The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

June 2022 (13th meeting)

Published: 1 July 2022

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 make 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 13-14 June 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 risks to financial stability, 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 and liquidity. The Committee also discussed the security and efficacy of financial market infrastructure and its importance for financial system stability. The Committee received information on resolution plans for the systemically important banks and on the preparation of an official financial stability policy, on which the Financial Stability Council is currently working.

The FSN decided to lower the maximum loan-to-value (LTV) ratio on mortgage loans to first-time buyers from 90% to 85% but the keep the ratio for other buyers unchanged at 80%. The Committee also decided to set a reference interest rate for the calculation of debt service in the Rules on Maximum Debt Service-to-Income Ratios for Mortgage Loans to Consumers. The reference rate is set at a minimum of 3% for indexed mortgages and 5.5% for non-indexed mortgages. Furthermore, the Committee decided to shorten the maximum loan period used to calculate debt service on indexed loans to 25 years. 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 Committee reiterated the importance of enhancing security in domestic payment intermediation and expediting the implementation of an independent retail payment solution.

Analysis of financial stability

The Committee considered the financial system to be on a solid footing and the state of financial stability to be good. Figures from Statistics Iceland for Q1/2022 showed that GDP growth was robust, and considerably stronger than the Bank had forecast in May. Data from the labour market indicated that the market was tightening. Unemployment had continued to fall since the FSN's last meeting, and the number of employed persons had risen. Demand for labour was strong. More than half of executives surveyed considered their companies short-staffed, and job vacancy numbers were high in virtually all sectors, although particularly in tourism and construction. The outlook for the tourism industry had improved rapidly in recent months, although it was uncertain how quickly companies in the sector would be able to expand their operations to keep pace with demand. The deteriorating inflation outlook, rising oil prices, and reduced purchasing power in key trading partner countries could cut into exports over the course of the year. The FSN was of the opinion that the economic recovery, the strong position of the banking system, and the recent rise in real wages were likely to boost households' resilience against shocks and mitigate the adverse effects of elevated global economic uncertainty on the domestic economy and financial system. The FSN's concerns about the real estate market had grown stronger between meetings, however, and the Committee was of the opinion that the risk of overleveraging alongside rapidly rising property prices had increased, which could have a negative impact on financial stability in the event of an economic downturn or a severe drop in property prices.

Banking system resilience

In the FSN's opinion, the systemically important banks are highly resilient. Their capital and liquidity are well above regulatory minima, giving them ample scope to support households and businesses. The three banks generated a profit of 14.2 b.kr. in Q/2022, and their liquidity in excess of requirements totalled 149 b.kr. as of end-April. Their liquidity ratios had fallen somewhat in recent months, mainly because of dividend payments and share buybacks. For the same reasons, their capital ratios also fell somewhat in Q1. Credit spreads on the banks' foreign issues had continued to rise in recent months, although spreads on comparable issues from foreign banks and done so as well, owing to the significant deterioration in global bond markets. The banks' near-term foreign refinancing risk was considered limited, however, because of their strong liquidity position. The first results of the Central Bank's annual stress test of the systemically important banks, which will be published this autumn, suggest that they are in a very strong position.

Operations and equity

The systemically important banks' operations were favourable in Q1/2022. Their return on equity was 8.9%, some 2.4 percentage points lower than in the same quarter of 2021. Net interest income was 29 b.kr. during the quarter, an increase of 4.8 b.kr. year-on-year, or 20%. Income from fees and commissions totalled 9.3 b.kr., a year-on-year increase of 13%. The systemically important banks' regular income – i.e., net interest income plus fees and commissions – has never been higher in a single quarter. A higher interest rate level widened the interest rate spread on total assets by 0.24 percentage points year-on-year, to 2.6% during the quarter.

The systemically important banks' expenses in Q1/2022 totalled 18.4 b.kr., an increase of 0.2 b.kr. between years. Because expenses were virtually unchanged while regular income increased 18% year-on-year, underlying operations strengthened between years.

Dividend payments and share buybacks totalled 59.2 b.kr. during the quarter, and dividend payments weighed heaviest in the more than two percentage point decline in the banks' capital ratios during the period. After adjusting for Íslandsbanki's planned 15 b.kr. share buyback and Arion Bank and Landsbankinn's dividend payments next year, their capital ratio lay in the 22.2-24.3% range at the end of March. The ratio was 0.5-1.5 percentage points above Central Bank requirements, after adjusting for management buffers and the increase in the CCyB.

Households' non-performing loan (NPL) ratios continued to decline, and household arrears are at an all-time low. Corporate arrears also continued to decline, as did the value of loans classified as forborne and performing. The position of firms that had needed forbearance measures due to the pandemic had therefore grown stronger.

Private sector debt

Real growth in household debt had slowed since the FSN's last meeting, from 4.1% in January to 2.5% in April. Nominal growth was still significant, however, at nearly 10%. The debt-to-GDP ratio fell in Q1, but the ratio of debt to disposable income rose marginally. Both ratios were still low in historical context. Growth in household debt was still driven by mortgage lending growth, although there were indications that other household debt was on the rise. Households were generally in a strong position, and key indicators suggested a positive trend. Nominal and real wages had continued to grow, unemployment had declined to 4.5% by April, and household arrears were low and had fallen since the Committee's last meeting.

Borrowers choose increasingly to fix mortgage interest rates for up to five years, and as of April, 54% of all mortgages and 67% of new mortgages bore fixed rates, as compared with 44% of all loans in April 2021. The ratio of indexed loans to new mortgage loans had risen in recent months, from 18% in April 2021 to 33% by April 2022.

The Committee discussed the new official property valuation, which had risen by an average of 19.9% nationwide. Some credit institutions had begun issuing loans based on the new valuation, even though it does not take effect until 1 January 2023.

Corporate credit growth had gained pace slightly since the last FSN meeting. In real terms, growth in corporate debt was still negative in Q1/2022, however, whereas in both nominal and price- and exchange rate-adjusted terms, it measured 4.5%. The change in developments in corporate debt is due mainly to an increase in credit institution lending to companies during the early months of the year.

The face value of loans issued by the systemically important banks to the tourism sector had remained relatively stable, with year-on-year growth measuring 2.1% in nominal terms and 3.7% at constant exchange rates at the end of Q1.

Asset prices

The FSN reviewed the situation in the real estate market, as it emerged that there were still severe imbalances between supply and demand. Prices had risen far in excess of fundamentals since spring 2021, and the Committee was of the opinion that the probability of stagnation or a correction of real prices had risen. It came to light that nominal property prices had risen by an average of 2.1% month-on-month in the past six months, and in April, prices measured 22.3% higher than in April 2021. Excess demand for housing had grown nationwide, and the price of both multi-family and single-family homes had therefore risen sharply in all regions. In the weeks prior to the Committee meeting, however, indicators of growing supply had begun to surface and the number of properties advertised for sale had risen marginally, although the average time-to-sale was still very short, at less than 30 days.

A relatively large number of new housing units had been built in 2019-2021. Indicators implied that the supply of newly constructed homes would be smaller than previously estimated. As a result, new housing supply – in greater Reykjavík and elsewhere – would be markedly smaller in 2022 than in the past three years. Committee members were concerned about the limited supply of residential housing.

The tally conducted by the Federation of Icelandic Industries suggested, however, that the supply of new fully finished properties would increase again in 2023.

The FSN discussed the impact of the new rules providing for borrower-based measures in the housing market. The loan quality of new consumer mortgages had improved somewhat since the rules on maximum LTV ratios had been tightened just under a year earlier. Loans issued to borrowers other than first-time buyers and bearing an LTV ratio over 80% had declined markedly in number. The number of borrowers with a debt service-to-income (DSTI) ratio above 35% had also declined quarter-on-quarter in Q1/2022, after the rules capping the DSTI ratio took effect in December 2021. Among first-time buyers, however, the average DSTI ratio had risen somewhat, to nearly 30% in Q1/2022. The FSN discussed the adverse effects of rising house prices on first-time buyers who had been forced to take on higher debt service in order to enter the market. The risk was that increased debt among these borrowers could dilute their resilience against a potential setback in the property market.

The commercial real estate (CRE) price index, a measure of real CRE prices in greater Reykjavík, had fallen marginally in the past two quarters, although the twelve-month rise in the index still measured 6.3% at the end of Q1. In terms of the face value of registered purchase contracts, capital area housing market turnover had been relatively strong in historical context over the past two years. In real terms, turnover was up 38% year-on-year over the first four months of 2022.

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

The price of listed Icelandic companies' shares had fallen, in keeping with the pattern seen widely abroad. The OMXI10 index had fallen by 13% since the Committee's last meeting, and by just over 20% year-to-date. Yields on both indexed and nominal Treasury bonds had continued to rise between FSN meetings. The breakeven inflation rate in the bond market had been well above the inflation target after having peaked shortly after Russia invaded Ukraine.

Exchange rate of the króna and international reserves

The króna had appreciated more or less uninterrupted since mid-March 2022, after having weakened rather abruptly in the wake of the invasion of Ukraine. The foreign exchange market had been quite stable and fluctuations had been moderate. Turnover in the interbank foreign exchange market had declined but was still above the 2019 average. As a result, the Central Bank had not needed to intervene much in the market, apart from large transactions in April, when the Bank bought foreign currency in direct trades in response to capital inflows relating to foreign investments in Treasury bonds. The pension funds had stepped up their net foreign currency purchases. In May 2022, the funds bought foreign currency for 17 b.kr., the largest single-month total since the Bank began collecting monthly data on the pension funds' foreign exchange transactions in 2017.

The current account deficit measured 50 b.kr. in Q1/2022. Net export revenues from tourism increased year-on-year but were still somewhat lower than before the COVID-19 pandemic. The income account showed a deficit for the second quarter in a row. It was offset somewhat by a surplus of just under 1 b.kr. on goods trade excluding ships and aircraft, which has been in deficit in recent years.

The financial cycle and cyclical systemic risk

A composite measure of financial cycles indicated an average level of cyclical systemic risk at present, although risk had increased since the FSN's last meeting. The housing cycle was increasingly the driver of the financial cycle, reflecting the steep rise in house prices in recent years. The credit cycle, however, showed the fastest increase, although credit growth had been modest overall in recent months. Even so, the credit cycle was at a low level, indicating that private sector debt was still manageable. This is because of the financial cycle indicator's emphasis on medium-long cycles, with short-term trends having little impact.

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 latter indicated that cyclical systemic risk was somewhat above average at present and had increased in the past two years, owing mainly to the flip from a large current account surplus to a deficit and to rising asset prices. The d-SRI fell marginally in Q1/2022, however, the first decline in two years. It was considered likely to continue falling in coming quarters, owing to the decline in share prices in Q2 to date, the ongoing brisk economic recovery, and the tighter monetary and macroprudential policy stance.

Rules on LTV and DSTI ratios

The Committee expressed concerns about the current state of the housing market. Members considered the tightening of borrower-based measures in 2021 an important move. Although house prices had surged in the recent term, the increase was generally not driven by excessive leverage. Household debt measured about 155% of disposable income, which is lower than in the other Nordic countries and low in historical context. Even though inflation was high, disposable income had increased, the number of employed persons had risen, and unemployment had fallen, while the economic outlook was good. Members noted, however, that debt levels were still rising, particularly among first-time buyers. They were concerned about the supply shortage in the housing market, which remained significant. It emerged that the outlook was for housing demand to continue to outpace supply. It was mentioned that there was a labour shortage, indicating that immigration would continue, and that a large cohort of young people was entering the housing market.

Demand for indexed mortgages had increased in tandem with the worsening inflation outlook. Negative real rates had prompted lenders to reduce their indexed lending rates, which were more than ½ a percentage point lower than when the FSN had approved the DSTI rules in September 2021. At the same time, interest rates on non-indexed loans had risen by nearly 2 percentage points. As a result, households were more likely to seek out indexed loans so as to reduce debt service in the short run. Committee members were of the view that this could be risky. Interest rates on indexed loans had fallen steeply in the past year and were historically low. The Committee considered it important to ensure that households did not become overleveraged on the basis of assumptions that in all likelihood would not stand the test of time. Furthermore, the debt service burden on indexed loans was proportionally lighter early on but grew heavier over the term of the loan. Inflation would be added directly to the loan principal, potentially eroding highly leveraged borrowers' resilience.

Committee members discussed the impact of the rules and were of the opinion that they had affected debt levels and debt service. Too little time had passed since their entry into effect, however, for the full impact of the rules to have come to the fore. It was unlikely that interest rates would remain low in the long run. As a result, it was appropriate to set a floor for interest rates for the calculation of debt services, so as to safeguard households' long-term resilience.

Following discussion by the Committee, the Governor proposed introducing a reference interest rate for the calculation of debt service in the Rules on Maximum Debt Service-to-Income Ratios for Mortgage Loans to Consumers. The reference rate would be a minimum of 3% for indexed mortgages and 5.5% for non-indexed mortgages, and the maximum loan term used to calculate debt service on an indexed loan would be shortened to 25 years. The changes in the DSTI ratio are intended to increase borrowers' awareness when they select from among loan types, thereby bolstering lenders' and borrowers' resilience. All members voted in favour of the Governor's proposal and agreed that the rules thus amended should take effect immediately. The new Rules on Maximum Debt Service-to-Income Ratios for Mortgage Loans to Consumers, no. 701/2022, were approved unanimously by FSN members.

Committee members discussed the pros and cons of lowering the LTV ratio. Borrower-based measures were intended to reduce the risk of excessive leverage and were an element in safeguarding the resilience of lenders, borrowers, and the financial system as a whole. Under the current circumstances, with house prices and inflation surging and the monetary stance growing tighter, it was more likely that house rice inflation would ease and that real house prices would fall. Committee members were of the opinion that under these circumstances, a 90% LTV ratio [for first-time buyers] was risky for both lenders and borrowers. As a result, it was advisable to lower the maximum LTV ratio for first-time buyers from 90% to 85% but hold it unchanged at 80% for other buyers. It emerged in the discussion that no credit institutions were advertising an LTV ratio higher than 85% for first-time buyers; however, loan data showed that some first-timers had borrowed more than 85% of the property value. The data showed that in Q1/2022, 19% of first-time buyers had had an LTV ratio higher than 85%. This represented 2.6% of the face value of new mortgage loans.

The Governor then proposed that the Rules on Maximum Loan-to-Value Ratios for Consumer Mortgages be amended so as to lower the LTV ratio on first-time buyers' mortgages from 90% to 85%, but to hold the ratio for other buyers unchanged. In view of the situation in the housing market, all Committee members voted in favour of the Governor's proposal. Members considered tightening the rules an important means of safeguarding lenders' and borrowers' resilience, as it seemed probable that house prices could deviate even further from fundamentals such as wages, construction costs, and rent prices. The new Rules on Maximum Loan-to-Value Ratios for Mortgage Loans to Consumers, no. 702/2022, were approved unanimously by the Committee.

Financial market infrastructure

One of the Central Bank of Iceland's roles is to promote an active and secure financial system, including domestic and cross-border payment intermediation. The Committee was given a presentation on the next steps in implementing an independent domestic retail payment solution. The presentation was based on an analysis of the available options, carried out by a working group of Central Bank employees. It emerged that netting and settlement of nearly all domestic payment card transactions was routed through foreign systems, which entailed risks; for instance, if international internet connections were disrupted or if the owners of the systems in question stopped doing business with Iceland. The Committee also discussed the costs associated with payment intermediation, which are higher in Iceland than elsewhere in the Nordic region. Payment intermediation is both less economical and less secure in Iceland than in the other Nordic countries, and the Committee considered it vital to expedite the introduction of a domestic retail payment solution. Discussions about the process of implementing an independent domestic retail payment system will be referred to the Forum for the Future, whose role is to shape the vision and priorities for development of core financial market infrastructure in Iceland. In addition to the Central Bank, deposit-taking financial institutions and the Ministry of Finance and Economic Affairs have representatives on the Forum.

The Committee received information from the Central Bank's interbank system, in the form of risk indicators for financial market infrastructure. The Bank uses the new system in order to maintain an overview of and assess risk associated with financial market infrastructure. The system is also useful for assessing potential weaknesses and operational bottlenecks in domestic payment intermediation.

The Committee was also given a presentation on operational security of financial market infrastructure. It was noted in discussions that the Central Bank has broad authorisations to set policy and adopt rules on financial market infrastructure. The Bank can impose certain basic security requirements in order to guarantee the security of payment intermediation infrastructure. It might prove necessary to strengthen the statutory framework for financial market infrastructure still further, however, and expand the Bank's authorisations to adopt rules. It was necessary to guarantee information flows and consultation among all stakeholders in this area. The FSN agreed that it was important for the Government and the Bank to place strong emphasis on taking the lead in policy setting and bringing about the changes necessary for effective and secure payment intermediation.

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. In September 2021, when the buffer was increased again to 2% (with an effective date of September 2022), the FSN was of the opinion that cyclical systemic risk was certainly no less than before the pandemic struck.

Indicators of the systemic risk level suggest that it is close to the average of recent years but is rising. Loan quality has generally improved and arrears have declined, particularly to include household arrears, which now account for less than 1% of the household loan portfolio. The measures taken by the Central Bank and the Government during the pandemic delivered results and mitigated the negative economic impact on households and the business community in Iceland. FSN members agreed that the banking system was on a solid footing. Resilience appeared to be sufficient in terms of the systemic risk level. 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.

The Committee discussed the economic outlook, which had improved, and the outlook for tourism, which was good. The Committee's concerns about lending to the tourism sector had diminished, and the systemic risk that was of particular concern now stemmed from the real estate market. The Committee agreed to examine the CCyB closely at its meeting in September 2022.

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

Material third countries

According to Article 86(d), Paragraph 3 of the Act on Financial Undertakings, no. 161/2002, the Central Bank of Iceland is authorised to set rules specifying a CCyB value for financial institutions' exposures vis-à-vis countries outside the European Economic Area (EEA), known as third countries, subject to prior approval from the FSN. According to European Systemic Risk Board Recommendation ESRB/2015/1, EEA states shall identify third countries of material importance vis-à-vis their own financial systems. If a third country is assessed to be of material importance, the EEA state in question shall monitor the financial markets in that country, particularly as regards excessive credit growth.

The ESRB’s methodology for identifying material third countries, presented at the meeting, is based on three risk indicators, or exposure metrics: risk-weighted assets, original exposures, and defaulted exposures originating in the third country concerned. The Committee was given a presentation of other EEA states’ methodologies for identifying material third countries. It was proposed at the meeting that the ESRB methodology be used, but with a few modifications: the exposure threshold would be set at 2% instead of 1%, defaulted exposures would be assigned a lower weight than the other two metrics, and expert opinion would determine the final decision on third country materiality. The FSN unanimously approved the proposed methodology for assessing third countries. It will be used as a reference for the identification of material third countries that may warrant the activation of a CCyB. According to the approved methodology, no third country is currently identified as material, but materiality will be reviewed on an annual basis.

At the end of the meeting, the Committee approved the statement for publication on the morning of 15 June 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, Central Bank of Iceland
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.