



The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 28-29 June 2021 (8th meeting)

Published: 27 July 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's meeting of 28 and 29 June, the Committee decided to lower the maximum loan-to-value (LTV) ratio for consumer mortgages from 85% to 80%. The LTV ratio will remain 90% for first-time buyers. The Committee also decided to set explicit rules on derivatives transactions in which the Icelandic króna is specified in a contract against foreign currency, on the basis of the new Foreign Exchange Act. The FSN decided to hold the countercyclical capital buffer unchanged at 0%.

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 individual financial institutions, stress tests, the real estate market, the financial cycle, financial market infrastructure, the new Foreign Exchange Act, and amendments to the regulatory framework for financial institutions' net stable funding ratios. Information on the current situation and developments since the FSN's mid-April meeting was made available to the Committee at the meeting.

Decisions pertaining to financial stability

In the Committee's opinion, the financial system is on a strong footing. Broad-based measures taken by the Bank and the Government in response to the pandemic have mitigated the economic impact on households and businesses. The measures have also supported the

stability of the financial system. The outlook has improved markedly. The economic contraction in 2020 was less pronounced than initially thought, and forecasts assume robust GDP growth in 2021. Vaccination efforts have advanced quickly, both in Iceland and in major trading partner countries, and all public health measures within Iceland had been lifted. Growth in tourism has gained pace, and the economy showed signs clear signs of increased demand. There were indications of a more rapid recovery of the labour market than had been expected.

The three large commercial banks remain strong. They generated a profit of just over 17 b.kr. in Q1/2021. Their liquidity remained ample, at 219 b.kr. in excess of requirements at the end of May; their capital position has strengthened, and their capital ratio was 24.3% at the end of March. The banks have been successful in obtaining funding in foreign credit markets, and credit spreads on their foreign issues are at their lowest since the 2008 financial crisis. Their domestic covered bond issues cannot keep pace with the growth of the mortgage loan portfolios on their balance sheets. The banks' growth in domestic currency terms is therefore funded largely with deposits. Although deposits have increased rapidly in the recent term, this trend could reverse now that the economy has begun to recover. In the long run, this could make it more difficult for them to offer fixed-rate financing, including residential mortgages.

The FSN discussed the first results of the Central Bank's 2021 stress test. In the Committee's opinion, the three large commercial banks are highly resilient and well positioned to withstand the repercussions of the economic shock. Furthermore, the stress test reveals that the banks' capital ratios would remain well above the statutory minimum even if the economic outlook were to deteriorate significantly and loan losses to increase.

Arrears had not yet increased to any marked degree, as loan freezes were still relatively widespread, particularly in tourism and related sectors. About 4.7% of corporate loans were in default at the end of April, including 11.5% of loans to tourism companies. About 40% of loans to the services sector as a whole were frozen at that time. The FSN is still of the opinion that credit risk due to borrowers' pandemic-related financial difficulties is the largest single risk factor on the banks' balance sheets. The Committee therefore urges the banks to continue working systematically on this problem so that liquidity problems do not develop into solvency problems once loan freezes are lifted.

Growth in household debt has gained pace in the recent term. Nominal growth in household debt measured 10.7% at the end of April, up from 9.7% at the end of 2020. Real growth measured 6.2% over the same period, up from 5.3% at the end of 2020, and is at its highest since 2008. Growth in net new lending to households peaked in October 2020, eased from then until March 2021, and then began gaining momentum once again. Corporate debt developed very differently, as price- and exchange rate-adjusted growth corporate debt was negative by 2.4% at the end of Q1/2021. The Committee is of the view that it is important to keep abreast of credit growth and the interaction between debt and asset prices.

The FSN discussed the domestic equity market in some detail. The Nasdaq OMXI10 index had risen by 3% between meetings. There had been considerable excess demand for shares in Síldarvinnslan, Íslandsbanki, and Play in the companies' recent stock offerings, and market turnover had surged between years. According to trend analysis of the stock market, comparisons with foreign markets, and comparisons of key ratios of companies in the domestic market, there were no clear signs of bubble formation. In the Central Bank's opinion, underlying factors such as low interest rates, the inclusion of the Icelandic market in the MSCI

index, and increased investor optimism have pushed market prices upwards. Nominal Treasury bond yields had risen since the last FSN meeting, particularly on short-term bonds. Indexed bond yields were more or less unchanged 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. The Central Bank had discontinued its regular foreign currency sales but had bought nearly 20 b.kr. in an *ad hoc* transaction relating to Íslandsbanki's initial public offering. The Bank accounted for about one-fourth of market turnover between FSN meetings.

The Committee discussed in particular the situation in the real estate market and developments in household mortgage lending. Steep price hikes had characterised the market in recent months, and the twelve-month real rise in house prices measured 9.7% in May. House prices had risen well above long-term trend, and before the FSN meeting, the measured deviation from trend was the largest since Q3/2008. There were signs that house prices had begun to deviate from fundamentals such as building costs and wage developments. The surge in housing market turnover in mid-2020 had continued into 2021, and the average time-to-sale for capital area properties fell to an all-time low in April. In their discussion, Committee members noted that demand for housing had risen concurrent with a year-on-year decline of one-fifth in the number of homes under construction in greater Reykjavík. The number of flats under construction was at its lowest in four years. The Committee discussed whether this trend could cause a housing shortage and trigger even further price increases. Growth in household debt had gained pace, maturities had lengthened, and a larger share of new mortgage loans had high LTV ratios. It was pointed out that the surge in house prices and demand in the wake of steep declines in interest rates in 2020 could prove to be temporary, as the most recent measurements showed a slowdown in house price inflation.

The financial cycle had been broadly unchanged between FSN meetings. It was still in a gradual upward phase, and subcycles were in various phases. The private sector debt cycle was still rising, due to an increase in household debt and to the contraction in GDP. On the other hand, the housing and funding cycles had stagnated or even declined slightly, after having risen strongly between 2012 and 2018. This indicates that there is no substantial accumulation of cyclical systemic risk, although real-time measurements of this type should always be interpreted with caution.

The Committee discussed the new comprehensive Foreign Exchange Act, no. 70/2021, which had been passed by Parliament in early June, particularly the provisions intended to safeguard economic or financial stability. While the new Act does not provide for significant changes from the current framework, authorisations are presented clearly, and more simply than before. Committee members considered it vital to be able to apply the financial stability tools in the new Act, both to lean against excessive risk-taking and to respond to risks already in evidence. It was clear, however, that applying policy instruments such as capital controls would be an emergency measure to be taken only if other options proved infeasible.

The Committee discussed whether the Icelandic Banks' Data Centre's (RB) payables pool should be considered a systemically important financial market infrastructure element. The payables pool is owned by RB, which administers various aspects of claims – collections, calculation, dissemination to payers, and payment and disposition – as well as providing payers with an overview of unpaid claims across the banking system. FSN members agreed that the payables pool should not be designated a systemically important financial market infrastructure element at this time; however, it was an important infrastructure element that

ensured basic functioning in the economy, and its development and importance should be monitored. Members also noted that it was necessary to define infrastructure elements that are not designated as systemically important but, like the RB payables pool, are nevertheless very important for effective payment intermediation in Iceland.

Rules on derivatives trading by financial institutions

The FSN was of the view that the simplification of the Foreign Exchange Act, passed during the spring legislative session, was a major step forwards, as it entailed, among other things, permitting derivatives transactions involving the Icelandic króna, which had previously been prohibited without Central Bank approval. Members agreed with the fundamental principle in the Act that all derivatives transactions with the Icelandic króna should be permitted, irrespective of their purpose. The Committee considered it appropriate, however, to ensure financial stability by limiting the total amount of derivatives trading by financial institutions. The Committee unanimously approved the draft version of Rules no. 765/2021, which was available at the meeting. According to the Rules, individual financial institutions' gross forward foreign currency position was capped at 50% of their capital base, and the position vis-à-vis each individual counterparty was capped at 10% of the capital base.

Countercyclical capital buffer

Asset prices have risen markedly in recent months, and in the Committee's opinion, the conditions for a debt-driven asset bubble could be developing. The Committee was of the view that clear signs of an increase in cyclical systemic risk had not yet come to the fore, but that it could be difficult to assess this based on real-time measurements. Members discussed the importance of examining thoroughly what the appropriate equilibrium countercyclical capital buffer value for Iceland should be, perhaps including an examination of developments in other countries; furthermore, [they noted that] a strong economic recovery concurrent with more rapid credit growth would call for an increase in the buffer sooner rather than later. All members supported the Governor's proposal to hold the countercyclical capital buffer unchanged at 0% for the present. The buffer value is reviewed on a quarterly basis, and the Committee will examine it again at its September meeting.

Borrower-based measures

The Committee discussed restrictions on consumer mortgages, in accordance with Articles 25 and 27 of the Act on Mortgage Lending to Consumers, no. 118/2016. Members were of the view that, with statutory amendments during the spring legislative session, important steps had been taken to strengthen the FSN's authorisations in the mortgage lending market. Currently, the Committee's policy instruments in this area, referred to collectively as borrower-based measures, are LTV ratios on mortgage loans (previously set at 90% for first-time buyers and 85% for all other borrowers) and restrictions based on borrowers' income; i.e., debt service-to-income ratios and loan-to-income ratios. The application of these measures is intended to boost borrowers' and lenders' resilience, prevent the build-up of systemic risk, and mitigate volatility in the longer term.

Committee members discussed whether it was appropriate to respond to developments in the housing market and strengthen the mortgage lending framework by tightening borrower-based measures. Applying borrower-based measures could also support monetary policy, in that interest rates could be lower than would be possible otherwise.

A majority of Committee members were of the opinion that developments in the real estate market indicated growing imbalances. A shorter average time-to-sale, reduced supply, and more rapid growth in household lending gave cause for concern. Demand had increased alongside rising disposable income and low interest rates. Rising house prices and historically low interest rates could result in an underestimation of debt service capacity. This, plus the prospect that supply would not be able to keep pace with demand in the coming term, could create the conditions for debt-driven house price inflation. One Committee member, however, considered it most likely that strong demand and steeply rising prices in the real estate market were a response to the temporary situation caused by the pandemic. Recent developments in the market indicated that house price inflation had begun to lose pace.

Committee members discussed the impact that the application of macroprudential tools would have on the market. It emerged that doing so should not be severely onerous for the market under current circumstances. On the other hand, it would be possible to have some preventative impact by applying them in coming months and reducing the likelihood that households' mortgage debt would exceed their medium-term debt service capacity. Furthermore, applying macroprudential tools could reduce the likelihood that real estate prices would deviate significantly from the fundamentals that generally determine long-term price movements. One Committee member was of the view that signs of imbalances would have to be clearer before tools that would pose more restrictions on low-income people and first-time buyers should be applied.

Committee members considered the pros and cons of coupling the LTV ratio with restrictions on either the debt service ratio or the loan-to-income ratio. All agreed that the debt service ratio would be the better candidate for such a pairing. It was also decided to entrust the Central Bank with further examination of the debt service ratio as regards its economic design and then to discuss the matter at the FSN's next meeting.

Following the discussion, the Governor proposed that the LTV ratio on consumer mortgages be lowered from 85% to 80% but that it remain unchanged for first-time buyers. All members voted in favour of the Governor's proposal, which had been introduced at the meeting in the draft of Rules no. 778/2021. The Committee was of the opinion that the aforementioned measure would be conducive to safeguarding borrowers' and lenders' resilience and would work against the build-up of systemic risk. Members also agreed to examine the application of the debt service ratio first and to entrust the Central Bank with designing it.

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

Guðrún 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 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.