CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2024

December
24th meeting
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The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

December 2024 (24th 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 intermediate 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 components, 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 its assessment of financial stability.

At its meeting of 26 November and 2 and 3 December 2024, the Committee was given a presentation on developments and prospects for the economy and for financial stability. The Committee discussed the principal risks to financial stability, such as economic developments, 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, and financial institutions' capital and liquidity. It also discussed global uncertainties. The Bank's work on the premises underlying the 2025 stress tests was presented to the Committee. Members discussed operational security in payment intermediation and were given a presentation on a contingency plan relating to operational disruptions in the financial system and to liquidity and capital adequacy problems. They were also given a presentation on the pension funds' position and investments, asset composition, and returns. Thereafter, they discussed the policy on the countercyclical capital buffer (CCyB) and the neutral buffer rate.

The FSN decided to lower the *systemic risk buffer* rate from 3% to 2% of the risk base on domestic exposures. The reduction was based on the Committee's assessment that systemic risk had receded and financial system resilience had grown since the buffer was first introduced in 2016. The FSN decided to hold the CCyB rate unchanged at 2.5% of the risk base on domestic exposures, and it approved a policy on the application of the CCyB, which entails, among other things, generally maintaining a buffer rate between 2% and 2.5%. The Committee reiterated the importance for financial institutions of maintaining a strong capital position so as to ensure resilience against shocks.

The FSN completed its annual review of systemically important financial institutions and the *capital buffer for systemic importance* (O-SII buffer) and confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. It decided to increase the O-SII buffer from 2% to 3% on all exposures.

The reduction of the systemic risk buffer and the increase in the O-SII buffer result in a virtually unchanged overall capital requirement imposed on the three systemically important banks. For smaller deposit institutions not considered systemically important, however, capital requirements are reduced.[1]

[1] For more details on capital buffers, see https://www.cb.is/financial-stability/macroprudential-policy/capital-buffers/

The FSN underscored the importance of continuing to work towards greater operational security in payment intermediation, and it expects the implementation of an independent domestic payment solution to begin in 2025.

Analysis of financial stability

GDP growth among Iceland's trading partners had developed in line with expectations in Q3, and inflation had fallen as projected. On both sides of the Atlantic, policy interest rates had been lowered since the FSN's previous meeting, held in September. Share prices had risen in the US but softened in Europe, where the political situation is uncertain in some countries and there have been significant concerns about Europe's debt levels and waning competitiveness. Key risks to financial stability in Iceland´s neighbouring countries centred on the economic impact of political uncertainty, on the one hand, and security matters, including cybersecurity, on the other. Furthermore, there are widespread concerns about high public debt levels and persistent fiscal deficits coupled with weak GDP growth. Increased uncertainty about the international political situation and fiscal policies could lead to higher long-term interest rates and risk premia and lower asset prices. Weak GDP growth and high interest rates could also result in increased arrears on residential and commercial real estate loans.

In Iceland, domestic economic activity had been broadly in line with expectations. GDP had shrunk by 1% year-on-year in the first three quarters of 2024. Indicators from the tourism sector – including hotel booking status, flight availability to and from the country, and corporate expectations – suggested that growth would be subdued in the near term. Labour market tightness had eased, and unemployment had inched up to 3.6% in October. Inflation had fallen to 4.8% (2.7% excluding housing) in November, after measuring 6% before the FSN's September meeting and 8% in November 2023. Inflation had fallen somewhat more than expected. The Central Bank's key interest rate had been lowered by 0.75 percentage points in two increments since the FSN's previous meeting. The Committee agreed that there was cause for optimism that inflation would fall further without a substantial increase in non-performing loan (NPL) ratios. There were few indications of financial distress among households and businesses, even though high inflation and interest rates had pushed many borrowers' debt service higher.

The FSN agreed that the foundations for financial stability in Iceland were robust. The foreign exchange market remained stable. Real disposable income had risen, and the most recent figures showed that it had increased more than previous numbers had indicated. Nevertheless, the FSN considered economic uncertainty to be one of the risks to financial stability, and while the outlook for Iceland was favourable in many respects, a high real interest rate concurrent with slower growth in economic activity could affect the financial system. The Committee was of the opinion that elevated geopolitical risk could have unforeseen implications. Economic developments would also depend on fiscal policy in other parts of the world, the impact of increased protectionism, and developments in ongoing wars. Financial stability could be strongly affected if more pessimistic scenarios for political risk should materialise.

Governments worldwide place strong emphasis on the operational security of financial market infrastructure, owing to the rise in cyberattacks and vandalism. The Committee underscored the importance of continued efforts to enhance operational security in payment intermediation. Positive steps had been taken towards an independent domestic payment solution, and the FSN expected implementation of such a solution to begin in 2025.

Banking system resilience

In the Committee's opinion, the financial system is on a strong footing. The domestic systemically important banks' (D-SIB) liquidity was well above the Central Bank's minimum requirements, whether in foreign currencies or in Icelandic krónur. Interest premia on the banks' foreign bond issues have continued to fall, and banks have ready access to foreign markets. They have issued foreign-denominated bonds on better terms than in 2023, and at the same time they have bought back foreign issues maturing in 2025. As a result, their foreign refinancing risk continues to decline. It is important that the banks maintain strong foreign liquidity.

Deposits are still growing, retail deposits in particular, and now account for about half of the banks' funding. The banks' króna-denominated funding comes primarily from deposits and covered bonds. The D-SIBs have continued to build up and expand their unsecured króna-denominated bond issues, but the buyer group is still small. The issues satisfy MREL requirements, and with a growing market for unsecured bonds in Iceland, the banks will become less dependent on foreign markets.

According to liquidity stress tests, the D-SIBs are highly resilient. They have enough liquid assets to cover 2024 and 2025 repayments in both local and foreign currency without being in breach of liquidity rules.

The D-SIBs' operations were strong in the first nine months of 2024. Their profits grew year-on-year to nearly 63 b.kr., while their return on equity was virtually unchanged between years, at 11.7%. There were few changes in individual income items during the period, with the exception of income from financial activities, which increased by 6.5 b.kr. year-on-year, to 7.8 b.kr. The D-SIBs' total income for the first nine months of 2024 was 157 b.kr. and was unchanged year-on-year in real terms. Their operating expenses totalled 61 b.kr. over the same period, a year-on-year increase of 1.4% in real terms. At the end of September, the D-SIBs' combined capital ratio was 23.6% of the risk base, which represents a slight increase year-to-date and relative to September 2023. Each of the three banks' capital ratio was 3.7 percentage points above the Central Bank's overall requirement. Dividends and share buybacks totalled 61 b.kr. during the first nine months of the year. The leverage ratio was unchanged between years, at 12.8% as of end-September. The financial institutions have sufficient own funds and eligible liabilities to satisfy the Central Bank Resolution Authority's minimum requirements for own funds and eligible liabilities (MREL requirements).

The most recent figures on households' NPL ratios show that arrears measured 1% at the end of September were virtually unchanged from the beginning of the year. The corporate NPL ratio rose over the same period by 0.3 percentage points, to 2.7%, but was unchanged quarter-on-quarter. As before, arrears were most pronounced among companies in the hospitality industry, at 8.4%, and had increased by 3.6 percentage points since the beginning of the year. The rise was due to a few large loans in the sector, however. The NPL ratio in the construction sector had risen by 2 percentage points over the same period, to 3.2% as of end-September.

Private sector debt

By end-September, household debt had increased by 0.3% in real terms over the previous twelve months. Households' debt ratios were still low in historical and international context. The debt-to-GDP ratio was 73% at that time and had risen marginally between years. The debt-to-disposable income ratio had continued to fall, however. In September it was 136%, its lowest since 1995. Revised household disposable income figures published recently by Statistics Iceland indicate that real disposable income grew far more in 2022, 2023, and 2024 to date than was previously estimated.

Demand for mortgage loans remains strong despite high interest rates, and about 70% of new mortgages issued in Q3 were inflation-indexed. In recent months, interest rates on new non-indexed mortgage loans have fallen in tandem with Central Bank rates, while interest rates on new indexed mortgages have risen to their highest level since 2012. At the same time, the banks have amended their lending terms and conditions and shortened the maximum maturity on new indexed mortgages. They have also lowered the maximum loan-to-value (LTV) ratio on base loans. This has made it more difficult for households to lighten their mortgage debt service burden. The impact has yet to surface, as NPL ratios have been unchanged, as has the share of first-time buyers. However, the share of indexed mortgages has fallen since the beginning of the year, when it reached 75%.

At the end of September, firms' debt to domestic financial institutions had increased by 5.2% year-on-year in real terms. Debt owed to domestic financial institutions equals roughly 82% of total corporate debt.

Growth in debt owed to domestic financial institutions has been strongest among real estate firms thus far in 2024, although debt among companies in the services, fishing, and construction sectors has increased as well. Lending growth has eased in recent months, however, perhaps indicating that corporate credit growth has peaked. Companies have increasingly sought out indexed loans, mainly real estate firms, and foreign-denominated loans, primarily fishing companies with foreign-currency revenues.

The private sector debt-to-GDP ratio was still well below its historical average at the end of September, despite increasing by 3.8 percentage points between years. Growth in lending to companies has exceeded GDP growth in 2024, which explains the year-on-year rise in the credit-to-GDP ratio.

Asset prices

The housing market has cooled in recent months as the effects of the seismic activity on the Reykjanes peninsula have tapered off. Furthermore, the monetary stance is tight. Housing market turnover contracted in Q3, and the number of purchase contracts declined, after a marked increase during the buy-up of homes in Grindavík in Q2. Over the first ten months of 2024, however, the number of purchase agreements nationwide grew by 53% year-on-year. Excluding Grindavík-related transactions – Þórkatla's[2] buy-up and Grindavík residents' subsequent purchase of new homes – the increase measured 30% year-on-year. The number of first-time buyers has risen in 2024, partly because of an increase in allocation of equity loans from the Housing and Construction Authority early in the year. Furthermore, households' sizeable accumulated savings have enabled first-time buyers to enter the market despite the limitations posed by tight borrowing requirements and high interest rates, and there are signs that increased parental assistance has helped as well.

The nationwide house price index was up 3.5% year-on-year in real terms at the end of October, and the rate of increase had slowed in the previous two months. The number of homes advertised for sale has risen in the recent term, especially newly built properties. House prices remain high relative to fundamentals, indicating that imbalances remain in the market. Although net inward migration has slowed, population growth has remained robust. In Q2, just under 20% of properties nationwide sold at a premium on the asking price, down from nearly 60% at the beginning of 2022. The outlook is for 3,400 fully finished new homes to be put on the market in 2024. New construction also gained steam from mid-year onwards, and by the end of November a record 8,000 homes were under construction or in the planning phase.

The commercial real estate (CRE) price index, which measures real prices in greater Reykjavík, was up more than 2% year-on-year at the end of Q3. Over the first nine months of 2024, turnover with commercial property had increased between years by nearly a fifth in real terms. Measures of demand for commercial property suggest that it has eased in 2024 to date, in line with the slowdown in economic activity. The stock of D-SIB loans to CRE companies, which accounts for around 20% of their total corporate lending, had grown in real terms by 16% year-on-year as of October, with nearly 60% of the loans inflation-indexed. Financing costs had risen with the increase in indexed lending rates. The real estate firms' market financing had increased in H2, after having been very limited in previous quarters. In Q3, the companies issued indexed bonds exclusively. The NPL ratio on D-SIB loans to the sector was 2.1% at the end of Q3, or nearly 1 percentage point lower than at the same time in 2023.

Share prices of listed companies had risen since the Committee's September meeting, and turnover had increased by 33% year-on-year. The OMXI 15 index was up 26% year-on-year, with most of the increase occurring the previous two months. The stock market was characterised by strong turnover and increased optimism in October. Turnover came to 130 b.kr. during the month, the largest single-month total since the 2008 financial crisis, apart from March 2022, when Íslandsbanki was listed on the exchange. Central Bank interest rate cuts and strong turnover with shares in Marel affected the market. Because of US firm John

[2] The Icelandic Government established asset management company Þórkatla in February 2024. Its purpose is to buy and manage residential real estate in Grindavík while earthquakes and volcanic eruptions make it impossible for residents to live there safely.

Bean Technologies' (JBT) takeover bid for Marel, foreign investors have seen an opportunity for profit by buying Marel shares on the Nasdaq Iceland exchange and short-selling JBT shares in the US.

Nominal Treasury bond yields had fallen since the FSN's September meeting. Indexed two- and five-year yields had peaked in early October, when the five-year indexed yield reached its highest since 2009. Indexed Treasury bond yields had fallen, however, and on the whole, the breakeven inflation rate had declined marginally between meetings. The breakeven rate had fluctuated somewhat, however, particularly because of uncertainty about the effect the new per-kilometre charge on motor vehicle use would have on the CPI. Yields on indexed covered bonds issued by the banks had fallen to 3.44% just before the FSN meeting, after peaking at 4.59% in October. Together with the decline in indexed Treasury yields, this indicates that the same pattern will show in rates on new indexed mortgage loans. None of the banks is offering indexed rates below 4%.

Exchange rate of the króna and international reserves

After a temporary dip in August, the króna began to appreciate again in the autumn and was 2.9% stronger at the end of November than at the time of the FSN's September meeting. Foreign currency inflows for new investment by non-residents were positive by 37 b.kr. in the first ten months of 2024, as compared with 24 b.kr. over the same period in 2023. Non-residents have bought Treasury bonds for 39 b.kr. this year. Inflows into Treasury bonds increased in September and October, totalling 12 b.kr., primarily for investment in long-term bonds.

The long-term interest rate differential with the US and the eurozone is smaller than the short-term differential and has narrowed recently because of rising long-term interest rates abroad. The short-term differential between Germany and Iceland is sizeable, however, and larger than in 2015, when non-residents invested heavily in Icelandic bonds. Although non-residents have stepped up their investments in Icelandic Treasury bonds, their share of outstanding Treasury issues is still small in historical and international context.

Tourism sector activity has supported the króna since the summer, as have inflows for investment. The services account surplus was large in Q3, and the balance on combined goods and services trade was positive by 0.2% of GDP over the first three quarters of 2024. On the other hand, the net forward position continued to decline in the autumn, and derivatives trading with the króna shrank by 17%, perhaps reflecting market expectations that the króna will not continue to appreciate. The pension funds bought foreign currency for 71 b.kr. in the first ten months of the year, about 5 b.kr. less than in the same period of 2023.

At the end of Q3, the Central Bank's international reserves totalled 899 b.kr., which is above all key reserve adequacy metrics. The Bank has not intervened in the foreign exchange market since February 2024.

Stress test for 2025

The Committee was given a presentation on a draft of the stress scenarios for the Central Bank's 2025 stress test on the D-SIBs. Scenario design takes account of developments in domestic and foreign risks, as well as the main drivers of the banks' returns. The stress scenario for 2025 will include unfavourable developments in unemployment, wages, GDP growth, inflation, and interest rates. The purpose of the stress test is to determine the D-SIBs' resilience and their ability to intermediate credit to households and businesses over a period characterised by such shocks, taking account of developments in asset markets and private sector debt.

Pension funds

The FSN was given a presentation on the pension funds' position and investments. Mutual pension divisions' combined real returns over the first nine months of the year were positive by 3.6% and were sustained primarily by favourable developments in foreign share prices. At the end of Q3, the pension funds' assets totalled 8,000 b.kr. and had increased by 630 b.kr. since the turn of the year. Of that total, mutual pension divisions' foreign assets accounted for 41% and had increased by just over 2% year-to-date. The maximum permissible ratio of foreign assets held by mutual pension divisions is set to increase by 1.5 percentage points on 1 January 2025, to 53%. The pension funds' investment strategies assume that foreign assets will continue to grow in 2025, to about 43% of total assets. The increased weight of foreign investment has mitigated concentration and helped diversify the pension funds' investment portfolios. The funds still play an important role in financing in Iceland. As of end-Q3, about 830 b.kr., or 17.5% of their domestic assets, took the form of deposits, bonds, or equities issued by the commercial banks. Covered bonds accounted for the largest share, at 338 b.kr.

Central Bank contingency plan for deposit institutions' liquidity and capital adequacy problems

The FSN was given a presentation on a draft version of the Central Bank's contingency plan for deposit institutions' liquidity and capital adequacy problems. The plan, which focuses on the Bank's powers to respond to such liquidity and capital adequacy problems, also contains provisions on communications within the Bank, with relevant Governmental authorities, and with stakeholders. The plan defines critical levels or response levels, roles and responsibilities, a contingency management team, and indicators and criteria for various response levels. Furthermore, it outlines the legal authorisations held by the Central Bank as competent financial supervisory body, lays down requirements and processes for decisions on loans of last resort, and describes how decisions that a credit institution is failing or likely to fail shall be taken. Finally, the plan focuses on how a credit institution's resolution plan shall be activated and how an institution with liquidity and capital adequacy problems shall be wound up. The FSN has an important monitoring role pursuant to Article 13 of the Act on the Central Bank of Iceland, no. 92/2019, in addition to taking decisions on the capital buffers imposed on financial institutions.

The contingency plan was tested at a joint Nordic-Baltic crisis simulation exercise in the autumn, where responses to liquidity and capital adequacy problems in a cross-border bank were tested. About 450 representatives from the relevant countries' central banks, financial supervisors, and government ministries participated.

Central Bank contingency plan for operational disruptions of financial market infrastructure and information technology risk

Operational risk and cyber risk have grown, and as a result, strong emphasis is placed on the operational security of financial market infrastructure and payment intermediation. It is important that the Bank analyse and assess which financial market infrastructure is critical from the standpoint of financial stability and should be classified as *core infrastructure*. This entails assessing which infrastructure components are of such a nature that a disruption in their activities could affect the intermediation of payments in the financial system, thereby affecting financial stability. The Bank's contingency plan for financial market infrastructure, which was presented to the Committee, includes a plan for essential preparedness by the Bank in the event of a threat or incident involving financial market infrastructure that jeopardises the operational security of payment intermediation. It also contains the Central Bank's assessment of which infrastructure components should be classified as core infrastructure. Furthermore, the financial system services that are significant for core infrastructure and payment intermediation are defined, a risk assessment for them is presented, and potential contingency measures identified. Finally, a coordination plan for core infrastructure is presented, and the relevant roles and responsibilities within the Central Bank are defined. Among other things, it is recommended that the Central Bank establish a financial market infrastructure incident centre for the financial system.

In its role as competent financial supervisory authority, the Central Bank collects data and monitors information technology risk in the financial system, in accordance with rules from the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) and guidelines from the Bank. The FSN was given a presentation on the process that the Bank's supervisory departments have designed to build on internal deviation analysis in order to assess the security of information and communications technology among supervised entities throughout the market. The assessment is, among other things, part of the Bank's supervisory review and evaluation process (SREP), which underlies the determination of the Pillar II-R capital requirements made of financial institutions.

Operational security in payment intermediation

The FSN was given a presentation on the work done by the Bank to enhance resilience in payment intermediation. Work is underway on a self-assessment and appraisal, based on the Principles for Financial Market Infrastructures (PFMI), of the Central Bank's interbank payment system, which is designated as systemically important financial market infrastructure. The appraisal is expected to conclude in 2025. The Central Bank has implemented a framework for TIBER cybersecurity testing. Two tests were conducted in 2024, and three are planned for 2025. When the EU's Digital Operational Resilience Act (DORA) is implemented in 2025, companies in the financial market will be subject to far more stringent requirements than they are currently, which should bolster resilience. The financial system is faced with growing external threats, including hybrid threats and cyberattacks. It is therefore important to consider a wide range of measures to enhance resilience in the system.

The Bank has begun a feasibility assessment of the possible use of the eurozone's TARGET services in Iceland. The assessment is expected to be complete before the end of 2025. An assessment will be made of the European Central Bank's TIPS real-time settlement system, on the one hand, and its T2 system for real-time gross settlement and centralised liquidity management, on the other. The Bank's main incentive for undertaking the feasibility study is that payment intermediation has evolved rapidly in recent years and the Bank's priorities have changed accordingly. As a result, the Bank has placed increased emphasis on operational security and resilience of payment intermediation, partly in response to increased cyberattacks and elevated geopolitical risks. Furthermore, the Nordic central banks are planning to implement TIPS and T2 for interbank payment intermediation or have already done so. The cost of the current system has risen in recent years and cybersecurity risks have grown, which calls for increased preparedness. The TARGET services will continue to evolve in line with the standards and regulations whose implementation in Iceland the Bank has worked towards.

An element in bolstering the operational security of financial market infrastructure is to establish a centralised infrastructure component for payment orders in Iceland. The Bank has published an advertisement inviting interested parties to submit proposals and cost estimates for such centralised infrastructure. Information on the investment expense and operational cost of the infrastructure is one of the premises for a determination of whether the requirements of the Competition Act are fulfilled. It is expected that this information on the cost of investment and operations will be available at the end of January 2025, whereupon it will be possible to carry out an assessment in accordance with the Competition Act.

Financial Stability Committee decisions

Criteria for the determination of the countercyclical capital buffer

The Committee discussed the benchmarks for determining the CCyB, which has the role of strengthening financial institutions' resilience and ensuring that their capital is sufficient to enable them to grant loans and absorb loan losses in the event of shocks. In its Financial Sector Assessment Program (FSAP) appraisal from 2023, the International Monetary Fund (IMF) had stated that it was desirable for the FSN to determine what the CCyB rate should be when it considered the level of financial system risk to be neither particularly high nor particularly low.

When the buffer was first introduced under Basel III, it was considered best that it followed the domestic financial cycle, particularly to include developments in non-financial private sector debt. Countries had actually been applying the CCyB in various ways, however. After the COVID-19 pandemic, many European countries had reviewed their CCyB policies and set a benchmark for a positive neutral buffer. This entails that the buffer is positive early in the financial cycle. It can be said that the identification of a positive neutral buffer value was European countries' response to their experience of the pandemic, as only some of them had activated the CCyB prior to the outbreak and those that had not done so had no scope to ease capital requirements on financial institutions when the pandemic struck. Institutions such as the European Systemic Risk Board (ESRB), the Basel Committee for Banking Supervision (BCBS), and the IMF have supported the determination of a positive neutral buffer rate that makes it possible to lower capital requirements on financial institutions in the event of unforeseen shocks that undermine financial stability, irrespective of the financial cycle position before that time. Such shocks can also affect subsequent developments in the business cycle and the financial cycle.

FSN members agreed that the CCyB should be positive under conditions indicating neither a high nor a low level of risk in the financial system. The buffer rate would generally need to be somewhere close to its current level, and developments in financial institutions capital ratios during the Central Bank's stress tests supported that conclusion. The Governor proposed that the positive neutral buffer rate should be between 2% and 2.5% of the domestic risk base. All members voted in favour of the Governor's proposal, and the Committee also decided to review the positive neutral buffer rate at regular intervals. The FSN discussed benchmarks for the determination of the CCyB and noted that it could increase the buffer rate when there were signs of elevated financial system risk. If the risk materialised, the Committee would lower the buffer rate or set it at zero to give financial institutions the scope to absorb loan losses and enable them to maintain an adequate supply of credit. The CCyB was thereby intended to support both financial institutions' resilience and the stability of the financial system. Following the discussion, the Committee's policy document on criteria for the determination of the CCyB was approved unanimously.

Systemically important financial institutions

The assessment of systemically important financial institutions, based on European Banking Authority (EBA) methodology, was presented to the Committee. The Central Bank's methodology, which was also used in 2023, is also based on additional indicators that measure foreign exchange market turnover. The importance of individual financial institutions was examined as well, with respect to whether their activities were of such a nature as to affect financial stability. This included an examination of whether specific indicators in the assessment of systemic importance are important for the functioning of the Icelandic 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.

Capital buffer for systemic importance

The capital buffer for systemic importance (O-SII buffer), first 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.

Based on Central Bank methodology, each of the three large commercial banks is systemically important at the national level. The failure of any one of them would probably have a significant negative impact on financial stability in Iceland, as well as spreading to other financial institutions and to the economy more broadly. The Committee therefore considered it appropriate to use the full scope afforded it by law in setting the buffer rate, which may range up to 3% following amendments made in 2022, upon the implementation of the CRD V directive. The buffer rate may be higher, however, subject to approval by the Standing Committee of the EFTA States. The Governor proposed that the O-SII buffer be raised from 2% to 3% on all exposures at the parent company level and the group level. The proposal was approved unanimously.

Systemic risk buffer

The systemic risk buffer is applied on the basis of persistent systemic risk relating to underlying risk in the Icelandic economy. Such systemic risk is considered non-cyclical, or built-in, and the buffer value is reviewed every two years. The Committee was given a presentation on developments in Iceland's business cycle, and it emerged that volatility of economic variables had diminished since the systemic risk buffer was first introduced in 2016. In the FSN's assessment, Iceland's strong net international investment position (NIIP) and ample international reserves had shored up its economic resilience and fostered increased stability. Furthermore, financial system resilience had increased with the application of macroprudential tools after the 2008 financial crisis. Capital buffers, liquidity rules, rules on net stable funding, rules on foreign exchange balance, and borrower-based measures were examples of macroprudential tools that had supported financial and economic stability.

Following the discussion, the Governor proposed that the systemic risk buffer be lowered from 3% to 2% on the domestic exposures of financial institutions authorised to accept deposits. The proposal was approved unanimously.

The reduction of the systemic risk buffer and the increase in the O-SII buffer result in a virtually unchanged overall capital requirement on the three systemically important banks. For smaller deposit institutions not considered systemically important, however, capital requirements are reduced.

Countercyclical capital buffer

The FSN was of the opinion that the banks were resilient. The framework for the financial system was sound and had delivered stability. The D-SIBs' capital ratios were ample and their liquidity position strong. Indicators of cyclical systemic risk suggested that risk was moderate, and greatest in the housing market. As yet, high interest rates had not led to an increase in arrears and loan losses. Economic activity had slowed down, and inflation had fallen more rapidly than expected. The breakeven inflation rate in the bond market had fallen and real interest rates had risen, and the effects had already begun to show in the housing market, where price increases had slowed and activity had cooled. It looked as though inflation would fall without significant side effects; i.e., neither an economic contraction in 2025 nor a surge in unemployment was expected. The foreign exchange market was stable, and the combined goods and services balance was in surplus. The long-term interest rate differential with abroad had narrowed. It was positive that the outstanding amount of derivatives had fallen concurrent with inflows for investment by non-residents. Committee members agreed that the financial position of most households in the mortgage lending market appeared good, debt ratios were low overall in historical and international context, households' equity position was sound, real disposable income had risen, and the employment situation was good.

Increased international political instability gave cause for concern, however, and loan quality could deteriorate and arrears could increase if the economic outlook worsened and unemployment rose. Last year's decision to increase the buffer to 2.5% had created important scope to respond in the event of an economic contraction that, all else being equal, could cause a decline in the supply of credit. Following the discussion, the Governor proposed that the countercyclical capital buffer rate be left unchanged at 2.5% of the risk base for domestic exposures, and the proposal was approved unanimously.

The Committee discussed the effects of incorporating amendments to the EU Capital Requirements Regulation (CRR) into Icelandic law in H1/2025. Implementing the amendments would result in significant changes in the calculation of financial institutions' exposures, particularly as regards risk weights for residential mortgage loans and real estate-backed corporate loans. In general, the amendments were conducive to making the standardised approach to risk weight calculation more risk-sensitive, as low-risk loans would generally be assigned a lower risk weight than under the current regulatory framework, while higher-risk loans would be assigned a higher risk weight.

At the end of the meeting, the Committee approved a statement for publication on the morning of 4 December 2024.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Tómas Brynjólfsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

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. Hermann Sæmundsson, Permanent Secretary of the Ministry of Finance and Economic Affairs, attended part of the meeting.

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; Rannveig Júníusdóttir, Director of the General Secretariat; Gísli Óttarsson, Director of the Microprudential Supervision Department; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; and Steinn Fridriksson and Thröstur Bergmann, specialists in 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.