The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

31 March 2020 (3rd meeting)

Published: 1 July 2020

The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the applications of the Central Bank of Iceland'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.

The following are the minutes of the FSN meeting held on 31 March 2020. At the meeting, the Committee confirmed the assessment of which financial institutions are considered systemically important and took decisions on capital buffers for systemic risk and systemic importance. The Committee also recommended to the Governor that a special temporary loan facility be established for financial institutions.

I Financial stability developments and prospects

Committee members discussed financial stability developments and prospects, the economic situation, developments in the domestic financial markets, the position of and risks in the financial system and in the operations of individual financial institutions, and risks in the operation of financial market infrastructure. The Committee had information at its disposal on the current situation and developments in recent weeks.

The economy

Air travel to and from Iceland had come virtually to a halt. The Government had made a temporary agreement with Icelandair to maintain two flights per week to Europe and two to North America. On 22 March, the Central Bank presented two scenarios concerning the potential impact of the COVID-19 pandemic and associated Government measures on the domestic economic outlook. The scenarios showed that the economic contraction could be as much as 5% in 2020 and that average unemployment could rise as high as 7%. The scenario analysis suggests that a shock of this magnitude could have a profound impact on the large banks' capital ratios, but would not push them below the required minimum.

Financial markets

Foreign stock markets had been highly volatile in recent days. Stimulative measures taken by governments and central banks helped to firm up the markets. The VIX index, which measures implied volatility in equity securities markets, had risen to an all-time high — for the present, at least — on 16 March. The yield on 10-year government bonds issued by the US, the UK, and Germany had risen since the FSN's previous meeting two weeks earlier.

In the domestic stock market, the price of shares in tourism-related companies fell the most. Treasury bond yields had risen, as it appeared that the Treasury would need to borrow a substantial amount, but they fell again after the Central Bank announced on 23 March that the Bank would begin buying Treasury bonds in the secondary market. The exchange rate of the króna had been broadly unchanged since the Committee's last meeting.

The banking system

The three large banks' liquidity position is well in excess of the Central Bank's required minimum. On 25 March, their liquid assets in excess of liquidity requirements totalled 249 b.kr. At that point, changed economic conditions had not yet damaged their liquidity. Because of lower interest rates, demand for liquidity and mortgage refinancing had increased, at least temporarily. There had been a significant number of applications for payment assistance measures because of the effects of the pandemic.

Interest premia on the banks' foreign bond issues had risen since the FSN's last meeting. The banks' generous foreign liquidity position gives them flexibility to respond to these challenging market conditions. The spread between the banks' covered bond rates and Treasury bond rates had also widened since the Committee's meeting two weeks earlier, indicating that funding terms in the domestic market were deteriorating.

Members discussed the banks' credit risk, particularly in connection with foreign-denominated lending to domestic companies. In recent years, access to such loans had been more or less restricted to companies with foreign revenues, such as those in fishing, aquaculture, manufacturing, transport, and transit. There were instances of substantial foreign-denominated lending to tourism companies, however.

Capital buffers

The three large banks' capital position is very strong. Their capital ratios were from 5.6-10.4% above the Central Bank's total capital requirement, which lay in the 16.8-18.4% range after the suspension of the 2% countercyclical capital buffer. The three large banks' combined capital buffer requirements — i.e., the systemic risk buffer, the capital conservation buffer, and the buffer for systemic importance — came to 7.5%. The requirements must be satisfied with assets of the highest possible quality — common equity Tier 1 (CET1) capital. Financial institutions can tap their "soft" buffers (the capital conservation buffer and the buffer for systemic importance) without losing their operating licence. These requirements combined totalled 4.5%. If the financial institutions need to tap the soft buffers, they must refrain from all distributions such as bonuses and dividends, as well as refraining from buying back their own shares.

The capital conservation buffer is intended to boost financial institutions' resilience in a downward cycle. It is supposed to ensure that financial institutions can face headwinds and tap into their capital without losing their operating licence.

The capital buffer for systemic importance is intended to address the adverse effects that systemically important financial institutions, because of their size and the nature of their activities, can have on financial stability and the real economy if they find themselves in difficulty.

The systemic risk buffer has been applied in Iceland in order to prevent or mitigate the impact of long-term non-cyclical systemic risk that the financial system could face, and that could have a severe negative impact on the financial system and the real economy. The buffer is therefore intended to address the risk entailed in building up the Icelandic economy and financial system. The domestic economy is sensitive to shocks that are reflected in wide fluctuations in economic variables relative to other countries, owing to the high level of sectoral concentration in the economy. The demands made of financial institutions as regards satisfying buffer requirements are more stringent for the systemic risk buffer than for other capital buffers.

Financial market infrastructure

In operating financial market infrastructure, emphasis had been placed in recent weeks on minimising pandemic-generated operational risk in payment intermediation and on securing day-to-day operations. System operations had gone smoothly. Domestic turnover in banknotes had declined, both because of shorter opening hours at retail establishments and because of increased emphasis on electronic payment intermediation. Demand for Icelandic banknotes abroad had contracted markedly, as passenger flights to the country were all but non-existent. Because of the pandemic, it might prove necessary to postpone the installation and launch of new financial market infrastructure systems, planned for this year.

Domestic payment card turnover had contracted by as much as half after the ban on gatherings took effect. Daily turnover with foreign cards had contracted even more sharply, or by over 80% in the first three weeks of March. A further contraction in foreign card turnover can be expected in April, owing to the lack of passenger flights to Iceland.

Framework for expansion of liquidity facilities

Because of the economic situation, it is vital that financial institutions have access to collateralised loans from the Central Bank on broader foundations than before. In order to respond to this, it is possible to set up a special temporary collateralised loan facility. Such loans would differ from the regular collateralised loan facilities offered to banks, particularly as regards eligible collateral and duration. It has been quite some time since the Central Bank last offered collateralised loans. Financial institutions have had abundant liquidity, but economic developments further ahead are highly uncertain.

II Decisions pertaining to financial stability

The Committee discussed financial institutions' capital position and the requirements according to capital buffers. Members were of the view that the three large banks had enough of a capital cushion to enable them to respond to the current situation. Lowering the countercyclical capital buffer to 0% had already given them considerable space for action. The Committee also considered it appropriate to reiterate that some of the capital buffers were soft and could be tapped as needed under circumstances like the current ones.

Capital buffers for systemic importance and systemic risk

Based on the results of the assessment of systemically important financial institutions in accordance with European Banking Authority (EBA) methodology, the FSN considered it obvious that Arion Bank, Íslandsbanki, and Landsbankinn should be confirmed as systemically important. Underlying the assessment are indicators pertaining to size, importance, complexity, and interconnectedness. The Governor presented a proposal to this effect, and it was approved unanimously.

Committee members discussed whether it was appropriate to lower the capital buffers for systemic importance and systemic risk, or to keep them unchanged. It emerged that the risks these buffers were designed to address were relatively inelastic and had remained broadly unchanged in recent years. It was also pointed out that there were plans to change the systemic risk buffer and the systemic importance buffer according to the European regulatory framework, with the implementation of Capital Requirements Directive V (CRD V). It was deemed premature to respond to these proposed changes, as it was unclear when they would be incorporated into the Icelandic regulatory framework.

In view of the discussion, the Governor proposed that the capital buffer for systemic importance be held unchanged at 2% on all exposures at the parent company level and on a consolidated basis. The proposal was approved unanimously.

The Governor then proposed that the systemic risk buffer for deposit-taking institutions remain unchanged at 3% of domestic exposures, and that it be applied both individually and on a consolidated basis, as appropriate. The proposal was approved unanimously.

Framework for expansion of liquidity facilities

Members discussed the framework for a special temporary collateralised loan facility for financial institutions eligible for regular Central Bank facilities. The Committee agreed unanimously to recommend that the Governor establish a special temporary collateralised loan facility based on an expanded list of eligible collateral.

Committee members agreed that the financial system was on a sound footing and that the banks' capital position was strong. Recent measures taken by the Central Bank – i.e., releasing the countercyclical capital buffer and changing minimum reserve requirements – had given the banks increased scope to support households and businesses during the shock brought on by the COVID-19 pandemic. The flexibility of the capital buffers currently in effect also provided greater scope for response to the conditions currently prevailing in the economy.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Financial Stability 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

Guðmundur 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 Þ. Þórarinsson wrote the minutes.