CENTRAL BANK OF ICELAND

MINUTES
FINANCIAL STABILITY COMMITTEE

2023

December
19th meeting
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The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

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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 of the meeting concerned. The minutes include information on the Committee's decisions, the rationale on which they are based, and the assessment of financial stability.

At the meeting of 20 and 28 November and 4-5 December 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, the impact of seismic activity on Reykjanes peninsula on the financial system and the economy more broadly, 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 position, and the financial cycle. The Committee also discussed the security, efficiency, and efficacy of financial market infrastructure and its importance for financial system stability. The Committee received information on pension funds' investment strategies, asset composition, and returns, as well as a presentation on matters relating to the funds' impact on financial stability. Furthermore, the Bank's work on the assumptions underlying the 2024 stress tests were presented to the Committee. The FSN heard a presentation on the supervisory review and evaluation process (SREP) of the commercial banks in 2023, the results of which are used to determine their Pillar II-R capital requirements. The Committee also received information on matters pertaining to the Resolution Authority and related statutory amendments.

In the FSN's quarterly review, it decided to keep the countercyclical capital buffer (CCyB) rate unchanged, but, in accordance with the Committee's March 2023 decision, the CCyB will increase from 2% to 2.5% on 16 March 2024.

The Committee supports the bill of legislation on enhanced operational security in payment intermediation that has been distributed via the Government's consultation portal. The Committee deems it important to give comprehensive consideration to the resilience of payment intermediation, adopt an independent domestic payment solution as soon as possible, strengthen financial institutions' cyber- and operational security, and ensure business continuity.

The FSN also completed its annual review of systemically important financial institutions and the capital buffer for systemic importance (O-SII buffer). It confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. The Committee also decided to hold the O-SII buffer unchanged at 2% for all exposures.

Analysis of financial stability

GDP growth in trading partner countries had lost pace, and inflation had fallen. Underlying inflation had fallen slowly in many economies, however, and it was expected that interest rates would be kept high for longer than previously anticipated. The risk attached to global financial stability, which had increased in 2023, was still considered substantial, and the effects of higher interest rates had come to the fore in, for instance, greater liquidity risk and credit risk faced by financial institutions. Credit spreads in global financial markets had inched upwards after falling steeply during the summer. The increase appeared to stem mainly from wars and global economic uncertainty, which could weaken households' and businesses' resilience and have a negative impact on the quality of banks' assets. Banks on both sides of the Atlantic had generated sound profits, however, and as a result, their resilience against potential loan losses was still considered good overall.

The FSN agreed that the status of financial stability in Iceland was good on the whole, high inflation and interest rates notwithstanding. Demand pressures in the economy were likely to subside gradually but reliably. GDP growth had slowed in Q3, and private consumption had contracted by just over 2% between quarters. The FSN was of the view that a protracted period of high interest rates could erode banking system asset quality but that, given the current situation and the most plausible outlook, the risk of such a development remained limited. The main risks to financial stability, in the FSN's view, centred on cyberthreats and risks associated with the residential and commercial real estate markets. FSN members agreed that borrower-based measures had preserved households' debt service capacity and helped to ensure that most households' financial situation was manageable. Arrears were limited and had risen only slightly, despite higher inflation and interest rates and a heavier debt service bur-den.

Banking system resilience

In the FSN's opinion, the domestic systemically important banks (D-SIB) are highly resilient. Their capital and liquidity were well above regulatory thresholds. The banks' liquidity had declined between meetings, owing to foreign bond maturities, and was nearly 326 b.kr. above the regulatory minimum at the end of October. The D-SIBs' combined liquidity ratio in all currencies was 176%, well above the 100% minimum required under Central Bank rules. Interest rate spreads on foreign issues declined considerably during the summer but began to rise again in October, in tandem with the rise in global credit spreads. In September, however, terms on the D-SIBs' unsecured eurobond issues were better than in May. It emerged at the meeting that there were no remaining instalments on the banks' foreign bonds for the rest of 2023, whereas year-2024 maturities totalled roughly 120 b.kr. The D-SIBs had enough liquid assets to cover instalments in both local and foreign currency without being in breach of liquidity ratios. As a result, they were well able to tolerate significant outflows of liquid assets. During the year, deposits had increased by 9%, or 229 b.kr. They accounted for about half of the banks' funding, while marketable bonds accounted for another 30%.

The D-SIBs' operations were strong over the first nine months of the year, delivering a combined 60 b.kr. in profit. The return on equity was 11.8%, or 1.4 percentage points more than over the same period in 2022. Net interest income totalled 113 b.kr., an increase of one-fifth year-on-year. Net fees and commissions from financial activities also increased between years in the first nine months of 2023, while other operating income was unchanged year-on-year. The banks' operating expenses in-creased at the same time. The D-SIBs' capital ratios ranged between 23.7% and 24.3% at the end of September, or 3.2-4.1 percentage points above the minimum required by the Central Bank, after adjusting for next year's dividend payments and the CCyB increase set to take effect in March 2024. At the end of Q3, their leverage ratios lay in the 11.8% to 13.5% range, or a combined 12.7%. The D-SIBs' minimum required own funds and eligible liabilities (MREL) as determined by the Central Bank ranged between 29.4% and 31% of their risk base as of end-September 2023. The banks' MREL funding ranged between 37.8% and 41.8% of their risk-weighted assets.

The facility-level non-performing loan (NPL) ratio for household debt was 0.8% at the end of September, while for corporate debt it was 2.4%. Both percentages had increased by 0.1 percentage points year-to-date.

The NPL ratio was highest among companies in the hospitality sector, although it had continued to decline since the FSN's last meeting. The share of loans classified as forborne and per-forming was 3.2% at the end of September, as compared with 7.3% at the end of 2022. The position of firms that had needed forbearance measures due to the pandemic had therefore grown stronger in recent months. On the other hand, high inflation and rising interest rates had added to most borrowers' debt service burden. Rising interest rates and increased financing costs generally have an adverse effect on loan quality.

Private sector debt

Nominal growth in household debt has eased since 2021, to 5.8% year-on-year at the end of Q3/2023. Household debt contracted in real terms during the quarter, the real growth rate was negative by 2.1% year-on-year in September. The pandemic-era rise in household debt relative to both GDP and disposable income had reversed more or less in full. Nevertheless, new lending to households had increased in recent months, although it was still below its long-term average. Households had increasingly refinanced non-indexed variable-rate loans with new indexed loans. Indexed loans therefore increased as a share of outstanding mortgage debt, from 43.8% at the beginning of the year to 49.3% at the end of October. Because of rising wages and households' attempts to limit the increase in their debt ser-vice burden despite higher interest rates, the share of households with a debt service-to-income ratio above 35% had held virtually unchanged since the summer and had risen modestly in 2023 to date; i.e., from 10% to 13.3% of households by the end of October, after adjusting for wage developments.

In October, real wages were up 2.8% year-on-year, and there were few indications of increased financial distress among households, although there were signs that some households' resilience was un-der pressure. Private consumption contracted by 1.7% year-on-year in Q3, and seasonally adjusted unemployment had risen. Arrears and other non-performance among households had increased marginally in 2023 to date but were limited in historical context. The FSN discussed developments in households' overdraft loans and noted that deposit institutions' overdraft loan figures also covered payment card debt, including outstanding month-end credit card balances. Overdraft loans according to statistical data move closely in line with card turnover and private consumption, thereby complicating the interpretation of the data. It came to light that, according to interest rate data from the Central Bank, households' overdrafts on deposit accounts had decreased in real terms in 2023.

Real year-on-year growth in corporate debt was negative by 1.1% at the end of Q3. Corporate debt measured 76.8% of GDP, its lowest since 1998. New lending had lost pace, and D-SIB lending to companies had contracted in nominal terms since the FSN´s last meeting. Corporate demand for indexed loans had increased somewhat, particularly loans to construction and real estate companies. Corporate bond issues had subsided between years, while alternative investment fund lending to companies had grown modestly. The results of the Central Bank's lending survey suggested expectations of a further contraction in corporate demand for credit in coming months. Corporate insolvencies had in-creased in number during the year, broadly reaching the pre-pandemic level, but new company registrations had also increased over the same period.

Asset prices

The number of property purchase contracts had fallen marginally year-on-year in Q3 but had risen between quarters. The composition of sold assets and of the buyer group had changed somewhat. For instance, the share of newly constructed properties in purchase agreements had declined since 2022, and the share of first-time buyers had risen to 32.5% in Q3, its highest in two years. Participating loans had grown more common after the regulation on them was amended in early July. From August through October, 30 participating loans were granted each month, yet this was only a small share of the nearly 1,000 contracts per month concluded in the real estate market as a whole. Even though the number of homes for sale had kept climbing, property prices had continued to rise. The capital area house price index had risen by an average of 1% per month from August through October. Year-on-year house price inflation measured 2.9% in nominal terms and -4.6% in real terms as of October 2023. Home prices remain high relative to fundamentals such as wages and rent prices. The deviation of house prices from estimated long-term trend was 7.4% in October.

The commercial real estate (CRE) price index, which captures real prices in the capital area, rose by 4% between quarters in Q3, and by 7.7% year-on-year, to a full 17% above its estimated long-term trend. Turn-over in registered CRE contracts has shrunk markedly since 2022 but was very high in historical terms during that year.

Construction market activity still appears strong, and the outlook is for more homes to be put on the market in 2023 than in previous years (excluding 2020). In real terms, construction market turnover held virtually unchanged year-on-year in July and August but had risen steeply until then. Labour demand still appears strong in the construction sector.

Listed share prices had fallen between meetings, with the decline driven by a small number of large companies. The OMXI10 index had fallen by 2.2% since the FSN's last meeting, and by 11% year-to-date. Turnover with equity securities in the stock market had shrunk by 29% year-on-year. Indexed Treasury bond yields had inched upwards in H2/2023, and the breakeven inflation rate in the bond market had fallen relative to H1, mainly on short maturities, but was still well above the Central Bank's inflation target. The spread between long- and short-term nominal bonds had narrowed, perhaps suggesting that market agents expect interest rates to remain high for a shorter period than they anticipated previously.

Exchange rate of the króna

The króna had depreciated by 6% since the FSN's late September meeting but was 1% stronger than at the beginning of the year. The Bank had sold currency on 13 November in order to mitigate exchange rate volatility caused by uncertainty stemming from the seismic activity on Reykjanes peninsula. Turn-over in the interbank foreign exchange market had nearly trebled between October and November. The short-term interest rate differential with abroad had widened during the year. In recent months, it had been broadly at the level seen in June 2015, when capital inflows from non-residents began to increase.

The current account showed a surplus of 42 b.kr. (1.4% of GDP) in the first three quarters of 2023 combined, as compared with a deficit of 54 b.kr. (1.9% of GDP) over the same period in 2022. The year-on-year improvement is due largely to the rebound in tourism. Tourist arrival numbers were only slightly fewer in the first ten months of 2023 than over the same period in the record year 2018. On the other hand, the number of overnight stays was greater and revenues from each tourist somewhat larger.

The banks' net forward foreign currency position was positive by 140 b.kr. at the end of October, after declining by 25% since end-June. Capital inflows from non-residents were positive by 33 b.kr. in the first ten months of 2023. Non-residents had bought listed securities and Treasury bonds for about 9 b.kr. more than over the same period in 2022. Furthermore, the pension funds had bought foreign currency for 76 b.kr. in the first ten months of the year, about the same as in 10m/2022. In October and November, however, they had scaled down their foreign currency purchases. The D-SIBs' foreign exchange balance held unchanged between meetings and was in equilibrium; i.e., the banks' foreign-denominated assets equalled their foreign-denominated liabilities.

The outlook is for commercial flight availability to and from Iceland in the first five months of 2024 to be considerably greater than in 2023. Flight bookings declined in the wake of news coverage about seismic activity on Reykjanes peninsula, as was stated in airlines' press releases. Both of Iceland's commercial airlines had recently announced that they had withdrawn their year-2023 earnings projections.

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 Q3/2023. The cycle was still driven by all sub-cycles – i.e., the debt, housing, and funding cycles – but there were signs that the upward movement in the housing cycle had slowed marginally. The real de-cline in house prices in 2023, plus reduced indebtedness in the private sector, could suggest that the financial cycle is either at a turning point or is stagnating. The domestic systemic risk indicator (d-SRI) showed a decline in systemic risk for the seventh quarter in a row, and developments in Q3 were due primarily to positive changes in the current account balance and falling real equity securities prices. Taken together, indicators of cyclical systemic risk suggested a moderate risk level and an overall de-cline in systemic risk.

Pension funds

The FSN was given a presentation on developments and prospects for pension fund operations. At the end of Q3, Icelanders' pension savings equalled 7,180 b.kr., or 176% of GDP, and had increased by 4.1% year-to-date for mutual and private pension funds combined. For mutual pension divisions, foreign assets accounted for 37.7% of total assets in Q3, after increasing by 1.2 percentage points since the turn of the year. The pension funds' authorisations for foreign investments were expanded with statutory amendments made this year to the Act on Mandatory Insurance of Pension Rights and on Activities of Pension Funds, no. 129/1997. The funds' investment strategies for 2024 show that they expect to reduce the share of foreign assets by 2.1 percentage points of total assets and increase the weight of Treasury bonds and equities to compensate. The pension funds' flexibility to take risks varies, and their priorities differ as regards investments in foreign assets and Treasury bonds. It emerged that the outlook was for returns from the pension funds' mutual pension fund divisions to be negative in 2023, for the second year in a row. Over the first nine months of 2023, their real returns were estimated to have been negative by around 2%. It emerged that if developments continued in the present vein, some of the pension funds could need to take steps to respond to a deficit in their actuarial position.

The FSN noted that the pension funds are dominant participants in the domestic financial market. Given the size of their asset portfolio relative to the size of the economy, their activities could affect financial stability. The FSN considered it important that the statutory framework for the pension funds should take account of this, and that the requirements made of them in connection with intermediation of credit should be comparable to those made of other financial market entities.

Stress test for 2024

The FSN was given a presentation on a draft of the stress scenarios for the Central Bank's 2024 stress test on the systemically important banks. The scenarios are designed based on the key drivers of the banks' earnings and an assessment of systemic risk. The 2024 stress test addresses developments in key variables such as unemployment, wages, GDP growth, inflation, and interest rates. The chain of events is designed so as to assess the banks' resilience under stress over a three-year period, with assumptions based on developments in key asset markets, interest rates, and public and private sec-tor debt.

Resolvability of systemically important financial institutions

The purpose of the Act on Resolution of Credit Institutions and Investment Firms is to preserve financial stability and minimise the adverse implications of financial shocks by protecting insured deposits and investors, customers' assets and vital company operations, and minimising the risk that capital contributions from the Treasury will be needed. The Resolution Authority explained the Governor's key decisions in matters relating its activities since the previous year's presentation to the FSN. Resolution plans for the D-SIBs had been completed and approved. At the same time, decisions had been taken on MREL for the three large commercial banks. Furthermore, the Act on Resolution, no. 63/2023, had entered into force after having been passed by Parliament in June 2023. The Act is in-tended to incorporate the EU Bank Recovery and Resolution Directive (BRRD II) into Icelandic law. The aim is that resolution plans for the four savings banks be completed by year-end 2023.

Decision on commercial banks’ minimum capital requirements

The FSN heard a presentation on the assessment of the minimum capital requirements imposed on the commercial banks. The SREP is an important factor in assessing the minimum capital requirement imposed on financial institutions. The results of the SREP produce an estimate of the Pillar II-R capital requirement, and they depend on risk factors relating to capital, liquidity and funding needs, business plan assessments, governance, and internal controls. In the most recent assessment, the capital requirement on all of the systemically important banks declined, whereas it increased for Kvika banki.

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 main-tain 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. The D-SIBs’ capital ratios were ample and arrears limited. The banks’ position was sound and their liquidity ratios ample, and their credit risk had declined. GDP growth had slowed, private consumption had contracted for three quarters in a row, and the current account balance had turned positive. Higher interest rates had yet not shown in increased arrears and loan losses. The banks’ foreign-denominated funding was on schedule and their refinancing need for the coming twelve months was relatively moderate, and as a result, their refinancing risk was lower than it might be otherwise.

The longer interest rates remained high, the greater the potential impact on the banks. Loan quality could deteriorate and arrears could increase if the economic outlook deteriorated more than was currently envisioned and if unemployment rose higher than currently expected. The increase in the buffer to 2.5%, decided in March 2023 (and to become effective in March 2024), 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. Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 2.5%, and the proposal was approved unanimously.

Borrower-based measures

The FSN discussed the impact of the seismic activity on Reykjanes peninsula on financial stability, and members agreed that based on the scenarios currently deemed likeliest, financial stability would not be threatened. Some borrowers could experience difficulty, however, and their situation could prove highly uncertain. The FSN was also of the view that there was no reason to respond by making changes to borrower-based measures.

Systemically important financial institutions

The assessment of the systemically important financial institutions, based on European Banking Authority (EBA) methodology, was presented to the FSN. The assessment was based on indicators pertaining to size, importance, complexity, and interconnectedness of financial institutions in Iceland. The importance of individual entities was also examined based on their impact on the financial system.

FSN members agreed 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. The FSN agreed to continue using EBA methodology to assess the systemic importance of Icelandic financial institutions, as well as using expert opinion based on additional indicators and assessments of the importance of other entities in the financial system, as is provided for in the Central Bank Act and the Act on Financial Undertakings.

Capital buffer for systemic importance
The capital buffer for systemic importance (O-SII buffer), activated in 2016, is imposed on financial institutions that, because of their size and the nature of their activities, can have a substantial negative impact on financial stability and the real economy if they are failing or likely to fail. The risk addressed with the O-SII buffer is therefore inelastic. The Governor proposed that the O-SII buffer be held un-changed at 2% on all exposures at the parent company level and on a consolidated basis. The proposal was approved unanimously. The capital buffers on systemically important banks in Iceland equal a combined 9.5%, excluding the planned increase in the CCyB in March 2024.

Financial market infrastructure
One of the Central Bank of Iceland's principal roles is to promote a safe and effective financial system, including domestic and cross-border payment intermediation. Work on strengthening Iceland's financial market infrastructure framework is still ongoing. The FSN discussed operational security and contingency plans. It heard a presentation on cash as a last-resort solution in the event of an interruption in electronic payment intermediation. Iceland is facing a decreasing use of cash, and access to cash has declined with reductions in the number of bank branches and ATMs. Many countries in Europe – including the Netherlands and Sweden – have taken steps to address this trend. The FSN discussed security relating to electronic authentication and noted the importance of a joint effort by market entities to resolve the issues that have arisen and to strengthen defences against cyberfraud.

The FSN was given a presentation from Nasdaq CSD SE and the securities depository Verðbréfamiðstöð Íslands hf., which operate Iceland's securities settlement system.

Members welcomed the distribution of a bill of legislation on operational security in payment inter-mediation via the Government's consultation portal and declared their support for the bill. The bill proposes that the Central Bank Act be amended so as to empower the Bank to set rules on operation-al security in payment intermediation, subject to prior approval by the FSN.

As before, the FSN was unanimous in considering it important to give comprehensive consideration to the resilience of payment intermediation, adopt an independent domestic payment solution as soon as possible, strengthen financial institutions' cyber- and operational security, and ensure business continuity.

At the end of the meeting, the Committee approved a statement for publication on the morning of 6 December 2023.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy, Central Bank of Iceland

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 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; Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department; and Rannveig Júníusdóttir, Director of the General Secretariat, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.