



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

## Minutes of the Financial Stability Committee meeting

Meeting held 14-15 December 2020 (6th meeting)

Published: 29 March 2021

The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the application of the Bank's financial stability policy instruments. "The Financial Stability Committee's decisions on the application of financial stability policy instruments shall be published and an account given of the rationale for the decisions, together with an assessment of the situation, and minutes on the topic shall be published unless such publication can be expected to have an adverse impact on financial stability. "In accordance with the Act, the Financial Stability Committee (FSN) has decided that, in general, it will publish the minutes of its meetings within four weeks.

At the Committee's meeting of 14-15 December 2020, it decided to keep the countercyclical capital buffer unchanged. Furthermore, the Committee decided to designate the new Central Bank interbank system and the Nasdaq CSD SE securities settlement system as systemically important infrastructure.

Committee members discussed financial stability developments and prospects, the economic situation, developments in the domestic financial markets, the position of and risk in the financial system and in the operations of individual financial institutions, the real estate market, financial market infrastructure, pension funds, powers of resolution, and the financial cycle. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in late September.

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

The FSN's assessment was that the outlook for financial stability was unchanged since the previous meeting. The economic outlook had deteriorated somewhat, according to the Central Bank's macroeconomic forecast as published in the *Monetary Bulletin 2020/4*, but the financial system remained strong.

The position of the banking system supports the Committee's assessment, as the system has demonstrated its resilience and has supported households and businesses through the economic shock, and the banks had operated at a profit despite considerable impairment in the first nine months of 2020. The systemically important banks' liquidity is strong, at 217 b.kr. in excess of requirements, and their capital ratio rose from 22.4% at year-end 2019 to 24.4% at the end of September 2020. The banks' funding has been successful, as can be seen in the decline in credit spreads on their foreign bond issues since the FSN's previous meeting. In the Committee's view, the actions taken by the Central Bank and the Government have cushioned against the blow and supported financial stability in recent months.

There are troubling signs ahead, however, as the systemically important banks' non-performing loan ratios have risen. Furthermore, there were signs that credit risk was materialising, as the banks had begun to restructure loans to large tourism companies. Such restructuring is necessary to lay the groundwork for a strong rebound when the pandemic has subsided. In addition, the banks' liquidity had deteriorated by 38 b.kr. between meetings, and the credit spreads on their covered bonds relative to Treasury securities had risen at the same time. This is a challenge for the banking system, but the FSN considered it highly likely that the system would withstand it.

The Committee considered it positive that private sector credit growth had been modest during the year, which could be a sign of greater-than-expected resilience. Real growth in household debt measured just under 4% at the end of Q3/2020, and price- and exchange rate-adjusted growth in corporate debt measured just under 2%. The FSN discussed the shift of household debt from indexed to non-indexed loans. As before, members considered it important that credit institutions should ensure that their credit assessments took account of the eventual rise in interest rates and that borrowers would remain able to service their debt. It was pointed out that the increased weight of non-indexed loans in household debt boosted the efficacy of monetary policy, as households' debt service burden depended to a greater degree on nominal interest rates.

Share prices had risen since the Committee's last meeting, and it was noted that this could indicate greater resilience in the domestic economy, although it could also be a response to lower interest rates on other investment options. The OMXI10 index had risen by 14% between meetings, and turnover was up strongly. Yields on nominal and indexed Treasury bonds had risen somewhat between meetings, particularly on longer bonds, where demand is weaker. At the same time, the króna had appreciated by 4%. The Central Bank's share in foreign exchange market turnover had grown, both because of increased intervention to mitigate exchange rate volatility and because of the regular currency sales programme launched in September to deepen the market. The pension funds' net foreign currency purchases had declined, and capital flows due to new investment remained negative.

The FSN also discussed the real estate market. Members were concerned about a potential housing shortage in greater Reykjavík. Price increases were still modest, however, and no signs of excess credit growth had emerged. Committee members agreed that if indicators to the contrary should emerge, they would be prepared to apply the tools at their disposal in the credit market and reduce the likelihood of asset bubble formation.

The measures taken by the Central Bank since the pandemic struck have increased system liquidity, which the Bank has mitigated by intervening in the foreign exchange market.

Committee members considered it necessary to ensure that the banks would have ready access to liquidity. On the other hand, it would be detrimental if the banks' internal criteria prevented them from using their current liquidity position to boost lending. The FSN declared its willingness to support the banks' ability to use their current liquidity position and asked the Governor to consider postponing the increase in the minimum króna-denominated liquidity requirement, which is set to take effect at the beginning of 2021.

It emerged that the financial cycle had stagnated for the most part. The private sector debt cycle was still rising, due to an increase in household debt and to the contraction in GDP. On the other hand, the housing and financing cycles had stagnated or even declined slightly. The past few months' rise in house prices could be a sign that the housing cycle will rise quickly in the months to come. Furthermore, credit spreads in capital market had fallen, which could support the financial cycle.

The Committee also continued the discussion from the previous meeting on the position of the pension funds. It emerged in the discussion that the funds' real returns had been quite acceptable in recent years, but that the low interest rate environment could create new challenges for the funds, which are systemically important, particularly if their benchmarks remained above the risk-free rate of return for a protracted period of time. In addition, the average duration of the funds' liabilities was twice the average duration of their assets. It emerged that this could lead to greater risk appetite and reduced willingness to commit funds to more secure domestic investments, which could pose a threat to the foreign exchange market and system liquidity simultaneously. In this context, it was pointed out that the pension funds own more than half of all outstanding domestic securities. But it was not considered a given that lowering their benchmark rate of return would solve the problem by itself. It was pointed out that changing the benchmark was not a simple action; rather, it could have various spin-off effects on, for instance, public expenditure, entitlements, and public support for pension saving. Lowering the benchmark from 3.5% to 3% could reduce the pension funds' actuarial position by 7-10%. Committee members agreed that this topic required continued examination. The Committee was of the opinion that the framework for the funds needed to be based on their systemic importance and their status as dominant investors in Iceland. The pension funds' asset-to-GDP ratio is among the highest in the world, having risen from 66% of GDP in 1997 to 178% by 2019. Members discussed whether there was a need to set a more stringent framework for the funds' activities and to expand financial stability policy instruments so as to cover the funds' activities more effectively.

The FSN discussed the powers of resolution that were recently entrusted to the Central Bank. These powers entail the authority to take decisions on resolution and to apply resolution measures in the case of a financial undertaking that cannot honour its obligations or is unlikely to be able to. Committee members agreed that this represented an important addition to the Central Bank's financial stability toolkit.

### **Countercyclical capital buffer**

Because the outlook was for the pandemic to drag on longer than previously expected, the Committee was of the opinion that no signs had emerged to justify deviating from its March 2020 decision to keep the countercyclical capital buffer unchanged until March 2021. There were no clear signs that cyclical systemic risk was increasing again, despite growth in household debt and rising house prices.

In view of the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 0%, in accordance with the Committee's March 2020 statement announcing that it would keep the buffer unchanged until at least March 2021. All Committee members voted in favour of the proposal.

### **Systemically important financial market infrastructure**

In the FSN's opinion, significant and rapid changes in financial market infrastructure merited closer attention from the Committee. It was important to consider both security (including cybersecurity) and economy in connection with renewal of infrastructure and development of new solutions. It was pointed out that through payment intermediation, all infrastructure elements are connected in one way or another, and that final settlement takes place in the Central Bank of Iceland's interbank system.

The Committee discussed in particular the Bank's new interbank system, the Icelandic branch of the Nasdaq CSD SE securities settlement system, the SWIFT payment portal, and retail payment intermediation. From a national security perspective, the Committee considered it important to strengthen the foundations of retail payment intermediation by supporting the implementation of account-to-account payment solutions comparable to those in use elsewhere in the Nordic region. This was especially important in order to foster greater efficiency and provide an alternative to the foreign card-based solutions that dominate the Icelandic financial market. Members also discussed the importance of a secure and reliable framework for cross-border payments. They agreed that the position of the Icelandic Banks' Data Centre warranted particular attention, as it was a systemically important provider of service to the domestic financial market.

In view of the discussion and at the recommendation of the Central Bank's Financial Stability Department, the Governor proposed that the Central Bank's new interbank system and the Icelandic branch of the Nasdaq CSD SE securities settlement system be designated systemically important infrastructure in the sense of Article 13, Item (d) of the Act on the Central Bank of Iceland, no. 92/2019. All Committee members voted in favour of the proposal.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Unnur Gunnarsdóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Tómas Brynjólfsson, Director General at the Ministry of Finance and Economic Affairs, attended the meeting, with the right to address the meeting and present proposals.

Haukur C. Benediktsson, Director of the Bank's Financial Stability Department, was present for the entire meeting. In addition, a number of Bank staff members attended part of the meeting.

Eggert Th. Thórarinsson wrote the minutes.