



*The Financial Stability Committee of the Central Bank of Iceland*

## Minutes of the Financial Stability Committee meeting

12-13 April 2021 (7th meeting)

Published: 31 May 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.

The FSN decided in late March to hold the countercyclical capital buffer unchanged. It decided at its meeting on 12 and 13 April to postpone its decision on which financial institutions should be designated as systemically important, as well as its decision on the capital buffer for systemic importance, until the September 2021 meeting.

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, default, the real estate market, stress tests, systemically important financial institutions, the financial cycle, and the tasks of the resolution authority. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in mid-December.

## **II Decisions pertaining to financial stability**

In the Committee's opinion, the financial system is on a strong footing. Even though the effects of the pandemic have not yet come fully to the fore, there are numerous signs that the end of the pandemic is in sight. The vaccine roll-out has gained pace over the course of the year, and broad-ranging measures taken by the Central Bank and the Government have supported households and businesses. The economic contraction in 2020 appears to have been less

severe than previously estimated, and the outlook for 2021 has improved. There is still a significant slack in the economy, however, and unemployment is high.

The three large commercial banks are in a strong position. They generated a profit of 29.7 b.kr. in 2020 in spite of loan impairment totalling 25.9 b.kr., which was 17.2 b.kr. higher than in 2019. Their liquidity remains ample, at 190 b.kr. in excess of requirements as of end-March, and their capital ratio rose from 22.4% at year-end 2019 to 24.6% at the end of 2020. The banks have been successful in obtaining funding in foreign credit markets, and credit spreads on their bond issues are now lower than they were at the onset of the pandemic. Their domestic market funding has not kept pace with balance sheet growth in krónur terms, however, and their growth is funded in large part with deposits. In the long run, this could make it more difficult for them to offer fixed-rate loans, including residential mortgages.

The FSN discussed the assumptions underlying the scenario in the Bank's 2021 stress test and the results of a reverse 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 modelled in the reverse stress test. Their CET1 capital ratios would have to fall by as much as 10 percentage points in order to affect their capacity to cover distributions. Their capital position would be considerably above the minimum capital requirement, and the scenario is unlikely to materialise unless the economic shock is prolonged excessively, unemployment become entrenched, the króna depreciates, and asset prices decline somewhat.

Defaults have not increased to any marked degree, as a large share of loans previously in moratorium have now been frozen. These loans are recorded as performing but forborne. Tourism and related sectors have generated virtually no revenues for over twelve months. In the Committee's opinion, it is important to prevent the liquidity problems facing tourism and related sectors from developing into solvency problems once the loan freezes are lifted. In some instances, debt restructuring could prove necessary in order to ensure a strong rebound when the pandemic is over. In the FSN's opinion, credit risk due to borrowers' pandemic-related financial difficulties is the largest single risk factor on the banks' balance sheets.

Private sector credit growth is still moderate, and the Committee considered this a sign that the recent rise in asset prices was not heavily debt-driven. Real growth in household debt measured just under 4.8% in 2020, whereas price- and exchange rate-adjusted corporate credit growth was negative by 1.0% over the same period. The FSN considered it important to monitor credit growth in the coming term. If strong credit growth went hand-in-hand with continued asset price inflation, it would give cause for concern.

In the Committee's opinion, asset markets reflect a higher level of optimism in the economy. Share prices had continued to rise since the FSN's previous meeting, and turnover had increased year-on-year. There had been strong trading with Arion Bank shares, and Taconic Capital Management, previously the largest single shareholder in the bank, had closed out its entire position. The OMXI10 index rose by 13% in the first three months of the year. Yields on nominal and indexed Treasury bonds had risen somewhat between meetings, particularly on longer bonds. The exchange rate of the króna had been broadly stable in the first three months of 2021. The Central Bank's share of total turnover was 35%. There had been an increase in the banks' net forward positions in foreign currency, particularly as a result of forward currency sales by exporters in recent months.

The FSN discussed the real estate market in depth. Turnover had increased strongly since the onset of the pandemic, and house price inflation had accelerated in the early months of 2021. In February, real prices were up 3.1% year-on-year. At the same time, however, rent had fallen by 7%. Committee members considered it clear that demand was strong in the market, and it emerged that the share of first-time buyers had never been higher. Even though a large number of new buildings had been put on the market in 2020, supply had shrunk significantly in recent months. Committee members were concerned about this development. As yet, however, increased market turnover had not been accompanied by strong credit growth, mitigating concerns about leveraged asset price inflation. Members agreed that they would be prepared to apply the tools at their disposal in the credit market to reduce the likelihood of debt-driven asset bubble formation.

There was little change in the financial cycle between meetings. The cycle had stagnated for the most part, although its 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 cyclical systemic risk is not accumulating to any marked degree.

### **Countercyclical capital buffer**

At the end of March, the FSN had agreed to keep the countercyclical capital buffer unchanged at 0% for the time being. In the Committee's opinion, no clear signs of increased cyclical systemic risk had come to the fore, and there was still some uncertainty about the quality of the financial institutions' loan portfolios due to the impact of the pandemic. The buffer value is reviewed on a quarterly basis.

### **Systemically important financial institutions and the capital buffer for systemic importance**

The Committee discussed the annual review of systemically important financial institutions. The designation is based on methodology developed by the European Central Bank (ECB). No all of the financial institutions reviewed were available, and the Committee must take a position on various issues relating to the definition of systemically important financial institutions. As a result, the FSN decided to postpone both the annual review of which financial institutions should be designated as systemically important and its decision on the capital buffer for systemic importance until the September 2021 meeting.

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.