2020

REPORT

FINANCIAL STABILITY COMMITTEE REPORT TO PARLIAMENT

Accompanying documents

REPORT

FINANCIAL STABILITY COMMITTEE REPORT TO PARLIAMENT FOR 2020

29 March 2021

Financial Stability Committee report to Parliament for 2020

According to Article 14, Paragraph 3 of the Act on the Central Bank of Iceland, the Bank's Financial Stability Committee (FSN) is required to report to Parliament on its work once a year. It is assumed that the substance of the report will be discussed in the Parliamentary committee of the Speaker's choosing.

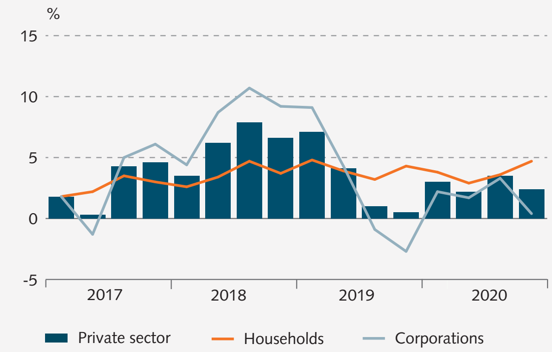
In 2020, the FSN's first year of operation, the Committee met six times. Members of the Committee are Ásgeir Jónsson, Governor, who acts as chair; Gunnar Jakobsson, Deputy Governor for Financial Stability, who acts as vice-chair; Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy; Unnur Gunnarsdóttir, Deputy Governor for Financial Supervision; Axel Hall, Assistant Professor; Bryndís Ásbjarnardóttir, Economist; and Gudmundur Kr. Tómasson, former Director. The Permanent Secretary or an appointed official from the Ministry responsible for financial stability also participates in Committee meetings as a non-voting member with the right to address the meeting and present proposals.

Financial stability

The main objective of financial stability policy is to maintain financial stability; i.e., to ensure that the financial system has the resilience to withstand shocks to the economy, financial system, and financial markets; that it can intermediate credit and payments; and that it can diversify risk appropriately. The Committee takes decisions on the application of the Central Bank's financial stability policy instruments. In addition, the FSN is tasked with assessing the current situation and outlook

Chart 1

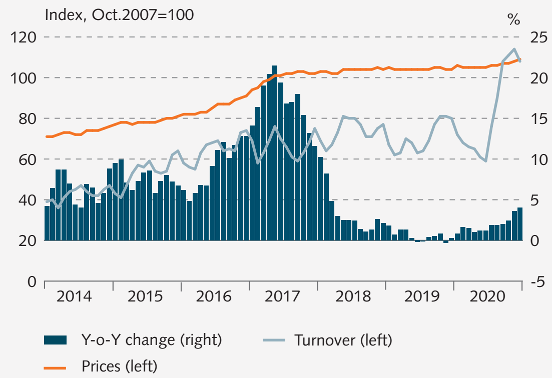
Private sector real credit growth[1]



Debt owed to financial institutions and bonds issued. Year-on-year change at constant prices. Public corporations are included.
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2

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



1. House price index for the capital city area deflated with the consumer price index. Turnover index shows a three month average turnover, deflated with the consumer price index. Turnover data is linearly interpolated in 2Q 2015 to correct for a strike at

for the financial system, systemic risk, and financial stability. Furthermore, the FSN is tasked with discussing and defining the actions deemed necessary at any given time in order to affect the financial system so as to strengthen and preserve financial stability, and to this end, the Committee is required to direct comments to the appropriate Governmental authorities when warranted. Moreover, it shall decide which supervised entities, infrastructure elements, and markets shall be considered systemically important and of such a nature that their activities could affect financial stability. The FSN's statements and minutes, enclosed with this report, contain the rationale for the Committee's decisions in 2020.

Developments in 2020

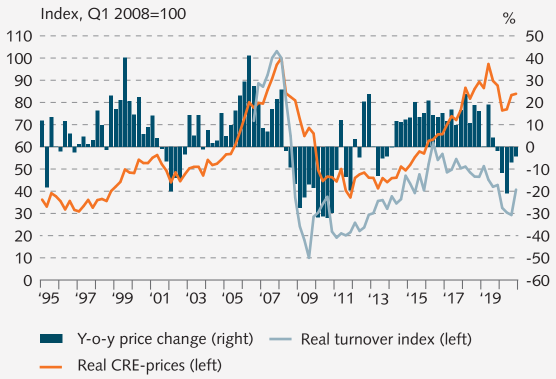
In 2020, economic activity was affected by the spread of the COVID-19 pandemic and the responses to it. Interest rate cuts have supported private sector access to credit, particularly household access. Favourable terms on new mortgages have stimulated both new lending and refinancing of existing debt, and real twelve-month growth in household debt measured 4.7% at the end of December 2020, as compared with 4.3% a year earlier. The commercial banks increased their share in the mortgage loan market during the year, while the share held by the Housing and Construction Authority's ÍL Fund and the pension funds declined. Growth in corporate debt was limited during the year. At the end of December, real twelve-month growth in corporate debt measured 0.4%, or -1.0% after adjusting for price and exchange rate movements. Foreign-denominated corporate debt increased during the year, while debt to domestic financial institutions declined. At the end of 2019, twelve-month real growth in corporate debt measured -2.7%, while price- and exchange rate-adjusted growth measured -2.6%.

The Central Bank and Government's responses to the pandemic have supported asset markets. The Nasdaq Iceland OMXI10 index rose by 20.5% in 2020. In the housing market, price increases were modest despite declining interest rates and increased turnover. The house price index rose by 4% in real terms in 2020, as compared with 0.3% in 2019. On the other hand, commercial real estate (CRE) prices declined, and the capital area CRE price index had fallen by 4.2% in real terms at the end of 2020, as opposed to a decline of 1.9% in 2019. Turnover declined marginally in real terms.

All three of the large systemically important banks recorded a profit in 2020, with returns averaging 4.8%, up from 4.5% in 2019. The interest rate spread on total assets narrowed slightly, as the Central Bank's key interest rate fell considerably. This put some pressure on the banks' credit spreads, particularly because interest rates on sight deposits were close to zero and the banks' scope for lower funding costs was accordingly limited. Economic conditions affected the banks' earnings reports, however, and loan valuation adjustments were negative by nearly 26 b.kr. (0.83% of total loans), as opposed to just under 9 b.kr. in 2019 (0.31% of total loans). The banks granted temporary moratoria on loan payments because of the pandemic. The share of corporate loans in moratorium peaked at 17.6% in August, and the share of household loans protected peaked at 9% in May. Non-performing loans increased significantly when the moratoria ended, as nearly half of loans previously protected by moratorium were then

Chart 3

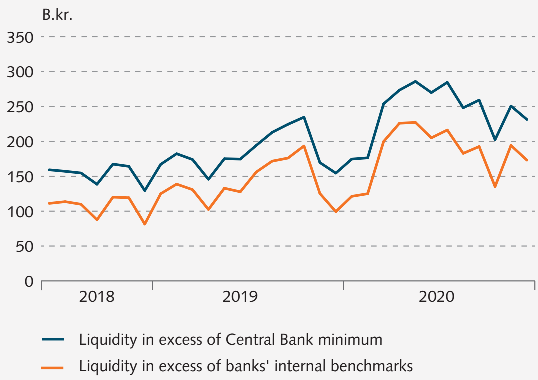
Real prices[1] and turnover[2] of CRE in the capital city area



1. CRE-price index, deflated with the CPI. The index shows a weighted average of industrial, retail and office prices. 2. Turnover index, deflated with the CPI, shows a moving 4 quarter average. Latest observations are preliminary.
Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

Chart 4

D-SIB: Excess liquidity[1]



1. Parent companies.
Source: Central Bank of Iceland.

frozen.[1] At the end of December, non-performing loans accounted for 2.9% of total loans to individuals, up from 2.1% at the end of 2019. For corporate loans, the same ratio rose from 4.8% at the end of 2019 to 18% in December 2020. The banks' strong capital position gives them scope to withstand the loan losses caused by the pandemic.

The banks' liquidity is strong, and well above both Central Bank minima and the banks' own internal benchmarks. Liquidity in excess of requirements increased by 65 b.kr. in 2020. When the Central Bank reduced its offerings of one-month term deposits and later discontinued them altogether, the banks shifted a portion of their króna-denominated liquidity from term deposits with the Bank to Treasury bonds.

The banks' market funding in krónur was largely limited to covered bonds, although the banks' new mortgage loans exceeded covered bond issuance by far in 2020. Credit spreads on the banks' foreign issues nearly trebled in late February and early March 2020, concurrent with the spread of the pandemic across Europe. They declined again over the summer and, by August, were more or less back to pre-pandemic levels. In H2/2020, all of the banks took advantage of ready access and favourable terms in foreign credit markets and refinanced their debt.

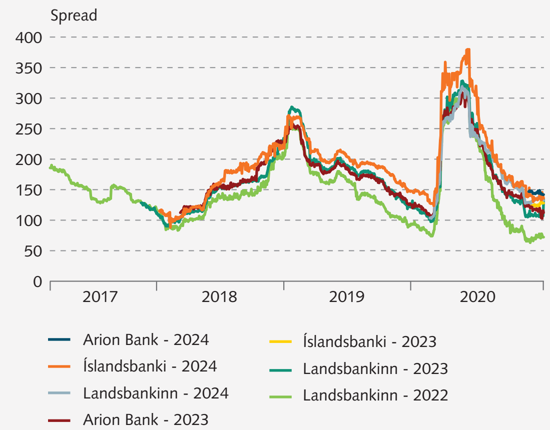
At the end of the year, the financial cycle appeared to have stagnated for the most part. The private sector debt cycle was still rising, due to increased debt and the contraction in GDP. On the other hand, the housing and financing cycles had stagnated or even declined slightly. There were signs of an upswing in both cycles in the coming term, however.

Intermediation of capital in the financial system depends on the efficacy of financial market infrastructure. In recent years, increased emphasis on information systems and cybersecurity has drawn attention to the importance of financial market infrastructure. This infrastructure comprises a large number of dissimilar systems. In some instances, they function independently, and in others they work together. In spite of the pandemic-induced surge in remote working, closure of bank branches, and other restrictions due to public health measures, there were no discernible disruptions in intermediation of credit and payments in 2020. In recent years, the commercial banks have undertaken a broad-based renewal of their payment and settlement systems, and in 2020 the Central Bank's new interbank system was launched. Although the renewal of financial market infrastructure entails a temporary increase in operational risk, it is a necessary step towards ensuring efficacy and boosting efficiency in the long run.

With the passage of the Act on Recovery and Resolution of Credit Institutions and Investment Firms, no. 70/2020, the Central Bank was entrusted with powers of resolution. These powers of resolution entail the authority to take decisions on resolution and to apply resolution measures in the case of a financial undertaking that cannot honour its obligations or is unlikely to be able to. The purpose of the Act is to preserve financial

Chart 5

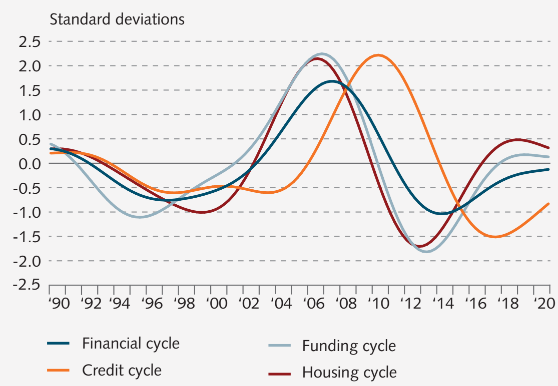
D-SIB: Spread on listed eruobonds[1]



1. Spread on euro benchmark curve.
Source: Seðlabanki Íslands.

Chart 6

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.

1 This refers to non-performing loans according to the cross-default method, according to which all of a borrower's loans are considered non-performing if one loan is frozen or in arrears by 90 days or more, or if the borrower is deemed unlikely to pay their obligations when due.

stability and minimise the adverse implications of financial shocks by protecting insured deposits and investors, customers' assets, and vital company operations, as well as minimising the risk that capital contributions or collateral from the Treasury will be needed.

Committee decisions in 2020

At its mid-March meeting, the FSN decided to lower the countercyclical capital buffer requirement on financial institutions from 2% to 0%, signalling that it would not increase the buffer in the ensuing twelve months. At that time, the economic outlook had deteriorated markedly because of the spread of the pandemic. In its statement, the Committee stressed the importance of mitigating the negative impact of increased arrears and impairment on the intermediation of credit. Releasing the countercyclical capital buffer requirement was a preventative measure designed to enable financial institutions to support households and businesses in foreseeable financial distress because of the pandemic, while simultaneously creating scope for new lending. The buffer was held unchanged at the FSN's meetings in June, September, and December. By law, the value of the countercyclical capital buffer must be reviewed on a quarterly basis. This puts it in a unique position among capital requirements. The purpose of the buffer is to address cyclical systemic risk. Increasing the countercyclical capital buffer during the upward financial cycle, as was done in 2016-2020, created the scope to lower the buffer in order to prevent an adverse chain reaction between credit supply, economic activity, and asset prices.

The Committee held other capital requirements unchanged during the year. By the time of the Committee's meeting in late March, the review of the capital buffers for systemic risk and systemic importance was complete. It was decided at the meeting that the systemic risk buffer would remain steady at 3% of deposit-taking institutions' domestic exposures. The FSN also confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn, in accordance with European Banking Authority (EBA) methodology. The capital buffer for systemic importance was held unchanged at 2% of all of the systemically important financial institutions' exposures. In the Committee's opinion, the risk addressed by these capital requirements was broadly unchanged, as it tends to change slowly over time.

At its December meeting, the FSN decided to designate the Central Bank's new interbank system and the Icelandic branch of the Nasdaq CSD SE securities settlement system as systemically important infrastructure elements in the sense of Article 13(d) of the Act on the Central Bank of Iceland, no. 92/2019.

The Bank applied a wide range of other measures to support financial institutions and ensure that they had sufficient access to liquidity in 2020. In March, it decided to lower deposit institutions' average reserve requirement from 1% to 0%. Furthermore, the treatment of the fixed 1% reserve requirement was changed, and institutions subject to reserve requirements were authorised to classify the balances in their term deposit accounts with the Central Bank as part of their liquidity buffer. At the beginning of April, it was decided to establish a special temporary credit facility in the form of collateralised loans to credit institutions. Furthermore, it was decided in June to develop a special temporary collateralised framework for support loans, at the Central Bank's seven-day term deposit rate. Then, in December, it was decided to lengthen the adaptation period for the increase in credit institutions' minimum liquidity ratio in Icelandic krónur. As a result, the ratio will remain unchanged in 2021. The Committee considered it important to ensure that the large systemically important commercial banks' liquidity remained ample.

On behalf of the Central Bank of Iceland Financial Stability Committee,

Ásgeir Jónsson

*Governor of the Central Bank of Iceland
and Chair of the Financial Stability Committee*

No. 8/2020
18 March 2020

Statement of the Financial Stability Committee
18 March 2020

The Financial Stability Committee of the Central Bank of Iceland has decided to reduce the countercyclical capital buffer on financial institutions from 2% to 0%. Rules to this effect have been approved and will take effect upon publication in the *Law and Ministerial Gazette (Stjórnartíðindi).* The Committee will not increase the countercyclical capital buffer in the next twelve months; therefore, according to the applicable rules, it will remain unchanged for at least two years, until Q1/2022.

The spread of COVID-19 has had a profound impact on communities, dampening economic activity and eroding financial conditions worldwide. It is uncertain how strong this impact will be and how long it will last, but it is clear that the economic outlook for Iceland has deteriorated markedly, at least for the short term.

The Icelandic banks' capital position is strong, and well above current Central Bank requirements. The banking system is well equipped to respond to shocks. It is important, however, to mitigate the negative impact of increased arrears and impairment on the intermediation of credit. Lifting the countercyclical capital buffer requirement will make it easier for the banking system to support households and businesses by increasing flexibility for new lending in an amount ranging up to 350 b.kr., or 12.5% of the current loan portfolio, all else being equal.

The main objectives of the countercyclical capital buffer are to strengthen financial institutions' resilience to cyclical risk and strengthen credit intermediation during contractionary episodes, thereby mitigating the impact of the financial cycle on the real economy. In recent years, the buffer has been built up in order to mitigate cyclical risk.

The Financial Stability Committee urges financial institutions to take into consideration the currently high level of economic uncertainty when they take decisions on dividend payments and stock buybacks in the coming term. The Committee expects the scope created with the reduction in the countercyclical capital buffer to be used to support households and businesses. The banking system's response, the position of households and businesses, and the financial conditions offered to them will be closely monitored in the coming term. The Committee is prepared to use the tools at its disposal to safeguard financial stability in Iceland.

Statement of the Financial Stability Committee

8 April 2020

The Financial Stability Committee of the Central Bank of Iceland has concluded its reassessment of capital buffers for systemic risk and systemic importance. The Committee has decided that both buffers should be held unchanged. The systemic risk buffer (SRB) for deposit-taking institutions will remain 3% of domestic exposures and will be applied both individually and on a consolidated basis, as applicable. The capital buffer due to systemic importance (O-SII buffer) will remain 2% of all exposures at both the parent company level and the group level. The review of systemically important financial institutions, carried out in accordance with European Banking Authority methodology, confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn.

Capital buffers are capital requirements imposed on financial institutions in addition to minimum capital adequacy requirements. The buffers are intended to ensure operational viability under stressed conditions. It is important to bear in mind that financial institutions may tap their capital conservation buffers and O-SII buffers if they need to. This only affects financial institutions' authorisations to make payments such as dividends and bonuses.

Rules on capital buffers for systemic risk and systemic importance have been approved and will take effect upon publication in the *Law and Ministerial Gazette (Stjórnartíðindi).*

Furthermore, the Financial Stability Committee considers it appropriate to establish special temporary credit facilities in the form of collateralised loans. The financial institutions' liquidity is sound, but due to the current uncertainty, the Committee considers it important that the Central Bank have at its disposal a measure that would permit a temporary expansion of eligible collateral. This is done with reference to Article 13 of the Act on the Central Bank of Iceland, no. 92/2019, and the Bank will implement the measure within the framework approved by the Committee.

The Financial Stability Committee re-emphasises its previous statement urging financial institutions to take into consideration the substantial uncertainty currently prevailing in the economy when they take decisions on dividend payments and stock buybacks in the coming term. As before, the Committee is prepared to use the tools at its disposal to safeguard financial stability in Iceland.

The Icelandic financial system is on a sound footing, and the banks' capital position is strong. Recent measures taken by the Central Bank – i.e., lifting the countercyclical capital buffer and changing minimum reserve requirements – have 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 provides scope for response to the conditions now prevailing in the economy.

Statement of the Financial Stability Committee

1 July 2020

The most recent GDP growth forecasts for Iceland assume that GDP will contract by 8% this year. Measures adopted by the Central Bank of Iceland and the Government in response to the COVID-19 pandemic have afforded financial institutions greater scope to support households and businesses during this challenging time.

The three large commercial banks have strong capital and liquidity positions. Although there is uncertainty about the real value of their loan portfolios under the current circumstances, the Central Bank's scenario analysis indicates that their capital position is strong enough to withstand the strain. It is important to expedite loan restructuring to the extent possible. Moratoria on payment alone will not solve the problems facing the most distressed borrowers.

The Financial Stability Committee is required to determine the value of the countercyclical capital buffer on financial institutions on a quarterly basis. In accordance with its statement of 18 March 2020, the Committee has decided to keep the buffer unchanged for the next nine months.

The risk exists that the Central Bank's easing of policy instruments could push asset prices higher and increase the likelihood that systemic risk will accumulate in individual sectors or in the economy more broadly. The Committee reiterates that it is ready to apply the policy instruments at its disposal in order to preserve financial stability in the wake of the pandemic.

Nr. 33/2020
23 September 2020

Statement of the Financial Stability Committee
23 September 2020

The battle to control the pandemic is proving more protracted than previously hoped, exacerbating uncertainty and adversely affecting financial institutions' loan portfolios. It is important that financial institutions work diligently on debt restructuring and that they use the scope provided by Government and Central Bank measures to support households and businesses.

The three large commercial banks are in a strong capital and liquidity position. Central Bank measures have significantly eased their access to liquidity, and credit spreads in international markets have narrowed. As a result, the banks have access to liquidity in both krónur and foreign currencies. They are therefore well positioned to address the repercussions of the pandemic.

The current low-interest environment creates new challenges for pension funds and financial institutions. The pension funds are dominant participants in the domestic financial market; therefore, the framework for their activities and the associated risks warrant further review.

The Financial Stability Committee is required to determine the value of the countercyclical capital buffer on financial institutions on a quarterly basis. In accordance with its statement of 18 March 2020, the Committee has decided to keep the buffer unchanged for the next six months.

The easing of the monetary policy stance has contributed to financial stability under the current circumstances.

The Committee reiterates that it is prepared to use every tool at its disposal to safeguard financial stability in Iceland.

No. 43/2020
16 December 2020

Statement of the Financial Stability Committee
16 December 2020

A more accommodative monetary stance has supported asset markets, enabled households and businesses to deal with the repercussions of the pandemic, and maintained financial stability. The reduction in the countercyclical capital buffer and measures to boost market liquidity have made it easier for financial institutions to work with distressed borrowers while simultaneously maintaining their lending capacity. In the Committee's opinion, cyclical systemic risk has not increased to any marked degree in the recent term.

The three large commercial banks are in a strong capital and liquidity position. Credit spreads on their bond issues have fallen. As a result, the banks have ready access to liquidity in both krónur and foreign currencies, which they have used for refinancing. They are therefore well positioned to address the repercussions of the pandemic.

The low-interest environment gives rise to new challenges in the financial market. This is particularly the case for the pension funds, which are dominant players in the domestic financial market and are systemically important. It is therefore important that the strategy formulation currently underway for the pension system take into account the pension funds' impact on financial stability.

The Financial Stability Committee has decided to designate the Central Bank's new interbank payment system and the Nasdaq CSD SE securities settlement system as systemically important infrastructure.

The Committee is required to determine the value of the countercyclical capital buffer on financial institutions on a quarterly basis and has decided to keep the buffer unchanged.

The Financial Stability Committee is prepared to use every tool at its disposal to safeguard financial stability in Iceland.

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Extraordinary meeting, 10 March 2020 (1st 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's extraordinary meeting held on 10 March 2020. At the meeting, the Committee approved its rules of procedure and discussed the changed economic outlook. The authorities' first pandemic response measures were presented as well.

Economic impact of COVID-19 and the authorities' initial response

The Committee received a presentation covering the highlights of the Government measures to address the economic impact of the COVID-19 pandemic, which had been introduced earlier that day. It emerged that a significant contraction in Treasury revenues was foreseeable, as was an increase in expenditures.

The Committee discussed the changed economic outlook. Despite substantial uncertainty about the future, it is clear, based on available forecasts, that the pandemic will have a severe negative impact on the global economy - and on global tourism in particular. Earlier in the week, the Organisation for Economic Cooperation and Development (OECD) introduced two scenarios of the virus' impact on year-2020 GDP growth. The baseline scenario assumes that the main impact will be limited to China and that global GDP growth will measure 2.4% for the year, while the alternative scenario assumes a broader impact, with GDP growth measuring 0.5%.

Because tourism weighs heavier in the Icelandic economy than in that of most OECD countries, the Committee considered it a given that the pandemic would have a profound impact in Iceland. Members noted that the impact of the pandemic on the Icelandic economy could be expected to depend largely on the size of the contraction in international air traffic and, consequently, in seat capacity on flights to Iceland in 2020. Reduced demand for commodities could also have an adverse effect on prices and demand for energy-intensive industrial products and marine products. The Committee was of the opinion that uncertainty would be pronounced in the coming term and that the impact of the virus could prove more widespread than existing scenarios indicated. Members also discussed the potential impact on the financial system and concluded that the system was on a sound footing and well prepared to withstand shocks.

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

Guðmundur Árnason, Permanent Secretary of 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.

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Extraordinary meeting, 16 March 2020 (2nd 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's extraordinary meeting held on 16 March 2020. At the meeting, the Committee decided to lower the countercyclical capital buffer from 2% to 0% and announced the decision on 18 March.

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 developments in cyclical systemic risk in the recent term. The Committee had information at its disposal on the current situation and developments in recent months.

The economy

The novel coronavirus had spread from China to large parts of Asia, Europe, and North America. Countries had begun to close their borders or impose restrictions on cross-border travel. Many countries imposed restrictions on large gatherings. In Iceland, the economic outlook had deteriorated significantly in recent days, as the virus spread and widespread closures were introduced in Iceland's main trading partner countries. The principal uncertainty centres on how long the pandemic will last.

Reduced appetite for travel and the closure of borders had made a profoundly negative impact on tourism companies. The price of shares in European airlines had tumbled. Several European airlines had already announced a significant reduction in their activities for the coming weeks or had cancelled them altogether. Icelandair was not spared the effects of this and had cancelled a number of flights in previous days. It was assumed that air travel could contract even further in the weeks ahead. Iceland's tourism industry depends on the success of efforts to control the spread of the disease before the peak summer season. In recent years, a third of all tourist visits to Iceland have taken place in June, July, and August. In many instances, companies in the sector have limited resilience after the contraction in 2019.

Financial markets

Share prices had fallen steeply and fluctuated widely in foreign markets. Some days saw fluctuations of 10%, the most pronounced volatility since October 2008. Investors had increasingly sought out less risky assets. The yield on 10-year government bonds issued in the US, the UK, and Germany had fallen, and the price of gold had risen. Oil prices had fallen by nearly 50% since the turn of the year, owing both to the pandemic and to the price war between Saudi Arabia and Russia.

Domestic markets had developed in a similar manner. Shares in nearly all companies on the Nasdaq Iceland Main List had fallen in price, and the OMXI10 index was down nearly 20% since the turn of the year. Treasury bond yields had fallen somewhat, and the yield on indexed Treasury issues was close to zero. The króna had depreciated by 8% since the beginning of the year, and volatility had increased. The Central Bank had intervened in the market in order to maintain foreign exchange market equilibrium.

Inflows of foreign currency for new investment had subsided markedly in the recent term. New investment was negative in the amount of just over 7 b.kr. in the first two months of 2020. The current account had shown a sizeable surplus in recent years, but uncertainty about foreign currency flows had escalated, particularly about tourism-generated revenues. The pension funds' response will be an important determinant of foreign currency flows in coming months. In 2019, for example, the funds bought currency for 121 b.kr., or about 4% of GDP. The Central Bank's international reserves amount to 30% of GDP.

Developments in private sector debt

Growth in household debt had changed little in the recent terms, measuring 4% in real terms. Lending figures for the period through end-January 2020 indicated that the pension funds' and banks' share had remained broadly unchanged. The weight of non-indexed loans in total household debt had increased still further. Growth in corporate debt declined rapidly last year, however. This could stem in part from the poorer economic outlook, repricing of risk, and individual financial institutions' lending policies. There were signs that to some extent, intermediation of credit to companies may have shifted out of the banking system in recent months.

The banking system

The three large banks' capital ratios ranged between 22.4% and 28.4%, while the total capital requirement ranges from 18.8-20.4%. The liquidity position remains well above the Central Bank's required minimum, and the banks' liquid assets in excess of requirements totalled 260 b.kr. The banks' liquidity ratios in Icelandic krónur had also been rising in recent months.

Interest premia on the large banks' foreign bond issues had risen rapidly in the past few days, to about the level seen in mid-2019. Issues totalling some 2.5% of GDP are scheduled to mature in 2020, and another 4% are scheduled to mature in 2021. The banks' ample foreign liquidity would enable them to pay off at least all of their 2020 maturities. The spread between the banks' covered bond rates and Treasury bond rates had widened in recent weeks, indicating that funding terms in the domestic market were deteriorating.

There were no signs that credit risk had begun to materialise in the banking system. The cross-default non-performing ratio on corporate loans rose in Q3 and Q4/2019. The first signs of debt service difficulties among tourism and construction companies were beginning to come to the fore. The impact of the spread of the virus had yet to surface, however. Loans to tourism companies accounted for just over 9% of the banks' total customer loans, the impact would probably be greatest there.

Cyclical systemic risk

The household debt-to-GDP ratio had been relatively stable between years, while the corporate debt-to-GDP ratio had fallen somewhat. Real house prices in the greater Reykjavík area were historically high, at nearly 10% above their long-term trend in January 2020. Commercial property prices had been broadly unchanged between years in real terms.

Leading financial cycle risk indicators based on quarterly data on credit growth, house prices, and the banks' foreign funding did not indicate that the downward cycle had begun by the end of Q4/2019. Instead, they indicated that the upward cycle had hit a plateau.

Daily data suggested a significant rise in unrest. Payment card turnover had contracted, the króna had depreciated, share prices had fallen, premia on the banks' market issues had risen, and yields on domestic bonds had fallen.

The authorities in several countries had already lowered countercyclical capital buffer requirements. In Denmark and the UK, for instance, the buffer was lowered from 1% to 0%, while in Sweden it was lowered from 2.5% to 0% and in Norway it was lowered from 2.5% to 1%.

II Decisions pertaining to financial stability

The Committee noted that it was important for financial institutions to have the scope to support the economy under current conditions, in terms of both capital and liquidity.

Members discussed the capital requirements made of financial institutions. Capital buffers had been built up during the upward cycle in order to boost financial system resilience. Under current circumstances, it was appropriate to examine the possibility of using the scope that the buffers had provided. Members discussed the risks that were likely to materialise during the ongoing crisis, and they agreed that it was important to respond decisively.

Countercyclical capital buffer

The Committee noted that lowering the countercyclical capital buffer would provide financial institutions the latitude to address increased loan losses and mitigate the negative impact on intermediation of credit.

Members considered two options: lowering the countercyclical capital buffer from 2% to 1% and lowering it from 2% to 0%. Releasing the buffer could prevent a negative chain reaction involving credit supply, economic activity, and asset prices. On the other hand, there were no clear signs that the downward financial cycle had begun. Lowering the buffer to 1% would leave the Committee some room for manoeuvre later on. Members agreed that it was important to keep the buffer unchanged for at least 12 months and issue forward guidance to this effect. It was also important to urge financial institutions to suspend all plans to pay dividends and buy back their own shares, in the interests of social responsibility and the banks' role and unique position in the economy.

The Committee noted that it was important to respond quickly to the situation that had developed. There would have to be incentives for the financial institutions to maintain the supply of credit. It would also be positive if the Committee's decisions could provide further support for transmission of monetary policy.

In view of the discussion, the Governor proposed that the countercyclical capital buffer be lowered from 2% to 0%. Furthermore, the Committee should provide forward guidance signalling that the buffer would not be changed again in the coming 12 months. All Committee members voted in favour of the proposal.

Members discussed the importance of using the scope provided by the reduction in the buffer to restructure loan portfolios and support businesses and households during the period of economic uncertainty that lay ahead.

It emerged at the meeting that the FSN would closely monitor developments in financial conditions and was prepared to apply the policy instruments at its disposal in order to preserve financial stability.

Committee members discussed the financial system position in general. They agreed that the banks were strong and the banking system well prepared to respond to shocks.

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

Guðrún Þorleifsdóttir, 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.

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.

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 22-23 June 2020 (4th meeting)

Published: 21 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 22 and 23 June 2020. Part of the meeting on 23 June was a joint meeting of the Financial Stability Committee and the Monetary Policy Committee. Members decided at the meeting to hold the countercyclical capital buffer unchanged. The FSN also agreed that the Central Bank should implement a special temporary collateralised loan framework to finance support loans bearing a 100% Treasury guarantee.

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, the financial cycle, the real estate market, powers of resolution, and support loans. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in late March.

The economy

The COVID-19 pandemic and the associated public health measures have had a profound impact on the domestic economy. According to the Central Bank's most recent macroeconomic forecast, published in *Monetary Bulletin* 2020/2, GDP will contract by 8% this year, the deepest single-year contraction in a century. The airline and tourism industries have borne the brunt of the damage, and the largest contraction in exports in the history of measurements is in the offing. This has been partially offset by a contraction in imports and an improvement in terms of trade. Private consumption contracted sharply year-on-year in March and April but rebounded in May. Job numbers have fallen steeply, and unemployment has risen. Unemployment is forecast to peak in Q3 and to measure just under 9% in 2020 as a whole. Inflation has not risen despite the depreciation of the króna, as lower oil prices and a worldwide decline in food and commodity prices have held inflation in check. Furthermore, inflation expectations have remained at target.

Financial markets

Foreign equity markets had rallied significantly since the Committee's March meeting, supported by government measures aimed at expanding access to capital and lowering financing costs. There were also expectations that the pandemic might be on the wane.

Comparable trends could be seen in the domestic equity market. The OMXI10 index had risen by over a fifth between FSN meetings, largely because of shares in Marel, which account for over half of the index in terms of market capitalisation and rose in price by nearly 30% during the period. Bond market yields had fallen in line with the decline in Central Bank interest rates, more on the short end of the yield curve than on the long end. This could be due to financial institutions' interest in buying short Treasury bonds and Treasury bills for liquidity management purposes after the Central Bank stopped offering one-month term deposits in May. Market yields had fallen to historical lows, and real rates on indexed one- and five-year Treasury bonds had turned negative.

The exchange rate of the króna was broadly the same as at the time of the FSN's previous meeting. The market appeared to be relatively shallow. The statement published by the Icelandic Pension Funds Association, urging the pension funds to refrain from purchasing foreign currency, supported the exchange rate but simultaneously reduced market depth, particularly on the buying side. The Central Bank has intervened in the foreign exchange market several times in order to mitigate volatility. The Bank's transactions year-to-date accounted for 17% of total market turnover. There had been no signs of capital outflows from Iceland. In the first five months of the year, new investment was negative by 5 b.kr., whereas from March through May it was positive by 2 b.kr.

Developments in private sector debt

Growth in household debt has held broadly unchanged in the recent term and measured 4% in real terms at the end of March. The weight of non-indexed debt has increased even further, to nearly a third of total household debt. Growth in corporate debt was negative by 0.3% at the end of March, however, after adjusting for price and exchange rate movements. This trend has been building up for quite a while, with corporate credit growth starting to slow in 2019, partly because of the poorer economic outlook and credit institutions' repricing of risk.

The banking system

Both the Central Bank and the Government have adopted broad-based measures aimed at mitigating the shock to households and business and supporting the financial system. Central Bank measures have aimed at easing the monetary stance and ensuring increased liquidity in circulation in order to support demand and enable financial institutions to cover loan losses.

The three large banks' liquidity position remains strong, although they may well have to tap their liquidity buffers when the full impact of the pandemic has emerged. On 10 June 2020, the banks' liquid assets in excess of liquidity requirements totalled 270 b.kr. an increase of nearly 20 b.kr. between FSN meetings. Stress tests of their liquidity suggest that the banks can tolerate large-scale outflows.

Premia on the banks' foreign bond issues had fallen by nearly 50 basis points since the FSN's last meeting. The banks' generous foreign liquidity position gives them continued flexibility to respond to these challenging market conditions without seeking foreign market funding. The credit spreads on the banks' covered bonds relative to Treasury bonds had fallen between FSN meetings and were back roughly to where they were at the beginning of the year.

The three large banks' operating losses in Q1/2020 totalled just over 7 b.kr. Their Q1 accounts were affected by an increase in impairment, which totalled nearly 12 b.kr. during the quarter. Further impairment is expected in the quarters to come. In spite of this, the banks' capital position is very strong, and their average capital ratio was 24.5% at the end of March, as compared with 22.4% at the end of December 2019. Stress tests carried out on the banks suggest that their capital position is very strong. A strong capital position and the suspension of the countercyclical capital buffer gives the banks the scope they need to withstand increased loan losses while simultaneously maintaining lending activity.

As of 10 June 2020, some 380 b.kr., or 12% of the three large banks' loans to customers, were in moratorium because of the pandemic. Moratoria are more common among corporate borrowers, at about 16% of the banks' corporate loan portfolios, than among households, some 9% of which are in moratorium. Nearly half of loans to tourism companies are in moratorium, as well as a fifth of loans to services companies and 10% of loans to businesses in retail and wholesale trade. The ratio is lower among companies in other sectors. There are signs that arrears (0-90 days) are on the rise.

Real estate market

The real increase in capital area house prices measured 1.1% year-on-year in May. Condominium prices were up by 1.7%, while detach housing prices were down 1.4%. In regional Iceland, prices had increased by 7.8% in May. Turnover shrank significantly in April but picked up again in May, most likely in reflection of public health measures. Capital area house prices have moved generally in line with their economic determinants in recent years. Indicators implied that households were refinancing their mortgages as a result of lower interest rates and moving increasingly from indexed to non-indexed mortgages. There also appeared to be a shift in household mortgage financing from the pension funds to the banks, which are now offering lower non-indexed interest rates than most of the pension funds do.

The commercial real estate price index in the capital area continued to fall in Q1/2020. By the end of March, the year-on-year decline measured 12% in real terms, up from just over 2% at the end of December. The effects of the pandemic will probably show even more clearly in

Q2. The supply of hotel and guesthouse space continues to increase, with some 51,000 square metres — about a fifth of the current total space available — now under construction in greater Reykjavík. The amount of commercial bank loans secured by lodging-based property and bearing a loan-to-value ratio of over 70% increased by nearly 15% in real terms in 2019.

The financial cycle

Quarterly data indicate that the upward financial cycle had peaked by end-2019 and Q1/2020. The private sector debt cycle was still rising, while the housing and financing cycles had by and large plateaued. The pandemic response measures taken by the Central Bank and the Government could reboot the housing cycle, and the debt cycle is likely to start rising again, particularly because of increased mortgage lending to households and bridge loans and support loans to businesses. All of this could revive the financial cycle. In general, though, risk appetite in the financial system appears to have diminished in recent years, which could have a negative impact on the upward financial cycle if this situation persists.

Resolution authority

The Committee received a presentation on the contents of the new Act on Recovery and Resolution of Credit Undertakings and Securities Firms, passed by Parliament on 15 June 2020. The Act enters into force on 1 September 2020. The Act incorporates the bulk of EU Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the bank recovery and resolution directive, or BRRD) into Icelandic law. Powers of resolution entail the administrative authority to adopt and implement measures and tasks relating to the preparation and execution of resolution measures for financial undertakings; i.e., dealing with individual entities' operational difficulties and shocks with the aim of minimising the adverse impact on the financial system as a whole. According to the new Act, this resolution authority will be part of the Central Bank.

Support loans

On 25 May 2020, the Central Bank of Iceland and the Ministry of Finance and Economic Affairs made an agreement under which the Bank will handle the granting of Treasury guarantees vis-à-vis credit institutions. The aim of support loans is to maintain employment and economic activity by supporting small businesses that have suffered a temporary drop in revenues because of the pandemic and the associated public health measures. This both reduces the likelihood that these businesses will default on their loans and boosts financial system loan quality. The loans fall into two categories: on the one hand, loans in amounts ranging up to 10 m.kr. and bearing a 100% Treasury guarantee, a loan period of up to 30 months, and interest rates equal to the Central Bank's seven-day term deposit rate as current at any given time; and on the other hand, loans ranging from 10-40 b.kr., bearing an 85% Treasury guarantee, a loan period of 30-48 months, and interest rates equal to the Central Bank's seven-day term deposit rate plus a premium charged by the lending institution concerned.

II Decisions pertaining to financial stability

The Committee discussed, in general, the easing of the policy stance as a result of the pandemic. Low — and even negative — interest rates have been in place in many economies for quite some time, and this, together with a more accommodative financial stability policy stance, has fuelled concerns about the status of financial stability. In Iceland, however, the situation is different, and the more relaxed stance is a recent development stemming from the bleak economic outlook. In spite of the more accommodative stance, the FSN is not yet worried about the status of financial stability. The increase in financial system liquidity does not appear to have led to increased corporate lending, and businesses' access to financing through the banking system may be limited to a degree. In recent months, private sector credit growth seems to have been restricted almost entirely to household mortgage lending. As a result, excessive growth in debt and unsustainable asset market price hikes do not yet give cause for concern in Iceland. Committee members considered it important, however, that all should be well aware that the current situation was a temporary one. The policy stance would have to be tightened again once the effects of the pandemic and associated public health measures had tapered off.

Countercyclical capital buffer

The Governor proposed that the countercyclical capital buffer be held unchanged at 0%, in accordance with the Committee's March 2020 statement announcing that it would keep the buffer unchanged until at least March 2021. All Committee members voted in favour of the proposal.

Financing of support loans

The Committee discussed the importance of encouraging credit institutions to grant support loans— among other things, because these loans could help viable small companies avoid insolvency, thereby improving financial system loan quality and supporting financial stability. It emerged at the meeting that, other things being equal, the loans would lower credit institutions' liquidity ratios and liquid assets, just as other loans do.

The Committee discussed the advantage of implementing a special temporary collateralised lending framework to guarantee credit institutions access to short-term funding at lower interest rates, so as to finance the support loans with a 100% guarantee. These loans were also the premise for the provision of support loans with an 85% guarantee. Such a framework would support lending appetite in the financial system, which was desirable under the current circumstances.

In view of the discussion, the Governor proposed that, because of the uniqueness of support loans bearing a 100% Treasury guarantee and the circumstances currently prevailing due to the pandemic, the Central Bank would develop a separate temporary collateralised lending framework for support loans, subject to the terms offered at any given time on seven-day term deposits with the Central Bank. All members voted in favour of the proposal.

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

Gudmundur 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 Th. Thórarinsson wrote the minutes.

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 21-22 September 2020 (5th meeting)

Published: 27 October 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 Bank'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 21 and 22 September 2020. Members decided at the meeting to hold the countercyclical capital buffer unchanged.

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 risk in the financial system and in the operations of individual financial institutions, the real estate market, financial market infrastructure, and the financial cycle. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in late June.

The economy

The economic outlook was coloured by the battle against the COVID-19 pandemic, which would seemingly be more drawn out than previously hoped. The Central Bank's most recent macroeconomic forecast, published in August in *Monetary Bulletin* 2020/3, assumes that GDP will contract somewhat less this year than in the Bank's May forecast. Preliminary national accounts figures show that GDP growth was more robust in H1 than had been assumed in the

August forecast. On the other hand, high-frequency indicators and surveys suggest that the outlook for H2 and further into 2021 has deteriorated.

The tourism sector has contracted sharply, but the fishing industry has withstood the pandemic better than forecasts had indicated. Various other services are suffering. Private consumption picked up during the summer but appears to have slowed down again as the autumn began. Job numbers have fallen steeply, unemployment has risen, and the labour participation rate is down. Unemployment is forecast to peak at around 10% towards the year-end. Inflation has risen, but inflation expectations have remained at target.

Financial markets

Foreign stock markets had held broadly flat since the Committee's last meeting, except in the US, where prices had risen. Central bank measures, government responses, relaxation of public health measures, and optimism about the development of a vaccine have supported prices in the markets.

Prices had also risen in the domestic stock market between meetings, but as has been the case in recent months, the increase was attributable largely to the rise in Marel shares. Icelandair had recently concluded a public stock offering that was oversubscribed by a considerable margin.

Yields on nominal Treasury bonds had risen, with long-term yields rising more than short-term yields, probably as a result of increased financial institution demand for securities for liquidity management purposes. Real rates on indexed one- and five-year Treasury bonds remained negative.

The exchange rate of the króna had fallen slightly since the Committee's last meeting. The Central Bank's share in market turnover had increased. The Bank had responded to the shallowness of the market by launching a regular foreign currency sales programme in mid-September. The pension funds had significantly scaled down their currency purchases in Q2 but bought for 8 b.kr. in July and August, a marked increase from the previous quarter. New investment was negative by just over 12 b.kr. in July through August and was negative by just over 10 b.kr. since end-February, when the first COVID-19 cases were diagnosed in Iceland.

Developments in private sector debt

Growth in household debt had eased to just under 3% at the end of Q2, as compared with nearly 4% at the end of Q1. The weight of non-index loans in household debt continued to rise. Price- and exchange rate-adjusted growth in corporate debt measured 0.6% at the end of Q2, after contracting marginally in Q1. On the whole, growth in private sector debt had increased little during the previous quarter.

The banking system

The three large banks' liquidity remained strong. On 16 September 2020, the banks' liquid assets in excess of liquidity requirements totalled 255 b.kr. after decreasing by 15 b.kr. since the June meeting. Stress tests of the banks' liquidity suggest that they can tolerate large-scale outflows.

Credit spreads on the banks' foreign bond issues had fallen markedly between meetings, in line with international trends. They are somewhat higher now than before the pandemic struck. The banks' generous foreign liquidity position has given them flexibility to respond to challenging market conditions without having to issue bonds. The credit spreads on the banks' covered bonds relative to Treasury bonds had also fallen between FSN meetings and were back roughly to pre-pandemic levels.

The three large banks' operating losses in H1/2020 totalled just over 0.7 b.kr. The banks' financial statements were affected by increased impairment, which totalled just over 23 b.kr. during the half. Further impairment is expected in the quarters to come if the pandemic drags on. In spite of this, the banks' capital position is very strong, and their average capital ratio was 24.8% at the end of June, as compared with 22.4% at the end of December 2019. A strong capital position and the reduction of the countercyclical capital buffer gives the banks the scope they need to withstand increased loan losses while retaining the strength for new lending.

As of mid-September, loans from the three large banks amounting to about 190 b.kr. were in pandemic-related moratorium, or just over 6% of the banks' loans to customers. This percentage had fallen rapidly in the weeks beforehand, as the six-month payment deadline had expired in many instances. Moratoria were more common among companies, at nearly 9% of corporate loans, as compared with just over 3% of household loans. Nearly one-fourth of loans to tourism companies, 12% of loans to services firms, and 10% of loans to companies in retail and wholesale trade were in moratorium. The ratio was lower among companies in other sectors. Default had risen. From the beginning of the year through the end of July, the banks' non-performing loan ratio had risen from 2.1% to 2.7% for household loans and from 4.8% to 8.9% for corporate loans.

Real estate market

The real rise in capital area house prices measured 1.9% year-on-year in August, and in regional Iceland, prices had increased by 8.6% over the same period. Turnover had contracted by 35% year-on-year in Q2. However, the turnover measurement is affected to a degree by delays in registration of purchase agreements because of an increase in other documents, including loan refinancing documents. Households have increasingly been refinancing their mortgages as a result of lower interest rates and have shifted from indexed to non-indexed mortgages. Data from credit assessments carried out by the systemically important banks indicate that borrowers with lower loan-to-value ratios have moved their business to the banks, improving the banks' loan quality.

The commercial real estate price index for the capital area was virtually unchanged in Q2 but fell by 21% year-on-year in real terms. Turnover had contracted in real terms by nearly 50% year-on-year in Q2. Many hotels and guesthouses are still under construction. In terms of guest capacity, projects under construction in the capital area equal about 16% of the space currently in existence, and in regional Iceland they account for about 10%.

Financial market infrastructure

Further core infrastructure renewal lies ahead for both the Central Bank and the commercial banks. Launching new infrastructure entails strain and possible spillovers if something goes wrong. The number of operational incidents in interbank systems had fallen from its peak in 2018, which occurred following the launch of new payment and deposit systems by some of the commercial banks. All over the world, governmental authorities and international institutions have focused increasingly on network and information security in various parts of important social infrastructure, including in the field of financial services. Electronic retail payment intermediation in Iceland is based mainly on international payment card infrastructure, and acquiring now takes place for the most part through international card systems. Use of physical currency for cash transactions has long constituted only a small share of domestic payment intermediation, and use of cash has diminished even further since the pandemic struck.

The financial cycle

The upward phase of the financial cycle appeared to have come to an end. The private sector debt cycle was still rising, while the housing and financing cycles had plateaued. Interest rate cuts had sustained household credit growth, but corporate lending was more uncertain. Measures enacted by the Government, such as bridge loans and support loans for companies, could boost credit growth, however. House price increases in recent months could indicate that the housing cycle will rise in coming months. Furthermore, credit spreads in capital market had fallen, which could support the financial cycle. Developments over the coming term were highly uncertain, however.

II Decisions pertaining to financial stability

The Committee discussed the measures undertaken by the Central Bank and the Government in response to the pandemic, which had focused on safeguarding purchasing power, supporting households and businesses that have suffered severe income losses, and enhancing financial institutions' lending capacity and scope for action. The Committee was of the view that the measures had cushioned against the blow caused by the pandemic. The pandemic was proving to be more protracted than previously expected, and uncertainty about the economic outlook had increased. Members were therefore of the opinion that the outlook for financial stability had deteriorated since the Committee's last meeting; therefore, they were less concerned now about the adverse impact of the Bank's more accommodative policy stance.

Members agreed that financial institutions' credit risk had increased. It would be necessary for lenders to act systematically but cautiously in refinancing the loans of the borrowers that had suffered the most severe income losses. Loan restructuring would strengthen the foundations of the financial system and create the scope for future resilience in the economy. Because of the high level of uncertainty, though, it was important to distinguish between companies that would be viable under normal circumstances and those that would not. Committee members emphasised that this was a complex and challenging task that placed great responsibility on the financial institutions, but that no one was in a better position to take it on.

The FSN considered it highly likely that elevated unemployment and continued uncertainty due to the pandemic would affect households to an increasing degree, showing in factors such as private consumption patterns and increased arrears. The Committee was of the view that the banks' capacity to respond to deteriorating conditions was still sufficient, as their liquidity and capital positions were strong. If the situation persisted, however, further action could be needed in order to expand the financial institutions' scope for response.

Members considered it positive that premia on the large banks' foreign bond issues had been falling, in line with international trends. They considered it important that the banks should take advantage of their position to lengthen their current funding, thereby maintaining their net stable funding ratios (NSFR) in foreign currencies. In recent months it had been obvious how important it was for the banks to maintain ample foreign liquidity.

The Committee was of the view that the Central Bank's measures had supported asset markets, particularly the real estate market. There were signs that supply had declined in the real estate market, although the rental housing supply had increased, which should ease demand for purchased residential housing in the long run. The past several months had seen significant mortgage refinancing as interest rates had fallen. Indicators implied, however, that the refinancing wave had peaked. Committee members discussed the changed composition of household mortgages. Credit assessment data from the banks' new loans indicated a shift within the banking system, with mainly strong borrowers moving their business from pension funds to banks, and suggested that these borrowers could better tolerate fluctuations in debt service on non-indexed floating-rate loans. Committee members discussed the general pros and cons of various forms of mortgages and considered it positive that households should take advantage of the options available; however, they stressed the importance of carrying out credit assessments so as to ensure that borrowers had enough head room to respond to changed conditions.

The FSN discussed the foreign exchange market. Exports had contracted sharply, owing to the downturn in tourism, but this was offset somewhat by the strong contraction in imports, which stemmed in part from reduced overseas travel by Icelanders. In spite of outflows due to non-residents' securities sales and the pension funds' increased foreign currency purchases, the exchange rate had been rather stable. The Committee was of the opinion that the Central Bank's foreign currency sales played a role in deepening the market and improving price formation.

The FSN discussed the position of the pension funds and their impact on the financial market, noting that the pension funds were dominant investors in Iceland, making it important that there be broad-based consensus on their framework. The Committee was concerned about the funds' position in the current interest rate environment, which could prompt them to take increased risk in search of higher returns. The Committee agreed to continue its discussion of the pension funds at its next meeting.

Members also discussed the importance of a strong foundation for retail payment intermediation in Iceland, where system effectiveness was not dependent on decisions taken by foreign entities. It would be important to continue working on developing a domestic option for retail payment intermediation so as to ensure financial stability and national security.

Countercyclical capital buffer

In view of conditions in the economy and the fact that the pandemic was more persistent than previously hoped, the Committee was of the view that no new premises had emerged that would warrant deviating from its March 2020 decision to keep the countercyclical capital buffer unchanged until March 2021. There were no visible signs that cyclical systemic risk was on the rise again, and the FSN was of the opinion that the scope afforded by the reduction in the buffer needed to remain in place for a while to come.

The Governor proposed that the countercyclical capital buffer be held unchanged at 0%, in accordance with the Committee's March 2020 statement announcing that it would keep the buffer unchanged until at least March 2021. All Committee members voted in favour of the proposal.

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

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 Th. Thórarinsson wrote the minutes.

Central Bank to reduce one-month term deposit supply

The Central Bank has decided to reduce significantly its offerings of one-month term deposits. The next auction will be held on 1 April 2020. This decision has been made because of the radical changes that have occurred in domestic market conditions in a short period of time. It is foreseen that Treasury expenditure will increase in coming weeks and months, as will Treasury bond issuance. The Bank will continue to offer seven-day term deposits on a weekly basis. The Bank will also continue to ensure that term deposits can be used as payment system collateral.

No. 10/2020
27 March 2020

Agreement on guarantee of credit institutions' supplemental loans to businesses

The Ministry of Finance and Economic Affairs and the Central Bank of Iceland have signed an agreement laying down terms and conditions for Treasury guarantees of credit institutions' supplemental lending to businesses in response to the COVID-19 pandemic.

Because of the pandemic, many companies are facing temporary but severe declines in revenues, as well as liquidity problems. In view of this, Parliament authorised the Minister of Finance and Economic Affairs to grant Treasury guarantees covering a portion of supplemental loans provided to companies by credit institutions, subject to specified conditions. The Minister was authorised to negotiate an agreement with the Central Bank concerning the implementation of the guarantee scheme.

The aim of the scheme is to support companies that are severely affected by the spread of COVID-19 and the Government measures taken in response to it. The guarantees are an element in maintaining the highest employment level and the most diverse economy possible.

Each credit institution can access to a specific portion of the total guarantee amount. The supplemental loans must be granted before the end of 2020, and the maximum term is 18 months from the date of issuance. The guarantee on any individual supplemental loan will be capped at 70%. The amount loaned to any individual entity is subject to a maximum of two times the entity's year-2019 wage costs. Furthermore, the company's wage costs must constitute at least 25% of its total operating expenses for 2019. Moreover, the maximum amount of any single guaranteed loan is 1.2 b.kr.

The design of the scheme should be finalised shortly, after further refinements between the Central Bank and the credit institutions. When this is complete, credit institutions will be able to begin granting Treasury-guaranteed loans.

Press release no. 13/2020
17 April 2020

Support loan agreements signed

The Act on Financial Support for Small Businesses due to the COVID-19 Pandemic, no. 38/2020, of 20 May 2020, provides for a full or partial Treasury guarantee of support loans provided by credit institutions, subject to specified conditions. The above-mentioned Act authorises the Minister to negotiate an agreement with the Central Bank of Iceland, which will administer the guarantees, including their settlement, vis-à-vis the credit institutions. On 25 May 2020, the Minister of Finance and Economic Affairs and the Central Bank signed an agreement under which the Bank will handle the granting of Treasury guarantees vis-à-vis credit institutions in connection with COVID-19-related support loans to business operators. On 29 May 2020, the Ministry of Finance and Economic Affairs issued the Regulation on Support Loans, no. 534/2020.

On the basis of these, the Central Bank has signed agreements with Arion Bank, Kvika banki, Landsbankinn, and Íslandsbanki concerning Treasury-guaranteed support loans. The aim of the support loans is to maintain employment and economic activity by supporting small businesses that have suffered a temporary drop in revenues because of the COVID-19 pandemic and the associated public health measures. The agreements lay the groundwork for the implementation of the above-described pandemic response measure, subject to the conditions laid down in Act no. 38/2020, the agreement between the Ministry of Finance and Economic Affairs and the Central Bank, the Regulation on Support Loans, and the agreements between credit institutions and the Central Bank. Applications for support loans may be filed through the centralised service portal on the website island.is.

Press release no. 21/2020
24 June 2020

Special temporary collateralised lending framework for COVID support loans

As is mentioned in the Central Bank press release of 24 June 2020, the Bank will offer commercial banks and savings banks special collateralised loans bearing a 100% Treasury guarantee, in connection with COVID-related support loans. The collateralised loans will be offered beginning on 2 September 2020. Until another decision is forthcoming, these special collateralised loans will be offered by auction once a month, on the first Wednesday of each month.

The loans will be granted at the Central Bank's key interest rate, currently 1%, against collateral deemed eligible for Central Bank facilities at any given time. In accordance with the above, the Bank will temporarily update its list of securities eligible as collateral and will make temporary amendments to the Rules on Central Bank of Iceland Facilities for Financial Undertakings, no. 1200/2019.

Press release no. 27/2020
28 August 2020

New legislation on resolution procedures for credit institutions and investment firms

The Act on Recovery and Resolution of Credit Institutions and Investment Firms, no. 70/2020 (the Act is only in Icelandic), enters into force on 1 September 2020. The purpose of the new Act is to preserve financial stability and minimise the adverse implications of financial shocks by protecting insured deposits and investors, customers' assets and vital company operations, and minimising the risk that capital contributions from the Treasury will be needed.

According to the Act, the Central Bank of Iceland is entrusted with powers of resolution – i.e., administrative powers – to take action and prepare and execute resolution procedures for credit institutions and investment firms.

The provisions of the Act apply to credit institutions and large investment firms. At present, ten credit institutions in Iceland and no investment firms fall under the scope of the Act. The role of the resolution authorities is to assess the resolvability of these credit institutions and prepare recovery plans for credit institutions not subjected to conventional winding-up proceedings. In order to achieve the objectives of the Act, the Central Bank of Iceland is authorised to apply one or more clearly defined resolution measures, either singly or together. For example, the Bank will be authorised to establish a bridge institution that will take over the assets and/or liabilities of a credit institution in resolution proceedings, sell operations or operational units from a credit institution in resolution proceedings, and split up assets held by such an undertaking and transfer them to an asset management vehicle. In addition, the Central Bank of Iceland will be authorised to demand that a credit institution satisfy minimum requirements for own funds and eligible liabilities (MREL); i.e., to demand that the institution's capital and other funding be sufficient to recapitalise should it be subjected to resolution proceedings, through write-downs of subordinated debt.

The Central Bank's decisions on the basis of the Act will be taken with reference to the relevant credit institutions' recovery plans, which are currently in preparation. In connection with recovery plan preparation, the Central Bank will soon request data from credit institutions falling under the scope of the Act. This data collection will be part of the preparation for the Bank's decisions on institution-specific MRELs. In the future, credit institutions may be required to ensure that their market-based funding satisfies the Bank's MREL criteria in terms of form and amount.

A separate department, the Resolution Fund, has been established within the Depositors' and Investors' Guarantee Fund (DIGF). The Resolution Fund, which operates under the auspices of the Central Bank, is intended to finance resolution proceedings in accordance with recovery plans. The contribution to the Resolution Fund for 2020 has already been decided, with a transfer of 1.2 b.kr. from the Deposit Department of the DIGF. The same will be done in 2021, but thereafter, it is assumed that the fund will be financed with fees charged to credit institutions falling under the scope of the Act.

The passage of the new Act will incorporate the provisions of EU Directive 2014/59/EU, called the Bank Recovery and Resolution Directive (BRRD), into Icelandic law. Previously, Act no. 54/2018 amending the Act on Financial Undertakings, no. 161/2002, was passed in order to implement the BRRD provisions centring on recovery plans and timely intervention in case of shocks affecting financial institutions' operations.

The Central Bank of Iceland encourages financial undertakings, the Icelandic Financial Services Association, and other stakeholders to acquaint themselves thoroughly with the contents of the Act. Queries about the Act may be sent to skilavald@sedlabanki.is.

Press release no. 29/2020
1 September 2020

10 December 2020

Memorandum

To: Financial Stability Committee
From: Central Bank of Iceland

Re: **Financial market infrastructure**

According to Article 13 of the Act on the Central Bank of Iceland, no. 92/2019, one of the tasks of the Financial stability Committee is to decide which supervised entities, infrastructure, and markets shall be considered systemically important and of such a nature that their activities could affect financial stability.

The Central Bank's interbank payment system and the Icelandic branch of the Nasdaq CSD SE securities settlement system satisfy the general requirements laid down in international criteria and Icelandic law for designation as systemically important financial market infrastructure, including requirements concerning turnover, number of transactions, substitutability, and other factors. Both systems have recently been recognised pursuant to the Act on the Security of Transfer Orders in Payment Systems and Securities Settlement Systems, no. 90/1999.

About the Central Bank of Iceland interbank payment system

The Central Bank's new interbank system was launched on 26 October 2020. It supplanted the real-time gross settlement (RTGS) system and the netting system, both of which were recognised pursuant to the Act on the Security of Transfer Orders in Payment Systems and Securities Settlement Systems, no. 90/1999. In 2015, the Financial Stability Council decided to classify the two systems as systemically important financial market infrastructure. Concurrent with the launch of the new interbank system, the Central Bank recommended to the Minister of Ministry of Finance and Economic Affairs that the system be recognised pursuant to the Act, as it satisfied the requirements laid down therein. The Minister accepted the Central Bank's recommendation and has notified the system to the EFTA Surveillance Authority (ESA) and the European Securities and Markets Authority (ESMA), as is provided for in the Act.

The interbank system is a standardised one already in use by the Nordic central banks, with the exception that the retail netting part of the system is a new, specially developed solution that can handle the same real-time payment intermediation previously offered by Iceland's legacy netting system. The interbank system has two components: the real-time gross settlement component, for large-value payments of 10 m.kr. or more; and the retail component, for payments of less than 10 m.kr. The retail component of the system is open year-round, 24 hours a day.

The two-component system is the largest and most important payment system in Iceland. All financial institutions must be interbank system participants, either directly or indirectly, in order to function in the Icelandic financial market. Final settlement of securities transactions (i.e., financial transfers in securities settlement systems) takes place in the interbank system. The Central Bank uses the interbank system in monetary policy conduct, as a channel for interest rate decisions and, if applicable, loans of last resort.

About the Nasdaq CSD SE securities settlement system

The Nasdaq CSD SE securities settlement system was licensed in autumn 2017 by the Latvian Financial and Capital Market Commission, on the basis of Regulation (EU) no. 909/2014 of the European Parliament and of the Council on improving securities settlement in the European Union and on central securities depositories (CSDR), The CSDR was incorporated into Icelandic law with the passage of the Act on Central Securities Depositories and Settlement and Electronic Registration of Financial Instruments, no. 7/2020, which entered into force on 6 February 2020.

On 20 May 2020, the Latvian Financial and Capital Market Commission granted Nasdaq CSD SE a licence to operate a branch in Iceland, in accordance with Article 19 of the CSDR. With a cross-border merger on 25 May 2020, Nasdaq CSD Iceland hf. and Nasdaq CSD SE merged their operations, and the activities of Nasdaq CSD Iceland were transferred to the Icelandic branch of Nasdaq CSD SE. Nasdaq CSD SE is subject to supervision by the Latvian Financial and Capital Market Commission in cooperation with the Central Bank of Iceland Financial Supervisory Authority, in accordance with the provisions of the CSDR.

On 25 August 2020, Nasdaq CSD SE launched a new securities settlement system for its Iceland operations. The new system, which was already in use in Estonia, Latvia, and Lithuania, supplanted Nasdaq CSD Iceland hf.'s legacy system, which was designated as systemically important financial market infrastructure by the Financial Stability Council in 2015. Nasdaq CSD SE's system is based on the company's rules and is subject to the requirements laid down in the CSDR, the Act on Central Securities Depositories and Settlement and Electronic Registration of Financial Instruments, no. 7/2020, and other regulatory instruments. It is the only securities settlement system in operation in Iceland.

Central Bank lengthens adaptation period for minimum liquidity ratio in Icelandic krónur by one year

Rules no. 1399/2020 amending the Rules on Credit Institutions' Liquidity Ratios, no. 266/2017, with subsequent amendments, were published today in the Law and Ministerial Gazette [Stjórnartíðindi]. With this amendment, the grace period previously granted to credit institutions to adapt to the required minimum liquidity ratio in Icelandic krónur has been lengthened by one year.

Amendments to the Rules on Credit Institutions' Liquidity Ratios, no. 266/2017, requiring an additional minimum liquidity ratio in Icelandic krónur of 50%, took effect on 1 January 2020. The minimum requirement took effect at the time the Rules took effect, but credit institutions were granted a two-year adaptation period. When the Rules took effect, the ratio was 30%. It was scheduled to rise to 40% on 1 January 2021 and 50% on 1 January 2022. The Bank has now decided to extend the adaptation period by one year; i.e., the minimum liquidity ratio in Icelandic krónur will remain 30% through the end of 2021. It will then rise to 40% on 1 January 2022 and 50% on 1 January 2023. Liquidity ratios for all currencies combined and for all foreign currencies combined are unchanged at 100%.

The extension of the adaptation period for the minimum liquidity ratio in Icelandic krónur is in accordance with the Bank's statements concerning facilitating credit institutions' access to króna-denominated liquidity and using the scope provided for in the Rules where possible and appropriate. The Rules also state that, in general, credit institutions shall manage the currency composition of their liquid assets to correspond to their outflows. However, in view of the economic uncertainty still prevailing as a result of the COVID-19 pandemic, the Bank considers it desirable that credit institutions should have greater short-term flexibility in managing the currency composition of their liquid assets with respect to their króna-denominated liquidity position. As is stated above, no changes are made to the requirement that credit institutions hold liquid assets to cover short-term liabilities in all currencies combined. At present, the banks have strong liquidity ratios and an ample liquidity position; therefore, they have the capacity to support the economy during the current downturn by granting loans to businesses and households.

The text of Rules no. 1399/2020 amending the Rules on Credit Institutions' Liquidity Ratios, no. 266/2017, with subsequent amendments can be found at the Ministerial Gazette website (in Icelandic).

SEÐLABANKI ÍSLANDS