uncertainty and weak economic growth continues to weigh on the willingness and ability of private non-financial sector 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 quality of loan portfolio remained stable in the first quarter of 2024. The share of Stage 2 loans is at historically low levels and overall the financial resilience of borrowers remains strong. The ability for households to service their mortgage loans is temporary supported by the interest rate compensation that is paid-out from the mortgage borrower protection fee⁶.

The **real estate** market activity continues to be subdued – in January-April 2024 the total number of real estate purchases was down by 2.6% compared to the same period in 2023. The Central Statistical Bureau of Latvia (hereinafter – CSB) data on house price index (that were available at the time of preparing this assessment) shows that in the fourth quarter of 2023 the annual growth rate of house prices slowed down to 1.0% (see Chart 6), but quarterly change was -2.5%. The price dynamics in new and used housing segments still differs. The limited supply and previously observed sharp increase in construction costs still supports high growth rate of prices for the new housing – in the fourth quarter of 2023 they increased by 11.6% year on year. In 2024 the growth rate of construction costs has abated and the number of new housing purchases has decreased. More operative data on standard apartments reveals that their price levels in March-April 2024 have stabilized after the downward trend observed since mid-2022. Between June 2022 and

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.

⁶ [The amendments to the Consumer Rights Protection Law of 06 December 2023](#) (available only in Latvian).

April 2024 the price of the standard apartments (which are mostly energy-inefficient) cumulatively declined by 12.7%, while the supply of these apartments remains at a historically high level.

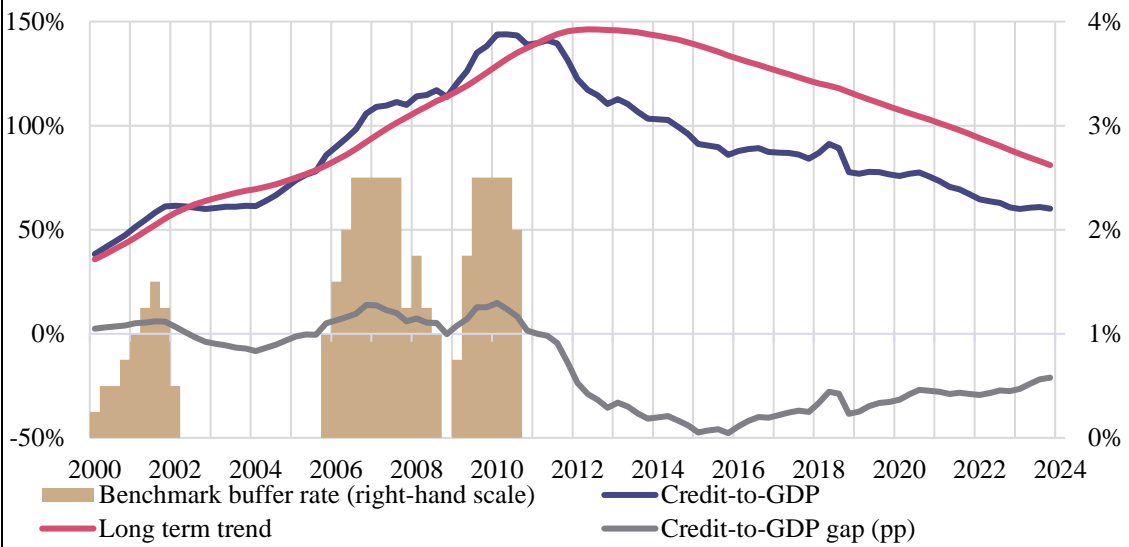
Continuously weak **macroeconomic development** in Latvia also suggests that the cyclical risk is low. The GDP grew by 0.9% in the first quarter of 2024 (both annually and quarterly). According to the forecast made by Latvijas Banka in the second half of 2024 and in 2025 the economic activity will gradually improve – albeit slower than previously expected. Consumption and private investment levels will recover slowly – in the short term primarily the domestic demand will drive the economic growth. Low inflation and rising real wages will positively affect the financial resilience of households. Going further the role of public investments will increase. Meanwhile, with the improvement of external demand, the share of export will gradually contribute more to the economic growth. The current account deficit in the first quarter of 2024 was low – 1.6% of GDP (see Chart 9).

Latvijas Banka's composite systemic cyclical risk indicator (hereinafter – the CCRI)⁷ declined from 4.8 points in the third quarter of 2023 to 4.6 points in the fourth quarter of 2023. It is still below the risk level that is considered to be above average (see Chart 11).

⁷ 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).

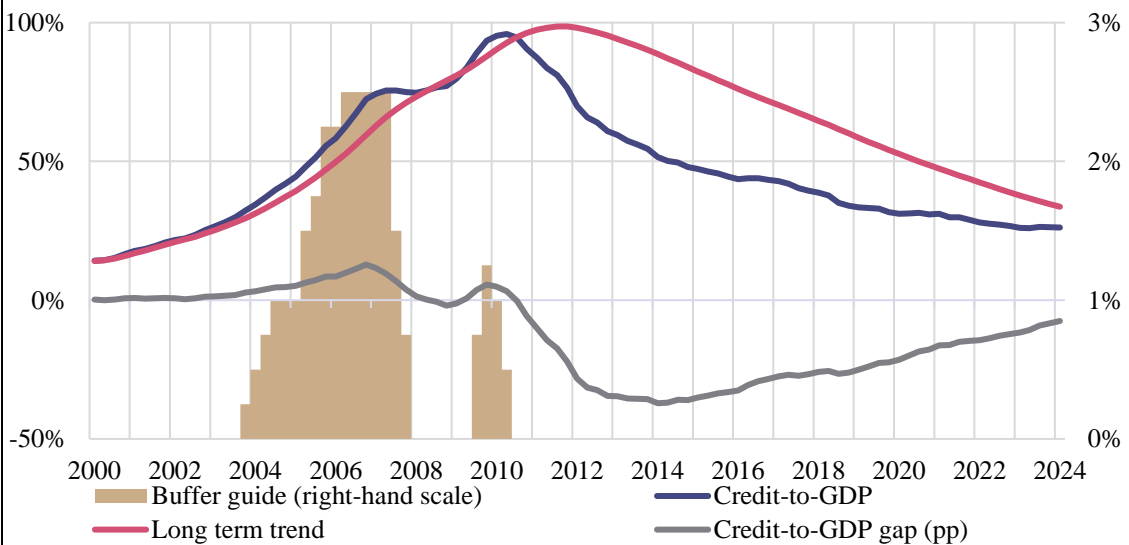
Annex 1. Key variables of the Financial Cycle

Chart 1. Standardised credit-to-GDP gap



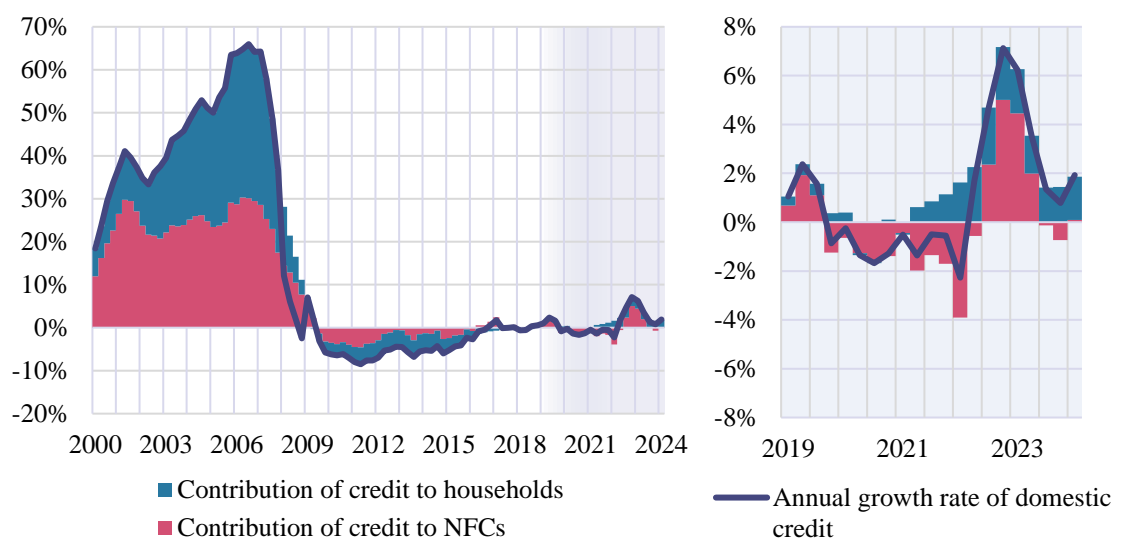
Source: Latvijas Banka, CSB.

Chart 2. Additional credit-to-GDP gap



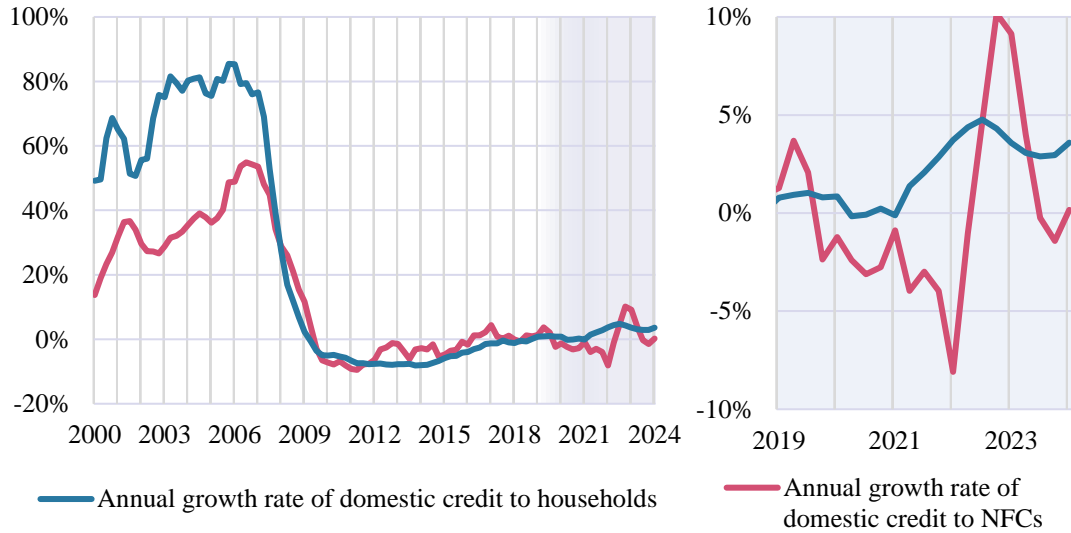
Source: Latvijas Banka, CSB.

Chart 3. Credit developments



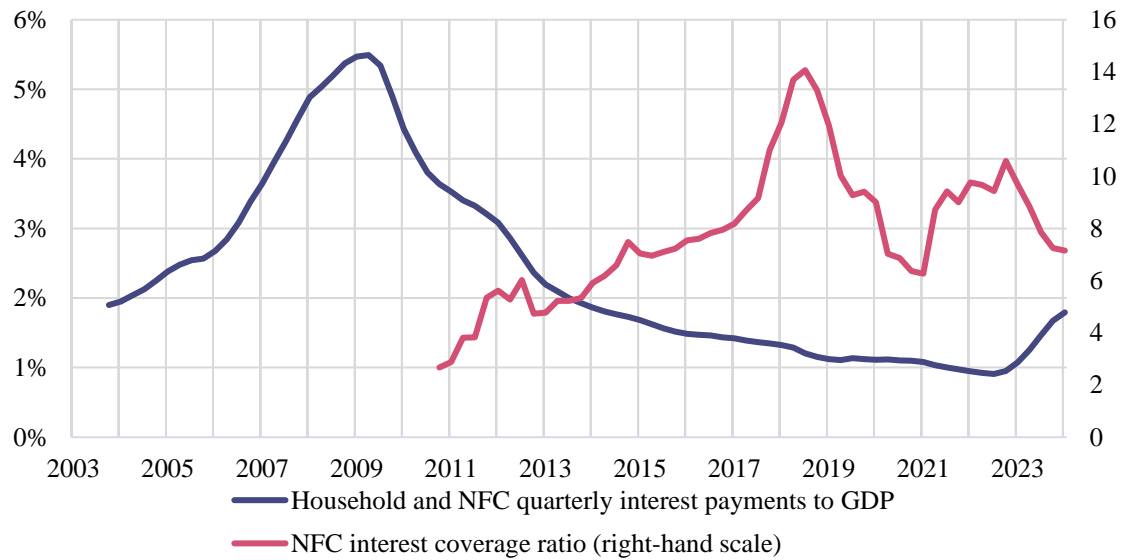
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

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



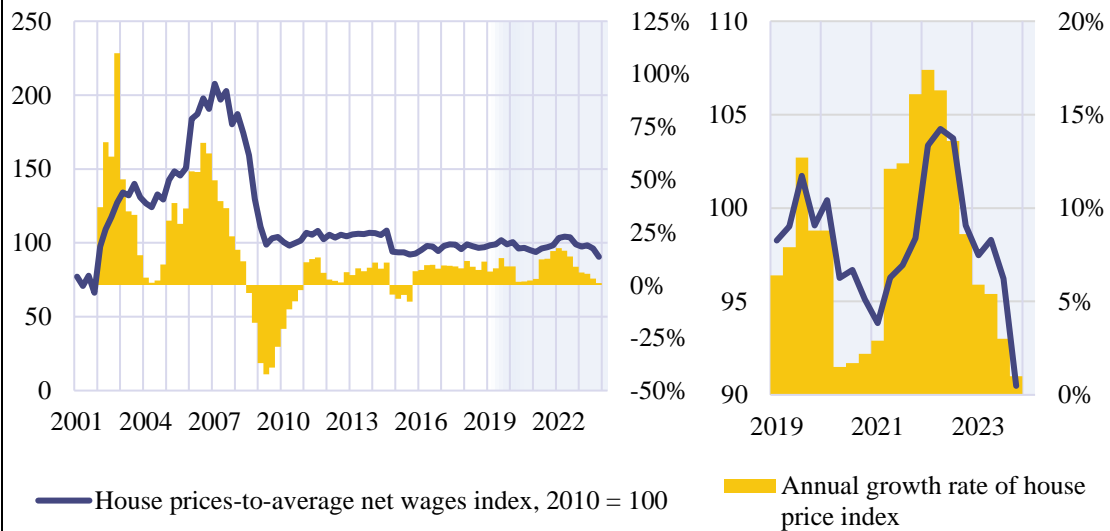
Source: Latvijas Banka, CSB. Note. The credit growth rate excludes overclassification and other one-time effects but includes loan write-offs.

Chart 5. Private non-financial sector debt servicing burden

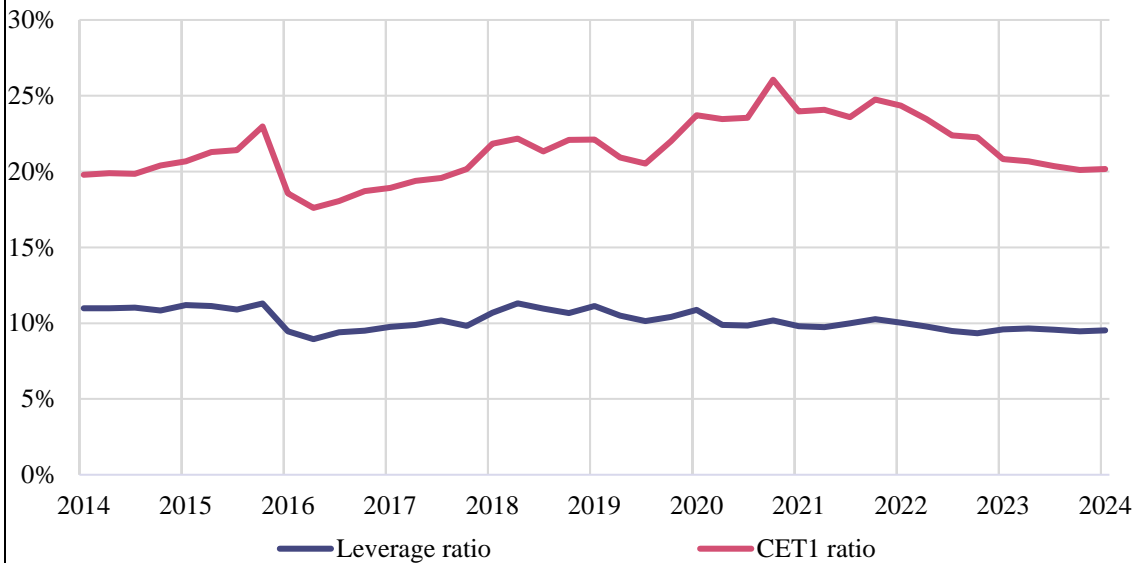


Source: Latvijas Banka, CSB. Note. The NFC interest coverage ratio includes the ratio of earnings before taxes and interest payments to interest payments.

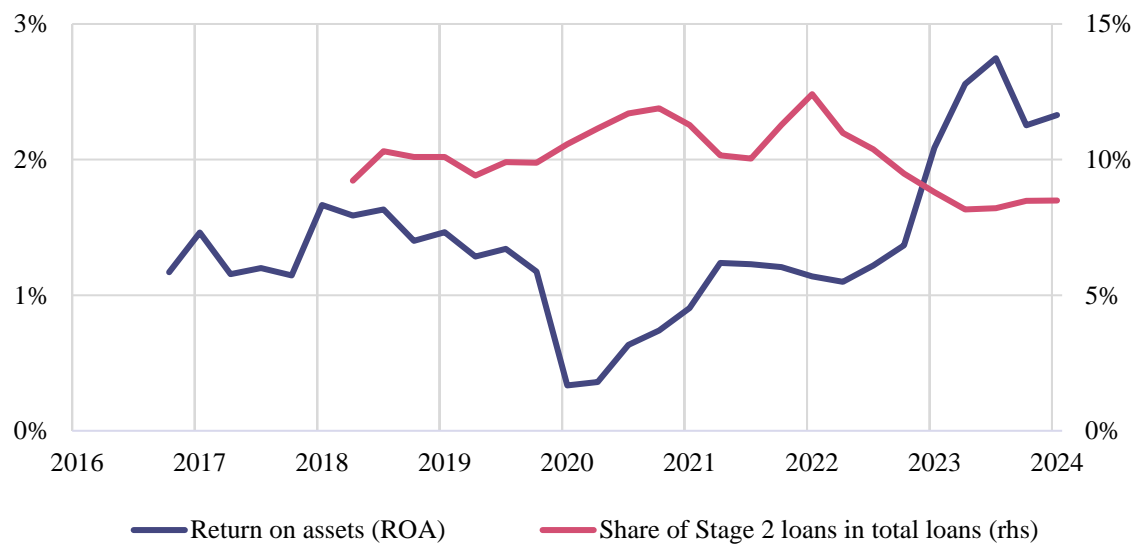
Chart 6. Potential overvaluation of property prices



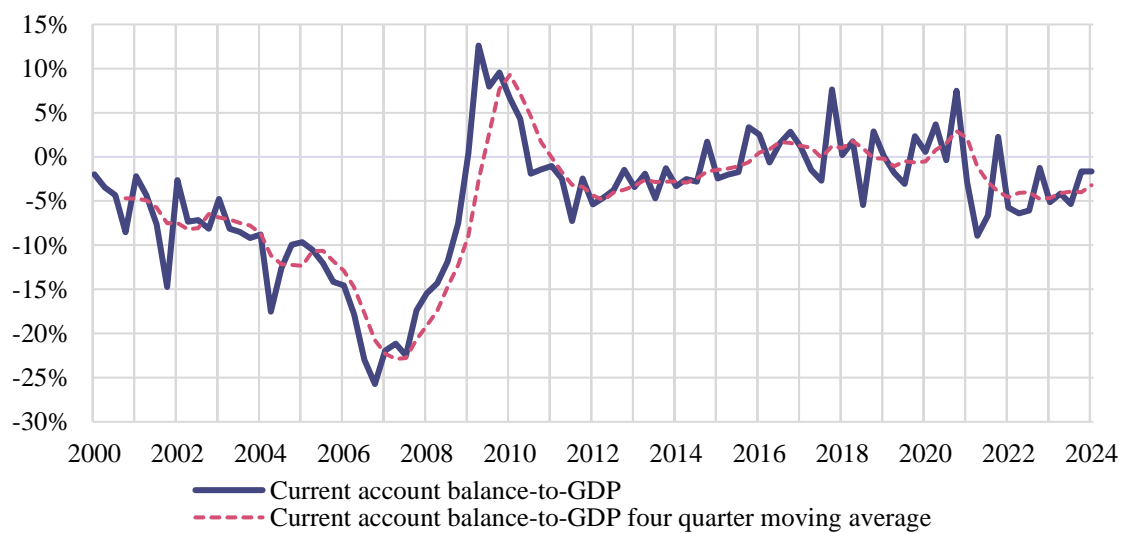
Source: CSB.

Chart 7. Resilience of credit institutions - capitalization

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

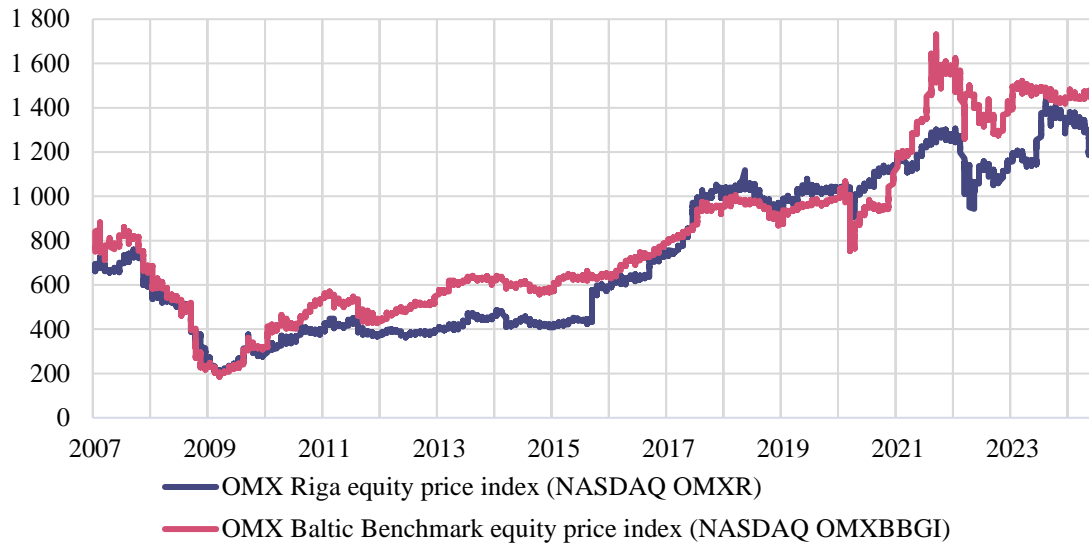
Chart 8. Resilience of credit institutions - profitability and asset quality

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

Chart 9. External imbalances

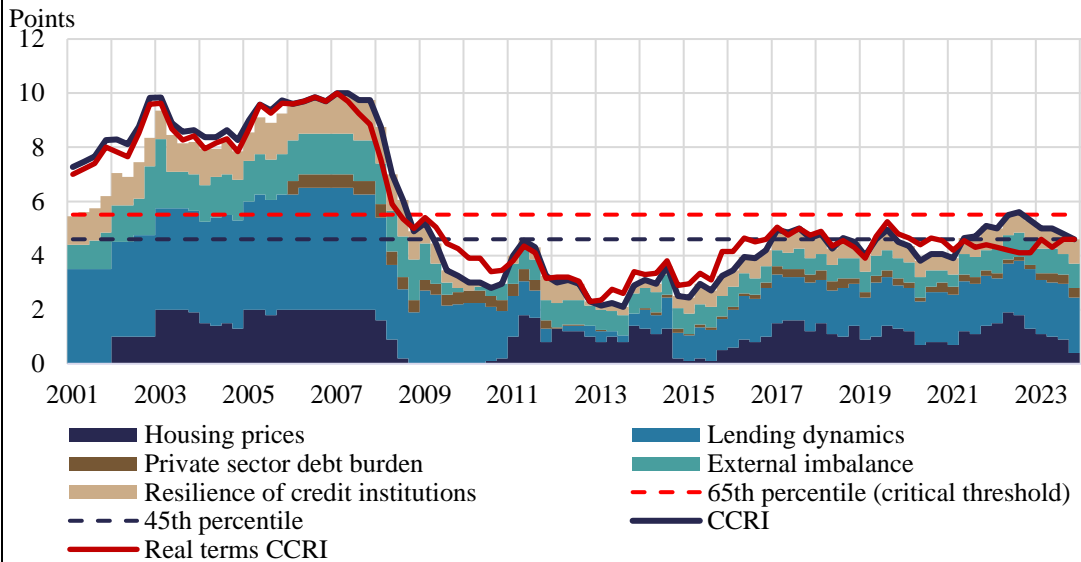
Source: Latvijas Banka, CSB.

Chart 10. Potential mispricing of risk



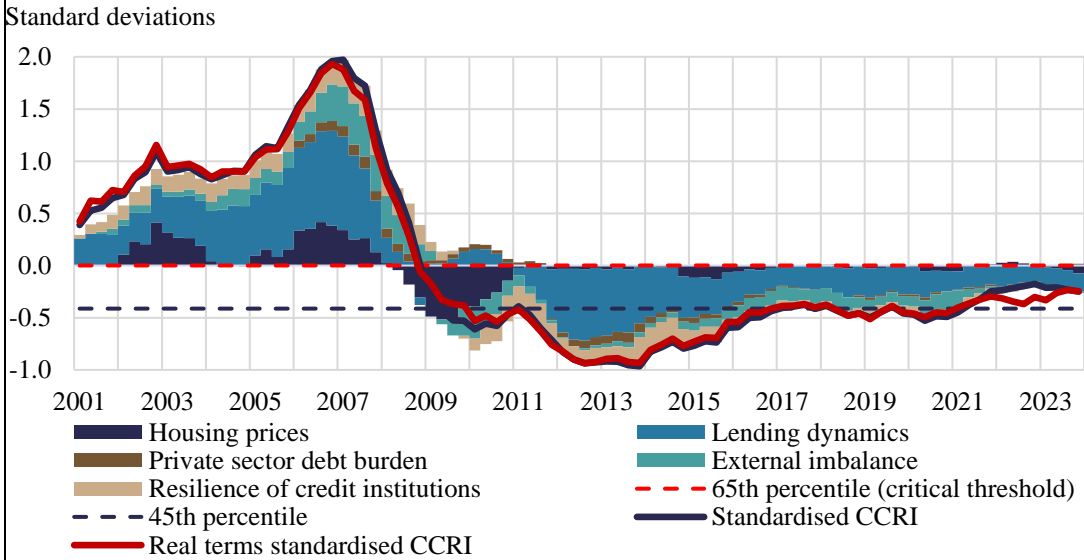
Source: Bloomberg.

Chart 11. CCRI – percentile method



Source: Latvijas Banka, CSB.

Chart 12. CCRI – standardised method



Source: Latvijas Banka, CSB.