CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2023

September
18th meeting
Published 1 November 2023

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

September 2023 (18th meeting)

Published 1 November 2023

The Financial Stability Committee (FSN) of the Central Bank of Iceland takes decisions on the application of the Bank's financial stability policy instruments. Financial stability means that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to diversify risks appropriately. The Committee is tasked with assessing the current situation and outlook for the financial system, systemic risk, and financial stability; defining the measures necessary to ensure financial stability; and deciding which entities, infrastructure elements, or markets shall be considered systemically important. When warranted, the FSN may make recommendations to the appropriate Governmental authorities concerning the measures needed to strengthen and preserve financial stability. In general, the Committee publishes the minutes of its meetings within four weeks, including information on the Committee's decisions, the rationale on which they are based, and its assessment of financial stability.

At the meeting of 18 and 19 September 2023, presentations were given on economic developments and prospects and the state of the financial system and payment intermediation infrastructure. The Committee discussed the current situation and outlook for financial stability and the principal risks to financial stability, such as economic developments, risks in the operations of financial institutions and the financial system, developments in domestic financial markets, household and corporate debt, the real estate market, the efficacy of borrower-based measures, financial institutions' capital and liquidity position, and the financial cycle. The FSN was also given a presentation on the methodology for designating systemically important financial institutions (D-SIB) and a presentation on the results of the annual stress test on the D-SIBs.

The FSN decided to keep the countercyclical capital buffer (CCyB) rate unchanged. In accordance with the Committee's March 2023 decision, the CCyB will increase from 2% to 2.5% on 15 March 2024. The FSN also urged lenders to give consideration to increased debt service. Most borrowers had ample equity, which should provide scope to adjust loan payments to match debt service capacity and simultaneously ensure that it remains in line with the criteria provided for in the borrower-based measures set by the FSN. The Committee also urged borrowers to avert potential financial distress by seeking prompt assistance from their lenders if they expect their debt service burden to become onerous.

The Committee also emphasised the necessity of strengthening financial institutions' cyber- and operational security and bolstering the resilience of payment intermediation in Iceland. In this context, the FSN considered the steps taken towards an independent domestic retail payment intermediation solution a positive move and agreed with Government proposals to expand the Central Bank's authority in this area.

Analysis of financial stability

Trading partner inflation had continued to ease since the FSN's June meeting but remained well above inflation targets. Trading partners' central banks had therefore continued to tighten their monetary stance. This had affected asset prices and global equity prices had therefore fallen. Inflation had tapered off in Iceland as well but measured 7.7% in August and was therefore far above the 2.5% target. The Central Bank's key interest rate had been raised by 0.5 percentage points since the Committee's June meeting.

The FSN agreed that the status of financial stability in Iceland was good on the whole despite high inflation and interest rates. The Committee considered cybersecurity one of the main risks to financial stability at present, although members were also of the view that risks associated with corporate debt and the commercial real estate market had increased. Most indicators implied that demand pressures in the economy would subside gradually but steadily. Risks associated with the residential property market had receded, but members were nevertheless somewhat concerned about household debt. Further ahead, however, rapidly rising financing costs could put strain on leveraged households, although households were quite resilient overall. In addition, poorer financial conditions had adversely affected businesses. The FSN considered it appropriate to urge lenders to consider increased debt service in a timely manner so as to prevent financial distress among borrowers and, if necessary, restructure borrowers' debt in order to ease the burden.

Banking system resilience

The Icelandic financial system is on a solid footing. The systemically important banks' capital and liquidity are strong. The banks' foreign refinancing risk has decreased with bond issues in recent months. Their foreign bond issuance had boosted their liquidity ratio between meetings, and their excess liquidity totalled 334 b.kr. at the end of July. Their liquidity ratio in all currencies had risen 22 percentage points between meetings, to 204%, well above the 100% required by the Central Bank. At that time, the liquidity ratio in foreign currencies was 429%, whereas the ratio in Icelandic krónur was 114%. The FSN was also given a presentation on the liquidity stress test carried out on the commercial banks, which showed a high level of resilience. The majority of the commercial banks' funding is in the form of deposits, covered bonds, and unsecured marketable bonds. In Q2/2023, deposits grew quarter-on-quarter by 5%, or 135 b.kr., and now constitute about half of the banks' funding. Household deposits rose the most, although there was a noticeable increase in large companies' deposits; however, deposits owned by pension funds and customers in the financial market declined. The banks' domestic funding comes primarily from deposits.

Credit spreads on the banks' foreign bond issues had fallen markedly since the June meeting and were broadly back to the levels seen at the beginning of the pandemic. This decline erased the surges from late 2022 and March 2023, the latter of which came in the wake of market uncertainty associated with banking sector turmoil in the US and Europe. The D-SIBs had all issued unsecured eurobonds since the last FSN meeting in order to refinance upcoming euro-denominated maturities. The banks' refinancing risk had therefore receded between meetings, and it emerged that they had enough foreign liquidity to cover all of their 2023 and 2024 maturities without breaking liquidity rules. Domestic bond issuance has been limited and has mainly taken the form of covered bonds, which exceeded net new lending to households in H1/2023.

The banks' interest income continues to rise, particularly because of balance sheet expansion and increased returns on liquid assets. Higher interest rates, credit growth, and low impairment rates have strengthened the D-SIBs' operating performance in the recent term. The banks' interest rate spreads have widened, particularly because of increased interest income from liquid assets; i.e., Central Bank deposits and Treasury bonds. Their return on equity was 12% in H1/2023, as opposed to 10% in H1/2022, when it was affected somewhat by Arion Bank's sale of Valitor. Their combined capital ratio was 24.2% at the end of June, after rising by 0.5 percentage points since the turn of the year. After adjusting for the forthcoming increase in the CCyB to 2.5%, already decided by the FSN, and next year's dividend payments, the banks' capital ratios are 3.5 - 5.2% above the overall required ratio. Their leverage ratio was unchanged year-to-date, measuring 12.9% at the end of Q2. The D-SIBs' minimum required own funds and eligible liabilities (MREL) as determined by the Central Bank ranged between 30.5% and 32.4% of their risk base as of end-June 2023. At the same time, their MREL funding ranged between 35.5% and 42% of the risk base.

Household arrears were still limited, and the non-performing loan ratio measured 0.8% at the end of June. A marginal rise in frozen bank loans to households had been detected in recent months, however, partly because individuals had taken increased advantage of deferred payment measures offered by the banks (for instance, due to childbirth leave). The D-SIBs' corporate non-performing loan ratio increased slightly in Q2, to 2.3%. It fell in all sectors apart from agriculture and fishing, manufacturing, and hospitality, where it rose marginally. The position of most borrowers that needed support during the pandemic has improved significantly, and impairment of loans to companies in the tourism sector has decreased. At the end of June, 3.8% of loans were classified as forborne and performing, about half the ratio seen at the turn of the year.

The results of the Central Bank's annual stress test of the systemically important banks showed that the banks were resilient and well equipped to withstand a severe stress scenario while continuing to intermediate credit to households and businesses.

Private sector debt

At the end of July, household debt had grown by 6.8% year-on-year in nominal terms but had declined by 0.8% in real terms. The banks' mortgage lending growth has eased, whereas pension fund lending has increased slightly. Households have increasingly sought out indexed mortgage loans, which accounted for 47.4% of the outstanding mortgage stock as of end-July, up from 44.3% at the end of 2022. The household debt-to-GDP ratio had fallen to 75.6% in Q2/2023. The ratio of household debt to disposable income had fallen as well, to 150.6%. Both ratios were low in historical context and lower than, for instance, in the Nordic countries.

Higher interest rates had increased debt service burdens, particularly for borrowers carrying non-indexed variable-rate loans. The fixed-rate clauses that have protected some borrowers against rising debt service are beginning to expire. The stock of loans subjected to interest rate reviews in August through December 2023 totals 1.3% of GDP (53 b.kr.). This amount is set to keep rising until H1/2025. Households appear quite resilient, however. Arrears were still limited and had increased only slightly since the last meeting, and there had been no increase in forborne loans. Unemployment was low and real wages high. There were signs that households were scaling down consumption and tapping into their savings. There are indications that many households have sought the available measures to lower debt service burdens, and data on net new household lending show that households are increasingly refinancing non-indexed debt with indexed loans in order to lower debt service. An analysis of the distribution of debt service-to-income ratios suggests that risk associated with debt service is on the rise. In July, 12.6% of borrowers had seen their monthly debt service increase by more than 100,000 kr. per month from the time of borrowing, up from 4.5% at the beginning of the year. This has been offset by pay rises, however.

Year-on-year growth in corporate debt had been significant recently, measuring 10% in nominal terms at the end of Q2/2023, its highest since 2019. It rose slightly between quarters, and the corporate debt-to-GDP ratio had risen to 77.5%, which is nevertheless historically low. Corporate debt owed to domestic banks had risen in real terms, while bond issuance had contracted. Banking system credit growth was strongest in lending to the construction sector, owing both to new loans and to reduced loan retirement as a result of slower sales of new buildings. Corporate demand for credit had therefore been considerable during the quarters prior to the FSN meeting in spite of rising interest rates; however, the first signs of a downturn in demand were coming to the fore. The four commercial banks' responses to the Central Bank's August lending survey suggested that the supply of credit to companies had shrunk. Indexed loans had been prominent in new corporate lending in recent months. This trend is due in large part, however, to a few large loans to real estate firms and construction companies. Interest rate hikes had strongly affected debt service on corporate loans, the majority of which were non-indexed variable-rate loans. Furthermore, cost increases due to wage developments and rising input prices had negatively affected companies.

Corporate arrears had increased by 0.1 percentage points quarter-on-quarter, and the D-SIBs' corporate non-performing loan ratio was 2.2% at the end of Q2. The ratio was highest in the hospitality industry, at 6%.

Asset prices

Housing market activity started to ease in mid-2022. Market turnover had shrunk, and the number of purchase contracts fell by a fifth year-on-year in the first seven months of 2023, to a low not seen since the first seven months of 2014. The number of homes for sale had risen, and the supply of new construction had risen significantly. The average time-to-sale had grown even longer since the FSN's June meeting. The share of newly built homes in purchase contracts had fallen somewhat year-on-year in Q3/2023. In addition, the share of first-time buyers had risen to 32%, its highest in two years. Twelve-month house price inflation in greater Reykjavík measured 0.8% in nominal terms in July, which meant that real prices fell by 6.3%. The ratio of house prices to fundamentals such as disposable income, building costs, and rent prices had fallen from the 2022 peak but remained high in historical context. It emerged that the Housing and Construction Authority had forecast that some 2,850 new homes would be built in 2023 and again in 2024, about the same as in 2022, but that new construction would ease in 2025. Tension in the real estate market had clearly receded, and real prices could be expected to keep falling in the coming term; however, because demand was strong and households well positioned in other respects, there was no risk of a steep drop in nominal prices, all else being equal. The number of employees in the construction industry had risen strongly in the recent term, and the number of job vacancies in the sector was still high in Q2. Furthermore, construction sector debt had increased by 70 b.kr. year-on-year in July. Sales of newly constructed homes had slowed, causing repayment of development loans to lose pace as well.

Turnover in registered commercial property transactions in greater Reykjavík has fallen significantly from the high point seen in 2022. The year-on-year rise in the index of real commercial real estate (CRE) prices in greater Reykjavík lost pace somewhat in Q2, measuring 4.1%. Nevertheless, the index was at a historical high and was just over 15% above its estimated long-term trend. Growth in the stock of fully finished commercial property remains sluggish, at 1% over the first seven months of 2023, down from 1.6% in 2022. There has been some increase in commercial property under construction, however. The large CRE firms – Eik, Reginn, and Reitir – had a strong operating performance in H1/2023. Leasing income had increased in real terms, and returns on investment assets had improved. The companies revised the value of their investment assets upwards during the period, particularly in

Q2, which weighed heavily in their positive performance for the period. Nevertheless, the companies' financing costs, which consist in large part of indexation component on indexed loans, have increased between years.

Listed companies' share prices had fallen between FSN meetings, and the Main List index was down about 7% year-on-year. Yields on short-term nominal Treasury bonds had risen since the FSN's last meeting, in line with the increase in the policy rate, and the breakeven inflation rate in the domestic bond market had fallen.

Exchange rate of the króna and international reserves

The króna had appreciated since the FSN's June meeting and was up by a total of 5% year-to-date. Interbank market turnover had declined somewhat, and forward positions with the króna had increased, suggesting expectations of an appreciation this summer, due partly to a buoyant tourist season and a foreign company's acquisition of Icelandic biotech firm Kerecis for 175 b.kr. (4.3% of GDP). Furthermore, Iceland's current account deficit narrowed to 0.2% of GDP in H1, from 4.1% in H1/2022. The year-on-year turnaround was due mainly to increased net factor income due to changes in the operating performance of foreign-owned Icelandic companies in the pharmaceuticals and aluminium sectors. In addition, the pension funds bought foreign currency for 68 b.kr. over the first eight months of the year. The D-SIBs' foreign exchange balance had increased between meetings and was positive; i.e., the banks' foreign-denominated assets exceeded their foreign-denominated liabilities.

The international reserves had declined between meetings, mainly because of the appreciation of the króna. At the end of Q2/2023, they measured 113% of the IMF's reserve adequacy metric, down from 124% at the end of 2022. The reserves were equivalent to 139% of short-term liabilities and 19% of GDP.

The financial cycle and cyclical systemic risk

Cyclical systemic risk can be estimated in a variety of ways, and the FSN uses more than one measure. A composite measure of financial cycles indicated that the cycle was still in an upward phase in Q2/2023, as were all of its sub-cycles. Financial cycle estimates and actual economic developments have begun to diverge recently, however. For example, real house prices have declined four quarters in a row, the household debt-to-GDP ratio fell by 22 percentage points from year-end 2020 through Q2/2023, and real private sector debt has held unchanged. This could indicate that the financial cycle is at a turning point or, at least, has stopped rising.

The financial conditions index had declined in recent months, primarily because of rising interest rates, reduced real estate market activity, and a lower exchange rate; however, it did not indicate that financial conditions were unusually tight in historical terms. The indicator is sensitive to the treatment of spreads between long- and short-term Treasury bond rates. A new version of the indicator was presented, showing that financial conditions had shifted from being relatively weak and expansionary in mid-2022 to being at their tightest in over a decade by mid-2023.

The financial cycle is one such measure that the Committee considers, and another is the domestic composite systemic risk indicator, or d-SRI. The d-SRI suggested that cyclical systemic risk had receded continuously for a year and a half. The majority of the increase from 2019 through end-2021 had reversed, and the indicator was therefore broadly back to its year-end 2020 level. Pulling in the other direction were, on the one hand, the increase in household debt service relative to disposable income, and on the other hand, the house price index, which was still high relative to the general wage index.

Taken together, indicators of cyclical systemic risk suggested a moderate risk level at present and an overall decline in systemic risk.

Cybersecurity
The Committee heard a presentation on cybersecurity. International institutions' forecasts indicate that operational risk will increase in coming years, particularly in connection with cyberthreats and payment intermediation. The Central Bank has begun working with the Ministry of Finance and Economic Affairs on improvements to cybersecurity and operational resilience in the financial system. Legislation on operational security and contingency preparations in payment intermediation has been strengthened in much of the Nordic region. The FSN deemed it important to prepare for comparable statutory amendments in Iceland.

The Committee considered it vital to continue strengthening financial institutions' cyber- and operational security and to bolster the resilience of payment intermediation in Iceland.

Financial Stability Committee decisions

Countercyclical capital buffer
The main purpose of the countercyclical capital buffer (CCyB) is to enhance financial institutions' resilience against cyclical systemic risk, thereby providing them with the scope to absorb losses and maintain the supply of credit during periods of stress. By law, the CCyB may range from 0% to 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate. Tighter borrower-based measures and the increase in the countercyclical capital buffer have bolstered the financial system's resilience against housing market corrections and tighter financial conditions. The FSN discussed the options available to households that cannot cover their mortgage debt service. Most households have considerable scope to lower their debt service; for instance, by lengthening loan maturities, refinancing supplemental loans, switching to an annuity format, or taking indexed loans to refinance non-indexed debt. Because of exemptions provided for in legislation on mortgage lending, rules on maximum loan-to-value ratios, and rules on maximum debt service-to-income ratios, borrower-based measures do not affect households' debt restructuring or refinancing options. The Committee also discussed the potential impact of household debt restructuring on the banks' capital requirements, noting that the number of forborne loans could increase, particularly if the economic outlook deteriorates more than is currently anticipated and unemployment rises higher than assumed. The increase in the buffer to 2.5%, decided in March 2023, created further scope to lower it in the future, in the event of an economic contraction that could cause a decline in the supply of credit.

Analysis of cyclical systemic risk suggested that risk was moderate at present and was on the decline, particularly because growth in private sector debt had not kept pace with GDP growth. The D-SIBs' capital ratios were ample and arrears limited. The banks were financially sound and their liquidity ratios strong, and they had recently refinanced their foreign-denominated debt, thereby reducing their refinancing risk. Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 2.5%, and the proposal was approved unanimously.

Systemically important financial institutions
Once a year, the FSN reviews its designation of systemically important financial institutions and the O-SII buffer. The European Banking Authority's (EBA) methodology for the identification of systemically important financial institutions was presented to the Committee, and at its December 2023 meeting,

the Committee will determine the O-SII buffer and decide which financial institutions should be designated as systemically important.

Financial market infrastructure

One of the Central Bank of Iceland's legally mandated objectives is to promote an active and secure financial system, including domestic and cross-border payment intermediation. The Committee was updated on the implementation of an independent domestic payment solution, which will greatly enhance the security of domestic payment intermediation. On the one hand, the Bank's Strategic Forum (is: *Framtíðarvettvangurinn*) is working on analysing and preparing recommendations on which solution should be selected, and on the other, Government authorities are preparing amendments to the Act on the Central Bank of Iceland, with the aim of expanding the Bank's power to set rules on payment intermediation and financial market infrastructure. The FSN also heard a presentation on cash, as cash payments at points of sale are continually declining. The Committee also discussed the fact that Icelandic merchants are not required to accept banknotes and coin.

The FSN considers the steps taken towards an independent domestic retail payment intermediation solution a positive move from the standpoint of security and efficiency and agrees with Government proposals to expand the Central Bank's authority in this area.

At the end of the meeting, the Committee approved a statement for publication on the morning of 20 September 2023.

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, Central Bank of Iceland

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Gudrún Thorleifsdóttir, Director General at the Ministry of Finance and Economic Affairs, attended part of the meeting, with the right to address the meeting and present proposals.

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; and Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.