The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 21-22 September 2020 (5th meeting)

Published: 27 October 2020

The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the applications 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.

The following are the minutes of the FSN meeting held on 21 and 22 September 2020. Members decided at the meeting to hold the countercyclical capital buffer unchanged.

I Financial stability developments and prospects

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, the real estate market, financial market infrastructure, and the financial cycle. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in late June.

The economy

The economic outlook was coloured by the battle against the COVID-19 pandemic, which would seemingly be more drawn out than previously hoped. The Central Bank's most recent macroeconomic forecast, published in August in *Monetary Bulletin* 2020/3, assumes that GDP will contract somewhat less this year than in the Bank's May forecast. Preliminary national accounts figures show that GDP growth was more robust in H1 than had been assumed in the

August forecast. On the other hand, high-frequency indicators and surveys suggest that the outlook for H2 and further into 2021 has deteriorated.

The tourism sector has contracted sharply, but the fishing industry has withstood the pandemic better than forecasts had indicated. Various other services are suffering. Private consumption picked up during the summer but appears to have slowed down again as the autumn began. Job numbers have fallen steeply, unemployment has risen, and the labour participation rate is down. Unemployment is forecast to peak at around 10% towards the year-end. Inflation has risen, but inflation expectations have remained at target.

Financial markets

Foreign stock markets had held broadly flat since the Committee's last meeting, except in the US, where prices had risen. Central bank measures, government responses, relaxation of public health measures, and optimism about the development of a vaccine have supported prices in the markets.

Prices had also risen in the domestic stock market between meetings, but as has been the case in recent months, the increase was attributable largely to the rise in Marel shares. Icelandair had recently concluded a public stock offering that was oversubscribed by a considerable margin.

Yields on nominal Treasury bonds had risen, with long-term yields rising more than short-term yields, probably as a result of increased financial institution demand for securities for liquidity management purposes. Real rates on indexed one- and five-year Treasury bonds remained negative.

The exchange rate of the króna had fallen slightly since the Committee's last meeting. The Central Bank's share in market turnover had increased. The Bank had responded to the shallowness of the market by launching a regular foreign currency sales programme in mid-September. The pension funds had significantly scaled down their currency purchases in Q2 but bought for 8 b.kr. in July and August, a marked increase from the previous quarter. New investment was negative by just over 12 b.kr. in July through August and was negative by just over 10 b.kr. since end-February, when the first COVID-19 cases were diagnosed in Iceland.

Developments in private sector debt

Growth in household debt had eased to just under 3% at the end of Q2, as compared with nearly 4% at the end of Q1. The weight of non-index loans in household debt continued to rise. Price- and exchange rate-adjusted growth in corporate debt measured 0.6% at the end of Q2, after contracting marginally in Q1. On the whole, growth in private sector debt had increased little during the previous quarter.

The banking system

The three large banks' liquidity remained strong. On 16 September 2020, the banks' liquid assets in excess of liquidity requirements totalled 255 b.kr. after decreasing by 15 b.kr. since the June meeting. Stress tests of the banks' liquidity suggest that they can tolerate large-scale outflows.

Credit spreads on the banks' foreign bond issues had fallen markedly between meetings, in line with international trends. They are somewhat higher now than before the pandemic struck. The banks' generous foreign liquidity position has given them flexibility to respond to challenging market conditions without having to issue bonds. The credit spreads on the banks' covered bonds relative to Treasury bonds had also fallen between FSN meetings and were back roughly to pre-pandemic levels.

The three large banks' operating losses in H1/2020 totalled just over 0.7 b.kr. The banks' financial statements were affected by increased impairment, which totalled just over 23 b.kr. during the half. Further impairment is expected in the quarters to come if the pandemic drags on. In spite of this, the banks' capital position is very strong, and their average capital ratio was 24.8% at the end of June, as compared with 22.4% at the end of December 2019. A strong capital position and the reduction of the countercyclical capital buffer gives the banks the scope they need to withstand increased loan losses while retaining the strength for new lending.

As of mid-September, loans from the three large banks amounting to about 190 b.kr. were in pandemic-related moratorium, or just over 6% of the banks' loans to customers. This percentage had fallen rapidly in the weeks beforehand, as the six-month payment deadline had expired in many instances. Moratoria were more common among companies, at nearly 9% of corporate loans, as compared with just over 3% of household loans. Nearly one-fourth of loans to tourism companies, 12% of loans to services firms, and 10% of loans to companies in retail and wholesale trade were in moratorium. The ratio was lower among companies in other sectors. Default had risen. From the beginning of the year through the end of July, the banks' non-performing loan ratio had risen from 2.1% to 2.7% for household loans and from 4.8% to 8.9% for corporate loans.

Real estate market

The real rise in capital area house prices measured 1.9% year-on-year in August, and in regional Iceland, prices had increased by 8.6% over the same period. Turnover had contracted by 35% year-on-year in Q2. However, the turnover measurement is affected to a degree by delays in registration of purchase agreements because of an increase in other documents, including loan refinancing documents. Households have increasingly been refinancing their mortgages as a result of lower interest rates and have shifted from indexed to non-indexed mortgages. Data from credit assessments carried out by the systemically important banks indicate that borrowers with lower loan-to-value ratios have moved their business to the banks, improving the banks' loan quality.

The commercial real estate price index for the capital area was virtually unchanged in Q2 but fell by 21% year-on-year in real terms. Turnover had contracted in real terms by nearly 50% year-on-year in Q2. Many hotels and guesthouses are still under construction. In terms of guest capacity, projects under construction in the capital area equal about 16% of the space currently in existence, and in regional Iceland they account for about 10%.

Financial market infrastructure

Further core infrastructure renewal lies ahead for both the Central Bank and the commercial banks. Launching new infrastructure entails strain and possible spillovers if something goes wrong. The number of operational incidents in interbank systems had fallen from its peak in 2018, which occurred following the launch of new payment and deposit systems by some of the commercial banks. All over the world, governmental authorities and international institutions have focused increasingly on network and information security in various parts of important social infrastructure, including in the field of financial services. Electronic retail payment intermediation in Iceland is based mainly on international payment card infrastructure, and acquiring now takes place for the most part through international card systems. Use of physical currency for cash transactions has long constituted only a small share of domestic payment intermediation, and use of cash has diminished even further since the pandemic struck.

The financial cycle

The upward phase of the financial cycle appeared to have come to an end. The private sector debt cycle was still rising, while the housing and financing cycles had plateaued. Interest rate cuts had sustained household credit growth, but corporate lending was more uncertain. Measures enacted by the Government, such as bridge loans and support loans for companies, could boost credit growth, however. House price increases in recent months could indicate that the housing cycle will rise in coming months. Furthermore, credit spreads in capital market had fallen, which could support the financial cycle. Developments over the coming term were highly uncertain, however.

II Decisions pertaining to financial stability

The Committee discussed the measures undertaken by the Central Bank and the Government in response to the pandemic, which had focused on safeguarding purchasing power, supporting households and businesses that have suffered severe income losses, and enhancing financial institutions' lending capacity and scope for action. The Committee was of the view that the measures had cushioned against the blow caused by the pandemic. The pandemic was proving to be more protracted than previously expected, and uncertainty about the economic outlook had increased. Members were therefore of the opinion that the outlook for financial stability had deteriorated since the Committee's last meeting; therefore, they were less concerned now about the adverse impact of the Bank's more accommodative policy stance.

Members agreed that financial institutions' credit risk had increased. It would be necessary for lenders to act systematically but cautiously in refinancing the loans of the borrowers that had suffered the most severe income losses. Loan restructuring would strengthen the foundations of the financial system and create the scope for future resilience in the economy. Because of the high level of uncertainty, though, it was important to distinguish between companies that would be viable under normal circumstances and those that would not. Committee members emphasised that this was a complex and challenging task that placed great responsibility on the financial institutions, but that no one was in a better position to take it on.

The FSN considered it highly likely that elevated unemployment and continued uncertainty due to the pandemic would affect households to an increasing degree, showing in factors such as private consumption patterns and increased arrears. The Committee was of the view that the banks' capacity to respond to deteriorating conditions was still sufficient, as their liquidity and capital positions were strong. If the situation persisted, however, further action could be needed in order to expand the financial institutions' scope for response.

Members considered it positive that premia on the large banks' foreign bond issues had been falling, in line with international trends. They considered it important that the banks should take advantage of their position to lengthen their current funding, thereby maintaining their net stable funding ratios (NSFR) in foreign currencies. In recent months it had been obvious how important it was for the banks to maintain ample foreign liquidity.

The Committee was of the view that the Central Bank's measures had supported asset markets, particularly the real estate market. There were signs that supply had declined in the real estate market, although the rental housing supply had increased, which should ease demand for purchased residential housing in the long run. The past several months had seen significant mortgage refinancing as interest rates had fallen. Indicators implied, however, that the refinancing wave had peaked. Committee members discussed the changed composition of household mortgages. Credit assessment data from the banks' new loans indicated a shift within the banking system, with mainly strong borrowers moving their business from pension funds to banks, and suggested that these borrowers could better tolerate fluctuations in debt service on non-indexed floating-rate loans. Committee members discussed the general pros and cons of various forms of mortgages and considered it positive that households should take advantage of the options available; however, they stressed the importance of carrying out credit assessments so as to ensure that borrowers had enough head room to respond to changed conditions.

The FSN discussed the foreign exchange market. Exports had contracted sharply, owing to the downturn in tourism, but this was offset somewhat by the strong contraction in imports, which stemmed in part from reduced overseas travel by Icelanders. In spite of outflows due to non-residents' securities sales and the pension funds' increased foreign currency purchases, the exchange rate had been rather stable. The Committee was of the opinion that the Central Bank's foreign currency sales played a role in deepening the market and improving price formation.

The FSN discussed the position of the pension funds and their impact on the financial market, noting that the pension funds were dominant investors in Iceland, making it important that there be broad-based consensus on their framework. The Committee was concerned about the funds' position in the current interest rate environment, which could prompt them to take increased risk in search of higher returns. The Committee agreed to continue its discussion of the pension funds at its next meeting.

Members also discussed the importance of a strong foundation for retail payment intermediation in Iceland, where system effectiveness was not dependent on decisions taken by foreign entities. It would be important to continue working on developing a domestic option for retail payment intermediation so as to ensure financial stability and national security.

Countercyclical capital buffer

In view of conditions in the economy and the fact that the pandemic was more persistent than previously hoped, the Committee was of the view that no new premises had emerged that would warrant deviating from its March 2020 decision to keep the countercyclical capital buffer unchanged until March 2021. There were no visible signs that cyclical systemic risk was on the rise again, and the FSN was of the opinion that the scope afforded by the reduction in the buffer needed to remain in place for a while to come.

The Governor proposed that the countercyclical capital buffer be held unchanged at 0%, in accordance with the Committee's March 2020 statement announcing that it would keep the buffer unchanged until at least March 2021. All Committee members voted in favour of the proposal.

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

Tómas Brynjólfsson, 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.