FJÁRMÁLAEFTIRLITIÐ
THE FINANCIAL SUPERVISORY AUTHORITY, ICELAND

Reykjavík, 1 February 2019

Financial Supervisory Authority‘s decision on raising the countercyclical capital buffer

On 1 November 2016, the Financial Supervisory Authority decided to impose a 1.25% countercyclical capital buffer in accordance with Article 86(d) of Act No 161/2002 on Financial Undertakings.[1] The financial undertakings subject to the buffer have therefore maintained the 1.25% countercyclical capital buffer since 1 Novermber 2017. The buffer has been maintained on a consolidated basis and covers all domestic credit exposures. On 15 May 2018 the Financial Supervisory Authority decided to raise the countercyclical capital buffer to 1.75%, effective 15 May, 2019.[2]

The Financial Stability Council is tasked with reviewing the countercyclical buffer rate every quarter in accordance with Article 86(d) of Act No 161/2002 on Financial Undertakings. On 19 December 2018 the Council submitted a recommendation to the Authority that the countercyclical capital buffer should raised to 2%.

On 1 February 2019, the Authority decided to raise the countercyclical capital buffer in accordance with the recommendations of the Council.

The Authority has announced its decision to the undertakings concerned and is hereby making the announcement public in accordance with Article 86(d)(1) of the Act on Financial Undertakings.

Decision on raising the countercyclical capital buffer

The purpose of the countercyclical capital buffer is to serve as a preventive measure in order to ensure the supply of credit is maintained during times of financial distress since a shortage of credit can aggravate economic downturns. Thus the countercyclical capital buffer is intended to mitigate the effects of financial cycles on the real economy. This objective is accomplished by accumulating the buffer during financial upswings and releasing it during times of stress.

Evidence from abroad and in Iceland suggests that financial cycles generally have a longer duration and amplitude than business cycles. It is therefore not unusual for

[1] See the recommendations of the Financial Stability Council from 30 September 2016.
[2] See the recommendations of the Financial Stability Council from 13 April 2018.

economies to experience business cycle downturns during an expansionary phase in the financial cycle in the lead up to a simultaneous financial and economic downturn. From this and the current developments of economic indicators, it may be inferred that the current financial upswing in Iceland will continue for the foreseeable future, even if the real economy has shown signs of slowing down. The Authority thus concurs with the Council's assessment that there is cause to continue the accumulation of the counter cyclical capital buffer.

In terms of credit-to-GDP the indebtedness of Icelandic households and firms is average compared to other developed nations. In terms of the ratio of household debt to disposable income Icelandic households are amongst the most indebted in the European Economic Area (EEA). The proportion of home-owners amongst the Icelandic population is high. However, the proportion of owner occupied housing with a mortgage in Iceland is the highest within the EEA. The above indicates that the credit growth of firms and households should continue to be closely monitored. Private credit growth during the last few years has been mostly driven by firm debt. The ratio of firm debt to GDP has been increasing during the past year, the majority of the increase having come about after the 15 May announcement to raise the countercyclical capital buffer. The growth of household debt has also increased. During the years 2015-2017 housing prices increased sharply and lending standards were relaxed, yet household debt did not grow to the same extent. Historically such developments have often been a prelude to increased credit growth. It's important that households do not utilize their increased scope for borrowing to extensively increase their indebtedness, possibly leading to further instability.

An assessment of the current state of the housing market was conducted by looking at prices in regards to the fundamentals that determine supply and demand in the long term. Housing prices have grown at a similar rate to the spending power of households while price increases have outpaced the growth of other fundamentals, indicating signs of overvaluation. Should housing prices continue to increase in concurrence with increased credit growth this could make households more sensitive to shocks in property prices. It's thus imperative that the resilience of financial institutions should be ensured in this regard, both against mortgage impairments as well as indirect losses resulting from possible tightening in aggregate demand due to decreases in household wealth and higher debt service ratios.

During times of economic stress commercial real estate prices tend to fall sharply and historically financial institutions have experienced considerable losses from commercial real estate loans. Credit risk is therefore increased if commercial real estate prices and the amount of commercial real estate loans are both increasing rapidly at the same time. Continuing price increases in commercial real estate could therefore lead to higher risk of sharp price decline which would have a negative impact on the loan portfolios of financial institutions.

The inflow of foreign capital can intensify the credit cycle and lead to current account imbalances. Private sector resilience to shocks is also reduced as the ratio of foreign denominated debt is increased. The three largest banks have increasingly been seeking funding in foreign credit markets. Furthermore, recently there has been an increase in the banks' foreign denominated lending to firms. Whether the banks' increased dependency on foreign denominated funding will further stimulate credit growth remains to be seen.

Considering the foregoing and the recommendation of the Financial Stability Council, the Authority imposes a countercyclical capital buffer of 2% on domestic exposures of all financial undertakings, both individually and on a consolidated basis, unless they are specifically excluded from the buffer according to Article 86(d)(4) of the Act on Financial Undertakings. The calculation of the own funds requirements shall reflect the weighted average of the countercyclical capital buffer rates that apply domestically and in other EEA-States, in accordance with each country's share of the exposure, pursuant to Article 86(d)(3) of the same Act.[3]

[3] The Financial Supervisory Authority will introduce rules implementing the regulatory technical standards in Commission Delegated Regulation (EU) No 1152/2014 that further prescribes the calculations, cf. Consultation Paper No 4/2016 available on the Authority's website. In addition, the Financial Supervisory Authority has laid down Rules No 506/2017 implementing the regulatory technical standards in Commission Delegated Regulation (EU) 2015/1555.