

Reykjavik, 20 December 2020

## Notification of an unchanged countercyclical capital buffer

On 15 May 2018 the Financial Supervisory Authority decided to raise the countercyclical capital buffer to 1.75% pursuant to Article 86(d) of the Act on Financial Undertakings.<sup>1</sup> As of 15 May 2019 financial undertakings have thus maintained a 1.75% countercyclical capital buffer unless exempt pursuant to the Act on Financial Undertakings. Furthermore, on 1 February 2019 the Financial Supervisory Authority decided to raise the countercyclical capital buffer to 2%, the increase coming into effect from 1 February 2020.<sup>2</sup>

The Financial Stability Council is tasked with reviewing the countercyclical buffer rate every quarter in accordance with Article 86(d) of Act No 161/2002 on Financial Undertakings. On 17 December 2019 the Council recommended to the Authority that the countercyclical capital buffer should be held unchanged at 2%.

The main purpose of the countercyclical capital buffer is to enhance financial system resilience against potential losses during unstable conditions following excessive debt accumulation and the build-up of cyclical systemic risk. The countercyclical capital buffer may be built-up while a comprehensive assessment indicates that systemic risk is increasing. Cyclical systemic risk may increase when substantial lending growth is concurrent with rapidly rising asset prices and low defaults and expectations of further growth are present. Tightening conditions can then have a significant impact on the value of the financial system's assets. Consequently, financial undertakings might respond by safeguarding their capital, e.g. by significantly reducing lending. Reduced supply of credit can cause a contraction in investment and economic activity, which in turn can lead to lower asset prices, an increase in corporate bankruptcy, increased unemployment and thus further deteriorate the quality of loan portfolios. When cyclical systemic risk is realized, a negative chain reaction between lending, economic activity and asset prices deepens the downturn. The purpose of accumulating a systemic risk buffer synchronously with the build-up of cyclical systemic risk and releasing the buffer when the risk recedes or is realized, is to give financial undertakings room to absorb losses on their loan portfolios, without restrictively reducing the supply of credit.<sup>3</sup> Releasing the buffer is not intended to affect economic cycles specifically, rather a financial downturn of the kind previously described, which could coincide with a contraction in the economy. The buffer should therefore not be released in an economic downturn if cyclical systemic risk is not realized or does not recede at the same time.<sup>4</sup>

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<sup>1</sup> According to recommendations of the Financial Stability Board of 13 April 2018.

<sup>2</sup> According to recommendations of the Financial Stability Board of 19 December 2018.

<sup>3</sup> Further information on the countercyclical capital buffer can be found in the Council's policy on the application of the buffer (available in Icelandic [here](#)) and in the Financial Supervisory Authority's web magazine (available in Icelandic [here](#)).

<sup>4</sup> See for example a [recommendation](#) of the European Systemic Risk Board on guidance for setting countercyclical buffer rates and BIS [guidance](#) for national authorities operating the countercyclical capital buffer.

The Council's recommendations references the Systemic Risk Committee's assessment and advices that the level of the countercyclical capital buffer remain unchanged at this point in time. The Council states that although the build-up of cyclical systemic risk has slowed considerably, since there are no indications that cyclical systemic risk has receded or been realized, a release of the buffer is not warranted at this time.

The price of real estate is still historically high, even when compared with its predictive factors. The real price of residential real estate is still considerably far above its long term trend. Commercial property prices have risen sharply in recent years and are still rising. Lower property prices could test the commercial banks' resilience, both due to a fall in collateral value and through lower demand or a contraction in the economy

The imbalances associated with credit growth are largely dictated by household indebtedness: Other things being equal, credit growth poses a higher risk if households' indebtedness is already high than if their indebtedness is low. Debt relative to income is higher in Iceland than other countries and some Icelandic households are therefore vulnerable to income loss or an increased debt burden. Furthermore, the share of mortgages in total household credit is among the highest in Europe, and therefore Icelandic homes have greater exposure to the risks inherent in the interaction between housing prices and household debt.<sup>5</sup> Household debt has grown significantly during the last several years and there are many indications that it will continue to do so for the foreseeable future.

Firms' debts grew in conjunction with the recent economic expansion, but now the growth has slowed down due to the current economic slowdown. At the end of the third quarter of this year, domestic corporate debt was 13% higher in real terms than at its lowest level three years earlier. Growth in credit granted by systemically important banks to domestic enterprises was high, or about 10% on average in real terms, from the fall of 2017 until the spring of this year. Firms' resilience is still high, while uncertainty remains about the business environment due to a less favourable economic outlook for 2020, especially for the tourism industry.

It is hereby announced, with reference to the Council's recommendations, that the Authority's Decision on 1 February 2019, on maintaining a 2% countercyclical capital buffer, will remain unchanged. The buffer will continue to cover the domestic credit exposure of all financial undertakings, both individually and on a consolidated basis, unless they are specifically excluded from the buffer according to Article 86(d)(4) of the Act on Financial Undertakings. The calculation of the own funds requirements shall reflect the weighted average of the countercyclical capital buffer rates that apply domestically and in the other EEA-States, in accordance with the share of credit exposure in each relevant country, pursuant to Article 86(d)(3) of the same Act.<sup>6</sup>

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<sup>5</sup> See for example a report by the European Systemic Risk Board on residential real estate sector vulnerabilities in the EEA countries.

<sup>6</sup> The Financial Supervisory Authority will introduce rules implementing the regulatory technical standards in Commission Delegated Regulation (EU) No 1152/2014 that further prescribes the calculations, cf. Consultation paper No 4/2016 available on the Authority's website. In addition, the Financial Supervisory Authority has laid down Rules no 506/2017 implementing the regulatory technical standards in commission Delegated Regulation (EU) 2015/1555.