10 December 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 in the wake of the pandemic. It was considered important to mitigate the adverse impact of this on intermediation of credit. With that decision, the commercial banks' scope to maintain lending activity alongside restructuring of loan portfolios increased markedly. 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 in recent months.

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.[1]

**Credit market**

Corporate credit growth has been largely unchanged in recent months. Corporate debt to domestic financial institutions has declined slightly in real terms, yet the credit stock has grown because of an increase in debt to foreign lenders. Over a third of total corporate debt is denominated in foreign currencies; therefore, the depreciation of the króna in the first nine months of 2020 exaggerates credit growth figures. At the end of Q3/2020, twelve-month real growth in corporate debt measured 4.1%, while price- and exchange rate-adjusted growth measured 1.7%.

Households continue to have ready access to credit. Twelve-month real growth in household debt measured 4.1% at the end of October. Favourable terms on new mortgages have given households an incentive to refinance. The commercial banks have increased their share in the household mortgage market at the expense of other lenders, particularly

[1] See the Central Bank of Iceland's memorandum of 18 March 2020: https://www.sedlabanki.is/library/Skraarsafn/Fjarmalastodugleiki/Minnisblad_sveiflujofnunarauki_18mars2020.pdf

the Housing Financing Fund. Loan-to-value ratios and debt service ratios on new bank loans have fallen, and indicators of credit quality have generally been positive. Therefore, expanding loan books are not necessarily a sign of increased risk.

As of end-November, some 2.5% of the banks' corporate loans were in pandemic-related moratorium. At the same point in time, 1.3% of individuals' loans were in moratorium. Between end-2019 and end-October 2020, the non-performing loan ratio for household loans (including frozen loans) rose from 2.1% to 2.3%, and the non-performing corporate loan ratio rose considerably more, or from 4.8% to 13.8%. Loans placed in moratorium due to the pandemic are not classified as non-performing. Arrears can be expected to increase even further if the economic shock drags on or the recovery is very weak.

**Real estate market**

The capital area house price index continues to rise and, by the end of October, was up 2.4% year-on-year in real terms. Market turnover has surged in recent months, and the average time-to-sale for listed properties has grown shorter. Interest rate cuts appear to have buoyed up the market. As yet, price hikes are modest, but increased upward pressures have developed in recent months. Thus far in 2020, house prices have risen relative to determinants such as construction costs and rent prices, whereas they have remained unchanged relative to the wage index.

The commercial property market stands on a weaker footing. At the end of Q3/2020, the capital area commercial real estate price index[2] had fallen 20% in the previous twelve months, amidst a significant contraction in turnover. 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. Furthermore, a large number of hotels and guesthouses have been under construction in recent years, and it appears that a glut of supply has developed.

**Banking market**

The banks' interest rate spreads have narrowed still further since the Financial Stability Committee's last meeting, alongside continued Central Bank rate cuts. Because non-indexed sight deposit rates are close to zero in most cases, the banks have little scope to lower their funding costs. 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 impairment in the banks' asset portfolios is based on expected credit losses and recoveries. Over the first nine months of 2020, the

[2] The CRE price index is based on the weighted average of industrial, retail, and office property.

large commercial banks recognised loan impairment in the amount of 0.6-1.1% of their loan portfolios. This wide range is a sign of the high level of uncertainty about near-term economic developments. Arrears 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.

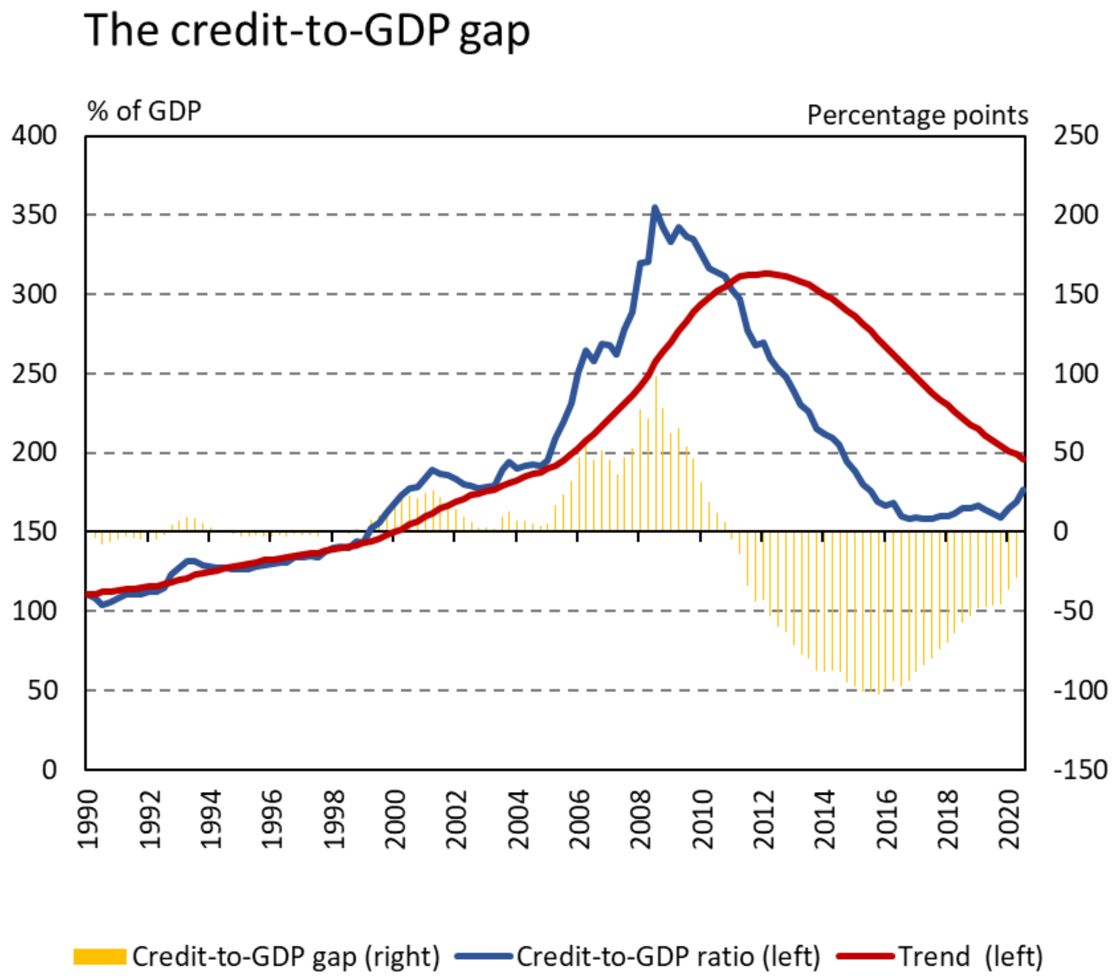
**Overall assessment of cyclical systemic risk**

Credit growth in and of itself has been moderate thus far, but risk indicators that place debt in the context of GDP show a significant increase. This could reverse quickly, however, if GDP growth proves robust next year. As a consequence, the debt ratio,[3] which has risen by 15.6 percentage points between years, does not necessarily give cause for concern when considered in this light, as it is well below its long-term trend.

Composite indicators that are intended to present a comprehensive view of developments do not show clear signs of an increase in cyclical systemic risk. Composite measures of the financial cycle indicate a less steep trajectory than in the past three years, when the countercyclical capital buffer was built up. The composite d-SRI indicator has risen once again in the past nine months, after having fallen since mid-2018, when difficulties in the tourism sector first surfaced. The main difference is the narrowing of the current account surplus and increased bank lending to private sector borrowers relative to GDP.

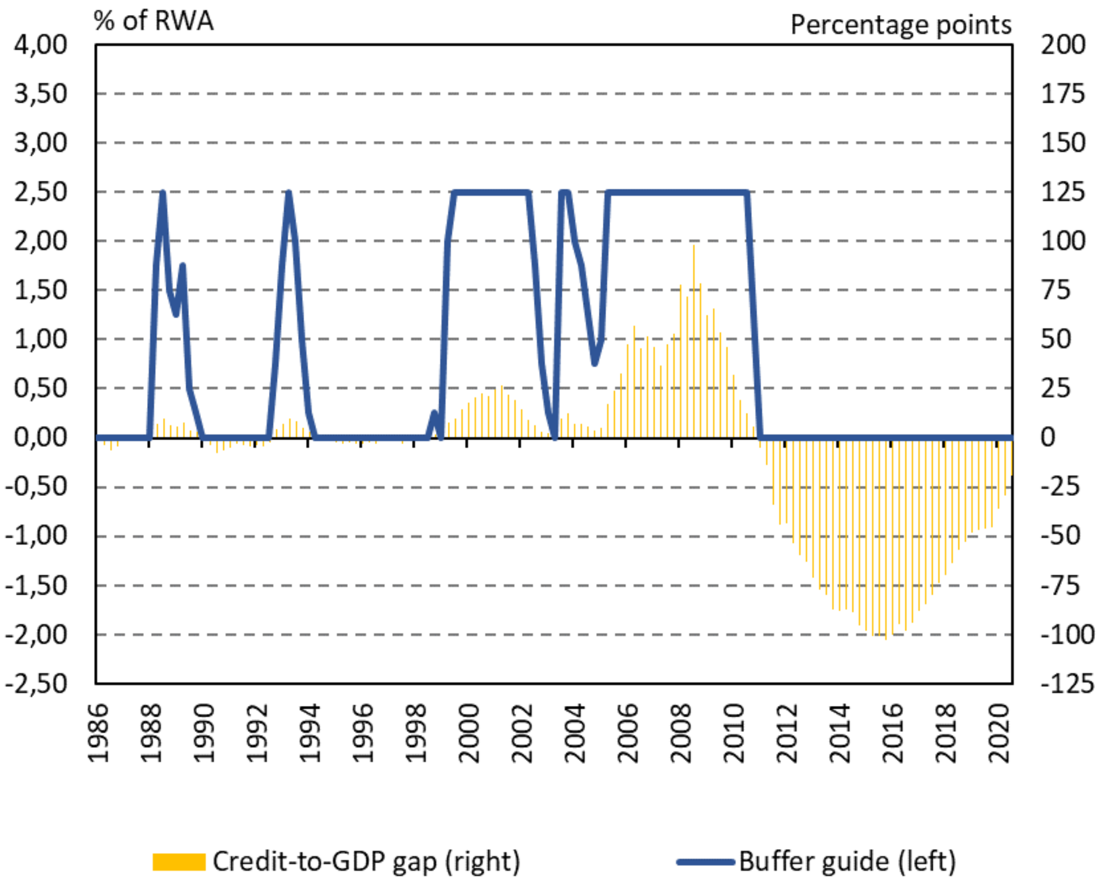
[3] The ratio of private sector debt – i.e., households and non-financial companies – to GDP.

**Appendix – Charts**



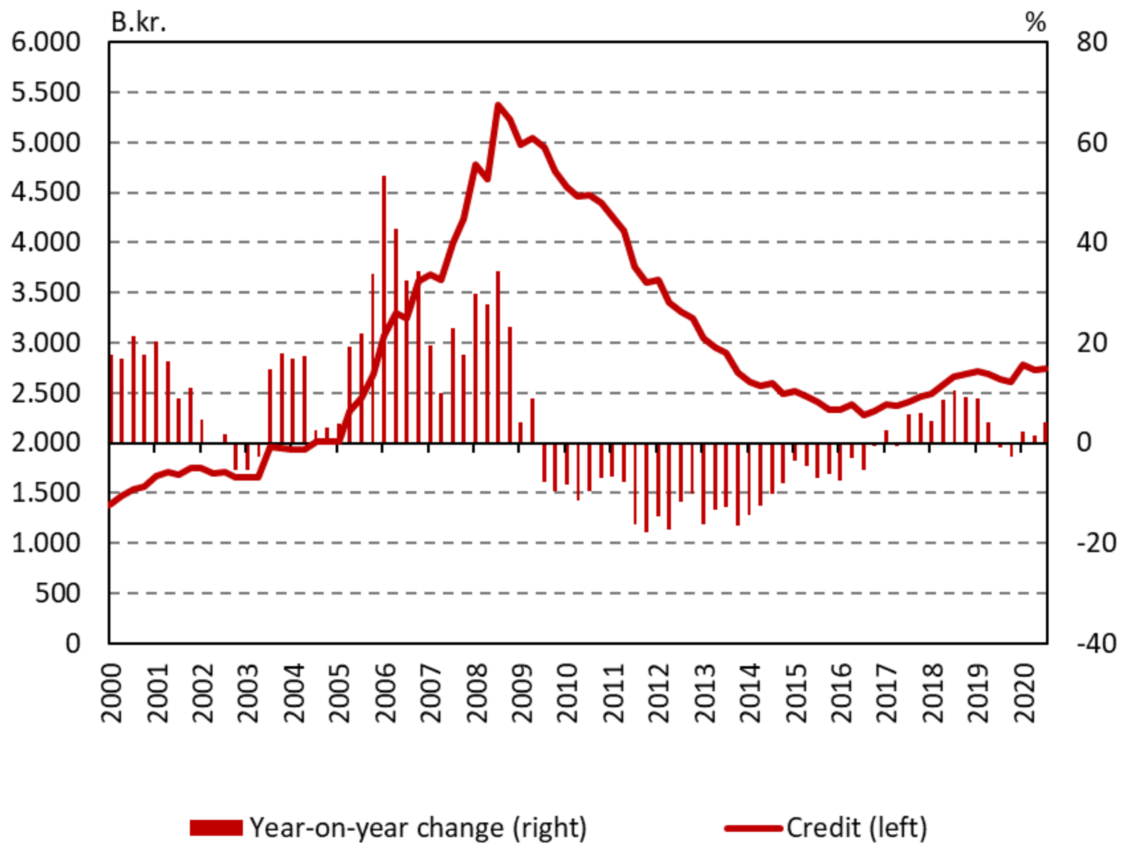

Claim value of total credit to households and firms as a share of GDP. The trend component is obtained with a one-sided HP-filter with λ=400.000.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## The buffer guide



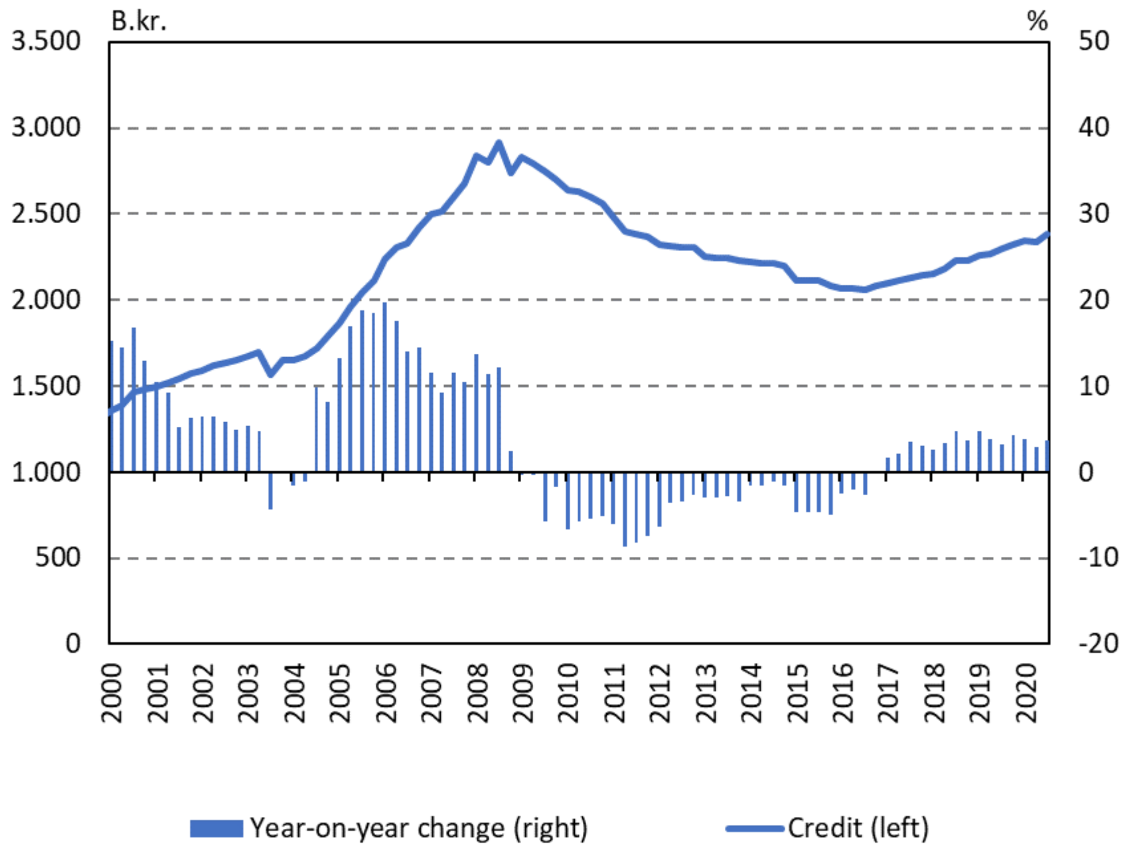

The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Real corporate credit growth[1]



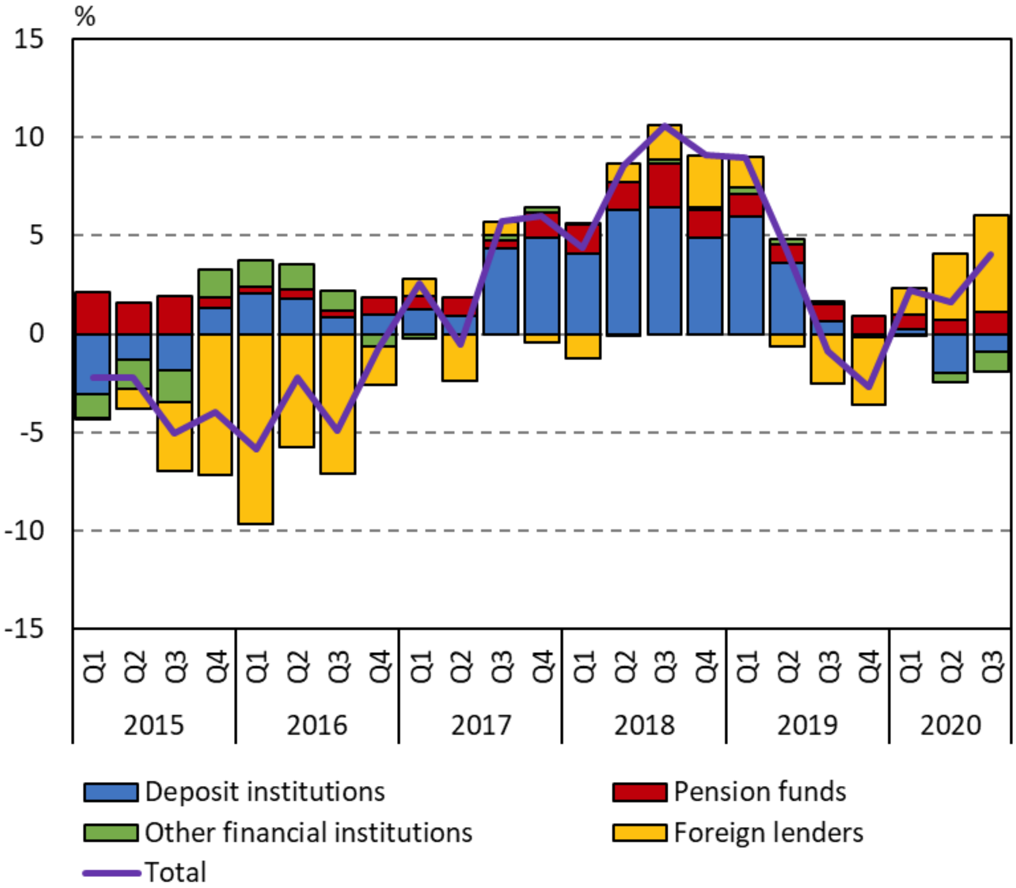

1. Claim value of credit to non-financial firms, at constant prices. Deflated with the consumer price index.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Real household credit growth[1]



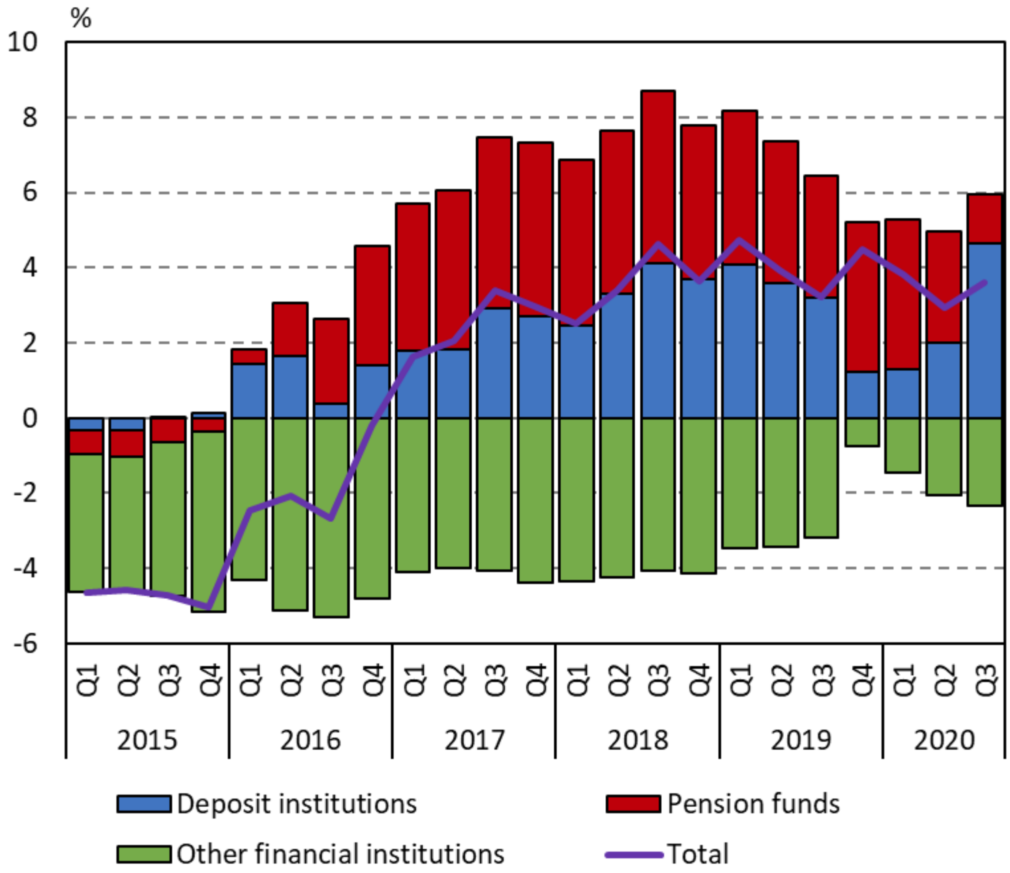

1. Claim value of total credit to households, at constant prices. Deflated with the consumer price index.
*Sources*: Statistics Iceland, Central Bank of Iceland.

Corporate debt, by lender[1]



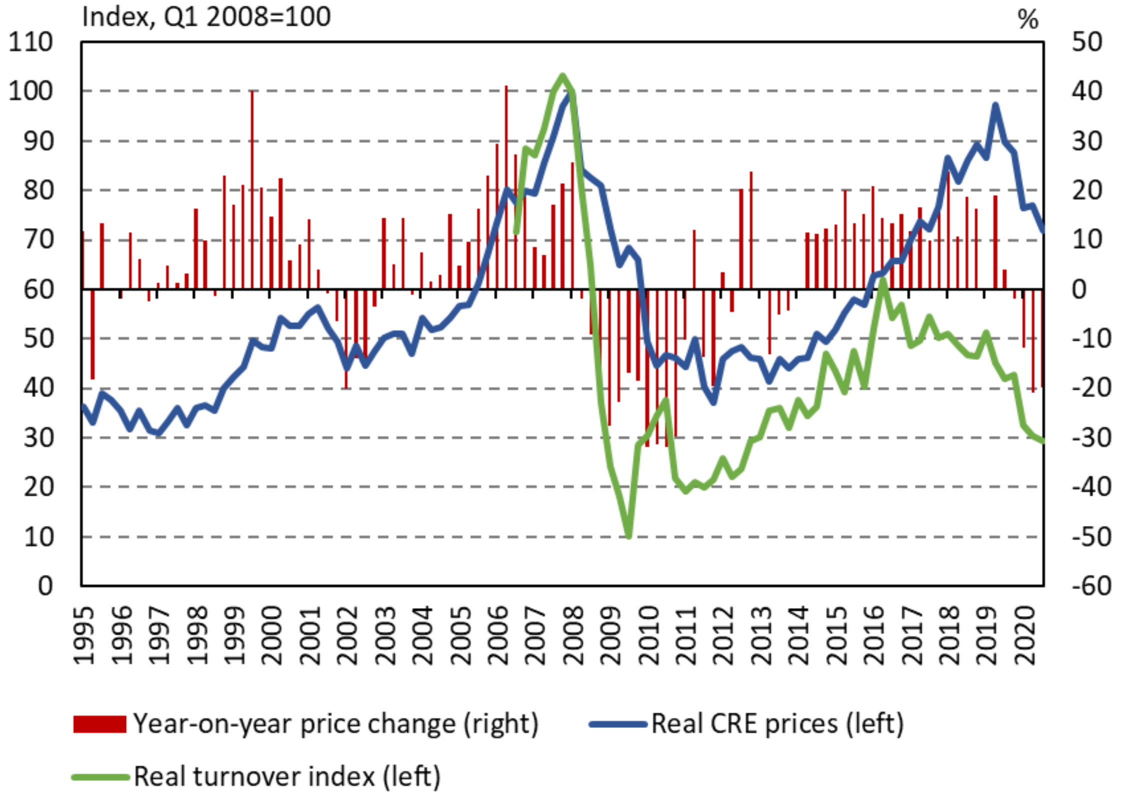

1. Real year-on-year change. Debt to financial institutions and issued marketable bonds.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Household debt, by lender[1]



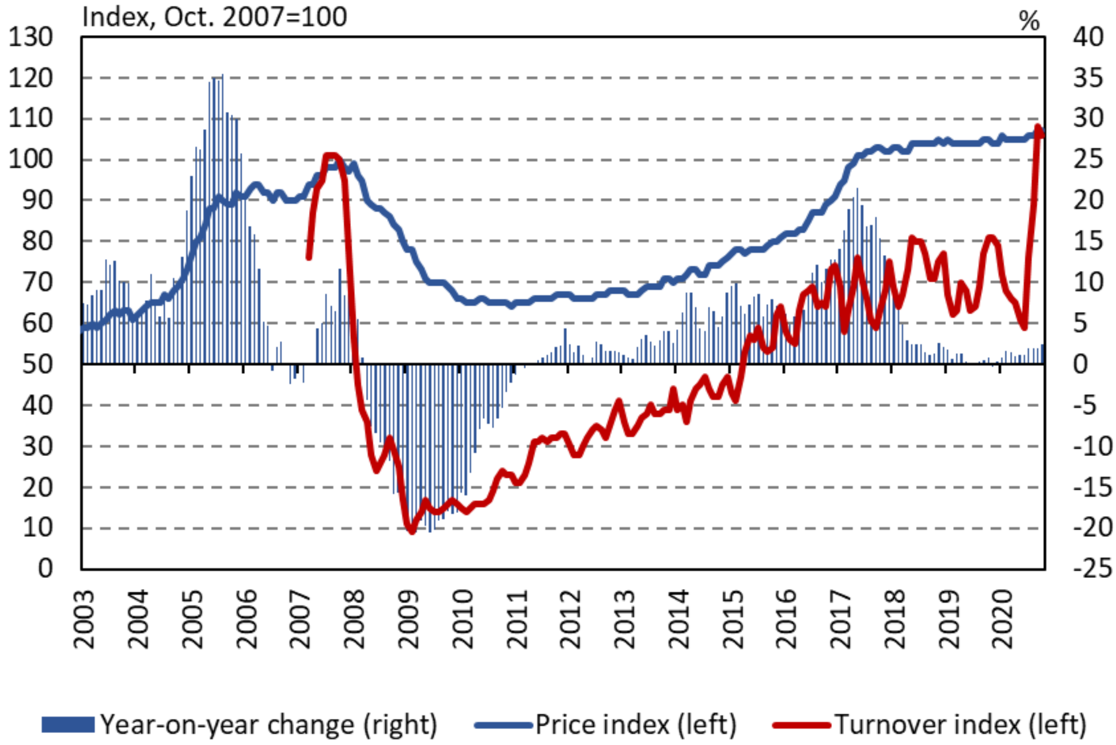

1. Real year-on-year change. Debt to financial institutions and issued marketable bonds.
*Sources*: Statistics Iceland, Central Bank of Iceland.

Real commercial property prices[1] and turnover[2] 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.

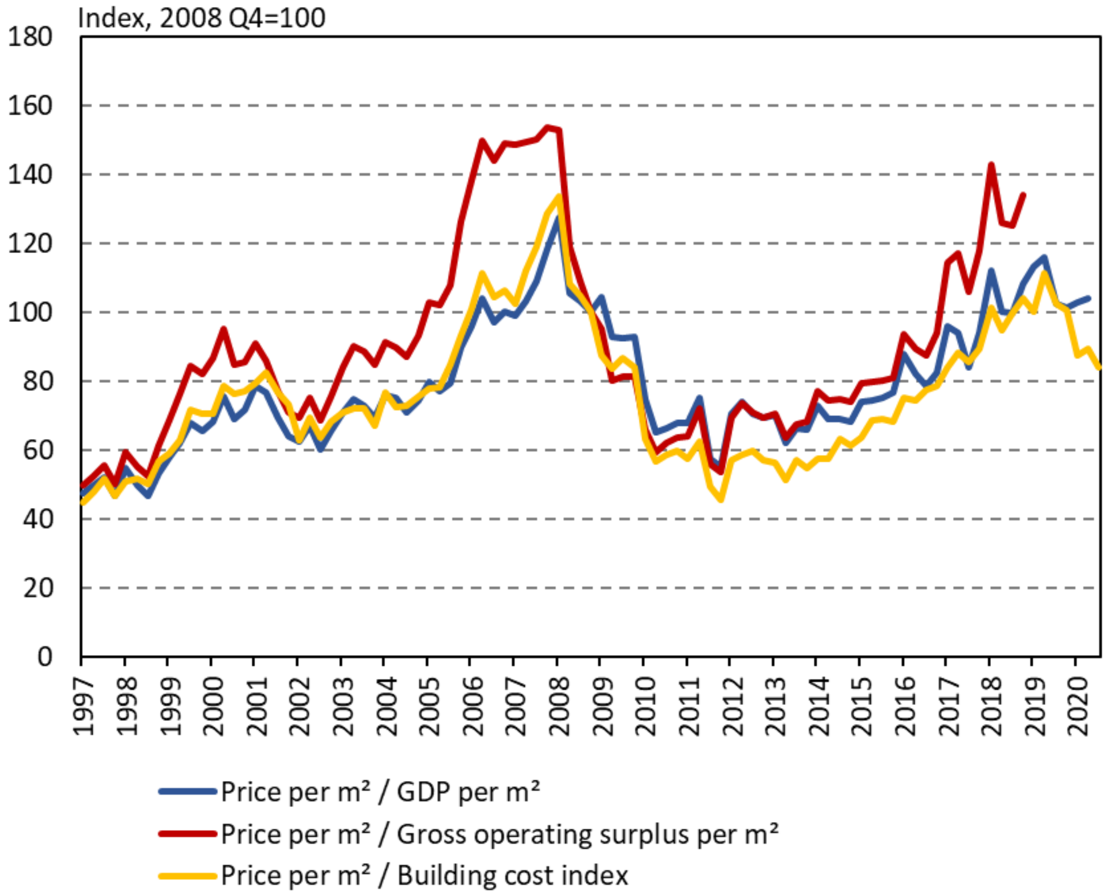
## Real house prices and turnover in the capital area[1]




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.

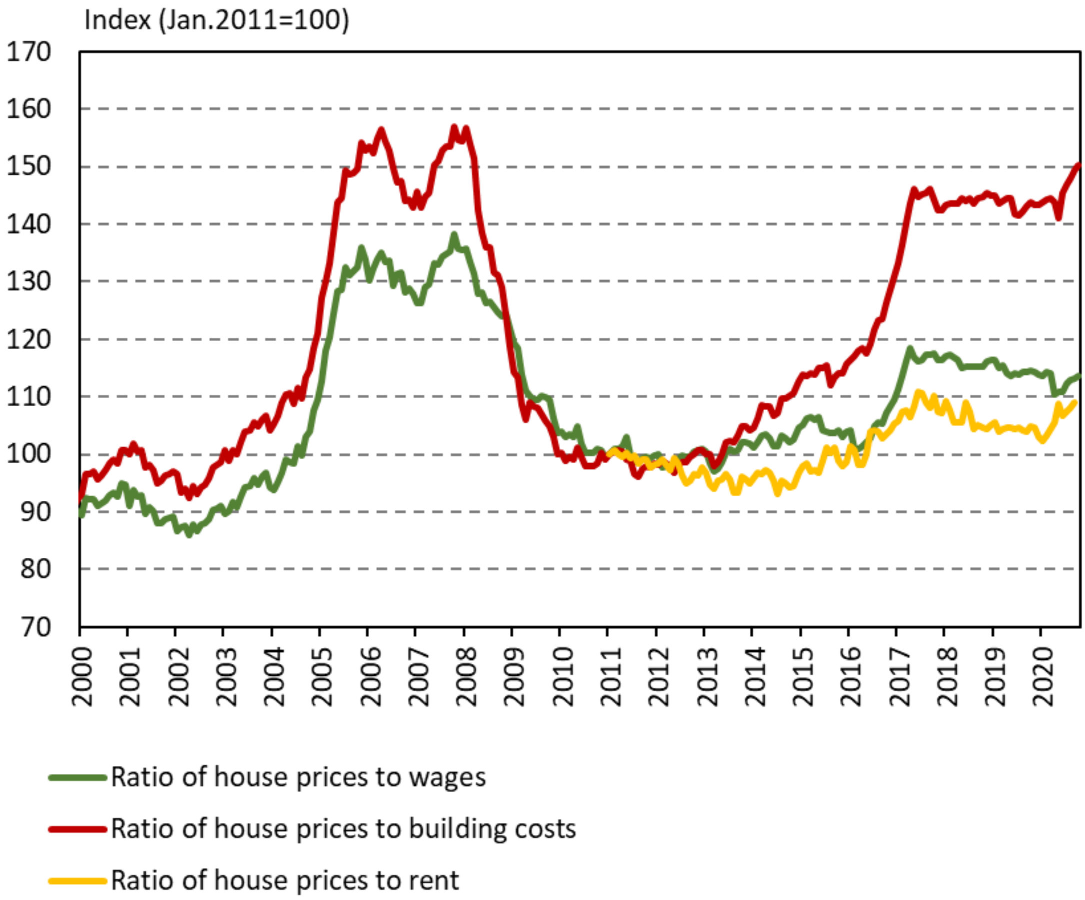
*Sources:* Registers Iceland, Statistics Iceland, Central Bank of Iceland.

## Commercial property price ratios[1,2]



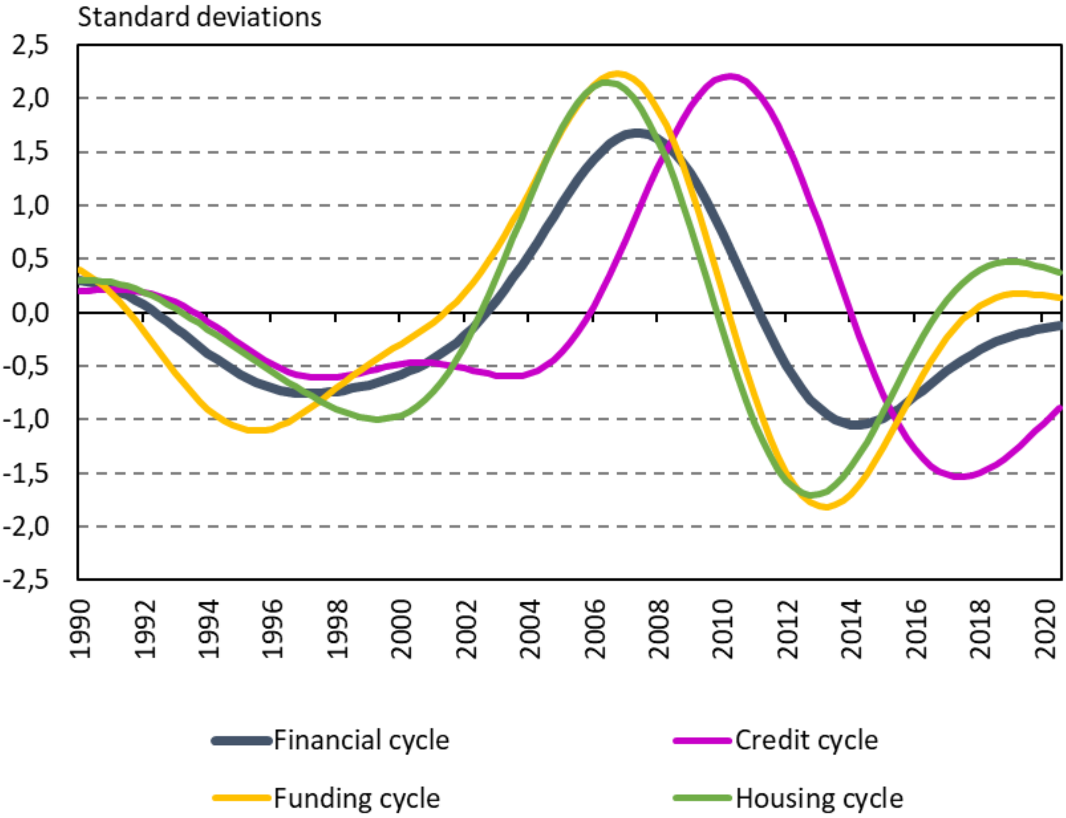

1. Annual data for gross operating surplus are non-linearly interpolated. 2. Annual data for the CRE stock are linearly interpolated.
*Sources*: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

## Capital area house prices and their determinants



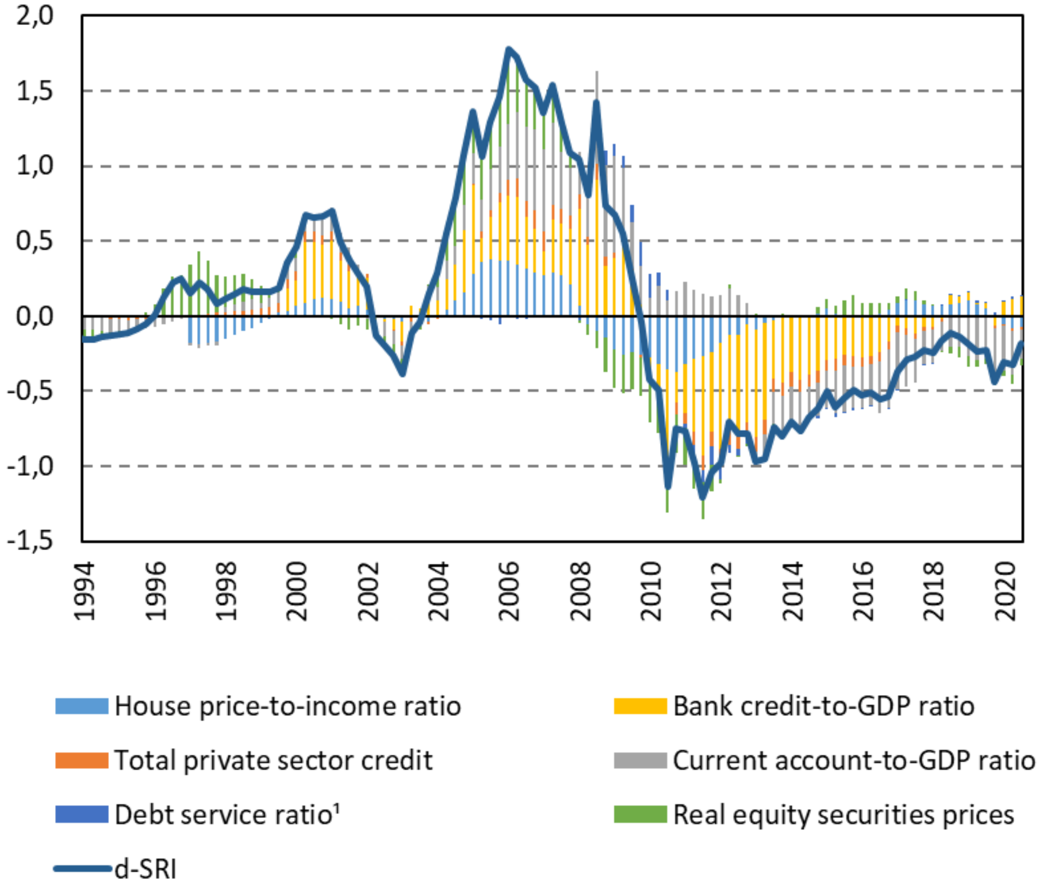

*Sources*: Registers Iceland, Statistics Iceland.

## Financial cycle and subcycles[1]



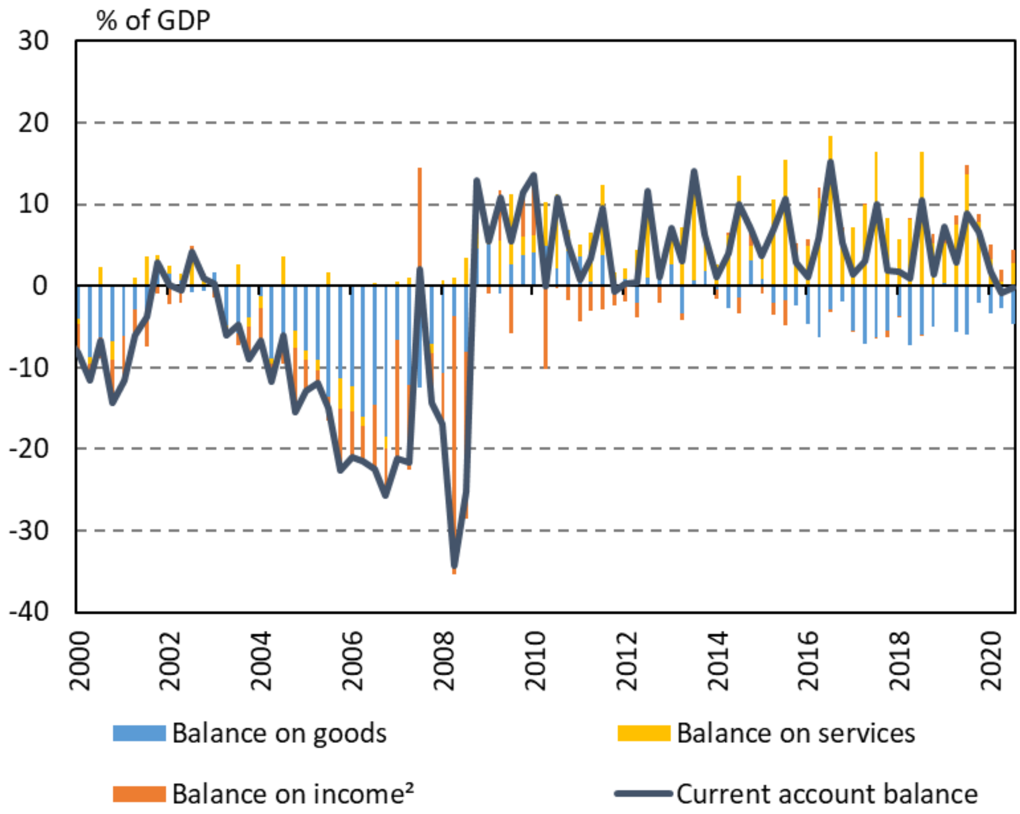

1. The financial cycle itself, the blue line, is the simple average of the subcycles. Each subcycle is the simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with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

## Cyclical systemic risk indicator (d-SRI)



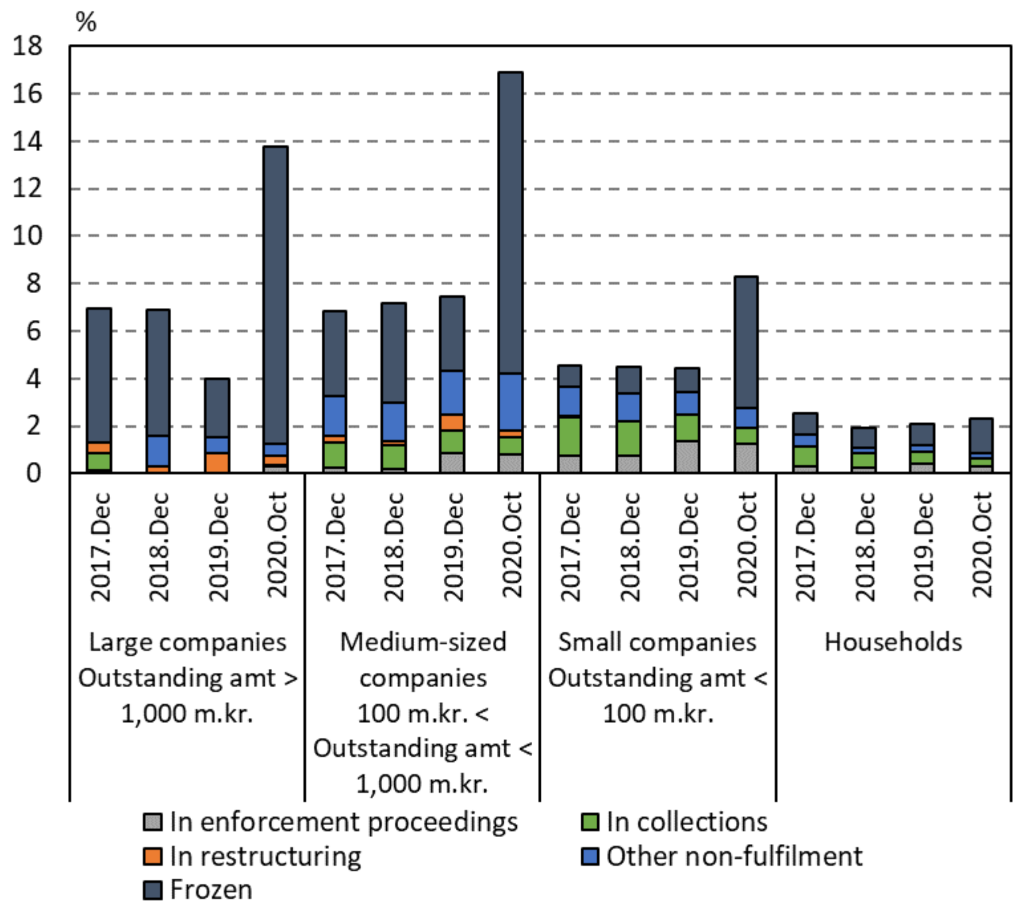

1. Estimates are used for Q1 to Q3 of 2020.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Current account balance[1]



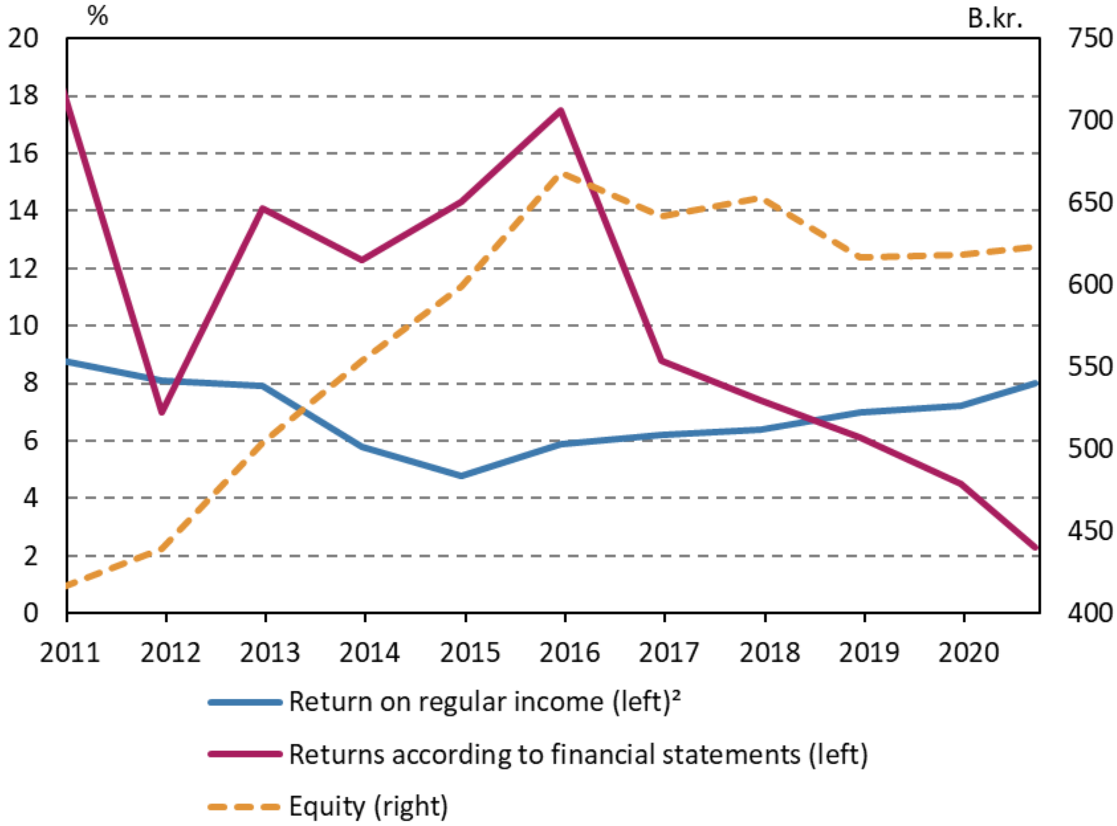

1. The effects of the old banks on factor income and the balance on services from Q4/2008 to Q4/2016 are ignored. From 2009 through 2012, the effect of Actavis on the balance on income is also ignored, owing to inaccurate data during the period.
2. Secondary income is included in factor income.
*Sources*: Statistics Iceland, Central Bank of Iceland.

D-SIB: Status of non-performing loans, by borrower and type of default[1]



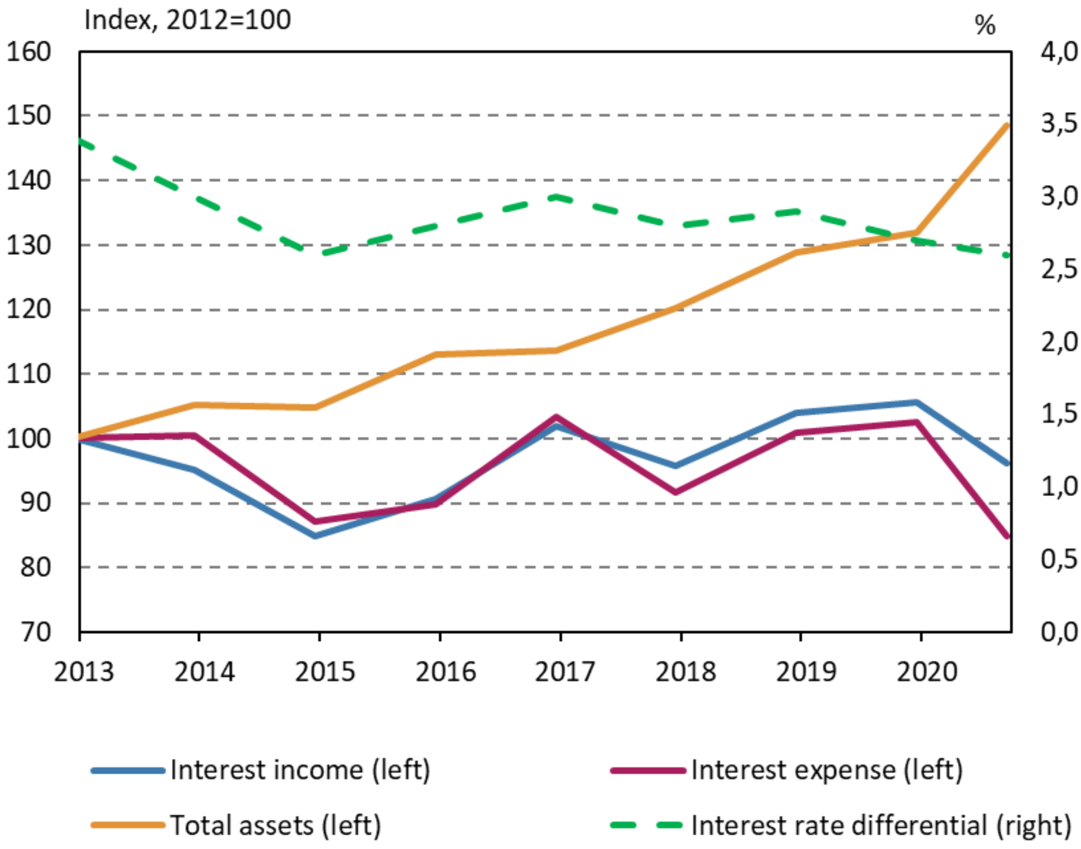

1. Share of non-performing loans to each business size category. Parent companies, book value. D-SIB: Domestic systemically important banks.
*Source*: Central Bank of Iceland.

## D-SIB: Returns[1]



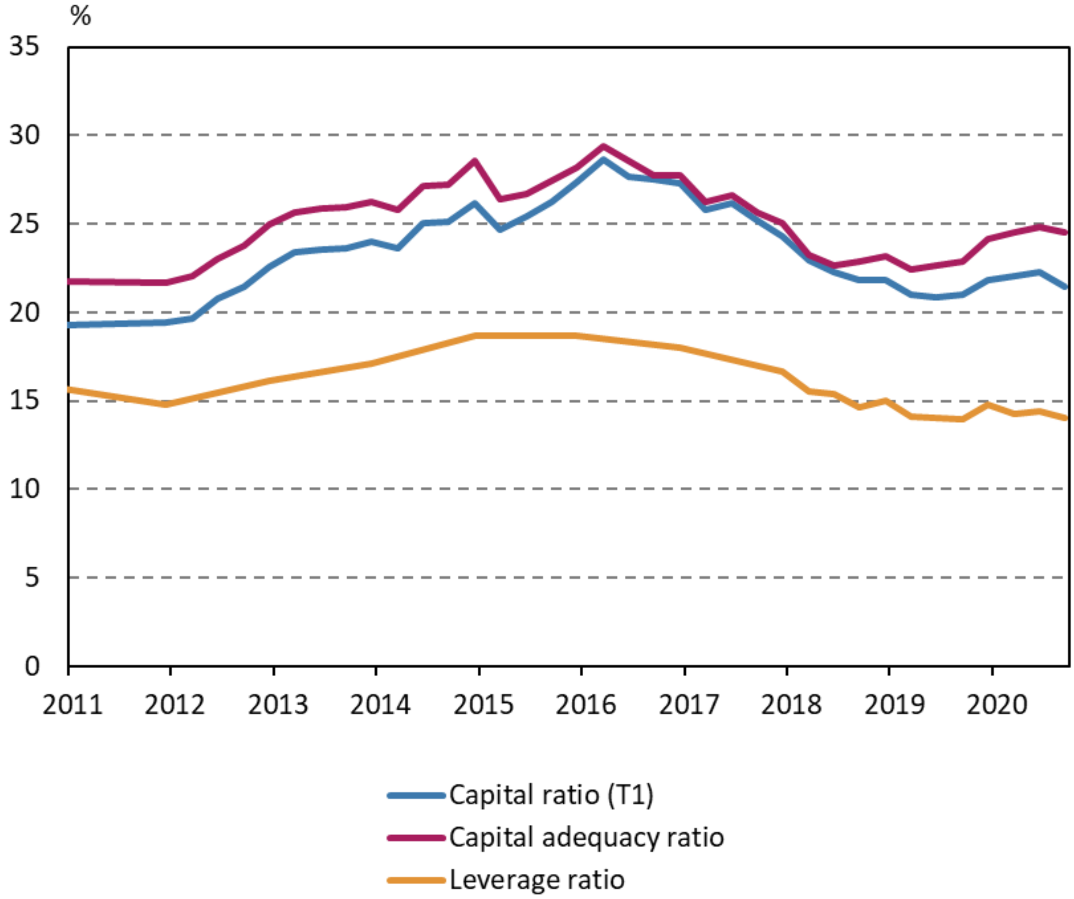

1.Returns are calculated on average equity. Domestic systemically important banks, consolidated figures. 2. The return on regular income is based on net interest income and fee/commission income net of regular expenses. The tax rate is 20% and is based on average equity. Valitor is excluded in 2017-2020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

## D-SIB: Interest income, interest expense and interest rate differential[1,2]




1. Domestic systematically important banks, consolidated figures.
2. Annualised Q3/2020 data.
*Sources*: Commercial banks' financial statements.

## D-SIB: Capital and leverage ratios[1]




1. Consolidated figures.
*Sources*: Commercial banks' financial statements.