CENTRAL BANK OF ICELAND

# MINUTES

## FINANCIAL STABILITY COMMITTEE

2023

March
16th meeting
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*The Financial Stability Committee of the Central Bank of Iceland*

# Minutes of the Financial Stability Committee meeting

## March 2023 (16th meeting)

## Published 12 April 2023

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 decide which entities, infrastructure elements, or markets shall be considered systemically important. When warranted, the FSN may make recommendations to the appropriate governmental authorities concerning 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 13 and 14 March 2023, presentations were given on recent economic developments and prospects and the state of the financial system and payment systems. The Committee also received a presentation on recent events in the global banking system. The Committee discussed the outlook for and principal risks to financial stability, such as economic developments, risks to the 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 Committee also discussed cybersecurity and received information on the TIBER project and measures to strengthen cybersecurity in payment intermediation. The Committee discussed the recent report by the expert committee tasked with evaluating the Central Bank of Iceland's performance in the attainment of its objectives concerning price stability, financial stability, and the conduct of financial supervision since the Bank's merger with the Financial Supervisory Authority in 2020.

The FSN decided to increase the countercyclical capital buffer (CCyB) rate from 2% to 2.5% of the domestic systemically important banks' (D-SIB) domestic risk base. The decision will take effect on 15 March 2024.

The Committee also stressed the importance of establishing an independent domestic retail payment rails and selecting a solution within a year.

## Analysis of financial stability

Since the FSN's December meeting, inflation in Iceland's main trading partner countries had proven more persistent than previously assumed, and year-2023 GDP growth prospects had generally improved. Central banks had responded to high inflation by raising policy rates, and in some countries macroprudential tools had been applied in order to tighten the policy stance. Uncertainty in global markets had grown in the wake of failures at US banks in March. Global asset prices declined after having risen early in 2023, and credit spreads in foreign financial markets widened again after tightening at the beginning of the year. Access to foreign funding had therefore worsened again.

Domestic GDP growth measured 6.4% in 2022 but is forecast to decline to 2.6% in 2023. Households' and businesses' financial conditions have tightened because of high inflation and interest rates. Interest rates on non-indexed loans to businesses were 10% and non-indexed mortgage rates were 8% in March, having risen by 4 percentage points since May 2021, when the Bank began its monetary tightening phase. Low unemployment and moderate debt levels among most Icelandic households enable them to meet increased debt service and worsening financial conditions. The FSN urged mortgage lenders to work with borrowers, as they have in the past, to minimize financial distress. Given that domestic demand is strong and developments in the financial markets uncertain, preserving domestic financial institutions' resilience is essential. The Committee considered the chief risks to financial stability to be economic developments and poorer funding terms, as well as cybersecurity; furthermore, the FSN was of the view that risk associated with the housing market still existed, although tension had eased in recent months.

**Banking system resilience**

The Icelandic financial system is on a solid footing. The D-SIBs' capital and liquidity are above regulatory thresholds. However, their liquidity position had declined between meetings, however. -This was due primarily to dividend payments and reduction in foreign debt. At the end of January, their liquidity in excess of requirements totalled 236 b.kr., and their liquidity ratio in all currencies combined was 160%. The banks are primarily funded by deposits, covered bonds, and unsecured issuance. Deposits, which account for about half of their funding, increased by 237 b.kr., or 10%, in 2022 in line with the banks' increased lending. Market funding conditions abroad had improved somewhat, and credit spreads on the banks' foreign-denominated bond issues had narrowed after surging in Q4/2022. The systemically important banks have obtained foreign market funding for their next maturities, and they have enough foreign currency liquidity to cover all 2023 payments without violating liquidity rules. Domestic bond issuance had been limited in the recent term, however, and net covered bond issuance had been negative in 2022.

The D-SIBs' operations were strong in 2022. The return on equity was 10.1%, or 2.3 percentage points less than in the previous year. Regular income – i.e., net interest income and commissions – increased by a fifth year-on-year, reaching an all-time high. Higher interest rates caused the net interest margin to widen by 0.39 percentage points year-on-year, to 2.81%. At the same time, their operating expenses rose only marginally, and underlying operations therefore improved markedly between years. The D-SIBs' capital ratio lay between 22.2% and 24.7% at the end of 2022, or 2.3-4 percentage points above the minimum set by the Central Bank. It fell by 1.2 percentage points between years, mainly because of dividend payments and share buybacks.

Household arrears had fallen to a post-2008-crisis low of 0.7% at the end of December. Corporate arrears had declined as well, and the financial position of companies that had needed forbearance measures during the pandemic had grown stronger. As a result, the banks have reversed unutilised impairment previously expensed as a precautionary measure due to the pandemic. A large share of the companies with forborne loans had already begun making full or partial payment on them.

New legislation amending the Act on Covered Bonds entered into force on 1 March 2023, thereby completing the implementation of European regulations on covered bond issuance. The main change provided for in the new legislation is that bonds satisfying the conditions laid down in the law may be marketed as European Covered Bonds or European Covered Bonds (Premium). In all likelihood, the change will have a positive impact on the Icelandic banks' covered bond issues, as they will be eligible as collateral for transactions with the European Central Bank. In all, the D-SIBs have issued covered euro bonds for 1,100 million euros, starting in September 2021 and have issued bonds for their own use in the amount of 550 million euros. The D-SIBs must also satisfy minimum requirements for own funds and eligible liabilities (MREL) by having sufficient funding to satisfy those requirements. Bonds maturing within one year are not MREL eligible. The banks therefore have to refinance continuously to fulfil MREL requirements.

**Private sector debt**

The ratios of household debt to GDP and to disposable income had declined since the FSN's last meeting and are low in historical context. Growth in household debt had lost pace and, in real terms, was marginally negative in January. Nominal growth remained robust, however, at nearly 10%, almost half of it due to indexation on indexed loans. Indexed mortgage loans had accounted for an increasing share of new lending in recent months. However, there had been few signs that households had begun to refinance older non-indexed debt with new indexed loans in an attempt to lighten their debt service burden.

In general, mortgage debt burden had increase alongside rising interest rates. As a share of disposable income, however, most households' debt service burden had risen only modestly. Just over half of households that had taken loans in January 2020 or later had seen their debt service rise by less than 30,000 kr. per month. In just over a fourth of cases, debt service had risen by more than 30,000 per month, and in another scant one-fourth of cases it had remained unchanged or declined. After adjusting for wage growth, which gives a more accurate view of households' housing cost burden, the ratio of debt service to disposable income is broadly unchanged. As of January 2023, the share of households whose debt service exceeds 35% of disposable income had risen by 2 percentage points, from 7% to 9%.

Part of the reason debt service has not increased more is that about a fourth of households are carrying non-indexed debt with interest rates fixed for three to five years. In addition, nearly half of households have taken indexed mortgage loans, and the debt service burden on these has risen more slowly than on non-indexed variable-rate loans. When interest rates on fixed-rate loans are reset in 2024 and 2025, some households could find it more difficult to cover the increased debt service, all else being equal. The possibility of switching to indexed loans or of extending loan maturities should considerably reduce the likelihood of financial distress. The Central Bank's rules capping loan-to-value ratios and debt service-to-income ratios do not apply to restructured loans, which are not considered as new loans, nor do they apply to refinancing, provided that the principal is not increased. The cap on loan-to-value ratios does not apply to borrowers in financial distress.

The available data indicate that households are generally well positioned. Arrears are limited, unemployment is low, and real disposable income has increased year by year since 2010.

Year-on-year growth in corporate debt turned a corner in 2022, flipping from being negative (at constant prices) in H1 to being positive by 0.4% at the year-end. Credit growth was driven by an increase in D-SIB lending, as companies appeared to seek financing from banks rather than from the market. The increase was greatest in lending to the real estate and construction sector.

At present, companies' main challenges lie in cost increases due to inflation, wage rises, and interest expense. Interest rates on corporate loans had risen markedly in recent months, as a large majority of corporate debt bears variable interest. Companies' financial position has developed favourably in the recent term, however, and arrears are limited. Businesses should be quite resilient.

**Asset prices**

The housing market turned around in mid-2022. Turnover in the residential real estate market contracted sharply, and the number of purchase agreements finalised in the capital area fell by 30% year-on-year. In January 2023, only a scant 290 contracts were concluded – the smallest single-month total since February 2011. The number of homes advertised for sale continued to increase, and by January the housing supply was broadly back to the pre-pandemic level. In January, house prices had risen year-on-year by 4.5% in real terms and 14.9% in nominal terms, with the entire increase in the index occurring in H1/2022. Since June 2022, house prices have risen by only 0.6% in nominal terms and have fallen by 3.4% in real terms. The ratio of house prices to fundamentals such as construction costs and rent prices had fallen in recent months, after peaking in mid-2022. At the end of January, the house price index measured 13% above trend, down from a peak of 19% above trend in June 2022.

The FSN was of the view that the interaction between borrower-based measures and higher interest rates had reduced imbalances in the housing market.

The price of shares in listed companies had remained unchanged since the FSN's last meeting. The Main List index had risen marginally in 2023 to date, however. Over the first two months of the year, stock market turnover had contracted by 3% between years. Nominal Treasury bond yields had risen since the Committee's last meeting, as inflation measured higher than expected.

**Exchange rate of the króna**

The exchange rate of the króna had been broadly unchanged since the Committee's early December meeting. An increased capelin quota and favourable fishing conditions were considered to have offset a sizeable goods account deficit, and the interest rate differential with abroad had widened as well. Forward positions with the króna had increased, and there had been moderate foreign investment inflows to Iceland. Furthermore, the pension funds had scaled down their foreign currency purchases year-to-date. The D-SIBs' foreign exchange balance was relatively unchanged between meetings and was in balance; i.e., the banks' foreign-denominated assets almost equalled their foreign-denominated liabilities.

**The financial cycle and cyclical systemic risk**

A composite measure of financial cycles indicated that the cycle was still in an upward phase at the end of 2022. It also indicated that cyclical systemic risk was at an average level and had increased marginally since the FSN's last meeting. The debt cycle was still in a relatively low position consistent with moderate household and corporate debt levels. The upward trend was estimated to be fastest and the position highest in the housing cycle, which runs counter to developments in house prices in the past few months, as the housing market began to cool in H2/2022. 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.

A new indicator that measures financial conditions with a monthly frequency and takes into consideration short-term movements in financial variables was presented to the Committee. That indicator showed a sharp decline in recent months, driven in particular by a cooling housing market, rising interest rates, and a depreciation of the króna, which suggested that financial conditions had shifted from being relatively accommodative and expansionary to being neutral. If the same trend continues in the coming term, financial conditions can be expected to be tight or even growth-impeding. The recent decline in the financial conditions index was considered to be a sign of uncertainty about whether the upward financial cycle would continue in the coming term.

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 were falling asset prices, slower credit growth, and strong GDP growth. On the other hand, the measure of growth-at-risk suggested that cyclical systemic risk had increased in 2022, as the fifth percentile of the probability distribution of GDP growth over the next two years had shifted downwards. Various indicators therefore give differing signals about developments in systemic risk, although all of the indicators imply that cyclical systemic risk is moderate.

**Cybersecurity**

The Committee received a presentation on cybersecurity. The cybersecurity framework in Iceland and measures to boost the resilience of financial market infrastructure were discussed. Significant work has been done in this area, which covers a broad range, as roles and responsibility are distributed widely through the administrative system. Emphasis was placed on the importance of the Central Bank as an active participant in formulating cybersecurity policy in cooperation with the Government.

The FSN received a presentation on two projects aimed at bolstering the resilience of financial market infrastructure. On the one hand, the Bank has decided to begin formal testing of cybersecurity and financial system resilience by introducing the so-called TIBER framework in Iceland. This entails directing unannounced tailor-made cyberattacks through important infrastructure and companies so as to determine the level of resilience against cyberattacks, thereby fostering increased financial stability. Participants receive an assessment of the quality of cyber defences and the weaknesses therein. The Central Bank administers the tests. On the other hand, a representative from Reiknistofa Bankanna (RB) presented an initiative designed to reduce the likelihood of cybersecurity-related incidents.

**Expert committee report on the Central Bank's performance in 2020-2022**

The expert committee tasked with evaluating the Bank's performance in attaining its objectives for price stability, financial stability, and financial supervision in the wake of its merger with the Financial Supervisory Authority, cf. Article 36 of the Act on the Central Bank of Iceland, delivered its report in January 2023. The expert committee's discussion of the FSN was very positive overall. The regulatory architecture and framework for financial stability is considered to be in line with international best practice and in compliance with European regulatory provisions. When the COVID-19 pandemic reached Iceland in 2020, the FSN responded promptly by lowering the CCyB. The Committee was similarly quick to respond to changes in financial conditions when it decided in September 2021, in view of increased accumulation of systemic risk, to increase the CCyB again, as it considered cyclical systemic risk to have risen to at least the pre-pandemic level. Furthermore, the Committee had acted appropriately in tightening borrower-based requirements in response to conditions in the housing market. The report states that the Bank's stress tests are carried out professionally, that the Bank had developed measures of the financial cycle in order to identify changes in financial stability, and that the *Financial Stability* reports were well prepared and covered significant ground.

The FSN discussed the expert committee's recommendations concerning increased cooperation between the Monetary Policy Committee and the Financial Stability Committee, a wider range of scenarios in the Bank's stress tests, and greater emphasis on the pension fund system from the perspective of financial stability. Work had begun on incorporating the recommendations into the work of the committees and the Bank.

## Financial Stability Committee decisions in 2022

**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.

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

The FSN discussed the outlook for financial stability. Prospects were generally good in Iceland: demand was strong, unemployment low, and private sector indebtedness modest. On the other hand, inflationary pressures had proven persistent, both in Iceland and internationally, and interest rates were high. The domestic banking system's market funding had grown more expensive, and elevated uncertainty in foreign funding markets had also pushed credit spreads upwards. Fixed interest rates of non-indexed loan agreements totalling 650 b.kr. would reset in the coming two years. Furthermore, the effects of recent events abroad had yet to emerge in full and there could be a material risk of financial spillovers. Even though the banks are resilient, external risks were on the rise, both on the assets side (owing to conditions in asset markets) and on the liabilities side (owing to conditions in funding markets). In view of this, the Committee agreed that there was reason for the banks to further strengthen their resilience by holding sufficient capital. The decision to increase the CCyB now would not be onerous for the banks, as their capital ratios were already 2.3-4% above Central Bank requirements. Therefore, increasing the buffer should not curtail their ability to intermediate credit to households and businesses.

Following the discussion, the Governor proposed that the countercyclical capital buffer rate be increased from 2% to 2.5%. The proposal was approved unanimously, and the increase will take effect on 15 March 2024.

**Financial market infrastructure**

One of the Central Bank of Iceland's principal roles is to promote a safe and effective financial system, including domestic and cross-border payment intermediation. Work on strengthening Iceland's financial market infrastructure framework and further enhancing operational security is still ongoing. To this end, the Payment Council has established a task force on trade and service providers' response to a disruption in payment intermediation in Iceland.

Committee members agreed unanimously that it was of vital importance for the Government and Central Bank to 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. Information flows and consultation among all stakeholders in this area are of utmost importance and to assess whether the statutory framework for financial market infrastructure needs strengthening.

The FSN received a presentation on the status of the project focusing on an independent domestic retail payment solution. The main objective of an independent domestic retail payment solution is to safeguard national security, with emphasis on the resilience of domestic payment intermediation, and to ensure that the solution is open, secure, effective, and efficient. The Forum for the Future has established a task force entrusted with making recommendations concerning possible cooperation on a domestic payment scheme for account-to-account payments.

The FSN reiterates the importance of establishing an independent domestic retail payment rail and supports the steps taken thus far towards achieving this goal. This work should be expedited as possible and conclusion reached within a year concerning which option to adopt in putting an independent domestic payment solution in place. Statutory framework for financial market infrastructure relating to retail payment intermediation may need to be strengthened and the Central Bank's power to set rules in this area augmented.

At the end of the meeting, the Committee approved the statement for publication on the morning of 15 March 2023.

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

Haukur C. Benediktsson, Director of the Bank's Financial Stability Department; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; Vigdís Ósk Helgadóttir, Head of the Financial Stability Department; and Rannveig Júníusdóttir, Director of the Bank's General Secretariat were present for the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.