



The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 27-28 September 2021 (9th meeting)

Published: 29 October 2021

The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the application of the Bank's financial stability policy instruments. "The Financial Stability Committee's decisions on the application of financial stability policy instruments shall be published and an account given of the rationale for the decisions, together with an assessment of the situation, and minutes on the topic shall be published unless such publication can be expected to have an adverse impact on financial stability." In accordance with the Act, the Financial Stability Committee (FSN) has decided that, in general, it will publish the minutes of its meetings within four weeks.

At the FSN meeting held on 27 and 28 September 2021, the Committee decided to adopt rules capping the ratio of debt service to disposable income on consumer mortgages. In general, the debt service-to-income (DSTI) ratio would be limited to 35% of disposable monthly income, and 40% for first-time buyers. The Committee completed its annual review of systemically important financial institutions and confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. Furthermore, it decided to hold the capital buffer for systemic importance (O-SII buffer) unchanged at 2% and to increase the countercyclical capital buffer (CCyB) from 0% to 2%, effective 29 September 2022.

Committee members discussed financial stability developments and prospects, the economic situation, developments in the domestic financial markets, the position of and risk in the financial system and in the operations of financial institutions, the real estate market, the financial cycle, financial market infrastructure, cybersecurity, and the resolvability of systemically important financial institutions. Prior to the meeting, members received information on developments and prospects since the previous FSN meeting, held in late June.

Analysis of financial stability

In the Committee's opinion, the financial system is on a strong footing. The accommodative monetary and macroprudential stance, followed by the economic recovery of the past few

months, had supported households and businesses and maintained their debt service capacity. However, the effects of this accommodative stance showed most clearly in asset markets, particularly in equity and housing prices, and in financial institutions' earnings reports. The earnings reports showed that the outlook for financial institutions had improved, owing to reduced uncertainty about the quality of assets on their balance sheets.

Forecasts indicate that GDP growth in Iceland will be robust this year. Vaccination programmes are proceeding apace in key trading partner countries, and governmental authorities have eased public health restrictions significantly in many areas. The number of tourist visits to Iceland has surged, and indicators suggest increased demand in the domestic economy. The labour market has recovered strongly, job numbers are up, and unemployment has fallen markedly.

In the FSN's opinion, the three large commercial banks remain strong. In H1/2021, they recorded combined profits of 37 b.kr. and a return on equity of 11.7%. Their capital position has strengthened, and their capital ratio was 24.9% at the end of June 2021. Their liquidity has grown in recent months, to 290 b.kr. in excess of requirements as of end-August. The banks have had easy access to funding abroad, and credit spreads have held stable.

The FSN is of the view that uncertainty about the banks' loan quality has receded significantly in recent months. Loan freezes have reduced arrears, and there have been signs that payments of instalments and/or interest on frozen loans have increased somewhat in the past few months. Non-performing loan ratios are broadly unchanged for corporate loans but have continued to fall in the case of household loans. The large commercial banks' recognised impairment has declined in tandem with improving economic forecasts, falling from 1.84% of the loan portfolio as of end-2020 to 1.34% at the end of June 2021. The Committee still considers it vital that the problems of borrowers experiencing financial distress in the wake of the pandemic continue to be firmly addressed.

Members expressed their concerns about increased growth in household debt and the relationship between debt and asset prices, particularly property prices. At the end of July 2021, real growth in household debt was at its highest since 2008, measuring nearly 6.8% year-on-year (11.3% nominal growth), up from 5.3% (9.0% nominal) at the end of 2020. It was noted, however, that household indebtedness was still modest and that the share of non-performing household loans had begun to fall. It was pointed out as well that consideration must be given to the likelihood that the increase in debt was due in part to a rising share of first-time buyers. Alongside declining turnover in the real estate market, there were signs that year-on-year growth in net new household mortgage lending had eased in recent months, after peaking in October 2020. Price- and exchange rate-adjusted growth in corporate debt was negative by 0.8% year-on-year at the end of Q2/2021, however.

The Committee discussed the situation in the real estate market and developments in new household mortgage lending. Steep price hikes had characterised the market in recent months, with the twelve-month rise in house prices measuring 11.6% in real terms (16.4% in nominal terms) in August. Single-family home prices had risen somewhat more than condominium prices. The house price index measured 14% above its long-term trend in August, up from 6% above trend at the beginning of the year. The deviation of house prices from fundamentals such as building costs and wage developments had widened still further. Turnover had eased in recent months, the number of purchase agreements was down by a fourth year-on-year, and the number of properties advertised for sale had fallen by nearly

45%. The average time-to-sale for property in the greater Reykjavík area was close to its historical low, and the share of homes selling at a premium on the asking price had risen. There were signs of an increase in average loan-to-value (LTV) and DSTI ratios on new household mortgages. FSN members expressed concerns about this trend, particularly in view of accelerated growth in household debt.

The Nasdaq OMXI10 index had risen between meetings, and the deviation of share prices from long-term trend is at its widest since 2008. Post-pandemic developments in domestic share prices have been broadly in line with developments in foreign markets. However, the Icelandic markets had been jittery during the days immediately preceding the FSN meeting, owing both to developments in global share prices and to uncertainty during the run-up to Parliamentary elections in Iceland. Uncertainty about developments in equity markets had escalated, as could be seen, for instance, in stronger demand for hedging instruments. Nominal Treasury bond yields had risen between FSN meetings, particularly on longer maturities. Indexed bond yields had fallen marginally over the same period, and the breakeven inflation rate had therefore risen. The exchange rate of the króna had been broadly unchanged since the Committee's last meeting.

Although the financial cycle had been broadly unchanged between meetings, it was noted that the previous few months' rise in house prices was not yet reflected in the assessment of the financial cycle, which takes account of fluctuations over the medium term. The cycle was assessed to be on a slow upward trajectory, and its sub-cycles were deemed to be in different phases. The composite indicator of cyclical systemic risk has risen rapidly since the onset of the pandemic and has turned positive for the first time since 2009. The indicator captures the ratio of house prices to wages, growth in the banks' private sector lending as a share of GDP, real growth in private sector debt, real equity securities prices, household DSTI ratios, and the ratio of the current account balance to GDP. Experience shows that these economic variables have given reliable indications of developments in financial system risk.

The Committee discussed in detail the recent incidents regarding the operational security of financial market infrastructure. Two acquirers had been subject to repeated cyberattacks that had also affected two of the large commercial banks. FSN members agreed that it was necessary to tighten operating entities' procedures and harmonise action plans, and that operating entities must ensure business continuity. They also agreed unanimously that it was essential to implement an independent domestic payment solution as soon as possible. The Committee decided to discuss the analysis of developments and prospects for domestic payment intermediation, information on individual participants' share in interbank payment intermediation, and participants' interconnectedness at its December meeting.

Members also discussed the Central Bank's temporary collateralised lending framework for financial institutions, introduced in the wake of the pandemic. They considered it appropriate that the framework should remain in place, given that the effects of the pandemic on the financial system were still uncertain.

Resolvability of systemically important financial institutions

The Resolution Authority presented the Committee with a draft assessment of the systemically important commercial banks' resolvability. The Committee decided to seek the

opinion of the Financial Supervision Committee (FMEN) on the matter, in accordance with Article 2.7 of the FSN Rules of Procedure.

Systemically important financial institutions

The FSN discussed the results of the assessment of the systemically important financial institutions, carried out in accordance with European Banking Authority (EBA) methodology. Underlying the assessment are indicators pertaining to size, importance, complexity, and interconnectedness. Small financial institutions can also be systemically important if their collapse would cause a chain reaction within the financial system. FSN members considered it obvious that the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn should be confirmed. The Governor presented a proposal to this effect, and it was approved unanimously.

Capital buffer for systemic importance

Committee members agreed that the systemic importance of the three large banks had not diminished and that the risk addressed with the capital buffer for systemic importance (O-SII buffer) changed slowly. In view of the discussion, the Governor proposed that the O-SII buffer be held unchanged at 2% on all exposures at the parent company level and on a consolidated basis. The proposal was approved unanimously.

Countercyclical capital buffer

The Committee discussed whether to increase the countercyclical capital buffer (CCyB). The main arguments expressed at the meeting in favour of increasing the CCyB were that the economic recovery had gained momentum, there were clear signs of improvement in financial institutions' asset quality, and prices in asset markets had risen steeply. However, it was pointed out that growth in corporate lending was still very sluggish. Committee members agreed that because an increase in the CCyB would not take effect until 12 months after it was announced, they should take forward-looking action and make a decision in a timely manner. Members discussed whether, in the event that the buffer should indeed be increased, it was appropriate to raise it by 1% or by 2%, which would restore it to its level in March 2020, when it was lowered. It was noted that cyclical risk was even greater now than before the buffer was lowered at the beginning of the pandemic, which gave cause to raise it again. Increased risk stemmed in particular from rising asset prices and accelerated household credit growth. The risk was also reflected in the aforementioned indicator of cyclical systemic risk in the domestic financial system, which had risen relatively sharply in the recent term and had been positive in 2021 to date. The FSN also discussed recent changes abroad in the position on application of the CCyB. In response to the pandemic, many countries significantly eased financial institutions' capital requirements as a precautionary measure. In view of this experience, there is widespread discourse on the need to make greater use of cyclical capital requirements when external shocks affect financial institutions' willingness and capacity to lend.

In view of the discussion, the Governor proposed that the buffer be increased to 2%. The proposal was approved unanimously. Next, the Governor presented a draft version of the Rules on Countercyclical Capital Buffers for Financial Undertakings, no. 1076/2021, which was approved unanimously. The Committee decided to examine more thoroughly what the long-term neutral value of the CCyB should be.

The debt service-to-income ratio

The Committee discussed the application of a cap on the debt service-to-income (DSTI) ratio, which is intended to boost borrowers' and lenders' resilience, prevent the build-up of systemic risk, and mitigate long-term market volatility. The application of the DSTI ratio is also intended to link mortgage lending to wage developments in the country.

FSN members were of the view that the LTV ratio, which has been used successfully in Iceland for several years, would not suffice by itself to combat the accumulation of systemic risk in the real estate market in the future – particularly not when property prices rose well above their long-term trend. As a result, it would be necessary to impose further restraint on the market and set a maximum DSTI ratio.

Members discussed how the cap would be implemented and how strong an impact they wished to see relative to the current situation. They discussed what the maximum ratio should be, how much additional scope should be given to first-time buyers, whether to allow a general exemption for a specified percentage of the volume of mortgage loans issued, and if so, how broad that exemption should be. In addition, they discussed whether to allow exemptions for distressed borrowers and whether loan maturity and interest rate criteria should be included in the calculation of the ratio.

The Committee used a scenario analysis to assess the impact of capping the DSTI ratio. The analysis showed that the impact would depend in large part on whether the ratio was calculated based on a specified minimum interest rate – for instance, 6% nominal interest – or on each borrower's contractual interest rate. It would be possible, however, to fine-tune the interaction between the reference interest rate and the general exemption from DSTI rules.

Committee members agreed that the application of the DSTI cap should focus primarily on creating a future framework for mortgage lending activities and reducing the likelihood of imbalances and volatility in the market. They were of the opinion that the market was imbalanced at present, as could be seen in factors such as the sharp reduction in supply; the continued rise in prices; the rising share of flats selling at a premium on the asking price; and the deviation of house prices from long-term trend, which was at its widest since 2008. Opinion was divided, however, on whether this was a temporary situation attributable solely to interest rate cuts and increased saving in connection with the pandemic, or whether the imbalances were likely to persist for a protracted period of time. It was pointed out that the maximum LTV ratio had already been lowered, that the FSN had approved an increase in the CCyB at the meeting, and that the monetary stance had been tightened since the spring. The impact of these overall tightening measures had not yet come to the fore. It also emerged that it was important to apply borrower-based measures with restraint, as the impact could differ from one income group to another. The opinion was expressed that such measures could also affect households' asset formation. On the other hand, it was pointed out that a general

exemption from the rules should facilitate mortgage lending to borrowers who did not satisfy the requirements but were considered by lending institutions to have sufficient debt service capacity.

The Committee discussed in detail the efficacy of the DSTI cap under various conditions. Members finally reached a consensus that at the current interest rate level, using a reference interest rate based on a specified minimum – for example, 6% nominal interest – to calculate the DSTI ratio would be too onerous for the market as a whole. The Committee considered it more favourable to base the calculation on contractual interest rates. Members agreed that using maturity criteria for the calculation was a different matter, as it would encourage more rapid asset formation by borrowers. One member wanted to set a more generous DSTI limit for first-time buyers than the others did.

After the Committee discussed the matter further, the Governor proposed setting the DSTI cap at 40% for first-time buyers and 35% for all others, basing the calculation on contractual interest rates, authorising financial institutions to grant exemptions from the rules for up to 5% of the volume of loans issued each quarter, and authorising an exemption for distressed borrowers even if the loan principal increased and a reference maturity was used to calculate the DSTI ratio. All Committee members voted in favour of the proposal. Then the Governor presented a draft version of the Rules on Maximum Debt Service-to-Income Ratios for Consumer Mortgages, no. 1077/2021, which was approved unanimously.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Unnur Gunnarsdóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Tinna Finnbogadóttir, representing the Ministry of Finance and Economic Affairs, attended the meeting, with the right to address the meeting and present proposals.

Haukur C. Benediktsson, Director of the Bank's Financial Stability Department, was present for the entire meeting. In addition, a number of Bank staff members attended part of the meeting.

Eggert Th. Thórarinsson wrote the minutes.