CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2022

DECEMBER
15th meeting
Published 4 January 2023

Minutes of the Central Bank of Iceland Financial Stability Committee meeting

December 2022 (15th meeting)

Published: 4 January 2023

The Financial Stability Committee (FSN) of the Central Bank of Iceland takes decisions on the application of the Bank's financial stability policy instruments. Financial stability means that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risk appropriately. The Committee is tasked with assessing the current situation and outlook for the financial system, systemic risk, and financial stability; defining the measures necessary to ensure financial stability; and deciding which entities, infrastructure elements, or markets shall be considered systemically important. When warranted, the FSN may direct recommendations to the appropriate Governmental authorities concerning the measures needed to strengthen and preserve financial stability. In general, the Committee publishes the minutes of its meetings within four weeks of the meeting concerned. The minutes include information on the Committee's decisions, the rationale on which they are based, and the assessment of financial stability.

At the meeting of 1 and 5-6 December 2022, presentations were given on economic developments and prospects and the state of the financial system and payment intermediation infrastructure. The Committee discussed the current situation and outlook for financial stability and the principal risks to financial stability, such as economic developments, risks in the operations of financial institutions and the financial system, developments in domestic financial markets, household and corporate debt, the real estate market, the efficacy of borrower-based measures, financial institutions' capital position, and the financial cycle. The Committee also discussed the security, efficiency, and efficacy of financial market infrastructure and its importance for financial system stability. The Committee received information on pension funds' investment strategies, asset composition, and returns, as well as a presentation on matters relating to the ÍL Fund. The Bank's assessment and analysis of climate risk scenarios was also presented to the Committee.

The FSN completed its annual assessment to identify systemically important financial institutions and determine the capital buffer for systemic importance (O-SII buffer). It confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. The Committee also decided to hold the O-SII buffer rate unchanged at 2% for all exposures. The Committee also received information on the Governor's key decisions in matters pertaining to the Resolution Authority and related statutory amendments.

In its quarterly review of the countercyclical capital buffer (CCyB), the FSN decided to hold the buffer rate unchanged at 2%.

The FSN also reiterated the importance of continuing the ongoing work relating to a domestic retail payment solution, with the aim of enhancing the security of domestic payment intermediation.

Analysis of financial stability

Global GDP growth had slowed still further, and the economic outlook for Iceland's main trading partners had worsened since the Committee's September meeting. Trading partner inflation had risen, and the monetary and macroprudential stance had been tightened in many economies. Real estate prices had fallen in many trading partner countries, and household purchasing power was on the decline; therefore, risk relating to financial stability had increased. On the other hand, indicators implied that inflation had peaked in the US, and share prices in foreign markets had begun to rise. The global economic outlook remained highly uncertain, and developments abroad could adversely affect the Icelandic economy in the coming term.

In the FSN's opinion, the systemically important banks were highly resilient. Imbalances in the housing market had receded and private sector arrears were at a historical low; furthermore, the household debt-to-income ratio had not risen during the pandemic. The overall financial position of Icelandic households and firms was therefore good, and the application of macroprudential tools had supported financial stability in the wake of the pandemic. The Bank's November forecast assumes that GDP growth will be stronger than previously estimated, driven in particular by robust private consumption, which has, among other things, given rise to the expectation of a current account deficit measuring 2% in 2022 and widening over the course of the forecast horizon. The FSN was of the view that the current account deficit, poorer funding terms, and cybersecurity posed the main risks to financial stability. Furthermore, the Committee is of the opinion that stagnation or a correction of house prices is still quite likely.

Banking system resilience

In the FSN's opinion, the domestic systemically important banks (D-SIB) are highly resilient. Their capital and liquidity are above regulatory thresholds. The banks' liquidity had grown stronger between meetings, owing to an increase in term deposits and foreign bond issues, and was nearly 300 b.kr. above the regulatory minimum at the end of October. Foreign funding conditions had deteriorated, however, and credit spreads on the banks' foreign-denominated bonds had risen. There were no remaining foreign-denominated bond maturities for the rest of the year, while year-2023 maturities totalled 126 b.kr. (just over 160 b.kr. if call-in provisions are exercised). Domestic bond issuance had been limited during the year, and net covered bond issuance in krónur had been negative in 2022 to date. The D-SIBs' capital ratio lay between 21.4% and 24.2% at the end of September, or 1.5-3.4 percentage points above the Central Bank minimum. It had fallen by 2.5 percentage points thus far in 2022, primarily because of dividend payments, but also due to share buybacks.

The D-SIBs' operations were favourable in the first nine months of the year, with a return on equity of 10.3%, which is 2.2 percentage points less than for the same period in 2021. Interest income and fees and commissions increased by a fifth year-on-year, to an all-time high of 124 b.kr. for the first nine months of 2022, partly because of balance sheet expansion and a widening interest rate spread in line with rising interest rates. The D-SIBs' net income from financial activities was negative by 12 b.kr. over this period, in a marked year-on-year change driven mainly by the fall in share prices. Total income over the first nine months therefore declined year-on-year, although operating expenses have fallen as well.

Household arrears had continued to fall, to a post-crisis low of 0.7% at the end of September. Corporate arrears had declined as well, and companies that had needed forbearance measures because of the pandemic have grown considerably stronger in the recent term. A large share of the companies with forborne loans had already begun to make payments on them, and the banks expect that by the turn of the year, or thereabouts, a large share of these loans will no longer be classified as forborne.

Private sector debt

Growth in household debt measured 9.6% in nominal terms in Q3/2022, or 0.2% in inflation-adjusted terms. Price indexation on indexed loans explains just under half of the nominal growth rate. Higher interest rates and tighter borrower-based measures had dampened demand for mortgage loans, and growth in net new mortgage lending was broadly similar to the pre-pandemic rate. The pension funds have increased their share of the mortgage lending market once again, and household demand for indexed loans has grown. Even so, the majority of net new mortgage loans were non-indexed.

The average loan-to-value (LTV) ratio on new mortgage loans had fallen, both overall and for first-time buyers, and the share of issued loans with a high LTV ratio had fallen as well. The average debt service-to-income (DSTI) ratio had been broadly stable overall but had been rising among first-time buyers, in line with rising mortgage lending rates. New rules on debt service calculation took effect this past summer, and the first data suggest that they played a part in slowing down [growth in] debt, as was intended.

Households were generally well positioned, unemployment was low, and wages had risen markedly in recent years, although real disposable income had contracted in H2/2022. Furthermore, GDP growth was strong, and the ratio of household debt to disposable income was low in both historical and international context. Debt service had increased in line with rising interest rates, particularly on non-indexed loans, which constituted just over half of total household debt. About 27% of consumer mortgages were non-indexed variable-rate loans, and the weighted average rate on such loans had risen to 8% by October. Higher interest rates could have some impact on households, but the FSN did not consider it likely that arrears would increase substantially, as households should be able to refinance their mortgages to lighten their debt service burden if the need arises.

Real growth in corporate debt was negative for the eighth quarter in a row, by 2.5% at the end of Q3. Corporate debt measured 80.5% of GDP, its lowest since 1998. Nevertheless, nominal growth in the D-SIBs' corporate lending had gained pace over the course of the year, particularly in lending to construction and services firms. Corporate bond issues and alternative investment fund lending to companies had grown modestly year-on-year.

Asset prices

Real estate market activity had subsided and tensions in the market had eased. Turnover was broadly back to the pre-pandemic level in real terms, but slightly below the average for the past five years. The number of properties advertised for sale had increased, and newly constructed homes were flowing steadily into the market. The year-on-year increase in house prices had therefore continued to lose pace, to 21.5% in nominal terms and 11% in real terms as of October. The Committee noted that it would take time for reduced housing market activity to show fully in house prices. The house price index was calculated based on the past three months' purchase contracts and was not quality-adjusted. The deviation of house prices from their long-term trend had narrowed slightly in recent months. Furthermore, the deviation of prices from building costs and rent prices appeared to have peaked. The FSN was of the view that tighter borrower-based measures and their interaction with higher interest rates would reduce demand pressures in the market. In the Committee's opinion, systemic risk in the housing market was still moderate.

The price of listed Icelandic companies' shares had risen between meetings, in keeping with the pattern seen widely abroad. The OMXI10 index had risen by 6% since the Committee's last meeting, and by just over 25% year-to-date. Equity market turnover on the exchange had increased by 7% over the same period. Nominal Treasury bond yields had risen since end-September, in tandem with Central

Bank interest rate hikes. There was little difference between long- and short-term yields, which could indicate that market agents do not expect interest rates to rise further.

Exchange rate of the króna

The króna had depreciated by 5.5% since the Committee's September meeting, mainly because of the sizeable deficit on goods trade, although the banks' forward currency position had declined by a total of 46 b.kr. in September and October, presumably due to changed expectations about the exchange rate. The Central Bank intervened three times in the interbank foreign exchange market in November, selling currency for just under 5 b.kr. The D-SIBs' foreign exchange balance held unchanged between meetings and was in equilibrium; i.e., the banks' foreign-denominated assets equalled their foreign-denominated liabilities.

The current account deficit for the first three quarters of 2022 totalled 65 b.kr. The tourism sector experienced a rebound, but the goods account deficit had widened over the course of the year. Preliminary goods trade figures suggest that the Q4 deficit on goods trade will be Iceland's largest single-quarter deficit relative to GDP since 2008. A continuing current account deficit could lead to a further depreciation of the króna.

The pension funds had stepped up their foreign currency purchases in recent months, and their average turnover in autumn 2022 was similar to that in 2019. Closer scrutiny of the pension funds' day-to-day foreign currency transactions shows that the funds primarily bought currency when the króna was appreciating within the month, indicating that they buy currency mainly when there is a surfeit in the market, thereby mitigating volatility. Capital flows due to inward foreign investment were positive by 68 b.kr. over the first ten months of the year and had been affected by several large foreign direct investments undertaken in recent months.

The financial cycle and cyclical systemic risk

A composite measure of financial cycles indicated an average level of cyclical systemic risk at present, although risk had increased marginally since the FSN's last meeting. The financial cycle had been driven by the housing cycle, owing to the steep rise in house prices in the recent term. The composite domestic systemic risk indicator (d-SRI) signalled that cyclical systemic risk was close to its average. It had fallen marginally for three consecutive quarters, particularly because the banks' private sector lending growth had not kept pace with GDP.

Pension funds and the ÍL Fund

The Committee was given a presentation on the pension funds' 2023 investment strategies, asset composition, and returns. After having generated annual real returns of close to 10% in 2019-2021, the outlook is for their mutual pension divisions to record negative returns in 2022, owing mainly to falling share prices.

The funds' investment strategies show that they have differing asset composition targets for the coming year, particularly as regards investments in Treasury bonds and foreign assets. The strategies take account of future payment flows, the economic outlook, risk appetite, and risk tolerance. The funds aim to increase their share of foreign assets by 3½ percentage points relative to total assets in 2023 but reduce the weight of Treasury bills and bonds. This reflects the impact of the Ministry of Finance and Economic Affairs' announcement of its intention to assess the future of the ÍL Fund and look for ways to wind it up. The deviation band in the pension funds' 2023 investment strategy is therefore wider for Treasury securities because of uncertainty about the fate of the ÍL Fund. The FSN was also given a presentation on the Ministry of Finance and Economic Affairs' report on the fund, which was introduced before Parliament, and discussed the potential impact on the pension funds.

Climate risk

Central banks have placed increased focus on analysing the risks associated with climate change, which has begun to have a direct impact on central banks' and financial supervisors' policy-making. This applies both to growing risk of climate-related events – for instance, increased risk of flooding and its impact on financial system loan quality – and the risk associated with governments' adaptation measures – i.e., incentives for energy transition and their impact on funding. Calls on central banks to assess the effects of climate risk on financial stability and to monitor this risk have therefore become firmer. The Central Bank of Iceland has participated actively in the work of the Network for Greening the Financial System (NGFS), an international network of central banks and financial supervisors, in the past two years.

The FSN was given a presentation on the work currently underway within the Central Bank on climate-related scenario analysis. The Bank plans to carry out a scenario analysis of the three systemically important banks' credit risk and publish the initial findings in the coming year. The scenario analysis will be based on NGFS scenarios, Central Bank data, and other data and models, as applicable.

Resolvability of systemically important financial institutions

The Resolution Authority presented the Governor's key decisions in matters relating to its activities since the last presentation to the FSN. Resolution plans for the D-SIBs have been completed and approved. Furthermore, Act no. 48/2022 has entered into force. The Act centres on funding for the Resolution Fund, among other things. Moreover, a new definition of eligible liabilities (for MREL) took effect upon the entry into force of CRR II. In addition, the principal regulatory amendments that lie ahead were presented, particularly those pertaining to the implementation of BRRD II.

Decisions of the Financial Stability Committee

Countercyclical capital buffer

The main purpose of the countercyclical capital buffer (CCyB) is to enhance financial institutions' resilience against cyclical systemic risk, thereby providing them with the scope to absorb losses and maintain the supply of credit during periods of stress.

Indicators of the cyclical systemic risk level suggest that it is close to the average of recent years. Loan quality has generally improved and arrears have fallen for both households and businesses. Household indebtedness was very modest relative to disposable income, and the private sector debt level was low in historical context and lower than in neighbouring countries. FSN members agreed that the banking system was on a solid footing. It appeared sufficiently resilient in terms of systemic risk, and capital and liquidity ratios were well above statutory minima. Based on financial institutions' position and the current risk level, it can be concluded that the countercyclical capital buffer (CCyB) is at an appropriate level.

The Committee discussed uncertainty in the markets and the rise in funding costs. The banking system's market funding had therefore become costlier than before. FSN members agreed that banking system liquidity and funding should be closely monitored.

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

Systemically important financial institutions

The assessment of the systemically important financial institutions, based on European Banking Authority (EBA) methodology, was presented to the Committee. Underlying the assessment are indicators pertaining to size, importance, complexity, and interconnectedness. The Committee then discussed systemically important financial institutions in the Nordic region. Concentration among financial institutions was greater in Iceland and Finland than in the other Nordic countries, while institutions in the region ranged in size from 4% to 234% of GDP, and from 2% to 68% of the domestic banking system. FSN members agreed that the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn should be confirmed. The Governor presented a proposal to this effect, and it was approved unanimously.

Capital buffer for systemic importance

The capital buffer for systemic importance (O-SII buffer), activated in 2016, is imposed on financial institutions that, because of their size and the nature of their activities, can have a substantial negative impact on financial stability and the real economy if they are failing or likely to fail. The risk addressed with the O-SII buffer is therefore inelastic. The Governor proposed that the O-SII buffer be held unchanged at 2% on all exposures at the parent company level and on a consolidated basis. The proposal was approved unanimously. The combined capital buffers on Iceland's systemically important banks equal 9.5% following the increase in the CCyB at the end of September 2022. They are the highest in the Nordic-Baltic region apart from Norway, where they range from 9.5% to 10.5%.

Financial market infrastructure

One of the Central Bank of Iceland's principal roles is to promote a safe and effective financial system, including domestic and cross-border payment intermediation. Work on strengthening Iceland's financial market infrastructure is ongoing, including the implementation of an Icelandic rulebook based on European standards from the European Payments Council (EPC), which will foster operational security and greater consistency in the execution and settlement of payments in deposit and interbank accounts in the financial system.

The Central Bank plays a key role in domestic payment intermediation as the owner and operator of the Icelandic deposit institutions' interbank system, which is the foundation for payments between accounts with domestic deposit institutions. Retail payment intermediation in Iceland is characterised by widespread use of payment cards, which rely on foreign infrastructure owned by international payment card conglomerates. Because over 90% of all retail payments are routed through this infrastructure, it is vital to find ways to boost system resilience and satisfy the requirements of the National Security Council. The FSN was of the opinion that doing so would enhance security relating to domestic retail payment intermediation, particularly as regards cybersecurity and business continuity. The Committee was informed that the Central Bank's Forum for the Future, which includes representatives from domestic deposit institutions, the Ministry of Finance and Economic Affairs, and the Bank, will soon discuss and decide on proposals for the next steps towards implementing a domestic retail payment solution.

The Committee was given a presentation on risk indicators from the Bank's interbank system. The interbank system has operated smoothly, and no serious incidents have been recorded in 2022. A review was conducted of the commercial banks' turnover, payments between the banks, and which banks conduct the most transactions with the Central Bank. The banks' intraday settlement time is in good order, with around 70% of all transactions (in terms of amount) typically completed around noon.

The FSN also received a presentation on turnover among entities licensed to operate as virtual currency providers.

It was noted in discussions that the Central Bank had broad authorisations to set policy and adopt rules on financial market infrastructure. The Bank could impose certain basic security requirements in order to guarantee the security of the infrastructure for payment intermediation. There was a need to continue exploring and assessing whether the statutory framework for financial market infrastructure should be strengthened and the Central Bank's power to set rules in this area augmented, particularly as regards important and systemically important entities and infrastructure. As before, the Committee agreed on the importance of bolstering security in domestic payment intermediation so as to guarantee business continuity, partly in view of growing cyberthreats.

At the end of the meeting, the Committee approved the statement for publication on the morning of 7 December 2022.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Unnur Gunnarsdóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Gudrún Thorleifsdóttir, Director General at the Ministry of Finance and Economic Affairs, attended the meeting, with the right to address the meeting and present proposals.

Haukur C. Benediktsson, Director of the Bank's Financial Stability Department; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; and Rannveig Júníusdóttir, Director of the Bank's General Secretariat were present for the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.