24 June 2021

# Memorandum

*To:* Financial Stability Committee
*From:* Central Bank of Iceland

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

On 18 March 2020, the countercyclical capital buffer was lifted because of the high level of uncertainty about developments in arrears and impairment following the spread of the pandemic in Iceland. It was considered important to mitigate the adverse impact of this on intermediation of credit. It is likely that lifting the countercyclical capital buffer played a role in maintaining households' and many firms' access to credit; for instance, the banks' household lending has grown significantly in the past year.

The Central Bank's actions make the financial system better able to support the economy strongly once the situation improves even further. It is important to ensure that cyclical systemic risk does not increase unduly – i.e., with excessive credit growth and unsustainable asset price hikes – when the economy begins to recover. An analysis of these variables could therefore prompt an increase in the countercyclical capital buffer sooner rather than later.[1]

## Credit market

Households continue to have ready access to credit. Twelve-month real growth in household debt measured 6.2% at the end of April. Favourable terms on new mortgages have given households an incentive to refinance. The commercial banks have increased their share in the household mortgage market at the expense of other lenders, particularly the Housing and Construction Authority's IL Fund and the pension funds. Loan-to-value ratios and debt service ratios on new bank loans have not risen discernibly, and indicators of credit quality have generally been positive. Therefore, expanding loan books are not necessarily a sign of increased risk.

Corporate lending has developed differently, however. At the end of March, corporate debt had contracted by 7.4% year-on-year in real terms. The contraction is due for the most part to the appreciation of the króna over the period, as over a third of the corporate credit stock is in

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

foreign currencies. In price- and exchange rate-adjusted terms, the contraction in corporate debt measured 2.4%.

The facility-level non-performing loan (NPL) ratio on loans to individuals has fallen marginally, measuring 1.1% at the end of April. However, about 2% of loans to individuals are frozen and are classified as non-performing. The corporate NPL ratio was 4.7% at the end of April, but it varies widely from one sector to another. It was highest in the tourism industry, at 11.5%. At the end of May, 15.8% of corporate loans were frozen (40% in the services sector), although the ratio has been declining gradually since the turn of the year.

## Real estate market

The rise in the house price index for greater Reykjavík has continued to accelerate, and at the end of May the year-on-year increase measured 9.7% in real terms. Turnover in the market has been very strong in the past nine months, apparently fuelled by low interest rates. Since mid-2020, house prices have risen relative to determinants such as construction costs and rent prices, whereas they remained broadly unchanged relative to the wage index until April, whereupon they started to rise.

The commercial real estate (CRE) market appears to have stabilised. The CRE price index for the capital area was more or less unchanged in Q1/2021 but had declined by 3.5% since the beginning of 2020.[2] In addition, turnover was up 76% year-on-year in real terms during the quarter. The impact of the pandemic on the large real estate firms' leasing income has been tapering off, as their Q1/2021 financial statements show an increase in cash from operations, after a steep decline in 2020.

## Banking market

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

Impairment of the banks' loan portfolios is based on expectations of future credit losses and recovery. In 2020, the large commercial banks recorded loan impairment ranging from 0.61% to 0.94%. As the economy recovers further and more firms' solvency problems are

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

unwound, uncertainty about the banks' ultimate credit losses should diminish.

Lifting the countercyclical capital buffer played a role in increasing the banks' capital above regulatory requirements at the beginning of the pandemic. The hiatus on dividend payments coupled with solid operating results maintained this position concurrent with significant balance sheet expansion during the year. In Q1/2021, the banks' capital ratios fell slightly, as they began paying dividends and buying back their own shares once again.

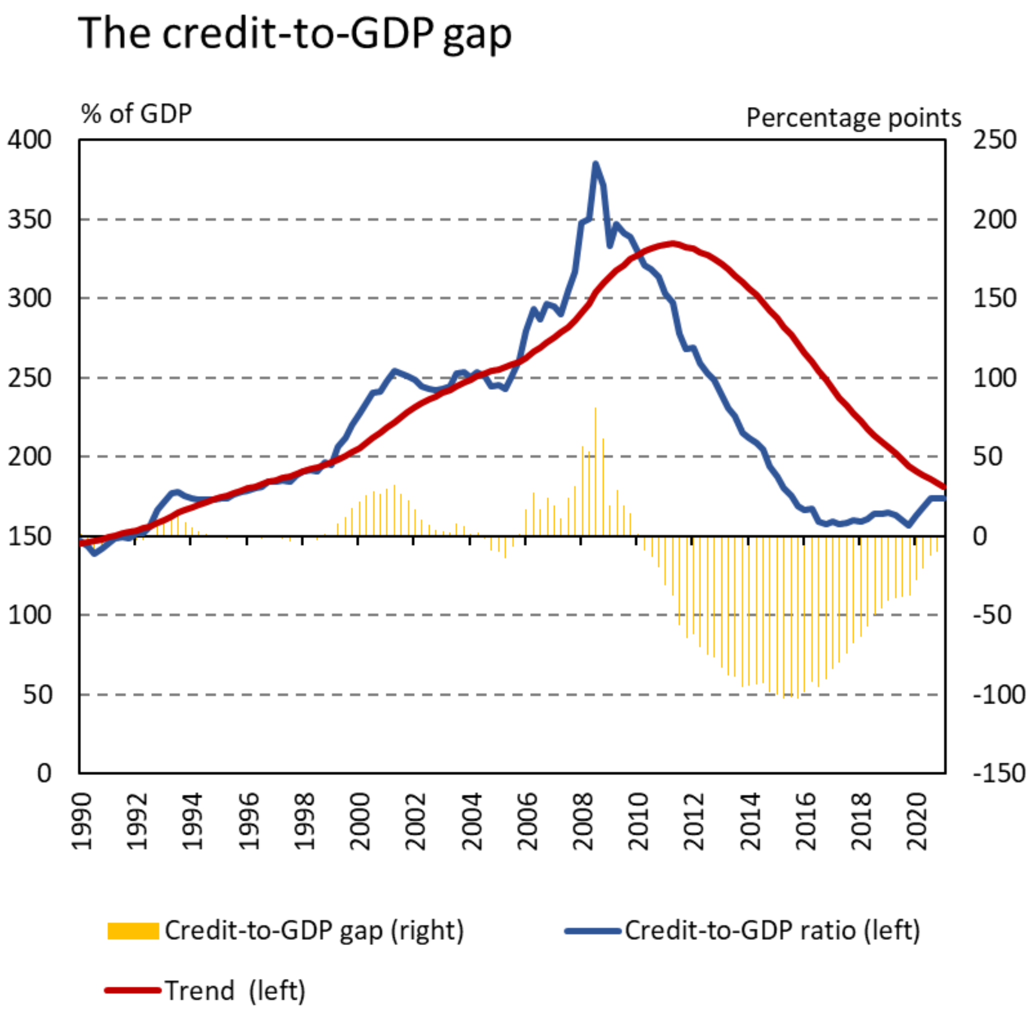
**Overall assessment of cyclical systemic risk**

Growth in private sector debt has been modest to date, although developments in households' and businesses' situation have diverged. The debt-to-GDP ratio rose steeply after the onset of the pandemic but has now levelled off, as GDP has been at a lower level for more than a year, but it can be expected to normalise quickly if GDP growth forecasts for the next two years materialise.[3] As a consequence, the debt-to-GDP ratio, which has risen by just over 16 percentage points since the pandemic struck, does not necessarily give cause for concern when considered in this light, as it is below its long-term trend.

Composite indicators that are intended to present a comprehensive view of developments do not show clear signs of an increase in cyclical systemic risk relative to a normal environment. A statistical presentation of the financial cycle is close to its long-term average and suggests a gentler upward slope than in 2016-2019, when the countercyclical capital buffer was last being built up.

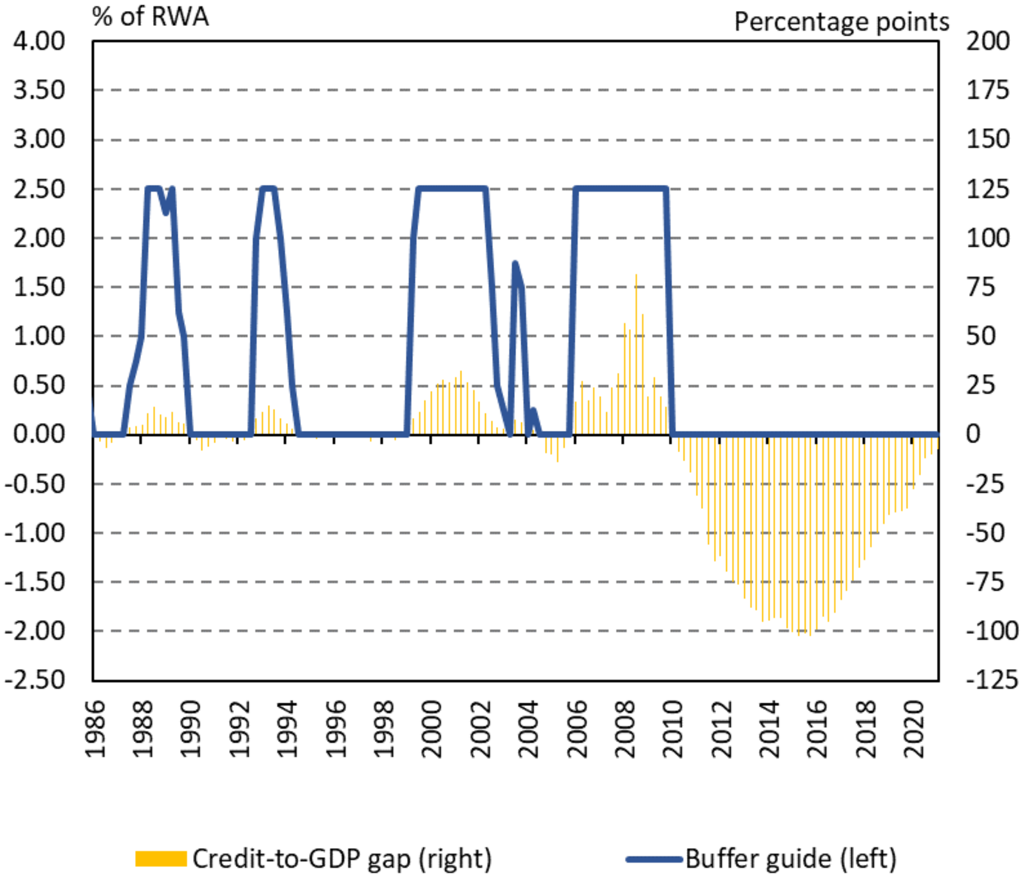
[3] The ratio of private sector debt – i.e., households and non-financial companies – to GDP.

## Appendix – Charts



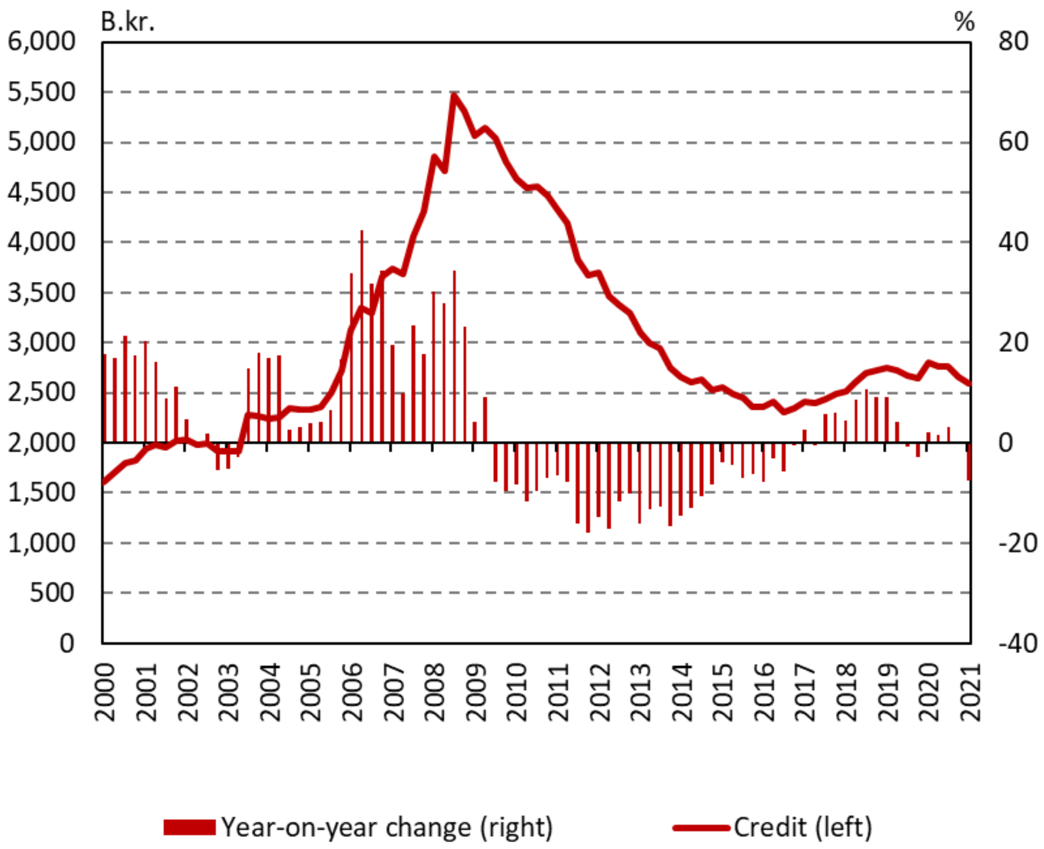

Claim value of total credit to households and firms as a share of GDP. The trend component is obtained with a one-sided HP-filter with λ=400.000.
*Sources*: Statistics Iceland, Central Bank of Iceland.

# The buffer guide



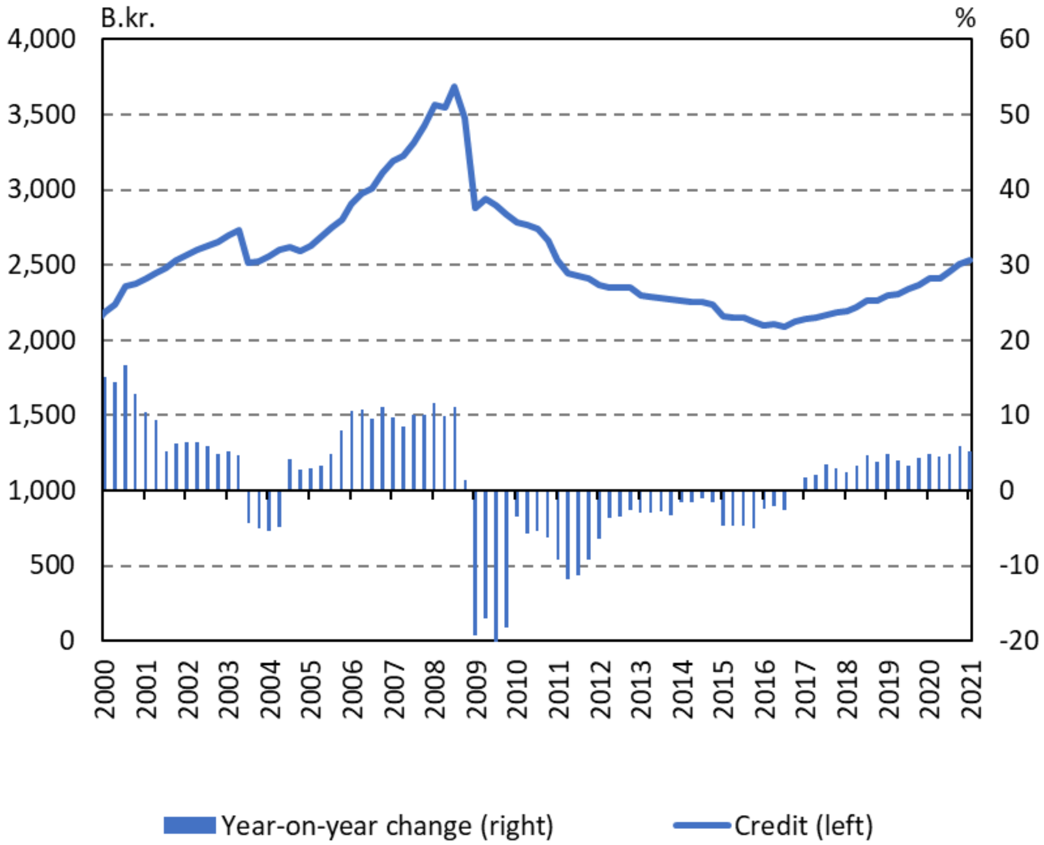

The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Real corporate credit growth[1]



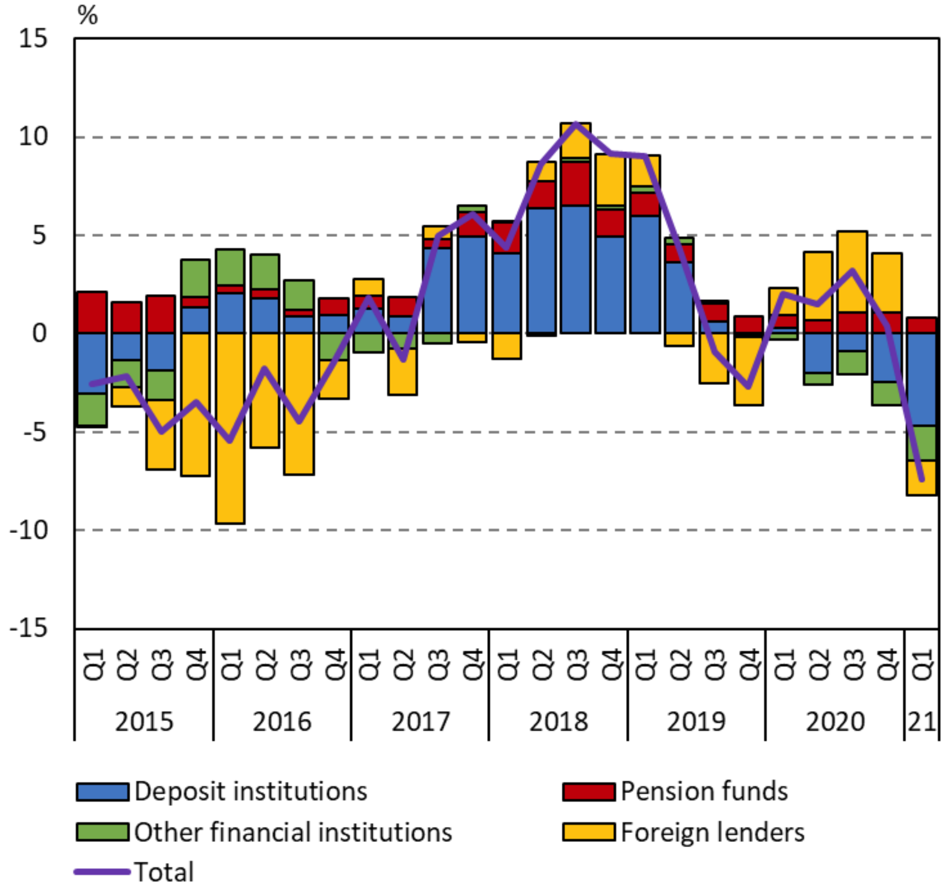

1. Claim value of credit to non-financial firms, at constant prices. Deflated with the consumer price index.
*Sources*: Statistics Iceland, Central Bank of Iceland.

# Real household credit growth[1]




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

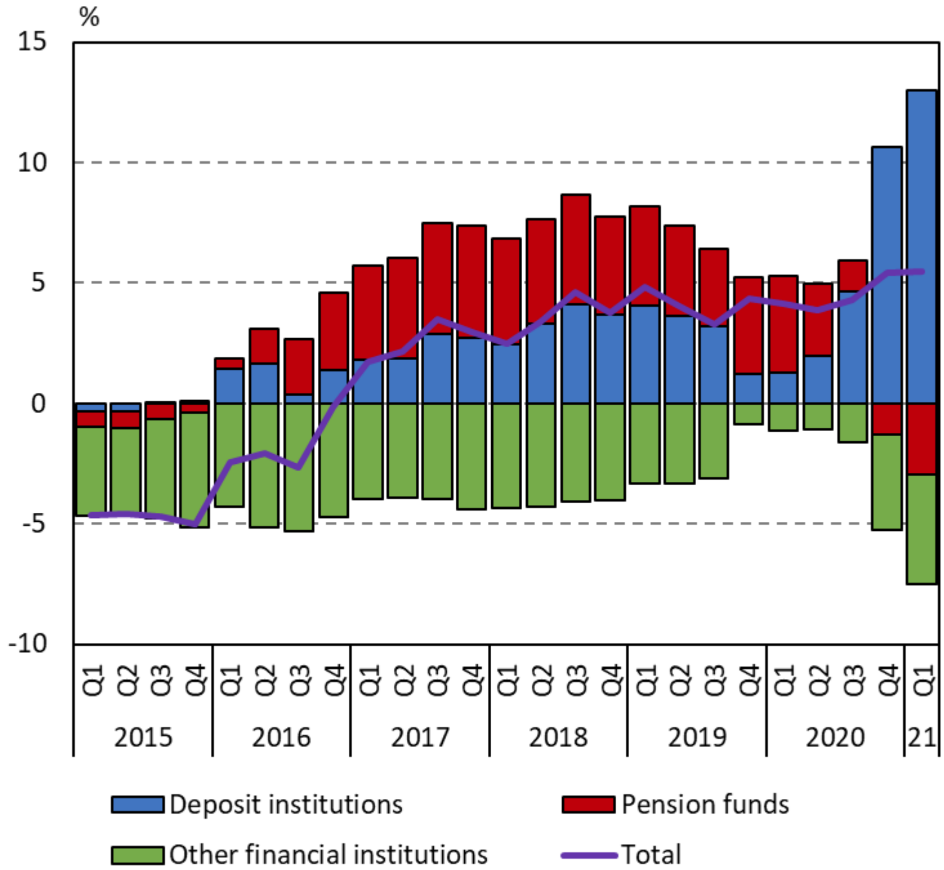
## Corporate debt, by lender[1]




1. Real year-on-year change. Debt to financial institutions and issued marketable bonds.

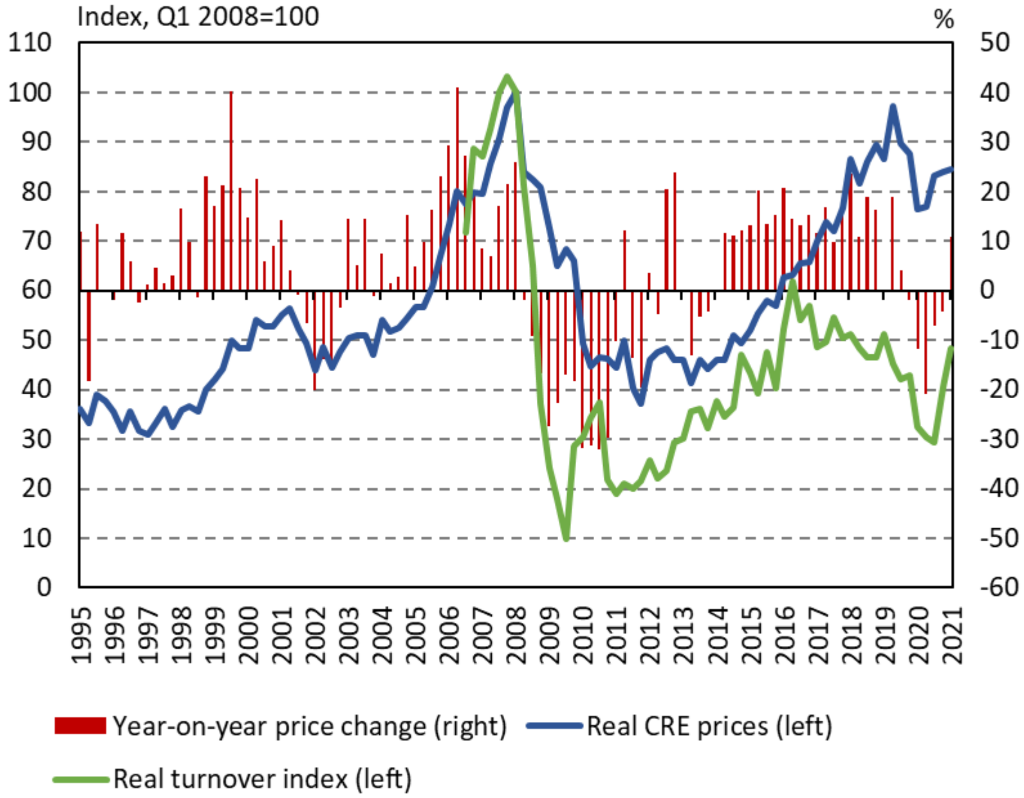
*Sources*: Statistics Iceland, Central Bank of Iceland.

Household debt, by lender[1]



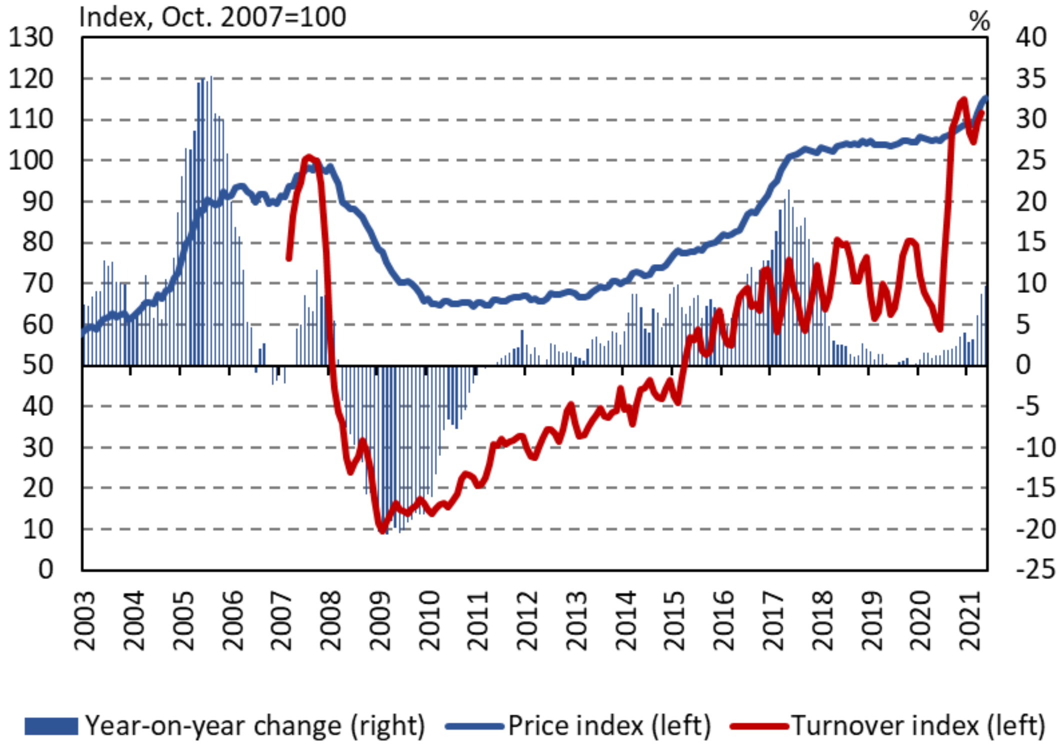

1. Real year-on-year change. Debt to financial institutions and issued marketable bor
*Sources*: Statistics Iceland, Central Bank of Iceland.

# Real commercial property prices[1] and turnover[2] in the capital area



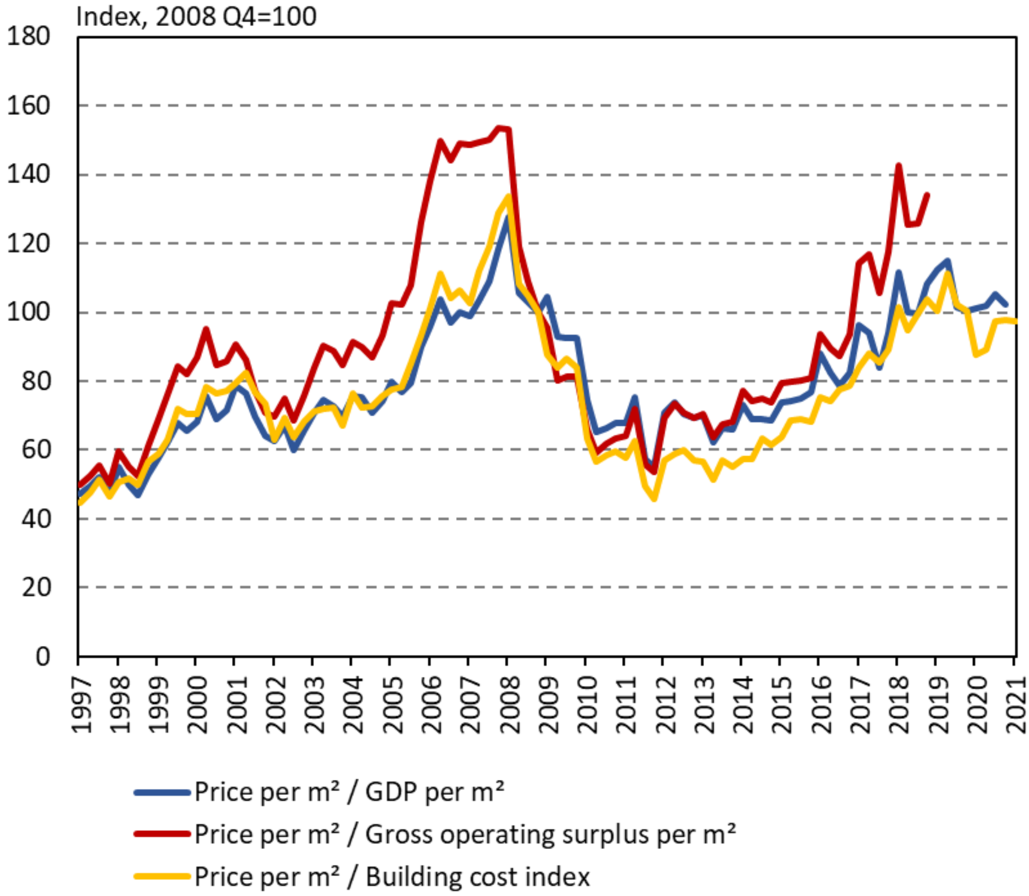

1. CRE price index, deflated with the CPI. The index shows the weighted average pri
of industrial, retail, and office space. 2. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminar
*Sources*: Registers Iceland, Statistics Iceland,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

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



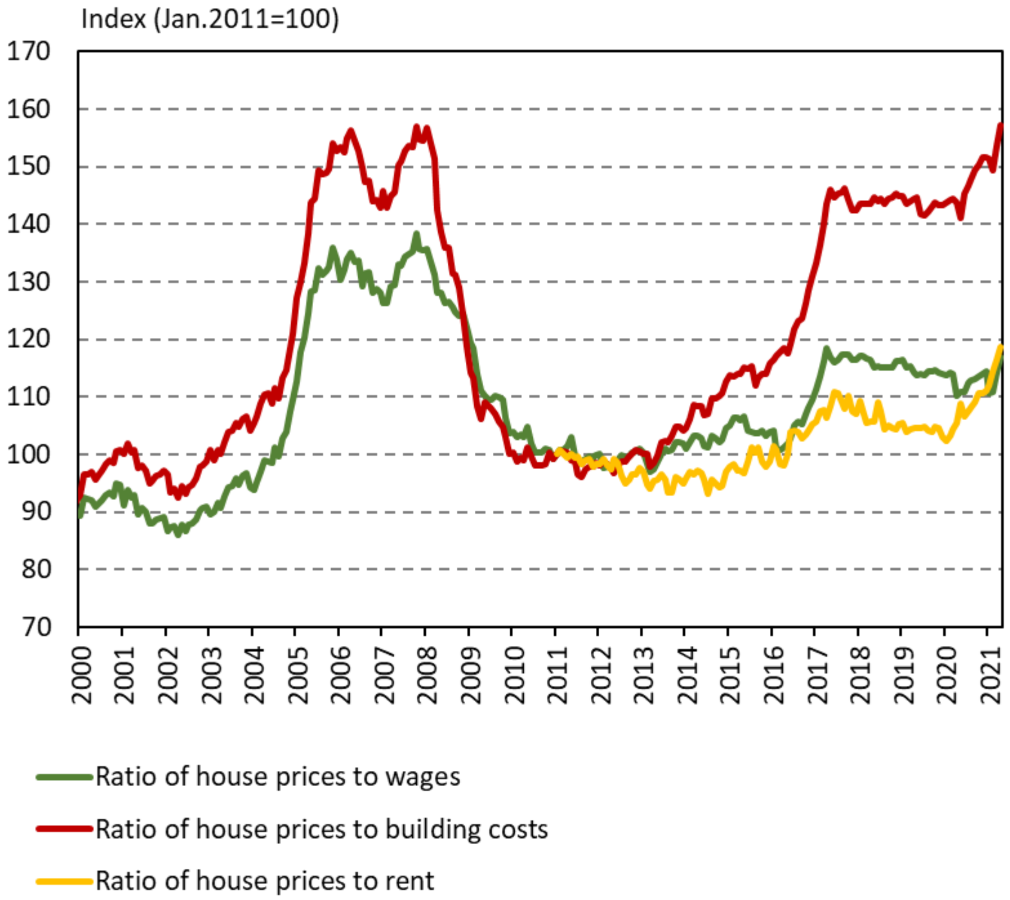

1. Capital area house price index, deflated with the consumer price index. The 9% threshold is taken from Laina, Nyholm & Sarlin (2015). The turnover index shows three-month average turnover, deflated with the consumer price index. The turnover data are linearly interpolated in 2Q/2015 to correct for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

## Commercial property price ratios[1,2]



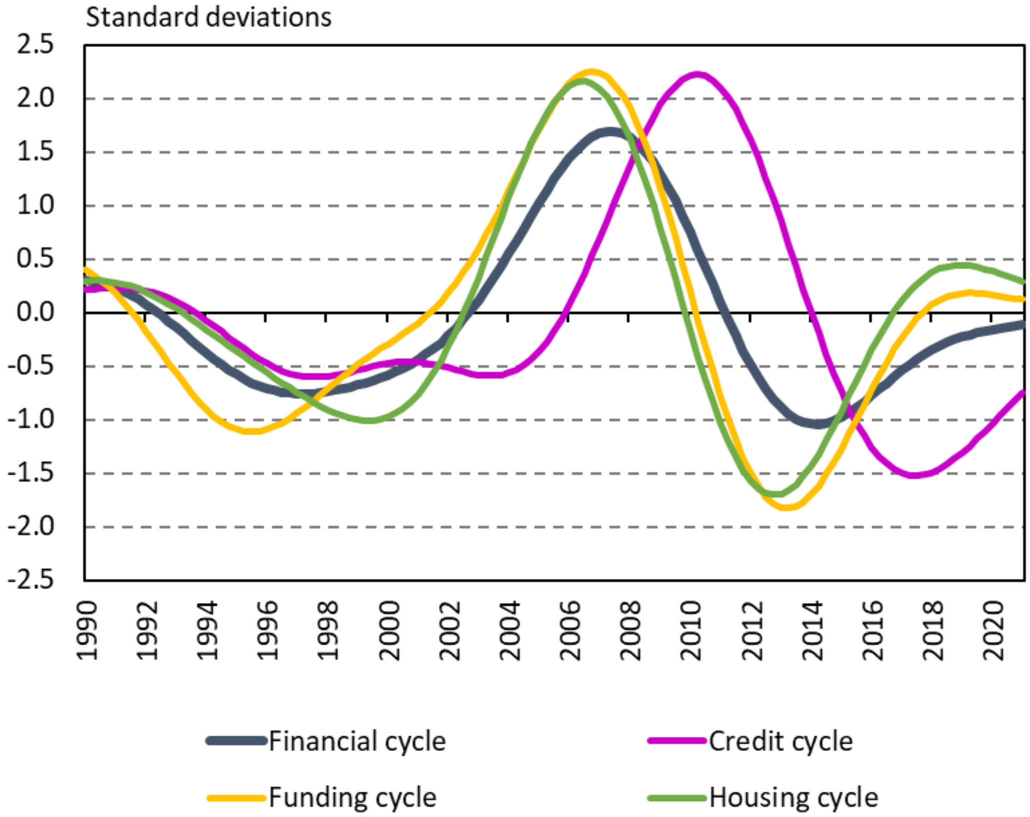

1. Annual data for gross operating surplus are non-linearly interpolated. 2. Annual data for the CRE stock are linearly interpolated.
*Sources*: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

Capital area house prices and their determinants



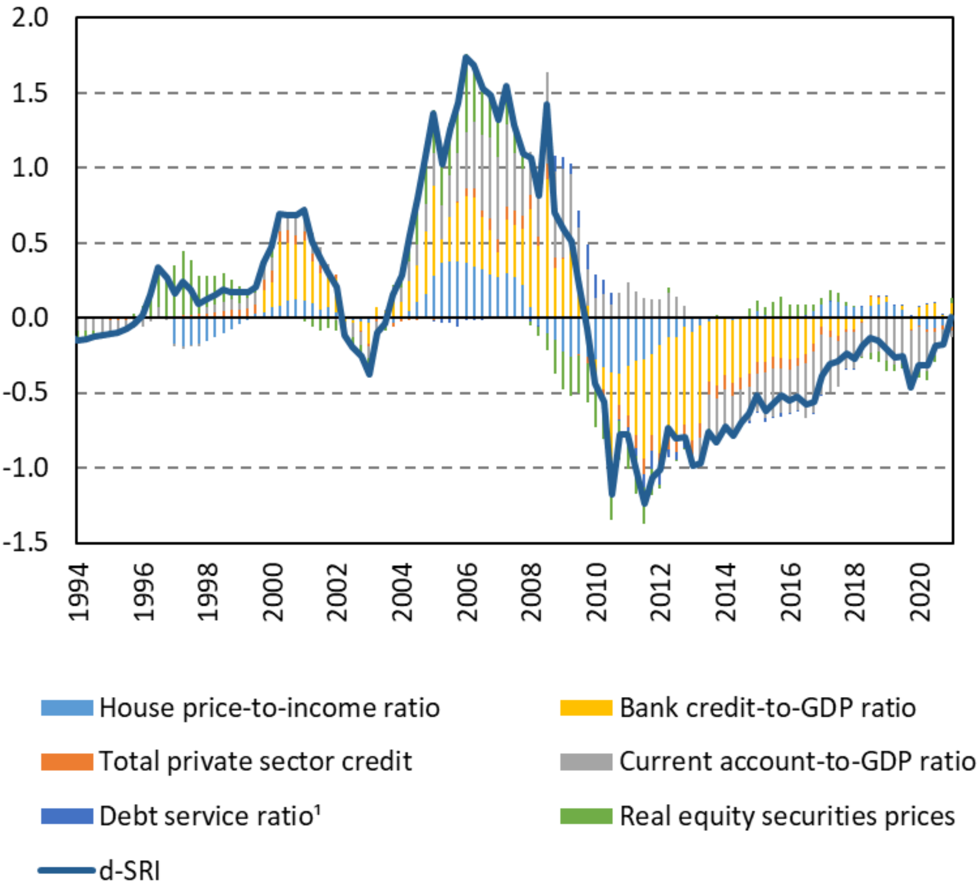

*Sources*: Registers Iceland, Statistics Iceland.

# Financial cycle and subcycles[1]




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

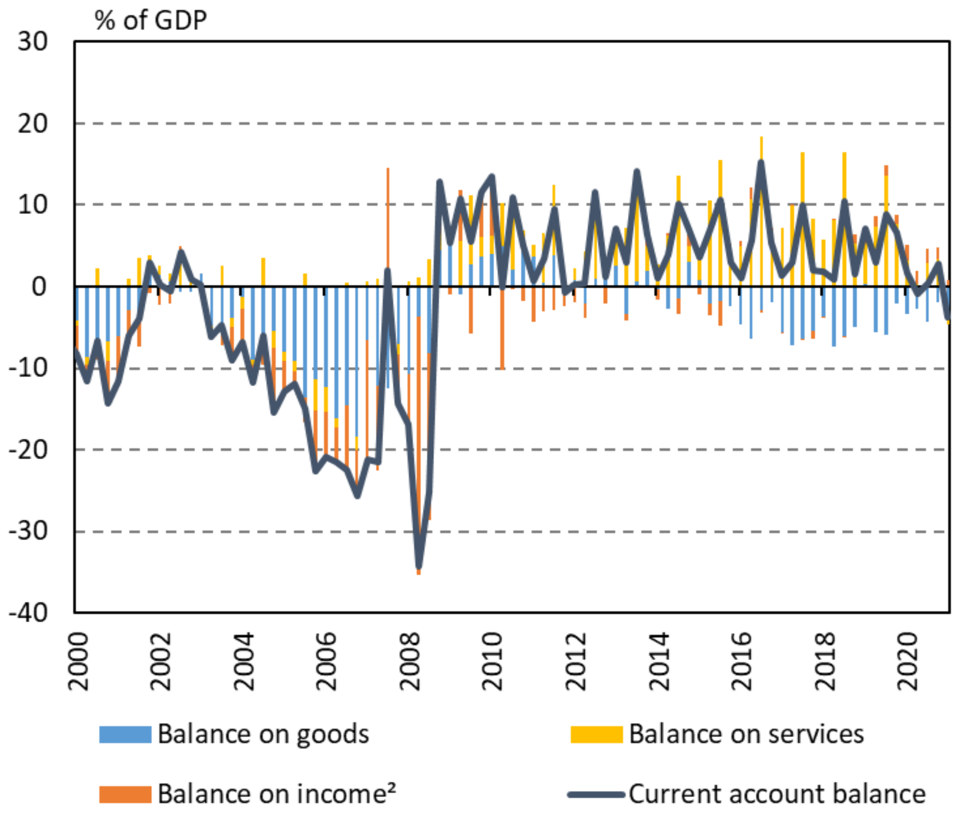
# Cyclical systemic risk indicator (d-SRI)




1. Estimates are used for Q1 to Q3 of 2020.

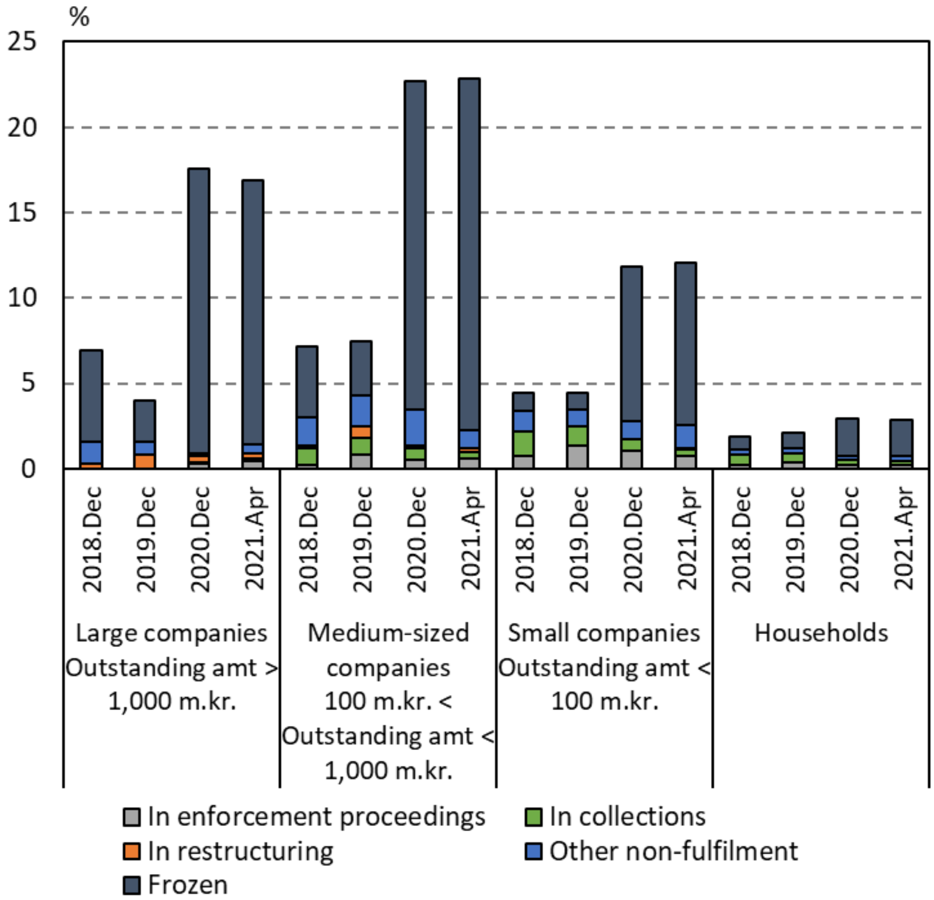
*Sources*: Statistics Iceland, Central Bank of Iceland.

## Current account balance[1]



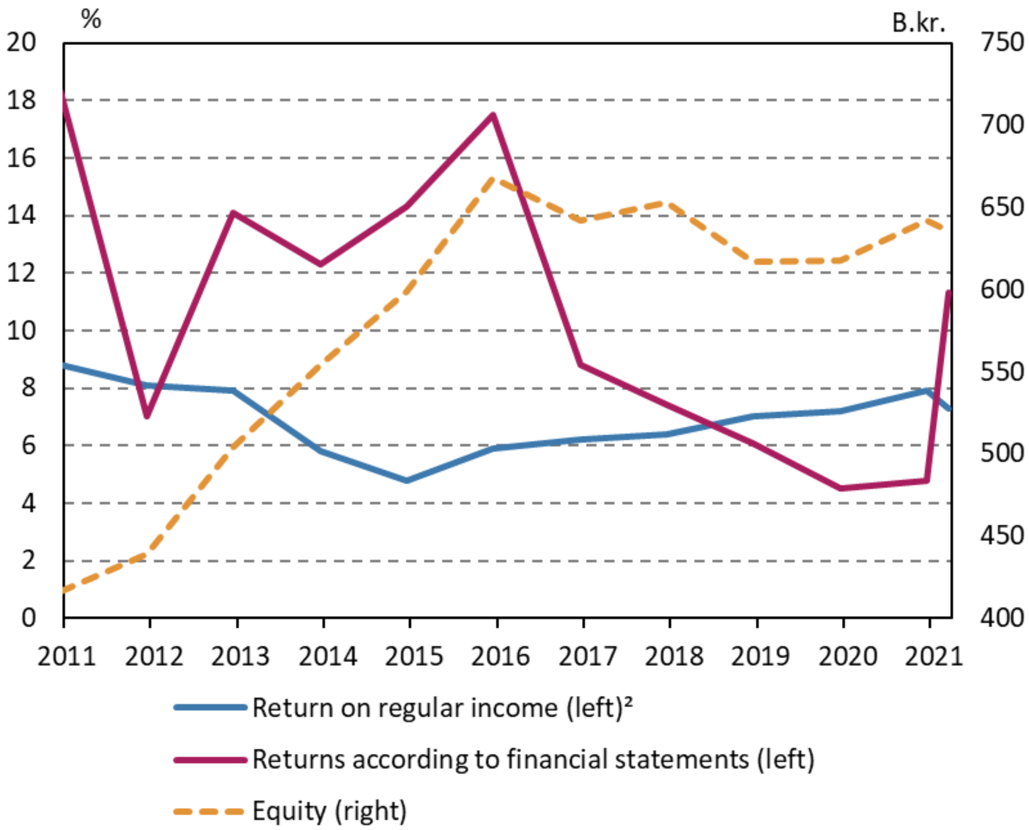

1. The effects of the old banks on factor income and the balance on services from Q4/2008 to Q4/2016 are ignored. From 2009 through 2012, the effect of Actavis on the balance on income is also ignored, owing to inaccurate data during the period.
2. Secondary income is included in factor income.
*Sources*: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

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



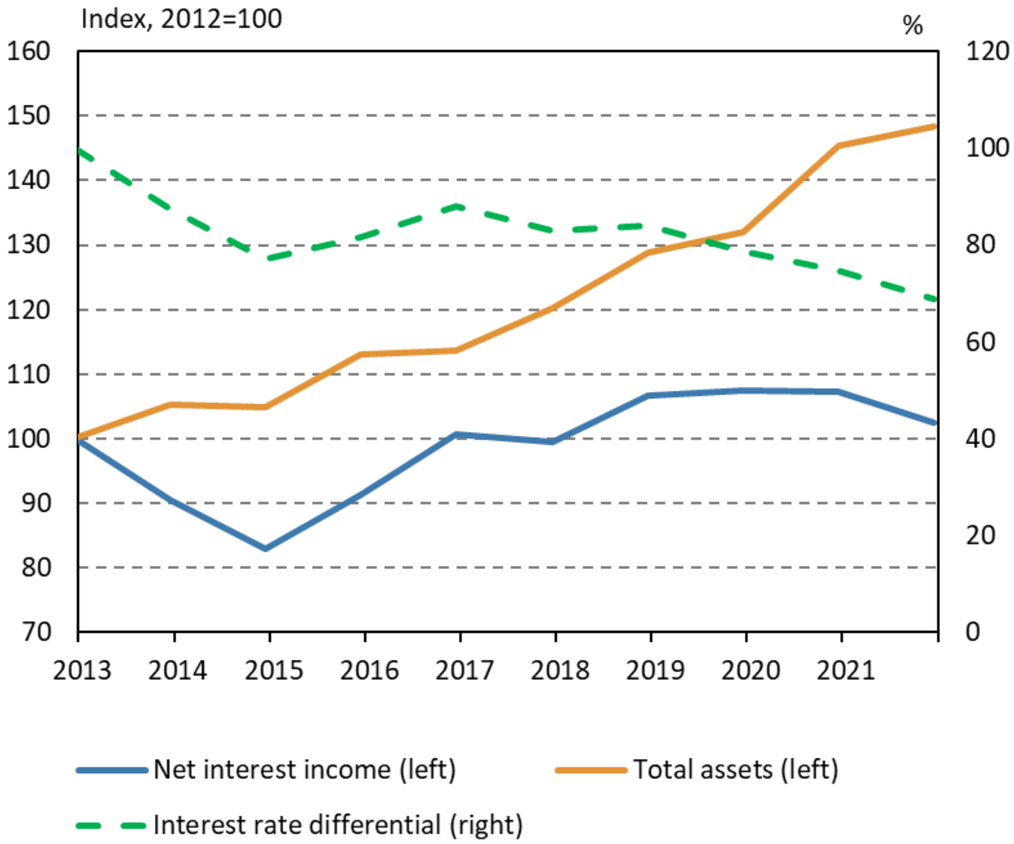

1. Share of non-performing loans to each business size category. Parent companies, book value. D-SIB: Domestic systemically important banks.
*Source*: Central Bank of Iceland.

## D-SIB: Returns[1]



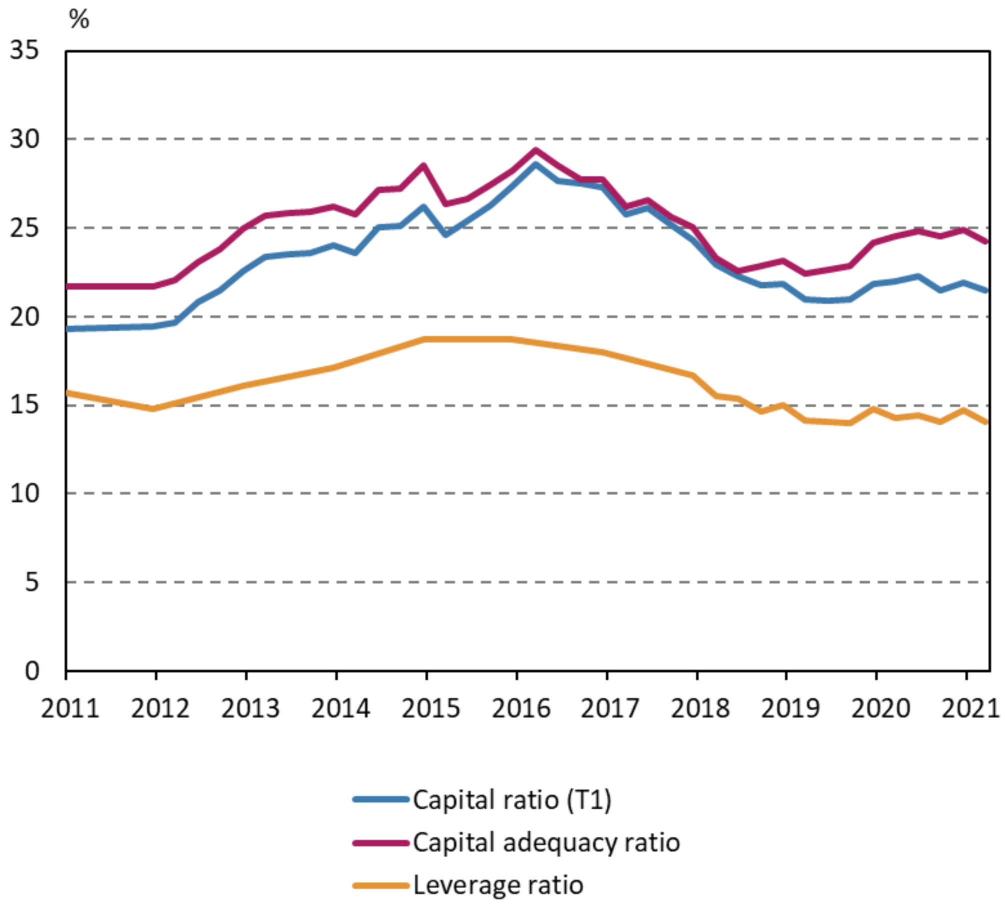

1.Returns are calculated on average equity. Domestic systemically important banks, consolidated figures. 2. The return on regular income is based on net interest incom and fee/commission income net of regular expenses. The tax rate is 20% and is base on average equity. Valitor is excluded in 2017-2020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

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




1. Domestic systematically important banks, consolidated figures. 2. Annualised Q1/2021 data.
*Sources*: Commercial banks' financial statements.

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




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