



1 December 2022

## Memorandum

*To:* Financial Stability Committee

*From:* Central Bank of Iceland

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

The Central Bank of Iceland Financial Stability Committee's (FSN) decision from 29 September 2021 to increase the countercyclical capital buffer (CCyB) on financial institutions from 0% to 2% took effect on 29 September 2022. The increase was based on the Committee's assessment that cyclical systemic risk was at least at the level seen before the spread of the pandemic, as asset prices had risen rapidly alongside an increase in household debt. The CCyB requirement is now at the same level as it was when the pandemic began to spread in Iceland. Increased capital strengthens financial system resilience and better enables the system to withstand financial shocks. Raising the CCyB gives the FSN the scope to lower it again later if warranted.

The economy rebounded successfully after the pandemic, and strong GDP growth in 2022 has been driven by rising private consumption and favourable developments in the tourism industry. The global output growth outlook has deteriorated, however, and global risks are at an unusually high level. Inflation has risen steeply in all of Iceland's main trading partner countries, and the monetary stance has been tightened. Furthermore, risk has accumulated in trading partner countries in recent years, owing to increasing debt levels and rising asset prices. Adverse developments in global markets could affect financial stability in Iceland, and worsening financial conditions abroad have already tightened Icelandic financial institutions' access to foreign credit markets.

### **Private sector debt**

Twelve-month real growth in household debt measured 0.2% at the end of September, as compared with 5.1% at the beginning of the year. Nominal growth in debt is still relatively strong, however, at 9.6% in September, after having fallen slightly in the past twelve months. A rising share of nominal growth is due to indexation on index-linked loans, which account for just under half of household debt. The pace of new lending is now similar to that seen before the pandemic, and the

credit system's net new mortgage lending to households has developed broadly in line with housing market turnover.

With rising nominal interest rates, debt service on new loans and existing variable-rate loans has increased, particularly on non-indexed loans. This reduces demand for credit. Rules on borrower-based measures, which entailed caps on loan-to-value (LTV) and debt service-to-income (DSTI) ratios, were also tightened in response to rapidly rising house prices and deteriorating loan quality. This is offset by the fact that in spite of rising nominal interest rates, higher inflation means that real rates on new non-indexed mortgage loans are still negative. Furthermore, real rates on indexed mortgages are historically low. Low or negative real rates are therefore still driving demand for new mortgages, while the borrower-based measures provide some counterweight. Household demand for indexed loans has grown in recent months, as these loans generally have a lower debt service burden in the early part of the loan period than comparable non-indexed loans do. In August, net new indexed lending to households was positive within the month for the first time since before the pandemic. Even so, the majority of net new mortgage loans issued in September were non-indexed.

Household debt came to 79.9% of GDP and 150.4% of disposable income at the end of September. Both of these ratios have been falling since mid-2021, although the debt-to-GDP ratio has fallen slightly more, partly because of strong GDP growth during the period.

By the end of September 2022, corporate debt had fallen in real terms by 1.3% year-on-year. In price- and exchange rate-adjusted terms, it had grown by 6%. Corporate credit growth has gathered pace during the year. This is due mainly to an increase in the commercial banks' corporate lending. Cumulative net new loans to companies in the first ten months of 2022 totalled just over 257 b.kr., a substantial increase relative to previous years. If lending continues to grow at this pace, growth in corporate debt will keep increasing in coming months, all else being equal.

Arrears on loans from the systemically important banks to individuals and businesses are historically low. The non-performing loan (NPL) ratio on loans to individuals is still falling, measuring 0.75% at the end of Q3/2022. Just over 0.8% of household loans were frozen in October. The corporate NPL ratio was 2.4% in Q3, after falling by nearly half a percentage point between quarters. As before, arrears are greatest among companies in the hospitality industry, at 7.2%, although the ratio fell by 1.5 percentage points quarter-on-quarter. The share of frozen corporate loans was 7.4% at the end of October and is also declining.

## **Real estate market**

The rise in house prices has eased in recent months. In October 2022, the capital area house price index had risen by 11.1% year-on-year in real terms, as compared with 15.3% in May. The same trend has been seen in regional Iceland, where the year-on-year increase also measured 11.1% in October. Housing market turnover has continued to contract in recent months and, in real terms, is now broadly similar to the level seen during the years preceding the pandemic. Furthermore, the number of flats available for sale has risen, and the average time-to-sale has grown longer.

The ratio of house prices to fundamentals is still very high, however. As of October, the ratio of the capital area house price index to the general wage index had risen by 12.6% year-on-year, and the ratio of the house price index to the rent price index had risen by 14.4%. The ratio vis-à-vis the building cost index had risen by 9.4% over the same period. The rise in house prices over and above fundamentals indicates significant imbalances in the housing market and the associated systemic risk. Indicators suggest, however, that imbalances are no longer accumulating. In June 2021, the FSN lowered the maximum loan-to-value (LTV) ratio on consumer mortgages, and in September 2021 it adopted rules capping debt service-to-income (DSTI) ratios, which took effect on 1 December 2021. In June 2022, the Committee lowered the maximum LTV ratio for first-time buyers and tightened the rules on DSTI ratios by introducing a minimum interest rate into the calculation of the ratio. These measures, together with interest rate hikes, have affected demand in the housing market. This is reflected in weaker lending growth and slightly improved overall loan quality of new mortgages in recent months. First-time buyers are still taking on increased risk, however, as the borrower-based measures are less stringent for them than for other buyers.

Turnover in registered commercial real estate (CRE) purchase agreements increased in real terms by more than one-fifth year-on-year in Q1/2022 and was high in historical context. The large CRE firms' operations have been quite successful recently, although rising interest rates negatively affected their operating results in Q3. Returns on investment assets measured a historically high 5.5% during the quarter. Positive valuation adjustments of investment assets are still a large item in the companies' operations, however, although increased financing costs in the assessment of fair value have counteracted this trend recently. The companies' equity ratios and LTV ratios have been broadly unchanged over the past twelve months. However, their liquidity has deteriorated in 2022 to date, their combined interest coverage ratio has fallen due to increased indexation on their debt, and large long-term loan maturities in the coming twelve months have lowered their current ratios and cash flow ratios. Nevertheless, they have scope for refinancing, owing to ample collateral capacity.

## **The banks**

The banks' interest rate spreads had widened year-on-year in Q3, in line with the increase in the Central Bank's key rate. High interest rates, inflation, and credit growth in the recent term have strengthened the return on their core operations, which measured 15% in Q3, as opposed to 11.3% at year-end 2021. The return on core operations, which is based on interest income and fees and commissions, is the banks' first line of defence against a drop in the capital ratio due to loan losses and other shocks to their operations.

By now, the banks have reversed a large share of the precautionary contributions they made to their impairment accounts because of the pandemic. The impairment of their loan portfolios is based on expected future losses and recoveries. The cross-default non-performing ratio on the banks' loans to customers was 4.8% in October, as compared with 9% a year earlier.<sup>1</sup> The facility-level non-performing loan ratio on their loans to customers was only 1.3% and had fallen by nearly a percentage point between years.<sup>2</sup> Tourism companies' position has strengthened with the rise in foreign visitor numbers, and the total for this year is expected to be on a par with that in 2016. Uncertainty in the sector has increased somewhat, however, partly because of adverse economic developments in key trading partner countries, which could cut into demand for tourism services further ahead. Pulling in the opposite direction are a weaker króna and lower oil prices.

Because of adverse developments in foreign markets and growing uncertainty, conditions in capital markets have deteriorated. The banks' access to foreign credit has grown tighter, and credit spreads on their foreign-denominated bonds have risen rapidly. There are no remaining foreign maturities in 2022, and year-2023 maturities total 120 b.kr. If conditions remain challenging, the banks could end up taking on additional risk in connection with funding.

The systemically important banks' capital ratio was 22.8% at the end of Q3, or 1.9 percentage points lower than at the same time in 2021. Following the increase in the CCyB to 2%, the banks' capital ratios are 1.5-3.5% above the overall required ratio.

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

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<sup>1</sup> 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.

<sup>2</sup> The facility-level non-performing loan ratio is calculated in accordance with EBA standards.

Private sector credit growth has been relatively modest in the recent past. Developments continue to diverge between households and businesses, however. Corporate credit growth has picked up somewhat, while household credit growth has lost pace. The debt-to-GDP ratio is now slightly higher than before the pandemic, after surging in 2020, mainly because of the contraction in GDP. It then fell once again, primarily because GDP began growing swiftly. It is expected to keep declining if credit growth remains moderate.<sup>3</sup>

The combined effects of higher interest rates and tighter borrower-based measures have contained the rise in house prices. It is likely that house price inflation has peaked, and indicators imply that imbalances are no longer accumulating. Significant imbalances remain, however, and there is some likelihood of a correction in prices.

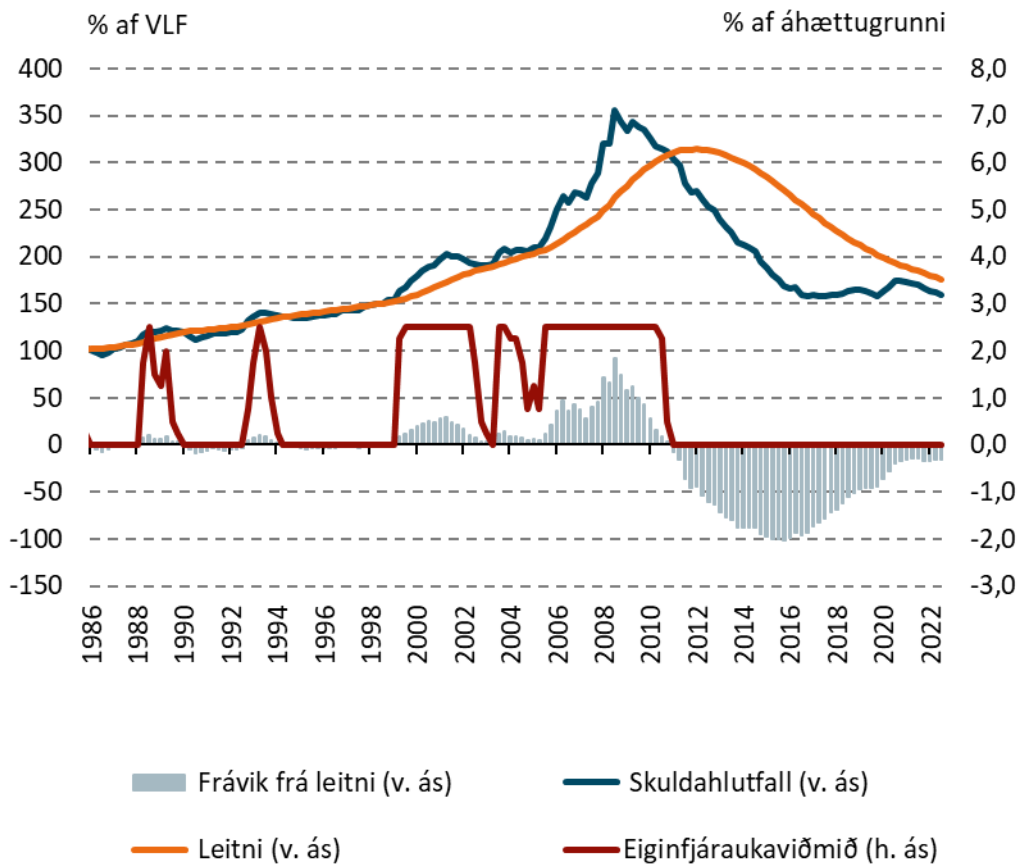
The statistical presentation of the financial cycle indicated that the financial cycle was still rising in Q3. The upward cycle is driven by fluctuations in house prices and the debt cycle, although it is offset by the fact that the debt cycle is still at a low position. The domestic systemic risk indicator (d-SRI) has been falling this year and is now just above its average. The decline is driven by the fall in the private sector debt-to-GDP ratio.

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<sup>3</sup> The ratio of private sector debt – i.e., households and non-financial companies – to GDP.

## Appendix – Charts

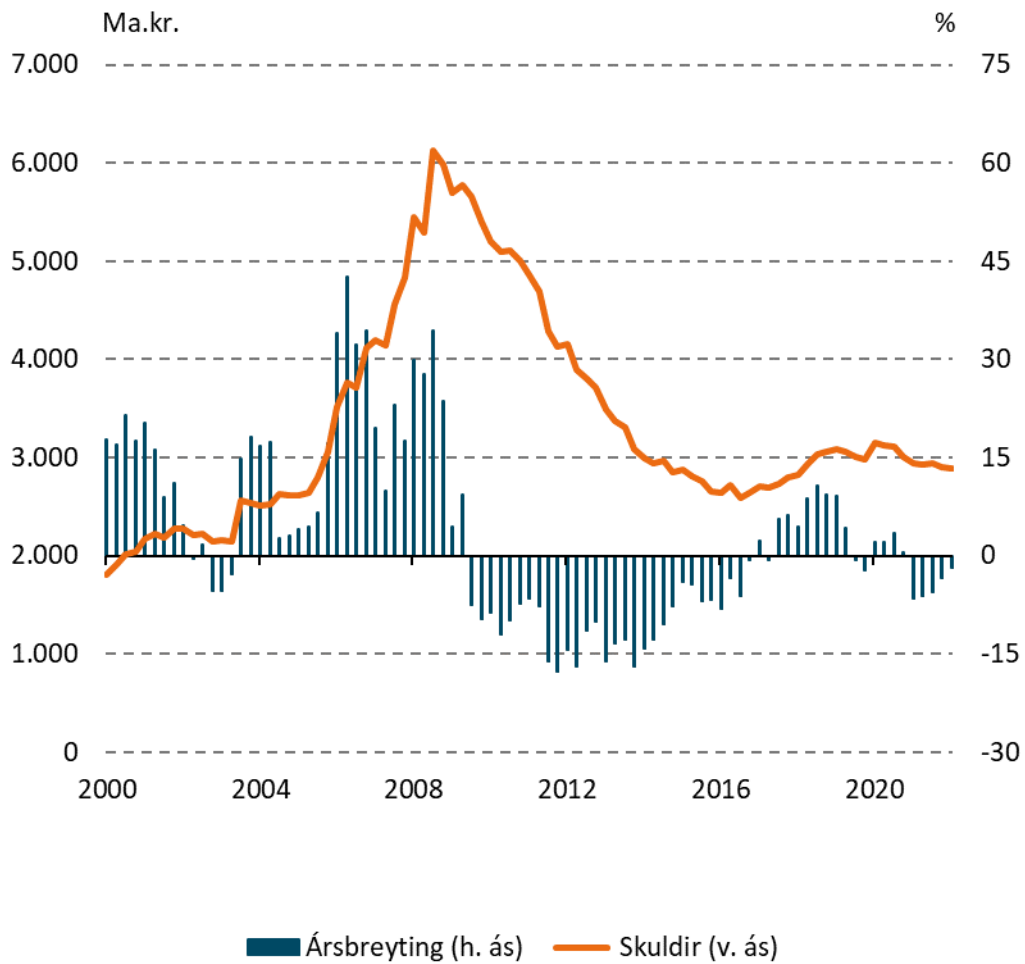
### Skuldahlutfall, frávik frá leitni og eiginfjárukaviðmið<sup>1</sup>



1. Heildarskuldir heimila og fyrirtækja að kröfuvirði, í hlutfalli við verga landsframleiðslu síðustu fjögurra ársfjórðunga. Leitni er fundin með einhliða HP-síu með sléttunarstikann  $\lambda=400.000$ .

Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

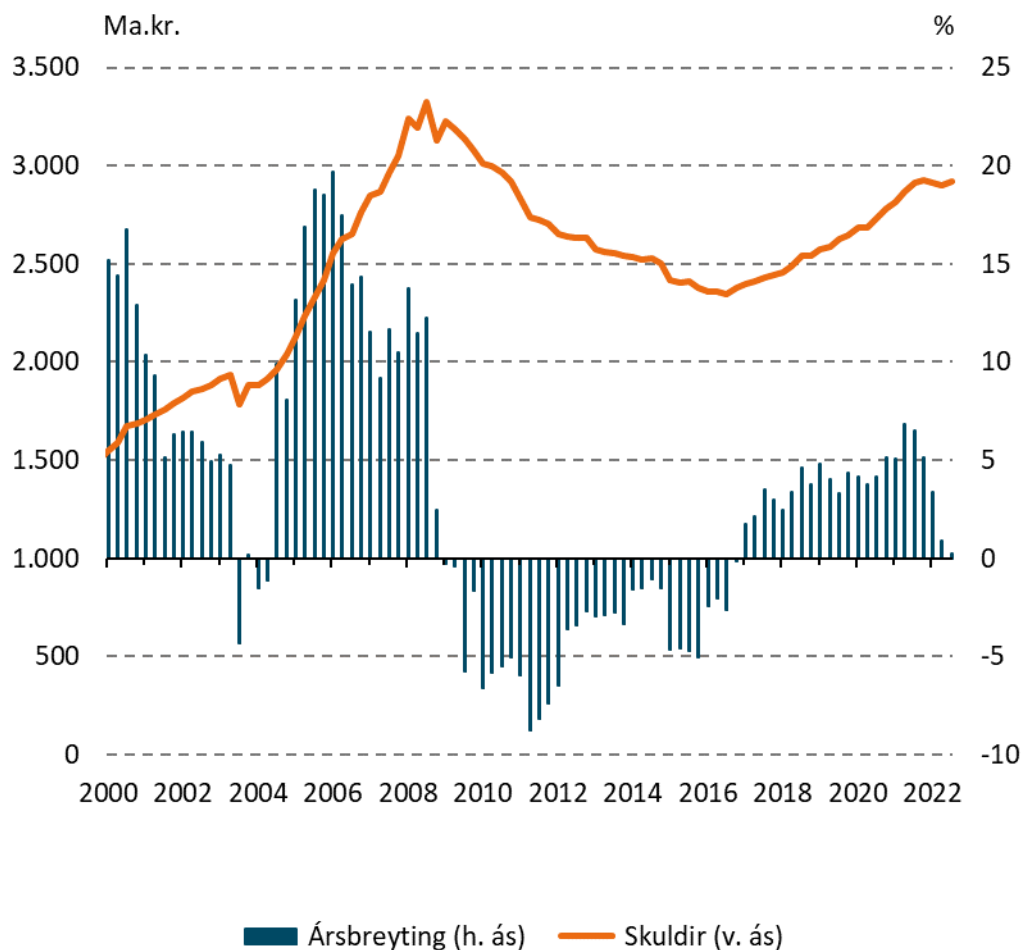
## Raunvirði skulda fyrirtækja



Skuldir fyrirtækja að kröfuvirði, á verðlagi nýjustu mælingar. Raunvirtar með vísitölu neysluverðs.

Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

## Raunvirði skulda heimila

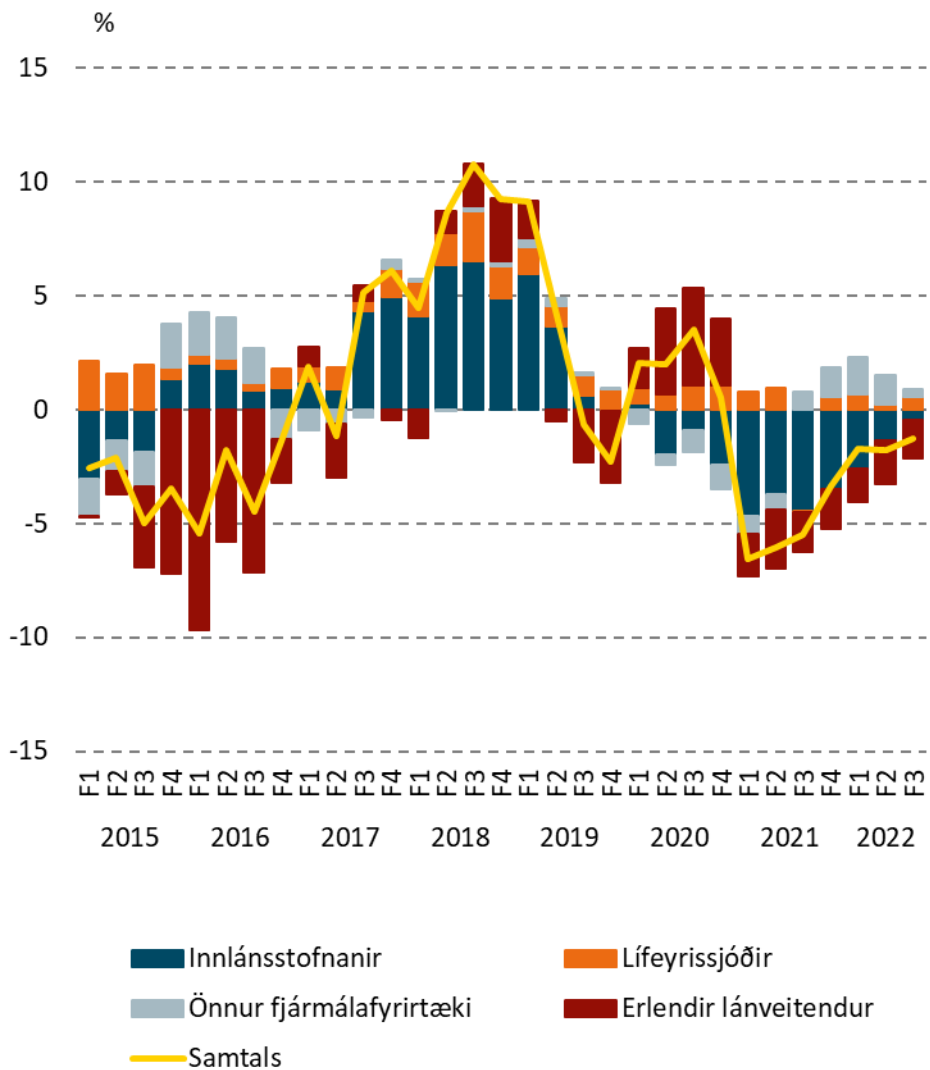


Skuldir heimila að kröfuvirði, á verðlagi nýjustu mælingar. Raunvirtar með vísitölu neysluverðs.

Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

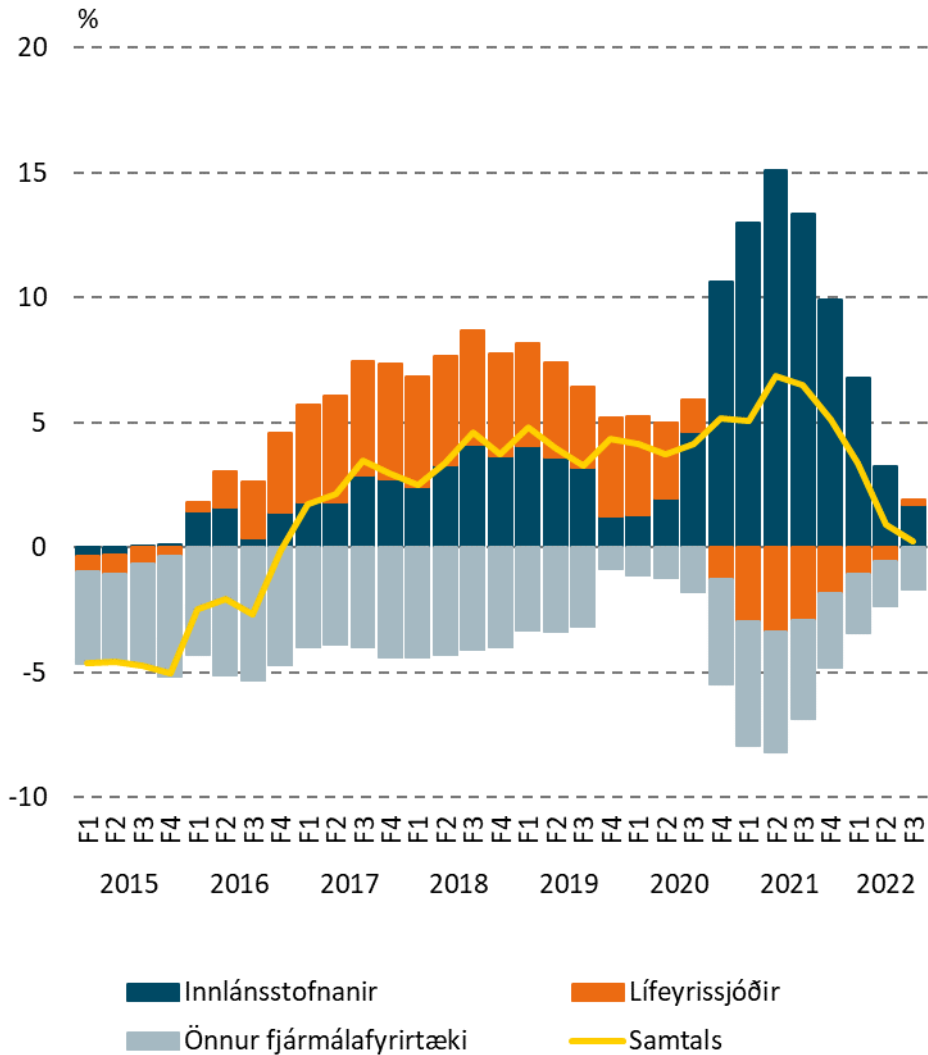


## Þróun skulda atvinnufyrirtækja brotin niður á lánveitendur



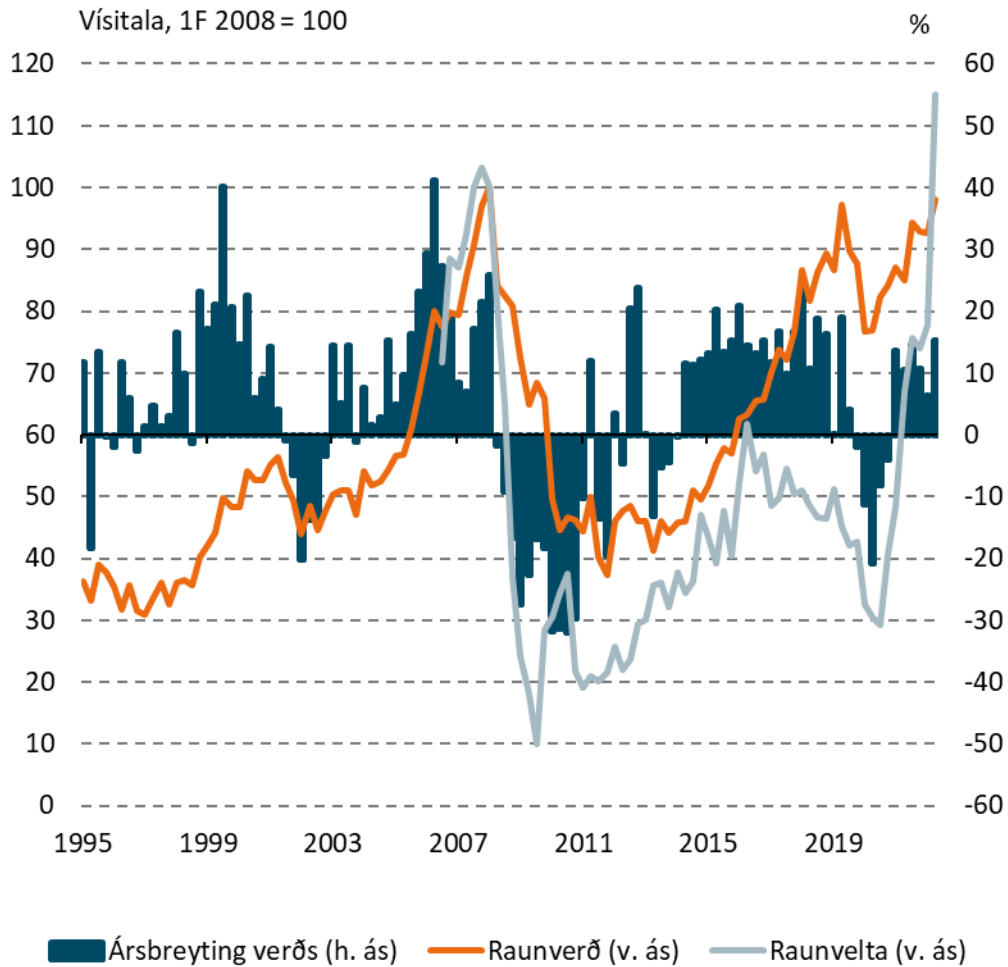
Heildarskuldir fyrirtækja að kröfuvirði, raunvirtar með vísitölu neysluverðs. Raunbreyting á milli ára og framlag hvers flokks lánveitenda til hennar. Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

## Þróun skulda heimila brotin niður á lánveitendur



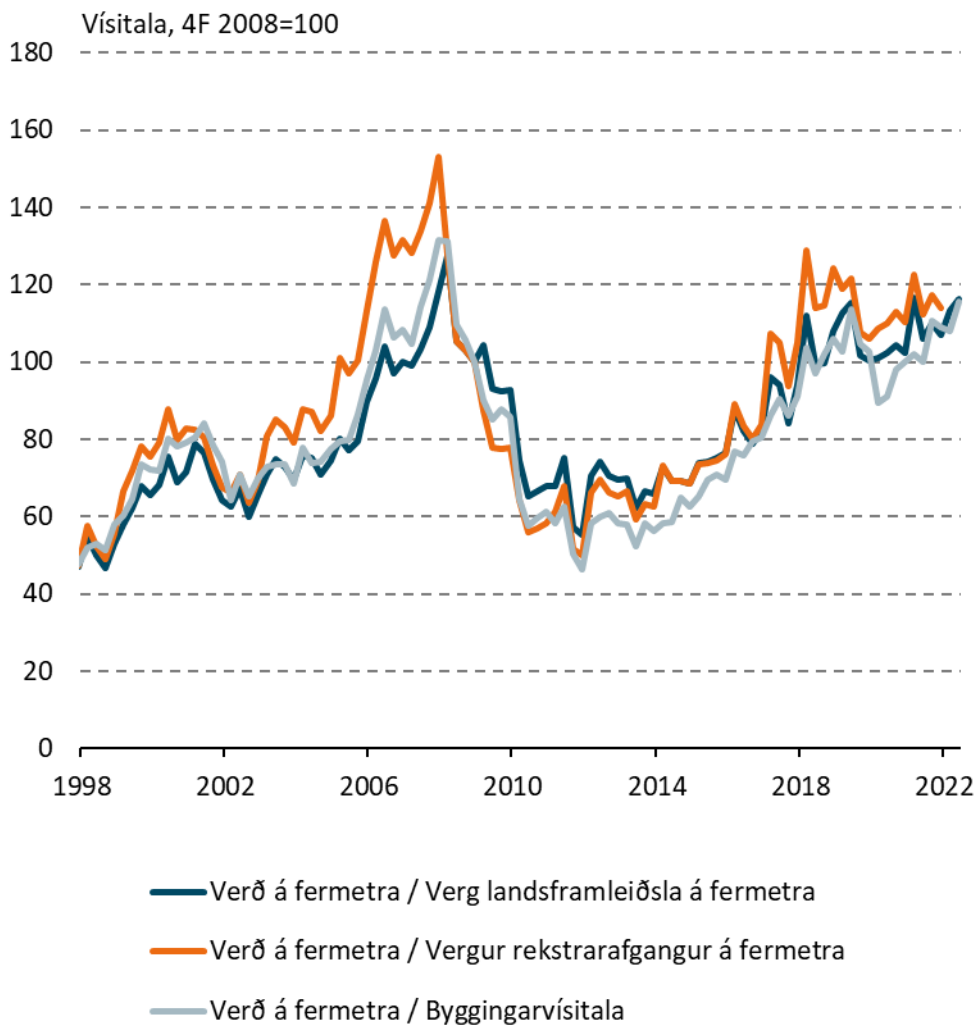
Heildarskuldir heimila að kröfuvirði, raunvirtar með vísitölu neysluverðs. Raunbreyting á milli ára og framlag hvers flokks lánveitenda til hennar. Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

## Raunverð og -velta atvinnuhúsnæðis á höfuðborgarsvæðinu



Verðvísitala raunvirt með vísitölu neysluverðs. Vísitalan byggir á vegnu meðaltali iðnaðar-, verslunar- og skrifstofuhúsnæðis. Veltuvísitala sýnir meðaltal raunvirtrar veltu síðustu fjögurra ársfjórðunga. Nýjustu gildi eru til bráðabirgða.  
*Heimildir:* Hagstofa Íslands, Þjóðskrá Íslands, Seðlabanki Íslands.

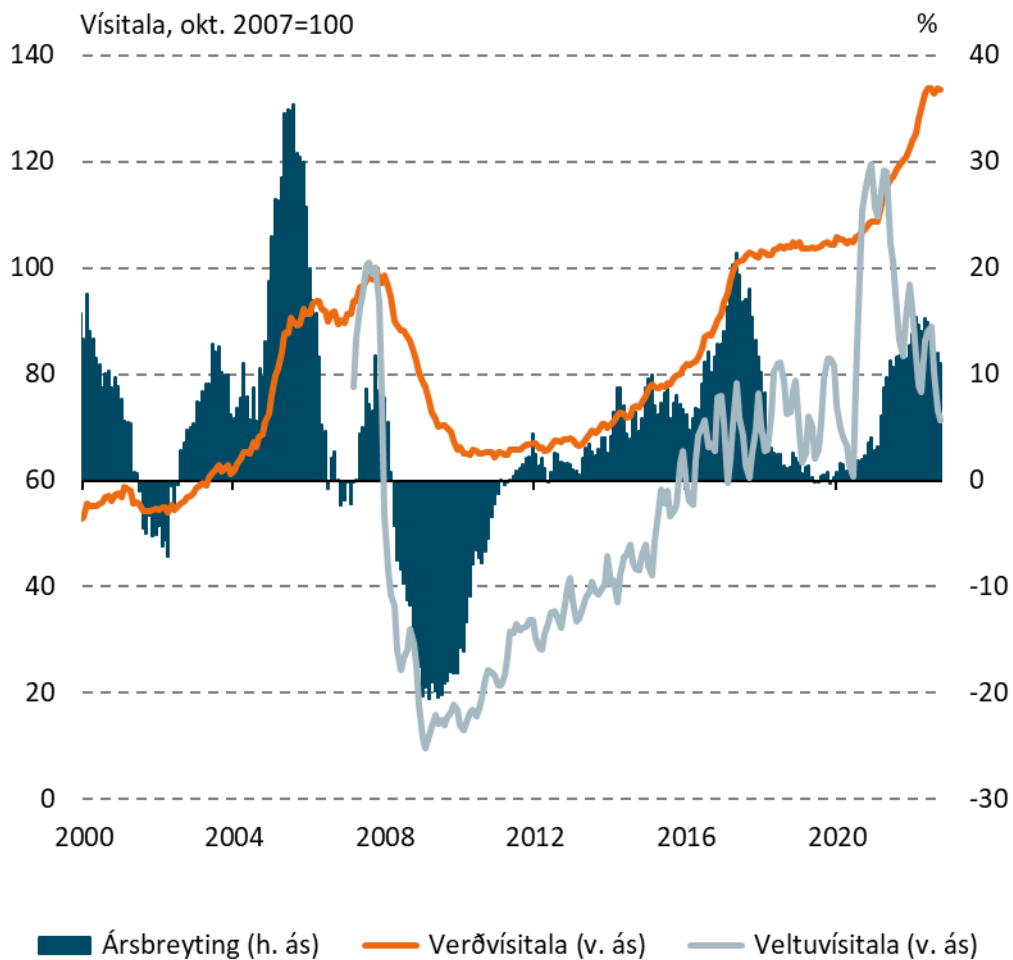
## Verðhlutföll atvinnuhúsnæðis



Árleg gögn um vergan rekstrarafgang eru tengd yfir ársfjórðunga með ólínulegri aðferð. Árleg gögn um atvinnuhúsnæðisstofn eru tengd línulega yfir ársfjórðunga.

Heimildir: Hagstofa Íslands, Þjóðskrá Íslands, Seðlabanki Íslands.

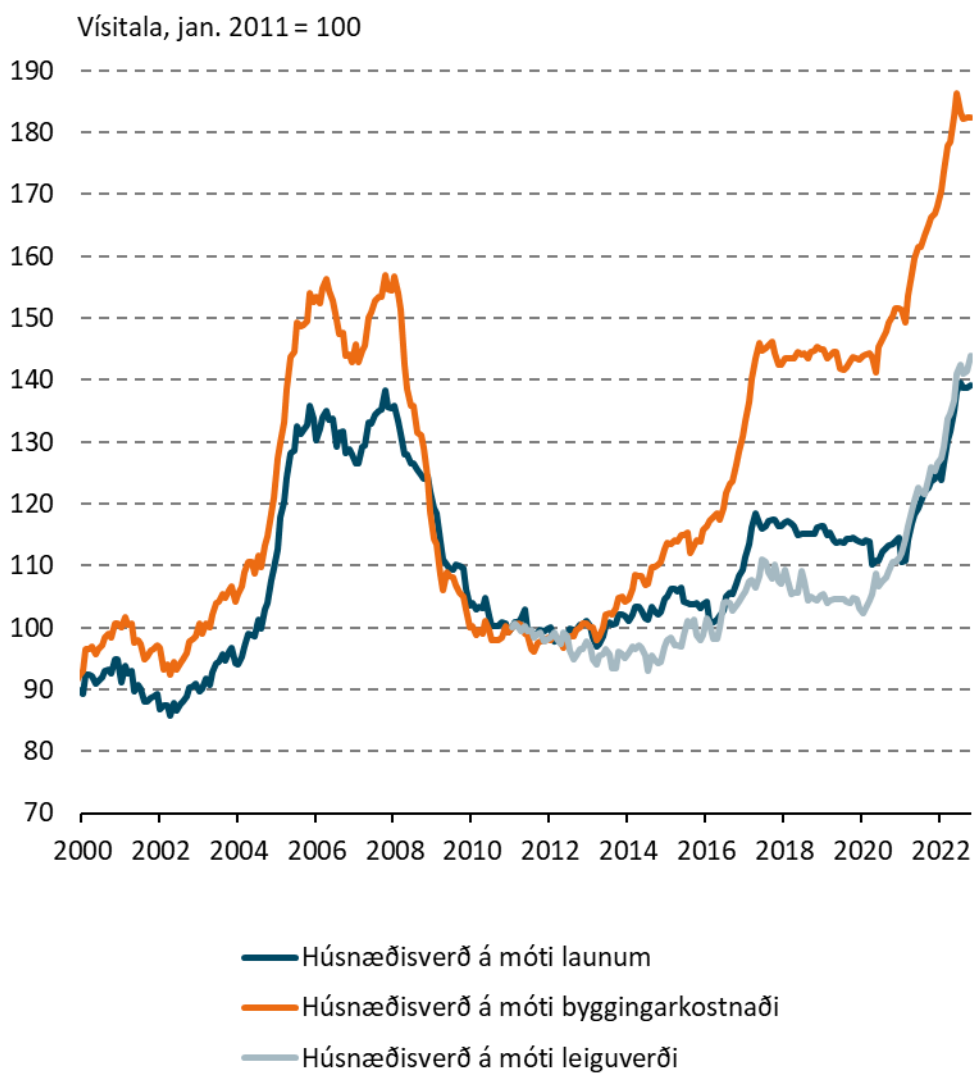
## Raunverð og raunvelta á íbúðamarkaði höfuðborgarsvæðisins



Vísitala íbúðaverðs á höfuðborgarsvæðinu, raunvirt með vísitölu neysluverðs. Veltuvísitala sýnir þriggja mánaða hlaupandi meðaltal veltu, sem raunvirt hefur verið með vísitölu neysluverðs.

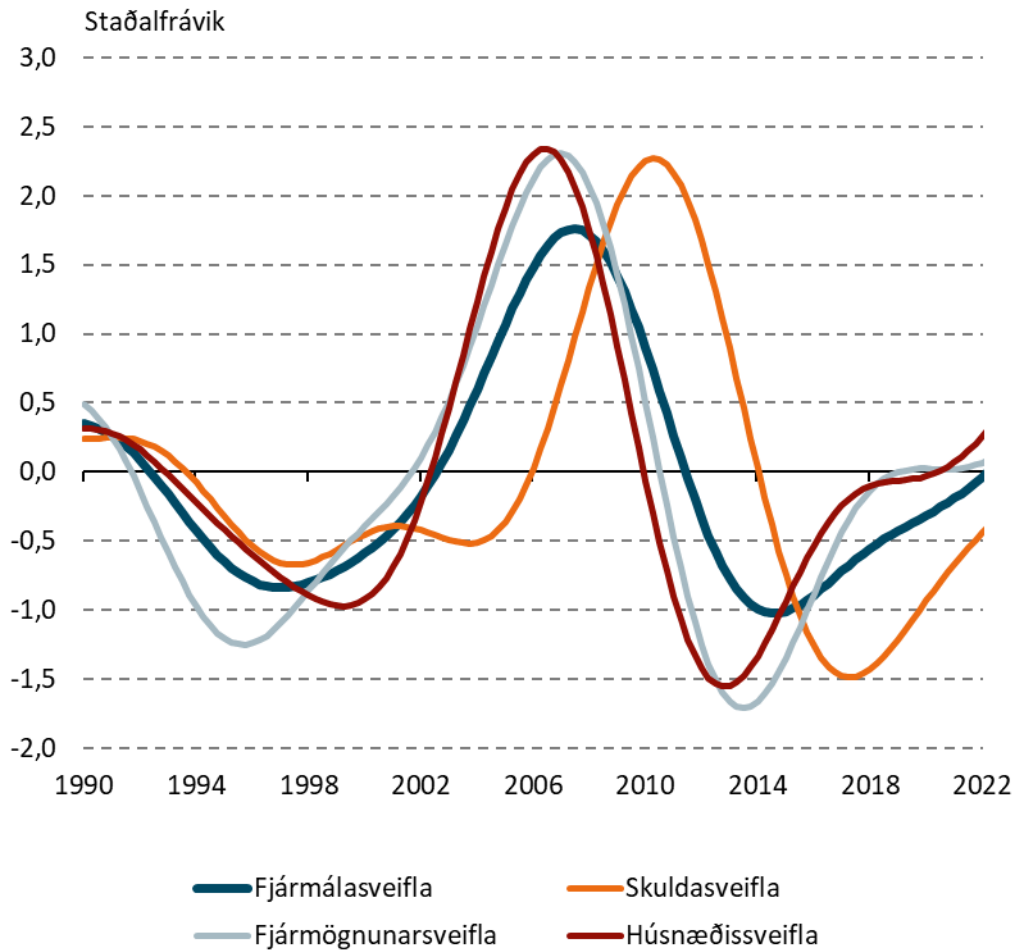
Heimildir: Hagstofa Íslands, Þjóðskrá Íslands, Seðlabanki Íslands.

## Húsnæðisverð á höfuðborgarsvæðinu og ákvarðandi þættir



Heimildir: Hagstofa Íslands, Þjóðskrá Íslands.

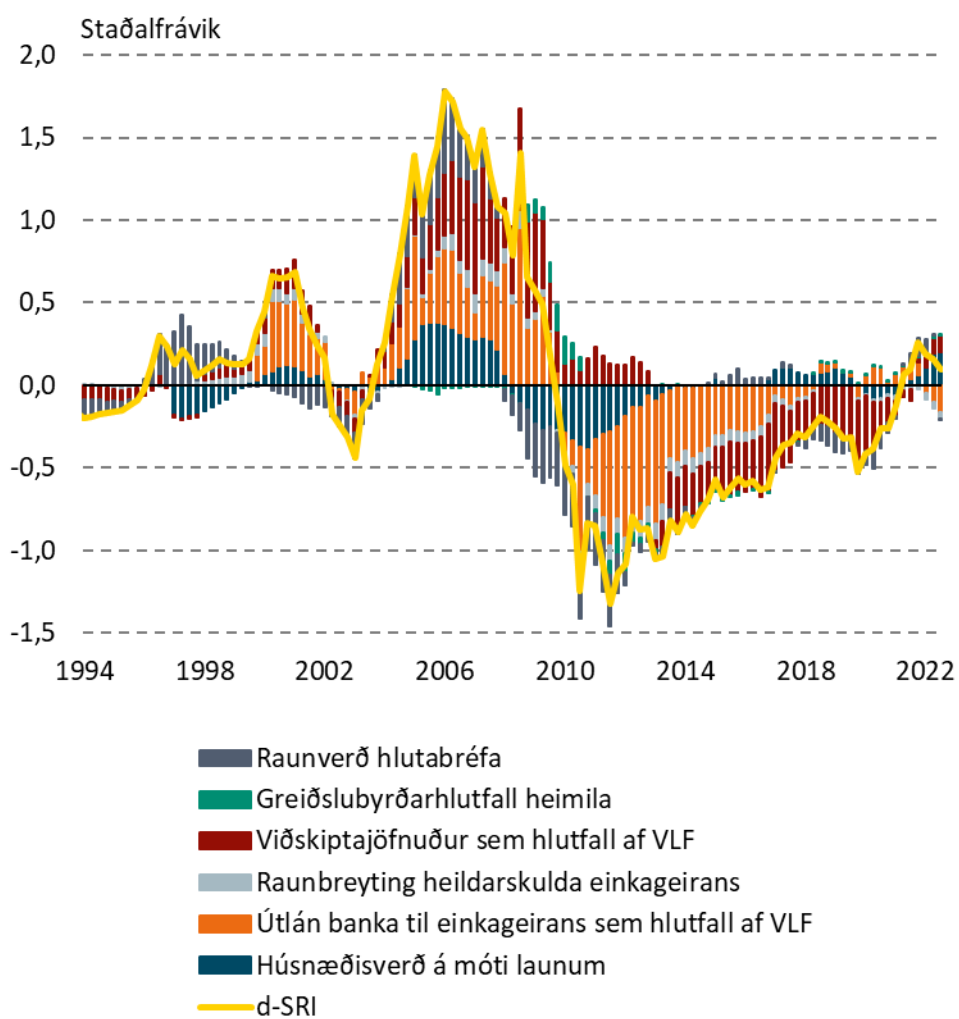
## Fjármálasveifla og undirþættir hennar



Fjármálasveiflan, bláa línan, er einfalt meðaltal undirþáttanna. Hver undirþáttur er einfalt meðaltal sveiflupátta úr breytum sem tengjast skuldum, húsnæðisverði og fjármögnun banka. Sveiflupættirnir eru fundnir með Christiano-Fitzgerald tíðnisú með tíðnisviðið 8-30 ár.

*Heimildir:* Hagstofa Íslands, Þjóðskrá Íslands, Seðlabanki Íslands.

## Samsettur vísir fyrir sveiflutengda kerfisáhættu (d-SRI)

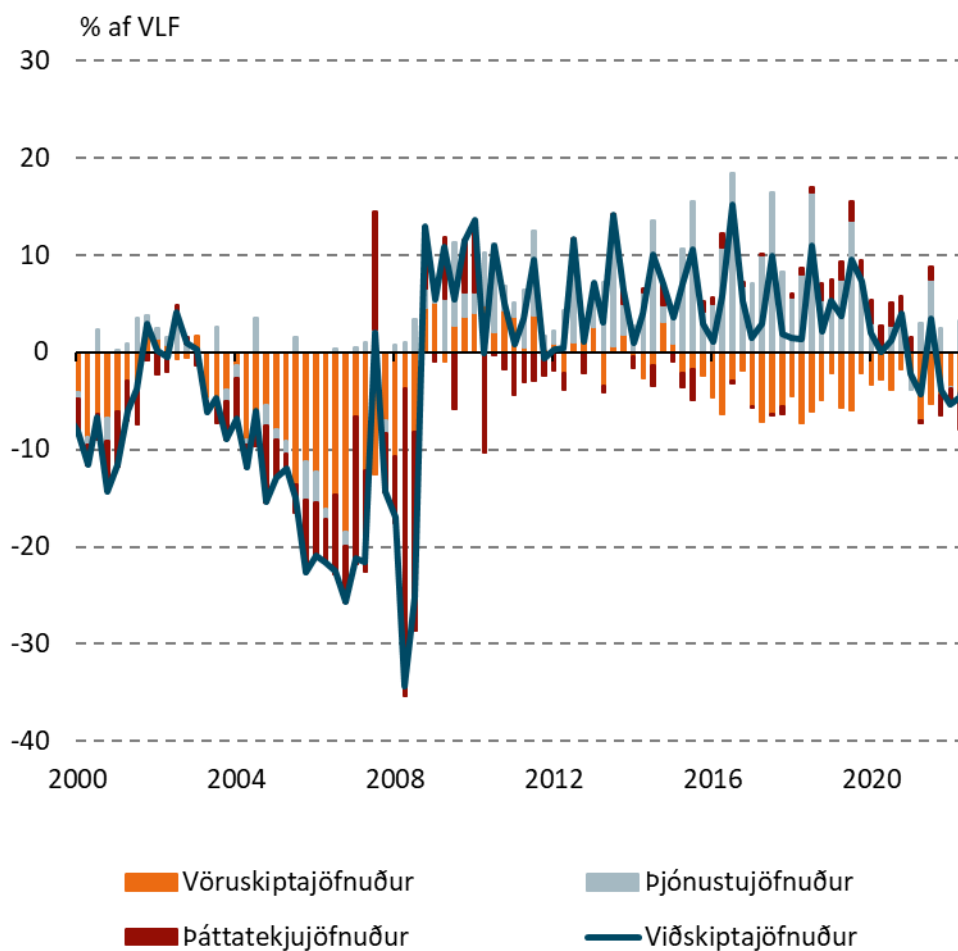


Spágildi eru notuð frá og með Q3 2020 fyrir greiðslur, að baki greiðslubyrðarhlutfalli heimila.

Heimildir: Hagstofa Íslands, Seðlabanki Íslands.



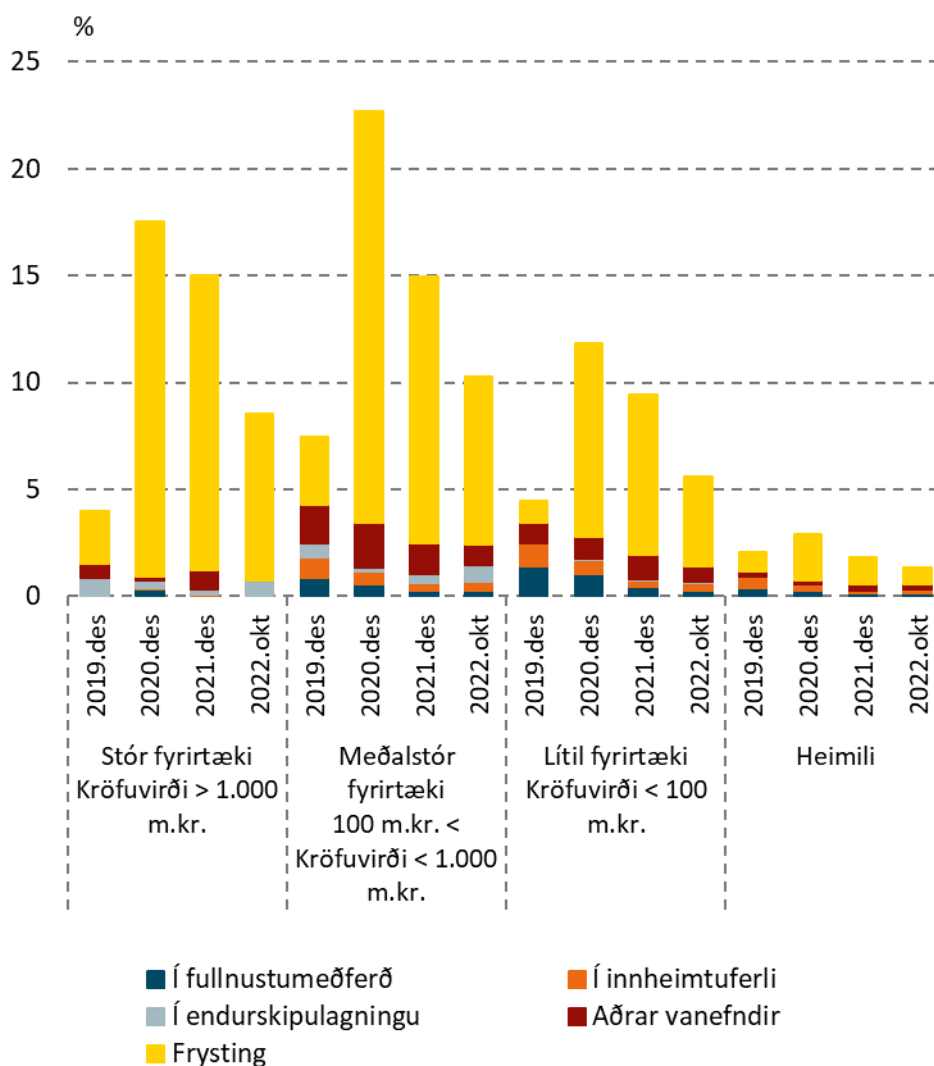
## Viðskiptajöfnuður



Miðað er við undirliggjandi viðskiptajöfnuð tímabilið 4F2008-4F2016, þar sem leiðrétt er fyrir áhrifum gömlu bankanna á þáttatekjur og óbeint mælda fjármálaþjónustu. Tímabilið 2009-2012 var þáttatekujöfnuður einnig leiðréttur fyrir áhrifum Actavis vegna ónákvæmra gagna á tímabilinu. Þáttatekujöfnuður tekur til frumþáttatekna og rekstrarframlaga.

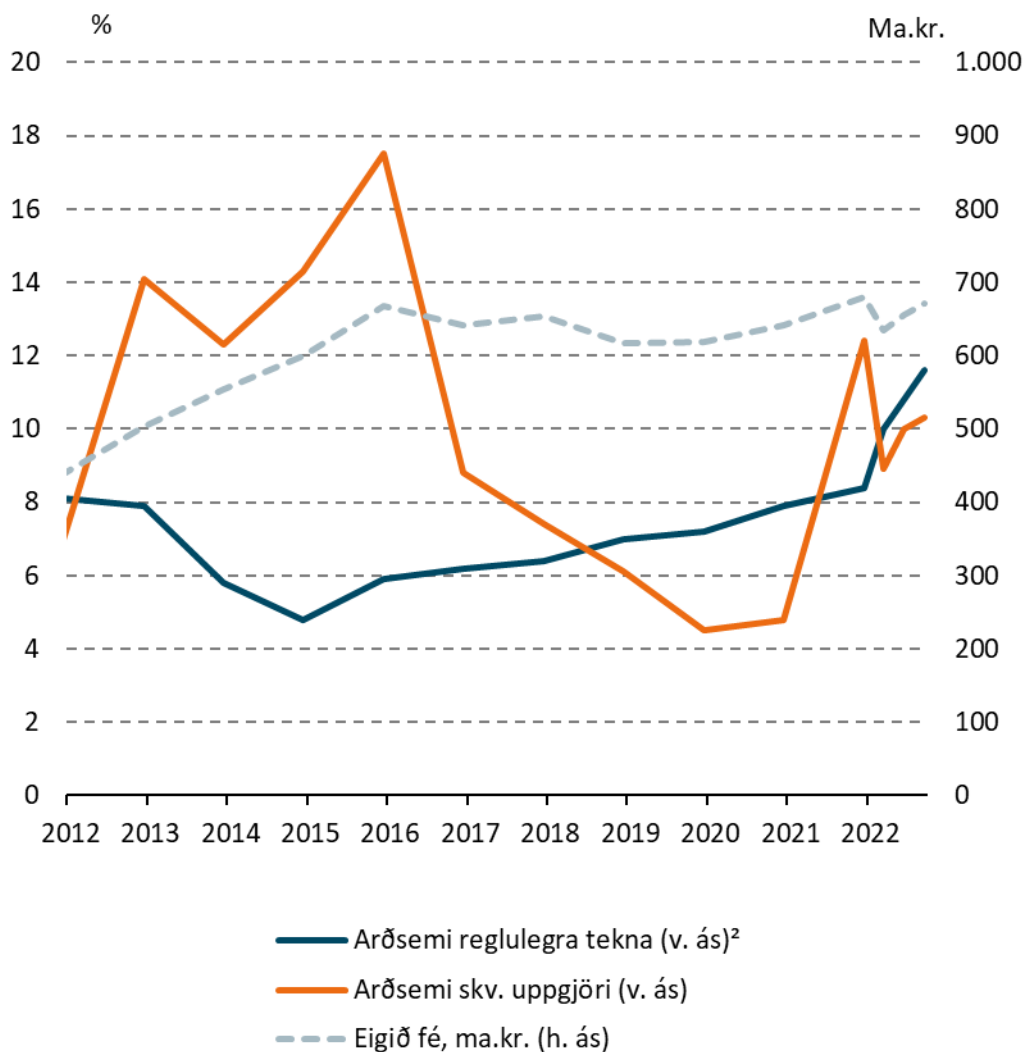
*Heimildir:* Hagstofa Íslands, Seðlabanki Íslands.

## Staða vanefnda útlána eftir lántaka og tegund vanefnda



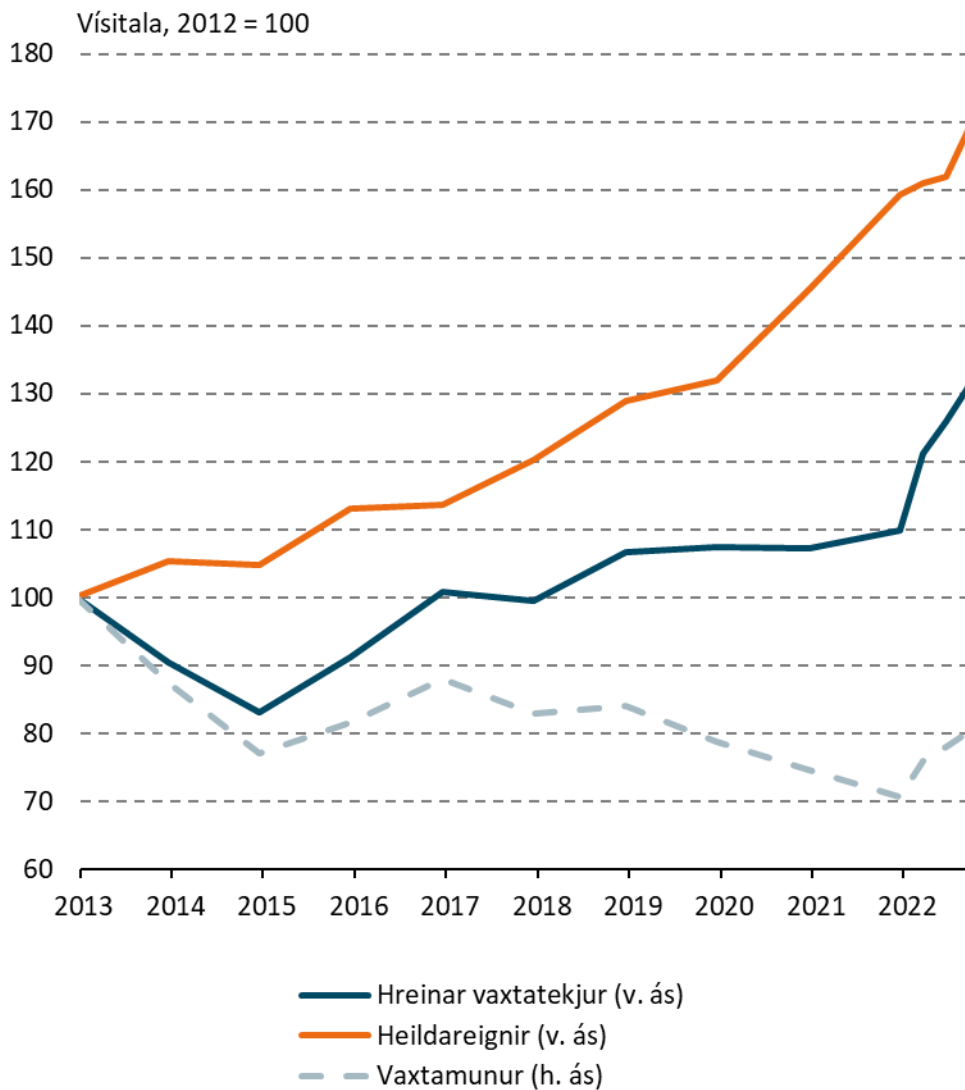
Vanskil samkvæmt lánþegaaðferð, hlutfall útlánnum til hvers stærðarflokks. Kerfislega mikilvægir bankar, móðurfélög, bókfært virði.  
 Heimild: Seðlabanki Íslands.

## KMB: Arðsemi



Arðsemi er reiknuð út miðað við meðalstöðu eigin fjár. Samstæður kerfislega mikilvægra banka. Valitor undanskilið árin 2017-2020. Arðsemi reglulegra tekna miðast við hreinar vaxta- og þóknunartekjur að frádregnum reglulegum kostnaði. Skatthlutfall er 20% og miðað er við meðalstöðu eigin fjár.  
*Heimildir:* Árs- og árshlutareikningar viðskiptabanka.

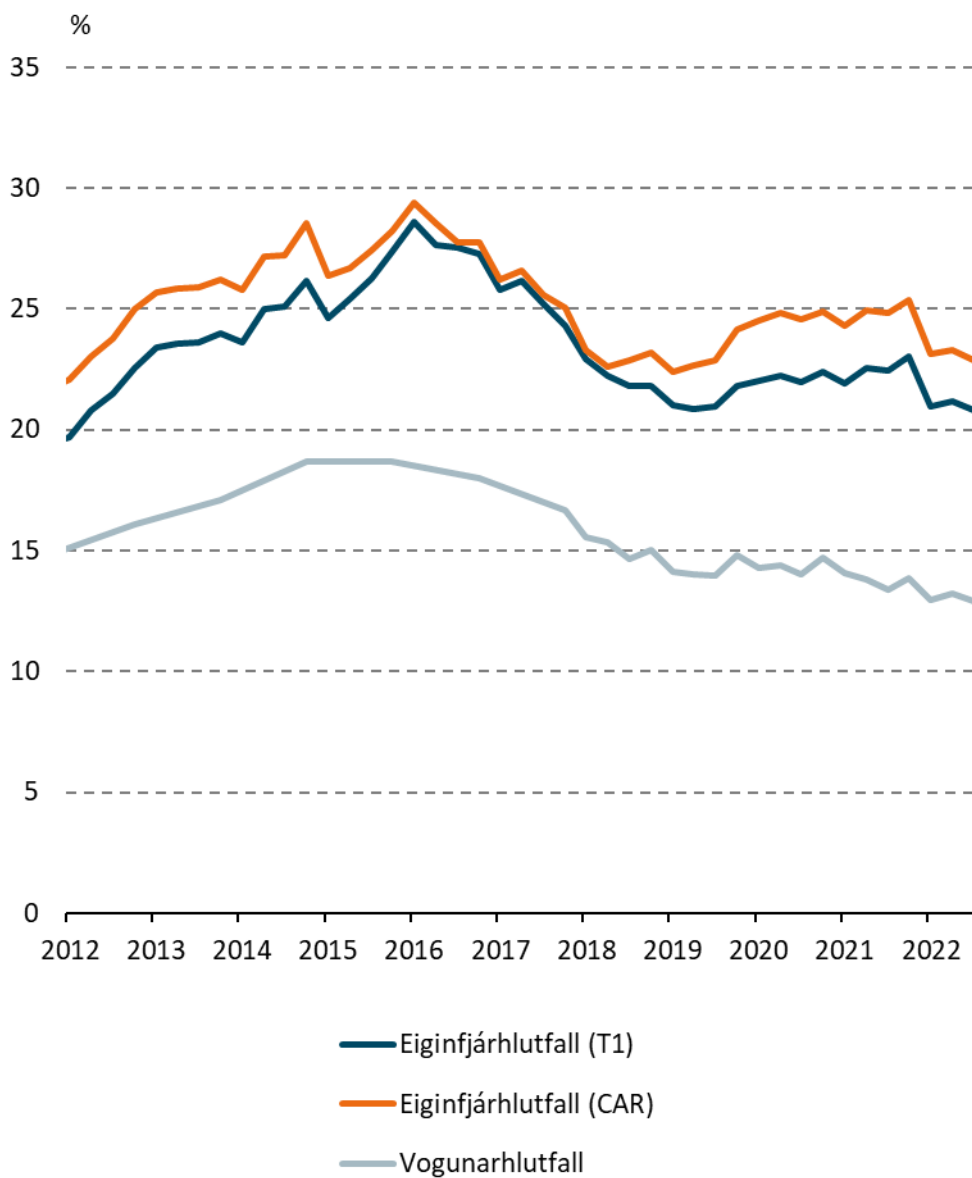
## KMB: Hreinar vaxtatekjur, vaxtagjöld og vaxtamunur



Samstæður kerfislega mikilvægra banka. Hreinar vaxtatekjur á 1. ársfjórðungi 2022 færðar á ársgrundvöll.

Heimildir: Árs- og árshlutareikningar viðskiptabanka.

## KMB: Eiginfjár- og vogunarlutföll



Samstæður kerfislega mikilvægra banka.  
*Heimildir:* Árs- og árshlutareikningar bankanna.