



17 September 2020

## Memorandum

*To:* Financial Stability Committee

*From:* Central Bank of Iceland

*Re:* Background to the decision on the countercyclical capital buffer

On 18 March 2020, the countercyclical capital buffer was lifted because of the high level of uncertainty about developments in arrears and impairment, which were expected to increase, in the wake of the pandemic. It was considered important to mitigate the adverse impact of this on intermediation of credit. Thereafter, the commercial banks' scope to maintain lending capacity alongside restructuring of loan portfolios increased markedly. Based on current economic forecasts, the Central Bank's scenario analysis does not indicate that the banks will fail to satisfy overall capital requirements. It is likely that lifting the countercyclical capital buffer played a role in maintaining households' and many firms' access to financing; for instance, the banks' household lending has grown significantly this summer.

The Central Bank's actions make the financial system better able to support the economy strongly once the situation improves. It is important to ensure that cyclical systemic risk does not increase unduly – i.e., with excessive credit growth and unsustainable asset price hikes – when the economy begins to recover. It is vital to monitor the financial cycle closely – including asset prices, debt levels, and related variables – and to raise the countercyclical capital buffer again if cyclical systemic risk begins to rise.<sup>1</sup>

### **Credit market**

Firms' access to financing has tightened because of diminished debt service capacity, wider credit spreads, and heightened uncertainty. Corporate debt to domestic financial institutions has declined, yet the credit stock has grown marginally because of an increase in debt to foreign lenders. Over a third of total corporate debt is denominated in foreign currencies; therefore, a depreciation of the króna exaggerates credit growth figures. At the end of Q2/2020, twelve-month real growth in corporate debt measured 1.6%, while price- and exchange rate-adjusted growth measured 0.6%.

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<sup>1</sup> See the Central Bank of Iceland's memorandum of 18 March 2020: [https://www.sedlabanki.is/library/Skraarsafn/Fjarmalastodugleiki/Minnisblad\\_sveiflu\\_jofnunarauki\\_18mars2020.pdf](https://www.sedlabanki.is/library/Skraarsafn/Fjarmalastodugleiki/Minnisblad_sveiflu_jofnunarauki_18mars2020.pdf)

Households have ample access to credit. Favourable terms on new mortgages have given them an incentive to refinance. The commercial banks are increasing their share in the mortgage lending market, at the pension funds' expense. Loan-to-value ratios and debt services ratios on new bank loans have been falling, and indicators of credit quality have generally been positive. Therefore, expanding loan books need not be a sign of increased risk.

In mid-September, some 8.6% of the banks' corporate loans and 3.4% of their household loans were in pandemic-related moratorium. Between end-2019 and end-July 2020, the non-performing loan ratio for household loans rose from 2.1% to 2.7%, and the non-performing corporate loan ratio rose considerably more, or from 4.8% to 8.9%. Loans placed in moratorium due to the pandemic are not classified as non-performing. Non-performing loans are expected to increase as moratoria expire in the months to come, and if the economic crisis proves long-lasting.

### **Real estate market**

The capital area house price index continued to rise this summer and, by the end of July, was up 1.9% year-on-year. Turnover has increased, although it was limited from April into June. Interest rate cuts have buoyed up the market. Price increases in the market are moderate as yet, averaging about 2% over the past three years. The ratio of the house price index and its determinants has risen this year, but thus far the changes have not been large.

The commercial property market stands on a weaker footing. The capital area commercial property price index has fallen 21% in the past twelve months, and turnover has contracted significantly. A large number of hotels and guesthouses have been under construction in recent years, and it appears that a glut of supply has developed. A large amount of office space is under construction in central Reykjavík, which could cause a localised glut in supply in the years to come.

### **Banking market**

The banks' credit spreads have narrowed with reductions in the Central Bank's key rate. Because non-indexed sight deposit rates are close to zero in most cases, the banks have very little room to lower their funding costs further. Profits on core operations are the banks' first line of defence against falling capital ratios due to loan losses and other shocks to their operations. Low interest rates could therefore undermine financial stability in the long run.

The banks' impairment is based on expected credit losses and recovery. In Q1/2020, the large commercial banks' impairment amounted to 0.4% of their loan portfolio. In Q2, impairment varied from bank to bank, at 0.1%, 0.3%, and 0.7%, indicating the high level of economic uncertainty prevailing. Default and insolvencies are expected to continue rising.

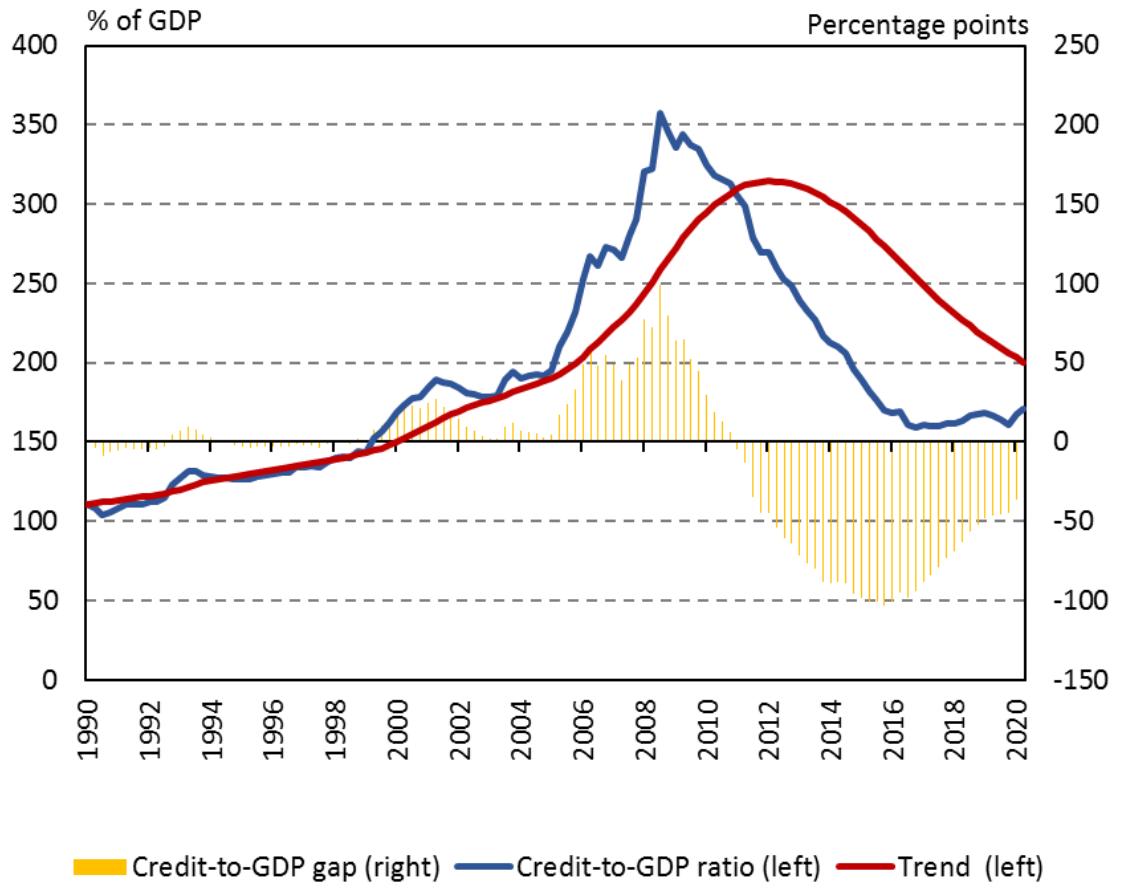
The banks' capital position has not been significantly affected thus far; therefore, it is broadly unchanged since the onset of the pandemic. Because the countercyclical capital buffer has been lifted, they have even more excess capital than they did at the turn of the year.

### **Overall assessment of cyclical systemic risk**

Overall, there have been no signs from specific areas that could be interpreted as an increase in cyclical systemic risk. Composite risk indicators that are intended to sketch out a comprehensive view of developments point in the same direction. The rise in the financial cycle is less pronounced than in the past three years, when the countercyclical capital buffer was built up. The composite domestic systemic risk indicator (d-SRI) does not signal increased systemic risk; in fact, the most recent measures show that risk has diminished since mid-2018, when the tourism sector started to suffer setbacks. The greatest difference is in the current account surplus, as research has shown that countries with a sustained current account surplus are less at risk of suffering financial shocks.

## Appendix – Charts

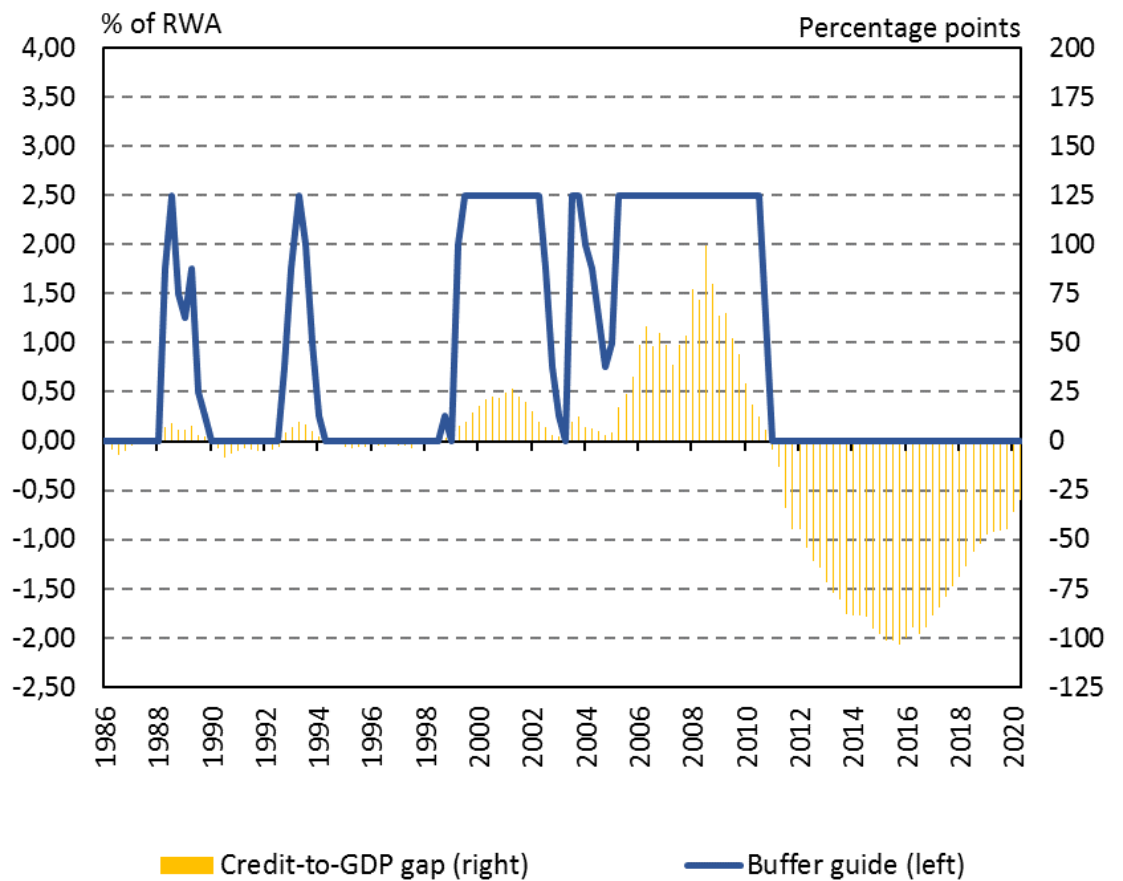
### The credit-to-GDP gap



Claim value of total credit to households and firms as a share of GDP. The trend component is obtained with a one-sided HP-filter with  $\lambda=400.000$ .

Sources: Statistics Iceland, Central Bank of Iceland.

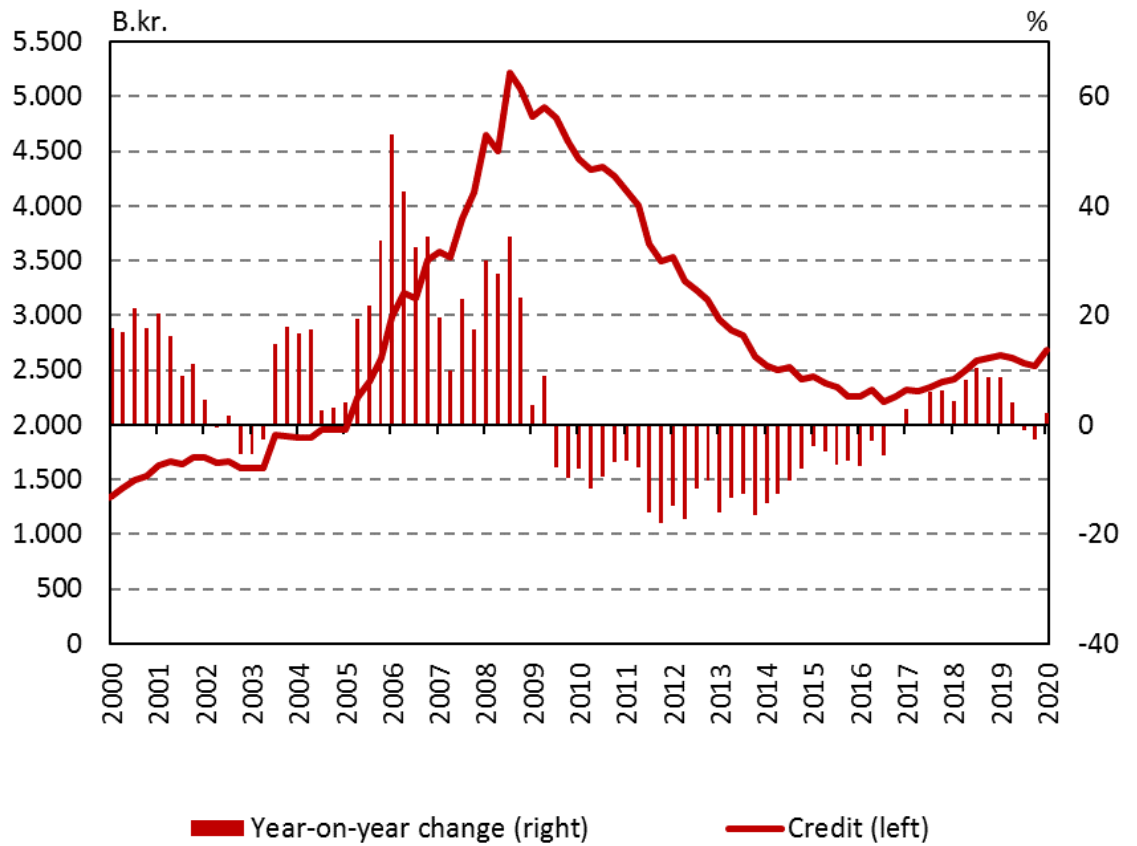
## The buffer guide



The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.

Sources: Statistics Iceland, Central Bank of Iceland.

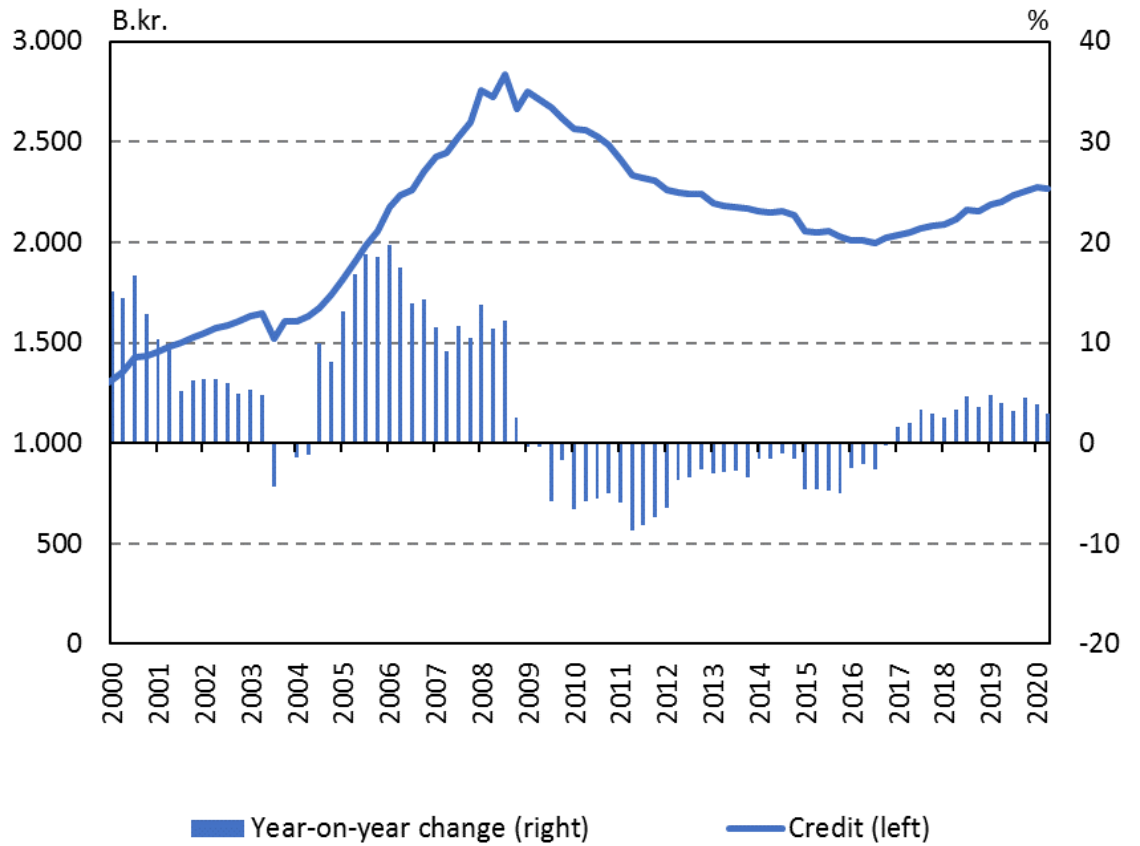
## Real corporate credit growth<sup>1</sup>



1. Claim value of credit to non-financial firms, at constant prices. Deflated with the consumer price index.

Sources: Statistics Iceland, Central Bank of Iceland.

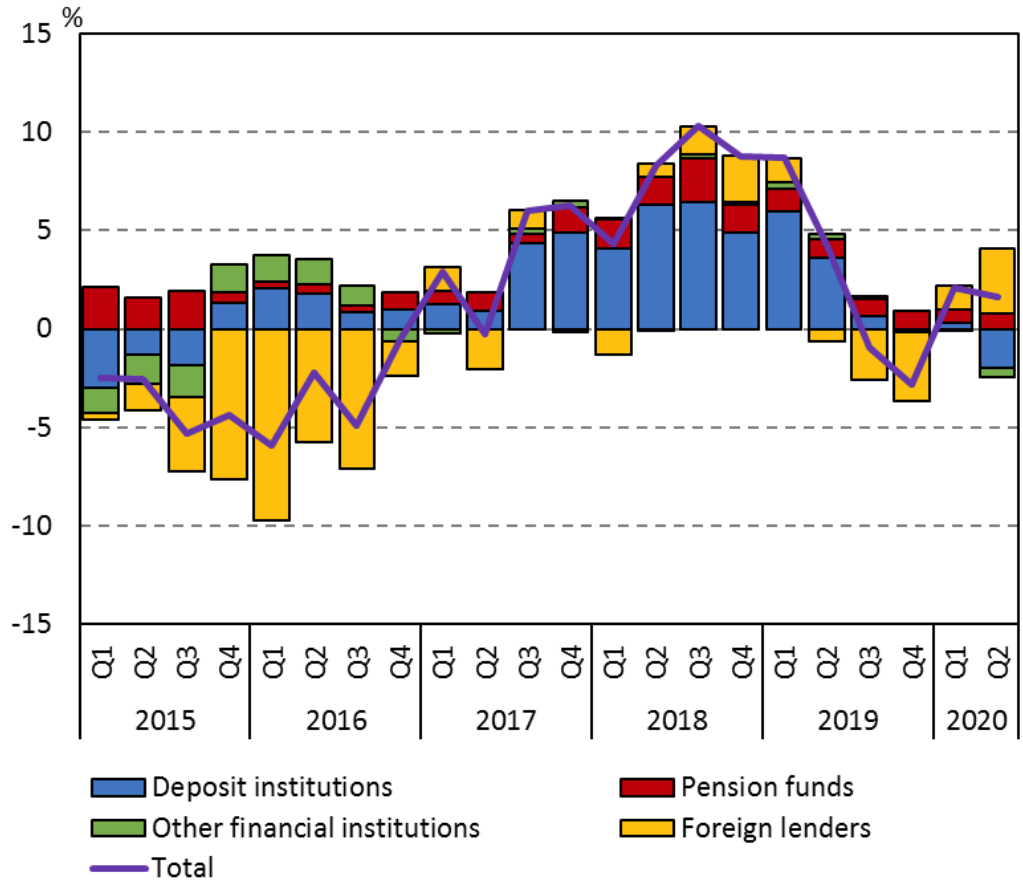
# Real household credit growth<sup>1</sup>



1. Claim value of total credit to households, at constant prices. Deflated with the consumer price index.

Sources: Statistics Iceland, Central Bank of Iceland.

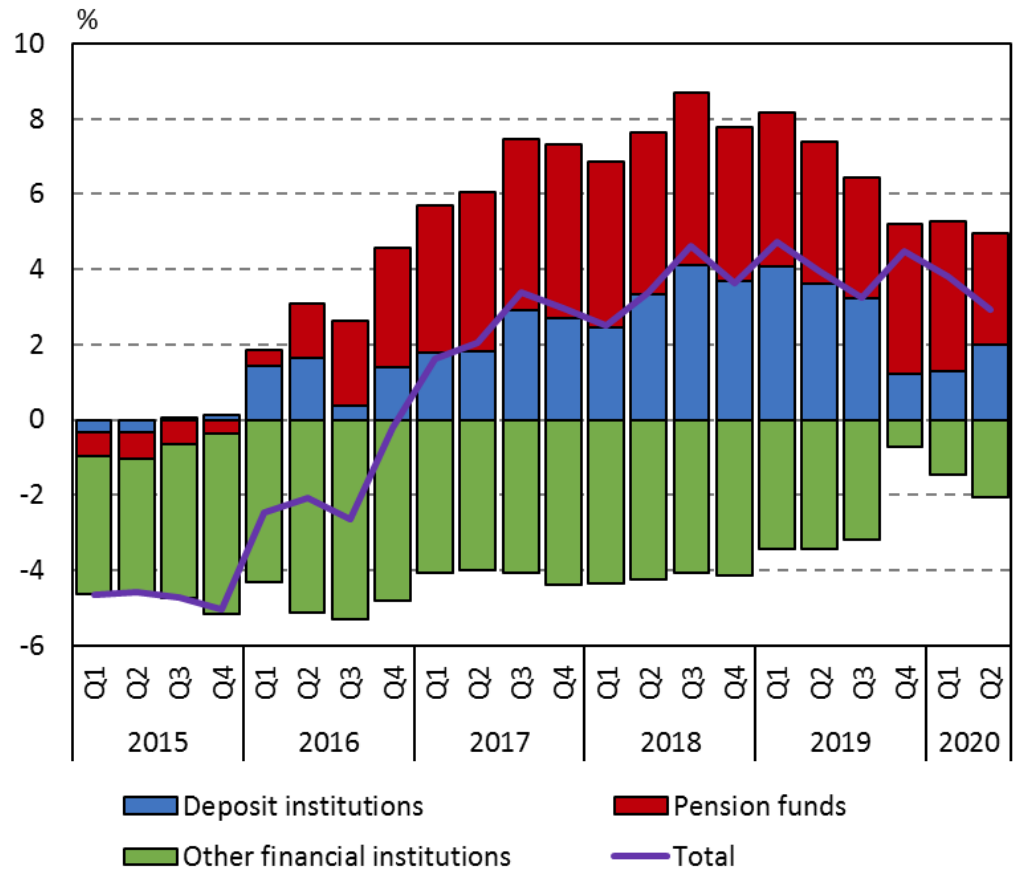
## Corporate debt, by lender<sup>1</sup>



1. Real year-on-year change. Debt to financial institutions and issued marketable bonds.  
 Sources: Statistics Iceland, Central Bank of Iceland.

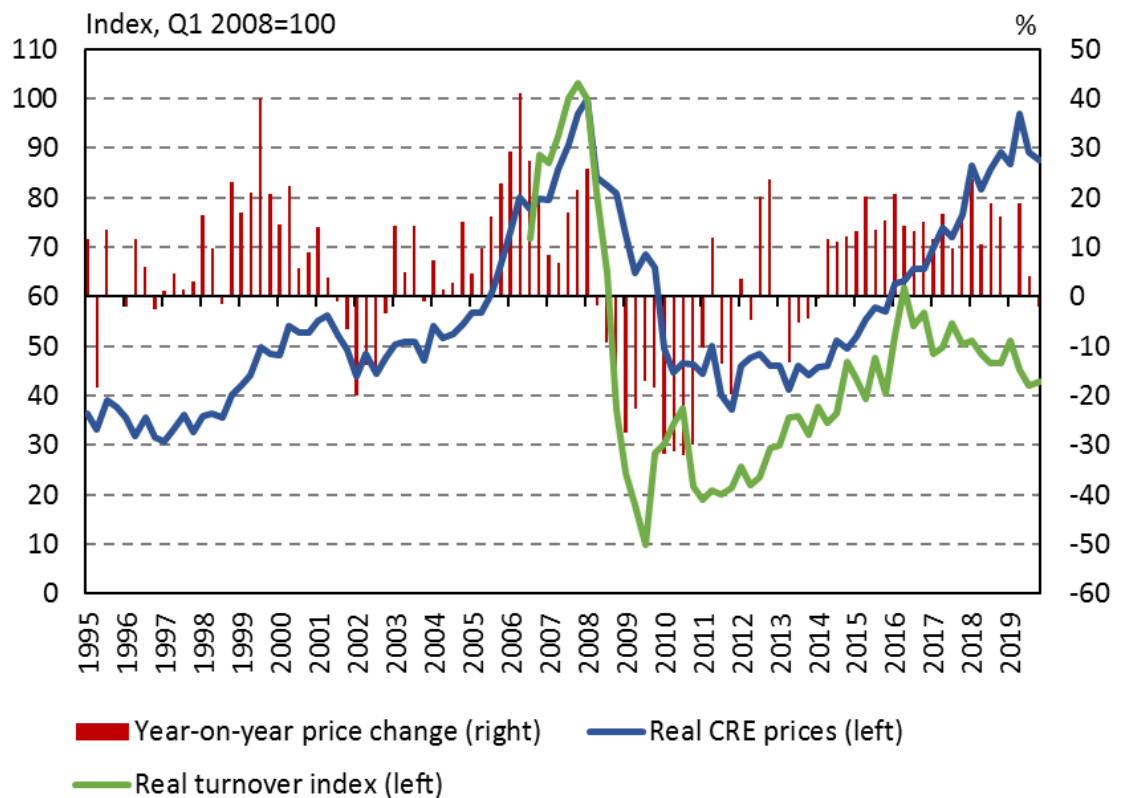


## Household debt, by lender<sup>1</sup>



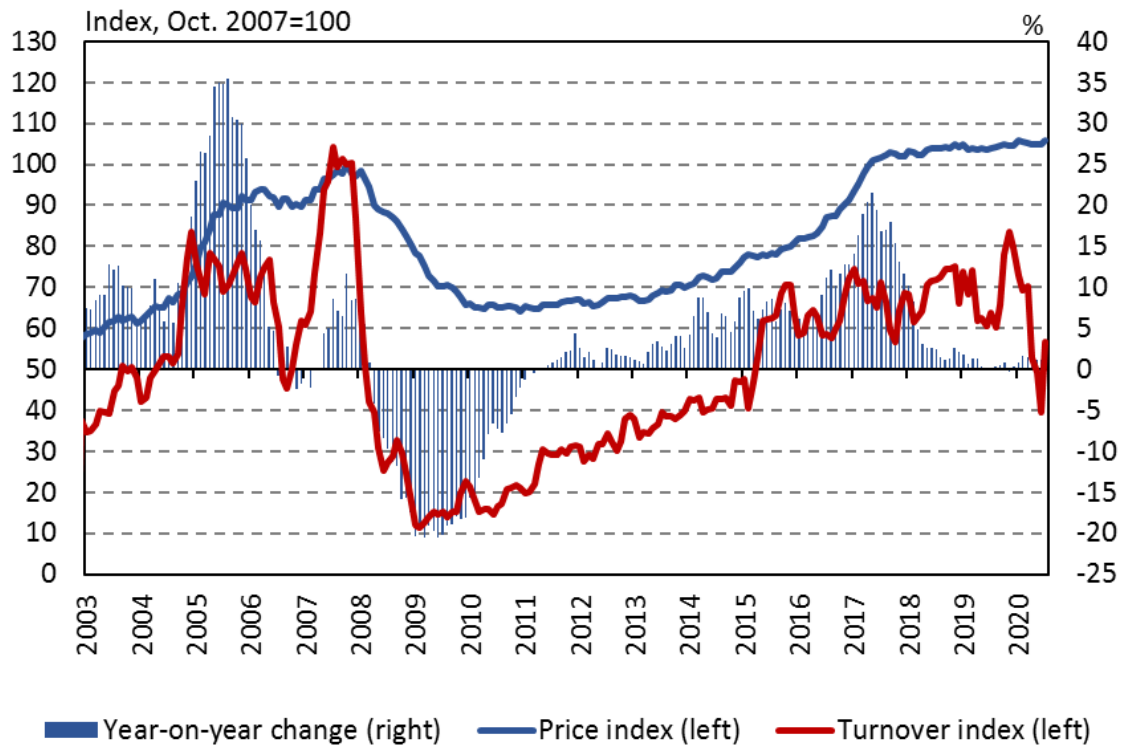
1. Real year-on-year change. Debt to financial institutions and issued marketable bonds.  
Sources: Statistics Iceland, Central Bank of Iceland.

## Real commercial property prices<sup>1</sup> and turnover<sup>2</sup> in the capital area



1. CRE price index, deflated with the CPI. The index shows the weighted average price of industrial, retail, and office space. 2. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminary.  
*Sources:* Registers Iceland, Statistics Iceland, Central Bank of Iceland.

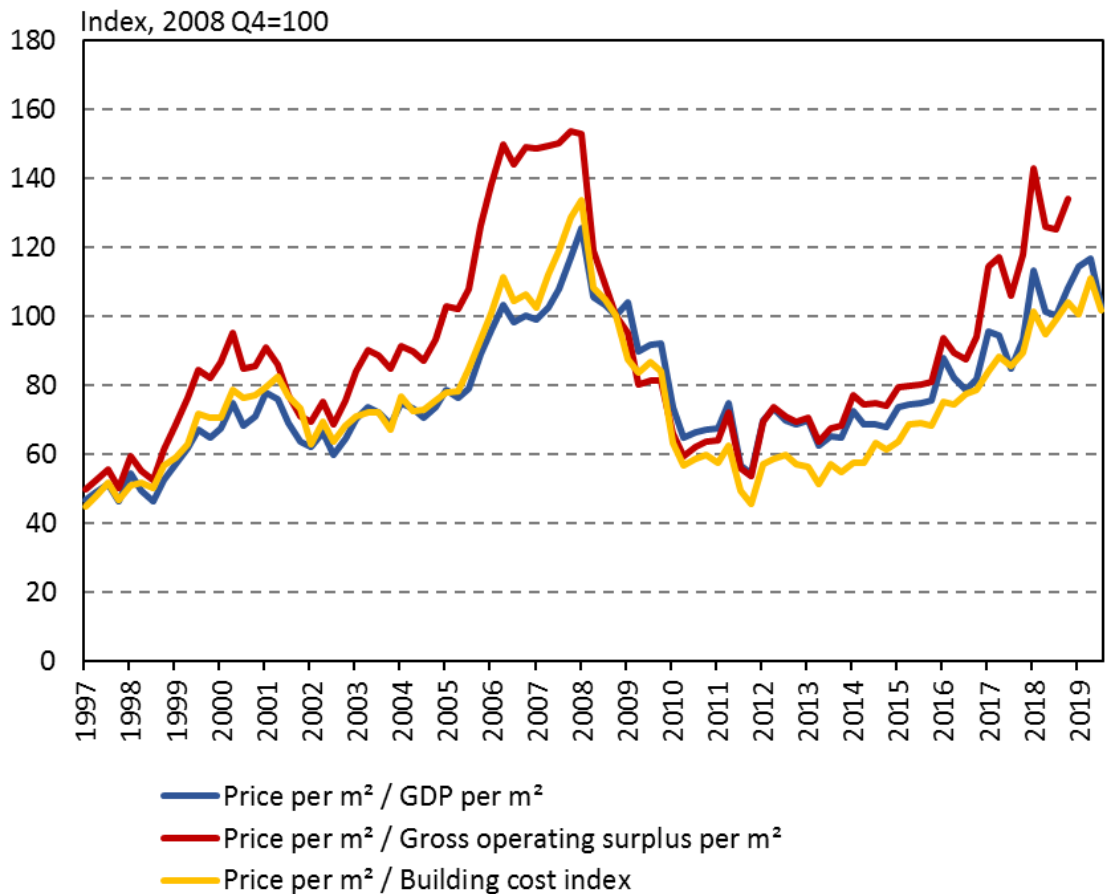
## Real house prices and turnover in the capital area<sup>1</sup>



1. Capital area house price index, deflated with the consumer price index. The 9% threshold is taken from Laina, Nyholm & Sarlin (2015). The turnover index shows three-month average turnover, deflated with the consumer price index. The turnover data are linearly interpolated in 2Q/2015 to correct for a strike at the Reykjavík Commissioner's office.

Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

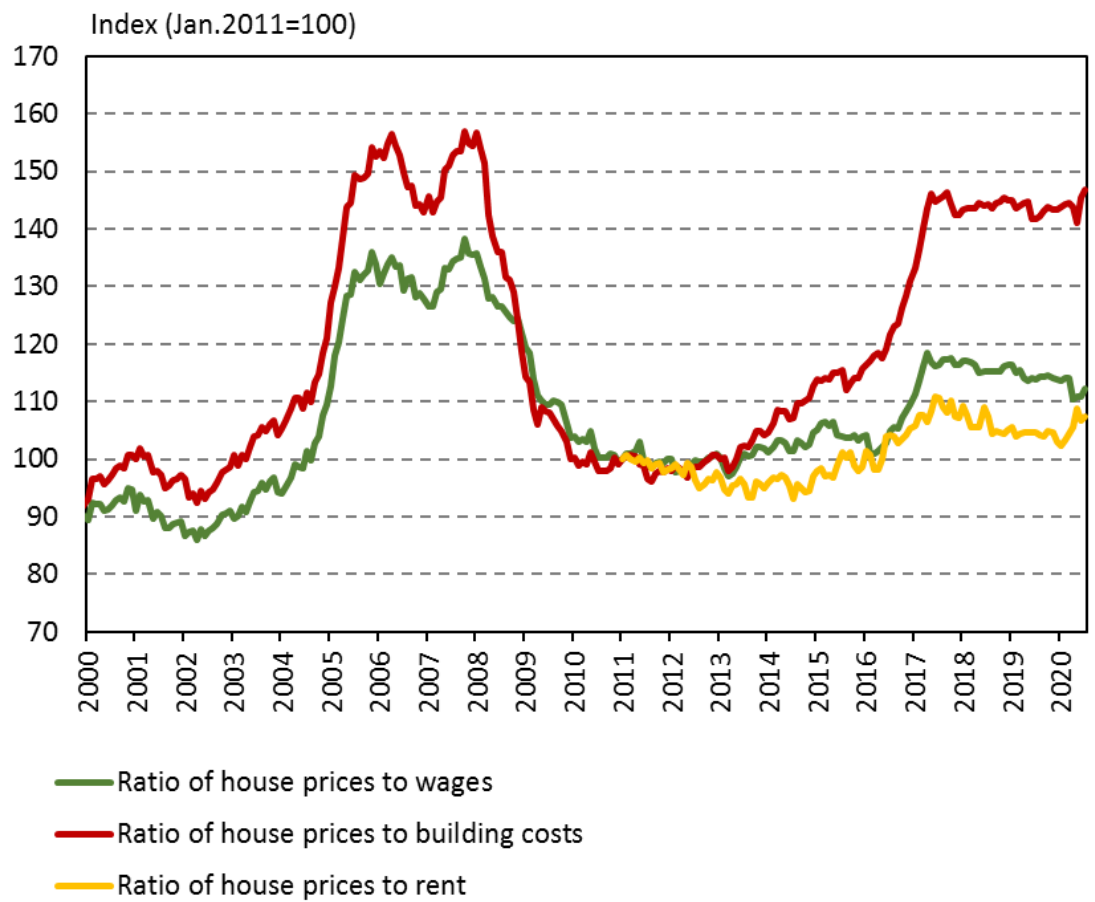
## Commercial property price ratios<sup>1,2</sup>



1. Annual data for gross operating surplus are non-linearly interpolated. 2. Annual data for the CRE stock are linearly interpolated.

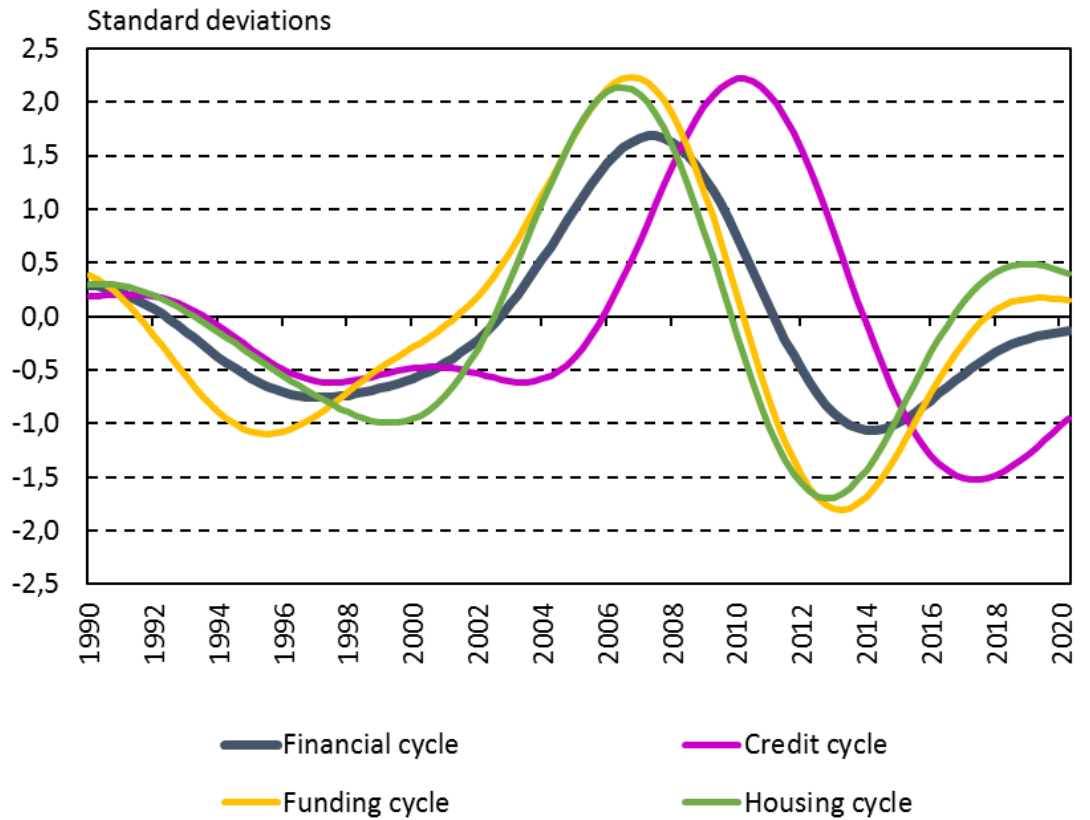
Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

## Capital area house prices and their determinants



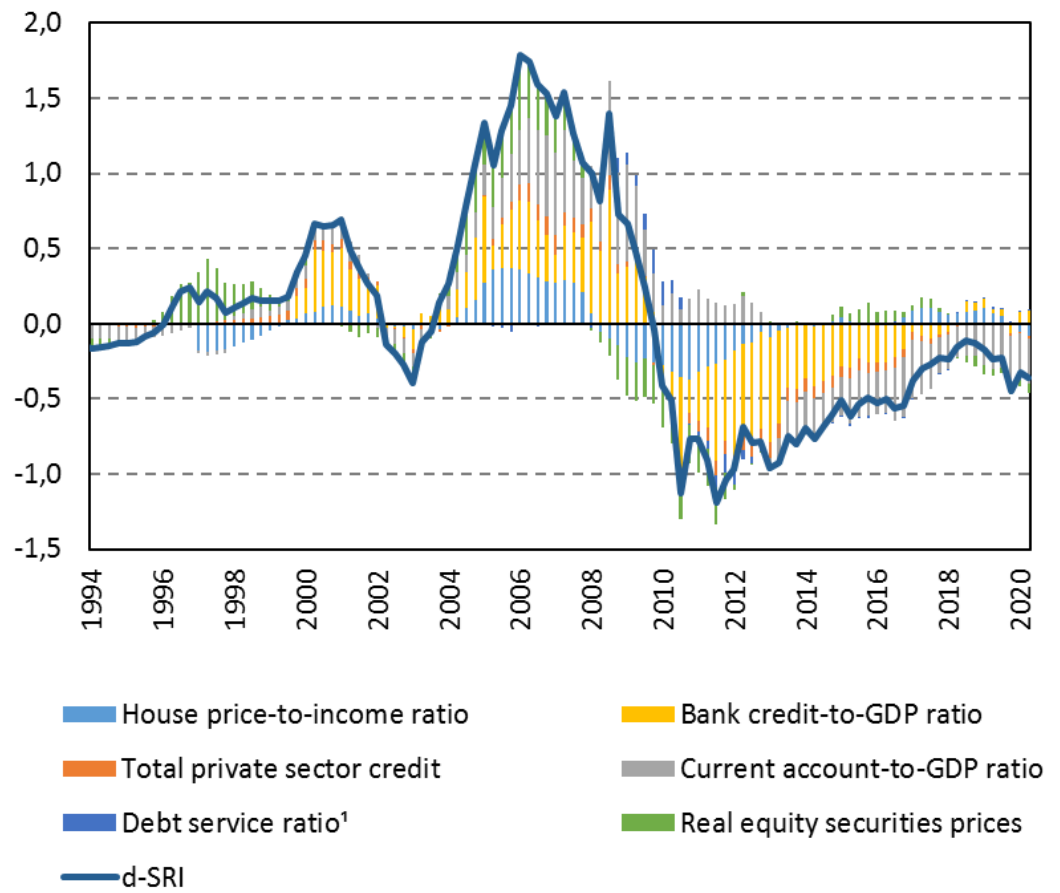
Sources: Registers Iceland, Statistics Iceland.

# Financial cycle and subcycles<sup>1</sup>



1. The financial cycle itself, the blue line, is the simple average of the subcycles. Each subcycle is the simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years. Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

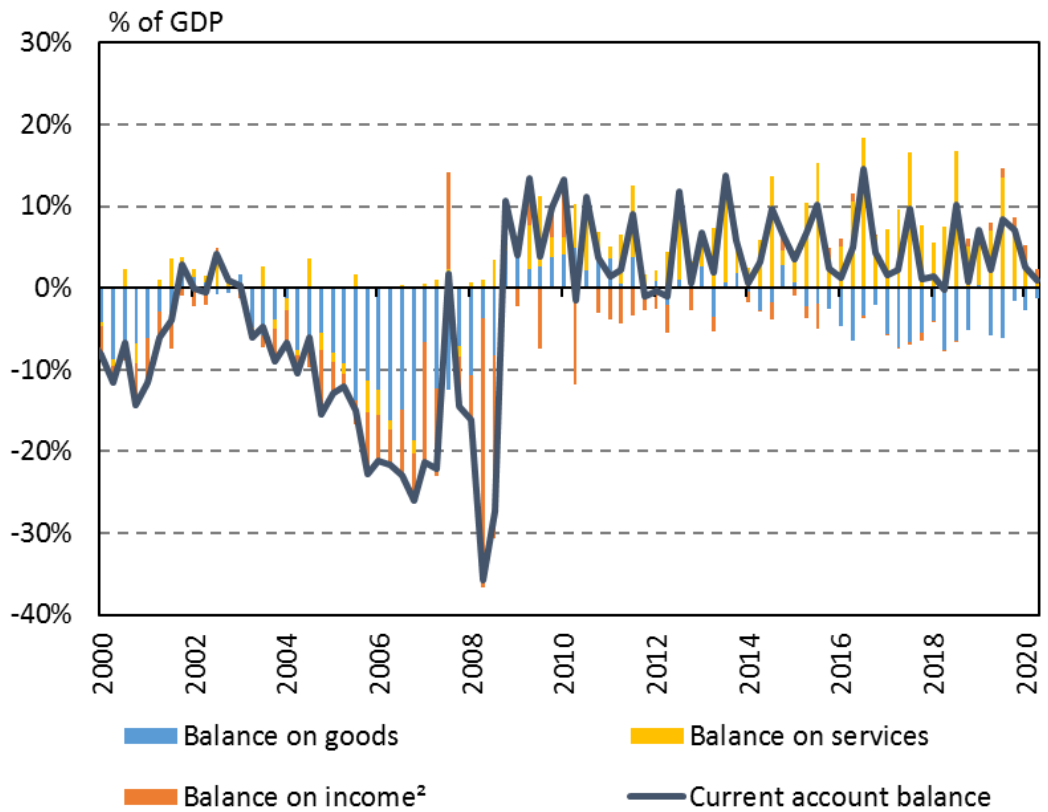
## Cyclical systemic risk indicator (d-SRI)



1. Estimates are used for Q1 and Q2 of 2020.

Sources: Statistics Iceland, Central Bank of Iceland.

## Current account balance<sup>1</sup>



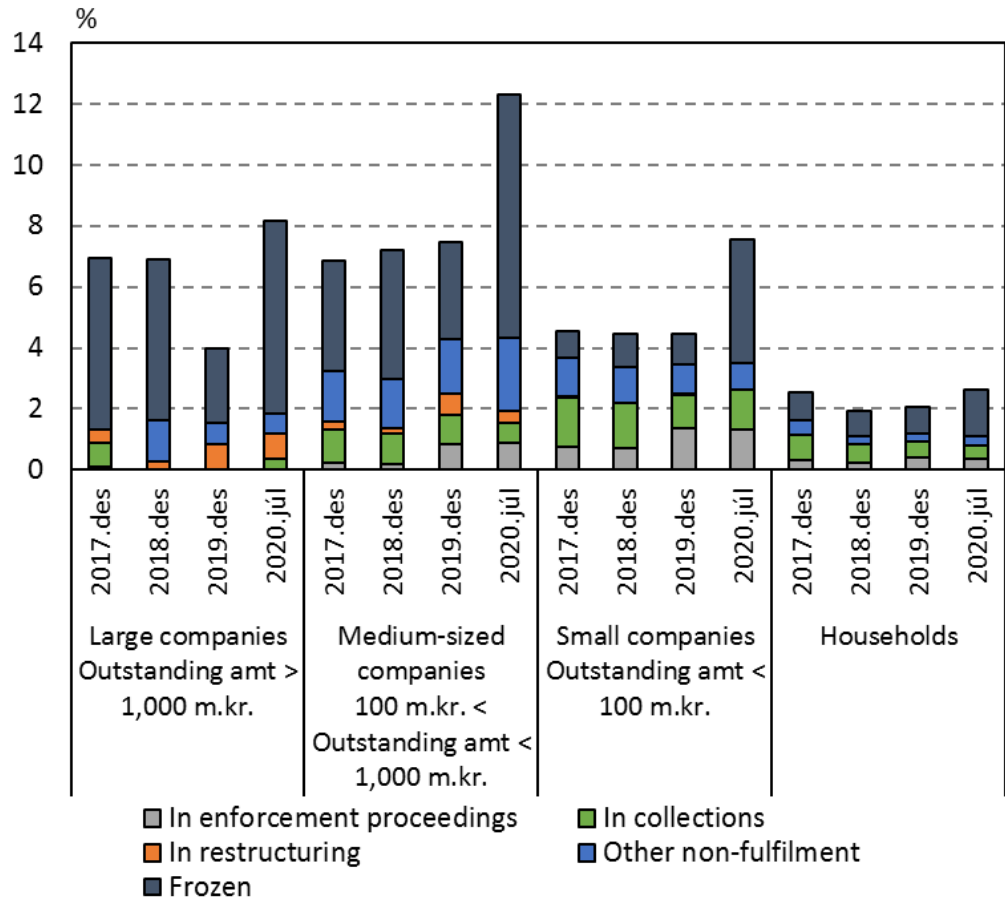
1. The effects of the old banks on factor income and the balance on services from Q4/2008 to Q4/2016 are ignored. From 2009 through 2012, the effect of Actavis on the balance on income is also ignored, owing to inaccurate data during the period.

2. Secondary income is included in factor income.

Sources: Statistics Iceland, Central Bank of Iceland.



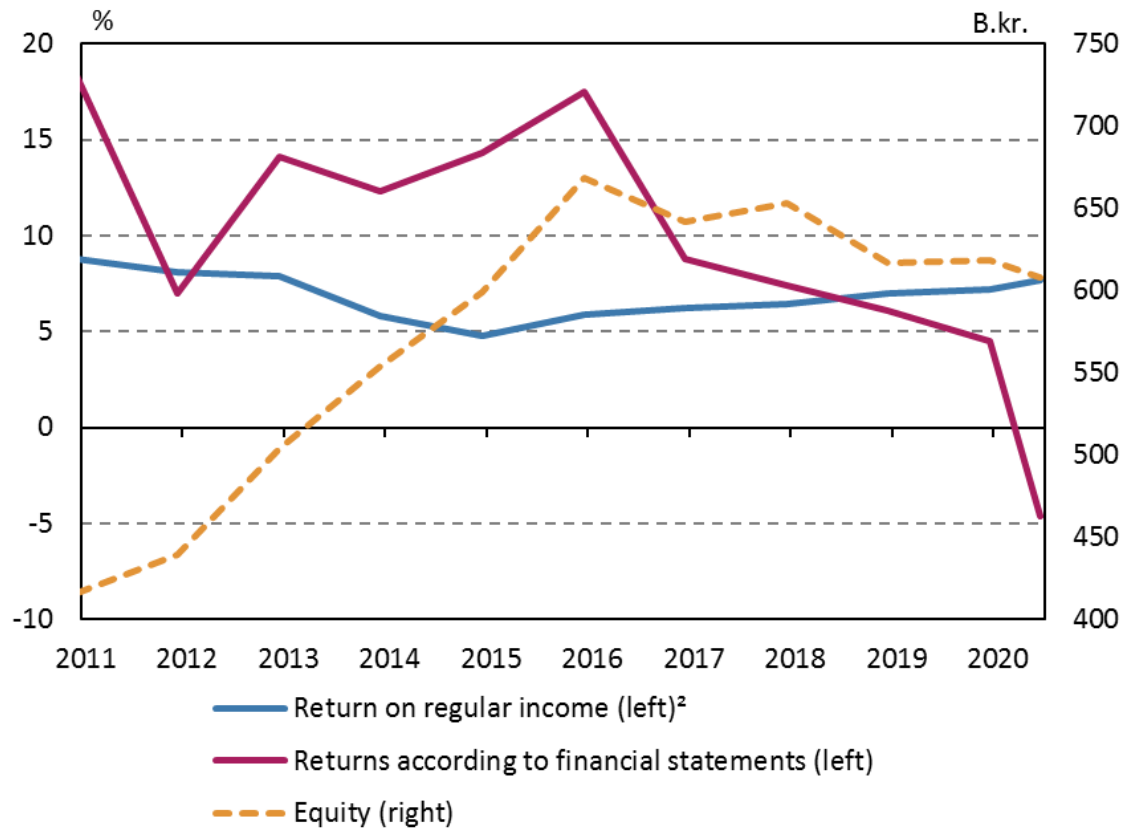
## D-SIB: Status of non-performing loans, by borrower and type of default<sup>1</sup>



1. Share of non-performing loans to each business size category. Parent companies, book value. D-SIB: Domestic systemically important banks.

Source: Central Bank of Iceland.

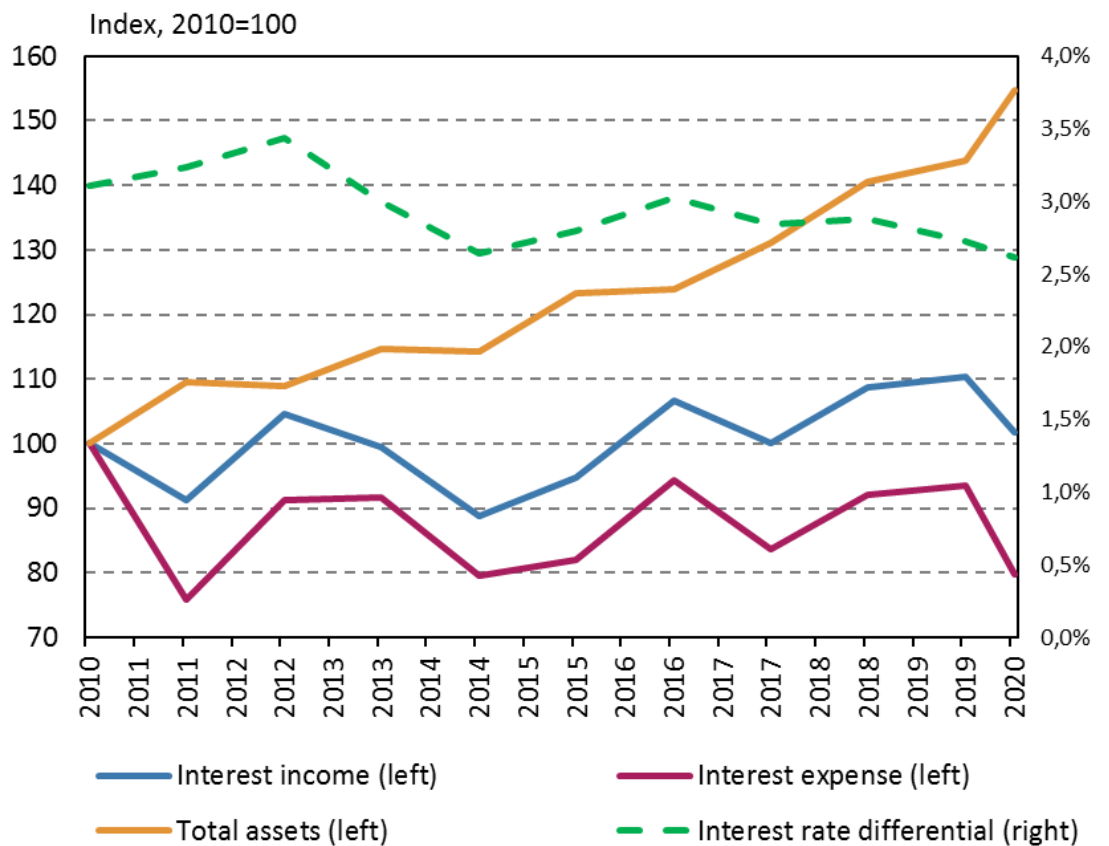
## D-SIB: Returns<sup>1</sup>



1. Returns are calculated on average equity. Domestic systemically important banks, consolidated figures. 2. The return on regular income is based on net interest income and fee/commission income net of regular expenses. The tax rate is 20% and is based on average equity. Valitor is excluded in 2017-2020 and Borgun in 2020.

Sources: Commercial banks' financial statements.

## D-SIB: Interest income, interest expense and interest rate differential<sup>1,2</sup>

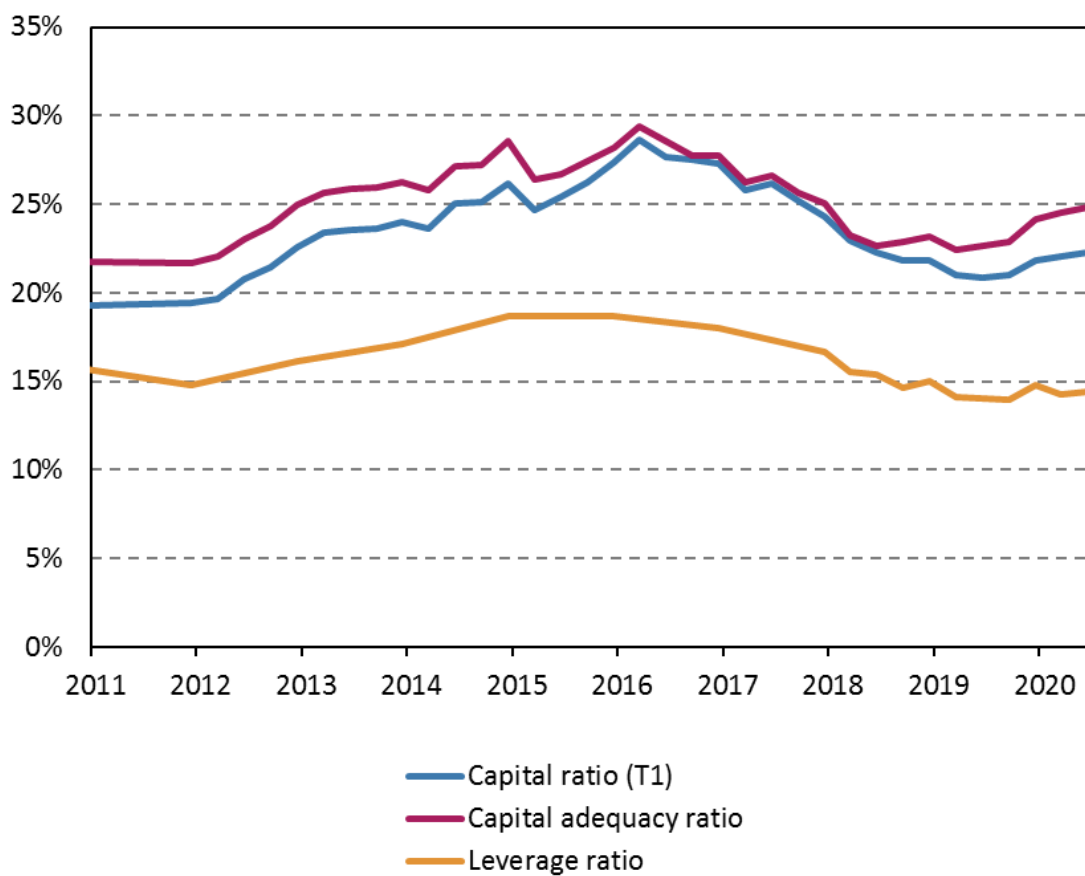


1. Domestic systematically important banks, consolidated figures.

2. Annualised H1/2020 data.

Sources: Commercial banks' financial statements.

## D-SIB: Capital and leverage ratios<sup>1</sup>



1. Consolidated figures.

Sources: Commercial banks' financial statements.