



FINANCIAL STABILITY COUNCIL

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Recommendation on countercyclical capital buffer

On a quarterly basis, the Financial Stability Council shall submit recommendations to the Financial Supervisory Authority concerning the value of the countercyclical capital buffer pursuant to Article 86(d), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002. In particular, the Council bases its recommendations on recommendations and analysis from the Systemic Risk Committee in determining the value of the countercyclical capital buffer; cf. the Act on a Financial Stability Council, no. 66/2014.

The main purpose of the countercyclical capital buffer is to enhance financial system resilience against potential losses following excessive debt collection and accumulation of cyclical systemic risk. The buffer may be built up concurrent with the accumulation of imbalances in the financial system. The buffer requirement is reduced or lifted during a concurrent downward financial and business cycle so as to enhance financial institutions' ability to maintain a sustainable supply of credit. The countercyclical capital buffer therefore changes with developments in cyclical systemic risk.

The output gap is still wide, GDP growth is driven increasingly by private consumption, and the current account surplus is narrowing rapidly. Although risk in the domestic financial system is still within moderate limits, there are signs that it has begun to increase. Debt has risen in real terms for more than a year and is currently growing faster than GDP. House prices are now at a historical high, and household mortgage debt is rising in real terms. Households' increased scope for borrowing, together with low mortgage lending rates and high property prices, could stimulate credit growth and make financial institutions more vulnerable to a downturn. The contagion from the tourism industry to the housing market, a result of labour importation and short-term rentals, exacerbates the risk of a sudden turnaround in the market. Commercial real estate (CRE) prices have risen sharply in the recent term, and the outlook is for moderate growth in lending for CRE-related projects in the near future. It is therefore important to build up financial institutions' resilience in due time so that they will be able to address this risk.

With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer be raised by 50 basis points, to 1.75%, for all financial undertakings – each institution individually and at the group level.

Systemic Risk Committee analysis

The decision to recommend a countercyclical capital buffer in Iceland takes account, among other things, of four core indicators that the Financial Stability Council has defined for the first intermediate objective of financial stability: growth in the credit-to-GDP ratio, real credit growth to households and businesses, real increases in residential and commercial real estate prices, and the credit-to-GDP gap. A number of other indicators are considered as well, so as to obtain a clear overview of cyclical systemic risk. Consideration is given to the fact that the implementation of the buffer entails a time lag; therefore, the assessment is based on the current situation and likely developments in coming months.

The financial cycle appears to be firmly in an upward phase. In the last quarter, twelve-month growth in total private sector debt measured 3.9% in real terms. Household debt was up 3.1% in real terms and corporate debt by 4.7%. The year-on-year change in total debt in Q4/2017, adjusted for price and exchange rate movements, amounted to 4.7%, as opposed to 5.7% in the preceding quarter, 4.3% in Q2/2017, and

5.5% in Q1/2017. By this measure, credit growth has been somewhat unevenly distributed between households and businesses. In Q4/2017, household debt grew by 3.4% and corporate debt by 5.9%. Household debt began to grow modestly in Q4/2016 and kept growing rather steadily throughout 2017. Corporate debt grew swiftly in 2017, however, peaking in Q2 at 8.9%. This continuous credit growth throughout 2017 suggest that cyclical systemic risk is on the rise.

Private sector debt has begun to rise relative to GDP after having declined more or less without interruption for the past eight years. The debt-to-GDP ratio bottomed out in Q4/2016 and has risen by 2.6 percentage points since then.

The strongest signs of a cyclical upswing can be found in the real estate market, however. Real house prices in the greater Reykjavík area have risen steeply in the recent term, with the twelve-month increase peaking at 21.5% in May 2017. The pace has eased, but in January 2018 it measured 10.2%. In the Greater Reykjavík area, real house prices reached the previous high in May 2017, and by January 2018 they were 3.1% above the year-2007 peak. Alongside the steep rise in prices, capital area real estate market turnover has grown substantially in the past few years. In real terms, turnover is now similar to that in 2005. The average time-to-sale for properties is also very short — close to the 2007 low. In 2017, price developments deviated somewhat from underlying fundamentals, which is a sign of increased systemic risk.

Because of the recent price increases, loan-to-value ratios for residential housing have fallen steeply, giving households much more scope to take on additional debt. Households that use that scope now and in the near future could find themselves in difficulties in a relatively short time if house prices fall.

Risk has also increased in specific sectors, but in those cases targeted measures cannot be implemented at present. It is appropriate to mention, on the one hand, the strong upward financial cycle and, on the other, the interplay between lending for CRE and real estate development projects and high CRE prices. Real CRE prices have risen rapidly for more than four years. The twelve-month price increase has measured 10% or more for that entire period, peaking at 20.8% in Q1/2016. In Q4/2017, prices were up 16.6% year-on-year. CRE-backed mortgage loans are an important part of financial institutions' loan portfolio, and the outlook is for robust growth in CRE lending in the near future. Supervisory bodies have difficulty, at least for the present, in assessing both the need for targeted policy instruments due to the housing market and the impact of applying such instruments.

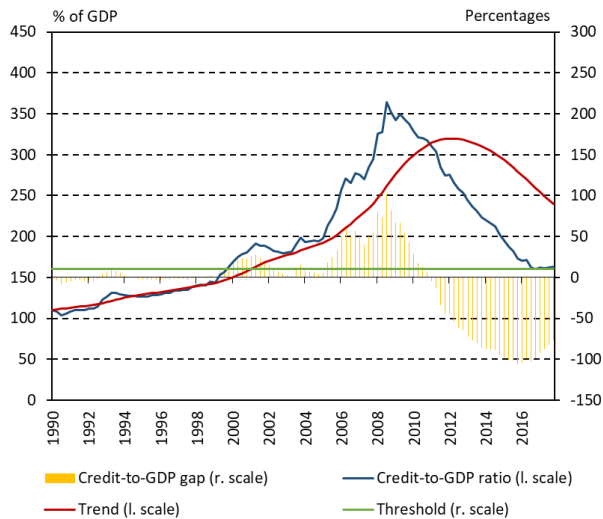
Conclusion

Developments in cyclical systemic risk since the last increase in the countercyclical capital buffer are considered to warrant continued build-up of the countercyclical capital buffer, as previous instructions from the Financial Stability Council have indicated that the countercyclical capital buffer is in an upward phase. With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer be raised by 50 basis points, to 1.75%, for all financial undertakings – each institution individually and at the group level – apart from those institutions that are exempt from capital buffers pursuant to Article 84, Paragraph 4 of the Act on Financial Undertakings, no. 161/2002, and that the buffer take effect twelve (12) months after the date of the Financial Supervisory Authority decision. The Financial Stability Council can therefore be expected to recommend that the build-up of the countercyclical capital buffer continue in line with increased risk in the financial system.

Appendix to recommendation concerning countercyclical capital buffer

In accordance with official financial stability policy, the Financial Stability Council shall regularly disclose which indicators it takes into particular consideration in analysing systemic risk. Below are the indicators considered most important in the assessment of the countercyclical capital buffer at the Financial Stability Council meeting of 20 March 2018.

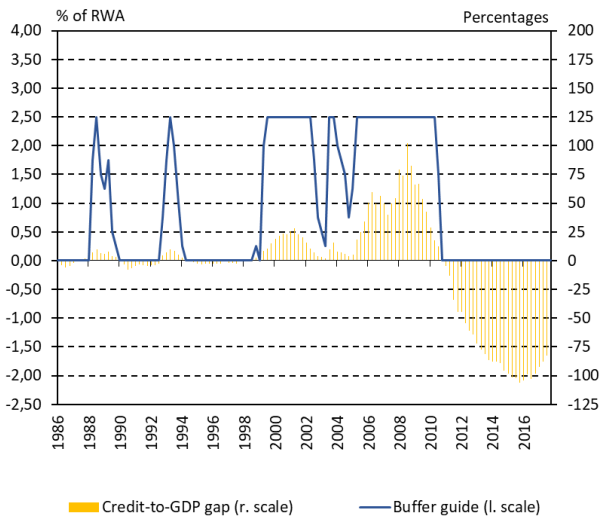
The credit-to-GDP gap



Total credit to households and firms in relation to GDP. The trend component is obtained with a one-sided HP-filter with $\lambda=400.000$. The 9% threshold value comes from Laina, Nyholm & Sarlin (2015).

Sources: Statistics Iceland, Central Bank of Iceland.

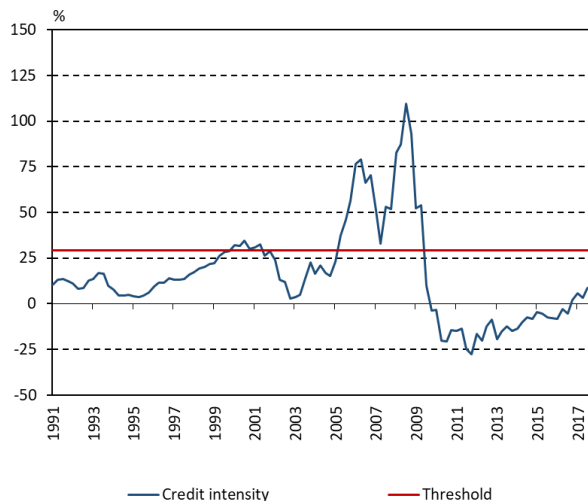
The buffer guide



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.

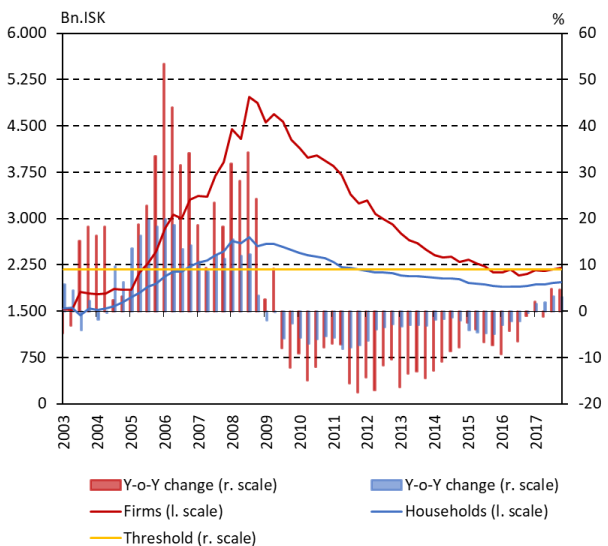
Credit intensity



Nominal credit growth in relation to GDP. The 29% threshold value is the 75th percentile of the distribution of the data from 1976-2017.

Sources: Statistics Iceland, Central Bank of Iceland.

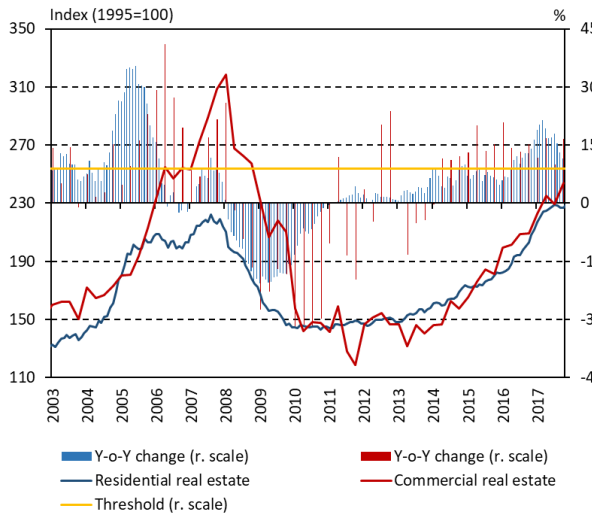
Real credit to households and firms



Total credit to households and firms, excluding holding companies. The 9% threshold value comes from Laina, Nyholm & Sarlin (2015).

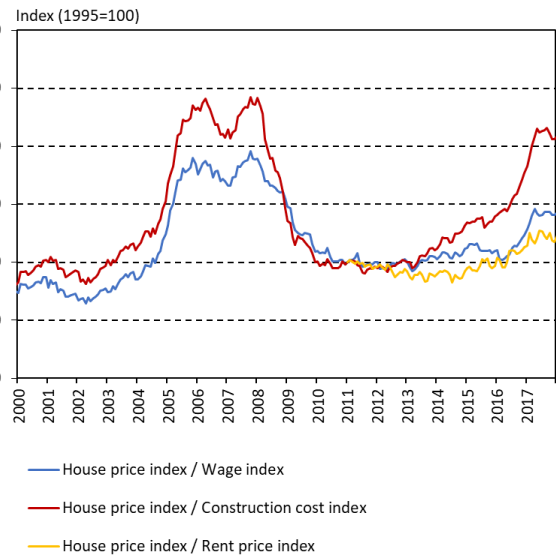
Sources: Statistics Iceland, Central Bank of Iceland.

Real property prices in the capital area



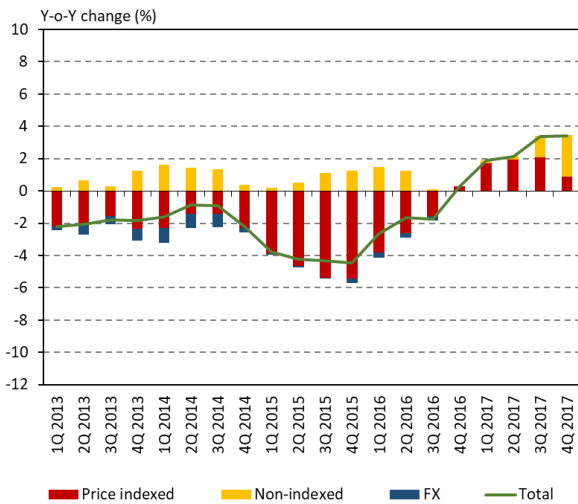
Price indices at constant prices according to CPI. Commercial property index is a weighted average of industrial, retail and office housing. The 9% threshold is from Laina, Nyholm & Sarlin (2015). Q1 2017 commercial property value is preliminary. Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

House prices, wages, construction cost and rent prices



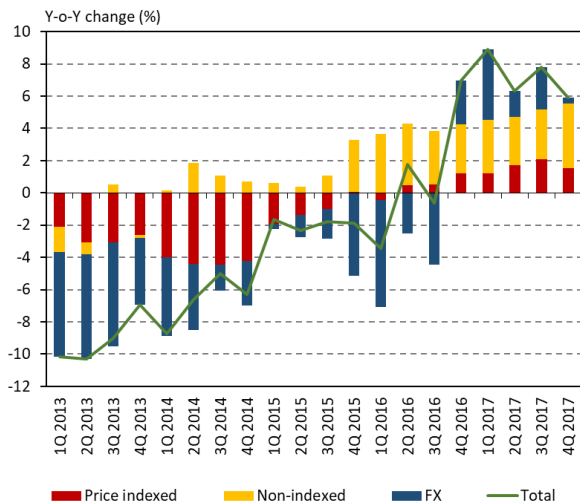
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

Household credit growth Price and exchange rate adjusted



CPI-indexed credit at Sept. 2017 prices. FX credit at end Sept. 2017 exchange rate. Non-indexed credit at current prices. Sources: Statistics Iceland, Central Bank of Iceland.

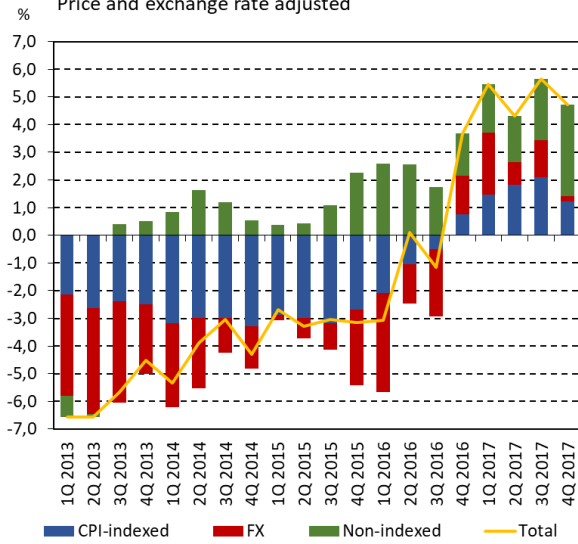
Firms credit growth Price and exchange rate adjusted



CPI-indexed credit at Sept. 2017 prices. FX credit at end Sept. 2017 exchange rate. Non-indexed credit at current prices. Sources: Statistics Iceland, Central Bank of Iceland.

Total credit growth

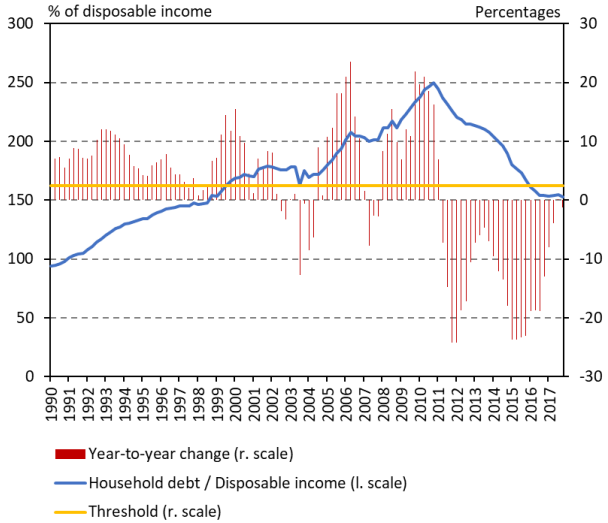
Price and exchange rate adjusted



Total credit to households and non-financial firms, claim value. CPI indexed credit at Dec. 2017 prices, FX denominated credit at year-end 2017 exchange rate and non-indexed credit at current prices.

Sources: Statistics Iceland, Central Bank of Iceland.

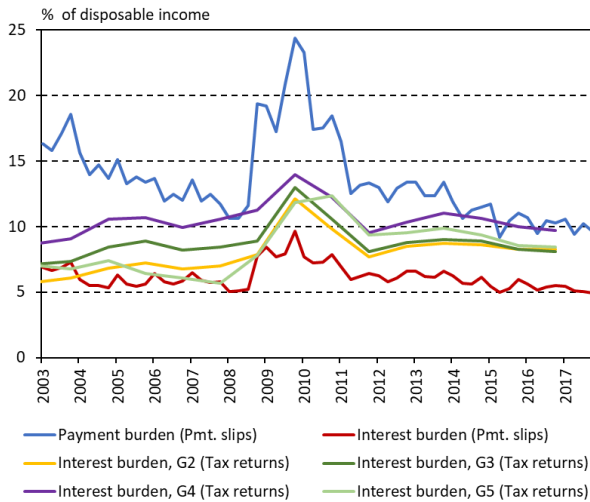
Household debt to disposable income



Disposable income data is obtained from the Central Bank's Quarterly Macroeconomic Model dataset. The value for 4Q 2017 is nowcasted. The threshold value is the average of the ratio's year-on-year change in the period 1989 to 2017.

Sources: Statistics Iceland, Central Bank of Iceland.

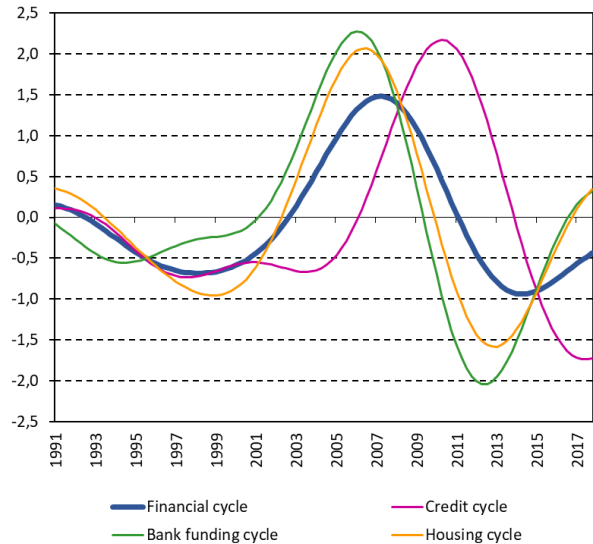
Household payment and interest burden



Payment burden is the sum of principal and interest payments according to payment slips, as a percentage of disposable income from to the Central Bank's QMM database. Interest burden is interest expenses net of interest benefits according to tax returns, as a percentage of disposable income. The lowest income group is left out of the tax return data.

Sources: Statistics Iceland, Central Bank of Iceland.

Financial cycle



Arithmetic mean of cyclical components from variables in each subsample and the complete set of variables. Cyclical components are obtained using the Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years.

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