



MINUTES

FINANCIAL STABILITY COMMITTEE



2022

March
12th meeting
Published 8 April

Minutes of the Financial Stability Committee meeting

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The Financial Stability Committee (FSN) takes decisions on the application of the Central 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 redistribute 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 direct 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 the state of financial stability.

The meeting of 14-15 March 2022 began with presentations and a discussion of economic developments and prospects and the state of the financial system. The Committee discussed the current situation and outlook for financial stability and the principal risk factors, such as economic developments, risks faced by financial institutions and the financial system, developments in domestic financial markets, household and corporate debt, the real estate market, and financial institutions' capital position. The Committee also discussed the security and efficiency of financial market infrastructure and its importance for financial system stability, particularly in view of elevated cybersecurity risk and the war in Europe. Furthermore, it discussed the report prepared by the appraisal committee tasked with assessing the experience gained from the work of the Bank's three committees in 2020-2021.

In its quarterly review of the countercyclical capital buffer (CCyB), the FSN decided to hold the buffer unchanged, as it had decided in September 2021 to increase the buffer from 0% to 2%, effective at the end of September 2022. The FSN also decided to hold the systemic risk buffer unchanged at 3% for deposit-taking institutions' domestic exposures. The Committee approved amendments to the Rules on Derivatives Transactions, no. 765/2021, as transactions between Icelandic banks are exempt from restrictions on derivatives trading. Furthermore, the FSN decided to amend its Rules of Procedure so that the Committee will no longer be involved in decisions pertaining to the resolution authority.

Committee members agreed unanimously that it was of vital importance that the Government and Central Bank place strong emphasis on Iceland's cybersecurity, the operational security of telecommunications infrastructure, and the connection between telecommunications infrastructure the operational security of financial market infrastructure. The FSN stresses the importance of safeguarding Iceland's cybersecurity and the operational security of telecommunications and financial market infrastructure. The current situation underscores how vital it is to bolster resilience in domestic

payment intermediation and expedite the implementation of an independent retail payment solution. The Committee reiterates that it is critical for operators to guarantee payment system security and business continuity.

Analysis of financial stability

The Committee considered the financial system to be highly resilient and the state of financial stability favourable. The economic outlook had worsened and uncertainty had escalated following Russia's invasion of Ukraine. The outlook indicated that economic sanctions and higher energy and commodity prices would slow down the global economic recovery, and the inflation outlook had deteriorated. It was uncertain how much direct and indirect effect the invasion would have on the domestic economy, but poorer prospects for GDP growth and inflation in trading partner countries suggested that there would probably be some impact. Higher inflation, higher oil prices, and reduced purchasing power in advanced economies could cut into international travel; however, prospects for marine product exports were good. The Committee was of the view that the strength of the banking system and Iceland's healthy balance of payments would mitigate the adverse effects of increased global uncertainty on the economy and financial system.

Banking system resilience

The FSN was of the opinion that the systemically important banks were highly resilient. Their capital and liquidity positions are well above regulatory minima, giving them ample scope to support households and businesses. The three banks generated a profit of 81 b.kr. in 2021, and their liquidity in excess of requirements totalled 255 b.kr. as of end-January. According to the Central Bank's most recent stress tests of their liquidity position, the banks can withstand significant outflows of deposits. Their capital increased by 39 b.kr. year-on-year in spite of dividend payments and share buybacks in 2021, and their combined capital ratio was 26.7% at the end of the year. Credit spreads on the banks' foreign bond issues had risen following Russia's invasion of Ukraine. Spreads on comparable issues of foreign banks had risen as well. The banks' foreign refinancing risk was considered limited, however, because of their strong liquidity position. Nevertheless, the Committee considered it important to continue keeping abreast of developments in global capital markets.

Arrears on banking system loans to both households and businesses declined in 2021. At the end of the year, non-performing loans accounted for 3.4% of corporate loans from the systemically important banks, and 12.1% of corporate loans were frozen at the end of January 2022. In the services sector, however, some 34% of loans were frozen. Household arrears have declined since the beginning of the pandemic. At the end of 2021, 0.8% of bank loans to households were non-performing, which is low in both historical and international context.

Private sector debt

Growth in household debt had eased in recent months, from 10% in nominal terms and 5.1% in real terms as of November 2021 to 10% in nominal terms and 4.1% in real terms as of January 2022. In the Committee's opinion, households' position is generally good, which should better enable them to cover higher debt service if interest rates rise further. Households also have access to various types of mortgages in order to react to inflation. Real wages had risen, unemployment was down, the labour participation rate had increased, and households' equity position had improved.

Growth in corporate debt had picked up marginally. In real terms, growth was still negative, but in price- and exchange rate-adjusted terms, it measured 1.8% at the end of 2021. This trend could be attributed mainly to increased issuance of marketable bonds and an increase in alternative investment

funds' corporate lending. Corporate financing had shifted increasingly from the banking system to market-based financing and other lenders, particularly alternative investment funds.

Asset prices

The FSN reviewed the situation in the real estate market. There were signs that the imbalances between supply and demand in the residential housing market had widened. Committee members were concerned about limited housing supply and steeply rising house prices. Surging prices would be most detrimental to first-time buyers and could increase household debt over time. The number of properties advertised for sale in the capital area had fallen by nearly 69% since year-end 2019, to the lowest level since data collection began in 2006. In February, the average time-to-sale was less than 30 days. The rise in the capital area house price index had continued to accelerate, and at the end of January the year-on-year increase measured 13.8% in real terms (20.3% in nominal terms). Turnover in the market had subsided in January but remained strong relative to the pre-pandemic period. The deviation of house prices from underlying economic fundamentals had widened even further since the Committee's last meeting. Their deviation from long-term trend widened by 11.5 percentage points year-on-year in January, its largest upward deviation from trend since 2008.

The construction market was relatively lively last year in historical terms. A total of 2,900 new residential properties had been assigned 2021 as their construction year, including 1,800 in the capital area. The number of new fully finished flats had declined slightly year-on-year, however, even though the number completed over a single year was historically high.

Committee members discussed the reduction last summer in maximum loan-to-value (LTV) ratios on residential mortgages (from 85% to 80%), noting that it had begun to have an effect: most buyers' LTV ratios had fallen, although first-time buyers' LTV ratios had risen alongside the rise in house prices. First-time buyers' average debt service-to-income (DSTI) ratio had therefore risen in recent quarters. Committee members were of the view that the impact of the rules capping DSTI ratios, which had taken effect in December, had yet to come more fully to the fore, and that the effect would grow stronger as the monetary stance tightened. All else being equal, the rules should bring about less indebtedness and should slow the pace of house price inflation.

The commercial real estate (CRE) price index, which measures real prices in the capital area, rose by 11.1% year-on-year in 2021 and had returned to its pre-pandemic level. Turnover in registered CRE purchase transactions had increased by 82% year-on-year in real terms, reaching its highest single-year value since 2007. The adverse impact of the pandemic had been short-lived, and the market was therefore relatively strong.

The FSN was of the opinion that there were indications of a house price bubble that could grow further in the coming term, but that there did not appear to be grounds for the same concerns about the CRE market.

Global investors had shifted increasingly to safer assets. Foreign share prices had fallen, although the decline had reversed in part before the FSN's meeting.

The price of listed Icelandic companies' shares had also fallen, as had share prices around the world. From 24 February, when Russia invaded Ukraine, until 10 March, the OMXI10 index had fallen by 8%. Alongside these declines, the deviation of share prices from their long-term trend had narrowed. The breakeven inflation rate in the bond market had risen year-to-date, in line with higher inflation and a bleaker inflation outlook. Demand for indexed Treasury bonds had therefore grown, and had increased still further after the Russian invasion of Ukraine, and yields on the bonds had therefore fallen swiftly.

Exchange rate of the króna and international reserves

The króna had appreciated by 4.4% from the beginning of the year until the invasion of Ukraine began, but had depreciated by 4% thereafter. The Central Bank had bought foreign currency for 11 b.kr. and sold currency for 10 b.kr., intervening in the market to mitigate exchange rate volatility as it deemed warranted. Turnover in the interbank foreign exchange market increased in February, while in January it was broadly at the pre-pandemic level. There had been a marked increase in derivatives contracts involving the króna against foreign currency, and the commercial banks' counterparties in such contracts had grown in number. The commercial banks' net forward foreign currency position had increased accordingly. In some instances, exporters had hedged against the appreciation of the króna, but after the Rules on Derivatives Transactions were amended in mid-2021, there was discernible position-taking with or against the króna. Exchange rate developments had therefore been more expectations-driven than before.

The pension funds' net foreign currency purchases amounted to 53 b.kr. in 2021, broadly the same as in the previous year. In the first two months of 2022, they had bought currency for 7.4 b.kr. As of year-end 2021, foreign-denominated assets accounted for 37% of the pension funds' total assets.

The Central Bank's international reserves totalled around 900 b.kr. at the end of February 2022, and the ratio of the reserves to the International Monetary Fund's (IMF) reserve adequacy metric (RAM) was 145% at the end of 2021. The FSN was of the view that the reserves were ample, and that they were large enough to enable the Central Bank to respond to unforeseen events that could otherwise undermine financial and economic stability.

The financial cycle

The rise in the financial cycle had accelerated between FSN meetings, which could indicate an increase in cyclical systemic risk. House prices have been rising for a protracted period of time, and the housing cycle is stronger than before. Even though all of the sub-cycles were in an upward phase, the financial cycle was still slightly below its long-term average. Estimating the impact of the financial cycle on economic developments in terms of growth-at-risk showed increased severity of potential economic shocks in comparison with year-end 2019, which indicates growing systemic risk.

Financial market infrastructure

Options for an independent domestic retail payment solution were discussed, based on an analysis carried out by a Central Bank working group in the months beforehand. Settlement of nearly all domestic payment card transactions is routed through foreign systems, which entails risks if international internet connections were to be disrupted or if the owners of the systems in question decide to stop doing business with Iceland. The working group's assessment of the options was discussed from the standpoint of security, cost-effectiveness, and efficiency, and the FSN agreed that work on the adoption of a domestic retail payment solution should be expedited.

The Committee received regular information from the Central Bank's interbank system, in the form of risk indicators for financial market infrastructure. The functionality of the new interbank system better enables the Central Bank to carry out its oversight and risk assessment role in the area of financial market infrastructure, which is also useful for assessing potential weaknesses and operational bottlenecks in domestic payment intermediation.

Committee members agreed unanimously that it was of vital importance 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. It was necessary to guarantee information flows and consultation among all stakeholders in this area.

Systemic risk buffer

The systemic risk buffer is applied on the basis of persistent systemic risk relating to homogeneity and 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. Because of the Icelandic economy's vulnerability to shocks, as is reflected in wider fluctuations in economic variables than in many other economies, the systemic risk buffer is set at 3% and applies to all of the deposit-taking institutions' domestic exposures.

The Committee discussed the key changes in the legal framework for the systemic risk buffer following the incorporation of CRD V into Icelandic law, which is planned for later this year. Among other things, the changes entail sharpening the purpose of the systemic risk buffer and its interaction with other capital requirements, and the possibility of applying the buffer to specified exposures. Following the discussion, the Governor proposed that the systemic risk buffer be held unchanged at 3% on the domestic exposures of financial institutions authorised to accept deposits. The proposal was approved unanimously.

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. This scope was used in March 2020, when the buffer was lifted at the beginning of the pandemic. Increasing the CCyB can have the side effect of slowing down credit growth during an upswing.

In September 2021, when the buffer was increased again, with an effective date of September 2022, the FSN was of the opinion that cyclical systemic risk had returned to its pre-pandemic level. The pandemic has had a limited impact on the financial system as a whole, and debt write-offs have been less than previously expected. Loan quality had generally improved and arrears declined, particularly to include household arrears, which now account for less than 1% of the banks' household loan portfolio. The measures taken by the Central Bank and the Government delivered results and mitigated the negative economic impact of the pandemic on households and the business community in Iceland. FSN members agreed that the banking system was highly resilient. Returns were strong, and capital and liquidity ratios were well above regulatory minima. As a result, the banking system was well prepared to continue restructuring corporate debt and to address increased arrears if they should develop. A higher CCyB value would not affect this.

In preparation for further discussion, the Committee had held an extraordinary meeting on 3 March 2022, and reviewed both the financial institutions' capital buffer requirements and the risks they are intended to address. The Committee also discussed what a neutral CCyB value might be, and how the buffer was applied in other countries, particularly with a view to its neutral value.

The FSN reviewed developments in cyclical systemic risk since its previous meeting and discussed the formulation of a long-term strategy for the CCyB and its interaction with other capital buffers. Members discussed the strategies of the European countries that have specified an equilibrium CCyB value, as well as the strategies of other European countries regarding capital requirements as a whole. They also discussed the rationale for a positive neutral buffer value and whether that rationale was applicable for Iceland, with a view to the structure of the economy, the position of the financial system, and the Central Bank's objective of promoting financial stability. Members agreed to continue this

work and the related discussion, but they were of the opinion that there was no reason at present to make further changes to the CCyB.

Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged, and the proposal was approved unanimously.

Rules on commercial banks' derivatives transactions

Among other provisions in the new Foreign Exchange Act, which entered into force in June 2021, restrictions on derivatives transactions involving the Icelandic króna were lifted, whereas such transactions had previously required prior approval from the Central Bank. At the same time, the FSN approved the Rules on Derivatives Transactions, no. 765/2021. In the interest of safeguarding financial stability, the Rules impose limits on individual commercial banks' total exposure to derivatives transactions. The gross forward foreign currency position may not at any time exceed 50% of the capital base of the commercial bank in question, and the position vis-à-vis each counterparty is limited to 10% of the capital base. The FSN considered the experience of the Rules to have been positive. The derivatives market was more active than before, and there were more diverse possibilities for derivatives trading than before, which had led to an increase in the number of both counterparties and trades. The commercial banks' gross position (excluding bank-to-bank transactions) had risen from 12% of their capital base to 19% since the rules had taken effect. FSN members agreed that there was no need to review the cap on the gross forward position at this time, but they considered the notification requirement in the Rules unnecessarily onerous. Furthermore, from the standpoint of financial stability, there was no need to include derivatives transactions between domestic banks with the forward position of each party concerned. It should be noted that the Central Bank has access to information on all trades, as it did before. The main objective of the Rules was to place certain limitations on the derivatives market by controlling the total scope of derivatives transactions involving krónur.

Following the discussion, the Governor proposed that Rules no. 765/2021 be amended so as to increase the limits for notification requirements to 1.5 b.kr. and 3 b.kr., and to exclude derivatives transactions between domestic commercial banks from the forward position of each bank. The Governor's proposal was approved unanimously. Committee members agreed that the amendments would not affect the main purpose of the Rules, as the total scope of domestic commercial banks' derivatives transactions would be the same as before.

Appraisal committee report on experience gained from the work of the Central Bank committees and matters relating to the resolution authority

The Committee discussed the report from the appraisal committee appointed to assess the experience of the work of the Central Bank committees in 2020-2021. The report pointed out, among other things, that the interactions between the resolution authority and the Bank's committees should be reviewed so as to ensure that the division of tasks was clear and in accordance with the law, and to ensure that decisions can be taken efficiently when circumstances require it. The appraisal committee also pointed out that there was no explicit statutory authority for entrusting the Financial Stability Committee with decision-making powers relating to the resolution authority, which are explained more fully and provided for in Article 2.7 of the FSN's Rules of Procedure. Members discussed this and considered it appropriate to delete Article 2.7 from its Rules of Procedure.

Following the discussion, the Governor proposed that Article 2.7 be deleted from the Financial Stability Committee's Rules of Procedure. The Governor's proposal was approved unanimously.

At the end of the meeting, the Committee approved the statement for publication on the morning of 16 March 2022.

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

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 Bank's Financial Stability Department; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; Gudrún S. Gunnarsdóttir, Deputy Director of the Bank's General Secretariat; and Gudrídur Lilla Sigurdardóttir, Specialist with the Financial Stability Department, were present for the entire meeting. In addition, several Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes