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Financial stability: a condition of the financial system enabling it to withstand shocks, thereby mitigating the likelihood of disruptions in the provision of financial services in the financial intermediation process.

Systemic risk: the risk of disruption in the financial system with the potential to have a significant negative impact on the functioning of the financial system as a whole along with the real economy.

The objective of the Financial Stability Report is to raise public awareness regarding the development of the Latvian financial system and to draw attention to systemic risks.

The Financial Stability Report analyses and assesses the functioning and risks of the Latvian financial system based on data up to the end of March 2025 or at the time of compiling the current report.

The calculation of the ROE, the TC ratio, T1 capital ratio, CET1 ratio, liquidity, and credit risk stress test results excludes data on branches of foreign credit institutions registered in the Republic of Latvia.

The Report was prepared by the Financial Stability and Macroprudential Policy Department of Latvijas Banka. The preparation of the Report was co-ordinated by Andrejs Semjonovs, Dace Antuža, Elmārs Zakulis, and Armands Pogulis. Editors: Irēna Katrīne Lapsa and Dace Ķerus, layout designers: Andris Grīslis and Aigars Nesters.

Latvijas Banka
K. Valdemāra iela 2A, Riga, LV-1050
Tel.: +371 67022300 info@bank.lv
https://www.bank.lv

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Abbreviations

AC – securities measured at amortised cost

AI – artificial intelligence

AS – joint stock company

CCoB – capital conservation buffer

CCRI – composite cyclical risk indicator

CCyB – countercyclical capital buffer

CDS – credit default swaps

CET1 – Common Equity Tier 1

CIT – corporate income tax

CRE – commercial real estate

CSB – Central Statistical Bureau of Latvia

DSTI – debt-service-to-income

DTI – debt-to-income

EBA – European Banking Authority

EC – European Commission

ECB – European Central Bank

EEA – European Economic Area

EIOPA – European Insurance and Occupational Pensions Authority

ESRB – European Systemic Risk Board

EU – European Union

EURIBOR – Euro Interbank Offered Rate

FCMC – Financial and Capital Market Commission

FSI – financial stress index

GaR – growth-at-risk or the potential (or expected) GDP change value under turmoil

GDP – gross domestic product

HICP – Harmonised Index of Consumer Prices

IFRS – International Financial Reporting Standards

IMF – International Monetary Fund

ISIN – International Securities Identification Number

IT – information technologies

LCR – liquidity coverage ratio

LGD – loss given default

LTV – loan-to-value

MFI – monetary financial institution

NFC – non-financial corporation

NPISH – non-profit institutions serving households

NPLs – non-performing loans

NSFR – net stable financing ratio

O-SII – other systemically important institution

PD – probability of default

RE – real estate

ROA – return on assets

ROE – return on equity

SC – solidarity contribution

SCR – solvency capital ratio

SFPS – state-funded pensions system

SIA – limited liability company

SRS – State Revenue Service

SyRB – systemic risk buffer

T1 – Tier 1

TC – total capital

TREA – total risk exposure amount

UK – United Kingdom

UN – United Nations

US – United States of America

Summary

As geopolitical fragmentation continues to increase globally, uncertainty has grown in several domains that significantly impact economic growth and financial stability. The **global and domestic impact of these uncertainties – delayed recovery of economic growth coupled with the deterioration of economic sentiment, increased volatility in financial markets, as well as cyberattacks and other unexpected large-scale disruptions in financial intermediation – also poses a systemic risk to the stability of Latvia's financial sector.**

Latvian credit institutions have limited direct financial exposure to the epicentres of geopolitical tensions. Elevated uncertainty affects Latvia's economic development and financial sector to a larger extent indirectly, including via having an impact on the NFCs involved in trade with the US through supply chains. At the same time, the risks of cyberattacks and other large-scale unexpected disruptions in the financial infrastructure remain high. Geopolitical tensions further underscore the imperative, including at the European level, to increase investment in security and to implement measures that foster economic growth and resilience, while also mitigating vulnerabilities related to cyberattacks and the availability of critical resources.

A weak investment environment and insufficient lending support for investment have long constituted a significant structural deficiency hampering Latvia's development and competitiveness. Although domestic lending has risen significantly, the ratio of the bank loan portfolio to GDP in Latvia remains very low. Several structural business environment factors – highlighted in previous financial stability reports – continue to limit investment and lending. These include the shadow economy, construction development, and human capital and financial capital markets. Moreover, amid high uncertainty and growing geopolitical fragmentation, **investment in long-term projects with high growth potential, albeit with a strong reliance on public policies, is being negatively affected by a lack of confidence in the implementation of a predictable, long-term national strategic development policy**.

Housing affordability and purchase activity are gradually recovering, but the growth rates of housing prices remain moderate. The number of dwellings available for purchase is beginning to decline, while the supply of new dwellings has long been insufficient. Compounding this, during the previous period of rising interest rates new housing construction activity has declined. This may lead to further upward pressure on housing prices. **In the CRE sector, some financial performance indicators have overall improved, but for a few market participants, mainly those possessing CRE with low energy efficiency, insolvency risks have not diminished.**

Solvency and resilience of borrowers in Latvia remain solid. Overall, household income growth continues to outpace inflation, and falling interest rates are gradually easing their debt burden. For some households, the streamlined possibility to refinance their mortgage with another lender and benefit from lower mortgage markups is also strengthening their solvency. The overall solvency of NFCs has improved slightly, and their debt servicing capacity remains strong. However, **in some NFC sectors, weak external demand and cautious domestic consumption are aggravating the financial situation. Uncertainty, including in global trade terms, may further aggrevate the financial situation going forward. The quality indicators of Latvian credit institutions' credit portfolio are stable or improving insignificantly, but weak economic activity and high uncertainty continue to sustain the credit risk at an elevated level.**

Latvia's financial system remains stable, among others, the capacity of credit institutions to absorb shocks is good and continuity in the availability of non-bank financial sector services is high. The profitability of credit institutions still remains good, and this helps to maintain high capitalisation and their voluntary capital buffers are sufficient to absorb potential losses in the event of financial shocks. The resilience of credit institutions against market risk overall is also good. The short- and long-term liquidity indicators of credit institutions are at a sufficient level, and the level of funding and liquidity risk in the credit institution sector remains low.

Overall, Latvijas Banka's macroprudential policy focuses on maintaining resilience. As part of a positive neutral CCyB approach, the CCyB base rate has come into effect. It further strengthens the resilience of banks and creates a macroprudential space, which is particularly important amid heightened external uncertainty. At the same time, in view of substantial amendments to the Capital Requirements Regulation and as part of the annual assessment of the appropriate risk weights for exposures secured by mortgages on CRE registered in Latvia, Latvijas Banka decided in December 2024 to no longer apply the increased risk weight to these exposures. Borrower-based measures continue to promote compliance with responsible and sustainable lending standards.

Systemic risks and vulnerabilities affecting the stability of Latvia's financial system

Systemic risks

Global and domestic impact of persistently high uncertainty and geopolitical fragmentation:

Deteriorated economic sentiment

Delayed growth recovery

Intensified fluctuations in financial asset prices

Cyberattacks and other unexpected large-scale disruptions in financial intermediation, which may reduce the quality of bank assets and profitability

Potential systemic vulnerabilities

Unsustainable housing market developments, including weak investment in the renovation of housing stock

Risks associated with climate change and other nature-related risks, including the loss of biodiversity

Lack of confidence in the implementation of a predictable long-term national strategic development policy negatively affects investment in important long-term projects with high growth potential, but a strong reliance on public policies

The resilience of credit institutions against shocks is good, as their capital and liquidity buffers overall are sufficient.

Macroprudential policy is aimed at maintaining resilience

1% CCyB rate under a positive neutral approach further enhances resilience.
Borrower-based measures are a backstop for sustainable lending standards.

Recommendations

- → Structural problems in the fields of investment and entrepreneurship, including in construction industry, and the availability of labour need to be addressed.
- → To promote investment in strategic development areas, it is essential to implement a well-defined national development strategic policy that is communicated consistently and applied in a targeted, predictable way over the long term.
- → More effective and targeted government support for loan availability to companies in strategic development areas and SMEs should be ensured.
- → Financial literacy for businesses and the population as a whole should be promoted.
- → The standard rate of fee for registering property rights in the Land Register for natural persons needs to be reduced to 0.5%. The reduction could be implemented gradually subject to the fiscal capacity of the state budget , with rate cut applied initially only to all families with children.

1. Macrofinancial environment and borrowers' solvency

External macrofinancial environment

Prepared by Andrejs Semjonovs

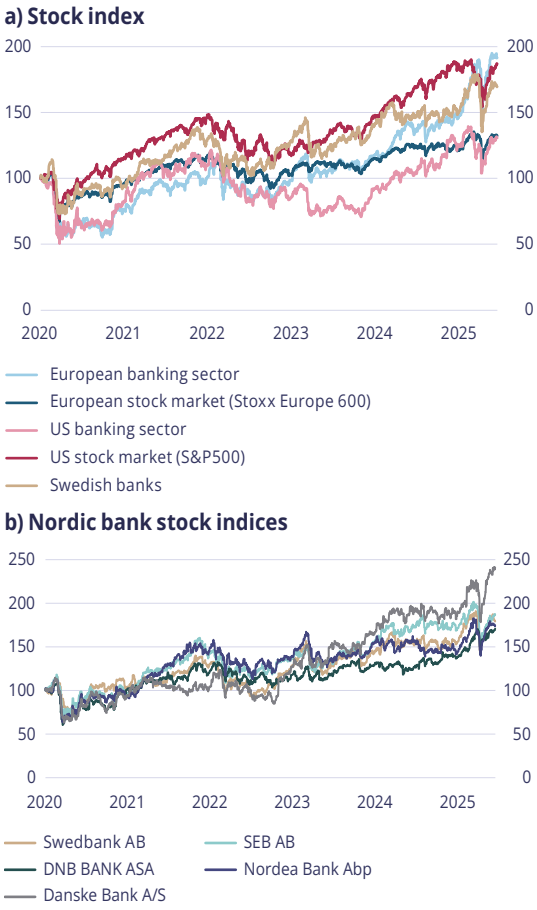
Note. This section mainly analyses the impact of global developments not only on Latvia, but also on the regions which are most important for the Latvian economy and financial sector, i.e. the European Union and Nordic countries.

At a time of elevated uncertainty, the risks to the global economic growth and financial stability have increased, driven among others by sharp fluctuations in financial markets, borrower vulnerability, cyber-attacks, and the potential amplification of other unexpected large-scale disruptions to financial intermediation. The resilience of the euro area banking sector to shocks is generally good and is supported by the high liquidity of banks and capitalisation, as well as profitability, which has still remained strong, and a limited increase in credit risk.

Uncertainty in numerous domains affecting the growth of the global economy and financial stability, including in trade policy, financial sector regulation, fiscal policy, as well as the foreign policy implemented by the new US government, **has increased**. In these circumstances, the risks of sharp fluctuations in financial markets, weaker economic development, as well as vulnerability of borrowers, especially of NFCs in the industrial sector, have increased.

The US government's communication regarding trade tariffs has led to significant fluctuations in the global financial markets (see Chart 1.1). The possibility of fluctuations in the value of securities caused by further unexpected changes of global significance remains high. A drop in bank stock prices might worsen the banks' ability to attract financing in capital markets.

Chart 1.1
Dynamics of stock indices and Nordic bank stock prices (starting point of the time series = 100)



Source: Bloomberg.

Sharp financial market fluctuations can worsen the financial performance of the non-bank financial sector of the euro area. Around half of the issuers of European shares held by the non-bank financial sector of the euro area are dependent on both exports to and imports from the US[1]. Amid growing trade fragmentation and tension, the risk of impairment of the value of those shares is high. Furthermore, the non-bank financial sector as a whole, including in Latvia, is characterised by a high share of foreign investments, which increases its exposure to global financial market fluctuations.

[1] For more information, see ECB Financial Stability Review May 2025.

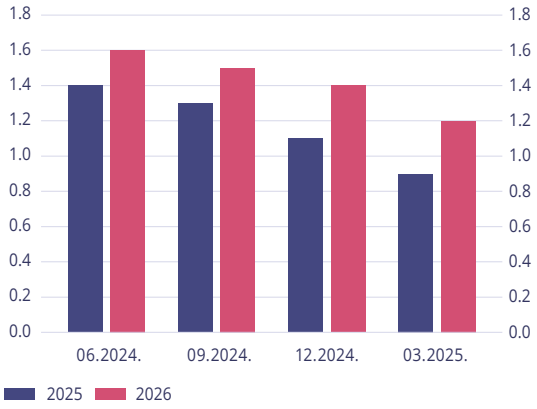
Affected by the growing tension in transatlantic trade relations and the risk of further escalation, the risks related to insufficient US dollar liquidity coverage at individual European banks have increased. According to EBA's report[2], for 60 out of 267 credit institutions with significant exposures in US dollars, their USD NSFR was less than 100% in December 2023. This increases the vulnerability of these banks to risks of USD liquidity reduction. Meanwhile, in each of the Nordic countries, the credit institutions' total USD NSFR was well above 100%, reducing their short-term financing risks.

The persistently high uncertainty hinders the revival of economic growth in the euro area. According to the IMF's April forecasts, global economic growth will slow in 2025, and the 2026 forecast figure is lower than growth in 2024. In March, the ECB's growth forecasts for the euro area for 2025 and 2026 were repeatedly adjusted downwards (Chart 1.2, panel (a)), mainly due to the slower growth of investments and exports in an environment of high uncertainty. Furthermore, economic growth in the euro area can be further weakened by potential US trade tariffs (Chart 1.2, panel (b)).

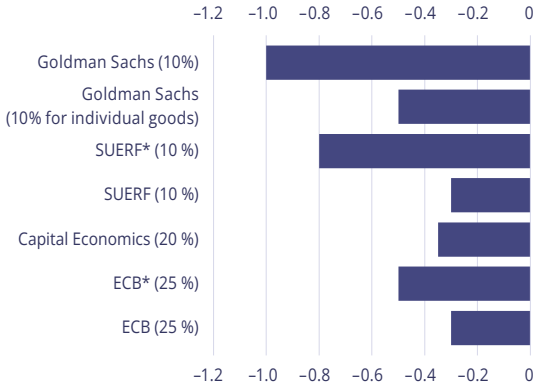
Escalation of trade conflicts may significantly deteriorate the solvency of euro area borrowers, especially in the manufacturing industry. Part of the manufacturing industry NFCs in the euro area depend on the US, not only as an export market, but also as a raw material supplier. A significant risk of insolvency can occur to euro area car producers, as they are negatively affected not only by the US import tariffs and the sharp fluctuations in their stock value in financial markets but also by the growing competition from China and the relatively high costs of energy resources. German car producers play a relatively significant role in the economy of the euro area countries and the size of the banks' exposures. The risks to the profitability of German credit institutions are, in addition, raised by the fact that the overall quality of the issued loans is slightly deteriorating in the CRE segment[3]. The deterioration of the solvency of the manufacturing industry of the euro area may have a negative influence on the NFCs in their supply chains.

Chart 1.2
The ECB's forecasts on the economic growth of the euro area and forecasts by various institutions on the potential impact of US import tariffs

a) ECB's forecasts on GDP growth in the euro area in 2025 and 2026, made from June 2024 to March 2025 (%)



b) Forecasts by various institutions on the impact of US import tariffs on the growth of the euro area in 2025; assumption on the size of the tariff is given in brackets (%)



Note. Panel (b) * in the chart reflects the impact on growth, assuming an introduction of euro area counter-tariffs. The Capital Economics forecast concerns the impact on growth in the next quarters. The forecasts on the impact of tariffs were provided at different times (Goldman Sachs – in November 2024; SUERF – in February 2025, Capital Economics – in April 2025, ECB – in March 2025).

Sources: ECB, Goldman Sachs, SUERF, Capital Economics.

Amid geopolitical tension, security is a precondition for financial stability. Thus, in Latvia, and Europe as a whole, it is important to continue increasing defence investments. More investments in defence will promote economic activity; however, the way in which these costs will be financed and how, and how swiftly, military production will be increased may affect the borrowing costs of all European countries and the potential to support the economy in times of shocks.

These same geopolitical tensions cause systemic risks associated with cyber-attacks and other unexpected large-scale disruptions in financial

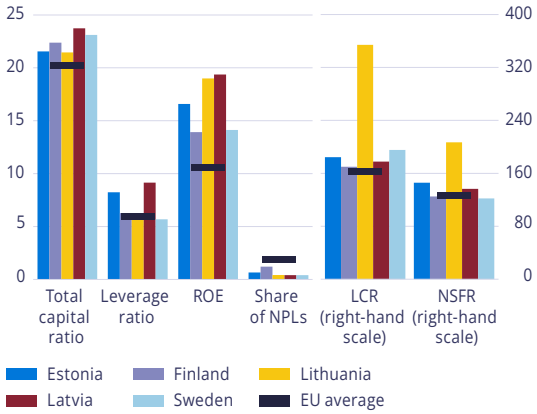
[2] See the EBA report from April 2025 "Analysis on EU/EEA banks funding structure and their dependence on asset and liability exposures in foreign currency".

[3] According to EBA data, in Germany, in the fourth quarter of 2024, the share of NPLs issued by CRE in the total portfolio of loans issued by CRE was 5.9%.

intermediation, both regionally and globally, to continue to rise. The geopolitical fragmentation on environmental issues weakens efforts to reduce climate change and adds to financial stability risks in the future.

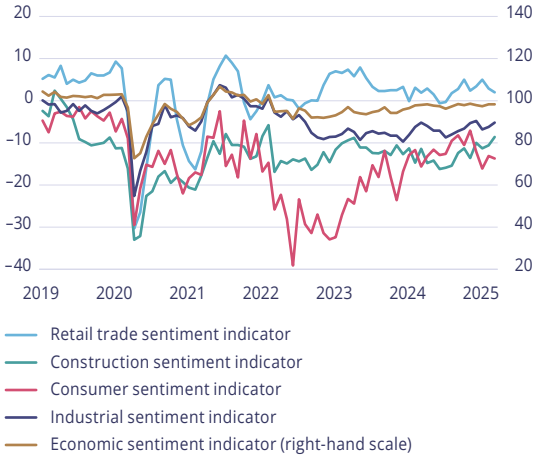
The resilience of the Latvian and other EU countries' banking sector to these shocks overall remains good. The resilience is supported by the banks' high liquidity and capitalisation (Chart 1.3), as well as the good profitability and limited rise in credit risk. In the countries where, similarly to Latvia, variable interest rates predominate loan pricing, the banks' profitability will decrease, yet it is still anticipated to be higher than before the rise in interest rates. Meanwhile, impacted by slower economic activity and deteriorating financial situation of borrowers, especially in the manufacturing industry, credit risk, which has been consistently low overall, may grow (in 2024, the share of NPLs in the banks' credit portfolios rose marginally; a slight increase in credit risks can still be observed in certain credit portfolio segments, such as CRE and consumer loans).

Chart 1.3
Main indicators of capitalisation, profitability, credit quality, and liquidity Latvian and other EU countries' banks (the fourth quarter of 2024; EBA's sample of the largest banks; %)



Source: EBA.

Chart 1.4
Economic sentiment indicator of Latvia's businesses (100 = average long-term value) **and sectoral sentiment indicators** (in points, net results of replies)



Source: EC.

Domestic macrofinancial environment

Prepared by Valdis Grudulis and Jekaterina Petkeviča

In 2024, economic growth was negatively affected by low investment activity, weak private consumption, and external demand. High uncertainty and geopolitical tensions are expected to constrain growth in 2025. The low unemployment rate is supporting wage growth which, during a period of moderate inflation, strengthens the purchasing power of households.

Weak private consumption and external demand, as well as low investment levels, contributed to the weakening of the Latvian economy in 2024 – GDP contracted by 0.4% (in comparable prices; seasonally and calendar adjusted data). Growth in government consumption was not sufficient to offset the decline in investment and exports, especially given the persistently weak private consumption. According to Latvijas Banka's June 2025 forecasts, economic growth is expected to resume this year (GDP will grow by 1.2%), driven by recovering consumer purchasing power and rising government spending. However, the recovery is hampered by the high level of uncertainty and weakening of growth in the region, which also causes downward forecast risks.

The overall sentiment in 2024 improved slightly; however, the economic sentiment indicators for both businesses and consumers in Latvia remained below the average long-term value (Chart 1.4). The improvement in consumer sentiment was facilitated by a more positive perspective regarding the current and future financial situation, as well as renewed optimism in terms of larger purchases in the future. Among businesses, the sentiment indicators were mainly on an upward trend, except for the fluctuating retail sales

sentiment indicator, which was negatively affected by the perspective of businesses when it comes to a reduction in business activity in the coming months.

Inflation in Latvia is affected by global price fluctuations and domestic wage developments but, generally, it is moderate. Since mid-2024, inflation has been increasing gradually, mainly due to higher food prices and a slower decline in energy prices. The growth of services prices is facilitated by the generally still strong wage dynamics, and the service prices continue to rise slightly faster than average inflation. According to Latvijas Banka's June 2025 forecasts, inflation will still increase in 2025 (3.4%) and remain moderate during the next two years, not exceeding 3% (Chart 1.5). However, due to tensions in international trade and geopolitics, the risks of more rapid fluctuations in the prices of global resources have increased, which may also lead to higher inflation in Latvia.

Despite slight moderation, the labour market remains resilient. According to Latvijas Banka's June 2025 forecasts, the unemployment rate will remain low in 2025–2027[4]. At the same time, wage growth is expected to moderate this year, affected by constraints on public sector wage increases[5]. Overall, the wage increase will maintain the previous improvement in household solvency, yet growing labour costs during weak economic activity poses additional challenges to the profitability of NFCs.

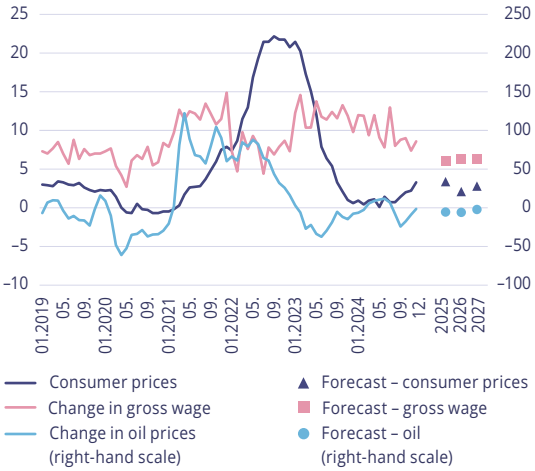
Although lending grows moderately, the investment activity and lending support to investments have remained low for a prolonged period, restraining economic development and competitiveness. The delay in implementing EU Fund projects and Rail Baltica, as well as high uncertainty, reduced the investment level in 2024. The geopolitical tension and high uncertainty will continue to limit the growth in investments; however, the investments in defence planned by the government and the approaching deadlines for the implementation of reforms and investment measures under the Latvian Recovery and Resilience Facility (end of August 2026), as well as the lower loan interest rates, may provide an additional impetus for the growth of investment activity in the following years.

[4] Latvijas Banka's June 2025 forecasts for unemployment rate at 6.9% for 2025, 6.7% for 2026, and 6.5% for 2027.

[5] According to data collected by the CSB, the average gross salary of those employed in the public sector grew by 12.2%, while in the private sector by 8.7% in 2024.

Chart 1.5

Annual changes in consumer prices, average gross wage, and Brent oil prices (%)



Note. Oil prices were expressed in EUR prior to calculating the annual change.

Sources: London Stock Exchange Group, CSB, Latvijas Banka's June 2025 and ECB's March 2025 forecasts, calculations by Latvijas Banka.

In 2024, the budget deficit of 1.8% was less than expected. This was due to both higher revenues and lower expenditures. According to Latvijas Banka's June 2025 forecasts, the budget deficit will reach 3.2% of GDP in 2025, with the public debt ratio to GDP approaching 50% by the end of 2027. This will result in an increase in debt servicing costs. Accordingly, under the circumstances of uncertainty prevailing globally, it is important to revise and restructure public spending by implementing a sustainable fiscal policy.

Development of the real estate market

Activity in the housing market is resuming gradually, with a moderate increase in housing prices observed. A resilient labour market and low debt level of households help limit the market fluctuations and financial stability risks. With improving household solvency and declining interest rates, housing affordability has increased.

Although the activity in the CRE market remains low, the investor sentiment is improving gradually. Regional markets outside Riga, which investors are starting to view as more promising development opportunities, are becoming more significant. This may indicate that the market downturn has bottomed out. Yet, market recovery is restricted

heavily by the geopolitical uncertainty. Energy efficiency will become a decisive factor, with tenants choosing premises not only in the office segment, but also in the industrial and warehouse premises sector where its significance continues to grow. Although the overall financial state of the CRE sector displays signs of improvement, for individual market participants, mainly those whose CREs are of low energy efficiency, insolvency risks do not yet decrease.

Housing market

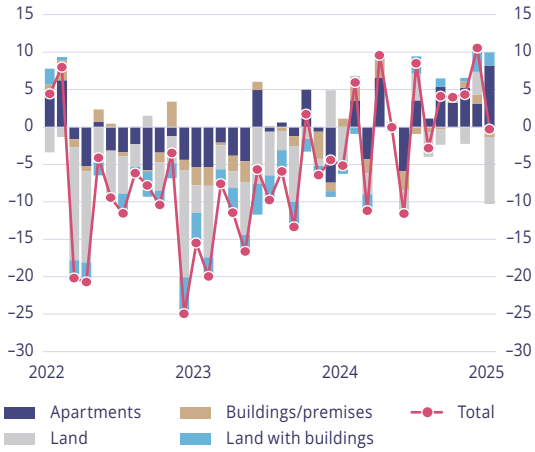
Prepared by Valdis Grudulis

In 2024, the overall transaction activity in the RE market stabilised, with the number of RE transactions increasing in the second half of the year[6]. The largest increase in activity was observed in transactions involving apartments. However, **recovery of activity cannot be observed in the entire market** – the number of land purchase transactions continued to decline[7] (Chart 1.6).

With household purchasing power gradually improving and interest rates on housing loans decreasing, the housing purchase activity in 2024 increased overall by 4.4% (Chart 1.7). Most of the transactions took place in the series-type apartment segment, especially in Riga where the transactions in this segment accounted for 50% of all transactions. In regions, the number of transactions involving series-type apartments grew at a slower pace. Although the number of transactions in the new projects segment continued to decline in 2024, data from the last few months show a slight recovery. While activity in housing lending has increased substantially, the household debt level remains low. This, together with a steady increase in wages, limits the risk of rapid changes in the housing market.

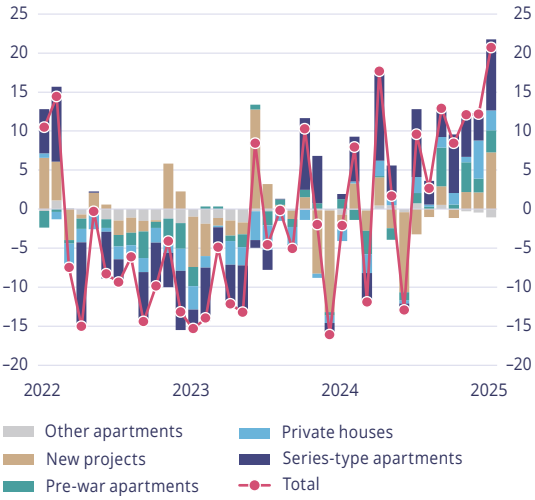
With the activity in the housing market recovering, the number of dwellings available for purchase is starting to decrease, and this might cause an upward pressure on housing prices in the future. Over the last three years, the number of dwellings offered on advertisement platforms increased sharply. The increase was observed in all segments, with the

Chart 1.6
Annual changes in the total number of RE transactions (%)



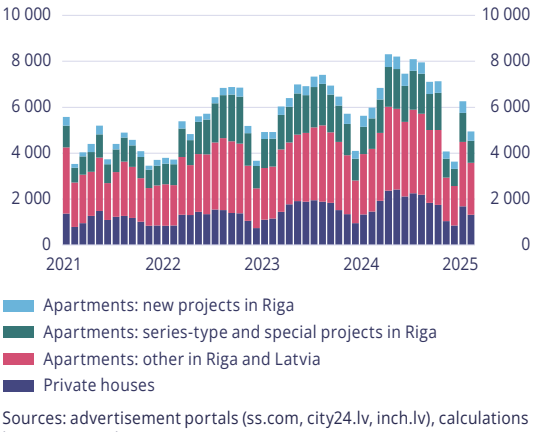
Sources: Latvia's Open Data Portal, calculations by Latvijas Banka.

Chart 1.7
Annual changes in the number of housing RE transactions (%)



Sources: Latvia's Open Data Portal, calculations by Latvijas Banka.

Chart 1.8
Number of advertisements offering apartments and private homes for sale



Sources: advertisement portals (ss.com, city24.lv, inch.lv), calculations by Latvijas Banka.

[6] According to RE purchase data statistics by Latvia's Open Data Portal, the number of RE transactions in the second half of 2024 grew by 5.9% as compared to the corresponding period for 2023.

[7] According to RE purchase data statistics by Latvia's Open Data Portal, the number of land purchase transactions in 2024 decreased by 2.7% as compared to 2023.

number of series-type apartment postings available for sale increasing most in 2022 (Chart 1.8). However, with the recovery of market activity in early 2025, the number of postings offering apartments for sale is starting to decrease in all segments.

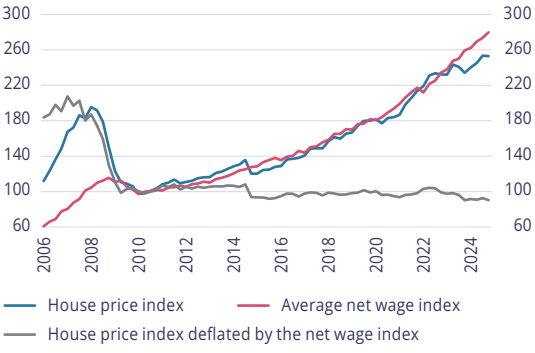
Overall, the rise in housing prices remains moderate. In 2024, CSB's house price index was 4.4% higher than in 2023. The rapid growth of housing prices has slowed down, while the price level of series-type apartments has remained consistently high.

During the period of rising interest rates, the construction activity of new dwellings decreased. Data collected by SIA Colliers International Advisors show that in 2024, the number of new apartments added to the RE market decreased by 35% as compared to the previous year, while in 2025 a moderate recovery of apartment construction activity is expected[8].

In order to ensure a sustainable and effective recovery of the housing offer, it is necessary to reduce the administrative obstacles in the construction process. This has been consistently emphasised by Latvijas Banka, and recently the government decided to bring this into practice[9]. In addition to a reduction of the administrative requirements, there is also a potential to simplify and accelerate the administration process by reducing the consumption of resources involved in the construction process, e.g. by improving the information exchange[10] with the Construction Information System. At the same time, it is important to continue the implementation of the 60-measure plan approved in 2024 in the RE development field[11] in order to remove gaps in the construction sector.

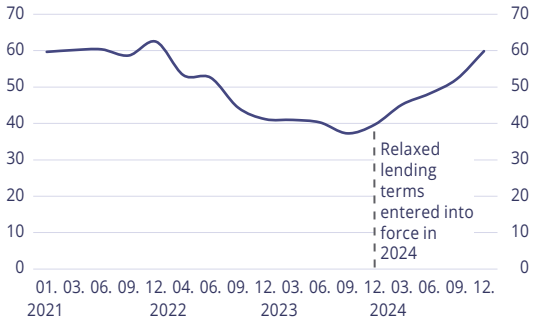
Since 2023, wage growth has outpaced the rise in housing prices. This was mainly the result of a slow-down in the rise of housing prices, leading to an improved affordability of dwellings (Chart 1.9). Besides, the income-based credit standards, relaxed in early 2024 for loans issued for the acquisition of an energy-efficient dwelling[12], have additionally facilitated the affordability of new dwellings – it has returned to the level which existed prior to the sharp interest rate rise (Chart 1.10).

Chart 1.9
Housing affordability (2010 = 100)



Sources: CSB and Latvijas Banka's estimates.

Chart 1.10
Maximum apartment size affordable in Riga for an average salary in a new project with bank co-financing (m^2)



Assumptions: even payment schedule, term of 30 years, 15% down payment, markup of 2% (in December 2024, a markup of 1.5% was applied following the rate reduction rate) + current 6-month EURIBOR.

Sources: CSB, ECB, SIA ARCO REAL ESTATE, Latvijas Banka's calculations.

The apartment rental market remains stable overall; however, the limited offer of new dwellings continues to put an upward pressure on rental prices, especially in the segments of new projects where an increase in rental prices has been more rapid[13]. At the same time, according to advertisement platform data[14], there was an observed slow reduction in the number of rental advertisements during 2024 in Riga.

[8] SIA Colliers International Advisors' Residential report, Riga area, 2024.
[9] Information report "On priority measures to cut the red-tape in 2025".
[10] By introducing a generative virtual assistant (including the option to partially fill applications), a data pre-processing tool supported by rules-based AI (which reduces errors during validation and eliminates the need for repeated approval cycles), and an AI-based tool that recognises information in various formats (images and system files) and converts it into a format compatible with the Construction Information System.
[11] Information report "On action plan to reduce the administrative burden in the real estate development field".
[12] For more information, see Bojāre, K. "Relaxed loan issuance requirements for acquisition of energy-efficient dwellings" (in Latvian), 02.07.2024.
[13] According to data on the website CenuBanka.lv, rental prices in Riga during 2024 for apartments of new projects grew by 12–13%, while for series-type apartments by 8%.
[14] Web scraping data collected by Latvijas Banka from advertisement platforms ss.com and city24.lv.

Commercial real estate market

Prepared by Jekaterina Petkeviča

In 2024, investment activity in the Latvian CRE market declined to its lowest point in the past decade. According to estimates by SIA Colliers International Advisors, the total amount of transactions was only 133 million euro[15], of which 79% was accounted for by transactions involving Baltic investors. Like in other Baltic States, the CRE market in Latvia is dominated by local investors, and a rapid return of interest from foreign investors has not been observed. At the same time, investors' sentiment is influenced by the growing geopolitical uncertainty and the increase in vacant areas in certain market segments. However, according to estimates by SIA Colliers International Advisors, **market activity will improve in 2025** – investment activity will grow gradually and could reach 300 million euro in total during the year. **The recovery will be facilitated by better financing conditions and the reduction of inflationary pressure on the financial position of tenants.**

A gradual drop in the interest rate on loans could lead to compression of the expected yields in the CRE segments, thereby increasing the CRE prices and market values. However, with the activity in transactions growing gradually, the reduction in the expected yield will most likely not be quick, and the CRE asset values are unlikely to experience a significant decline in 2025.

Even if the CRE value decreased, this would not lead to a substantial increase in insolvency risks, with the market value of the pledged CRE substantially exceeding the respective outstanding loan. **The loan-to-value (debt-to-collateral) ratio for loans issued to the RE sector stands at 47% on average. Around** two thirds of the RE loan portfolio consists of loans with a loan-to-value ratio of 60% or less. Insolvency risks in the RE sector are expected to decrease alongside the expected increase in the CRE value.

Although the reduction of interest rates is reflected in borrowers' payments with a significant time lag and a sharp improvement in the borrowers' ability to cover debt payments was not initially expected, **in 2024 the first signs of recovery in the debt serviceability were observed in the CRE segment**[16]. Since the turnover in the sector remained almost unchanged, this recovery was driven by improved profitability. Despite the risks of deterioration concerning payment discipline, no increase in either the share of forced sales or of delinquent loans is observed in the CRE market (NPLs at the end of 2024 – 1.8%). This shows that **so far, the debt payment discipline of borrowers in the RE sector has been good**.

Considering the reduction of interest rates, stabilisation of the value of CRE, and the increasing lending activity of the banks, **the possibility for companies to refinance the existing loans used for the financing of CRE grows**.

In response to cyclical and structural risks, the CRE market adapts to changes in demand. **In office, as well as industrial and warehouse premises sector, the demand for smaller, more energy-efficient, and environmental-friendly areas is increasing.** As a result, a prolonged time is necessary to attract tenants to large Class A premises in the office segment, while in the industrial and warehouse premises sector, there is a growing interest in multi-functional and warehouse buildings where a single building combines the functions of a store, office, and warehouse. Like in the office premises market, also in the industrial and warehouse segment, the rental rate difference between newly constructed energy-efficient buildings[17] and old premises is becoming more pronounced. This is mainly determined by the substantial difference in public utility payment costs.

In the Class B office premises segment, the risks of insolvency continue to increase due to a reduced demand for non-energy efficient premises, as well as structural factors. This is reflected in a growing share of non-rented premises and lower rent (Chart 1.11). At the same time, the share of bank loans in this segment is limited, thereby reducing the potential risks to financial stability.

High construction costs, including growing wages, substantially limit the development of new projects

[15] 41% less than in 2023.

[16] According to data from the CSB's NFC survey, for companies in the RE sector, the interest coverage ratio (profit before interest payments and taxes to total interest payments ratio) improved from 2.05 to 2.59 times in 2024.

[17] Including newly constructed buildings with an increased energy-efficiency class and corresponding sustainability standards, as shown by certification.

in the office premises segment. According to the SIA Colliers International Advisors assessment, the level of rent which would ensure a return of investments at the current level of construction costs is currently too high and non-competitive. As a result, launching new construction projects is currently not economically viable. Developers therefore remain cautious, opting to delay implementation, and choose to wait for more favourable market conditions. This will, most likely, result in a rent gap between newly constructed and previously constructed Class A office projects.

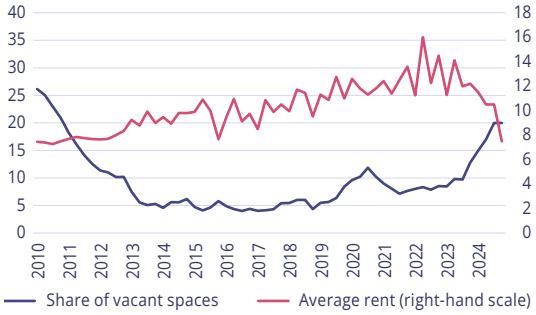
Differences in future development plans will largely determine the changes in the share of vacant premises in various market segments. In the industrial and warehouse premises sector, the leading developers have already announced several new projects which are currently in the planning stage, and which will increase the volume of available premises in the future. Meanwhile, in the office premises market, a sizeable increase in new spaces is only expected in 2027–2028; therefore, a gradual reduction in vacant spaces can be expected over the next years in the Class A office segment. Rental fees in both segments currently remain broadly unchanged.

Considering the modest consumption by households, caution in the retail segment exists regarding the implementation of new products and the increase in sales spaces. Tenants of retail premises focus on increasing efficiency – spaces are optimised and the number of points of sales is reduced. Like in the office premises sector, non-typical tenants tend to occupy spaces increasingly often, such as medical service providers and businesses from various other sectors. **At the same time, regional markets outside Riga are gaining more importance**, as retailers are actively seeking strategic locations outside the saturated big city markets. **In the Baltic States, the retail premises segment is the most sought-after by investors**[18].

The hotel segment is recovering gradually – both hotel occupancy and the number of guests served increase; however, overall activity still lags behind the pre-pandemic level.

[18] According to SIA Colliers International Advisors data, in 2024 this segment accounted for half of the total size of investments across the three Baltic states.

Chart 1.11
Share of vacant Class B office premises and average rent in Riga (non-prestigious location) (%, euro/m^2)



Sources: SIA Colliers International Advisors, SIA LATIO.

Financial vulnerability of borrowers

With household income growing faster than inflation, the financial situation of households continues to improve. A gradual reduction in interest rates is containing the effect of rising household debt burdens. Household income resilience is supported by a stable labour market and the low level of household indebtedness. Household debt payment discipline remains very good.

The overall solvency of NFCs has improved slightly, and their debt service capacity remains at a good level despite interest rates remaining rather high. However, in individual NFC sectors, weak external demand and cautious internal consumption deteriorate the financial situation.

Household solvency

Prepared by Valdis Grudulis

The overall financial situation of households continues to improve gradually, as wage growth outpaces consumer prices. Latvijas Banka's June 2025 forecasts show that households' total disposable income will continue to grow faster than inflation, also in 2026 and 2027.

In 2024, when EURIBOR rates were still at historically high levels, **the mortgage borrower support programme implemented by the state reduced households' payment burden**. The support paid to borrowers reached 79 million euro, or 12% of households' total interest payments to bank and non-bank lenders. This helped limit the increase in the risk of household insolvency. Taking into account the previous reduction in

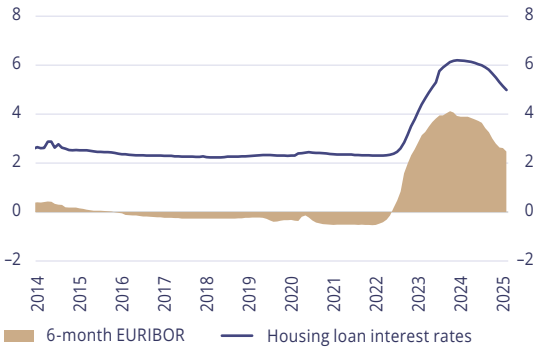
rates, suspension of the support programme in 2025 has not substantially increased the insolvency risk of households (Chart 1.12). A reduction in mortgage rate markups[19], driven by the easing of mortgage refinancing conditions, will improve the financial resilience of some households.

Insolvency risks are currently very low for certain household borrowers, as evidenced by the increase in household deposits with MFIs[20] and early repayment of housing loans (see the Section "Credit Risk").

Under the circumstances of relaxing monetary policy, the increase in households' debt burden slowed. The debt burden increase in 2024 was driven by the rise in the total size of debt[21] and gradual pricing of reference rates in total loan rates. The negative impact of the payment burden on the economy and financial stability is limited by a resilient labour market and the still low household debt level (Chart 1.13).

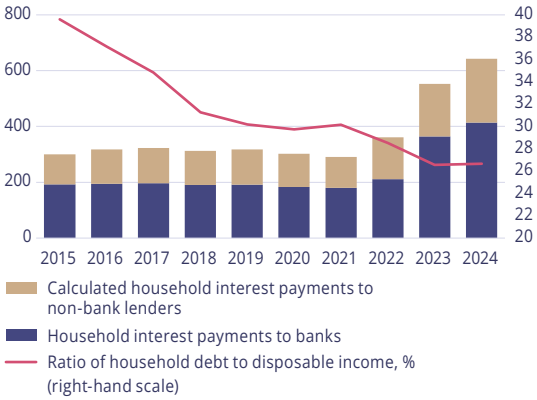
Household debt payment discipline is very good. The difference between calculated and recognised household loan interest payments has been low for an extended period of time. With the income of households continuing to increase, and a high level of savings continuing to support solvency, payment discipline will remain very good this year.

Chart 1.12
Interest rates on issued housing loans and 6-month EURIBOR (%)



Sources: ECB, Latvijas Banka's calculations.

Chart 1.13
Household debt to bank and non-bank lenders and debt burden dynamics (millions of euro)



Source: Latvijas Banka and its calculations.

NFC solvency

Prepared by Jekaterina Petkeviča

The financial indicators for NFCs have not worsened significantly, except for debt service capacity which was mainly influenced by high interest payments. The development of NFCs is constrained by both the increasing geopolitical risks and uncertainty coupled with the cautious consumption and savings by households. Labour costs, which are growing faster than profitability, pose additional obstacles to the ability of NFCs to ensure high profits and are weakening their competitiveness in foreign markets.

The fall in the total turnover of NFCs in 2024 (–1.2%) was determined by a reduced turnover in major sectors – energy (–22.6%), transportation and storage (–6.8%), processing industry (–2.7%), and trade (–0.5%) (Chart 1.14). The sharp reduction in turnover in the energy sector was mainly caused by lower energy resource prices while also facilitating profitability of other sectors. The activity in the transport sector is improving; however, railway cargo volumes continue to decline[22]. The situation in sub-sectors serving transit and transport remains challenging. The development potential of the construction sector is hampered by a delay in the implementation of EU funding-related projects, including Rail Baltica, and weak investment planning. Low external demand delays the development of the processing industry.

[19] According to information from the Credit Register of Latvijas Banka, in the first four months of 2025, the added interest rate was reduced for 6.3 thousand mortgage loans. The total value of these loans reaches almost 500 million euro or 10% of the entire mortgage portfolio in Latvia.

[20] In April 2025, deposits with MFIs were 9.7% larger than a year before.

[21] At the end of September 2024, debt to MFIs, leasing companies, other non-bank financial sector (non-leasing) participants, businesses, and other households was 4.7% higher than the previous year.

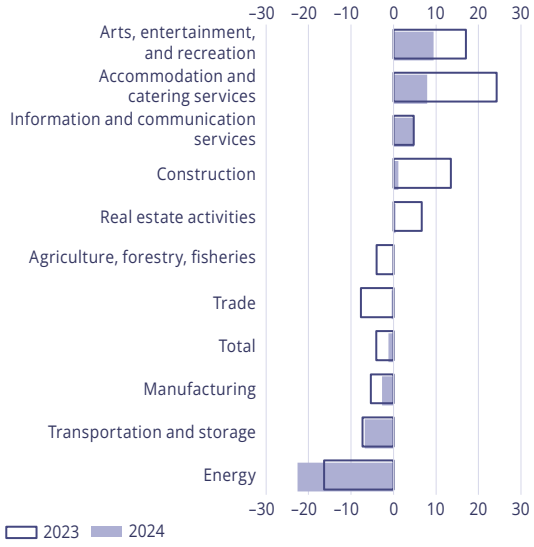
[22] For more details on the volumes of transported cargo, see "In 2024 a drop in freight transported by all modes of transport", Official Statistics Portal, press release, 07.03.2025.

Despite the growing labour costs and weakening of the economy, the overall profitability of NFCs – profit-to-turnover ratio – has improved slightly (by 0.1 percentage points; see Chart 1.15). Sectorally, the dynamics is uneven – the largest fall in profitability is observed in the agricultural sector (–2.7 percentage points) and ICT services sector (–3.15 percentage points); however, the profitability level of both sectors in 2024 was close to the pre-pandemic level[23]. Due to the fall in cargo transit, the profitability of the transportation and storage sector continues to decrease (–1.5 percentage points). **A slow recovery of economic growth in 2025 will limit further improvements in the profitability of NFCs to the pre-pandemic level. Geopolitical tensions, trade wars, and high uncertainty may further limit the recovery of profitability, especially for export companies, including in the processing industry.**

In mid-2024, the total size of NFC interest payments reached its peak before decreasing gradually with the drop in EURIBOR. However, the pricing of lower reference interest rates is slow and gradual. **In 2024, the overall debt serviceability of NFCs decreased slightly, but still remains at a good level** – the profit before interest and taxes was 6.9 times higher than interest payments (Chart 1.16). The debt serviceability of the transportation and storage sector has deteriorated significantly, reaching a very low level (1.59 times), while in the RE operations sector, this indicator has improved slightly with the profitability growing (2.59 times). It should be noted that according to the results of a detailed analysis of the financial standing of the transport sector borrowers, their solvency is better than in the sector as a whole. In other sectors, where a drop in interest cover is observed, debt serviceability remains at a sufficiently good level. **It is expected that in 2025, the debt servicing burden will continue to decrease under the influence of gradual pricing of lower reference interest rates.**

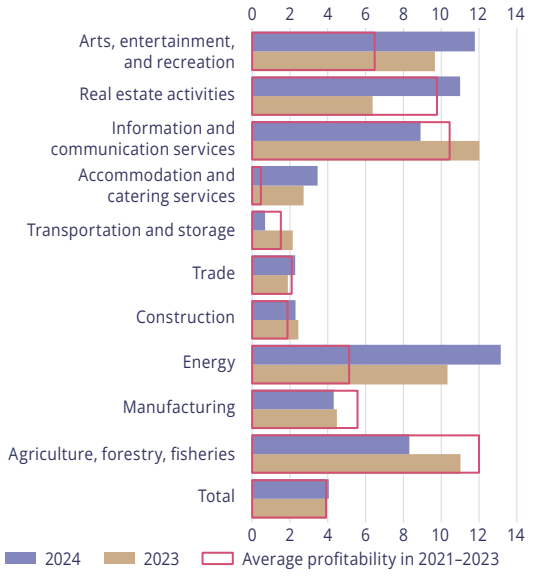
At the end of 2024, **the total capital of NFCs exceeded their liabilities**, with the debt-to-equity ratio reaching 0.99 (Chart 1.16). The reduction in the debt burden of NFCs can be partially explained by money balances and accrued capital, which previously increased during the period of high inflation. In addition, the capitalisation

Chart 1.14
Annual changes in NFC turnover (%)



Source: CSB.

Chart 1.15
NFC profitability (%)



Source: CSB.

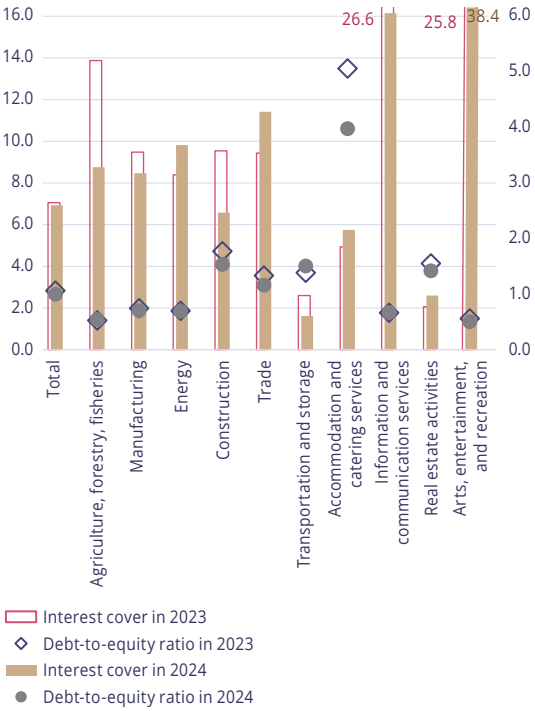
of NFCs was positively affected by the CIT reform implemented in 2018, which facilitated not only reinvestment of the profit in companies, but also the presentation of true profit. In 2024, the aggregate NFC debt amounted to 48.9% of GDP (including debt to credit institutions and leasing companies – 17.4% of GDP[24]).

[23] The drop in profitability of the agricultural sector was determined by a higher raw material (fertiliser) price and unfavourable weather conditions. Before the pandemic, the average three-year profitability was 10.3% for the agricultural, forestry, and fisheries sectors and 10.2% for the ICT services sector.

[24] In 2023 – 45.7% and 17% of GDP respectively.

Although **the number of filed insolvencies of legal entities in 2024 grew by 18%**[25]**, it is still at a historically low level and is lower than before the pandemic.** However, according to data from the Enterprise Register, only a small share of the total number of companies being liquidated are subject to insolvency proceedings (3.6% on average from 2020 to 2024). The low share of insolvency proceedings can be explained by several factors, including the high costs involved – which often exceed the potential recoverable value for small lenders – the possibility of settling with creditors or opting for self-liquidation, and the overall structure of the business environment[26]. Meanwhile, the number of newly registered companies remains low due to ongoing uncertainty and geopolitical risks, and it is still significantly below pre-pandemic levels[27].

Chart 1.16
NFC interest burden* and debt-to-equity ratio (right-hand scale) (times)



* The ratio of pre-tax profit to interest payments in the respective sector and period.

Source: CSB.

[25] The increase can be explained by the base effect, as the number of filed insolvencies of legal entities in the previous year was one of the lowest in the last 13 years.

[26] For example, in cases where a company fails to provide annual statements, pay taxes, or does not carry out economic activity for a prolonged period of time, the SRS is entitled to initiate its liquidation.

[27] In 2024, the number of newly registered NFCs was 6% more than in 2023. However, this figure is 32% less as compared to the average number of newly registered companies over the period from 2010 to 2019.

2. Development and risks of the credit institution sector

Lending development

With interest rates decreasing gradually, the activity in domestic landing has increased substantially. However, after protractedly weak lending, the bank loan-to-GDP ratio remains at a very low level. High uncertainty, slow domestic economic growth, and several structural indicators continue to limit a more active growth of the loan portfolio. Domestic non-bank lending – by both leasing companies and other non-bank lenders – grew slower overall. A sharp decrease was observed in the growth of the loan balance of other non-bank lenders, but it is still at a high level.

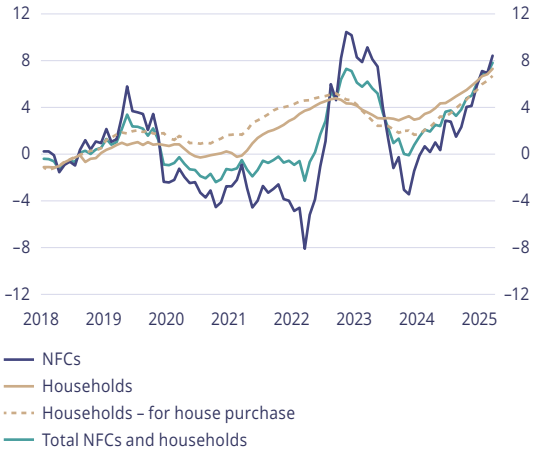
Lending by credit institutions

Prepared by Andrejs Kurbatskis

The pace of lending has improved in both the household and the NFC sectors. In March 2025, the aggregate pace of annual growth of loans issued to domestic NFCs and households reached 7.8%[28] (in March 2024 – 1.9%), including to NFCs – 8.4%, and to households – 7.3% (in March 2024 – 0.2% and 3.6% respectively; see Chart 2.1). According to the euro area bank lending survey, the credit standards for NFCs remain stable, and the demand for these loans does not substantially change, while for loans to households for house purchase, the standards are being relaxed slightly and demand is growing.

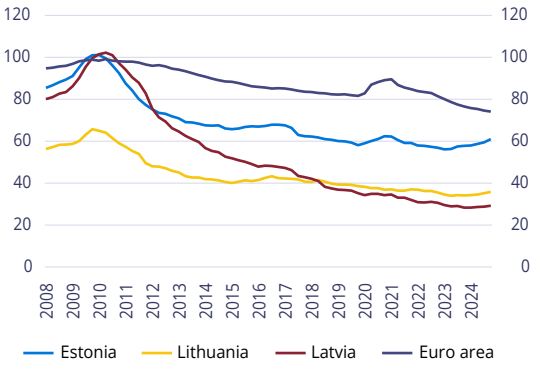
However, the loan-to-GDP ratio has not changed significantly and remains at a very low level. At the end of 2024, the ratio of loans to NFCs and households to GDP stood at only 29%. On average, this indicator is substantially higher in euro area countries, as well as in neighbouring Estonia. The gap with Lithuania is less pronounced but continues to widen (Chart 2.2). **Insufficient lending support for investments, as well as a weak investment environment, is a persistently relevant and systemic problem.** Its relevance is increased by the acute necessity to carry out substantial investments, also in order to restore the housing stock, facilitate the resilience to climate change and other risks in general, and strengthen national security.

Chart 2.1
Annual rate of change in loans to domestic NFCs and households (%)



Source: Latvijas Banka and its calculations.

Chart 2.2
Ratio of domestic loans to NFCs and households to GDP (%)



Sources: ECB, Eurostat, Latvijas Banka.

The lending to NFCs is currently facilitated by middle-sized and small banks, the majority of which are banks with local capital ownership. Although the loans issued by those banks still make up a rather small portion of the banking sector's aggregate domestic NFC loan portfolio (in March 2025 – 20%), their contribution to the growth of lending is currently larger than that of the five largest banks which all have foreign capital ownership (Chart 2.3). The NFC debt is low,

[28] To simplify the comparison, the one-off effects associated with the structural changes in the banking sector and sectoral reclassification have been excluded from the sections on lending development and credit risk (including Charts 2.1, 2.3–2.5, and 2.10–2.15).

there is insufficient pressure from the competition in their lending, and the lending policy of the largest banks remains conservative, therefore, an increase in activity of smaller banks is to be viewed positively. For smaller banks, interest rates are still higher than for larger banks, yet the differences are no longer as large as before[29]. This allows banks to issue loans to borrowers in a wider risk profile.

The improvement of lending activity is mainly facilitated by long-term loans to NFCs (Chart 2.4) **issued mainly for the financing of investment projects.** The growth of this loan portfolio might be more resilient than the previous time there was an increase in activity of lending to NFCs, in late 2022–early 2023, because then a significant share was made up by short-term loans that were repaid during the next 12 months. In terms of sectors, the most notable growth in long-term loans is in the energy sector[30]; also, in the manufacturing and several of its sub-sectors, significant growth can be observed. For the RE operations sector (the largest sector in the banks' NFC loan portfolio), there is still positive annual growth, yet its contribution is becoming less. This is due to stagnation in the CRE market (see details in the Sub-section "Commercial property market").

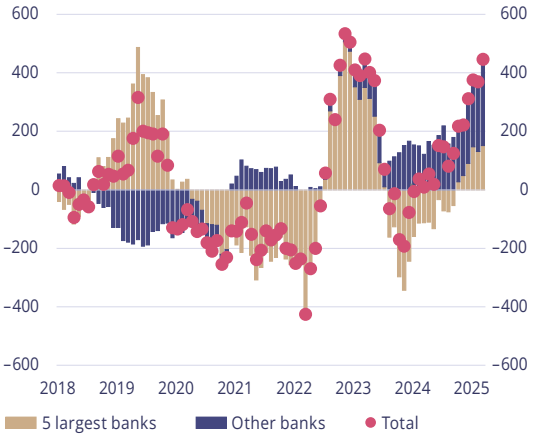
For leasing and factoring, there has been a moderately positive contribution for several years. However, currently, a slow-down in the growth of lending is observed in this segment (see Chart 2.4 and Sub-section "Lending by the non-bank financial sector" for more details).

With interest rates falling, also the pace of growth in lending to households is improving. Its increase is ensured by stronger housing loan dynamics. The annual growth rate for the outstanding amount of these loans is still moderate (in March 2025 – 6.7%), but is at its highest since the 2008 crisis. **The increase in activity of lending might have been facilitated by the pent-up demand for loans**, as previously with a sharp rise in EURIBOR rates, a part of households most likely chose to wait and postpone the intended household purchase, and the growth rate of housing loans was substantially slower (Chart 2.5).

[29] For more information, see Kurbatskis, A., Siņenko, N., "Anatomy of banks' interest rates – how much does it cost for companies to borrow, and what has changed in the last years" (in Latvian), makroekonomika.lv, 13.01.2025.

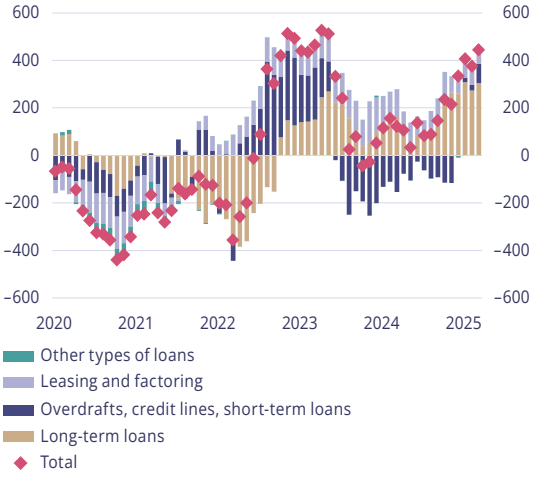
[30] This was largely determined by one sizeable loan contract that was concluded in the fourth quarter of 2022, but the financing thereunder was only issued after roughly two years when the EURIBOR base rate and hence also the loan interest rate dropped significantly.

Chart 2.3
Annual changes in the domestic NFC loan portfolio in the five largest banks (by domestic NFC loan portfolio) and in other banks (millions of euro)



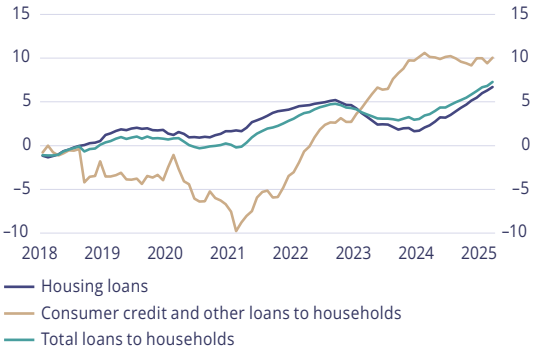
Source: Latvijas Banka and its calculations.

Chart 2.4
Annual change in the domestic NFC loan portfolio of banks and related leasing companies (millions of euro)



Source: Latvijas Banka and its calculations.

Chart 2.5
Annual rate of change in loans to domestic households (%)



Source: Latvijas Banka and its calculations.

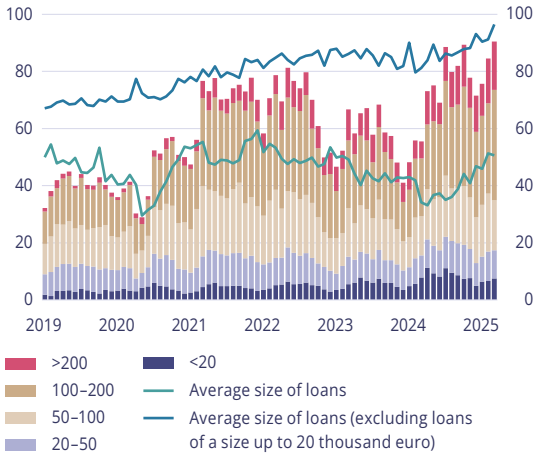
Among the loans issued for purchase of new housing, large loans of a size above 100 000 euro grew the most (previously during the period of high interest rates, loans of this size decreased substantially). The average size of housing loans in Latvia is still small (around 50 000 euro) and is significantly smaller than in other Baltic States. When excluding loans of up to 20 000 euro, which make up a negligible share of the volume of new loans and mainly consist of loans for housing repairs, the average loan size is higher (around 95 000 euro; see Chart 2.6). This indicator tends to increase gradually, alongside the generally moderate rise in housing prices.

The State guarantee programme for housing purchase continues to provide a significant boost to housing lending. After a decline in previous years, its role in the growth of new loans increased again in the second half of 2024 and the beginning of this year, with the share of loans issued under the programme exceeding 40% (Chart 4.4). Loans with a state guarantee already accounted for 37% of outstanding housing loans at the end of March 2025. During time periods when the role of the state support programme in the increase in the volume of new loans is larger, the share of loans with a high LTV is higher, as state guarantees partially replace the down payment. It should be noted that the programme's growing significance is only partly due to the 2024 amendments, which increased support for areas outside Riga and Pieriga.

Improvements to the programme remain pertinent to ensure that government support is more targeted. This primarily includes measures to prevent inefficient use of the programme funds as some borrowers apply for the programme solely to benefit from a reduced stamp duty for property registration in the Land Register. To counter this incentive, Latvijas Banka proposes to establish a lower (0.5%) stamp duty for the registration of property in the Land Register, at least for families with children (currently, such a reduced fee is available only for large families with at least 3 children).

The outstanding amount of consumer loans and other loans issued to households, other than loans for housing purchase, continues to grow significantly, with its growth rate stabilising at around 10% (Chart 2.5). The share of these loans in the overall household loan portfolio is rather small and is no longer growing substantially (in March 2025 – 18%).

Chart 2.6
New loans for housing purchase by size (millions of euro) **and the average size of loans** (thousands of euro)



Source: Latvijas Banka and its calculations.

The increase in the outstanding amount of consumer loans and other loans could be largely explained by the more active issuance of these loans for housing repairs and energy-efficiency solutions – the outstanding amount of rather large new loans, the size of which exceed 10 000 euro, has increased more significantly. In contrast to secured housing loans, the terms for their receipt are much simpler, and this facilitates their usability.

In 2025, the domestic loan portfolio is likely to grow. In the NFC sector, this could be facilitated by some large loan contracts which were concluded in late 2024 and early 2025, but the financing had not been issued at all or only partially by March. Lending to households will likely continue to grow moderately, taking into account the fall in interest rates (including also with interest rates spreads set by the banks decreasing gradually[31]) and the strong financial position of households. Credit institutions could be more motivated to increase lending more actively, also by the adoption of the Solidarity Contribution Law in 2024, which provides for the possibility for credit institutions to receive a discount if the outstanding amount of their issued loans grows more than the thresholds set in the Law (for more information, see Box 2.3). However, lending

[31] This process has been gradually taking place for several years, yet interest rates are still among the highest in the euro area. The pressure from competition in the housing lending segment could be facilitated by the simplification of mortgage loan refinancing. Corresponding amendments to laws were adopted in 2024. They are expected to primarily reduce the added interest rates to existing housing loans issued in the previous years. However, with competition tightening, they could also slightly push down interest rates of new mortgage loans.

will be limited by uncertainty and cautiousness due to external trade and geopolitical risks, as well as the current structural factors.

Lending by the non-bank financial sector

Prepared by Kārlis Ločmelis

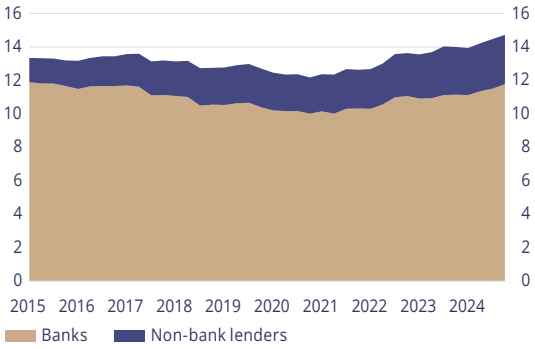
Non-bank lending grows slower than the loan portfolio of banks. In 2024, the non-bank lenders' loan portfolio to domestic NFCs and households increased by 3.8%. The growth was mainly facilitated by household activity with households acquiring passenger cars through leasing, and by an increase in the use of consumer loans. Meanwhile, in the NFC sector, there was less interest in entering into new commitments – this was due to the rise in prices of commercial and agricultural machinery, which reduced both the willingness and ability to borrow, and to the growing uncertainty.

The share of loans issued by non-bank lenders in the total domestic NFC and household loan portfolio of non-bank lenders is low, but it has grown since 2015 (Chart 2.7). The total loan portfolio of bank and non-bank lenders to domestic NFCs and households grew by 5.7% in 2024.

The stock of loans issued by bank-related leasing companies to domestic NFCs grew by 3.7% in 2024 (in 2023 – 12%). This slow-down in the rate of growth versus the previous year could be explained by the reduction of pent-up demand and more cautiousness in the circumstances of high uncertainty. The decrease in demand was most pronounced in the agricultural, forestry, and fisheries sectors where the prices of tractors and combine harvesters have grown substantially, while the grain prices have not. Hence, both the willingness and ability to enter into new commitments in the agricultural sector have decreased, despite the substantial drop in EURIBOR rates in 2024 which facilitates the availability of loans.

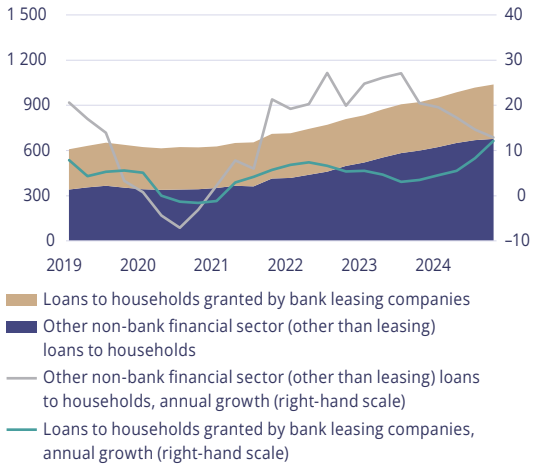
In 2024, new loans granted to domestic households by bank leasing companies was 12.1% higher than the previous year. The strong demand was mainly driven by the reduction in EURIBOR rates, as well as government support for the acquisition of electric vehicles and new externally rechargeable hybrid cars. Depending on the type of vehicle and the individual's family status, government support ranges from 3350 to 9000 euro[32]. A further increase in households' leasing loans is expected, as at the beginning of the year the Cabinet of Ministers granted an additional 11 million euro for this state support programme.

Chart 2.7
Stock of loans issued by bank and non-bank lenders to domestic NFCs and households (billions of euro)



Source: Latvijas Banka.

Chart 2.8
Balance of bank leasing companies and other non-bank financial sector (non-leasing) loans (millions of euro) **and annual growth rate** (%) **to households**



Source: Latvijas Banka.

Other loans by the non-bank financial sector, excl. leasing companies, to households continue to grow rapidly. However, in 2024, the growth rate dropped to 12.9% (in 2023 – 20.5%), with the loan balance reaching 677 million euro at the end of 2024 (Chart 2.8). The constantly rapid growth of consumer loans indicates the need to improve the financial literacy of households.

[32] For more detailed requirements and the size of the support, see Cabinet Regulation No 896 of 21 December 2021 "Regulation of the open tender "Reducing Greenhouse Gas Emissions in the Transport Sector – Support for Acquisition of Zero- and Low-emission Vehicles" of projects financed by the Emission Allowance Auction Instrument".

Credit risk

Prepared by Andrejs Kurbatskis

Weak economic activity, high uncertainty, and the unfavourable geopolitical environment keep credit risk high. At the same time, loan portfolio quality indicators remain stable or improve slightly. The still strong profitability of credit institutions and high capitalisation increase banks' resilience to a possible deterioration of the loan portfolio quality.

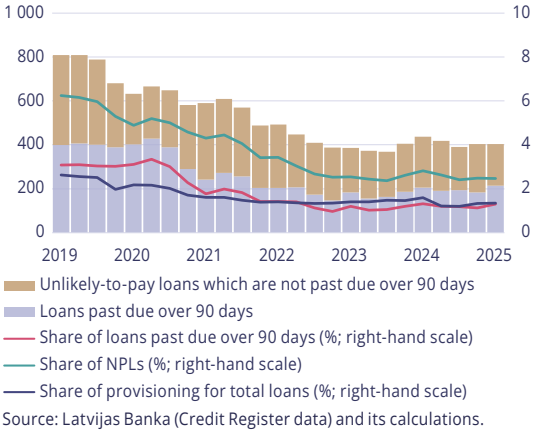
The NPLs – both the long past due and the unlikely-to-pay – and their share have not changed substantially (Chart 2.9). In March 2025, the share of NPLs in the aggregate loan portfolio was 2.5%[33] (it fell slightly as compared to March 2024 when a temporary increase in NPLs was observed in the corporate sector – for more information, see Financial Stability Report 2024). Also, the size of provisions set aside and their share in the aggregate loan portfolio remained stable.

For most sectors, the outstanding amount of NPLs and their share remains almost unchanged or decreases slightly. Agriculture is the only sector where the loan quality is deteriorating slightly (Chart 2.10). This could be explained by a substantial and rather prolonged fall in profitability in this sector (for more details, see the Sub-section "NFC solvency"). The decrease of NPLs in the household sector was determined by the gradual improvement of the quality of housing loans. The outstanding amount and share of NPLs in the loan portfolio of consumer and other households have improved since March 2024, but this improvement was mainly due to the assignment of these loans by one bank and their removal from the balance sheet. There is a still very high outstanding amount and share of NPLs in the foreign loan portfolio, and this is primarily due to the loans that have been in this status for a prolonged period (more than five years).

The share of forborne loans, which grew substantially in late 2023 and early 2024 in the NFC sector, is decreasing gradually, while the share of these loans in the NFC loan portfolio is still significant. This warrants close monitoring of the quality of these loans. The share of forborne loans, other than NPLs, in the aggregate loan portfolio was 2.4% in March 2025, including in the domestic NFC loan portfolio – 6.1%

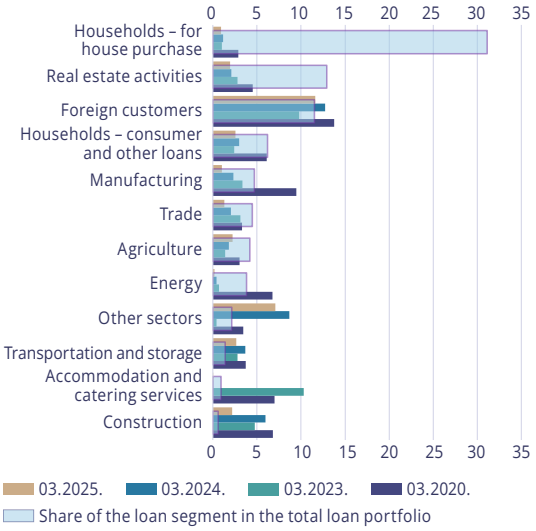
[33] This section analyses more operational loan quality data, which are non-consolidated data.

Chart 2.9
NPLs (millions of euro) **and the share of NPLs and provisions in the aggregate loan portfolio of credit institutions** (%)



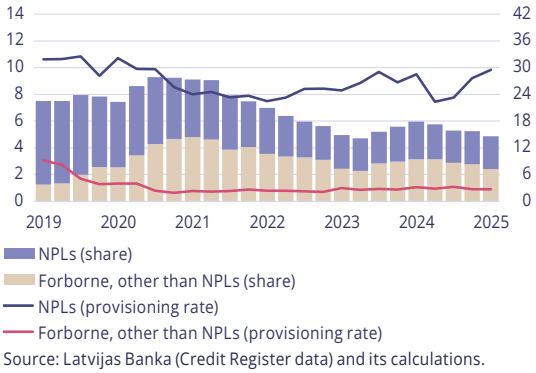
Source: Latvijas Banka (Credit Register data) and its calculations.

Chart 2.10
Structure of the loan portfolio and the share of NPLs in the respective loan portfolio (%)



Source: Latvijas Banka (Credit Register data) and its calculations.

Chart 2.11
NPLs and forborne loans, other than NPLs (% of the aggregate loan portfolio), **and the coverage ratio for these loans** (%)



Source: Latvijas Banka (Credit Register data) and its calculations.

(for comparison: in March 2024 – 3.2% and 7.9% respectively; see Charts 2.11 and 2.12). Forborne loans are characterised by increased risk, as their borrowers have been granted concessions due to financial difficulties. However, in recent years, these risks have not materialised in the Latvian banking sector as a whole, since loan forbearance measures have usually helped prevent more serious solvency problems for borrowers.

Provisions for NPLs and their ratio to the outstanding amount of these loans have been rather stable for an extended period (Chart 2.11). In addition to provisions, individual banks have historically made major capital adjustments[34] (a total of 19% of the outstanding NPLs as of December 2024). The significant shocks that were successfully overcome indicate that this practice of making provisions is adequate overall.

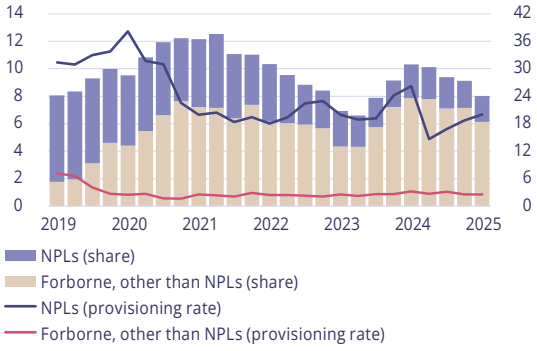
The outstanding amount of Stage 2 loans[35] and their share in the aggregate loan portfolio has remained broadly unchanged.

The rather small share of housing loans with extended maturity and unchanged outstanding amount indicates a good resilience of households to previous shocks. Extension of the loan maturity and deferral of payments are solutions that could be early warning indicators of deterioration of the loan portfolio quality. Currently, these indicators are at a historically low level (Charts 2.13 and 2.14) and additionally signal that the households' financial position is strong overall.

In contrast, partial early repayment of housing loan commitments is observed much more often. This process became more active with money market indices growing. However, also during the period of a further drop in EURIBOR, the volume of early repayments became even more pronounced (Chart 2.13).

The expected weak growth of the economy, geopolitical fragmentation and uncertainty, including the impact of tariff wars, could lead to a deterioration

Chart 2.12
NPLs and forborne loans, other than NPLs, in the domestic NFC loan portfolio (% of the respective loan portfolio) **and the coverage ratio for these loans** (%)



Source: Latvijas Banka (Credit Register data) and its calculations.

Chart 2.13
Outstanding loans for house purchase the maturity of which has been changed during the respective quarter (millions of euro and % of the loan portfolio – right-hand scale)

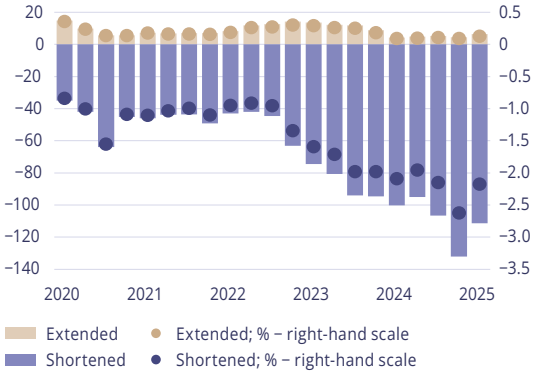
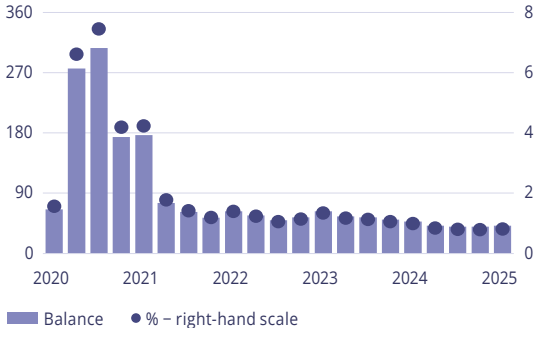


Chart 2.14
Outstanding loans for house purchase the balance of which did not change during the respective quarter (millions of euro and % of the loan portfolio – right-hand scale)



Source: Latvijas Banka (Credit Register data) and its calculations.

of the loan portfolio quality. These direct and indirect risks more greatly affect the loans issued to the NFC sector, especially export companies (see Appendix 1 "Risks to Latvia's financial stability arising from high geopolitical tensions, fragmentation, and

[34] CET1 capital reduction pursuant to Article 3 of Regulation (EU) 2024/1623 of the European Parliament and of the Council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor. Some credit institutions in Latvia make capital adjustments to compensate for an inadequate amount of provisions for credit risk.

[35] Stage 2 loans are loans whose credit risk has increased significantly since the initial recognition, but they are not yet credit-impaired within the meaning of IFRS 9.

uncertainty"). The financial situation of households is better and has improved substantially in the previous years. Although the issuance of housing loans has become more active, credit standards have not been relaxed substantially, and for most borrowers, the loan burden is not disproportionally high. **The generally strong profitability and capitalisation are indicative of the robust ability of banks to absorb a potential increase in NPLs** (see the Chapter "Stress tests of credit institutions").

Funding and liquidity risks

Prepared by Mārcis Risbergs

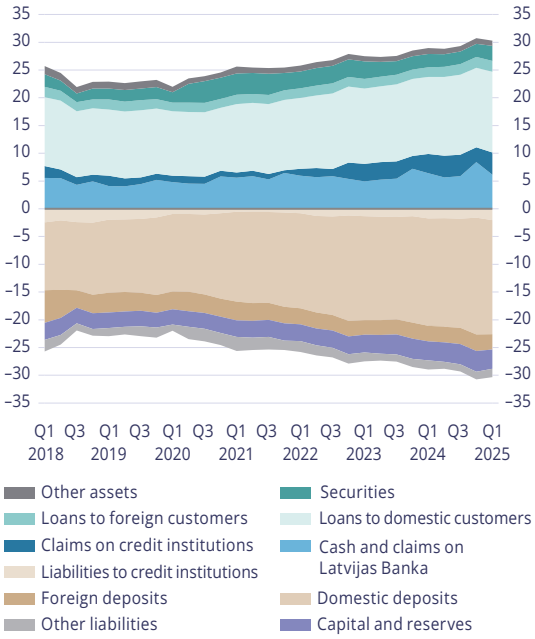
The level of funding and liquidity risk in the credit institution sector has not changed over the year and remains low. The main factors determining this are the steadily growing deposit base of the domestic private sector which reduced the need for banks to borrow in financial markets, the still significant deposits by credit institutions in Latvijas Banka's deposit facility operations, and the very small amount of pledged assets.

In March 2025, the balance-sheet of the credit institution sector continued to grow with an annual growth rate of more than 4%, which was determined by the four largest banks[36] whose assets account for 83% of the total assets of credit institutions. The growth was maintained by a stable growth in deposits in the domestic private non-financial sector and the growing role of parent banks, both in assets and liabilities (Chart 2.15). There is still a significant amount of investments in claims against Latvijas Banka, as well as a gradual growth in lending. In March 2025, a slight decrease in assets was due to the banks' dividend payment from the 2024 profit.

The deposits of the domestic private non-financial sector is the most important item in the credit institutions' balance-sheet, and in March 2025 accounted for 74% of all financial liabilities (non-bank deposits account for 80% of the total financial liabilities), and their annual growth rate increased, reaching 6.9%. This growth was mainly maintained by the steady rise in the deposit balance of households by 9.2% (Chart 2.16). Meanwhile, the deposit balance of domestic NFCs grew more slowly, by 3.6%.

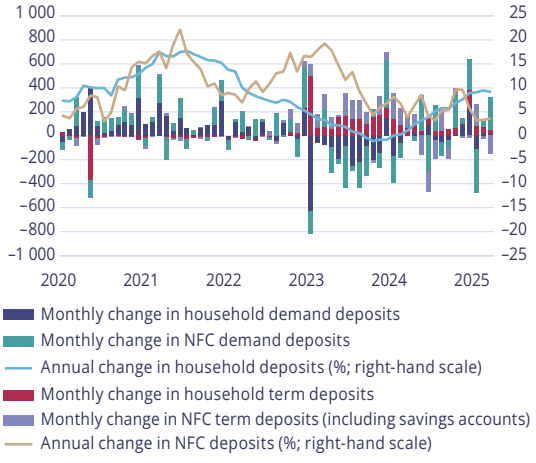
[36] The largest banks are Swedbank AS, AS SEB banka, AS Citadele banka, and the Latvian branch of Luminor Bank AS.

Chart 2.15
Structure of credit institution assets and liabilities (billions of euro)



Source: Latvijas Banka.

Chart 2.16
Term structure dynamics of deposits by domestic households[37] and NFCs (millions of euro, %)



Source: Latvijas Banka.

Although in the second half of 2024 the ECB's deposit facility rate started to fall, no sudden changes in the term structure in the domestic private non-financial sector deposits were observed. This can be explained, first, by a slower decrease of term deposit interest rates as compared to the ECB's deposit interest rate (see Box "Interest rates and margins of deposits of the domestic private non-financial sector").

[37] Household deposits were adjusted by transferring the savings account balances to be withdrawn the same day from demand deposits to term deposits.

Second, deposits by households in savings accounts are becoming more popular – the annual growth rate of their size reached 40%, and in the households' deposit structure they already accounted for 19% by replacing term deposits (Chart 2.17). In terms of liquidity, for many banks[38], savings accounts do not differ from demand deposit accounts in general, while a substantially higher compensation is paid for deposits in savings accounts.

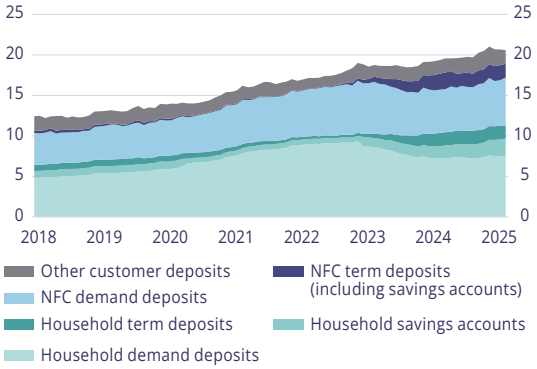
During 2024, direct[39] investments in other financial assets that households made through financial institutions of countries of the euro area[40] grew. However, they still account for a small part of the total financial assets of households (see Box "Features of domestic household investments"). In March 2025, under the influence of the high uncertainty prevailing in financial markets, household investments in financial instruments decreased (Chart 2.18).

Deposits from foreign customers fell slightly (Chart 2.19), and in March 2025 accounted for only 12% of the total non-bank deposits (including with the share of non-EU deposits remaining unchanged at 4%). Deposits by foreign customers fell by 1.6% during the year. It was since the financing of local capital banks from internet deposit platforms decreased, which was replaced by deposits from domestic customers, mainly from deposits raised by NFCs.

For credit institutions, there is currently no need to attract market financing to finance credit portfolios, as the domestic loan-to-deposit ratio remains low (71% in March 2025), and each of the four largest credit institutions with domestic deposits are able to fully finance domestic loans. If deposits attracted from euro area countries (mainly those raised from deposit platforms) are additionally taken into account, almost all credit institutions can finance domestic loans without attracting additional market funding, except for small branches of foreign credit institutions, which usually use parent bank financing in Latvia. At the same time, there are credit institutions in the Baltic States which regularly attract funds from financial markets, and their branches also operate in Latvia.

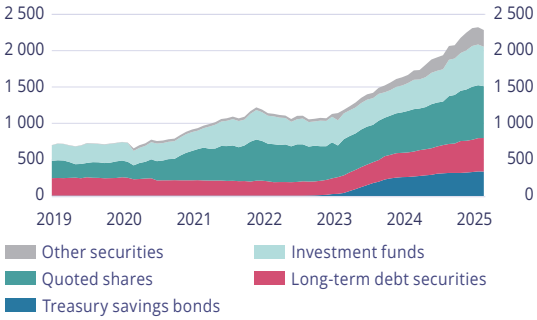
Both short-term and long-term liquidity in the banking sector remained at a sufficient level by exceeding the EU average (Chart 2.20). This was mainly ensured by Latvijas Banka's deposit facility operations which still generated adequate returns and provided larger profit from these demand deposits with Latvijas Banka than the banks' average fee for their customers' demand deposits. In March 2025, claims against Latvijas Banka

Chart 2.17
Dynamics of deposits by domestic non-bank customers (billions of euro)



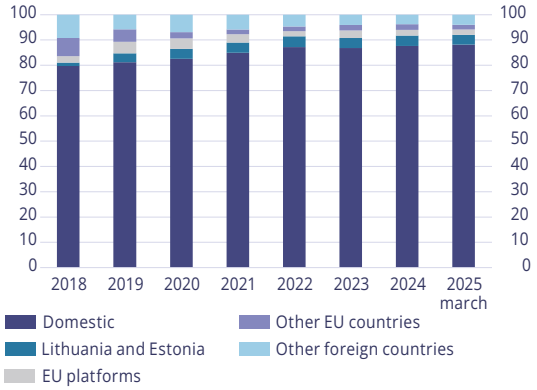
Source: Latvijas Banka.

Chart 2.18
Securities held by Latvian households and acquired through financial institutions of the euro area (millions of euro)



Source: Latvijas Banka.

Chart 2.19
Structure of deposits with credit institutions by country (%)



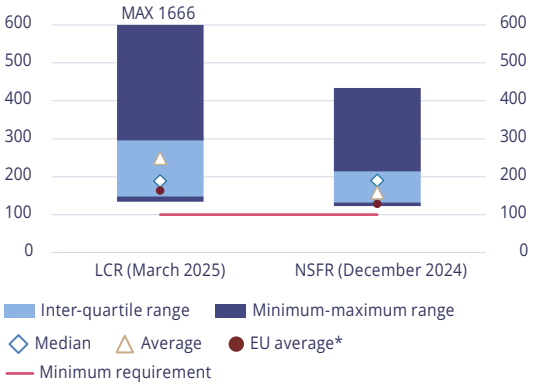
Source: Latvijas Banka.

[38] Availability of funds within one to three days.
[39] Here, households' deposits in the 2nd and 3rd pension pillars, as well as investments made using non-euro area financial institutions are not considered.
[40] Except for individual countries which do not identify deposits by Latvian households.

accounted for 69% of the liquid assets of the LCR and 19% of the total assets of credit institutions (without branches). A substantial factor in ensuring additional liquidity is a low ratio of encumbered assets to total assets with credit institutions, which stood at 1.8% at the end of 2024 (EEA average – 24.1%). Meanwhile, the share of assets which are used as a pledge in central bank operations was 12.8%. This shows that banks have readily available funds to ensure additional liquidity.

According to liquidity stress tests conducted by Latvijas Banka, there are currently no significant liquidity risks in the banking sector (see the Section "Liquidity stress tests of credit institutions").

Chart 2.20
LCRs and NSFRs of credit institutions (%)



* EBA Risk dashboard.
Sources: Latvijas Banka, EBA.

Box 2.1. Features of domestic household investments

Prepared by Mārcis Risbergs

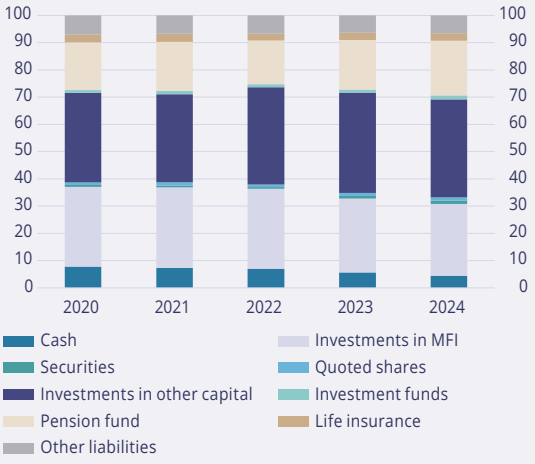
Although deposits by Latvian households with banks continue to grow steadily, households are ready to invest more of their funds in riskier financial assets.

In Latvia, the largest part of households' financial assets during the last year was made up by funds invested in other capital – funds invested in business activity (e.g. the equity capital of limited liability companies and individual merchants), followed by deposits in financial institutions (mainly banks), and contributions to pension funds (mainly the 2nd pension pillar). The share of investment funds, securities, and quoted shares is also increasing (Chart 2.21).

This shows that **households are gradually starting to invest their funds in higher-risk assets**. In recent years, deposits in securities and investment funds grew most rapidly (Chart 2.22). Since the growth started from a low level, the share of such deposits in the total financial assets of households only slightly exceeds 1%. At the same time, in 2023 and 2024, the volume of cash held by households decreased gradually.

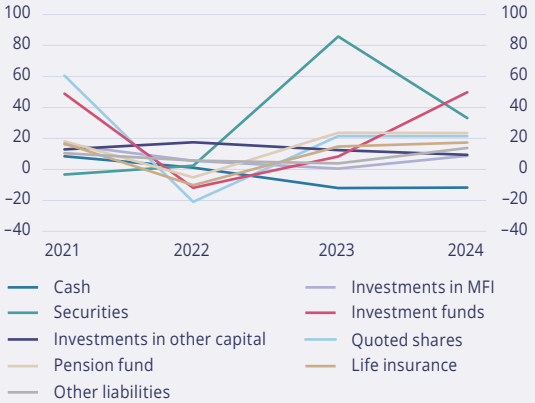
The amount of financial investments by households in Latvia is one of the lowest in the region. In Sweden, the ratio of households' financial assets to GDP was 347% at the end of 2024 (Chart 2.23) – this is much more than in Finland and the Baltic States, as well as the euro area on average. When looking at investment strategy (Chart 2.24), it can be seen that Swedish households place significantly less of their funds in

Chart 2.21
Breakdown of financial assets of Latvian households (%)



Sources: financial accounts, Eurostat.

Chart 2.22
Annual growth rate of financial assets of Latvian households (%)



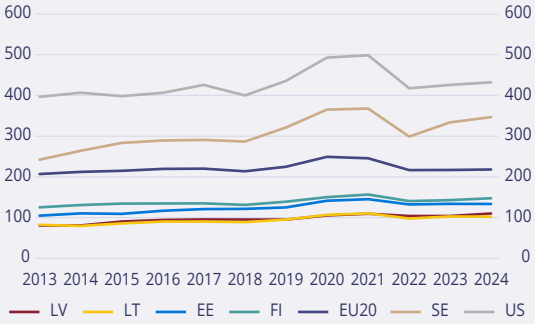
Sources: financial accounts, Eurostat.

MFI deposits and hold less cash. Instead, households channel them into pension funds and invest in financial markets. A similar strategy can also be observed in the US where the ratio of households' financial assets to GDP is even larger (432%). **Meanwhile, in the Baltic States and euro area, the share of households' MFI deposits in the total financial assets is much larger overall. This indicates both a more conservative approach to placing own funds and less developed local capital markets.** In February this year, during the annual Latvian Capital Market Forum, Latvijas Banka stressed the necessary steps for the development of the local capital market[41].

In the Baltic States, when broken down by household investments, the largest volume of investments in other capital, which includes both non-quoted shares and investments in smaller companies (equity capital of limited liability companies and individual merchants), is in Estonia. Meanwhile, in Latvia, most investments are in pension funds, mainly due to the larger mandatory contribution to the 2nd pension pillar. In addition, investments by Estonian households in pension funds were adjusted, as since 2021 in financial account statistics pension fund balances have been added to investment funds. In the euro area in general, the breakdown of investments in capital is much more even.

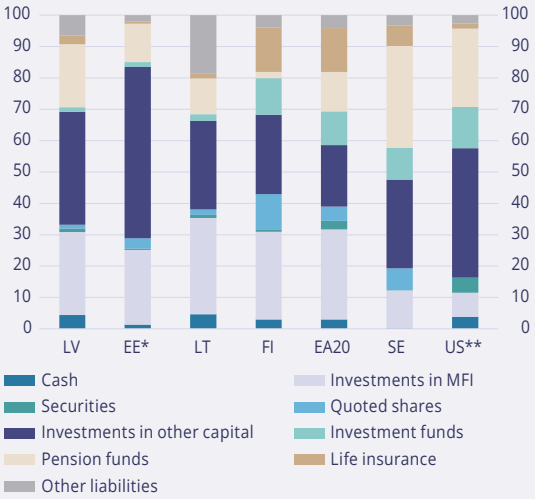
Lower investments in riskier assets in the Baltic States facilitated a more even growth in financial assets than in the USA and Sweden, where significant rises and falls in households' financial assets can be observed (Chart 2.25). Households in these countries are also more exposed to future asset price fluctuations related to the current geopolitical tension and high uncertainty in financial markets. Besides, the high uncertainty around the development of financial markets, this year may create an additional obstacle to the growth of households' financial assets.

Chart 2.23
Ratio of households' financial assets to GDP by country (%)



Sources: financial accounts, Eurostat, and Federal Reserve System.

Chart 2.24
Households' financial assets by country as of the end of 2024 (%)

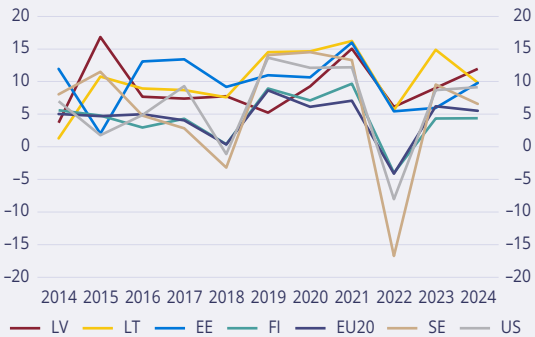


* In the breakdown of financial assets of Estonian households, investments in pension funds are taken from the Estonian Central Bank statistics[42], thus reducing the amount of investment funds as financial account investments in pension funds are added to investment funds.

** US investments in capital instruments are not broken down, as there is no more detailed breakdown in the data source used.

Sources: financial accounts, Eurostat, and Federal Reserve System.

Chart 2.25
Annual growth rates of households' financial assets by country (%)



Sources: financial accounts, Eurostat, and Federal Reserve System.

[41] See Purgaile, S., "Necessary steps for the development of the capital market yet to be taken" (in Latvian), Latvijas Banka, 13.02.2025.

[42] *Funds assets and liabilities by fund type*, Eesti Pank, 10.02.2025.

Box 2.2. Effect of the ECB's interest rate changes on the interest rates offered by credit institutions

Prepared by Mārcis Risbergs

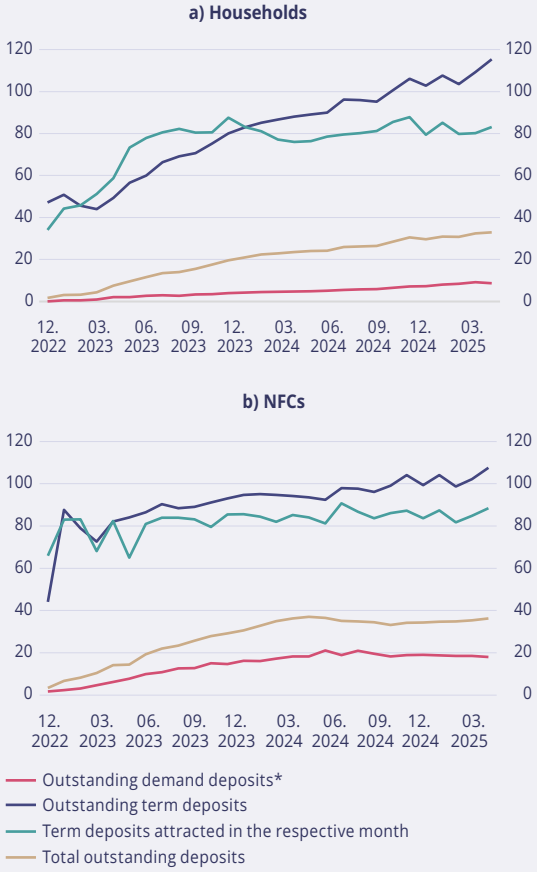
The ECB's interest rates fell faster than average weighted interest rates of household deposits with credit institutions; however, the difference between lending and deposit interest rates remains higher than the historically average level.

With the inflation rate in the euro area decreasing and slowly approaching 2%, the ECB has gradually reduced interest rates since June 2024. Until the end of March 2025, the ECB's deposit facility rate fell to 2.5% (by a total of 1.5 percentage points since June 2024).

An analysis of the movement of the average deposit rates charged to domestic households (Chart 2.26, panel (a)) and NFCs (Chart 2.26, panel (b)) toward the ECB deposit facility rate shows that, **at the start of the ECB interest rate hikes at the end of 2022 and in the first half of 2023, these average deposit rates followed the ECB interest rates relatively slowly, still approaching the interest rate set by the ECB in the next interest rate hike period. This trend did not change when the ECB started to decrease interest rates and, at the end of 2024, the average weighted term-deposit rates even exceeded the ECB's deposit facility rate.**

The overall term deposit interest rates for households reached the ECB's deposit facility rate in September 2024 and continued to grow. Meanwhile, the ratio of the interest rate of new term deposits to the ECB's deposit facility rate grew until the second half of 2023 when it reached 80% and did not change substantially thereafter.

Chart 2.26
The ratio of interest rates on deposits by domestic households and NFCs with credit institutions to the ECB's deposit facility rate (%)



* Balances in savings accounts with immediate availability of funds, which are presented as demand deposits in statistics, have been subtracted from households' demand deposits.

Source: Latvijas Banka and its estimates, ECB

Meanwhile, interest rates of NFC term deposits approached the ECB's deposit facility rate much faster, but did not exceed it substantially. Also, with regard to new NFC transactions, it can be seen that a level similar to that of household deposits is achieved quickly, but is not further affected by either an increase or reduction in ECB interest rates. This shows that banks pre-price every change to ECB interest rates. The fact that NFC term deposit rates approached the interest rate set by the ECB much quicker was most likely determined by the funds deposited by large companies. Larger companies have more available alternatives to placing funds in financial markets and have an inherent need to administer large amounts of deposits by placing them in short-term deposits.

In turn, the ratio of the demand deposit interest rate to ECB interest rate grew very slowly. This is the main reason why the difference between lending and deposit rates is still elevated (in March 2025, the difference was 4.7 percentage points, decreasing by 0.9 percentage points during the year, while in previous

years, it stood steadily at 3 percentage points; see the Section "Profitability"). The growth rate of the household deposit interest rate relative to the ECB interest rate is much slower than for NFCs, as only individual credit institutions pay modest compensation for demand deposits. However, it should be noted that several credit institutions offer a savings account[43] product with an increased interest rate and a term of availability of funds from immediate availability to 30 days.

The total average weighted outstanding deposit interest rate for households continued to approach the ECB's deposit facility rate slowly, and has practically reached the average weighted interest rate for NFCs. The average weighted outstanding deposit interest rate for NFCs relative to the ECB interest rate has not changed substantially since the first quarter of 2024. However, this rate is far from the interest rate set by the ECB. Therefore, also in future, it will be beneficial for credit institutions to place a part of their free funds with Latvijas Banka's deposit facility operations.

Overall, it can be concluded that the average weighted interest rates on balances of term deposits with credit institutions decrease slower than the ECB's deposit facility rate. This is temporarily affected by term deposits already issued, the term of which usually does not exceed one year. However, the interest rate on new term deposits has always been lower than the ECB rate, which means that when the ECB rate stabilises, the average weighted interest rate on term deposits with credit institutions will, most likely, be lower than the ECB's deposit facility rate.

Another factor which prevents the bank deposit rates from approaching the ECB rate more quickly, and reducing the difference between lending and deposit interest rates, is the large share of demand deposits in total deposits – this exceeds 70% of the total deposits of households and NFCs. In particular, households should consider possibilities for the more efficient placement of funds either in credit institutions' savings accounts from which the funds are readily available, or by channelling a part of the funds to more profitable long-term deposits. In turn, **NFCs administer their free funds by using the profitability offered by short-term deposits more efficiently, quickly, and in larger amounts.**

In order to promote the financial literacy of citizens and NFCs and motivate the use of savings accounts and term deposits, Latvijas Banka has been publishing an overview of interest rates offered by credit institutions since 2023, covering the largest banks both in Latvia and in all Baltic States.

[43] Here, savings accounts are to be understood to mean deposits which are redeemable at notice, as well as savings accounts with the immediate possibility to withdraw funds.

Profitability

Prepared by Mikus Āriņš

In 2024, the profits of credit institutions decreased slightly, mainly due to the mortgage borrower protection fee. At the same time, profits remained significantly higher than before 2023. This allows credit institutions to pay out dividends while maintaining strong capitalisation. Looking ahead, the profits of credit institutions are expected to decline, driven by falling market interest rates, a possible increase in credit risk, and solidarity contributions.

In 2024, the total profits of credit institutions at the consolidated level stood at 569.5 million euro – 7.9% lower than in 2023, when the profits of credit institutions were at a record high (Chart 2.27). **The decrease in the profits of credit institutions was largely due to a rise in administrative expenses**, which are mainly related to the mortgage borrower protection fee[44]. This fee was due by credit institutions in 2024 and accounted for almost 60% of the increase in administrative expenses. The rise in other administrative expenditure was primarily driven by higher staff costs, but it is seen as proportional to the overall wage growth in the economy.

[44] See the Sub-section "Household solvency" in the Section "Financial vulnerability of borrowers" of Latvijas Banka's Financial Stability Report 2024.

In 2024, the net interest income of credit institutions increased only slightly – 2.4% year on year. It should be noted that this is an increase from the peak of 2023, which was almost twice as high as in 2022 (Chart 2.28). The ECB started easing its tight monetary policy in 2024, prompting market interest rates to decline. Taking into account that the decline in interest rates began from a very high level, that credit institutions' interest rate spreads remain wide (Chart 2.29), and that their loan portfolios have grown, interest income earned by credit institutions on household and NFC loans has continued to increase[45]. Additionally, credit institutions' interest income on other assets also rose. As household and NFC deposits continued to grow, credit institutions placed additional funds in the central bank's deposit facility and with associated and affiliated credit institutions. In turn, the interest expenses of credit institutions nearly doubled, mainly due to an increase in interest expenses on term deposits and savings accounts of households and NFCs.

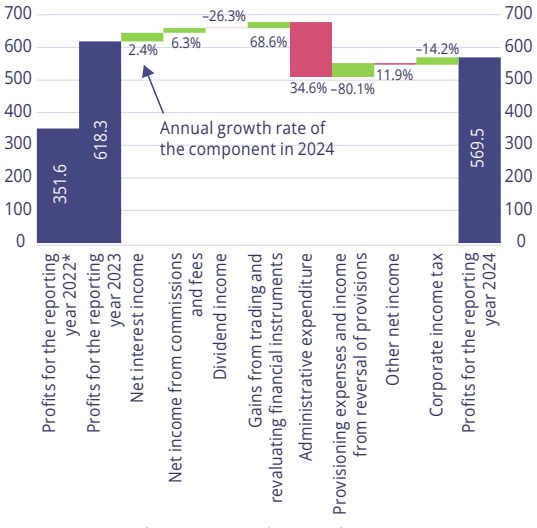
Net provisioning expenses were generally lower than in 2023. Some credit institutions even generated income from the reversal of provisions, as the risk associated with the high interest payment burden of households and NFCs, for which these credit institutions had previously made provisions, failed to materialise.

There were no significant changes in other items in the profit or loss statement. Net income from commissions and fees rose slightly (mainly due to higher income from commissions and fees related to asset management). Income from financial instrument trading, revaluation, and exchange rate fluctuations also grew.

Credit institution **profitability indicators**, although lower than their overall peak in 2023, **remain high**: in 2024, the ROE averaged 17.2%, while the average ROA reached 1.96% (Chart 2.30). Meanwhile, the cost to income ratio stood at 47.7% (in 2023 – 37.2%).

While overall profits for credit institutions are likely to decline in 2025, most are still expected to post healthy results. First, the decline in market interest rates reduces interest income compared to 2023 and 2024. At the same time, market interest rates remain over two percentage points higher than before the

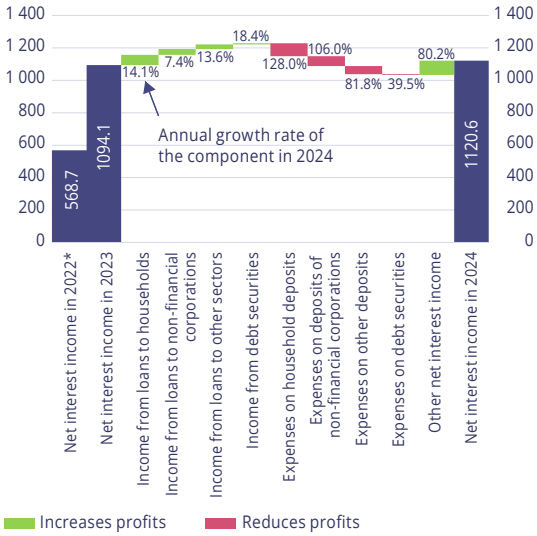
Chart 2.27
Credit institutions' retained earnings in the reporting year and the contribution of their components to changes in profits in 2024 (millions of euro)



* Only currently active credit institutions (adjusted for the merger between Signet Bank AS and AS Expobank in 2022).

Source: Latvijas Banka.

Chart 2.28
Net interest income of credit institutions and the contribution of their components to changes in net interest income in 2024 (millions of euro)



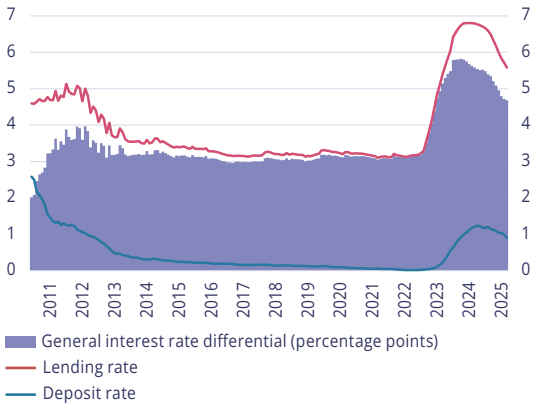
* Only currently active credit institutions (adjusted for the merger between Signet Bank AS and AS Expobank in 2022).

Source: Latvijas Banka.

[45] The loans issued by Latvian credit institutions are mostly variable rate loans linked to a market interest rate, primarily EURIBOR. By the end of 2024, nearly 90% of the loans to households and NFCs were variable rate loans.

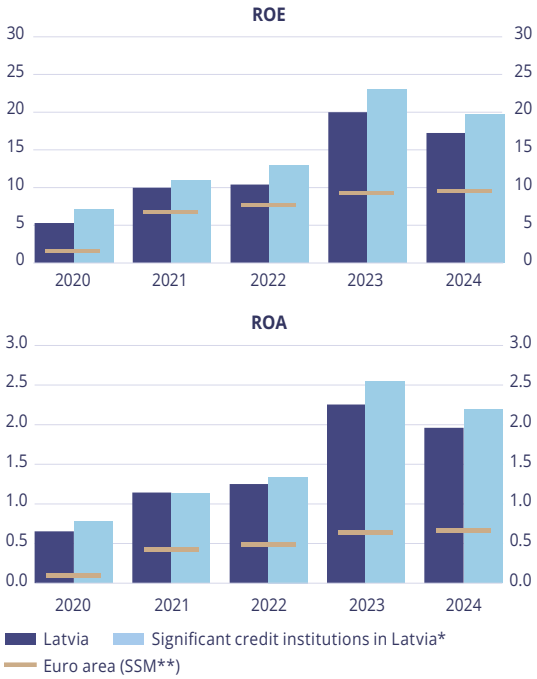
ECB started its policy to curb inflation. Consequently, the interest income of credit institutions will remain elevated compared to the pre-2022 period. Second, from 2025 to 2027, credit institutions are required to pay the SC (see Box 2.3 "Solidarity Contribution Law") which will generate significant expenditure for a number of credit institutions, potentially exceeding the amount of the mortgage borrower protection fee paid in 2024. The impact of these factors is already evident in the operational data for the first three months of 2025, where the average profits of credit institutions decreased by about a third year on year. The threat to profitability is further heightened by the significant rise in uncertainty related to trade wars at the beginning of 2025. It may worsen the Latvian economic outlook and raise credit risk. This, in turn, will require credit institutions to increase their provisioning expenses.

Chart 2.29
Average interest rates on loans and deposits granted by credit institutions to domestic households and NFCs (%) and their differential
(percentage points)



Source: Latvijas Banka.

Chart 2.30
Average ROE and ROA for credit institutions in Latvia and the euro area



* Significant credit institutions are the credit institutions currently supervised by the ECB: Swedbank AS, AS Citadele banka, and AS SEB banka.

** Euro area averages are calculated based on the data on credit institutions under direct supervision of the ECB's SSM, covering all euro area countries and Bulgaria.

Sources: Latvijas Banka and ECB.

Box 2.3. Solidarity Contribution Law

In order to raise additional funds for strengthening national security and defence, at the end of 2024, the Saeima announced the Solidarity Contribution Law[46], which stipulates that credit institutions registered in Latvia and branches of foreign credit institutions from other countries in Latvia must pay the SC from 2025 to 2027.

The SC rate is 60%, with the SC base being the portion of net interest income earned in the calendar year that exceeds the 2018–2022 average by more than 50%. The SC may not exceed 33% of the payer's profits before the CIT is paid. Thus, the SC cannot create a situation where the credit institution incurs losses.

The SC payer has the opportunity to receive an SC discount if it significantly increases lending. The SC discount may reach up to 100% if the outstanding loans granted by the SC payer to Latvian NFCs, households, and NPISHs rise more than the thresholds specified in the SC Law, which are linked to the projected nominal GDP growth rate used for the Law on the State Budget for the relevant calendar year. For example, this nominal GDP growth forecast is 5.9% in 2025[47]. In order for an SC payer to receive a 25% discount, its relevant outstanding loans would have to increase by at least 1.75 × 5.9% or by 10.33% year on year, whereas in order to receive a 100% discount, the relevant outstanding loans would have to increase by at least 2.5 × 5.9% or by 14.75% (for more details on the discount calculation, see Section 6 of the Solidarity Contribution Law).

[46] Solidarity Contribution Law.
[47] Information from the Ministry of Finance dated 4 March 2025 "Information for the application of Section 6 of the Solidarity Contribution Law during the payment period for 2025".

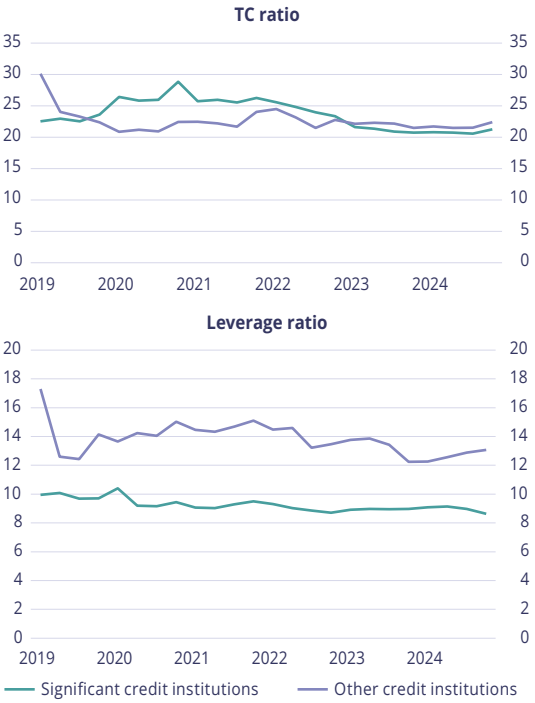
Capitalisation

Prepared by Ilze Vilka

Overall, the capital buffers of credit institutions are sufficient to absorb potential losses in the event of financial shocks. Good profitability helps to maintain high capitalisation and increase shareholder remuneration. Credit institutions, in particular the two largest significant institutions[48], also intend to make substantial dividend payments in 2025. There is an increasing interest among credit institutions in Tier 2 capital instruments to meet total capital requirements.

The capitalisation of Latvian credit institutions[49] remained high. In 2024, the average TC ratio of credit institutions was 21.5% on a consolidated basis, the CET1 capital ratio – 19.5%, and the leverage ratio – 9.3%[50]. To compare, EU significant banks had an average TC ratio of 20.2%, a CET1 capital ratio of 16.1%, and a leverage ratio of 5.9% at the end of 2024[51]. TC ratios in significant and other credit institutions have become similar, but the spreads in leverage ratios indicate differences in average risk weights across both groups of credit institutions (Chart 2.31).

Chart 2.31
Capitalisation ratios of credit institutions (% of TREA)



Source: Latvijas Banka.

[48] The significant credit institutions are Swedbank AS, AS Citadele banka, and AS SEB banka – all supervised by the ECB.
[49] Capitalisation calculations and figures only include currently active credit institutions at the consolidated level.
[50] In 2023 – 20.9%, 20.1%, and 9.5% respectively.
[51] EBA Risk Dashboard Q4 2024.

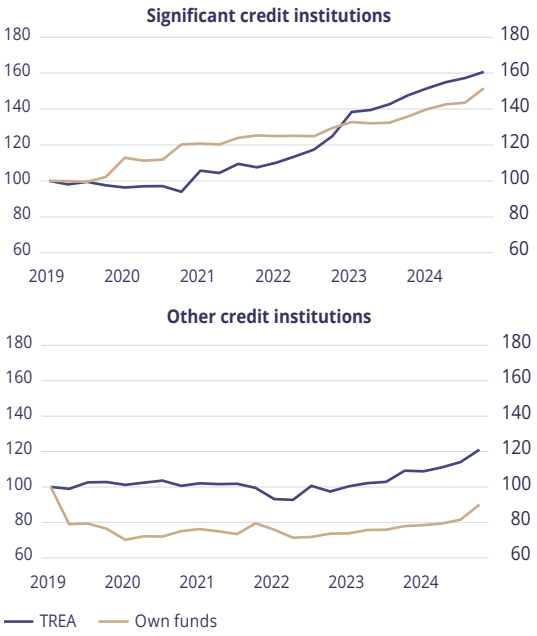
As the amount of Tier 2 capital instruments increased, the total capital of Latvian credit institutions grew faster than TREA in 2024. In 2024, the TREA of significant institutions expanded by 808.3 million euro or 8.8%, while the amount of own funds increased by 219.9 million euro or 11.5%. In its turn, the TREA of other credit institutions increased by 245.5 million euro or 10.8%, while their own funds grew by 75.6 million euro or 15.5% (Chart 2.32). Among significant institutions, Tier 2 capital more than doubled. For other institutions, it contributed 26.6% to the total increase in own funds.

The voluntary capital buffers of credit institutions rose from 4.7% at the end of 2023 to 5.1% at the end of 2024 and are sufficient to absorb potential losses due to borrowers' solvency and other shocks (see the Section "Credit risk and market risk shock absorption capacity stress tests"). At the end of 2024, significant institutions' buffers above total capital requirements stood at 4.8%, while the voluntary capital buffers of other credit institutions reached an average of 6.6% (Chart 2.33).

With the revenues of credit institutions remaining high, the majority of credit institutions plan to pay out dividends. The profit distribution plans of significant credit institutions remain as substantial as last year, with an average payout of 80% of prior-year profits for the second consecutive year. In 2025, significant credit institutions announced dividend payments totalling 377 million euro, equivalent to 84% of their 2024 profits. The profit distribution plans of other credit institutions are more moderate: dividends in the amount of 24.8 million euro were announced in 2025, corresponding to 56.8% of the 2024 profits.

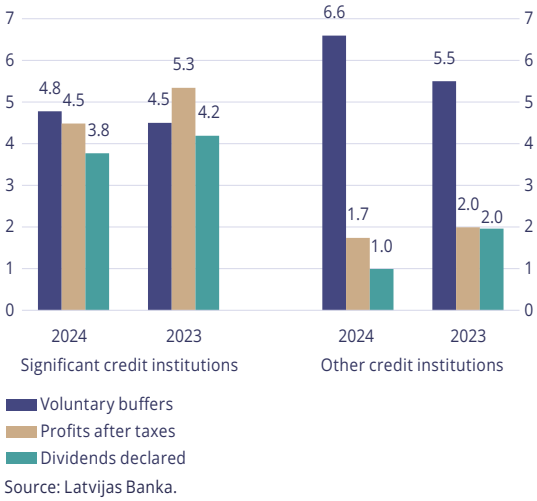
The resilience of credit institutions against unexpected risks is strengthened by a 1% CCyB rate (see the Chapter "Macroprudential policy"), which will be available to credit institutions to cover losses if risks in the financial sector materialise and the voluntary buffers are insufficient.

Chart 2.32
Capital ratio numerator and denominator
(Q1 2019 = 100)



Source: Latvijas Banka.

Chart 2.33
Voluntary capital buffers, profits, amount of dividends paid and declared by credit institutions[52] (% of TREA)



Source: Latvijas Banka.

[52] Voluntary buffers of credit institutions are shown excluding profits.

3. Stress tests of credit institutions

Credit risk and market risk shock absorption capacity stress tests

Prepared by Nadežda Siņenko, Ilze Vilka, Jānis Strazdiņš, and Mikus Āriņš

The results of the macroeconomic stress test suggests that the resilience of Latvian credit institutions to potential shocks remains high – under conditions of financial stress, all institutions would be able to meet the minimum capital requirements. Credit institutions have sufficiently high voluntary capital buffers to absorb shocks, which will be replenished by expected profits[53].

According to the results of the sensitivity analysis, at the end of 2024, all credit institutions would be able to meet the minimum own funds requirement of 8%, even in the face of a potential increase in credit risk that would result in a rise in the share of loans past due over 90 days by more than 19 percentage points. Thus, even without considering the implementation of a more complex macroeconomic stress scenario, it can be concluded that these results already indicate a high level of resilience potential losses (see the Section "Capitalisation").

The macroeconomic stress test has been carried out to assess the capability of credit institutions to absorb a potential increase in credit risk and market risk caused by a deterioration of the macrofinancial environment. In the stress scenario, the most significant risks are persistently weak economic growth and geopolitical tensions resulting in global trade fragmentation which, combined with an unexpected external macrofinancial shock, could affect bank customers and asset quality.

Methodology

Latvijas Banka conducts a sensitivity analysis[54] and macroeconomic stress tests[55] of credit institutions on a regular basis. The calculations of the macroeconomic stress test are based on the consolidated data of credit institutions as at the end of 2024, and the assessment covers the period until the end of 2025. The thresholds used for the stress tests are as follows: meeting the minimum capital requirement – a TC ratio of 8%, T1 capital ratio of 6%, and CET1 capital ratio of 4.5%[56]. Failure to meet any of the minimum capital requirements is considered failure to meet the overall capital requirements.

Taking into account the high share of secured loans in the loan portfolio of Latvian credit institutions, from 2022 onwards, the weighted average loss given default (LGD_i) of each credit institution is used instead of the former single provisioning rate. The weighted average LGD is calculated for each group of resident loans presented separately from other loans in the stress test description, as well as for the largest sectors. Its calculation is based on the data available in the Credit Register of Latvijas Banka on collateral of individual credit obligations. In the calculation, state guarantees and cash are taken in the full amount, for real estate, a differentiated haircut is applied depending on scenario assumptions, while for physical collateral a haircut of 30% is applied.

[53] Even if the profit projection is not included in the calculations, the shock absorption capacity of credit institutions remains good.

[54] A credit risk sensitivity analysis provides an indication of the magnitude of an increase in loans past due over 90 days a credit institution would be able to absorb before its capital adequacy ratios fall below the minimum capital requirements. The sensitivity analysis assumes that a credit institution must build provisions in the amount of at least 50% for its portfolio of loans past due over 90 days and build additional provisions totalling 50% of the increase in the loans past due over 90 days; unlikely-to-pay loans must be provisioned by at least 35%. The credit institution capital and TREA are reduced by the amount of the additional provisions.

[55] Macroeconomic stress tests measure the resilience of Latvian credit institutions to strong adverse macroeconomic shocks whose materialisation is plausible, yet their probability is low. The results of the credit risk and market risk stress tests allow for the assessment of whether credit institutions have sufficient capital for absorbing losses in particularly severe and even extreme macroeconomic stress circumstances without additional capital injections.

[56] A characteristic feature of the capital structure of Latvian credit institutions is the fact that the T1 capital requirement is met with CET1 capital; therefore, compliance with the T1 capital requirement automatically means compliance with the CET1 capital requirement as well. As a result, a relatively high stress test threshold is applied to high quality capital.

The market risk component of the stress test uses the data on each credit institution's securities portfolio, including the securities measured at fair value through profit or loss, securities measured at fair value through other comprehensive income, and securities measured at amortised cost (AC). This stress test methodology applies market shocks to all securities in order to assess the overall economic effect of the changes in the market value of the securities portfolio on capital, assuming that changes in the value of securities will need to be recognised regardless of their accounting treatment. Given the changes in the interest rate environment, the revaluation of AC securities at market value, previously conducted in past reports, is no longer performed.

Since data on the securities portfolios of individual credit institutions are available at the highest level of granularity, the analysis was based on these data, while the group-level securities portfolio was extrapolated assuming it was structurally similar to that of the credit institution's level.

The securities of each credit institution's bond portfolio are grouped by major risk factors (euro area and US bond yields of different maturities, credit rating, and sector) according to the assessment of experts. Given their share in the portfolio, the bonds of the three largest issuers have been reported separately. The modified duration of each bond is set using Refinitiv data or, in the absence of data, using the residual maturity of the bond as a proxy. The modified duration is used to calculate the impact of the interest rate shock scenario. The foreign exchange risk has been reported separately from the revaluation effect, and the shock scenario is applied to the open foreign exchange position.

Stress test scenarios

Tables 3.1–3.4 summarise the parameters of the stress test scenarios.

The baseline scenario uses Latvijas Banka's forecasts of June 2025 for the domestic loan portfolio, which projects Latvia's GDP growth to be 1.2% in 2025 (seasonally adjusted data).

Under the baseline scenario, when calculating the loss given default, a haircut applied to real estate collateral reflects a depreciation in the value of the collateral as a result of a fire sale[57]. Under the stress scenario, the haircuts applied to the real estate values are higher than under the baseline scenario, as they reflect the risk of impairment due to both the fire sale and the decrease in the real estate prices. Under both scenarios, the haircuts applied to commercial real estate are larger than those applied to the residential segment (Table 3.1).

While the outstanding forborne loans accumulated on bank balance sheets in previous years decreased in 2024, a further deterioration in the quality of forborne loans is possible under macroeconomic stress. To reflect this risk, the stress scenario envisages a migration of these loans to the category of loans past due over 90 days. **The increase in NLPs foreseen in the stress scenario is applied after the migration.**

The rise in NPLs in the stress test (Table 3.1) is assessed using a credit risk model.

[57] Under the baseline scenario, a haircut is not a forecast of price dynamics in the real estate market.

Table 3.1
Parameters of the macroeconomic stress test (%; percentage points)

Macroeconomic and credit risk parameters	Baseline scenario	Stress scenario
Latvia		
Annual changes in Latvia's GDP in 2025	1.2	–6.9
3-month EURIBOR forecast[58]	2.2	2.2
Probability for a performing loan or a loan that is past due less than 90 days and not forborne to become a loan past due over 90 days within a year	0.5	5.4
Probability for an unlikely-to-pay loan to become a loan past due over 90 days within a year	2.1	21.6
Share (%) of forborne loans other than NPLs that will migrate to the category of loans past due over 90 days within a year	0.5	100
Increase in the share of loans past due over 90 days in the loan portfolio of domestic customers at the end of 2025[59] (percentage points)[60]	0.6	8.8
Haircut applied to commercial real estate (%)	20	40
Haircut applied to residential real estate (%)	10	30

[58] 3-month EURIBOR annual average by the end of 2025; Eurex Exchange, 21.03.2025.
[59] Loans that have migrated from the categories "a performing loan or loan that is past due less than 90 days", "unlikely-to-pay loans", and "forborne loans other than NPLs" to the category "loans past due over 90 days" have been added up.
[60] This increase cannot be regarded as a forecast because of a static balance sheet and other conservative assumptions.

Given the current risks, in the context of significant changes in the US international trade tariff policy, **the stress scenario models additional losses from loans to companies whose exports to the US account for at least 20% of their turnover**. The scenario assumes a provisioning of 20% for such loans.

Assumptions regarding credit risk parameters for customers of other countries are presented in Table 3.2. The stress test scenarios assume that the PD for loans extended to borrowers from the Baltic States is the same as that of loans to domestic customers, while the provisioning rate is 60%. The PD for loans to customers from other EU and OECD countries is larger than to customers of the Baltic States, whereby the LGD has been set at 75%. In turn, borrowers from other countries have an increased PD, but the LGD is set individually for each bank with such exposures, taking into account only the real estate collateral located in Latvia or other EU countries, to which a haircut is applied in accordance with scenario assumptions.

Table 3.2
Assumptions regarding loans to foreign customers under the baseline scenario (%)

Loans to foreign customers	PD	LGD
Customers from Lithuania and Estonia	0.5	60
Customers from other EU and OECD countries	5	75
Customers from other countries[61]	20	LGD_i

To ensure a more accurate reflection of the potential losses arising from foreign exposures, the exposures in those countries have been adjusted based on Credit Register data on country risk transfer, taking into account all risk transfers to categories with higher country risk.

In the market risk component of the baseline scenario, no significant shocks or losses from changes in the securities portfolio are assumed, based on the premise that even if there are disruptions in securities markets, they will return to their previous state during the stress test horizon. **In both the baseline and stress scenarios, securities issued by Russian and Belarusian issuers are treated separately, with a 100% discount rate applied to their value**.

[61] Both the baseline and stress scenarios assume that all loans to residents of Russia, Belarus, and Ukraine, as well as all loans, for which Russia, Belarus, and Ukraine are identified as risk transfer countries, are written off. However, when recognising these as losses, previously accumulated provisions and real estate collateral located in Latvia or in other EU countries are taken into account, with the value of the collateral adjusted in line with the scenario assumptions (Table 3.1). Credit exposures of significant credit institutions in Russia, Belarus, and Ukraine are generally low, and their write-offs have no material impact on the institutions' capitalisation.

It should be noted that, **overall, the assumptions made in the baseline scenario are quite conservative, thus the stress test results in this scenario should not be interpreted as a forecast of capital ratios**.

From 2023 onwards, the stress scenario has been developed using the forecasts from the GaR model, which reflect **the 5th percentile** of the future probability distribution of GDP growth rates, based on the latest available GDP data and the value of deflated composite cyclical risk indicator developed by Latvijas Banka. **According to the calculations, in the stress scenario, GDP would contract by 6.9% in 2025.**

The assumptions made for foreign exposures in the stress scenario are presented in Table 3.3.

Table 3.3
Assumptions regarding loans to foreign customers under the stress scenario (%)

Loans to foreign customers	PD	LGD
Customers from Lithuania and Estonia	5.4	60
Customers from other EU and OECD countries	10	75
Customers from other countries	40	LGD_i

The stress scenario for the **market risk component** is based on the securities portfolio as at the end of December 2024. For market risk, **a stress scenario simulates a global market shock scenario**[62] (Table 3.4) **where significant shocks are applied to risk premia on government securities**, while a smaller shock is applied to risk premia of issuers and stock indices. The impact calculation assumes constant initial amounts of securities.

[62] Under the stress scenario, shock parameters have been set for the debt securities portfolio, mostly using the historic monthly changes in indices corresponding to each risk factor (market data since 2006 have been used) and assuming that the current investments in securities remain unchanged. Then, the sum of changes over the previous 12 months is calculated for each month, resulting in the total changes from the previous year. Finally, 1% of cases or months with the largest estimated hypothetical 12-month losses accumulated in the aggregate portfolio of credit institutions are calculated. The average values of the identified cases are used in the scenario. Given that the stock and funds portfolio of Latvian credit institutions is rather small and notably lacks market data, the shock scenario applied to this portfolio uses a simple parameter of a percentage fall in the portfolio value, corresponding to 1% of the most adverse changes in the STOXX EUROPE 600 stock index value since 2006.

Financial derivatives comprise a wide range of financial assets, characterised by a lack of market price and liquidity, as well as relatively high risk. Thus, based on experts' opinion, a plain percentage value shock of 50% has been applied to these instruments.

Table 3.4
Parameters of market risk stress test under the stress scenario

Instrument	**Original value** (%)	**Changes under the stress scenario** (in basis points)
Benchmark yield curve		
Securities in euro (1 month–10 years)	1.8 to 3.1	278 to 390
Securities in US dollars (1 month–10 years)	4.1 to 4.6	229 to 457
Risk premium of the key categories[63]		
Investment class (government, corporate sector)	1.2 to 1.4	7 to 72
High yield class (government, corporate sector)	3 to 5.4	–34 to 103
Risk premium of the three major issuers	0 to 1.4	255 to 374
Other significant market shocks		**Changes under the stress scenario** (%, compared to the baseline value)
Equities, funds, and other instruments (excluding financial derivatives)		–5
Financial derivatives		–50

[63] The difference between the yield on a security and the benchmark rate of the respective currency. No risk premium shock is applied to German and US government bonds.

Stress test results

Table 3.5 summarises **the results of the stress test**.

Under the conservative assumptions of the baseline scenario, it is expected that the estimated total losses could reach 157.0 million euro or 0.6% of credit institutions' total assets. Losses in the baseline scenario are mainly driven by losses arising from investments in the countries affected by warfare[64] (59.6%). These losses are concentrated in individual non-significant credit institutions, and the write-off of these assets from balance sheets would not pose problems in meeting capital requirements even in a stress scenario. The remaining losses are determined by the necessary additional provisions for the loan portfolio of residents and non-residents.

Table 3.5
Aggregated macroeconomic stress test results

Indicator	**Baseline scenario**	**Stress scenario**
Estimated losses (millions of euro)	157.0	895.9
Estimated losses (% of total assets of credit institutions)	0.6	3.5
TC ratio		
Number of credit institutions with the TC ratio below 8%	0	0
Additionally required capital (millions of euro)	0	0
T1 capital ratio		
Number of credit institutions with T1 capital ratio below 6%	0	0
Additionally required capital (millions of euro)	0	0
CET1 capital ratio		
Number of credit institutions with CET1 capital ratio below 4.5%	0	0
Additionally required capital (millions of euro)	0	0

Under the stress scenario, the share of loans past due over 90 days in the domestic loan portfolio would increase by 8.8 percentage points by the end of 2025. In the event of the stress scenario materialising, the estimated total losses could reach 895.9 million euro or 3.5% of credit institutions' total assets. Losses arising from market risk would constitute 36.3% of the total losses, while losses arising from investments in the countries affected by warfare would amount to 10.5%[65]. Meanwhile, losses from loans to domestic customers and customers from other countries would account for 53.23% of total losses. Chart 3.1 shows changes in the TC ratio of the banking sector under the stress

[64] **The results of the stress test in the baseline scenario cannot be considered a capital ratio projection for 2025.** First, the stress test was conducted under the assumption of a constant balance sheet of banks. Second, the assumption that customers from Russia and Belarus, as well as those whose country risk has been transferred to Russia and Belarus, will fail to fulfil their obligations in full is rather conservative. Direct investments in Russia and Belarus do not take into account the transfer of country risk to other countries, e.g. there are many loans whose country risk is transferred to Latvia (e.g. a firm's economic activity takes place in Latvia), thus reducing the risk of default. It has also been assumed that all loans, whose country risk has been transferred to Russia and Belarus, are not repaid either. The country risk has been transferred while also taking account of factors such as the country where the collateral is registered and the country where the guarantor is situated. Indeed, the location of the collateral or guarantor in Russia or Belarus increases the risk of losses, but the PD may turn out to be lower than 100%.

[65] Includes losses arising from investments in securities and shares of these countries.

scenario. Changes in the capital ratio do not take into account the profit projection[66], and it is shown in the chart for informational purposes. Also, under the stress scenario, no credit institution experiences a capital deficit that would prevent it from meeting the minimum capital requirements. Chart 3.2 reflects the weighted average amount of own funds in significant and other credit institutions.

Liquidity stress tests of credit institutions

Prepared by Mārcis Risbergs

The results of the liquidity stress tests of credit institutions conducted by Latvijas Banka suggest that their capacity to absorb the shocks caused by potential funding outflows remains high.

Liquidity stress tests are used to evaluate the significance of the potential consequences of funding outflows. They are based on the data available at the end of March 2025 and use consolidated supervisory reporting data on liquid assets and liabilities up to 30 days[67]. The tests aim to calculate the liquidity ratio[68], which would be equivalent to the liquidity ratio previously used for banking supervision in Latvia, with a minimum requirement of 30% binding on all credit institutions until the LCR requirements become fully effective.

The methodology from the previous years is still used to conduct these short-term liquidity stress tests. It helps to obtain indicators of the resilience of banks to liquidity risks, which are more easily understood[69].

The results of the stress tests indicate the tolerance of credit institutions to the outflows of domestic non-MFI customer deposits and of foreign non-MFI customer deposits before their liquidity ratio (and thus the amount of their liquid assets) would decrease to 0, assuming that credit institutions have no access to additional resources to offset the funding outflows.

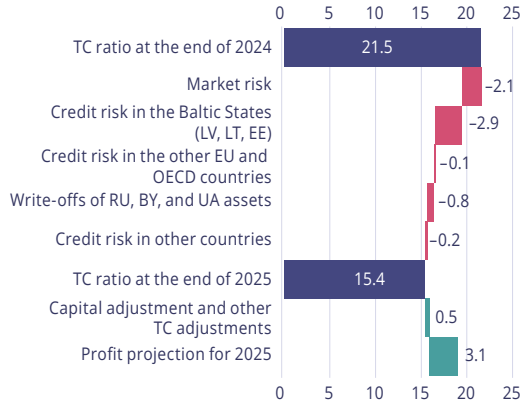
[66] The profit projection before taxes and before provisioning expenses for loans and securities has been calculated according to each scenario.

[67] According to the requirements of the common reporting framework (COREP), a report on additional liquidity monitoring metrics (ALMM) has been prepared on a consolidated basis or, if a bank does not provide reports on a consolidated basis, on an individual bank level.

[68] The ratio of unencumbered liquid assets to the total current liabilities of credit institutions with residual maturity of no more than 30 days.

[69] For a description of the methodology, see Financial Stability Report 2023.

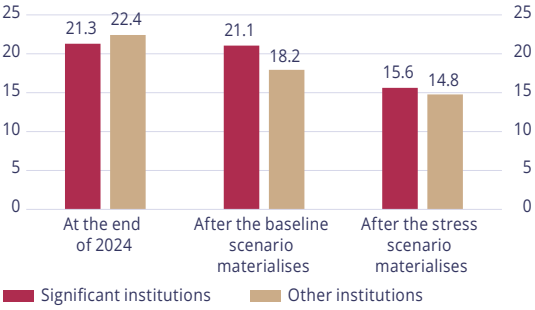
Chart 3.1
Changes in the TC ratio under the stress scenario by loss component and other corrections, and the expected profit for 2025 (% of TREA)



*The profit projection before taxes and before provisioning expenses for loans and securities.

Source: Latvijas Banka's calculations.

Chart 3.2
TC ratios under stress test scenarios (% of TREA)



Source: Latvijas Banka's calculations.

According to the stress test results (Chart 3.3), **all credit institutions would be able to withstand the outflows of up to 20% of domestic customer deposits or the outflows of more than 60% of foreign customer deposits**. The stress test results have remained the same overall compared to March 2024. When analysing the ability of major credit institutions to withstand the outflows of domestic customer deposits, the possibility for several credit institutions to obtain additional liquidity from their parent banks if needed was also taken into account.

Additional stress tests involving two particularly adverse scenarios were performed.

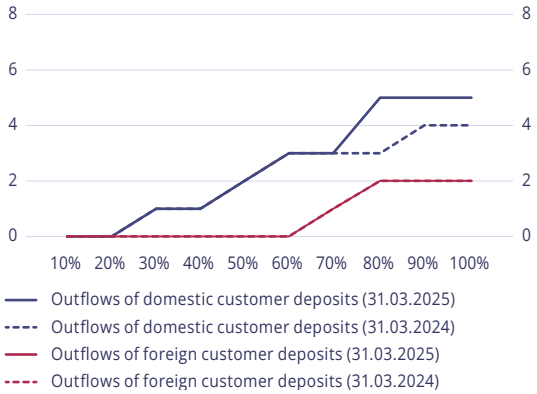
According to the assumptions of the first adverse scenario, it is impossible to pledge or sell the securities portfolio, except euro area government securities with a credit rating no lower than A– and those issued by countries' governments where at least one of the

long-term ratings by three international credit rating agencies is AAA. Regarding euro area government securities, it is assumed that they would lose 15% of their value under the first adverse scenario and could be used in the Eurosystem's monetary policy operations with a haircut of 3%.

Under the second adverse scenario, in addition to the assumptions of the first, no credit institution has access to overnight claims on credit institutions in the country where it holds the largest volume of such claims, including intra-group claims[70].

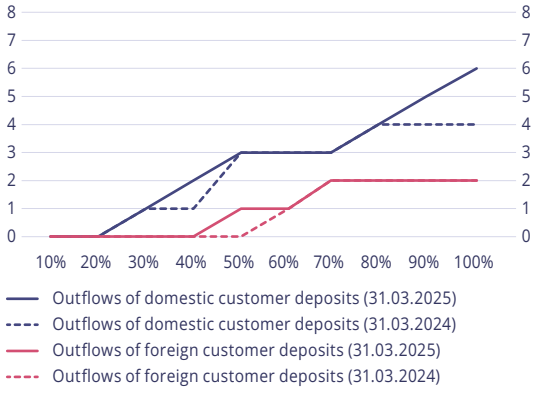
The application of the first adverse scenario does not yield significantly worse results than the standard stress test, and credit institutions **would be able to withstand the outflows of up to 20% of domestic customer deposits or 40% of foreign non-MFI customer deposits** (Chart 3.4). **The application of the second scenario does not practically change the ability to withstand outflows of non-MFI deposits** either (Chart 3.5). Compared to the previous year, the results of foreign deposit outflows were slightly affected by the reduction in highly liquid assets of certain banks, partially replacing them with lower-level liquid assets. However, the total amount of liquid assets remained high.

Chart 3.3
Results of liquidity stress tests (number of illiquid credit institutions[71])



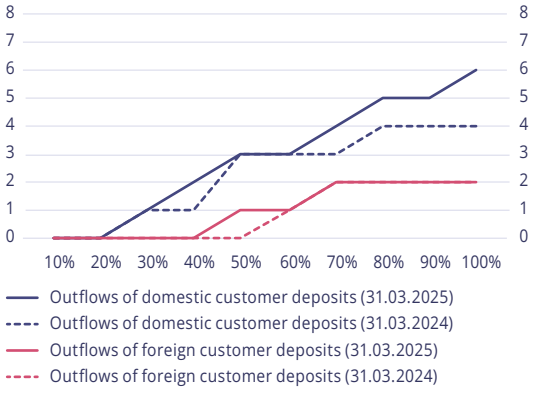
Source: Latvijas Banka and its calculations.

Chart 3.4
Results of the stress tests for the first adverse scenario (number of illiquid credit institutions)



Source: Latvijas Banka and its calculations.

Chart 3.5
Results of the stress tests for the second adverse scenario (number of illiquid credit institutions)



Source: Latvijas Banka and its calculations.

[70] For example, if the value of the security portfolio decreases substantially due to turmoil in the global financial markets, the repayment of overnight claims to a credit institution from another foreign credit institution is delayed.

[71] Only banks active at the end of March 2023 (nine credit institutions).

4. Macroprudential policy

Prepared by Dace Antuža

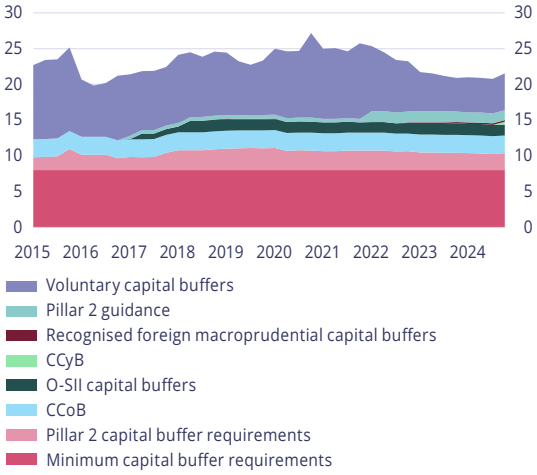
Latvijas Banka's macroprudential policy stance is aligned with its assessment of financial stability risks and the resilience of the financial sector. As part of a positive neutral CCyB approach, the CCyB rate further strengthens banks' resilience and creates macroprudential space, which is particularly important amid heightened external uncertainty. Borrower-based measures encourage compliance with sustainable lending standards.

Overall, Latvijas Banka's macroprudential policy is aimed at maintaining resilience. This policy is in line with the ECB Governing Council's statement on macroprudential policies of 7 July 2025[72], in which the ECB called on the macroprudential authorities of the euro area Member States to maintain and, where possible, also increase macroprudential capital buffers. The aim of this is to enhance resilience to potential shocks that may also result from geopolitical and macro-financial uncertainties. In its statement, the ECB called for maintaining existing borrower-based measures to ensure sustainable lending standards, while allowing for targeted adjustments to those measures where necessary.

The range of macroprudential measures in place in Latvia is summarised in Table 4.1, while the set of capital requirements is shown in Chart 4.1. The previously adopted CCyB rates entered into force in December 2024 and June 2025. The O-SII capital buffer rates for two credit institutions were slightly reduced in December 2024, and the increased risk weight for exposures secured by a mortgage on CRE registered in Latvia was removed. A wide range of borrower-based measures continues to be in place.

As part of a positive neutral CCyB approach[73], the 0.5% CCyB rate requirement took effect on 18 December 2024, and the 1% CCyB rate requirement – on 18 June 2025[74]. According to this approach, the CCyB rate is maintained at a positive base level of 1%. This is already under standard risk conditions or at the neutral stage of the financial cycle when the cyclical systemic risk is neither elevated nor significantly low. In the event of increasing cyclical systemic risk, the CCyB rate is raised proportionately to its intensity, starting from an existing positive base rate. The total CCyB requirement, therefore, comprises the base rate and the cyclical component, the size of which is assessed on a quarterly basis.

Chart 4.1
The capital requirements for Latvian credit institutions and their voluntary capital buffers (% of TREA)



Source: Latvijas Banka and its calculations.

In 2024, Latvijas Banka reviewed and refined its analytical framework for the assessment of the cyclical risk (see Appendix "Revised cyclical risk assessment framework"). The framework should be reviewed periodically to ensure that the cyclical risk assessment method is appropriate. According to Latvijas Banka's assessment, **the cyclical risk in Latvia is low and the CCyB cyclical component should not be increased**, given the moderate activity in the real estate and lending markets, as well as the slow economic development. The credit-to-GDP ratio of the private non-financial sector is low. Its deviation from the long-term trend is gradually decreasing, but remains negative. The financial

[72] Governing Council statement on macroprudential policies, ECB, 28.06.2024.

[73] Latvijas Banka's approach to the application of the countercyclical capital buffer rate.

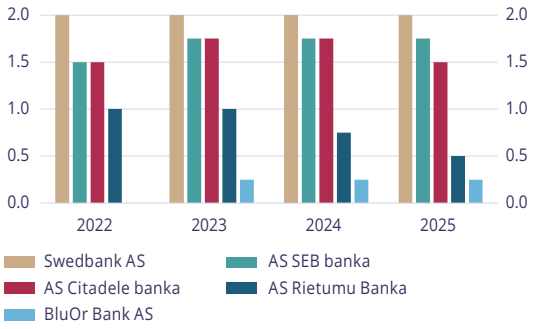
[74] Latvijas Banka decided to start implementing a positive neutral CCyB approach and gradually increase the CCyB rate (General Administrative Act No 444/10 of Latvijas Banka "On setting the countercyclical capital buffer rate for exposures to residents of the Republic of Latvia at 1%").

resilience of borrowers overall remains good. Banks' balance sheet resilience indicators – capitalisation, profitability, and asset quality – are also very strong. The CCRI indicates that the cyclical risk is low (see Chart P3.4).

According to Latvijas Banka's annual assessment of the systemic importance of credit institutions, **the range of credit institutions identified and recognised as O-SIIs remained unchanged in 2024: on 9 December 2024, Latvijas Banka decided**[75] **to reduce the O-SII capital buffer rates of AS Citadele banka and AS Rietumu Banka** by 0.25 percentage points (to 1.5% and 0.5% respectively), taking into account the decline in their relative systemic importance. The O-SII buffer rate for other credit institutions will most likely remain unchanged (see Chart 4.2). It should be noted that, on 20 December 2024, the ECB published its framework for assessing the requirements of O-SII[76], which will enter into force in 2028. The objective of the framework is to reduce heterogeneity in O-SII capital buffer rates across the euro area Member States and to introduce the minimum O-SII capital buffer thresholds at specific O-SII scoring levels. The new framework will have a greater impact on those banks in the Member States where O-SII capital buffer rates are significantly lower than those applied to other O-SIIs with a similar systemic assessment.

Two reviewed EU legal acts were published on 19 June 2024: the Capital Requirements Regulation (CRR)[77] **and the Capital Requirements Directive (CRD)**[78]**.** The updates to these legal acts introduce the global Basel III standards[79], which aim to strengthen

Chart 4.2
Latvia's O-SIIS and their capital buffer requirements (% of TREA)



Source: Latvijas Banka.

banks' resilience and risk management, as well as to enhance the sustainability aspects of banking supervision. One of the most important innovations is the introduction of the output floor. Accordingly, banks that calculate their capital adequacy based on internal models are required to maintain own funds requirements of at least 72.5% of the capital requirements that would apply if they were using the standardised approach. This innovation limits the risk of excessive reductions in banks' capital requirements and enhances comparability between banks using internal models and those applying the standardised approach. Banks using internal models are more affected by the introduction of the output floor and the risk weights resulting from these models are significantly lower than those under the standardised approach. **The CRR updates include significant amendments to the calculation of the capital requirement for credit risk**, including new principles for exposures secured by CRE. On 9 December 2024, **taking into account the amendments to the CRR and as part of its annual review of the risk weights applied to exposures secured by mortgages on CRE registered in Latvia, Latvijas Banka decided**[80] **to discontinue the application of higher risk weight (80%) to such exposures** as of 1 January 2025[81]. Accordingly, banks using the standardised approach will be subject to a minimum risk weight of 60%[82] for these types of exposures, as set out in the amended CRR.

75 The official statement "On the identification and recognition of other systemically important institutions and the determination of the capital buffer rate of another systemically important institution", 12.12.2024.

76 *Governing Council statement on macroprudential policies – the ECB's framework for assessing capital buffers of other systemically important institutions*, ECB, 20.12.2024.

77 Regulation (EU) 2024/1623 of the European Parliament and of the Council of 31 May 2024 amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor.

78 Directive (EU) 2024/1619 of the European Parliament and of the Council of 31 May 2024 amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks.

79 Updates to the CRR, which implements the Basel III standards, entered into force in 2025, while the requirements of the CRD are transposed into the national laws and regulations of the EU Member States. An exception is the Fundamental Review of the Trading Book (FRTB), where the introduction of adjustments has been postponed until 2026 to prevent EU institutions from facing a competitive disadvantage in trading activities compared to international counterparts due to delays in the implementation of the relevant global standards.

80 The Council of Latvijas Banka revoked Administrative Act No 444/8 of 18 December 2023 "On setting the risk weight for exposures secured by mortgages on commercial real estate located in the territory of the Republic of Latvia at 80%.

81 From 30 June 2024 to 1 January 2025, an 80% risk weight was applied to exposures secured by mortgages on commercial real estate in Latvia, in accordance with Article 126 of the CRR. Prior to 30 June 2024, this risk weight was 100%.

82 The minimum risk weight for these exposures, as set out in the CRR until now, was 50%.

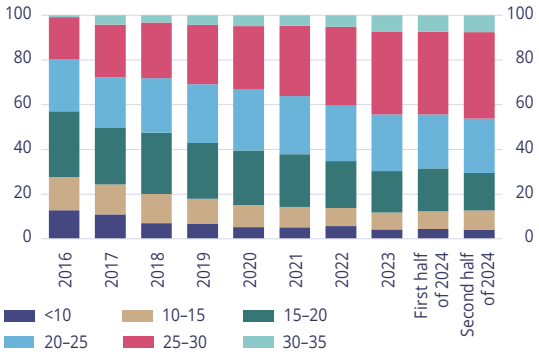
There were no amendments to the borrower-based measures in 2024 and the first half of 2025. As of 2024, differentiated DSTI/DTI limits have been applied to loans aimed at financing the purchase of energy-efficient housing. Data on DSTI and DTI values at the individual loan level are not yet available in the Credit Register of Latvijas Banka, making it difficult to effectively assess the impact of the differentiated limits on their distribution. According to Latvia's Open Data Portal, the share of new and renovated housing in the housing purchase structure did not increase in 2024. This may be partly explained by the still relatively weak overall demand for housing loans. In addition, credit institutions also use other incentives (lower interest rates in the first year of loan repayment, reduced commissions, or other bonuses) for loans used to finance the purchase of new and energy-efficient housing offered by their partner companies.

Data from the Credit Register of Latvijas Banka on the maturity breakdown of new housing loans show that **the trend toward longer maturities observed during the period of high interest rates came to a halt** in 2024. In the second half of 2024, the average maturity of new housing loans was 21.7 years (see Chart 4.3).

At the same time, **changes in the distribution of LTV values for new housing loans correlate with the intensity of state support programme usage for house purchase**[83]. In the second quarter of 2024, the average LTV value for new housing loans was 77.5%, and the share of loans granted under the state support programme in new housing loans reached 44.3% (see Chart 4.4).

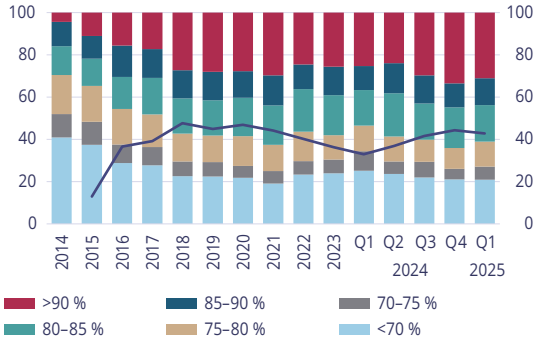
In other countries, macroprudential policy also generally focusses on strengthening the resilience of credit institutions. While current macro-financial conditions are challenging and cyclical risks have not increased significantly across EU countries overall, macroprudential capital buffers are being raised in many places, given the strong financial performance of banks and the benefits of building resilience buffers.

Chart 4.3
Maturity breakdown of new housing loans (in years)



Source: Latvijas Banka and its calculations.

Chart 4.4
LTV breakdown of new housing loans and share of loans granted under the state support programme in new housing loans (%)



Source: Latvijas Banka and its calculations.

An increasing number of EEA countries[84] **have opted for a positive neutral CCyB approach.** In January 2025, the ECB and the ESRB published a review of the early application of the CCyB, including the implementation of a positive neutral CCyB approach[85]. In response to changes in systemic risks, Czechia activated the SyRB in 2024 and early 2025, Denmark and Italy introduced a sectoral SyRB, while Germany and Iceland reduced the level of the SyRB rate. Norway imposed a stricter risk weight requirement for exposures secured by CRE. In the area of borrower-based measures, Bulgaria and Croatia introduced new borrower-based measures, Hungary implemented differentiated LTV and DSTI requirements for loans financing energy-efficient housing, while Norway and Austria slightly eased or simplified existing borrower-based requirements.

[83] The maximum LTV value for loans secured by a mortgage on real estate and a state guarantee in accordance with the Law on Assistance in Solving Apartment Matters is set at 95%.

[84] At the time of preparing the review, the 17 EEA countries were: Cyprus, Czechia, Denmark, Estonia, Spain, Greece, Hungary, Ireland, Iceland, Lithuania, Latvia, the Netherlands, Norway, Poland, Portugal, Sweden, and Slovenia.

[85] *Using the countercyclical capital buffer to build resilience early in the cycle, European Systemic Risk Board and European Central Bank*, January 2025.

Table 4.1
The macroprudential policy measures that are currently in place and effective in Latvia

Measure	Rate	Effective and decision dates
Countercyclical capital buffer; CCyB	0.5% 1%	18.12.2024 18.06.2025 (decision[86] taken on 18.12.2023)
O-SII (other systemically important institutions) capital buffer	Swedbank Baltics AS – 2% ''Swedbank' AS – 2% AS SEB banka – 1.75% AS Citadele banka – 1.50% AS Rietumu Banka – 0.50% BluOr Bank AS – 0.25%	16.12.2024 (decision[87] taken on 09.12.2024) Reviewed on an annual basis
Loan-to-value (LTV) ratio	90% for all consumer credits exceeding 100 minimum wages and secured by a mortgage on real estate	12.06.2007 (amendments to the law[88] were adopted on 17.05.2007).
	95% for loans secured by a mortgage on real estate and a state guarantee in accordance with the Law on Assistance in Solving Apartment Matters	25.09.2014 (amendments to the law[89] were adopted on 18.09.2014)
	70% for buy-to-let housing loans or other housing loans generating income as a result of real estate activities*	01.06.2020 (regulatory amendments[90] were adopted on 27.11.2019) (The Regulation[91] was adopted on 18.12.2023 and took effect as of 01.01.2024)
Debt service-to-income (DSTI) (the total monthly amount of loan payments to financial institutions to the borrower's monthly net income)#	40% 45% for loans for obtaining energy efficient housing**	
Debt-to-income (DTI) ratio#	6 times 8 times to loans issued for the purchase of energy efficient housing**	
Loan maturity limits#	30 years for mortgage loans, 7 years for consumer credits	

#The tolerance margin may not exceed 10% of new loans granted to natural persons in a given quarter.

[86] General Administrative Act No 444/10 of Latvijas Banka "On setting the countercyclical capital buffer rate for exposures applied to residents of the Republic of Latvia at 1%" of 18 December 2023.
[87] The official statement "On the identification and recognition of other systemically important institutions and the determination of the capital buffer rate of another systemically important institution", 12.12.2024.
[88] The Consumer Rights Protection Law.
[89] As provided for in the same law.
[90] FCMC Regulation No 120 "Regulation on Credit Risk Management" of 9 July 2019.
[91] Latvijas Banka's Regulation No 265 "Regulation on Credit Risk Management" of 18 December 2023.

5. Developments and risks in the non-bank financial sector

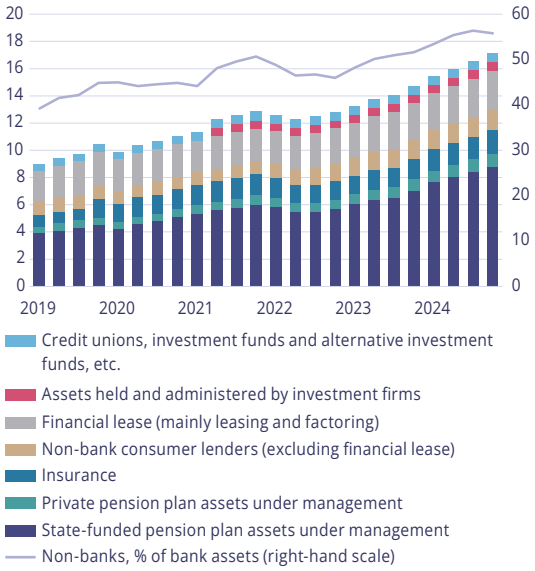
Prepared by Kārlis Ločmelis and Kristīne Petrovska

In 2024, the optimism in financial markets and rising yields contributed to an increase in the assets of sub-sectors of the non-bank savings service providers – the 2nd and 3rd pillar pension plans and insurers. Meanwhile, in 2025, trade wars and geopolitical risks are expected to present further challenges for savings service providers. However, the results of the insurers' market risk stress test suggest that insurers are well positioned to withstand market shocks. As global economic growth remains weak and asset quality deteriorates, investment firms selling securitised loans are becoming increasingly risky. Market optimism, closer ties between the crypto-industry and the financial sector, and expectations regarding the crypto-asset regulation in the EU have increased investors' willingness to buy crypto-assets.

In 2024, the non-bank financial sector continued to grow rapidly. The assets of this sector increased overall by 16.7% compared to 14.6% in 2023 (see Chart 5.1). Higher contributions to pension funds, optimism in financial markets, and rising yields contributed to the growth of the non-bank savings service sub-sectors. The non-bank lending sectors also experienced moderate growth. In 2024, the assets of the non-bank consumer credit service providers increased by 7%, while those of financial leasing companies grew by 6.5% (see the section entitled "Lending development").

The direct interconnectedness of Latvia's non-bank financial sector with Latvian credit institutions remains low. According to Latvijas Banka's financial accounts statistics, in 2024 the assets of the participants of Latvia's non-bank financial sector accounted for 10.5% of the total assets in the structure of assets of credit institutions (12.3% in 2023), while their liabilities made up 10.5% of the total liabilities (10.7% in 2023)[92].

Chart 5.1
Assets of the non-bank financial sector by sub-sector[93] (billions of euro) **and in relation to credit institutions' assets** (%)



Sources: Latvijas Banka's and CSB's statistics and calculations.

The continuity in the availability of non-bank financial sector services in Latvia's financial system is high, since the exit of a market participant would be offset by other participants providing similar services necessary for its functioning. The role of Latvia's non-bank financial sector in the financial industry and economy remains considerably less significant compared to other euro area countries. This is primarily due to the low level of long-term savings of the population, as Latvians have accumulated savings over a shorter period compared to many other euro area countries. Nevertheless, household investment has increased in recent years, including in riskier assets (for more information, see the box entitled "Investment habits of domestic households"). However, the average financial literacy of the Latvian population and businesses (which, for the population, is below the OECD average[94]) is also an important consideration.

[92] Although credit institutions have limited exposures to the non-bank sectors in their consolidated assets, they own the majority of pension managers and financial leasing companies. While credit institutions have limited direct exposure to the risk of a decline in the value of the non-bank financial sector's assets – since this sector does not represent a significant share of the credit institutions' income – the profitability of the non-bank financial sector still affects them indirectly.

[93] The assets of all sub-sectors of the non-bank financial sector are aggregated. There may be instances where one sub-sector has invested funds in another non-bank financial sub-sector; however, such cases are not typical and do not significantly inflate the size of the non-bank financial sector.

[94] For Latvia, 59 points on a 100-point scale, OECD average of 63 points. See OECD (2023), OECD/INFE 2023 International Survey of Adult Financial Literacy, OECD Business and Finance Policy Papers, No 39, OECD Publishing, Paris.

Savings service providers

Household savings for retirement purposes account for the largest share of the non-bank financial sector's assets. At the end of 2024, the funds accumulated under the state funded pension scheme amounted to 51%, while the assets of the 3rd pillar pension scheme made up 5.7% of the total assets of the non-bank financial sector.

The returns on pension savings were strong in 2024, contributing to the recovery of the purchasing power of accumulated funds following the inflation shocks of 2022 and 2023. In 2024, the returns on investment plans of the state funded pension scheme and private pension plans reached 14.9% and 10.5% respectively. The returns on investment plans, whose prospectuses allow up to 100% investment in the shares of pension savings and other risk-equivalent instruments (hereinafter referred to as "shares"), were higher (16.62%), while returns on investment plans not intended for investment in shares were 4.68%. Consequently, the increase in the purchasing power of pension savings participants has not been uniform and may vary significantly depending on whether the participant has invested in an investment plan focused solely on fixed income instruments or in one that invests in shares.

Global stock markets experienced substantial shocks at the beginning of this year. The US government imposed higher import tariffs than expected by financial market participants on a large number of trading partners, but these tariffs were suspended for 90 days shortly after their introduction for most countries. These, and other shocks, weighed on the global economic growth outlook. These events also triggered stock price adjustments and led to a reassessment of the US asset risk premium.

In Latvia's pension investment portfolios, a large portion of the funds has been directed to the North American stock markets. As a result, the largest fall in prices was observed in those investment plans where more than 50% of assets were invested in shares. For the remaining investment plans, the impact of the shock has been more moderate. However, in the group of investment plans that do not include investments in shares, the value of their units has not decreased since the beginning of the year.

Geopolitical developments and risks are expected to continue impacting the global economy and the returns on pension investments. Trade wars, de-globalisation, increased investment in defence, concerns about the sustainability of sovereign debt, military conflicts, and other factors may continue to significantly alter the level of investment risk, reprice risk premiums, change the level of benchmark rates, and reduce the value of investments.

In 2024, the Saeima of the Republic of Latvia adopted a decision to reduce the social contribution rate for the state funded pension scheme. According to the amendments, from 2025 and for a period of four years, the contributions of participants to the state funded pension scheme will be reduced from 6% to 5% of a person's gross remuneration, while the contributions to the 1st pillar pension scheme will be increased from 14% to 15%. These changes will not significantly increase liquidity pressures in the state funded pension scheme, as Latvijas Banka estimates that even with a social contribution rate of 5% of a person's gross remuneration, the incoming contributions in the coming years will exceed the pension capital to be paid out. It should be noted that increasing contributions to the 1st pillar pension scheme will raise the state's obligations under this scheme when individuals retire.

In the second half of 2025, the Ministry of Welfare, in cooperation with the Ministry of Finance, will organise a discussion on potential changes to the state funded pension scheme. The discussion is expected to cover the amount of investment contributions and the possibility of voluntary participation in the state funded pension scheme. Reductions in contributions and, in particular, voluntary participation in the state funded pension scheme can significantly affect the liquidity of its investment plans, their investment structure, and future investments in both global and domestic markets. These changes could also impact the economy and, ultimately, the amount of an individual's pension. Thus, both the benefits and drawbacks of any policy changes to the state funded pension scheme need to be carefully considered.

Investment firms offering securitised credit claims (investment platforms)

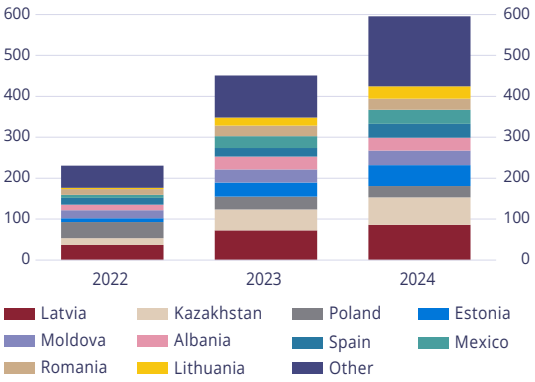
The value of assets managed by investment firms[95] **amounts to 669.8 million euro**, representing a year-on-year increase of 10.1%. The growth was supported by investor optimism, an upswing in the financial market, and the high rates of return offered by investment firms. However, in 2025, the negative sentiment, volatility in financial markets, and elevated uncertainty may deter investors from reinvesting in alternative, high-risk investments offered by Latvian investment firms. Although investment platforms provide investors with access to an alternative investment class, they are not considered systemically important for Latvia's financial system. The income of these platforms largely depends on the flow of securitised credit claims offered, which is directly determined by the economic cycle and investors' willingness to purchase high-risk assets. In addition, investments in effective IT systems contributed to a negative average ROE in the investment firm sector in 2024 (–22.9%). At the same time, investor confidence in the platforms remains high, as customers' non-invested assets consistently remained below 9% of the total assets held at the end of 2024.

Investment platforms in Latvia securitise high-risk consumer loans and sell them primarily to private investors across Europe

Securities from Latvia, Kazakhstan, Poland, Estonia, and Moldova account for the largest share of credit claims (loans) securitised in Latvia (see Chart 5.2). The distribution of the countries of origin of credit claims has not changed significantly since the end of 2022. It is dominated by countries where consumer protection, especially in consumer lending, is lower than in Latvia, posing increased risks. The majority (73.7%) of securitised loans are consumer loans to households.

The quality of securitised loans is gradually declining. At the end of 2024, 7% of the outstanding securitised loan portfolio was more than 30 days past due (4.6% at the end of 2023). Of the loans past due over 30 days, 30.5% did not have a buyback guarantee (9% at the end of 2023). It is important for investors to assess whether significant solvency issues faced by the original borrowers could lead to solvency problems for the original lender, as in this case the guarantee may no longer be valid or may become enforceable only through legal proceedings.

Chart 5.2
Initial credit risk country distribution of securitised credit claims from 2022 to the end of 2024 (millions of euro)



Source: Latvijas Banka's statistics and calculations.

Securities statistics maintained by Latvijas Banka suggest that credit claims securitised in Latvia have been acquired mainly[96] by private (household) investors from Germany, Latvia, Spain, Czechia, and the Netherlands (the concentration of investors from these five largest investor countries accounted for 64.7% of the total outstanding amount at the end of 2024). The high concentration of investors has remained unchanged in recent years. If the sentiment of investors in a particular country shifts, it poses a potential vulnerability to the business model of the platforms.

Securitised credit claims entail a number of risks. The most significant risks are the guarantee risk and the liquidity risk. Other important risks are the credit risk and its proper assessment, the risk of legal loopholes, particularly in cross-border (non-EU) activities, the currency risk, the servicer risk related to the management of the securitised loan portfolio, and the originate-to-distribute risk. The sanctions risk also cannot be ruled out.

Insurance corporations

The polarisation of business sustainability between the life and non-life insurance segments is becoming more pronounced. Non-life insurers are succeeding in developing their business by both increasing

[95] Given that 99.3% of the total assets managed by the sector are held by investment platforms with investment brokerage licences, the term ''investment firms'' will refer to investment platforms in the section below.

[96] Households owned 83.7% of the investment portfolio (as at the end of 2024).

premiums and expanding business lines (such as health insurance), as well as by reducing losses from climate catastrophes through reinsurance. Meanwhile, life insurers are losing competitiveness to other types of investments, even amid continued investors' optimism in financial markets. On the one hand, high uncertainty and increased investor caution pose significant challenges for the life insurance sector. On the other hand, the rising purchasing power of the Latvian population and the growing importance of insurance in reducing (climate) losses support the development of the non-life insurance sector. These opposing factors are expected to continue shaping the development of the insurance sector. Meanwhile, insurance corporations continue to maintain high solvency capital ratios (SCR)[97] (see Chart 5.4).

In 2024, the favourable financial market conditions, along with the purchase of securities with higher interest rates, allowed insurance corporations to achieve positive returns on both assets and investments (see Table 5.1).

Table 5.1
Key indicators of insurance corporations

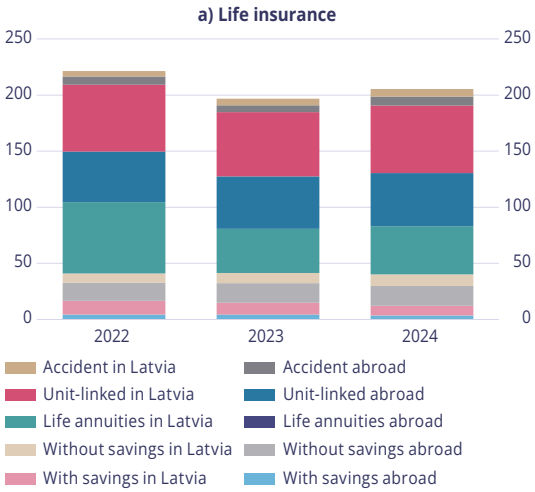
Indicator	2022	2023	2024
Assets (millions of euro)	1391.8	1546.1	1 715.8
Profitability of life insurers (assets) (%)	1.0	0.8	2.2
Profitability of non-life insurers (assets) (%)	3.0	4.9	4.9
Return on investments of life insurers (%)	–33.2	5.0	5.5
Return on investments of non-life insurers (%)	0.5	1.6	2.2

Source: Latvijas Banka's statistics and calculations.

Life insurance premiums written resumed some growth in 2024, increasing by 4.4% compared to 2023, although still lagging behind the level recorded in 2022 (see Chart 5.3, panel (a)). By comparison, life insurance premiums written in the EEA rose by 14.4% in the first half of 2024[98]. Although life annuities grew by 9% compared to 2023, their level in 2024 still remained below that of 2022. **Currently, claims paid in life insurance with savings product are 2.23 times higher than the amount of premiums written. This raises further concerns about the sustainability of this line of business.** With more profitable investment alternatives available, the attractiveness of life insurance products with an investment component (such as accumulative life insurance and unit-linked life insurance) significantly declined in the eyes of consumers.

The amount of non-life insurance premiums written increased by 15.8% in 2024 (see Chart 5.3, panel (b)) **driven by continued cost pass-through to consumers and growth in health insurance.** Property insurance premiums continued to grow in 2024 (+13%) due to both the revaluation of coverages and the pricing-in of flood risk following the July 2024 floods.

Chart 5.3
Annual premiums written by Latvian insurance corporations and branches of foreign insurance corporations[99] (millions of euro)



Source: Latvijas Banka's statistics and calculations.

Rapid price increases affect consumers' ability to purchase property insurance, which in turn **contributes to vulnerability to climate change** and catastrophes. The storm and floods in July 2024[100] highlighted weaknesses in catastrophe insurance: unclear contract terms in flood-related cases led to numerous disputes between insurers and customers. This prompted a reassessment of risk modelling and product design practices. Several companies paid out indemnities in excess of

[97] The available ratio of equity to the solvency capital requirement. The calculation of the solvency capital requirement is based on the assessment of all the risks an insurance corporation is exposed to, including the assessment of the insurance underwriting risk, market risk, credit risk, and operational risk. Each risk module is calibrated according to the VaR method, using a 99.5% confidence level over a one-year time horizon; see Latvijas Banka's Regulation No 376 "Regulation on calculating the insolvency capital requirement and own funds of insurance undertakings, reinsurance undertakings and branches of foreign insurance undertakings".

[98] *EIOPA Financial Stability Report*, December 2024.

[99] Premiums written abroad include both premiums written by foreign branches of Latvian insurance corporations and those written according to the principle of freedom to provide services.

[100] "The storm experienced at the end of July was the strongest summer storm in the history of Latvian observations", lsm.lv, 02.08.2024.

the original insurance cover to preserve customer trust and protect their own reputation. For a long time, the practice of covering uninsured risks within policies has undermined the sustainability of the business. In a survey on the insurance protection gap resulting from natural catastrophes, EIOPA concluded that the gap in Latvia is currently smaller than the potential average, although it remains above the current EEA average[101]. At the same time, 30% of the Latvian population would rely on the state to cover catastrophe losses – nearly twice the EU average (16%)[102].

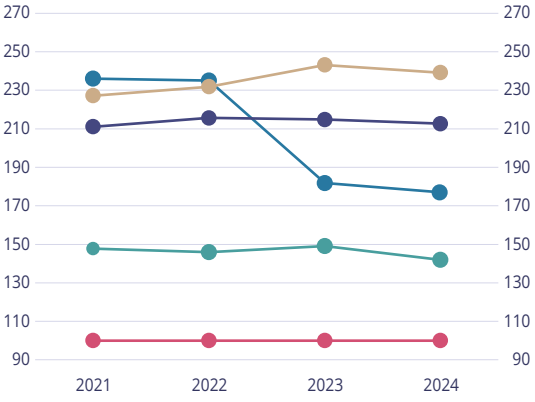
Cross-border activities are important to Latvian insurance corporations, as is the case for insurance corporations in other small markets, since they help diversify and manage risks and promote profitability. At the end of 2024, the share of non-life insurance premiums written abroad in the total amount of premiums written was 34%, remaining relatively stable for several consecutive years, while that of life insurance premiums written abroad made up 33.4%, reflecting a decrease of 3.7 percentage points.

The biggest risks to the future activities of insurance corporations in Latvia stem from the purchasing power of consumers and economic growth (which may lead to the abandonment of non-compulsory insurance services), fluctuations and uncertainty in financial markets, as well as acute climate shocks (catastrophes).

According to EIOPA's assessment, the main **systemic risks for the insurance sector at the EU level** include geopolitical tensions and climate change, uncertainty in the economy and financial markets, the risk of investment revaluation (including in less liquid assets), insurance underwriting profitability risk[103], cyber risk, as well as the overall risk of economic growth[104].

At the same time, the ability of insurance corporations to absorb potential shocks remains good, as their solvency capital ratios remain high (see Chart 5.4), with none of the insurance corporations using exemptions under the regulation[105] to improve the solvency capital ratios. Even after the catastrophic floods in July 2024, the SCR remained high for non-life insurers. The small decrease in the SCR of Latvian life insurance corporations can be attributed to the payment of accumulated profits from previous years. Also, modelled market risk stress test shocks do not lead to a significant decline in insurers' solvency ratios (for more information, see the box entitled "Insurers' investment market risk stress test – a new tool for resilience analysis").

Chart 5.4
Solvency capital ratio (SCR) of Latvian and EEA insurance corporations (%)



* Data at the end of the second quarter of 2024.

Source: Latvijas Banka's statistics and calculations.

The risks, particularly those related to climate catastrophes, are somewhat alleviated by using reinsurance. In 2024, reinsurance accounted for 16.8% of compensation payments in non-life insurance[106] and 0.7% in life insurance[107].

[101] For EEA floods, the current gap is estimated at 1.5 (on a 5-point scale), while for Latvia it is 2. It is 1 for storms in the EEA and 1.5 for Latvia (EIOPA notes that scores below 3 indicate an insignificant gap). However, unlike the EEA, where historically 20% of losses have been insured, Latvia's data show that only 5% of losses have been insured. This reduces risks for insurers but exerts pressure on national and local budgets. *Dashboard on insurance protection gap for natural catastrophes*, EIOPA.

[102] *Graphic presentation Fash Eurobarometer Consumer trends in insurance and pension services*.

[103] The insurance underwriting profitability risk refers to the risk that an insurer sets premiums improperly, resulting in compensation payouts exceeding the premiums written. For example, inflation is leading to an unpredictable rise in the compensation costs, while the revision of premiums is constrained by competition and the duration of the contracts concluded.

[104] *Financial Stability Report December 2024*, EIOPA.

[105] Exemptions cover, for example, the long-term guarantees measures, including the volatility adjustment and the matching adjustment of the long-term risk-free interest rate used to discount the technical reserves. These exemptions are used by insurers in Germany and, to a lesser extent, in France. For more information, see *EIOPA, 2020. Report on long-term guarantees measures and measures on equity risk 2020*.

[106] Due to the catastrophic floods in July 2024, the reinsurer's share of compensations paid increased to 18.1%. This clearly indicates that Latvia, as a small country, relies on reinsurance to cover extraordinary losses.

[107] The low proportion of reinsurance is attributable to the fact that investment risks are primarily borne by the insured rather than the insurance corporation.

Box 5.1. Insurers' investment market risk stress test – a new tool for resilience analysis

Prepared by Kristīne Petrovska and Jānis Strazdiņš

Given the growing importance of the insurance sector within the financial industry and the prevailing instability in financial markets, Latvijas Banka is developing its own set of analytical tools to assess the resilience of Latvian insurers to (financial) market shocks.

The insurers' investment market risk stress test was established on the basis of a similar market risk stress test method applied to credit institutions (for more information, see Chapter 3) and was supplemented by an additional solvency capital requirement[108], arising from the decline in the value of insurers' investment portfolios.

Methodology

The decline in the portfolio value resulting from a significant but plausible market shock over a one-month period

The stress test is applied to insurers' securities portfolios, i.e. equity securities, fixed income securities, and fund units. Securities outside the public market that are subject to an equivalent stress scenario are also included.

The investment portfolio data of each individual insurance corporation are used, including the ISIN code of each instrument, its market value and its value under the Solvency II[109] regulation, the instrument category, and the modified duration indicator. The securities in the bond portfolio are grouped according to the key risk factors identified through expert judgement, following the same principle used in the market risk stress test for credit institutions.

The size of the stress scenario shock (see Table 5.2) is primarily determined based on historical monthly changes in the relevant market index for each risk factor (using market data since 2006), assuming a static distribution of the existing portfolio. Historical monthly changes are also used to estimate changes in stock values (using a stock exchange index), while changes in historical net assets are used for funds with sufficiently long historical data series. Meanwhile, for funds lacking sufficient data, the average changes observed in funds with sufficiently long data series are used. The 1% of cases, or months with the largest estimated hypothetical losses in the insurers' total portfolio, are calculated. The average values of the identified cases are used as parameters for the shock scenario. In addition, a prolonged stress scenario is developed in which, following the principle described above, the changes over the previous 12 months are aggregated for each month, and the 1% of cases, i.e. months with the highest estimated accumulated losses, are selected. This scenario simulates a prolonged shock or crisis in financial markets, resulting in a more significant impact on the value of financial instruments.

Table 5.2
Parameters of the market risk stress test under the stress scenario

	Shock value for yields (in basis points)	
	Stress scenario	Prolonged stress scenario
EUR benchmark rates (1 month–10 years)	–40 to 30	–118 to –54
USD benchmark rates (1 month–10 years)	–80 to 0	–341 to –80
Investment grade risk premium	70 to 170	178 to 636
High yield risk premium	110 to 230	–1 126 to 1200
	Shock value for the price	
Stock index shock	–11.5%	–49.4%
Average fund shock	–5.40%	–12.1%

Avots: Latvijas Banka's calculations.

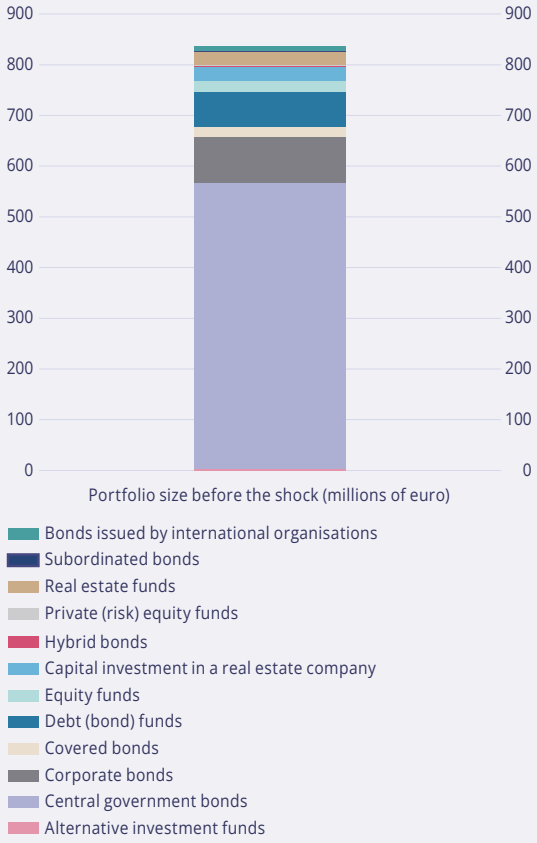
[108] The additional solvency capital requirement reduces insurers' voluntary capital buffers. The solvency capital requirement for insurers necessitates an increase in own funds if, following a shock, the voluntary capital buffers decrease significantly, and the solvency ratio falls below the minimum permissible level.

[109] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

The group of entities subject to the stress test **includes insurance corporations licensed in Latvia**: two life insurance companies and four non-life insurance companies. Only the resilience of the portion of the investment portfolio not linked to life insurance with savings or indices (i.e. only the part of the investment portfolio where the insurance corporation itself bears the risk) is assessed. Real estate loans or loans intended for real estate development are excluded from the assessment.

At the end of 2024, the investment portfolio subject to the stress test amounted to 836.35 million euro. The government bonds (mainly from the EU Member States) accounted for 68.9% of the total portfolio (see Chart 5.5). By currency, 91.1% of the portfolio was denominated in euro, 5.9% in Polish zlotys, 2.3% in Danish kroner, 0.5% in US dollars, and 0.2% in other currencies. Meanwhile, by country, the portfolio was distributed as follows: 94.6% of the portfolio was invested in the EU (including 19.2% in Latvia, 10.6% in Luxembourg and Ireland combined), 1.6% in the US, and 3.8% in the rest of the world.

Chart 5.5
Structure of the investment portfolio of insurers at the end of 2024 (millions of euro)



Sources: Latvijas Banka's supervisory statistics, Latvijas Banka's calculation.

Additional capital requirements resulting from a decline in the value of investments

Additionally, required capital is assessed only within the equity and spread risk modules[110; 111; 112]. If the decline in the value of a given investment caused by a market shock exceeds the amount of capital required under supervisory requirements[113], the excess amount leads to the calculation of additionally required capital (i.e. the additional solvency capital requirement).[114] This, in turn, reduces the voluntary capital buffers.

The results of the calibration suggest that the market risk shock typically does not exceed the shocks priced in the equity risk module, as the shock modelled by Latvijas Banka covers only a one-month horizon and, therefore, the resulting decline in the value is relatively small. In addition, the equity risk module also incorporates a liquidity component (the risk of price haircuts when assets are sold). By contrast, the particularly low capital requirements set under the spread risk module for certain investment grades, such as the short-term covered bonds, result in the need for additional capital following a market risk shock.

110 Each risk module represents a material group of risks that may affect the financial position of the insurance undertaking, such as the market risk module, the life insurance underwriting risk module, the insurance underwriting risk module, etc.
111 The currency risk module is not subject to an individual stress test, as insurance corporations generally do not hold significant currency positions (exceeding 10% of the investment portfolio), or such positions are offset by their business models (where income-generating assets cover potential liabilities from insurance operations conducted in foreign currencies).
112 Possible changes in interest rates and ratings are not assessed separately, partly also because typical rating changes occur over a longer time frame than the one-month period following the shock. At the same time, financial markets often price in possible rating changes in advance, and these haircuts are already reflected in the market shock values. In a prolonged stress scenario alone, fewer than five investments would experience a rating downgrade (based on historical data), resulting in an increase in the additional solvency capital requirements. The additional solvency capital requirement would increase by 0.07 million euro, which is considered immaterial.
113 The capital required by the supervisory requirements was calibrated in accordance with the technical standards for calculating the capital requirements under Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).
114 Changes in interest rates and investment ratings are not measured separately, as the shock period is limited to just one month (it is assumed that such changes are already reflected in the instrument price shock under a prolonged stress scenario; however, the additional solvency margin from potential rating changes is not considered). The calculation also does not take into account the effect of diversification, which reduces the required solvency margin.

When assessing the results of the calibration under a prolonged stress scenario, a larger decline in the value of investments than that envisaged in the spread risk module can be observed more frequently, resulting in the need for an additional solvency capital requirement. The most significant positions include investments in real estate, shares, covered bonds, and corporate bonds.

Results

The drop in the value of the investment portfolio under the stress scenario amounts to 45.9 million euro or 5.3% of the portfolio size. However, the solvency capital requirement would need to increase by 2.5 million euro, while the solvency ratio of the sector would fall by only 1.74 percentage points on average, reaching 149%. In the case of a prolonged stress scenario, the drop in the value of the investment portfolio amounts to 122 million euro or 14.2% of the portfolio size. The additional solvency capital requirement would need to increase by 29 million euro, while the solvency ratio of the sector would decrease by 17.67 percentage points on average, reaching 133.1%.

Given that the investment portfolio of insurers mainly consists of EU government bonds, the losses caused by the shock and the additional required capital requirement are also small (see Table 5.3). In addition, the solvency ratio also remains high even after the shock. The additional solvency capital requirement mainly arises from covered bonds with very minimal supervisory requirements, as well as debt investment funds (see Table 5.4). For capital investments, the shock level does not exceed what is already foreseen in the solvency requirements; therefore, no additional capital requirement is needed.

Table 5.3
Aggregated results of the market risk stress test

Indicator	Stress scenario value	Prolonged stress scenario value
Estimated losses (millions of euro)	45.9	122
Additional required capital[115] (millions of euro)	2.5	29
Solvency ratio following the shock	149%	133.1%
Decrease in the SCR due to the shock (in percentage points)	–1.74	–17.67

Source: Latvijas Banka's calculations.

[115] The drop in the value exceeds the amount of capital required by supervisory requirements, resulting in a reduction of the existing capital reserve.

Table 5.4
Stress test results by investment type

Stress scenario

Type of investment	Investment value before the shock (millions of euro)	Estimated losses due to the market risk shock (millions of euro)	Market risk (% of the portfolio)	Additional capital requirement (millions of euro)	Additional capital requirement (% of the investment value)
Alternative investment funds	0.03	0.00	–5.4	0.000	0.0
Central government bonds	566.85	–27.07	–4.8	0.239	0.0
Corporate bonds	90.62	–2.93	–3.2	0.286	0.3
Covered bonds	21.04	–1.86	–8.8	1.120	5.3
Debt (bond) funds	67.55	–3.67	–5.4	0.899	1.3
Equity funds	22.34	–1.22	–5.4	0.000	0.0
Capital investment in a real estate company	28.29	–3.24	–11.5	0.000	0.0
Hybrid bonds	2.16	–0.22	–10.1	0.000	0.0
Private (risk) equity funds	0.14	–0.01	–5.4	0.000	0.0
Real estate funds	26.51	–1.42	–5.4	0.000	0.0
Subordinated bonds	1.68	–0.12	–6.9	0.000	0.0
Bonds issued by international organisations	9.15	–1.24	–13.6	0.000	0.0

Prolonged stress scenario

Type of investment	Investment value before the shock (millions of euro)	Estimated losses due to the market risk shock (millions of euro)	Market risk (% of the portfolio)	Additional capital requirement (millions of euro)	Additional capital requirement (% of the investment value)
Alternative investment funds	0.03	0.00	–12.1	0.000	0.0
Central government bonds	566.85	–69.90	–12.3	2.283	0.4
Company shares	25.20	–12.46	–49.4	6.859	27.2
Corporate bonds	90.62	–5.36	–5.9	4.319	4.8
Covered bonds	21.04	–6.05	–28.8	5.313	25.3
Debt (bond) funds	67.55	–6.34	–9.4	2.351	3.5
Equity funds	22.34	–1.61	–7.2	0.000	0.0
Capital investment in a real estate company	28.29	–13.98	–49.4	7.464	26.4
Hybrid bonds	2.16	–0.96	–44.6	0.332	15.4
Private (risk) equity funds	0.14	–0.02	–12.1	0.000	0.0
Real estate funds	26.51	–3.20	–12.1	0.000	0.0
Subordinated bonds	1.68	0.50	29.7	0.083	4.9
Bonds issued by international organisations	9.15	–2.61	–28.5	0.000	0.0

Source: Latvijas Banka's calculations.

Conclusions

In the short term, the investment portfolio of insurers is resilient to market shocks, as existing capital requirements oblige insurers to withstand larger and longer-term shocks, including liquidity shocks, while the portfolio itself is relatively geographically diversified. In the long term, the portfolio of insurers incurs significant losses, which could create an incentive to sell investments at a loss to avoid a reduction in equity resulting from additional solvency requirements.

Crypto-assets

Latvian households also moderately increased their transfers to crypto-asset wallets, following the growth of the crypto-asset market in 2024. Investments are primarily made by young people with higher incomes[116].

Data from a survey conducted in February 2025 show a slight increase in the number of people investing in crypto-assets (9%[117]). The growing popularity is driven both by the new US government's initially positive stance on crypto-assets, which contributed to an increase in their market capitalisation, and by the entry into force of the EU Regulation on crypto-assets and the provision of a new supervisory framework for the EU market[118].

This is also reflected in the data on payments made by Latvia's residents to holders of crypto-asset wallets with payment cards issued-by Latvian credit institutions[119]: in 2024, the total value of such payments was 7.3% higher than in 2023, reaching 45.8 million euro (see Chart 5.6). The sharp decline at the end of 2023 and the beginning of 2024 can be explained by the reluctance of households to invest during periods when the sector is hit by scandals[120].

Payments to Lithuania, accounting for 56.8% of the total number, continue to dominate. This is due to the activity of the popular crypto exchange Binance in the neighbouring country and the openness of various payment institutions to cooperate with the holders of crypto wallets. The share of on-site payments remains low (1.4%), suggesting that the use of crypto-asset

[116] According to the results of a survey conducted by Latvijas Banka and SIA Latvijas Fakti.

[117] According to the results of a survey conducted by Latvijas Banka and SIA Latvijas Fakti (7% in 2024).

[118] For more information, see the section entitled "Crypto-assets. Licensing".

[119] For more information on the methodology and calculations, see K. Petrovska's article entitled "Prevalence of crypto-assets in Latvia: the first steps of evaluation", www.macroeconomics.lv, 30.12.2021.

[120] For more information, see K. Petrovska's article entitled "A record fine on a crypto-asset exchange scares holders of crypto-assets also in Latvia", www.macroeconomics.lv, 22.01.2024.

ATMs is not popular in Latvia. The average payment amount also continues to stabilise: 50% of payments are up to 60 euro, while 70% are up to 100 euro.

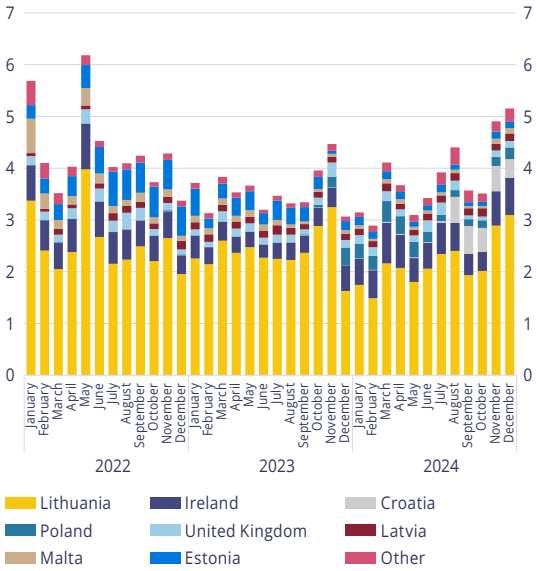
It is essential for Latvijas Banka to monitor the extent to which people invest in crypto-assets through financial instruments such as exchange traded funds and other types of securities, as this allows for the assessment of links between traditional financial markets and high-risk assets. Such links may amplify the transmission of volatility to the financial system and influence the behaviour of investors, particularly in the event of rapid market adjustments.

Therefore, to at least partially identify how the Latvian financial sector, households, and private non-financial enterprises have invested in financial securities with income linked to the crypto-asset market, the Securities Statistics Database maintained by Latvijas Banka – which reflects the share of such investments made through Latvian financial institutions – was used[121].

Such investments are gaining popularity in Latvia, reaching a balance of 2.3 million euro at the end of 2024 (see Chart 5.7; the increase in their balance is only partly explained by the significant rise in the prices of crypto-assets). The Latvian non-bank financial sector has also started investing in these types of assets. A more detailed look at the investments suggests that **direct holdings of crypto-assets through trusts, shares in crypto-asset mining companies, and investments in other crypto-asset firms** are the most common.

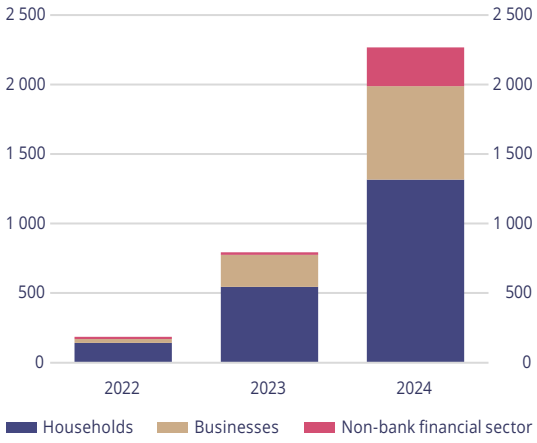
The main risks in the crypto-asset market include ill-considered consumer investments in risky or fraudulent assets, growing links between crypto-asset companies and supervised financial sector participants, high concentration among service providers (leading to potential abuse of market power), and involvement in money laundering and other illegal activities.

Chart 5.6
Payments made with payment cards issued by Latvian credit institutions by country of the crypto-wallet holder's account (amount; millions of euro)



Source: Latvijas Banka's data and calculations.

Chart 5.7
Investments by Latvian economic sectors through Latvian financial institutions in securities of crypto-asset companies from 2022 to 2024 (balance; thousands of euro)



Sources: Latvijas Banka's statistics on securities held by Latvian financial institutions, Latvijas Banka's calculations.

[121] For more information on the methodology, see K. Petrovska's article entitled "How common are financial products that provide investment in crypto-assets in Latvia?", www.macroeconomics.lv, 22.01.2025.

Appendix 1. Risks to Latvia's financial stability arising from high geopolitical tensions, fragmentation, and uncertainty

Prepared by Andrejs Semjonovs and Velga Ozoliņa

Global economic development and the financial sector are increasingly affected by heightened geopolitical tensions, fragmentation, and uncertainty. Given their wide-ranging impacts on the financial system, these aspects may pose a threat to its stability. Risks to Latvia's financial stability are mitigated by several factors: the limited direct exposure of credit institutions to the epicentres of geopolitical tensions, the low share of securities held by credit institutions in total assets, and the credit institutions' high profitability, capitalisation, and liquidity.

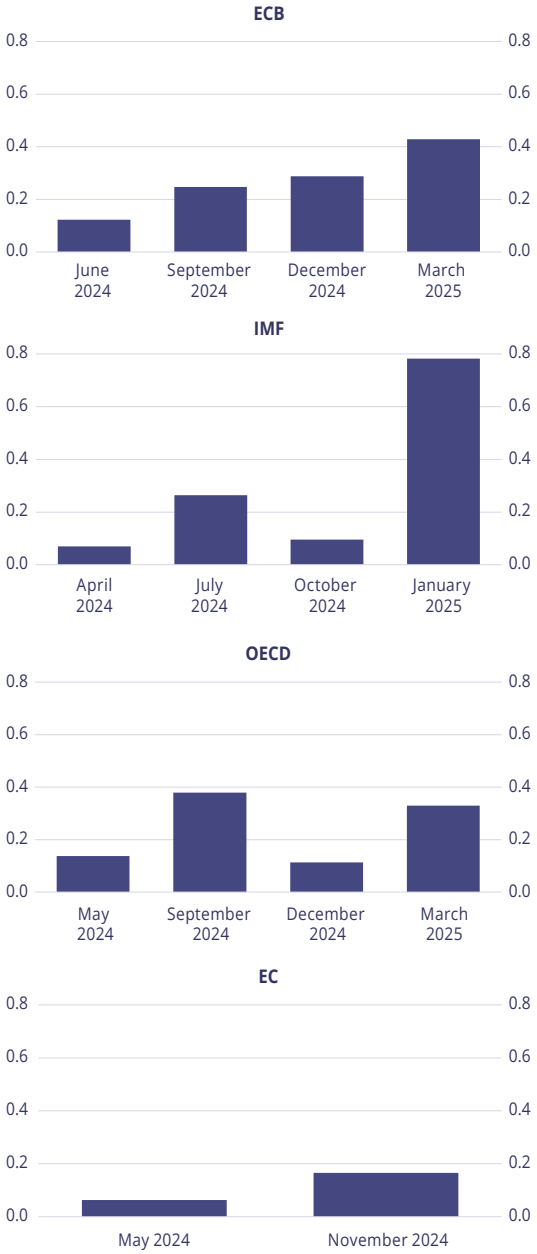
Geopolitical tensions, fragmentation, and uncertainty. Recent developments in the global and euro area context

In 2025, economic development and the functioning of the financial sector both globally and within the euro area are increasingly affected by escalating geopolitical fragmentation and tensions, as well as the heightened uncertainty they generate. The economic outlook for the world and the euro area in 2025 increasingly reflects the evolving geopolitical landscape, associated uncertainties, and their implications (Chart A1.1).

In recent years, alongside analyses of the financial sector, financial stability reports have significantly increased their focus on geopolitical issues and their impacts (Chart A1.2). Since 2014, reviews have increasingly incorporated insights on geopolitical issues, initially focusing on the conflicts between Russia and Ukraine and developments in the Middle East, followed by the US-China trade war (2018–2019), and Brexit (2016–2020). Geopolitical aspects have been particularly emphasised since 2022, as geopolitical risks became global. This was marked by Russia's full-scale war in Ukraine, escalating conflicts in the Middle East, upcoming major elections in several countries, heightened trade tensions between the US, China, and the European Union, and rising tensions in other regions. This growing focus on geopolitics has also

Chart A1.1

Representation of geopolitical risks and uncertainty in the forecast reports of various institutions, and the share of keywords *geopolitic and *uncertain** in the total word count of each institution's forecast reports (%)**



Sources: Forecast reports of the relevant institutions and Latvijas Banka's calculations.

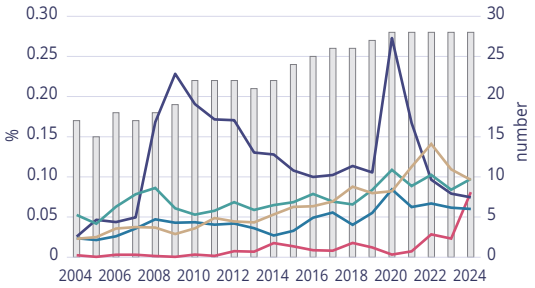
intensified attention to associated uncertainties and shocks.

Financial stability reports complement risk analysis with an assessment of vulnerabilities. The frequency of vulnerability analysis exhibited an upward trend until 2022. The pronounced increase followed by a decline in recent years was primarily driven by fluctuations in energy and other prices associated with geopolitical events.

The Geopolitical Risk Index[122] further underscores the increased significance of geopolitical risks globally, with values since 2022 largely surpassing historical averages (Chart A1.3, panel a). Conflicts, or the threat thereof, have become significant factors exerting direct or indirect impacts on the economies and financial sectors of both the countries involved and their partners.

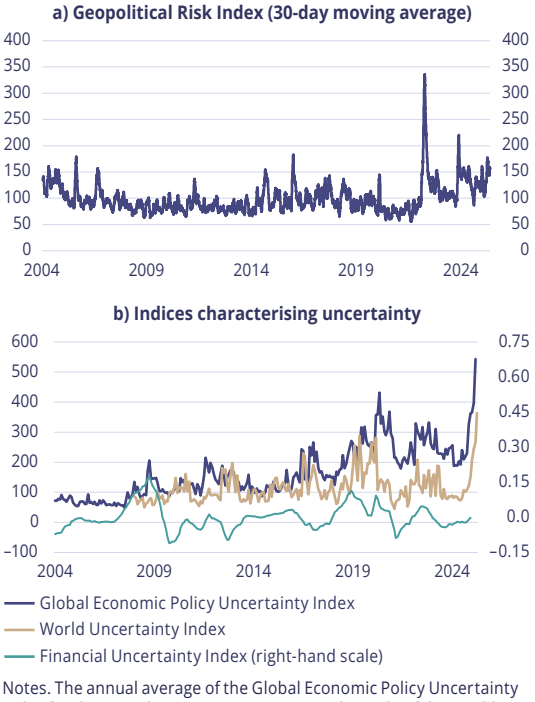
Global indices at the start of 2025 also indicate elevated uncertainty (Chart A1.3, panel b), **largely driven by political developments in the US**. The Global Economic Policy Uncertainty Index[123] has exhibited its highest values to date during the early stages of the COVID-19 pandemic and the Russia-Ukraine war. At the beginning of 2025, the World Uncertainty Index[124] exceeded the level of uncertainty observed during Brexit and the peak periods of the COVID-19 pandemic. Financial uncertainty[125], however, rose most sharply during the global financial crisis. Notable increases were also recorded during the heightened trade tension of 2019, Brexit, the COVID-19 pandemic period, and the early stages of the Russia-Ukraine war. Uncertainty levels rose again at the end of 2024.

Chart A1.2
Presentation of geopolitical risks, uncertainty, and vulnerabilities in financial stability reports



Notes. Geopolitics-related keywords searched for in financial stability reports[126] are *geopolitic**, *fragment**, and *trade war*, crisis-related keywords are *crisis* and *downturn*, the uncertainty-related keyword is *uncertain**, the shock-related keyword is *shock**, and the vulnerability-related keyword is *vulnerab**.

Chart A1.3
Global trends in geopolitical risk and uncertainty indices



Notes. The annual average of the Global Economic Policy Uncertainty Index for the period 1997-2015 is set at 100. The scale of the World Uncertainty Index has been adjusted (the original values have been scaled by dividing them by 200). The Financial Uncertainty Index captures year-on-year changes over a 12-month horizon.

Sources: Geopolitical Risk Index, Global Economic Policy Uncertainty Index, World Uncertainty Index, and Macro and Financial Uncertainty Indexes.

[122] The Geopolitical Risk (GPR) Index, developed by Caldara and Iacoviello, reflects the share of articles reporting negative geopolitical events across 10 leading English language newspapers from around the world, including the *Chicago Tribune, The Daily Telegraph, Financial Times, The Globe and Mail, The Guardian, Los Angeles Times, The New York Times, USA Today, The Wall Street Journal*, and *The Washington Post*.

[123] The Global Economic Policy Uncertainty Index, compiled by Baker, Bloom, and Davis, is a GDP-weighted average of 21 countries representing various world regions. For each country, the index reflects the proportion of national media articles containing keywords related simultaneously to the economy, politics, and uncertainty.

[124] The World Uncertainty Index, developed by Ahir, Bloom, and Furceri, is constructed as a GDP-weighted average of 71 countries (monthly data) or 142 countries (quarterly data). For each country, the index measures the frequency of uncertainty-related terms in the Economist Intelligence Unit's quarterly country reports.

[125] The Macro and Financial Uncertainty Indexes, developed by Jurado, Ludvigson, and Ng, are calculated using a comprehensive set of financial indicators.

[126] Financial stability reports in English published by the central banks of the ECB, EIOPA, Austria, Belgium, Croatia, Czechia, Denmark, Estonia, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom.

Impact of geopolitical tensions, fragmentation, and uncertainty on financial stability

Chart A1.4

Geopolitical tensions, fragmentation, and resulting uncertainty. Channels through which they affect financial stability

Sources: Latvijas Banka, ESRB, ECB.

Geopolitical fragmentation and tensions, together with the resulting uncertainty, can exert wide-ranging effects on the financial systems of the euro area and Latvia through several channels (Chart P1.4). Moreover, the channels of influence are interrelated, for instance, shifts in financial conditions can affect economic activity.

1. Financial intermediation

Cyber-attacks and other large-scale, unexpected disruptions to financial intermediation, driven by geopolitical tensions, continue to pose a systemic risk to the stability of Latvia's financial sector. Such attacks and disruptions may pose a threat not only to cyberspace but also to the security of the information and physical infrastructure. Their impact can be amplified by interconnections among financial institutions, including dependencies on parent banks and developments in their home countries, as well as by a potential loss of confidence in the affected financial sector entity during times of threat.

The availability and development of AI tools in Europe may heighten exposure to geopolitical risks, given that the majority of AI models are developed outside Europe. Major AI models have been predominantly developed in the US, with European countries holding the second position until 2022, after which China overtook them in 2023[127]. In 2024, 40 new AI models were developed in the US, 15 in China, and only 3 in Europe (all in France). This trend may lead to Europe's increased long-term reliance on third countries for advancing cyber resilience.

2. Access to finance and financial conditions

Under conditions of geopolitical tensions, risks of sudden changes in access to finance and financial conditions have increased, including the risk of a sharp repricing of certain assets. This is vividly exemplified by the significant volatility observed in global stock and bond markets following the US government's import tariffs announcements. With uncertainty and tensions remaining elevated, the risk of further substantial market fluctuations persists.

Geopolitical tensions and heightened political uncertainty can raise financing costs for countries, financial institutions, and therefore also for NFCs and households, especially in countries with high debt levels and large budget deficits. According to De Nederlandsche Bank's assessment[128], in countries with high public debt, the sovereign bond risk premium – and thus overall funding costs – can be several times higher than in low-debt countries when uncertainty increases or geopolitical shocks occur. Banco de España also mentions continued uncertainty as a factor in the increase in the cost of funding for the banking

[127] The 2025 AI Index Report, Stanford University.

[128] Financial Stability Report – Autumn 2024, De Nederlandsche Bank.

sector[129]. **High levels of public debt and deficit may also exacerbate geopolitical risks, as the government has limited scope to provide support in the event of economic shocks.**

3. Availability of strategic products and progress towards climate objectives

With increasing geopolitical fragmentation, the vulnerability of European countries to import dependencies on strategic products, including critical raw materials, is becoming more important. According to Banco de España[130], EU imports 40% of its highly dependent strategic product categories[131] from China and, in value terms, 63% of EU imports are from outside the EU. 70% of these imports originate from countries with political stances differing from the EU, thereby heightening the vulnerability of these imports to geopolitical risks. For instance, a significant proportion of the surveyed producers in Italy, Spain, and Germany that import critical raw materials from China acknowledge the challenges in substituting these imports with raw materials from other countries. **Significant disruptions in the supply of these raw materials and products can lead to greater volatility in growth, inflation, and financial markets in both Latvia and the wider European region.**

Geopolitical fragmentation in climate matters weakens global efforts to mitigate climate change and, consequently, heightens future financial stability risks. The climate policy decisions[132] made thus far by the newly elected US administration, coupled with the growing uncertainty and indecisiveness among several other major global economies[133] regarding the implementation of medium-term climate objectives, significantly elevate the risks associated with the climate transition. This may weaken adaptation to climate change, thereby contributing to potential systemic vulnerabilities[134] in the financial sector.

4. Economic activity and economic confidence

Geopolitical fragmentation, tensions, and the related uncertainty can undermine economic development and erode business confidence, thereby threatening financial stability. The financial situation of export-based NFCs may deteriorate, hampering overall economic growth. This could lead to a weakening labour market, fluctuations in energy and consumer prices, and diminished consumer and investor confidence. Consequently, borrowers' credit risk may increase, impairing the profitability and liquidity of credit institutions.

Exposure of the Latvian financial system to risks arising from geopolitical tensions

According to the 2024 Annual Report[135] of Latvia's Constitution Protection Bureau, European countries are facing escalating threats from sabotage, diversion, and physical attacks orchestrated by Russian intelligence and security services, and this trend intensified notably in 2024. Latvia's cyber threat landscape has been assessed as elevated but stable.

Amid geopolitical tensions and rapid AI-driven cyber evolution, the likelihood of cyberattacks and other large-scale disruptions in Latvia remains high. According to the assessment provided in the Annual Report 2024[136] of the State Security Service, the rapid development of AI tools is likely to drive a surge in phishing[137] campaigns and significantly bolster social engineering[138] efforts. Disinformation has also been identified as a major short-term (2-year) risk by the World Economic Forum in its Global Risks Report

[129] Financial Stability Report. Spring 2022, Banco de España.
[130] Financial Stability Report. Autumn 2024, Banco de España.
[131] Products critical to defence, healthcare, or the green and digital transitions, which are highly concentrated in imports and thus heavily dependent on a few non-EU suppliers not widely available within the EU, and whose absence could not be replaced with EU exports. They also include critical raw materials.
[132] Including the freezing of federal funding for several sustainability projects and the withdrawal from the UN climate deal.
[133] For example, according to the UN Nationally Determined Contributions Registry, Australia, South Africa, India, and EU countries had not submitted updated climate targets for 2035 by the UN deadline of 10 February 2025.
[134] On the impact of climate-related and other natural risks, as well as related transition risks, on the banking sector in Latvia, see Financial Stability Report 2023 and 2024, including an analysis of banks' stress tests.
[135] 2024 Annual Report of the Constitution Protection Bureau.
[136] Annual Report 2024 of the State Security Service.
[137] Fraudulent schemes designed to harvest personal data, such as banking and card information, via e-mail, mobile communication (SMS), or fraudulent websites.
[138] A strategy used by individuals or groups to manipulate and deceive people to reveal sensitive information or take actions that threaten their security.

2025[139]. The Finnish Security and Intelligence Service (Supo) warns that Russia is likely to intensify hybrid operations[140] across Europe, following the end of the war in Ukraine[141].

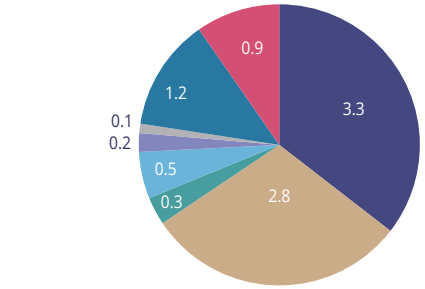
Risks to Latvia's financial stability stemming from the rapid repricing of individual assets are mitigated by the relatively low proportion of securities within the total assets of Latvian credit institutions (Chart A1.5). The share of households' direct investments in securities remains low relative to their total financial assets (see the box entitled "Deposit habits of domestic households") As a result, asset repricing has a limited effect on household solvency. However, rapid changes in asset values have a direct impact on the 2nd and 3rd pension pillar savings, which are considerably more significant in terms of population coverage. Opting for an excessively high-risk investment plan before reaching retirement age can increase the risk of financial hardship in old age.

Latvian credit institutions have limited direct financial exposure to the epicentres of geopolitical tensions. Since the annexation of Crimea in 2014, credit institutions have markedly scaled back their investments in Russia, Belarus, and Ukraine. They are currently small and accounted for just 0.3%[142] of credit institutions' total assets in December 2024. They consist primarily of loans, with a smaller portion comprising of claims on other credit institutions. Funding (mainly deposits) raised from Russia, Belarus, and Ukraine accounted for 1.1% of credit institutions' total liabilities and capital in December 2024 (Chart A1.6, panel a).

At the same time, according to Latvijas Banka's and CSB statistics, the total loan portfolio of the largest NFCs[143]

Chart A1.5

Share of value of securities held by credit institutions in total assets in December 2024

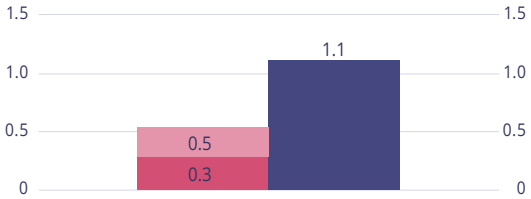


Euro area government bonds – valued at amortised cost
Euro area government bonds – valued by other methods
US government bonds – valued at amortised cost
US government bonds – valued by other methods
Euro area government bonds – valued at amortised cost
Government bonds of other countries – valued by other methods
Other securities valued at amortised cost
Other securities valued by other methods

Source: Latvijas Banka and its calculations.

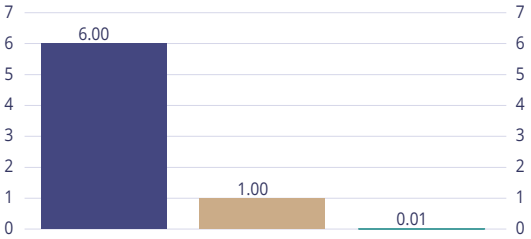
Chart A1.6

The share of Latvian credit institutions' liabilities and investments in Russia, Belarus, and Ukraine in total assets December 2024 (%)



Liabilities
Assets (taking account of the information on loans, for which Russia, Belarus, and Ukraine have been designated as risk transfer countries)
Assets

b) Share of loans to major US-exporting NFCs in the total NFC loan portfolio of credit institutions and leasing companies in February 2025 (%)



All companies covered in the analysis
of which the companies whose exports to the US constitute at least 20% of turnover
of which the companies whose exports to the US constitute at least 50% of turnover

Sources: CSB, Latvijas Banka and its calculations.

[139] M. Elsner, G. Atkinson, and S. Zahidi, Global Risks Report 2025, *World Economic Forum,* 15.01.2025.

[140] Coordinated harmful actions planned and carried out with malicious intent to target an objective, such as a state or an institution, by various means, often in combination. Operations are organised to avoid crossing any boundaries that would escalate them into acts of warfare or provoke the outbreak of hostilities.

[141] Finland must prepare for growth in Russian influencing, Finnish Security and Intelligence Service press release, 04.03.2025.

[142] 0.8% of the assets, if credits for which Russia, Belarus, or Ukraine is indicated as the country of risk transfer are included (according to the national risk transfer basis in accordance with Appendix 11 to the Regulation on the Credit Register of Latvijas Banka) and thus indirect exposure to risks related to Russia, Belarus, and Ukraine is taken into account.

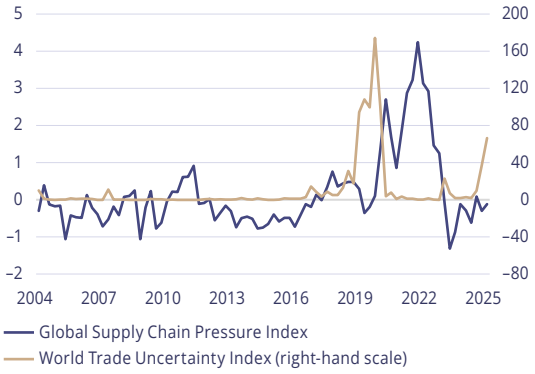
[143] The sample of 210 NFCs includes NFCs whose exports of goods to the US in 2024 amounted to at least 100 000 euro. The total exports of these NFCs account for 92% of Latvia's total exports of goods to the US. Of these, 106 NFCs had liabilities with credit institutions or leasing companies in February 2025, according to the Credit Register.

exporting to the US represented 6% of the total loan portfolio granted to NFCs by credit institutions and leasing companies in February 2025. Furthermore, **the total loan portfolio of NFCs for which the US market represents a substantial share of turnover, based on annual reports, is very small**[144] (Chart A1.6, panel b).

Geopolitical tensions have a more pronounced indirect impact on Latvia's economic development, including adverse effects on NFCs involved in trade with the US through supply chains and supply raw materials to other countries. The broader geopolitical situation has a stronger impact on the economic development of Latvia's key trade partners, such as Germany and Sweden, which in turn constrains the growth prospects of NFC borrowers exporting to these markets.

Geopolitical tensions disrupt global supply chains and weaken international trade, thereby posing risks to economic growth, particularly in open economies like Latvia. The Global Supply Chain Pressure Index[145] has been on the rise since mid-2023. This reflects the consequences of the attacks on the Red Sea (Chart A1.7).[146] At present, the index remains below its historical average and does not yet indicate major supply chain disruptions that could significantly affect oil and other commodity prices or economic growth. By contrast, the World Trade Uncertainty Index[147] rose sharply at the end of 2024. The United Nations Conference on Trade and Development highlights a continued rise in uncertainty driven by escalating geo-economic tensions, protectionism, and trade disputes[148].

Chart A1.7
Dynamics of global supply chain pressure and world trade uncertainty indices



Sources: New York Fed and World Uncertainty Index.

Elevated geopolitical uncertainties further undermine the willingness to invest and spend. This uncertainty hampers the recovery of the commercial real estate market (see the section Commercial Property Market). Moreover, there is an escalating risk that trade tensions and geopolitical fragmentation could further disrupt global capital flows, affecting both direct and portfolio investments.

Overall, given its pervasive adverse impact, **uncertainty heightens the downside risks to Latvia's GDP growth**. Quantitative assessments suggest that these effects may continue to endure for up to two years into the future (Chart A1.8). The magnitude of the estimated impact depends on the specific uncertainty indicator employed. Risks to trade uncertainty are higher in the next few quarters: the potential GDP under turmoil or stress scenarios (GDP growth-at-risk (GaR)) is projected to decrease by 1.8 and 0.3 percentage points respectively. Economic policy uncertainty becomes more pronounced only at a later stage, reducing GaR to 1 percentage point per quarter. In contrast, the financial uncertainty indicator remains a significant factor for almost two years, reducing GaR by 0.7–1.2 percentage points.

Risk-absorbing capacity of the Latvian financial sector

In general, robust profitability, liquidity, and capitalisation underpin the resilience of the Latvian financial sector. Risk-mitigating factors include the strong profitability, capitalisation, and overall sound financial performance of the largest banks in the Nordic countries, as well as the generally low levels of government debt in Latvia

[144] Turnover data for these NFCs in 2024 is incomplete, as some of the sampled NFCs have not yet published their annual reports for 2024. Therefore, the 2023 annual reports of the NFCs sampled were used in the analysis to determine whether exports of goods from these NFCs to the US accounted for at least 20% or at least 50% of their turnover in 2023. In cases where 2023 turnover data were unavailable, turnover figures from 2022 were used instead. In February 2025, the total loan portfolio of NFCs whose exports to the US exceeded 20% and 50% of turnover represented 1% and 0.01% respectively of the total loan portfolio issued to NFCs by credit institutions and leasing companies.

[145] The New York Fed Global Supply Chain Pressure Index combines several indicators of transport costs and supply chain performance.

[146] See *Hutiešu uzbrukumu dēļ ierobežo kuģošanu Sarkanajā jūrā* ("Maritime traffic in the Red Sea is being restricted due to Houthi attacks", lsm.lv, 04.01.2024.; *ASV veic triecienus pret Jemenas hutiešiem* ("The United States is conducting airstrikes targeting Yemen's Houthis"), lsm.lv, 15.03.2025.

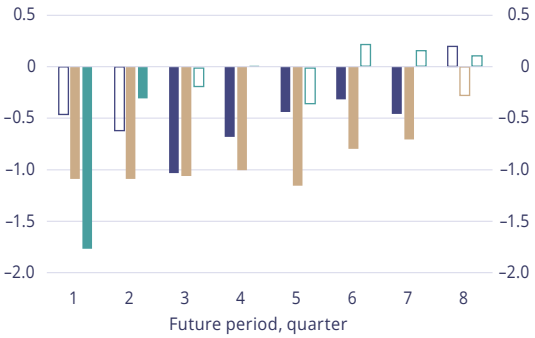
[147] The World Uncertainty Index, developed by Ahir, Bloom, and Furceri, is constructed as the average of indices from 143 countries. Each country's index reflects the frequency of keywords related to trade uncertainty appearing in the quarterly country reports of the Economist Intelligence Unit (EIU).

[148] Global Trade Update (March 2025): The role of tariffs in international trade, *UN Trade and Development*.

and the Nordic countries – with only Finland exceeding the 60% public debt-to-GDP threshold.

In the context of geopolitical tensions, continued investments in national security – particularly in defence and cyber resilience – is crucial for strengthening the long-term resilience of the financial sector. Geopolitical tensions further underscore the imperative, including at the European level, to implement measures[149] that foster economic growth and resilience, while also identifying and mitigating vulnerabilities related to the availability of critical resources.

Chart A1.8
Impact of uncertainty indicators on downside risks to GDP growth



Notes. The 5th percentile GaR model is employed in the assessment to estimate the lowest 5% of GDP growth outcomes over specified number of periods ahead, taking into account current GDP, CCRI, and uncertainty indicator values.[150] The graph presents the uncertainty indicator coefficients. The solid bars denote statistically significant coefficients.

Source: Latvijas Banka's calculations.

[149] See Mario Draghi's report The future of European competitiveness and Enrico Letta's report Much more than a market.

[150] A similar approach is also used by other central banks, such as Deutsche Bundesbank, the Central Bank of Ireland, and Magyar Nemzeti Bank.

Appendix 2. Climate risk coverage in European central banks' financial stability reports

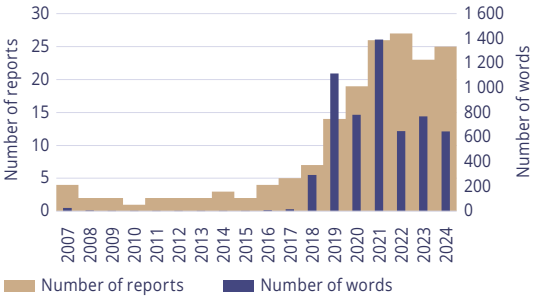
Prepared by Velga Ozoliņa

Climate risks have received growing attention in the financial stability reports of European central banks since 2018. Central banks perform stress tests and analyse the channels through which climate risks affect both the overall financial system's stability and the resilience of financial institutions, contingent on their risk exposures. The findings demonstrate that prompt and adequately rapid progress towards climate neutrality can significantly lessen the adverse effects on financial stability.[151]

Climate-related issues have garnered growing attention in the financial stability reports of central banks and EIOPA[152] since 2018 (Chart A2.1). Initial observations **on the adverse effects of climate change on the insurance sector were published as early as 2007. However, it was not until 2019 that the ECB recognised**[153] **that climate change could impact** not only the insurance sector but **also other participants within the broader financial sector**. With respect to the analysis scope, climate risks were most prominently addressed in 2019 and 2021. Meanwhile, all financial stability reports included in this study made reference to or provided a further analysis of climate risks in 2022.

Several central banks have formally recognised **climate risk analysis as an integral part of their mandate**. The Swiss National Bank[154] plays a significant role in determining the extent to which climate risks may affect financial stability. Banque de France[155], the Central Bank of Norway[156], and Sveriges Riksbank[157] highlight that climate risks represent the source of financial risks, and that it is within the mandate of central banks and supervisory authorities to assess and strengthen the financial system's resilience to such risks. Nationale Bank van België/Banque Nationale de Belgique[158] attributes climate risks to its macroprudential mandate. This provides financial institutions with a clearer understanding of the processes used to monitor, assess, and manage climate-related risks.

Chart A2.1
Mentions of the word *climate* in financial stability reports



Note. The word count in the reports does not fully capture references to climate risks due to both technical limitations (e.g. the software failing to recognise the specific word) and because of the widespread use of the word *climate*, which cannot always be automatically isolated in context.

Source: Latvijas Banka's calculations based on the financial stability reports of the ECB, EIOPA, and 26 European central banks.

As global phenomena, climate risks are expected to impact all sectors of the economy – either directly or indirectly –thus also presenting risks to financial stability. Climate risks currently pose, or may evolve into, systemic threats by affecting the financial system concurrently and through various channels. Central banks emphasise that physical climate risks tend to be systemic and non-diversifiable, consistently exerting adverse effects. Climate transition risks are non-systemic since their effects may differ by sector, allowing for risk diversification. Central banks focus predominantly on risk identification and impact mitigation, leaving the development of climate policy assessments and recommendations, or the pursuit of climate objectives, chiefly to governmental authorities.

151 For more detailed information, see Velga Ozoliņa's article What? Where? When? – Reflection of climate risks in financial stability reports, macroeconomics.lv, 10.07.2025.

152 This study uses the English version of the financial stability reports of the ECB, EIOPA, and the central banks of Austria, Belgium, Croatia, Czechia, Denmark, Estonia, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Malta, the Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom. No other climate studies of these organisations were analysed.

153 ECB Financial Stability Review, May 2019.

154 Financial Stability Report 2020, Swiss National Bank.

155 Assessment of the French financial system – June 2021, Banque de France, 28.06.2021.

156 Financial Stability Report 2019: vulnerabilities and risks, Norges Bank.

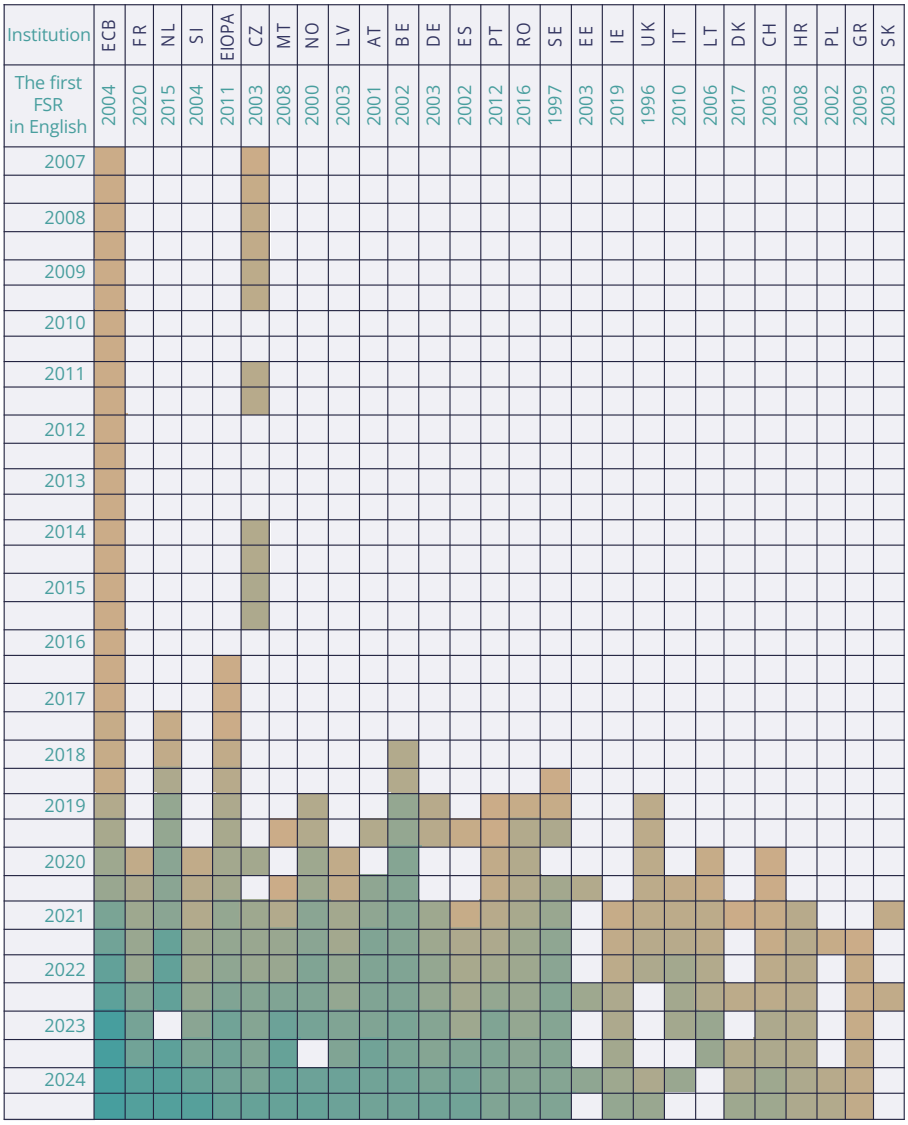
157 Financial Stability Report 2019:2, Sveriges Riksbank.

158 Financial Stability Report 2019, Nationale Bank van België/Banque Nationale de Belgique, 03.06.2019.

Most central banks routinely address climate risks within their financial stability reports (Chart A2.2). The financial stability reports of the ECB and the central banks of France, the Netherlands, and Slovenia provide the most extensive coverage of climate risks, followed by EIOPA and the central banks of Czechia, Malta, Norway, Latvia, Austria, Belgium, Germany, Spain, and other countries. Within the majority of institutions, 50% or more of the climate content is qualitative in nature, centred on risk characterisation and their channels of impact. Quantitative analyses are relatively more prevalent in the financial stability reports of the ECB and the central banks of Poland, Czechia, Latvia, Italy, and Estonia.

Quantitative analyses predominantly assess exposure to climate risks. Exposure to physical risks is commonly assessed as low. The degree of exposure to transition risks is contingent upon the specific economic structure of the country in question. The coverage of

Chart A2.2
Diversity of climate topics in financial stability reports



Notes. Two periods are assigned to each year, as certain countries publish financial stability reports biannually. In cases where a country publishes its financial stability report annually, the assigned score is duplicated across both periods. The gold colour signifies the first instance in which climate risk is included in the institution's financial stability report, with coverage of at least one full paragraph. The colour designation remains unchanged if climate risks are referenced only briefly in future reports. If new information on climate risks or their assessment is published, the colour transitions to a progressively greener shade. When climate risks are entirely absent from the report, the corresponding colour is grey. The assessment of newly introduced topics depends on the inclusion of new information of at least paragraph length, rather than on the overall volume. Within the tables, institutions are ordered based on the total count of analytical materials produced in the latest reporting period.

Source: Latvijas Banka's calculations based on the financial stability reports of the ECB, EIOPA, and 26 European central banks.

climate stress tests and their results is comparatively limited. Latvijas Banka has undertaken analyses of risk exposure, performed stress tests, and conducted additional related research[159].

Key messages from central banks' financial stability reports

Climate risks may materialise and affect financial stability over short-, medium-, and long-term horizons. Physical climate risks tend to dominate in the short term, whereas transition risks become more prominent in the medium and long term. Predictable implementation of policy decisions can help mitigate transition risks, including those within the financial sector.

While insurance is a vital tool for managing potential losses from physical climate risks, the increasing impacts of climate change may lead insurers to adjust premiums or reduce coverage to safeguard their financial stability.

The quicker the transition to climate neutrality, the lower the long-term exposure to physical climate risks. Accordingly, the overall (long-term) costs in this scenario would be lower than in a case where no measures are implemented to advance the climate transition. The financial sector can support the climate transition both by leading through example, such as selecting sustainable investment locations, improving the energy efficiency of its buildings, and implementing other measures, as well as by financing climate-relevant projects and businesses.

The Russian war in Ukraine is referenced as a key driver underscoring the immediacy of climate transition risks. These developments have facilitated greater adoption of renewable energy and enhanced energy efficiency. Nevertheless, some countries have chosen to augment the use of indigenous fossil fuels in the short term, which will require the implementation of more rigorous climate policy decisions going forward. Concerns also persist that the climate transition may be impeded by rising military expenditures, frequently associated with increased fossil fuel consumption, as well as by the physical aftermath of war, which results in significantly elevated emissions from sources such as fires, infrastructure damage, and forest destruction.

In the realm of macroprudential policy, central bank publications consistently conclude that macroprudential measures would be necessary and appropriate for addressing climate and transition risks. Macroprudential authorities can apply tools that enhance resilience and, where possible, also curb the build-up of risks. Among the most frequently cited choices in publications are the SyRB and borrower-based measures[160].

[159] Latvijas Banka's financial stability reports from 2024, 2023, 2022, 2021, and 2020.

[160] These instruments to limit climate risks are already applied in Latvia, Slovakia and Hungary.

Appendix 3. Revised framework for assessing cyclical risk

Prepared by Ilze Vilka

Latvijas Banka has revised its analytical framework for assessing cyclical risk. Going forward, a broader indicator will be incorporated into the calculation of the CCyB guide: loans issued by bank leasing subsidiaries have been added to the existing supplementary measure. The range of additional indicators used in the assessment has been tested and reviewed. These indicators are now grouped into categories, with each category aggregated into an index designed to signal shifts in the corresponding risk dimension. The CCRI has been reviewed and calibrated to include additional indicators.

Latvijas Banka, as the authority responsible for setting the CCyB rate, conducts quarterly assessments of cyclical systemic risk and determines or adjusts the CCyB rate as necessary. These assessments are based on a broad set of quantitative indicators, complemented by qualitative assessment. **Periodic reviews of the quantitative assessment framework are essential** to ensure alignment with changes in the financial sector.

The quantitative assessment comprises the so-called main indicators, additional indicators, and models, such as composite indicators. The main indicators include the deviation of the credit-to-GDP ratio from its long-term trend, and the CCyB benchmark – referred to as the CCyB guide – calculated based on this deviation[161]. In accordance with the ESRB recommendation[162], the main indicators serve as a starting point for the assessment and should be published on a quarterly basis. At the same time, when determining the appropriate CCyB rate, competent authorities complement the rules-based approach with the exercise of their discretionary powers. The decision on the CCyB rate is based on a broad array of quantitative and qualitative inputs drawn from the cyclical risk assessment, without relying solely on main indicators. This is because individual indicators, when viewed in isolation or lacking sufficient signalling power on their own, may provide an incomplete or even misleading information. Furthermore, the credit-to-GDP gap derived from the Hodrick–Prescott filter has several shortcomings, which limit its suitability for providing a complete assessment of credit dynamics.

As part of the review of the cyclical risk assessment framework, and in light of the increasing role of loans from the non-bank financial sector, an evaluation was conducted to determine whether the credit measure used in the CCyB guide calculation is still appropriate. To date, an additional credit measure[163] (see its definition in Table A3.1) has been used to determine the CCyB guide and the deviation of the credit-to-GDP ratio from its long-term trend.

Leasing loans have grown as a proportion of total loans to domestic households and NFCs provided by bank and non-bank financial sector lenders (Chart A3.1). The majority of these loans are issued by banks and their leasing subsidiaries. Furthermore, the largest banks have chosen to integrate their leasing subsidiaries into their parent banks. Consequently, including loans from both banks and their leasing subsidiaries, as part of the additional credit measure, provides a more accurate reflection of total private non-financial sector liabilities and the evolving cyclical risk.

[161] The CCyB guide is the CCyB reference benchmark rate, which indicatively signals a potentially required CCyB rate. At the same time, the CCyB guide is not an automatic threshold for increasing the CCyB. The CCyB benchmark rate is calculated based on the deviation of the credit-to-GDP ratio from its long-term trend (in line with the ESRB's recommendation, this trend is estimated using a Hodrick–Prescott filter with a smoothing parameter λ = 400 000). With the credit gap ranging from 2 to 10 percentage points, the CCyB benchmark rate rises proportionally from 0% to 2.5%.

[162] Recommendation of the ESRB of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1) (2014/C293/01).

[163] As recommended by the ESRB, competent authorities should calculate the CCyB benchmark rate using the standardised credit measure (see Table A3.1). In addition to the CCyB benchmark rate calculated through this method, authorities may also determine the CCyB benchmark rate based on an alternative supplementary measure. The CCyB benchmark rate calculated from the most nationally appropriate credit measure is referred to as the CCyB guide.

Table A3.1

Credit measures for the calculation of CCyB benchmark rates

Standardised measure	Additional measure used so far	New additional measure supplemented by loans granted by bank leasing subsidiaries
Loans granted by banks, non-bank financial institutions, and other NFCs to domestic households, NFCs, NPISHs	**Bank** loans to domestic households, NFCs and NPISHs and holdings of private NFCs and NPISH debt securities	**Bank** loans to domestic households, NFCs and NPISHs and holdings of private NFCs and NPISH debt securities, **and loans granted by banks' leasing subsidiaries**

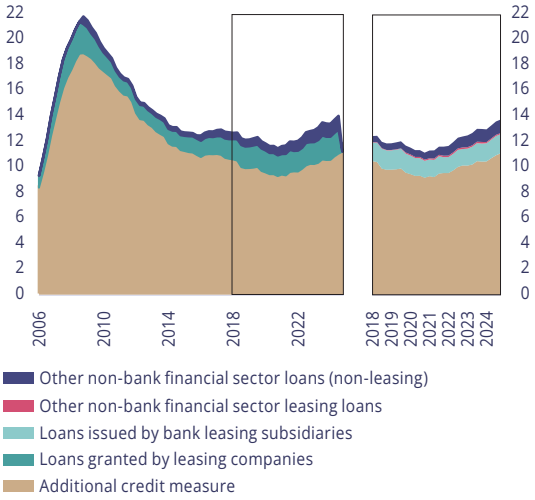
A univariate analysis was used to test the ability of various credit measures to signal a potential crisis – changes in the Latvian FSI[164]. The analysis concluded that **FSI changes were most effectively anticipated by an additional credit measure that includes loans granted by bank leasing subsidiaries**. Incorporating all other loans from non-bank financial sector lenders into this measure did not enhance the signalling ability of the composite indicator. On the other hand, the standardised credit measure demonstrated the weakest signalling capacity.

The credit measure, supplemented with loans from bank leasing subsidiaries, along with the CCyB benchmark rate derived from it, more accurately reflects the historically required CCyB rate (Chart A3.2). The new benchmark rate more effectively captures the accelerated increase in cyclical risks prior to the crisis and refrains from producing false signals of risk accumulation during 2009–2010, when those risks had already materialised.

Loan data from bank leasing subsidiaries are accessible through the Credit Register of Latvijas Banka, while data on total loans issued by non-bank financial sector lenders, including leasing loans from other non-bank institutions, are available only after considerable delays. Furthermore, loans issued by other non-bank financial institutions are considerably smaller in volume compared to those granted by bank leasing subsidiaries. Accordingly, **the assessment of the appropriate CCyB rate will henceforth be based on the additional measure used so far supplemented by leasing loans issued by bank leasing subsidiaries.**

Chart A3.1

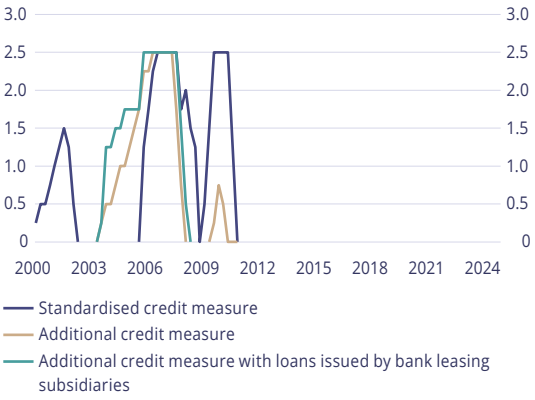
Loans to domestic households and NFCs by bank and non-bank financial sector lenders (billions of euro)



Sources: Latvijas Banka's calculations and the CSB.

Chart A3.2

CCyB benchmark rates (% of TREA)



Sources: Latvijas Banka's calculations.

To select the most suitable additional indicators for assessing cyclical risk, several indicators were tested for their ability to provide early warning signals of a potential crisis. In light of the scarcity of observed crisis episodes, the univariate regressions employed the FSI as the dependent variable. Indicators that failed to produce statistically significant coefficients or demonstrated relatively low explanatory power, as measured by R^2, were removed from the pool of additional indicators and substituted with those offering superior early warning performance (Table A3.2).

[164] The Latvian FSI aggregates a range of financial indicators that collectively capture the primary measurable signs of heightened stress within the Latvian credit institution sector. These include deposit outflows, declining profitability of credit institutions, increases in loan-loss provisions, and sharp contractions in loan volumes. See N. Siņenko, D. Titarenko, M. Āriņš, Latvian Financial Stress Index. Riga: Latvijas Banka, Discussion Paper No 1, 2012.

Given that changes in the macroeconomic environment are taken into account in the practical assessment of cyclical risk, **a new category of additional indicators – focused on the macroeconomic environment – has been established**.

For each of the five categories, a composite index has been developed (Chart A3.3). The indices are calculated as the mean of the sum of standardised indicators, expressed in terms of standard deviations. Indicators for which higher values correspond to lower cyclical risk are multiplied by –1. The long-term trend of the index, derived using the Hodrick–Prescott filter (λ = 1600) to smooth out short-term fluctuations, provides supplementary insights.

For each index, risk thresholds have been determined based on its historical values. Index values and their trends falling below the 45th percentile of the distribution correspond to low risk, those exceeding the 80th percentile correspond to high risk, and values within the 45th to 80th percentile range correspond to medium risk.

Table A3.2
Additional indicators: previous and revised versions

Category of indicators	Previous indicators	Revised indicators
Macroeconomic environment		Annual change in real GDP; % Annual change in HICP; %
Potential revaluation of property prices	Ratio of the house price index to the average net wage index; 2010 = 100 CSB's annual growth rate of the house price index; %	Ratio of the house price index to the average net wage index; 2010 = 100 CSB's annual growth rate of the house price index; %
Lending development	Annual growth rate of loans, %	Annual changes in adjusted bank loans and leasing loans; % Annual changes in bank loans to households; % Annual changes in the ratio of bank loans (including leasing) to seven-year average GDP; %
External imbalances	Current account-to-GDP; %	Current account-to-GDP; %
Resilience of banks' balance sheets	CET1 capital ratio; % Leverage ratio; % ROA; % Share of Stage 2 loans in the total loan portfolio; %	CET1 capital ratio; % Domestic loan-to-deposit ratio; %
Private sector debt burden	Annual interest payments-to-GDP ratio of households and NFCs; % NFC interest coverage (four-quarter moving average); %	Annual interest payments-to-GDP ratio of households and NFCs; % Debt service ratio of households and NFCs; %
Potential mispricing of risks	OMX Riga All Stock Index (OMXR) OMX Baltic Benchmark Index (OMXBBGI)	Spread between the interest rate on new housing loans to households over the six-month EURIBOR; percentage points

Note. Previous indicators, highlighted in red, will no longer be utilised, while those highlighted in green denote newly introduced indicators.

Finally, the CCRI, which aggregates information on cyclical risk changes, was also reviewed. The review of the indicators comprising the CCRI incorporated the findings from the revised main and additional indicators:

- within the debt service indicator, the debt measure has been updated to incorporate additional loans, including those issued by bank leasing subsidiaries;
- the annual changes in adjusted bank loans have been replaced by the annual changes in adjusted bank loans combined with leasing;
- the two-year change in the credit-to-GDP ratio has been substituted with the annual changes in the credit-to-GDP ratio calculated over a seven-year period;

- The category bank's balance sheet resilience has been excluded from the CCRI sub-indicators, as it is better suited for signalling the risk level rather than its changes. Considering the robust capitalisation and liquidity of the Latvian banking sector, fluctuations in these indicators are usually not significant.

The revised CCRI provides a more accurate signal of changes in cyclical risk, reflecting a more appropriate risk level during the 2008–2010 crisis period and the COVID-19 pandemic. See Chart A3.4 for the previous and revised CCRIs.

Chart A3.3
Indices of additional indicators (standard deviations)

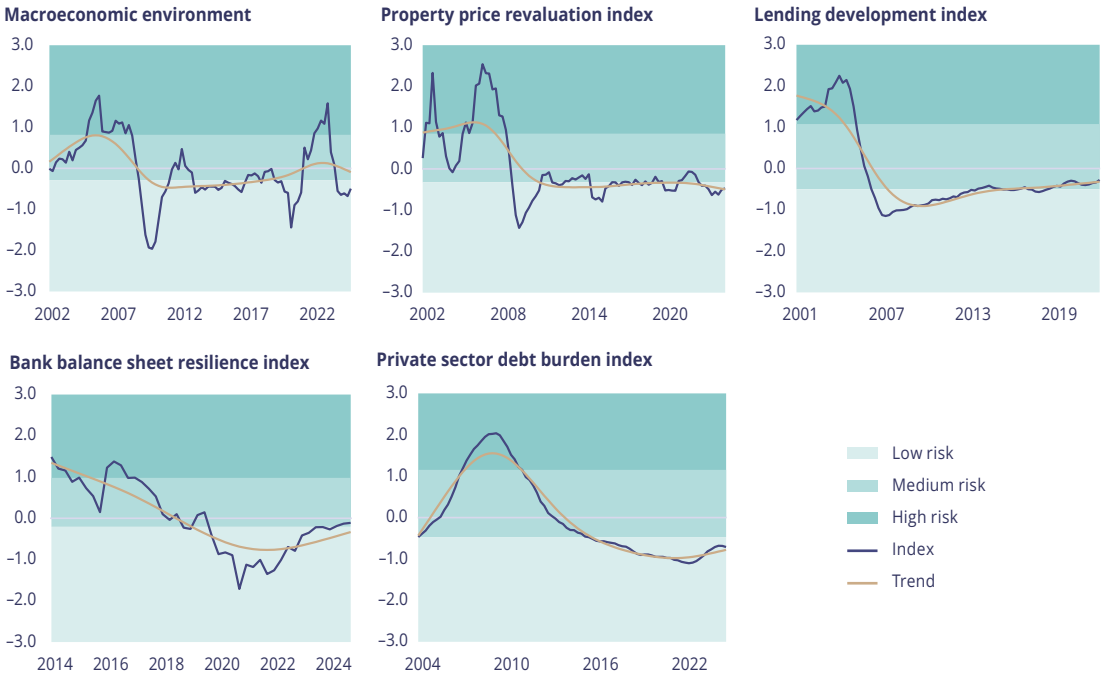
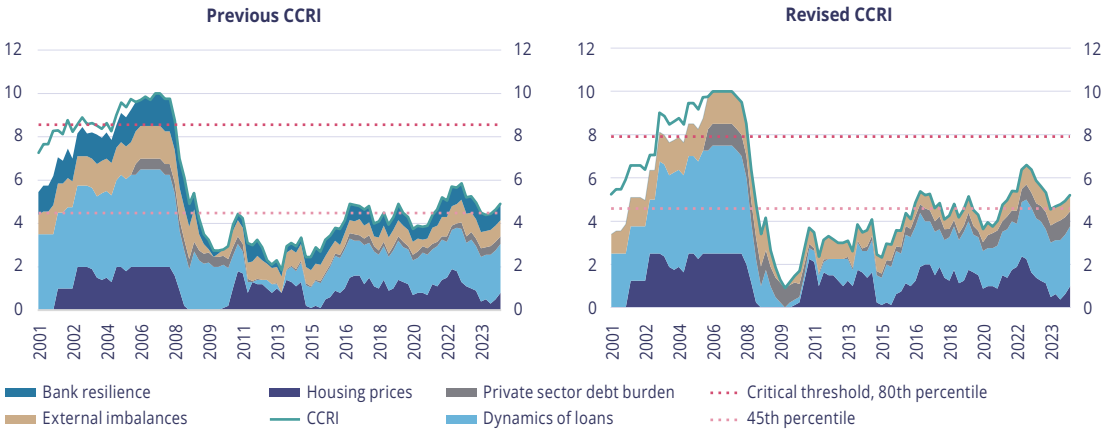


Chart A3.4
CCRI changes (points)



Appendix 4. Results of the credit institution survey on risks

All risk categories, except for external macro-financial risks, declined in the credit institutions' risk ratings. Additionally, in the evaluation of individual risk factors, the weight of most factors decreased, with the most notable reduction observed in the *climate change* risk factor.

Chart A4.1
Assessment of risk levels across key risk categories by credit institutions[165] for the upcoming year (based on the likelihood of occurrence and potential negative impact)

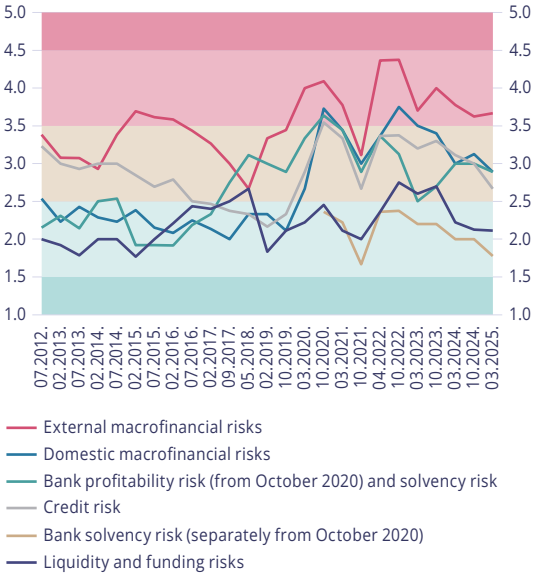
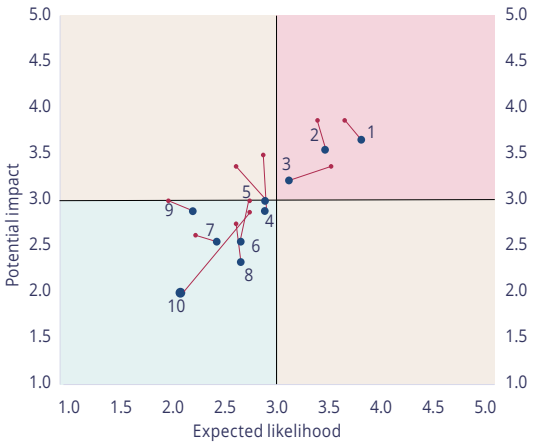


Chart A4.2
Assessment of the risk factors provided by credit institutions in March 2025 over the coming year

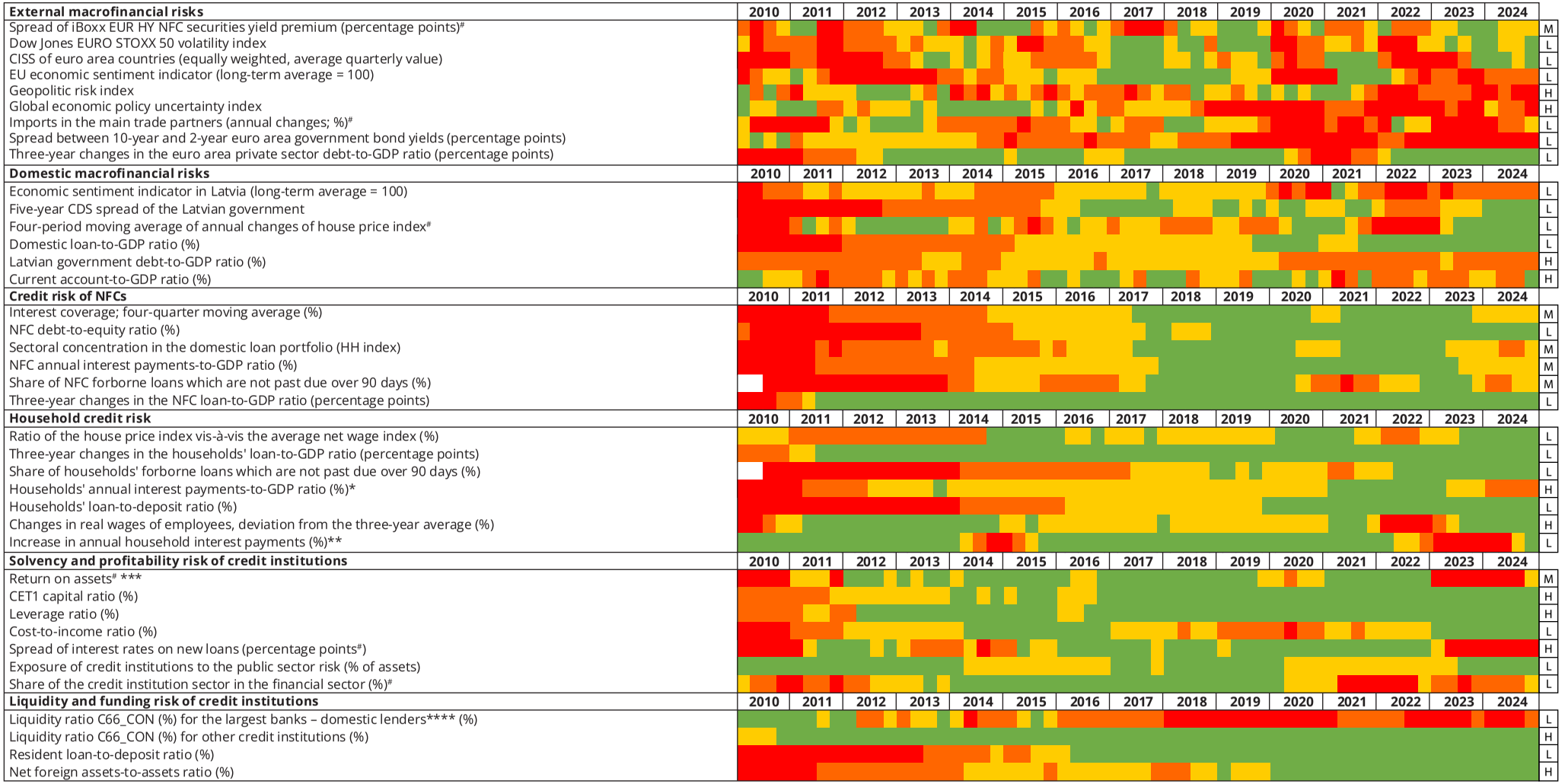


Risk factors (in descending order)

1. IT security risk to Latvia's financial system
2. Negative impact caused by significant deterioration in the external macro-financial environment on the Latvian economy
3. Deterioration of Latvia's economic situation due to domestic factors
4. Deterioration of NFC solvency
5. Deterioration of household solvency
6. A significant fall in demand in the commercial real estate market
7. Rising risks in the parent banks of the largest Latvian banks or in their home countries (including rising macro-financial risks in their economies or an increase in funding risks in the parent banks)
8. Reputational risk and other risks related to financial crime (including fraud, ML/TPF, and circumvention of sanctions) in Latvia and the Baltics
9. Substantial changes in residential real estate prices
10. Impact of physical and transition risks from climate change on Latvia's financial system

[165] In March 2025, Latvijas Banka conducted a credit institution survey regarding their assessment of risks to Latvia's financial system. The survey respondents were Swedbank AS, AS SEB banka, the Latvian branch of Luminor Bank AS, AS Citadele banka, BlueOr Bank AS, AS Reģionālā investīciju banka, the Latvian branch of OP Corporate Bank plc, AS Rietumu Banka, and AS Industra Bank.

Appendix 5. Heatmap of early warning indicators



Notes. For each indicator, the letter added at the end of the row in the table represents the level of last reading ("L" for low, "M" for medium, "H" for high).

In light of the impact of geopolitical shocks on financial stability (see Appendix 1 "Risks to Latvia's financial stability arising from high geopolitical tensions, fragmentation, and uncertainty"), the category of external macro-financial risks has been expanded to include two additional indices: the Geopolitical Risk Index and the Global Economic Policy Uncertainty Index. The Geopolitical Risk Index captures the intensity of global events, threats, and conflicts – and their associated risks – dating back to 1900. It is constructed from the analysis of articles published in 10 leading newspapers across the US and internationally. The Global Economic Policy Uncertainty Index, available since 1997, measures the level of economic policy uncertainty worldwide based on a content analysis of local newspapers in 21 countries.

In the household credit risk section, the thresholds for the indicators "credit-to-deposit ratio (%)" and "household interest payments-to-GDP ratio (%)" were revised upwards by incorporating comparative benchmarks from the Baltic States into the calibration process.

A two-sided indicator

* The sharp increase and elevated level of household interest payments in 2024 has been adjusted to reflect the impact of government support measures for mortgage borrowers.

** Since 2014, non-bank interest payments as well.

*** The unusually high profitability was supported by a significant surge in interest rates. Such profitability is not considered sustainable and is expected to decline with the normalisation of interest rates. Currently, there is no reason to believe it poses significant risks to the activity of credit institutions in the medium term, as borrowers' solvency remains stable, and the present high profitability allows credit institutions to maintain an adequate level of provisioning.

**** Data until 2019 and those for 2019 include the top four and three largest credit institutions respectively, since branches are excluded from the calculation of liquidity ratio. The liquidity ratio of this credit institution group is relatively lower, as liquidity of subsidiaries is managed at the group level. The liquidity ratio is not compulsory for these credit institutions from a supervisory standpoint, it serves as a tool for monitoring risks.

The heatmap is only one of the tools used by Latvijas Banka for the analysis of systemic financial stability risks. The assigned risk level should not be interpreted in absolute terms. Instead, it should be viewed in comparison with the historical benchmarks of the chosen indicators, warning of the build-up of risks. For the explanation of the heatmap methodology, see Appendix "Heatmap: analytical tool for the analysis of systemic financial stability risks in Latvia" from Latvijas Banka's "Financial Stability Report 2018".

The risk level is indicated by colour:

Appendix 6. Performance indicators of credit institutions

Table A6.1

Overall performance indicators of credit institutions

Indicator	2019	2020	2021	2022	2023	2024	March 2025
Balance sheet indicators							
Number of credit institutions and branches of foreign credit institutions	19	16	16	14	13	14	14
Total assets (millions of euro)	23 202.9	24 558.1	25 447.2	27 880.7	28 495.8	30 726.1	30 317.5
Share of loans in assets (%)	58.1	52.7	56.7	55.4	54.7	53.1	54.5
Annual growth rate of domestic loans (%)[166]	–1.5	–3.3	11.8	7.6	1.4	3.4	4.9
Share of deposits in total liabilities (%)	74.2	76.0	78.6	78.2	77.3	78.1	77.0
Annual growth rate of domestic deposits (%)	7.3	8.4	10.3	11.8	0.7	9.9	6.2
Share of liabilities to MFIs in total liabilities (%)	6.6	3.2	2.5	4.3	4.7	5.3	6.7
Domestic loan-to-deposit ratio (%)	84.1	73.8	74.8	72.0	72.5	68.2	70.7
Profitability[167]							
ROE (%)[168]	3.1	5.2	10.0	10.0	20.0	16.70	–
ROA (%)[169]	0.4	0.7	1.2	1.2	2.2	1.94	–
Cost-to-income ratio (%)[170]	65.0	68.2	62.5	55.6	39.3	49.41	–
Capital adequacy[171]							
Own funds (millions of euro)	1 936.8	2 316.1	2 335.5	2 310.5	2 397.3	2 692.8	–
CET1 (millions of euro)	1 802.6	2 219.7	2 241.6	2 206.9	2 299.4	2 441.0	–
TREA (millions of euro)	9 188.8	8 624.5	9 266.5	10 055.6	11 468.2	12 522.0	–
TC ratio	21.1	26.9	25.3	23.0	20.9	21.5	–
CET1 ratio (%)	19.6	25.7	24.3	21.9	20.1	19.5	–
Leverage ratio (%)	9.8	10.5	10.3	9.3	9.5	9.3	–
Liquidity[171]							
Liquid assets to total assets ratio (%)[172,173]	32.1	35.6	35.3	37.6	39.3	41.7	38.8
LCR (%)	314.5	373.7	319.3	221.8	251.7	248.0	252.8
NSFR (%)	144.9	155.9	173.1	157.7	167.5	172.6	–
Asset quality[174]							
Ratio of provisions for non-performing loans in the loan portfolio (%)	3.3	1.9	1.6	1.6	1.7	1.5	1.3
Share of loans past due over 90 days in the loan portfolio (%)	3.9	2.3	1.5	1.1	1.2	1.2	1.3
Share of NPLs in the loan portfolio (%)	7.1	4.7	3.6	2.7	2.7	2.7	2.5

[166] The indicator has been calculated using individual-level data and incorporates all one-off effects referred to in Section 2 "Development and Risks of the Credit Institution Sector".
[167] Indicators for 2019–2021 have been calculated based on Latvijas Banka's consolidated-level data.
[168] Annualised profit/loss ratio to average capital and reserves of the reporting period (excluding data of foreign credit institution subsidiaries).
[169] Annualised profit/loss ratio to average assets of the reporting period.
[170] Cost-to-income ratio = (administrative expenses + intangible and fixed asset depreciation and disposal)/(net interest income + income from dividends + net commissions and fees + profit/loss from trades of financial instruments + financial instrument revaluation result + net ordinary income + adjustment for impairment of available-for-sale financial assets) × 100.
[171] Data are shown at the consolidated level.
[172] Liquid assets = vault cash + claims on central banks and other credit institutions + central government fixed income debt securities (those having a regular, unlimited market, i.e. they can be sold in a short period of time without considerable loss or used as loan collateral).
[173] Until 2021 – Latvijas Banka's estimate.
[174] The loan quality indicators for 2019–2024 have been calculated based on consolidated-level data for the credit institutions subject to consolidated supervision and on individual-level data for other credit institutions and branches of foreign banks (for the first quarter of 2025 – at the level of individual credit institutions). Credit risk ratios have been presented without excluding the one-off effects referred to in Section 2 "Development and Risks of the Credit Institution Sector".