CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2023

June
17th meeting
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The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee 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 mediate 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 elements, 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 the assessment of financial stability.

At the meeting of 2, 5, and 6 June 2023, presentations were given on economic developments and prospects and the state of the financial system and payment intermediation infrastructure. The Committee was also given a presentation on the Central Bank of Iceland's roles and responsibilities in ensuring the cybersecurity of the domestic financial market. The Committee discussed the current situation and outlook for financial stability and 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, financial institutions' capital and liquidity position, and the financial cycle. The FSN also received information on the methodology for assessing the financial cycle and cyclical systemic risk, as well as financial indicators. Members were informed of the results of the International Monetary Fund's (IMF) recent appraisal of Iceland's financial system and macroprudential policy.

The FSN decided to keep the countercyclical capital buffer (CCyB) rate unchanged, as in accordance with the Committee's March 2023 decision, the CCyB will increase from 2% to 2.5% on 15 March 2024. The FSN urged lenders to give timely consideration to preventing financial distress among borrowers who could have difficulty covering increased debt service on their mortgage loans as a result of higher interest rates.

The Committee also emphasised the importance of strengthening financial institutions' cyber- and operational security and bolstering the resilience of payment intermediation in Iceland. In this context, the FSN welcomed the steps taken to date towards an independent domestic retail payment intermediation solution.

Analysis of financial stability

Inflation had subsided in Iceland's main trading partner countries since the FSN's March meeting. Global GDP growth had lost pace but was nevertheless stronger than previously forecast. Inflation had eased in tandem with commodity prices, however, high services price inflation had widely impeded the decline in underlying inflation. Trading partners' central banks had continued to tighten their monetary stance. Volatility had eased in foreign markets after rising somewhat in March 2023, owing to operational difficulties in US and European banks. Global asset prices had risen as volatility subsided, and credit spreads in foreign capital markets had tapered off, although they remained high. Icelandic borrowers' access to foreign market financing had therefore improved.

GDP growth in Iceland measured 7% in Q1/2023 but was weaker than previously anticipated. For 2023 as a whole, GDP growth is expected to be stronger than previously assumed, owing both to robust growth in domestic demand and increased tourism sector activity. The labour market was still very tight, registered unemployment had fallen, and job numbers had risen since the FSN's March meeting. There were signs that strain on domestic production factors had peaked, however. The Central Bank's key interest rate had risen by 2.25 percentage points since the Committee's March meeting. Inflation had receded from its February peak of 10.2% and was expected to keep falling in the coming term, albeit more slowly than previously estimated.

The Committee agreed that households' overall position was good in many respects. Members were of the view that the key risks to financial stability were banking system funding and cybersecurity, while risks associated with the housing market had eased, although they were still in evidence. Higher financing costs could put strain on leveraged households, however, even though households were quite resilient. It was foreseeable that households that had taken fixed-rate non-indexed mortgages would see their debt service rise when their mortgage rates came up for review over the next two years. Poorer financial conditions had adversely affected businesses as well. The FSN urges lenders to consider this increased debt service in a timely manner so as to prevent financial distress among borrowers and, if necessary, restructure borrowers' debt in order to ease the burden.

Banking system resilience

The Icelandic financial system is on a solid footing at a time when both financial conditions and the monetary stance have tightened. The systemically important banks are strong, and their capital and liquidity are well above regulatory minima. The banks' liquidity ratio increased between meetings, owing mainly to foreign bond issuance. Their excess liquidity totalled 289 b.kr. at the end of April, and their liquidity ratio in all currencies was 182%, far above the 100% threshold required by the Central Bank. The banks' liquidity was therefore strong, and their high-quality liquid asset holdings were close to their highest ever. The FSN was also given a presentation on liquidity stress tests carried out on the commercial banks, which showed a high level of resilience. The majority of the commercial banks' funding is in the form of deposits, covered bonds, and unsecured marketable bonds. Deposits grew by 4% in Q1/2023, in line with lending growth, and they now account for around half of the banks' funding. Credit spreads on the banks' foreign bond issues had fallen slightly since the FSN's March meeting, and all of the banks had issued large eurobonds since then, in order to refinance upcoming euro-denominated maturities. The banks' refinancing risk had therefore receded, and it emerged that they had enough foreign liquidity to cover all of their 2023 maturities without violating liquidity rules. The systemically important banks must also satisfy minimum requirements for own funds and eligible liabilities (MREL) by issuing unsecured bonds. Their domestic bond issuance has been limited in the recent past, but in Q1/2023 it still exceeded net new lending to households.

The banks' interest income continues to rise, particularly because of balance sheet expansion and increased returns on liquid assets. Higher interest rates, credit growth, and very low impairment have strengthened the banks' operating performance in the recent term. Their return on equity was 12.5% in Q1/2023, as compared with 8.9% a year earlier. Their combined capital ratio was 24.0% at the end of Q1/2023, after rising by 0.3 percentage points during the year. After adjusting for the forthcoming increase in the CCyB to 2.5%, already decided by the FSN, the banks' capital ratios are 2.0-4.2% above the overall required ratio.

Household arrears are still low, and facility-level non-performing loan (NPL) ratio for household loans was 0.75% at the end of Q1. The banks have seen a slight increase in frozen loans to households in recent months, however. The NPL ratio on the banks' corporate loans declined in Q1, to 2.1%. It fell in all sectors apart from the hospitality industry, where it rose marginally. Business insolvencies have increased somewhat in 2023 but remained close to the historical average.

Private sector debt

New mortgage lending had declined considerably, while retirement of non-indexed variable-rate mortgages from deposit institutions increased marginally at the same time. Households therefore appeared to have begun restructuring their mortgage debt to a degree, possibly to lower debt service. The share of indexed mortgages in new lending was virtually unchanged from the last meeting, after having risen somewhat over the months beforehand. Slightly less than half of new mortgages issued since the Committee's last meeting were indexed. Nominal growth in household debt eased to 8.5% in Q1/2023. Real growth in household debt was negative by 1.3% in March 2023, however, its most negative in any single month since September 2016. The household debt-to-GDP ratio had fallen significantly in the recent term, whereas the debt-to-disposable income ratio had held stable. Both ratios were historically low, however, and below those in, for instance, the Nordic region.

In general, households' mortgage debt burden had continued to increase alongside rising interest rates. Non-indexed rates on household mortgages averaged 9.3% in May and had risen by 5.5 percentage points since May 2021, when the Central Bank began its monetary tightening phase. As a share of estimated disposable income, however, most households' debt service burden had risen only modestly. The share of households whose debt service burden exceeded 35% of their disposable income was estimated to have risen from 9% in January to 10.9% in April, assuming that disposable income rose in line with the general wage index (loans taken after 1 January 2020). One reason debt service had not risen above 35% of disposable income for a larger share of households was that a fourth of household mortgages were non-indexed loans with interest rates fixed for three to five years. In addition, nearly half of household mortgage debt was indexed, and the debt service burden had risen much more slowly on these loans than on non-indexed variable-rate loans.

Low unemployment, wage growth, and moderate debt levels among most Icelandic households enable households to withstand increased debt service and worsening financial conditions. The available data indicate that households are generally well positioned. Arrears were limited, and real disposable income had risen steeply since 2010.

Year-on-year growth in corporate debt had peaked in late 2022 at 10%, its strongest since 2019. It eased slightly in Q1, and the corporate debt-to-GDP ratio had fallen quarter-on-quarter to a historically low 77.5%. Corporate debt to domestic banks is rising in real terms, while foreign debt and bond issuance have contracted. Banking system credit growth has been strongest in lending to the construction sector, owing both to new loans and reduced loan retirement as a result of slower sales of new buildings. The results of the Central Bank's lending survey, carried out in early April among the four commercial banks, suggest that both supply and demand for corporate loans could ease in coming months.

Corporate arrears are still on the wane despite higher costs due to inflation, wage rises, and higher interest rates.

Asset prices

Housing market activity has been on the decline since mid-2022. Market turnover shrank, and the number of purchase contracts fell by a fourth year-on-year in the first four months of 2023, to a low not seen since the first four months of 2014. The number of properties for sale had increased and the average time-to-sale had grown significantly longer. In April, for instance, it took nearly six months to sell a home, whereas in May 2022 the average time-to-sale had bottomed out at one month. The share of first-time buyers had fallen and was close to its long-term average. Twelve-month house price inflation in greater Reykjavík measured 8.6% in nominal terms in April, which meant that real prices fell by 1.1%. After having fallen month-on-month for three months, house prices started rising again in February. It emerged that this was surprising in view of the slower activity in the housing market, perhaps indicating that the shift was temporary. The ratio of house prices to fundamentals such as disposable income, building costs, and rent prices had fallen from the 2022 peak but had been unchanged in recent months. The house price index measured 11% above trend in April 2023, after peaking at 18% above trend in June 2022. The FSN was of the view that the combination of borrower-based measures and interest rate hikes had kept prices from deviating even more from fundamentals. It emerged that the Housing and Construction Authority had forecast that some 2,800 new homes would be built in 2023 and again in 2024, but that new construction would ease in 2025. The FSN was of the view that the combination of borrower-based measures and interest rate hikes had kept prices from deviating even more from fundamentals. Tension in the real estate market had clearly receded, and real prices could be expected to keep falling in the coming term; however, because demand was strong and households well positioned in other respects, there was no risk of a steep drop in nominal prices.

The commercial real estate (CRE) price index, which measures prices in the greater Reykjavík area, continued to rise in Q1, to a year-on-year rate of 14.4%. The index was at a historical high and was just over 20% above its estimated long-term trend. The large CRE firms' operations were strong in Q1/2023. Occupancy rates are high and returns on investment assets slightly higher than in Q1/2022. The CRE firms' financing costs have increased, however, and their cash flow ratios have fallen. A comparison of the companies with their foreign counterparts suggests that the ratio of investment properties available for leasing is relatively low and the return on investment properties relatively high. On the other hand, the Icelandic companies are more heavily leveraged than comparable firms abroad, and their financing costs are higher.

Listed companies' share prices had fallen between FSN meetings, and the Main List index was down about 7% year-to-date. Yields on short-term nominal Treasury bonds had risen since the FSN's last meeting, in line with the increase in the policy rate, while long-term yields had fallen marginally.

Exchange rate of the króna and international reserves

The króna had appreciated since the FSN's March meeting and was up by a total of 2.1% year-to-date. A wider interest rate differential with abroad and a narrower current account deficit are considered to have had the greatest impact on the trend. Forward positions with the króna had grown, and inflows for foreign investment in Iceland had increased with FTSE Russell's upgrade of Iceland to the emerging secondary market category, but trading in Treasury bonds had been limited. Furthermore, the pension funds bought more foreign currency in the first four months of 2023 than over the same period in 2022. The systemically important banks' foreign exchange balance had been broadly unchanged between meetings and was close to equilibrium; i.e., the banks' foreign-denominated assets nearly equalled their foreign-denominated liabilities.

The international reserves had shrunk in 2023 to date, mainly because of the appreciation of the króna. In Q2/2023 they measured 117% of the IMF's reserve adequacy metric, down from 124% at the end of 2022.

The financial cycle and cyclical systemic risk

A composite measure of financial cycles indicated that the cycle was still in an upward phase in Q1/2023 and that cyclical systemic risk was at an average level. The debt cycle was still in a relatively low position consistent with moderate household and corporate debt levels. The upward cycle was estimated to be fastest and the position highest in the housing cycle, which may seem paradoxical, as house price inflation has slowed markedly in the past year. The mismatch between the housing cycle and recent months' developments in house prices is due to the indicator's emphasis on medium-long cycles and its relative insensitivity to short-term developments.

The FSN was given a presentation on a new indicator that measures the financial cycle position on a monthly basis. The financial cycle indicator can be useful in forecasting economic activity in the near future and can thereby support analysis of how monetary policy makes an impact on the economy by affecting financial conditions. Furthermore, it can support assessments of the macroprudential stance and cyclical systemic risk. The indicator had fallen steeply in recent months, owing mainly to higher interest rates, reduced real estate market activity, and a weaker króna. This suggests that financial conditions had moved from being relatively accommodative and stimulative to a more neutral position.

Cyclical systemic risk can be estimated in a variety of ways, and the FSN uses more than one measure. The financial cycle is one such measure that the Committee considers, and another is the domestic composite systemic risk indicator, or d-SRI. The d-SRI indicated that cyclical systemic risk had declined throughout 2022 and was back to its historical average, after having been above average at the beginning of 2022. The main drivers of the decline in Q1/2023 were weaker credit growth, strong GDP growth, and the narrowing of the current account deficit in the previous twelve months. Taken together, indicators of cyclical systemic risk suggest a moderate risk level at present.

Cybersecurity

The Committee heard a presentation on cybersecurity. The presentation focused on the Central Bank's role and priorities, as the Bank monitors supervised entities' operational risk, including ensuring that cybersecurity is consistent with the law and Governmental directives. The Bank also oversees the operational framework for systemically important financial market infrastructure, the Central Bank's interbank system, and the Nasdaq CSD SE securities settlement system in Iceland.

Committee members considered it important that the Government and Central Bank place strong emphasis on cybersecurity in Iceland, operational security of telecommunications infrastructure, and the connection between telecommunications infrastructure and the operational security of financial market infrastructure.

IMF appraisal of Iceland's financial system and macroprudential policy
The FSN was given a presentation on the results of the IMF's recently concluded financial sector assessment program (FSAP) appraisal of Iceland's financial stability and macroprudential policy. The purpose of the FSAP appraisal was to determine the resilience of the financial system, the quality of the regulatory and supervisory framework, and the country's ability to respond to financial shocks. The Fund's advice following such an appraisal could focus on either microprudential or macroprudential policy, or both. The IMF presented 150 comments directed at the Central Bank or Government ministries, or both, and the FSN heard a presentation on the comments centring on financial stability and macroprudential policy. The comments pertained, among other things, to further data collection, the application of macroprudential tools, stress testing of financial institutions' liquidity and capital, pension funds' lending activities, powers of resolution, cybersecurity, and climate risk. It emerged at the meeting that the IMF's comments would be addressed in a given order of priority and that attempts would be made to respond to the most important of them within a year.

Financial Stability Committee decisions

Rules on Maximum Loan-to-Value Ratios for Mortgage Loans to Consumers
Although a majority of households with mortgages were well positioned, the FSN considered it important to prepare for tighter household financial conditions. It emerged that it could prove more difficult for some households to cover the additional debt service once interest rates that had been fixed until 2024 and 2025 came up for review. These loans totalled some 650 b.kr., or just over a fourth of household mortgage debt. The FSN considered it appropriate to urge lenders to consider this increased debt service in a timely manner so as to prevent financial distress among borrowers. Where necessary, lenders should consider lengthening loan maturities, adopting an annuity format, capping nominal interest rate payments, and offering a range of loan types that offer differing debt service. The Committee was of the view that many borrowers had ample equity and should have considerable flexibility to ensure that their debt service would remain in line with the criteria provided for in the borrower-based measures set by the FSN.

After the presentation and discussions, the Governor proposed amendments to the rules on maximum loan-to-value ratios on consumer mortgages, which entailed that Article 1 be amended so as to remove all doubt that the rules did not apply to those who refinanced existing mortgage debt because of financial distress. The Committee was of the opinion that the amendments were not of a substantive nature but instead represented a clarification of this aspect of the rules. All members voted in favour of the Governor's proposal, and new Rules on Maximum Loan-to-Value Ratios for Consumer Mortgages, no. 550/2023, were issued following the meeting.

Countercyclical capital buffer
The main purpose of the countercyclical capital buffer (CCyB) is to enhance financial institutions' resilience against cyclical systemic risk, thereby providing them with the scope to absorb losses and maintain the supply of credit during periods of stress. The CCyB performs an important role when it is necessary to respond to unforeseen events that could jeopardise financial stability; cf. the reduction in the buffer at the beginning of the COVID-19 pandemic. The increase in the buffer to 2.5%, decided in March 2023, creates further scope to lower it in the future, in the event of an economic contraction that could cause a decline in the supply of credit. By law, the CCyB may range from 0% to 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.

Analyses of the level of cyclical systemic risk indicate that it has increased in recent years and is now near its historical average. The main drivers of the increase are the surge in real estate prices since the beginning of the pandemic and the high inflation rate, which affects debt service burdens and repayment capacity.

It also emerged that the increase in the CCyB in March 2023 should not compromise the banks' capacity for lending or for private sector debt restructuring as needed. The banks' interest rate spreads had increased year-on-year, as had their return on equity. The systemically important banks' capital ratios were ample, averaging 24.0% at the end of Q1/2023, and had risen by 0.3 percentage points between years. After adjusting for the forthcoming increase in the CCyB to 2.5%, already decided by the FSN, the banks' capital ratios are 2.0-4.2% above the overall required ratio. Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 2.5%, and the proposal was approved unanimously.

Financial market infrastructure

An element in promoting an effective and secure financial system, including domestic and cross-border payment intermediation, is to collect data on various payment instruments and assess the cost of using them. The Committee was given a presentation of the results of an analysis of the cost of retail payment intermediation, which showed that the cost to households of retail payment intermediation was around 30% higher than, for instance, in Norway.

Work on strengthening Iceland's financial market infrastructure framework and further enhancing operational security is still ongoing. The FSN heard a presentation on the status of the project focusing on the implementation of an independent domestic retail payment solution, which is intended to enhance national security and prioritise the resilience of domestic payment intermediation. A work group representing the Forum for the Future had previously submitted a proposal for an independent retail payment solution that had been presented before the Committee. The proposal entails the development of a joint core infrastructure that provides connections with all of Iceland's deposit institutions and would be open to all providers with the required licences. Furthermore, a work group operating on behalf of the Prime Minister's Office is preparing legislation aimed at providing a stronger legal foundation for an independent domestic retail payment solution.

The FSN is of the opinion that the steps already taken towards an independent domestic retail payment intermediation solution were a move in the right direction towards strengthening financial institutions' cyber- and operational security and enhancing the resilience of payment intermediation in Iceland.

At the end of the meeting, the Committee approved the statement for publication on the morning of 7 June 2023.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Rannveig Sigurðardóttir, Deputy Governor for Monetary Policy, Central Bank of Iceland

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Guðmundur Kr. Tómasson, external Committee member, approved the Governor's proposal electronically. 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.

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; Eggert Þ. Þórarinsson, Deputy Director of the Financial Stability Department; and Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.