5 June 2024

Memorandum

To: Financial Stability Committee
From: Central Bank of Iceland

Re: Background to the decision on the countercyclical capital buffer

The Central Bank of Iceland Financial Stability Committee's (FSN) March 2023 decision to increase the countercyclical capital buffer (CCyB) from 2.0% to 2.5% took effect on 16 March 2024. Raising the CCyB gives the FSN greater scope to lower it again later if warranted.

An analysis of the cyclical systemic risk level indicates that it is on the decline, largely because credit system lending to the private sector has declined once again as a share of GDP, owing to slower credit growth and strong GDP growth in recent years. Other factors include favourable developments in the current account balance and falling equity prices. Cyclical systemic risk appears to persist in the housing market, however. Conditions in foreign credit markets have improved in recent months, however, after having been tight for a period of time. The domestic systemically important banks' (D-SIBs') returns contracted in Q1, owing in part to costlier funding, reduced income from fees and commissions, and increased impairment and tax payments. Their capital and liquidity position are still very strong. Increased capital shores up financial system resilience and better enables the system to withstand shocks.

According to the Act on Financial Undertakings, the CCyB for exposures in Iceland shall generally range between 0% and 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.[1]

[1] cf. Article 85(a), Paragraph 3 and Article 85(b), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002.

Recent economic developments and outlook

GDP shrank by 4% year-on-year in Q1/2024, after a growth phase of over three years. The contraction was driven mainly by destocking due to the failed capelin catch, and by a larger deficit on goods and services trade. Private and public consumption increased between years. Pressures in the labour market appear to be easing, and unemployment has risen again after having been close to its historical low in the recent term. The short-term inflation outlook has worsened slightly, even though measured inflation has fallen. Inflation is still high, and economic uncertainty has grown in the wake of the earthquakes and volcanic eruptions on the Reykjanes peninsula. Financial conditions have improved in recent months but are still rather tight in historical context. Year-on-year house price inflation lost pace in H1/2023, but prices have turned upwards again in recent months. The stock market has been in a lull, long-term bond market interest rates have fallen, and the interest rate differential with abroad has narrowed.

The global output growth outlook has improved marginally. Inflation has eased, real interest rates have risen, and GDP growth has been weak in most advanced economies in the recent term. Nevertheless, nearly all of the world's leading central banks have held their policy interest rates unchanged thus far.

Private sector debt

At the end of March 2024, household debt had fallen 1% year-on-year in real terms, although nominal growth is still relatively robust, at 5.7%. Although the impact of price indexation on nominal lending rates has declined with falling inflation, it is offset in part by the past few months' rise in indexed loans as a share of total household debt. Higher debt service on non-indexed mortgages has prompted more households to take indexed loans. New non-indexed loans net of non-indexed loan retirement have measured negative since May 2023, while net new indexed loans have increased. This trend can be expected to continue while nominal interest rates remain high. Indexed mortgages now account for a larger share of outstanding mortgage debt than non-indexed loans do, although the non-indexed mortgage share is still far above its pre-pandemic level. Net new lending to households increased in H2/2023, which may reflect reduced uncertainty and increased expectations that interest rates and inflation have peaked. Nevertheless, the total stock of new loans is still somewhat below its long-term average, as new lending was sharply lower from year-end 2022 through spring 2023.

Household debt measured at the end of March 2024, at 73.8% of GDP, as opposed to 73.1% at the end of December 2023. The household debt-to-GDP ratio had been falling since around mid-2021. Household debt as a share of disposable income has been on the decline, measuring 145% as of end-March. Debt ratios are low in historical terms and in comparison with those in neighbouring countries.

At the end of March, firms' debt to domestic financial institutions had increased by 0.5% year-on-year in real terms, as compared with a 1.1% contraction at the end of December. In nominal terms, it had grown by 7.3%, up from 6.5% as of end-December.[2] Financial institutions' new corporate lending has been strong in the recent term, and companies' demand for bank loans still appears robust despite high interest rates. Companies took advantage of favourable non-indexed lending rates during the pandemic and scaled down their indexed debt accordingly. In the recent past, they have turned increasingly to indexed loans, while their bond issuance in the market has declined. As of end-April, institutional investment funds' corporate loans had increased by 27 b.kr., or 15.4% year-on-year in real terms. About half of the increase was due to the funds' purchases of corporate loans from the banks.

On the whole, private sector debt has held relatively stable in real terms in the recent past. As of year-end 2023, it equalled 147% of GDP, its lowest since 1998. The past few years' changes in the debt ratio have been driven primarily by fluctuations in GDP.

Arrears on loans from the D-SIBs to individuals and businesses are historically low. At the end of March, the non-performing loan ratio on loans to individuals was unchanged year-to-date at 1%. Frozen loans have risen marginally as a share of the household

[2] Debt owed to domestic financial institutions equals roughly 82% of total corporate debt.

credit stock, to 1.7% at the end of March. This is an increase of 0.7 percentage points since March 2023. Corporate non-performing ratios have risen slightly in 2024, measuring 2.5% at the end of March. As before, NPL ratios were highest among companies in the accommodation and food service sector, at 4.8%, the same as in the quarter beforehand, although they had fallen by 1.5 percentage points year-on-year. In the construction industry, the NPL ratio had risen by nearly a percentage point in Q1. The share of frozen corporate loans had increased slightly in 2024 to date, to 3% at the end of March, but had fallen by nearly 2 percentage points year-on-year. It is assumed that higher financing costs will show sooner or later in the form of increased arrears, but in this context, it should be noted that arrears can come to the fore with a time lag.

Real estate market

Housing market activity has picked up again. In April 2024, the capital area house price index had risen in real terms by 0.2% year-on-year, as compared with a decline of 2.9% in December 2023. Condominium prices had risen by 1.1%, while single-family home prices fell by 1%. The number of homes on the market has held relatively stable in 2024 to date, after surging in 2023. Furthermore, housing market turnover has increased alongside a rise in the number of purchase agreements, owing in part to real estate firm Þórkatla's purchases of homes in Grindavík and to an increase in equity loans from the Housing and Construction Authority (HMS). In the first four months of the year, turnover rose in real terms by 52% year-on-year in the capital area and by 66% nationwide.

House prices remain high relative to fundamentals, indicating an imbalance in the market. Near-term developments in house prices will probably be determined by inflation and interest rates, allocations to HMS equity loans, developments in wages, and the impact of Government support for Grindavík residents.

The commercial real estate (CRE) price index declined 8.6% year-on-year in Q1/2024. At that time, it was 4.2% above its estimated long-term trend, as compared with 14.7% above trend at the end of December 2023. At the same time, turnover in registered CRE transactions in the capital area increased by 24% in real terms.

Demand for commercial property has grown in recent years but is expected to ease in the coming term. Domestic economic activity has subsided, and job growth has lost pace. The three large CRE firms' operations are affected by high financing costs.[3] Returns on investment assets measured 5.6% in Q1 and were virtually unchanged between years. The calculated risk premium declined slightly during the same period, however, owing to higher yields on indexed Treasury bonds. Positive valuation adjustments in investment assets are still a large item in the firms' profit and loss accounts, at around 60% of operating revenues in Q1. The CRE firms' combined equity ratio measured 31.9% at the end of Q1 and increased by a percentage point between years. The companies will face limited refinancing risk in coming years.

D-SIBs

The D-SIBs' interest income has continued to increase, mostly because of balance sheet growth and stronger returns on liquid assets. Higher interest rates, credit growth, limited impairment, and a real decline in expenses have strengthened the D-SIBs' operating performance in the recent term. Their return on equity was 9.7% in Q1/2024, as compared with 12.5% a year earlier. The poorer outcome is due in part to higher funding costs, reduced income from fees and commissions, and increased impairment and tax payments. The D-SIBs' impairment accounts grew marginally during the quarter, to 0.84% of their loan portfolio. Their NPL ratio was 1.7% at the end of Q1, an increase of 0.1 percentage points during the quarter.[4] The rise is attributable to corporate loans, as is discussed in the section on private sector debt. Higher debt service has generally had a negative impact on loan quality, although arrears are still limited.

The D-SIBs' domestic market-based funding is relatively homogeneous and is limited almost entirely to covered bonds. Conditions in foreign credit markets have been challenging for quite a while, but in the past few months they have been developing favourably, and credit spreads on the D-SIBs' foreign bond issues have narrowed. In the past few months, the D-SIBs'

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[3] Eik, Heimar og Reitir.

[4] The facility-level non-performing loan ratio is calculated in accordance with EBA standards.

have issued foreign-denominated bonds on more favourable terms than before, thereby reducing their refinancing risk to a significant degree. In order to limit their refinancing risk still further, it would be beneficial for the D-SIBs to increase their króna-denominated funding in unsecured bonds that satisfy the Central Bank's MREL requirements.

The D-SIBs' capital ratio was 24% at the end of Q1 and is unchanged relative to Q1/2023. Following the increase in the CCyB to 2.5%, the D-SIBs' capital ratios are 3.4-4.2% above the required overall ratio.

Overall assessment of cyclical systemic risk

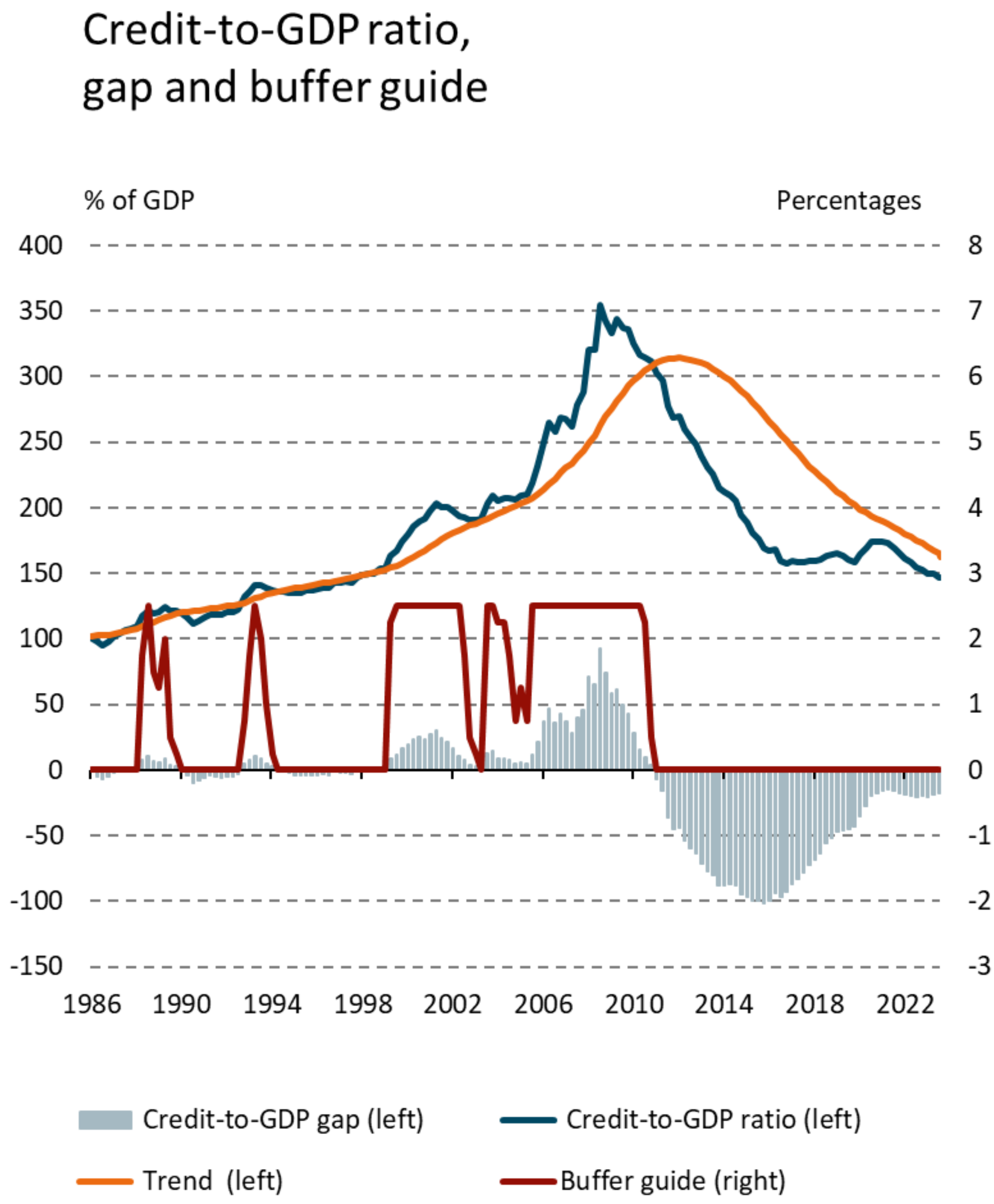
Financial conditions have improved in recent months. From mid-2022 through end-2023, they tightened in line with rising interest rates, but the trend reversed this year. The improvement in financial conditions is due to several factors: house prices are up again after the year-on-year rise lost pace in H1/2023, long-term interest rates fell early in 2024, and the interest rate differential with abroad narrowed. Even though financial conditions have started to improve, they remain slightly tight in historical context.

The combined effect of higher interest rates and tighter borrower-based measures has impeded the rise in house prices and somewhat mitigated imbalances in the market. The number of properties for sale has held virtually unchanged in 2024 to date, but the average time-to-sale has fluctuated in recent months. Imbalances remain between house prices and fundamentals, however, and it is not yet clear whether the housing market correction is at an end.

Even though the D-SIBs' profits contracted in Q1/2024, their core operations have been strong and their access to credit markets has eased in recent months. Interest premia on the D-SIBs' foreign-denominated bonds have been falling year-to-date, and if the trend continues, it will have a positive impact on foreign-denominated lending rates.

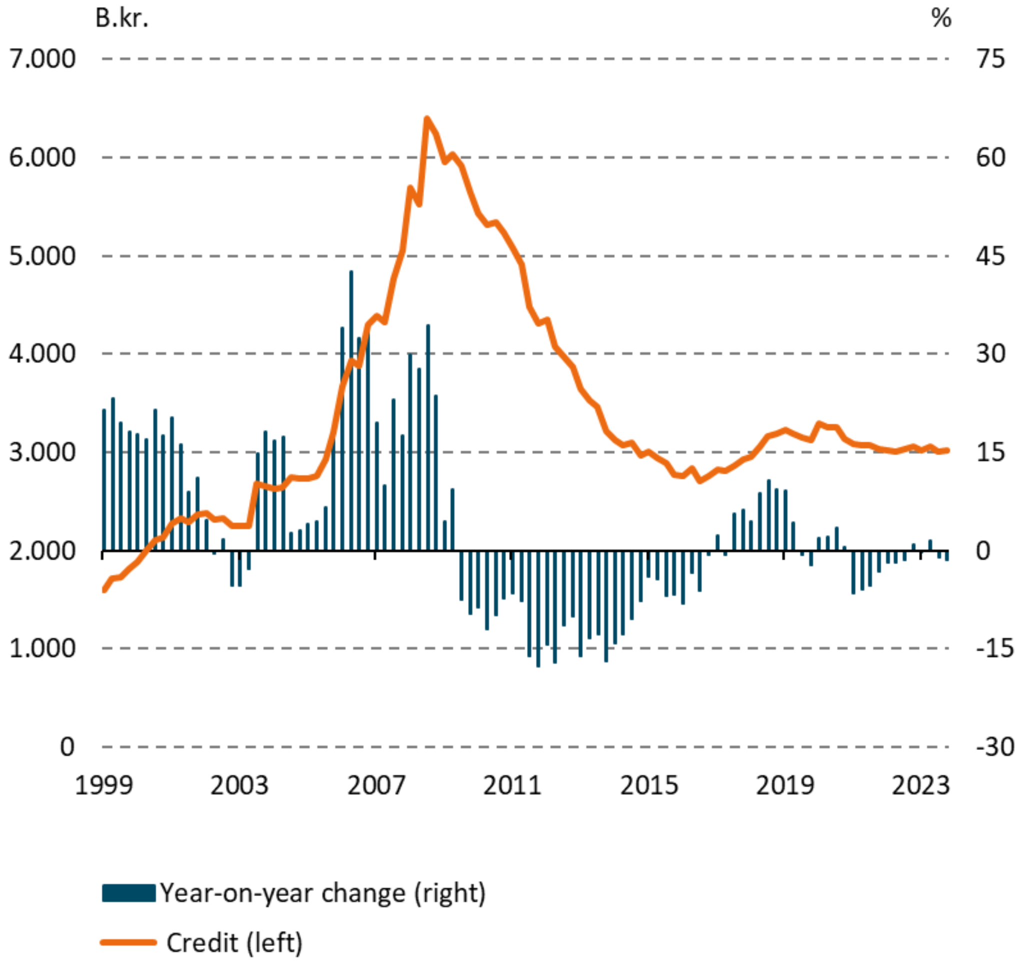
The statistical presentation of the financial cycle indicated that the cycle was still rising in Q4 of last year. All of its sub-cycles have risen in the recent term: the credit cycle and funding cycle are up slightly, while the housing cycle has risen rather briskly. The domestic systemic risk indicator (d-SRI) has fallen uninterrupted since year-end 2021. Declining systemic risk during the quarter can be attributed primarily to positive developments in the current account balance and falling real equity securities prices, but also to the turnaround in deposit institutions’ private sector lending relative to GDP. Most indicators imply that cyclical systemic risk is falling rather than rising.

Appendix – Charts



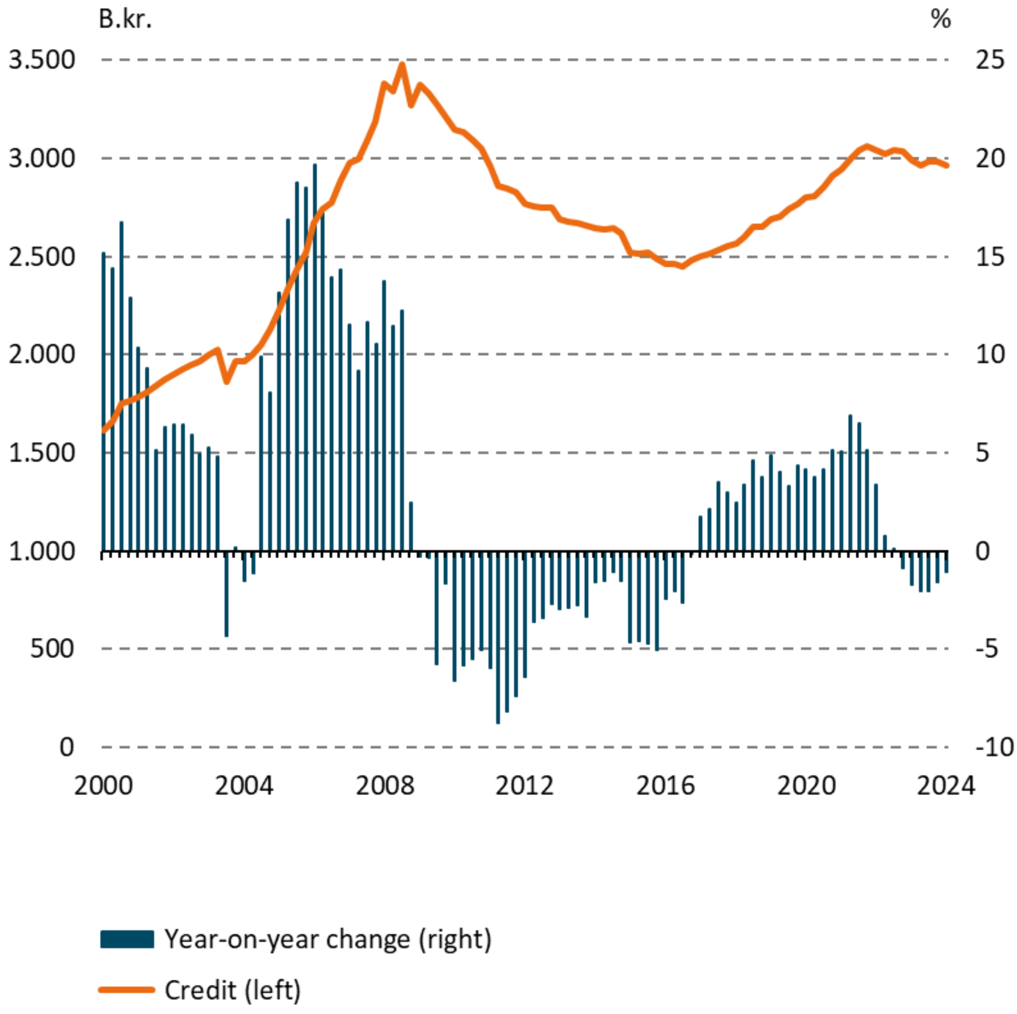
Total credit to households and firms, at claim value, as a percentage of the last four quarters GDP. The trend component is obtained with a one-sided Hodrick-Prescott filter with λ=400.000.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit to non-financial corporations



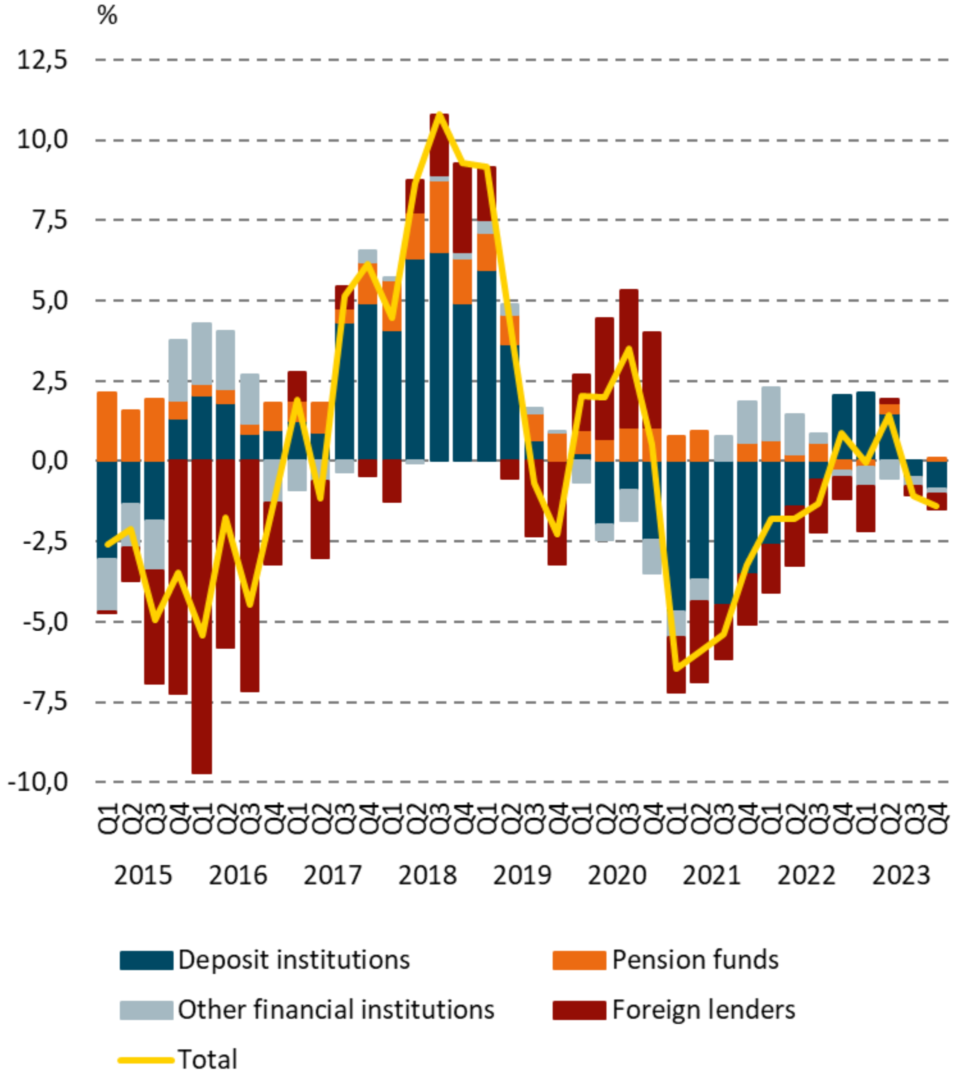
Claim value of non-financial corporations' debt to domestic and foreign financial institutions and marketable bonds issued, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Real household credit



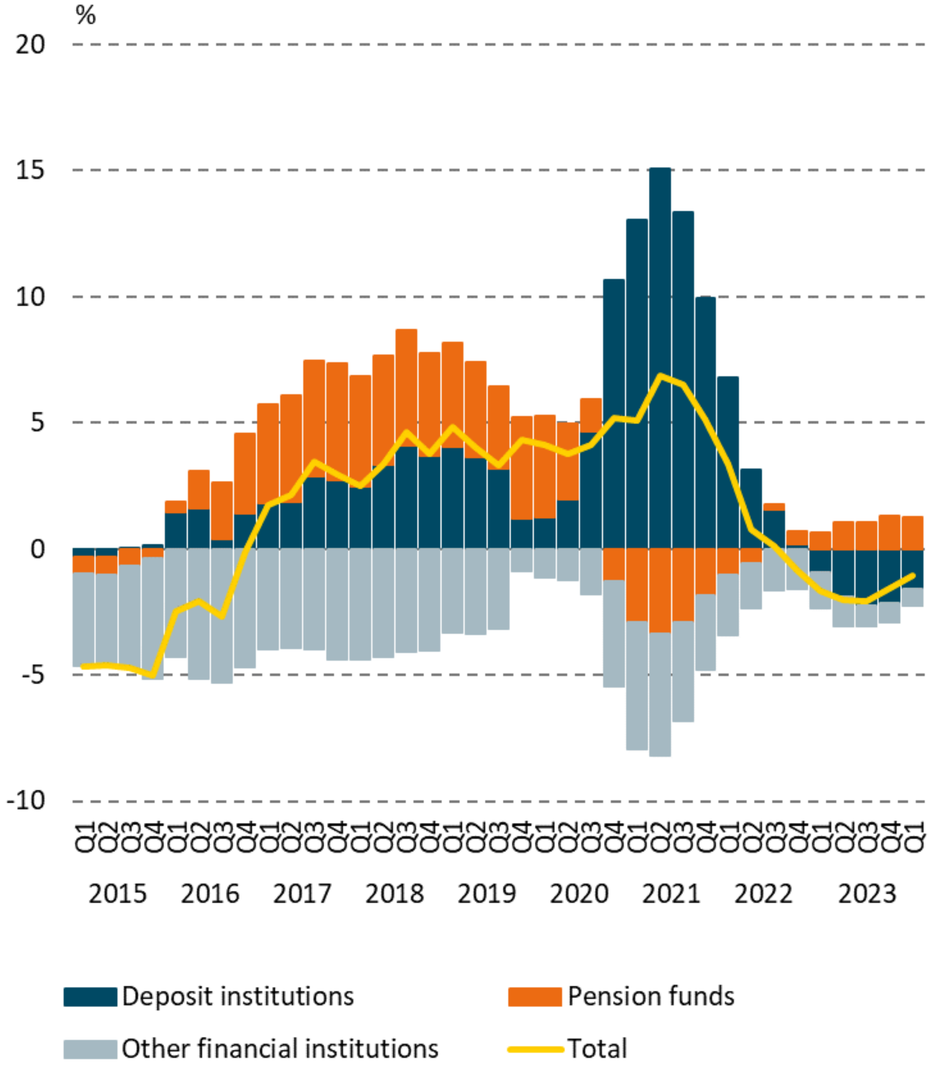
Claim value of household debt to financial institutions, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Corporate debt real growth disaggregated by lender type



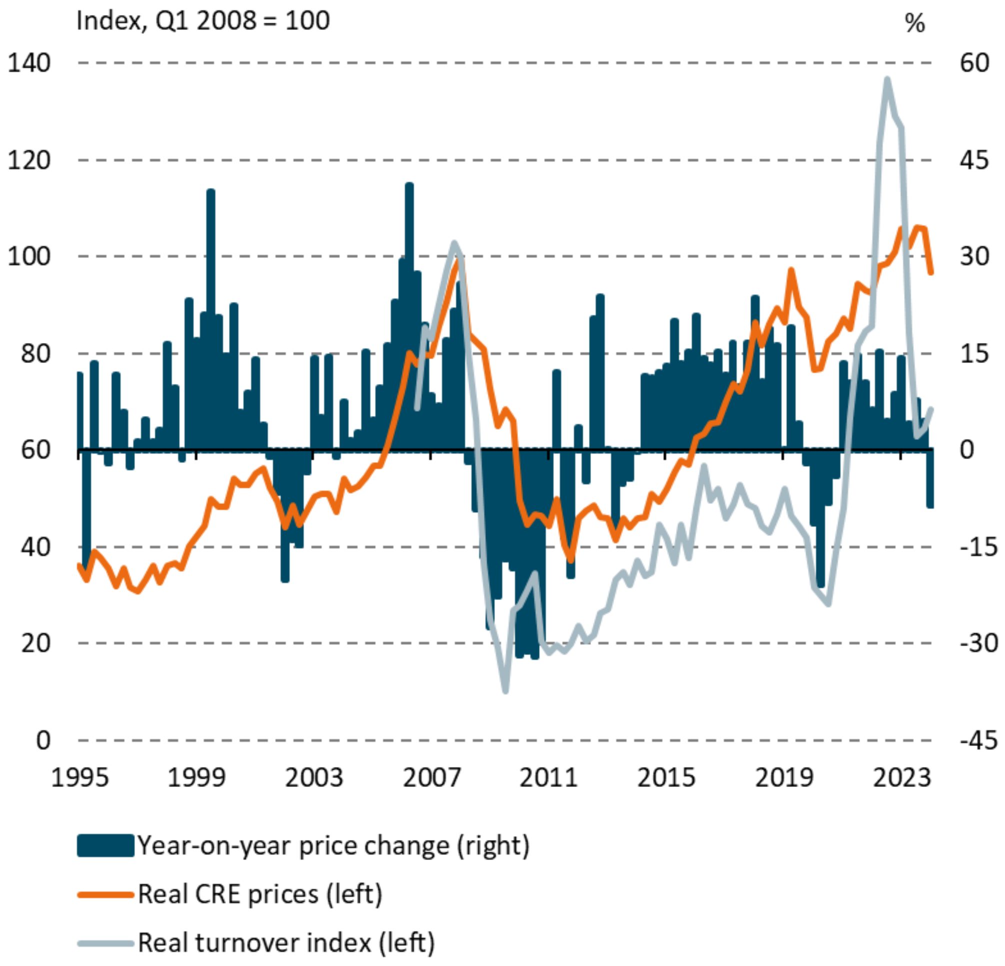
Debt to financial institutions and issued marketable bonds, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.
Sources: Statistics Iceland, Central Bank of Iceland.

Developments in real credit to households, disaggregated by lender type



Household debt to financial institutions, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.
Sources: Statistics Iceland, Central Bank of Iceland.

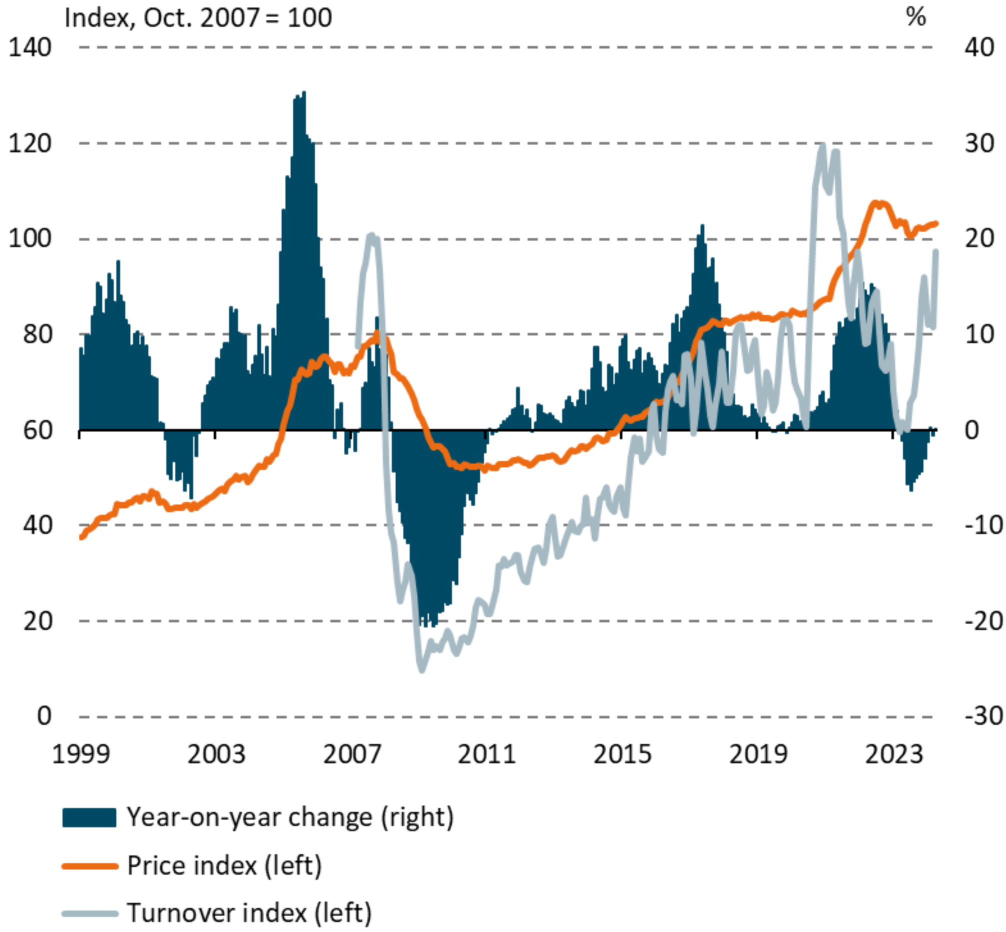
Real commercial property prices and turnover in the capital area



CRE price index, deflated with the CPI. The index shows the weighted average price of industrial, retail, and office space. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminary.

Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

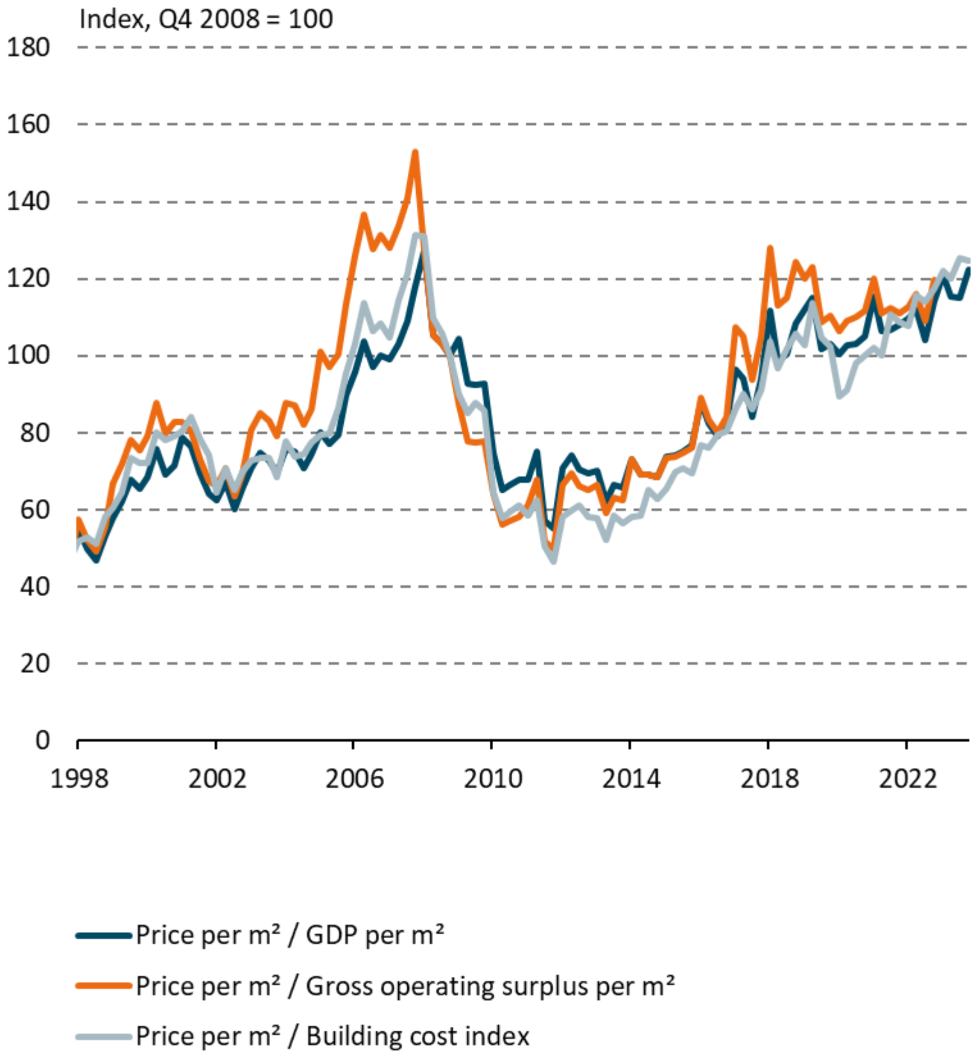
Real house prices and turnover in the capital area



The combined index of capital area house prices is based on a new sub-index for January 2024 and previous indices prior to that time. The index is deflated with the CPI. The turnover index shows a three-month moving average of turnover, deflated with the CPI.

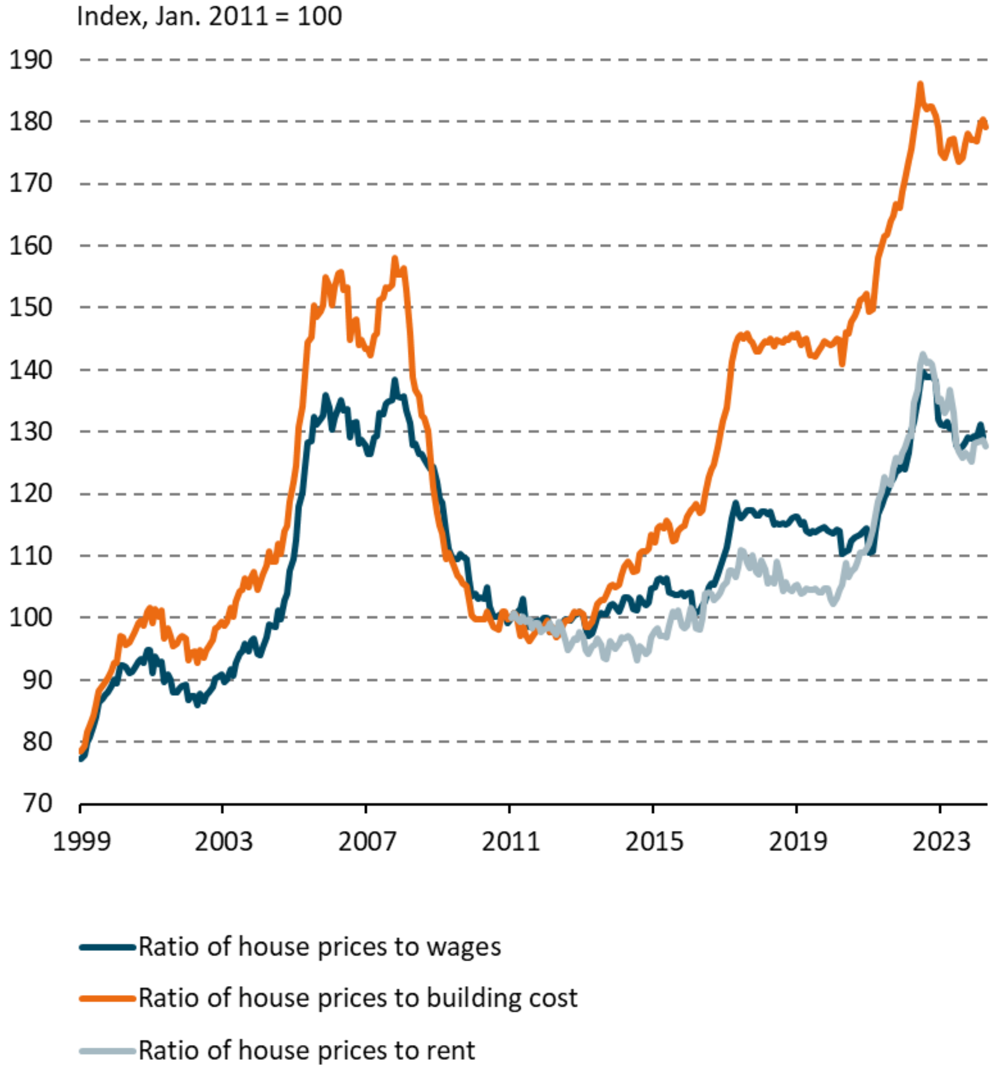
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Commercial property price ratios



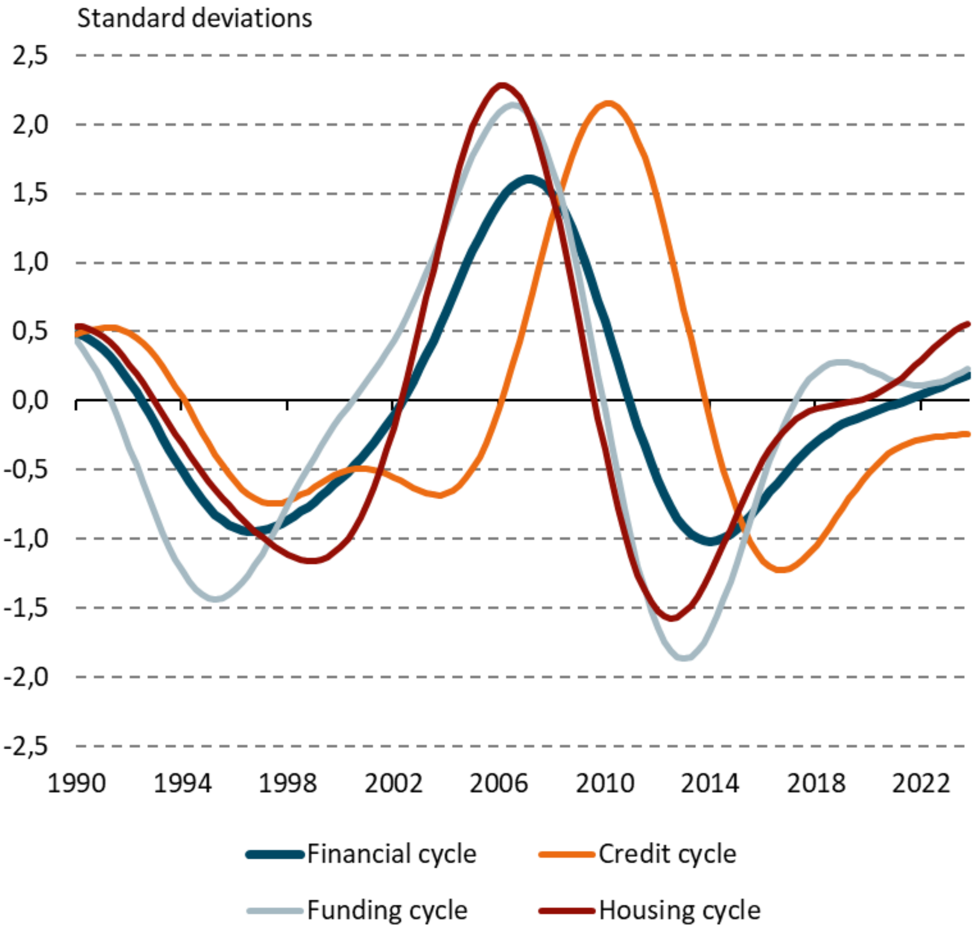
Annual data for gross operating surplus are non-linearly interpolated.
Annual data for the CRE stock are linearly interpolated.
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Capital area house prices and determining factors



Sources: Housing and Construction Authority, Statistics Iceland, Central bank of Iceland.

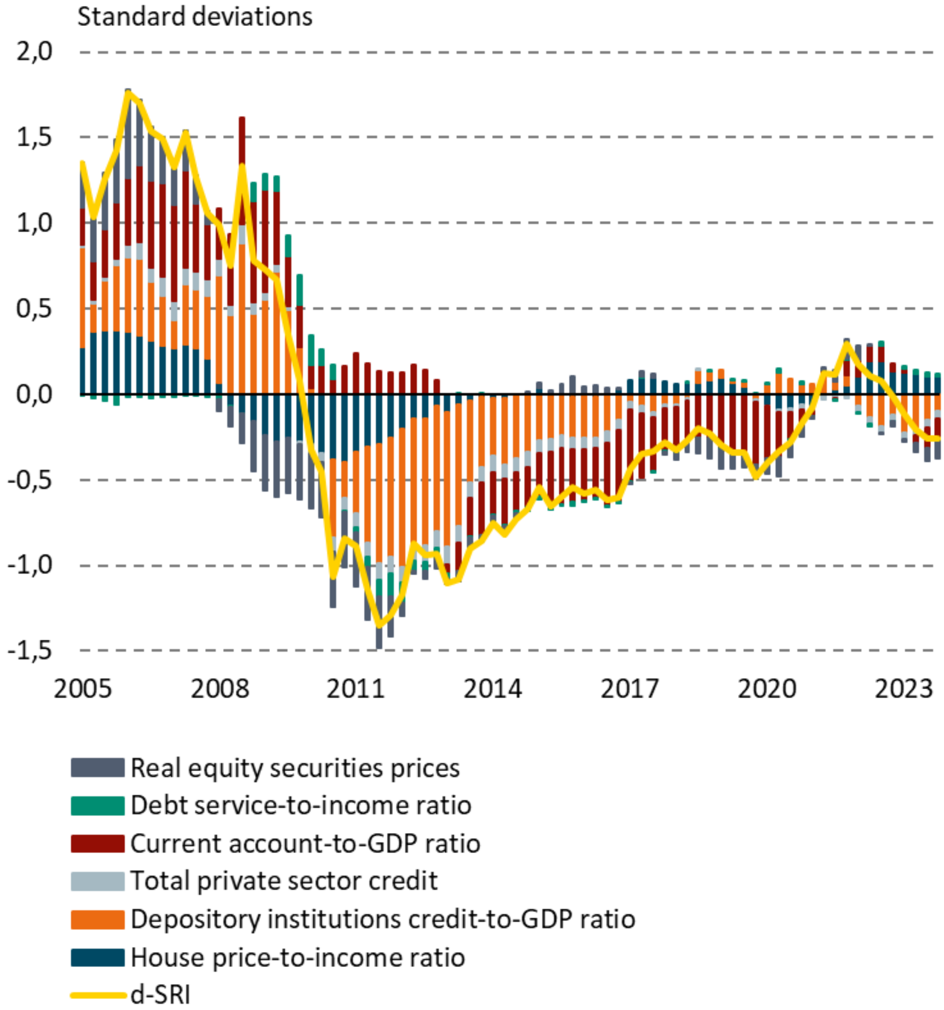
Financial cycle and subcycles



The financial cycle, the blue line, is a simple average of the subcycles. Each subcycle is a simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years.

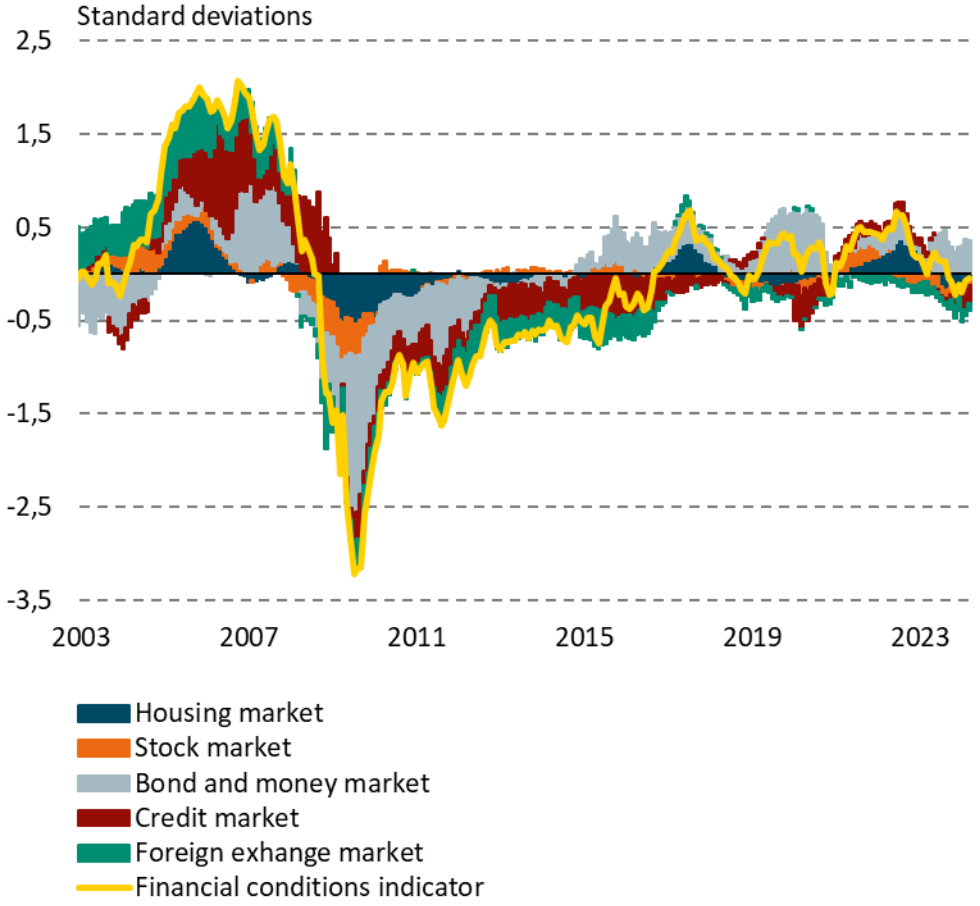
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Domestic systemic risk indicator (d-SRI)



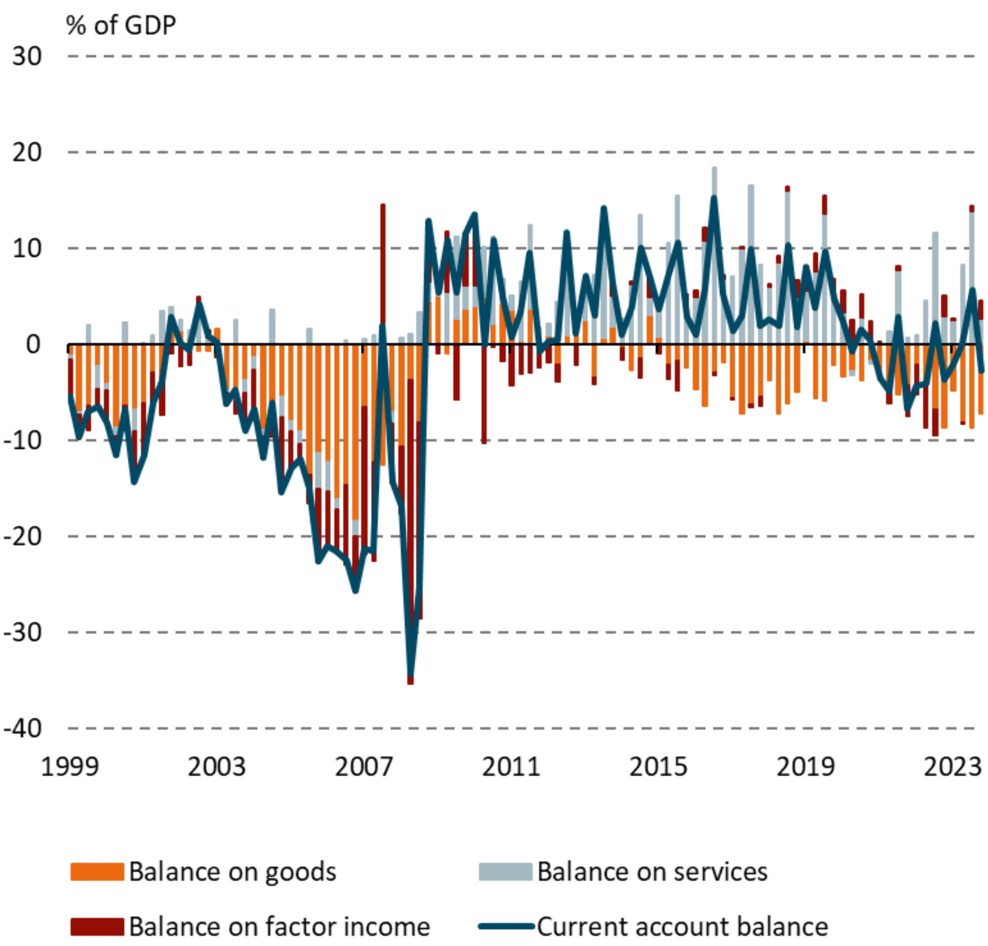
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Domestic financial conditions



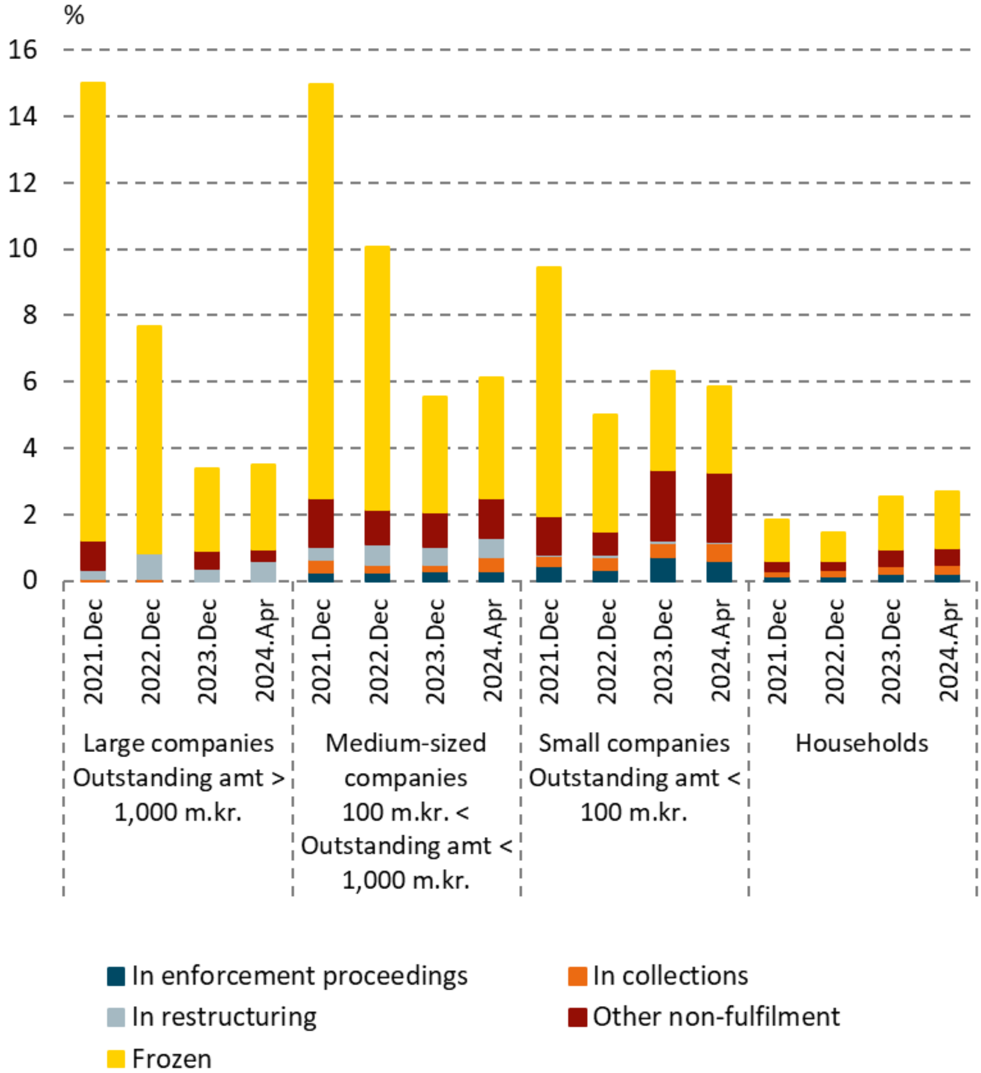
The financial conditions indicator consists of the first three principal components of selected indicators of financial conditions, scaled so that the mean is 0 and the standard deviation is 1. A lower index value indicates a deterioration in financial conditions. The estimation period is 2002-2023. *Sources*: Housing and Construction Authority, Nasdaq OMX Iceland, Statistics Iceland, Central Bank of Iceland.

Current account balance



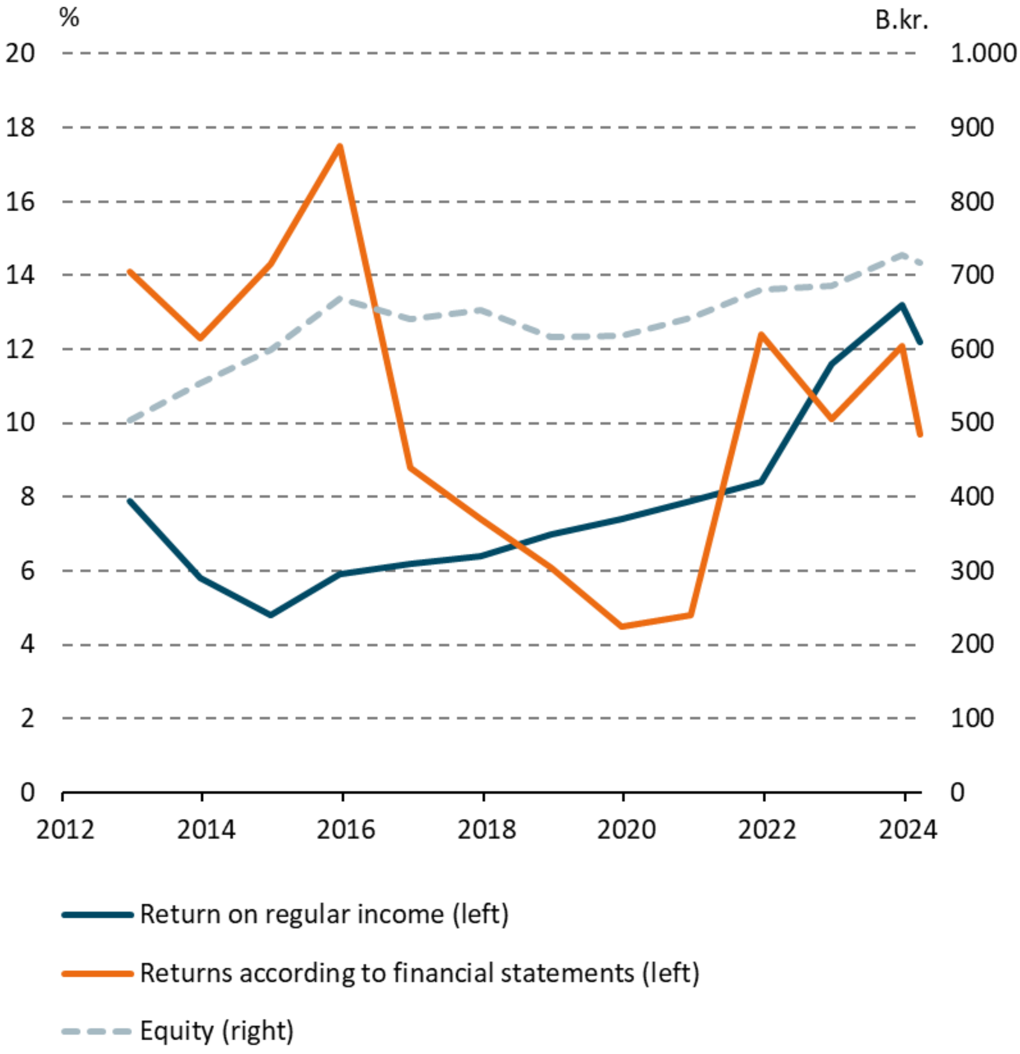
The effects of failed banks on factor income and the balance on services from Q4/2008 to Q4/2016 are ignored. From 2009 through 2012, the effect of Actavis on the balance on income is also ignored, owing to inaccurate data during the period. Secondary income is included in factor income.
Sources: Statistics Iceland, Central Bank of Iceland.

Status of non-performing loans, by borrower and type of impairment



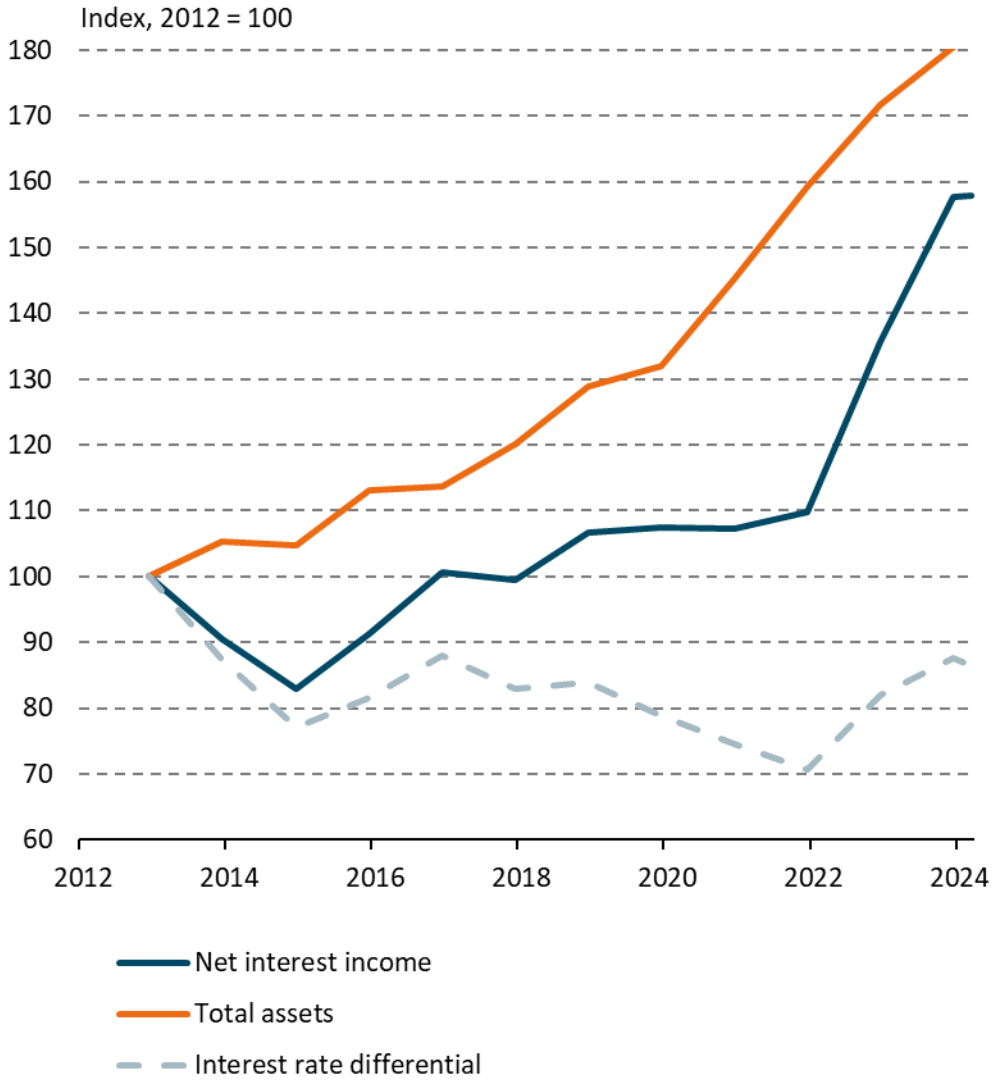
Cross-default non-performing loans, share of loans within each category. Domestic systemically important banks, parent companies, book value.
Source: Central Bank of Iceland.

D-SIB: Returns



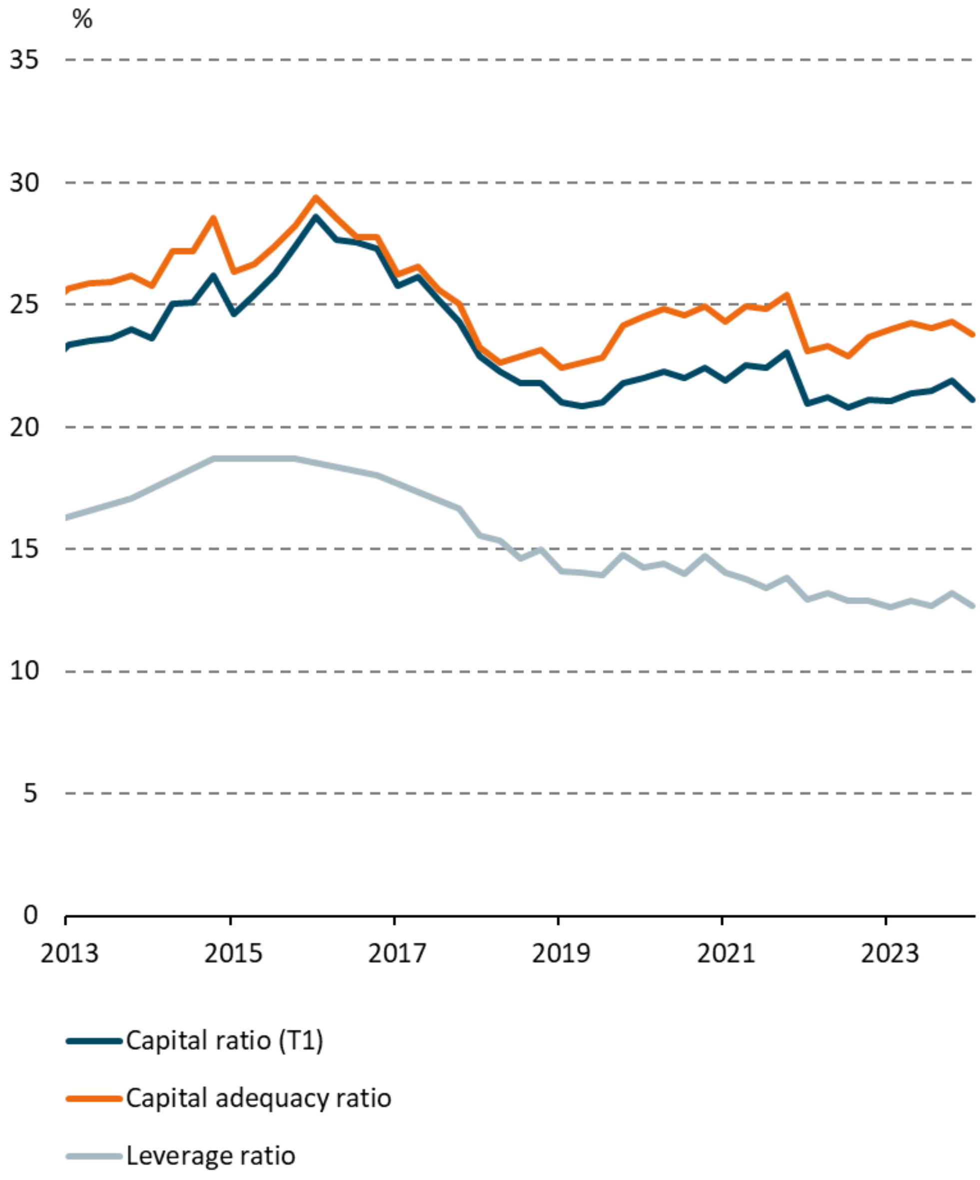
Returns are calculated on average equity, consolidated figures. The return on regular income is based on net interest income and fee/commission income net of regular expenses. The tax rate is 20% and is based on average equity. Valitor is excluded in 2017-2020.
Sources: Commercial banks' financial statements.

D-SIB: Net interest income, interest expense and interest rate differential



Domestic systematically important banks, consolidated figures. Yearly data.
2023 figures are annualised Q3 data.
Sources: Commercial banks' financial statements.

D-SIB: Capital and leverage ratios



Domestic systemically important bank, consolidated figures.
Sources: Commercial banks' financial statements.