SEÐLABANKI ÍSLANDS

REPORT

FINANCIAL STABILITY COMMITTEE REPORT TO PARLIAMENT

2024

REPORT

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25 February 2025

Accompanying documents

This report is accompanied by the following documents

Financial Stability Committee report to Parliament for 2024

As is required by law, the Central Bank of Iceland Financial Stability Committee (FSN) reports to Parliament on its work once a year. The report shall be discussed in the Parliamentary committee of the Speaker's choosing. In 2024, the FSN's fifth year of operation, the Committee held five formal meetings. Members of the Committee during the year were: Ásgeir Jónsson, Governor, Chair; Gunnar Jakobsson, Deputy Governor for Financial Stability, until he left the Bank's employ at the end of April; Arnór Sighvatsson, sitting Deputy Governor for Financial Stability from 1 May through end-July; Tómas Brynjólfsson, Deputy Governor for Financial Stability from 1 August onwards, Vice-Chair; Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy; Björk Sigurgísladóttir, Deputy Governor for Financial Supervision; Axel Hall, Assistant Professor; Bryndís Ásbjarnardóttir, Economist; and Guðmundur Kr. Tómasson, former Director with the Central Bank of Iceland. The Permanent Secretary or an appointed official from the Ministry responsible for financial stability also participates in Committee meetings as a non-voting member with the right to address the meeting and present proposals.

Financial stability

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 diversify risks 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 components, or markets shall be considered systemically important. When warranted, the FSN may make 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 Committee's assessment of financial stability. The FSN's statements and minutes, enclosed with this report, contain the rationale for the Committee's decisions in 2024.

Developments in 2024

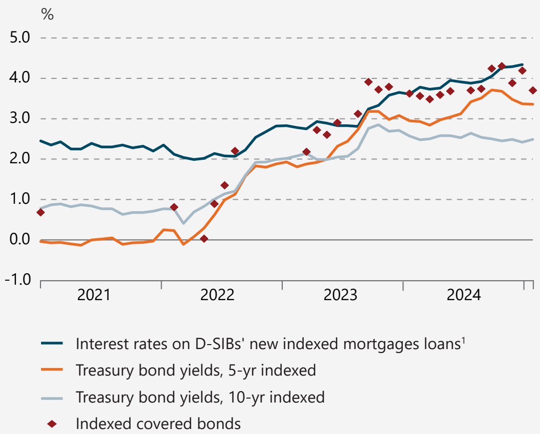
In the wake of the easing of tension in the economy, as well as declining inflation and inflation expectations, the Central Bank's Monetary Policy Committee (MPC) lowered the Bank's interest rates by a total of 0.75 percentage points in H2/2024. For the most part, non-indexed interest rates in the market fell in line with Central Bank rate cuts, whereas inflation-indexed rates rose somewhat during the year, particularly in H2, in tandem with declining inflation. Yields in auctions of the banks' indexed covered bonds peaked at 4.3% in October. Yields on short-term indexed Treasury bonds developed in a comparable manner.

Households' and businesses' capital position was strong overall, and equity ratios were historically high, irrespective of business sector or household income

Chart 1

Indexed market rates

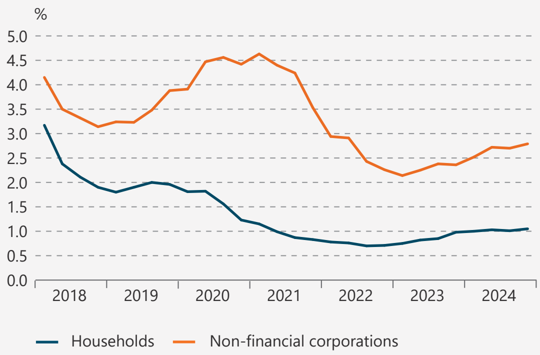
January 2021 - January 2025



1. Domestic systemically important banks (D-SIBs).
Sources: Nasdaq Iceland, Central Bank of Iceland.

Chart 2

D-SIBs: Non-performing loans ratio[1]



1. NPL ratio calculated according to EBA standards. Domestic systemically important banks (D-SIBs).
Source: Central Bank of Iceland.

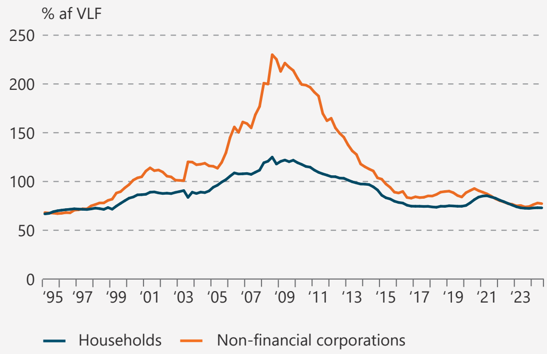
and age group. By the same token, private sector debt ratios were low. The corporate debt-to-GDP ratio rose during the year, however, owing to a contraction in GDP and fairly strong credit growth. The household debt-to-GDP ratio rose slightly in 2024, but the debt-to-disposable income ratio fell by about 2.5 percentage points during the year, to 136%. The latter ratio is at its lowest since 1995.

High real rates and tighter lending rules dampened private sector demand for credit. Many lenders tightened their terms and conditions, particularly on inflation-indexed loans; for instance, by shortening maximum maturities on new loans and by placing restrictions on new indexed annuity loans. This has curbed growth in private sector debt. The average interest rate on new mortgage loans of the most common type – variable-rate inflation-indexed mortgages – weighted by face amount of loans issued, was 4.3% at the end of 2024 and had risen by 0.7 percentage points during the year. On the other hand, the average rate on non-indexed variable-rate mortgages had fallen by 0.8 percentage points over the same period, to 10.3% at the year-end.

Many households and businesses took steps to address high debt service, as could be seen, for instance, in weaker private consumption growth and increased debt restructuring. Private sector demand for inflation-indexed loans remained strong during the year, as the debt service burden on these loans is lighter than on comparable non-indexed loans. In October 2024, just over 59% of outstanding mortgage debt was indexed, as compared with 51% at the beginning of that year. Even so, the ratio was still somewhat

Chart 3

Household and NFC credit-to-GDP ratios

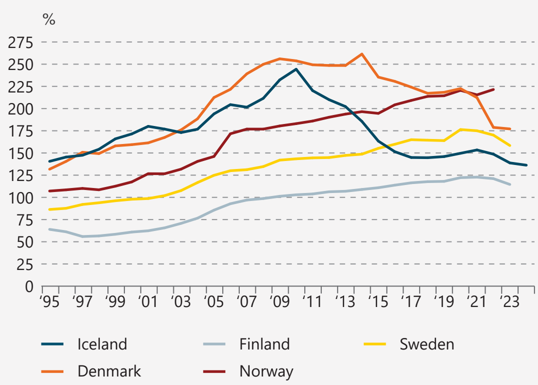


1. Household debt to domestic financial undertakings. Non-financial corporations debt to domestic and foreign financial undertakings and debt securities issued.
Sources: Statistics Iceland, Central Bank of Iceland.

Mynd 4

Household debt-to-disposable income ratio in the Nordic countries

1995 - 2024[1]



1. Value for year 2024 is based on Q3 2024.
Sources: Macrobond, Statistics Iceland, Central Bank of Iceland.

below the pre-pandemic level. Indexed debt accounted for 28% of total corporate debt at the end of Q3, after increasing by slightly more than 3 percentage points over the course of the year.

High inflation and interest rates put pressure on households' and businesses' financial position in 2024. Borrowers' strong resilience and their efforts to address their heavier debt service burden are part of the reason there were few signs of widespread private sector financial distress during the year. The facility-level non-performing loan (NPL) ratio on loans issued by the systemically important banks (D-SIB) was only 1% at the end of Q3 and held unchanged over the course of the year.[1] At the same time, the NPL ratio on the D-SIBs' corporate loans was 2.7% and had risen by 0.3 percentage points during the year. Both ratios were low in historical and international context. Furthermore, there were no visible signs of an increase in shorter-term arrears among either households or businesses. Moreover, figures on the number of households and businesses on the CreditInfo default register did not indicate growing private sector financial distress.[2]

Real estate firm Þórkatla's buy-up of homes in the town of Grindavík and residents' relocation to other communities affected the housing market last year. Market turnover soared in Q2 as a result, particularly in the southwest corner of Iceland. The number of purchase contracts for homes in greater Reykjavík more than doubled year-on-year in Q2/2024, and on the Reykjanes peninsula it jumped more than sixfold. The house price index rose by 2.8% in real terms in 2024. Even though the increased turnover is due in large part to purchases by former Grindavík residents, the number of first-time buyers rose 6% between H2/2023 and H1/2024, and by 50% between H1/2023 and H1/2024. House prices continued to rise. The impact of Grindavík residents' home purchases tapered off significantly around mid-year.

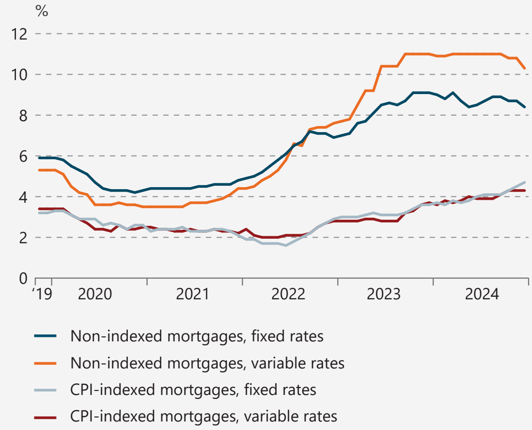
Despite strong demand in the housing market, there were over 500 more properties for sale at year-end 2024 than at the end of 2023. The number of unsold newly built properties grew especially strongly over the same period, or by more than 400. Newly built properties accounted for 42% of all homes advertised for sale nationwide at the end of December. In the past few months, the ratio of newly built homes to the total

1. The non-performing loan ratio is calculated according to European Banking Authority (EBA) methodology and includes loans that have been in arrears for 90 days or longer, as well as loans that, in the lender's assessment, are unlikely to be repaid in full.
2. Loans that have been in arrears for more than 30 days but less than 90 days.

Chart 5

D-SIBs: Interest rates on new mortgages to households[1]

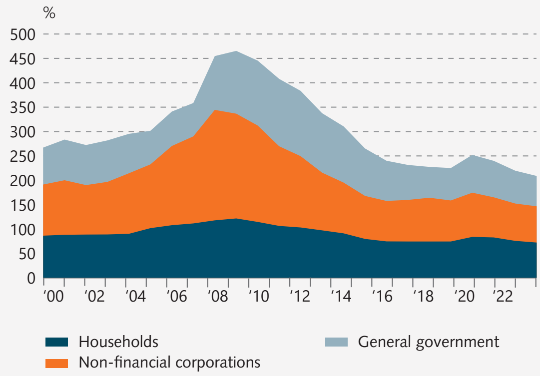
November 2019 - December 2024



1. Weighted average interest rates on new mortgages to households. Domestic systemically important banks (D-SIBs).
Source: Central Bank of Iceland.

Chart 6

Credit-to-GDP ratio

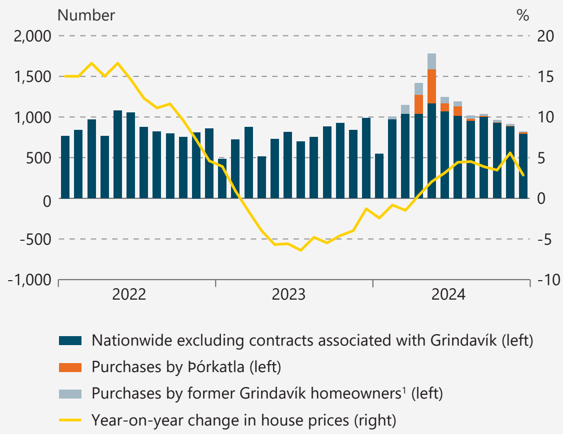


Sources: Statistics Iceland, Central Bank of Iceland.

Chart 7

Real house prices and number of purchase agreements nationwide

January 2022 - December 2024



1. Purchase agreements of owners of housing in Grindavík at year-end 2023.
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

supply has been at its highest since data collection began in Q4/2017.

Home prices rose year-on-year by 2.6% over and above the general wage index in 2024, and the ratio of the house price index to the general wage index was a full 21% above its average in the twenty-first century to date. House prices have deviated somewhat from their long-term trend, to an increasing degree as the year advanced. Prices were high by most measures, and the risk of a real decline in house prices remained broadly unchanged during the year.

Activity was strong in the residential construction sector. A total of nearly 3,700 new properties were put on the market during the year, 2,300 of them in the greater Reykjavík area. By the end of 2024, nearly 8,000 properties were under construction or in the planning stage, an increase of almost 1,000 during the year. Strong activity in the construction sector during the year can also be seen in figures on imports of construction materials, which reached their highest since data collection began in 2015. The sector continued to add jobs, which reached a total of 19,000 by end-Q3, or 4% more than in the same period a year earlier. At the same time, there were a large number of job vacancies in the construction industry – far more in proportional terms than in other sectors. Few indicators emerged during the year to suggest that activity in the sector had slowed.

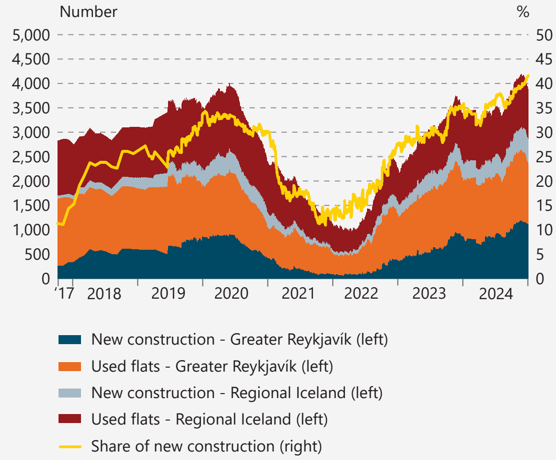
Lending to construction companies totalled 348 b.kr. at the end of November, an increase of just over 10% year-on-year in nominal terms. The rise was due in part to a slowdown in early repayment of development loans as the number of new homes for sale rose. The non-performing loan (NPL) ratio on the commercial banks' loans to construction companies has risen somewhat. It was 3.2% at the end of September, as compared with 1.1% in the same month of 2023. This is slightly higher than the 2.7% NPL ratio on loans to companies as a whole.

The foreign exchange market was stable during the year, and the króna appreciated by 4%. Total turnover in the interbank foreign exchange market contracted by 10% year-on-year, and the Central Bank intervened only once in the market. Exchange rate volatility was low in historical context. This indicates that foreign currency flows to and from Iceland and among the large commercial banks were well balanced. The interest rate differential with abroad played a role in piquing foreign investors' interest in Iceland, and there were considerable capital inflows for investment in Icelandic Treasury bonds during the year. Trading in

Chart 8

Number of properties listed for sale[1]

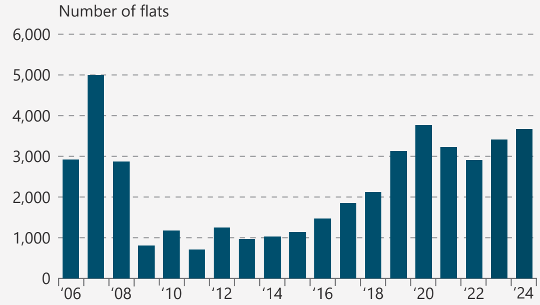
1 October 2017 - 31 December 2024



1. Linear interpolation is used for dates where data is missing.
Sources: Fasteignir.is, Housing and Construction Authority, Central Bank of Iceland.

Chart 9

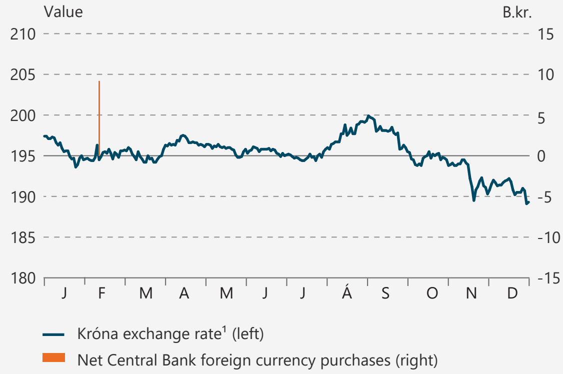
Fully finished homes nationwide[1]



1. Fully finished housing units are those in construction stages 7 and 8.
Sources: Housing and Construction Authority, Central Bank of Iceland.

Chart 10

Exchange rate of the króna and Central Bank foreign exchange market activity in 2024

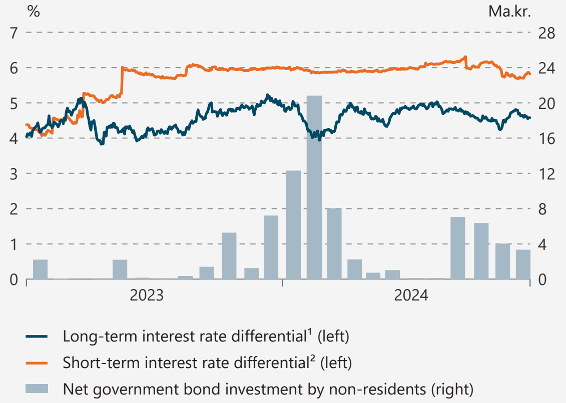


1. Narrow trade-weighted exchange rate of the króna (1%).
Source: Central Bank of Iceland.

Chart 11

Interest rate differential between Iceland and Germany

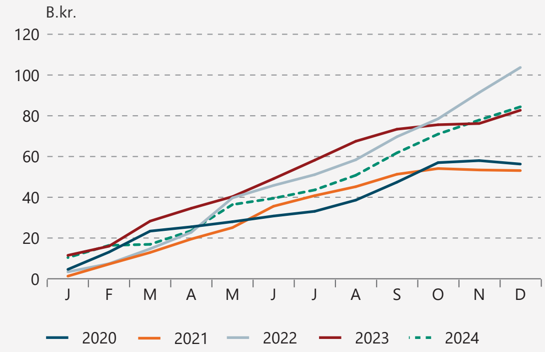
January 2023 - December 2024



1. Based on 10 year government bonds. 2. Based on three month interbank rates.
Sources: LSEG datastream, Nasdaq Iceland, Central Bank of Iceland.

Chart 12

Pension funds' aggregate net foreign currency transactions



Source: Central Bank of Iceland.

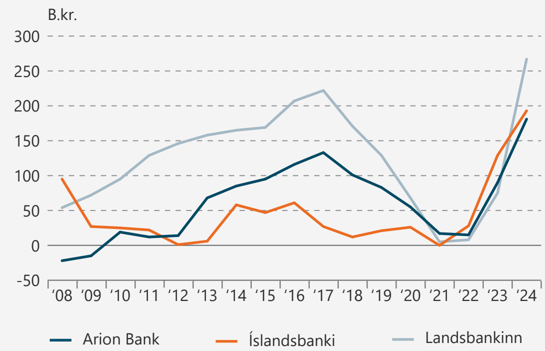
connection with US company John Bean Technologies' (JBT) takeover offer for Marel also strengthened the króna in H2, as Marel was majority-owned by domestic entities, including pension funds. As before, the pension funds were active buyers of foreign currency, with purchases totalling 84 b.kr., about the same as in 2023. The commercial banks' net forward foreign currency position declined during the year, as companies and investors scaled down their forward position-taking with the króna, indicating that they did not expect it to appreciate further. The current account was fairly well balanced, with a good year for tourism offset by a significant deficit on goods trade.[3]

The three large systemically important commercial banks all generated good profits in 2024. Their return on equity averaged 12.0% during the year and was unchanged relative to 2023. The interest rate spread on total assets was 2.86% during the year, as compared with 2% in 2023. The banks' net interest income was unchanged between years, as their balance sheet expanded by nearly 7% during the year. Income from fees and commissions declined marginally, and it can be said that there were few changes in individual income items between years, with the exception of income from financial activities, which increased by 8 b.kr. year-on-year, to 15 b.kr.

Expenses increased in real terms by 1.3% year-on-year in 2024. The cost-to-income ratio was just over 39%, an increase of 1 percentage point between years.

Chart 13

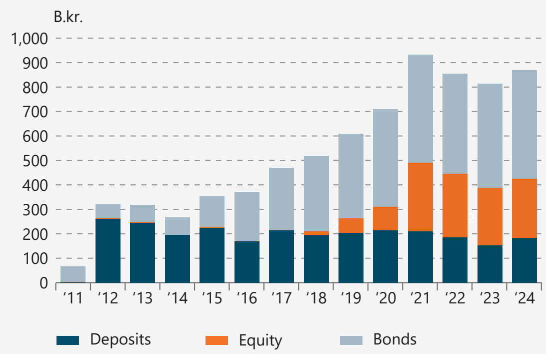
D-SIB: Indexation imbalance[1]



1. Domestic systemically important banks (D-SIBs), consolidated figures.
Sources: Commercial banks' financial statements.

Chart 14

The pension funds' investments in the banking system[1]



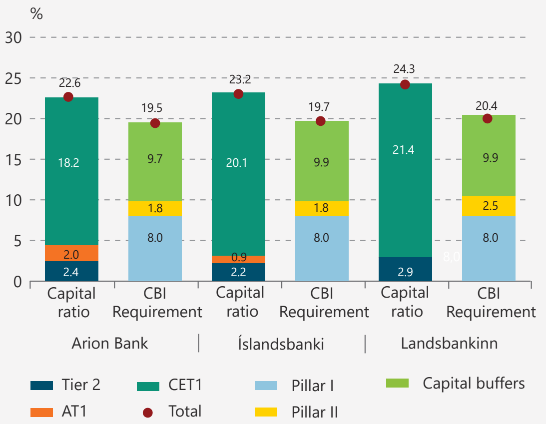
1. Fixed prices.
Sources: Statistics Iceland, Central Bank of Iceland.

Stronger demand for inflation-indexed loans has caused the D-SIBs' indexation imbalance to widen significantly, as new indexed loans are funded to a large

3. Strong imports of investment goods in H2, in connection with investments in data centres, do not require increased foreign currency flows but do add to the current account deficit. These investments do not put additional pressure on the exchange rate.

Chart 15

D-SIB capital requirements and capital adequacy ratios at the end of 2024[1]



1. Domestic systemically important banks (D-SIBs), consolidated figures. In calculating the capital ratio, the portion of the 2024 profit to be paid as a dividend in 2025 has been deducted from the capital base.

Sources: Commercial banks' financial statements and other published materials.

degree with non-indexed deposits. The indexation imbalance was 641 b.kr. at the end of 2024, or 84% of capital, and had increased by 347 b.kr. during the year. Towards the end of the year, the banks responded to the increased mismatch and took measures aimed at reducing it.

Their capital adequacy ratio averaged 23.5% at the end of 2024, having decreased by 0.8 percentage points year-on-year. The three banks' capital adequacy ratios exceeded overall Central Bank requirements by 3.1-3.9 percentage points. The financial institutions have enough own funds and eligible liabilities to satisfy the Central Bank Resolution Authority's minimum requirements for own funds and eligible liabilities (MREL requirements).

The banks' end-2024 liquidity ratio in all currencies was 170%, well above the 100% minimum required under Central Bank liquidity rules. Liquid assets in excess of requirements declined by 38 b.kr. in 2024, to 302 b.kr. at the year-end. Liquidity ratios were high at the beginning of the year but declined until the spring. They increased again in the autumn, in tandem with the banks' foreign bond issues. In general, it can be said that the banks' liquidity was strong in 2024. Their króna-denominated market funding was largely limited to covered bond issues, but they have stepped up their issuance of general unsecured bonds in krónur in the recent term. They also issued subordinated bonds in krónur in 2024.

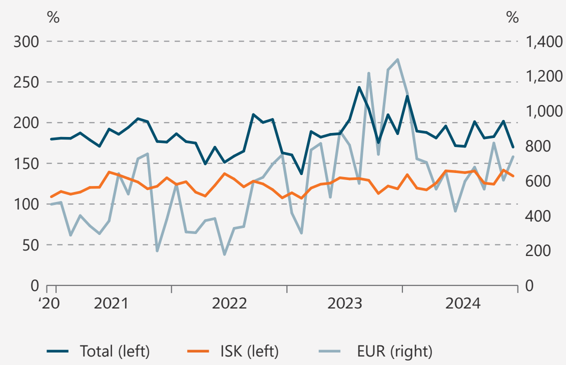
Interest rate spreads on the banks' foreign issues declined fairly steadily during the year. Foreign-denominated bond issues totalled 267 b.kr. in 2024. The banks have sold euro-denominated covered bonds in the combined amount of 1,100 million euros in recent years, but in 2024 there were no such issues. Interest rate spreads on covered bond issues were far lower than spreads on unsecured issues when spreads rose to their highest in 2022 and 2023, but the differential has now narrowed considerably.

The financial system is faced with constantly growing cyberthreats. Hybrid threats have been in focus everywhere, and there is no let-up in cyberattacks – even serious ones – either in Iceland or abroad. In view of this trend, strong emphasis has been placed on the operational security of Icelandic financial market infrastructure and payment intermediation.

Chart 16

D-SIB: Liquidity coverage ratio[1]

'December 2020 - December 2024



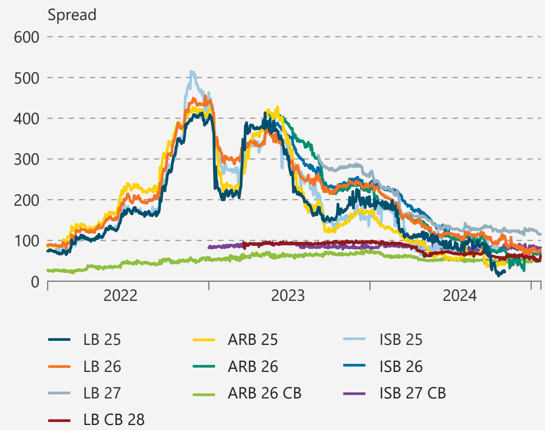
1. Domestic systemically important banks (D-SIBs), consolidated figures.

Source: Central Bank of Iceland.

Chart 17

D-SIB: Spread on listed foreign bonds, EUR[1]

31 December 2021 - 22 January 2025



1. Domestic systemically important banks (D-SIBs). Z spread.

Source: LSEG datastream.

The Act on the Central Bank of Iceland, no. 92/2019, was amended during the year. The Bank was granted broader authorisations to set rules aimed at strengthening security and bolstering resilience in domestic payment intermediation. Work is being done towards the implementation of a domestic retail payment intermediation solution, with the aim of shoring up the resilience of payment intermediation in accordance with the priorities outlined by the Financial Stability Committee. The technical design of the infrastructure is complete, and an advertisement soliciting proposals for execution and a cost assessment was published in late 2024.

During the year, work was done on a coordination plan providing for responses to operational incidents in the financial market. Furthermore, the Central Bank participated in contingency exercises and execution of cybersecurity testing. The objective of the plan is to ensure a streamlined response and establish a dedicated incident centre, so that lines of communication can be shortened with the aim of minimising disruption in the financial system in the event of operational incidents.

The Central Bank has adopted a framework for TIBER cyberattack testing for institutions and companies that are important in the context of the domestic financial system. Testing has already begun, with the aim of identifying vulnerabilities in defences and thereby bolstering resilience. The TIBER project places emphasis on providing cyberdefence training to employees in the Icelandic financial system.[4]

Committee decisions in 2024

The FSN agreed that the foundations for financial stability in Iceland were robust on the whole. The framework for the financial system has proven its value and delivered stability. The systemically important banks were well positioned financially, in terms of both capital and liquidity. Their access to foreign financial markets had also improved markedly from the previous year. Private sector debt had been moderate in international and historical context, although corporate debt had increased somewhat. The balance of payments was broadly in equilibrium during the year, and the króna appreciated in H2, after weakening in late summer.

The Committee considered uncertainty about economic developments to be one of the key risks to financial stability. In particular, the housing market appeared poorly balanced, and in the Committee's assessment, house prices were high by most measures. Furthermore, real interest rates rose somewhat over the course of the year, even though the Central Bank's key rate had been lowered by 0.75 percentage points in two increments in H2, to 8.5%. The FSN was of the view that even though many factors were improving in Iceland, a high real interest rate alongside slower growth in economic activity could put strain on some households and businesses. If that risk materialised, it could affect the financial system as a whole. Few indicators of general financial distress among households and businesses had emerged, however. Households and businesses had turned increasingly to inflation-indexed loans at the expense of non-indexed loans. The banks' indexation imbalances grew rapidly as a result, and the Committee was of the opinion that this could create challenges for the financial system.

The Committee discussed payment intermediation at all of its meetings during the year and considered cyberattacks one of the chief threats to financial stability in 2024. Governments worldwide placed strong emphasis on the operational security of financial market infrastructure, owing to the rise in cyberattacks and vandalism. During the year, important steps had been taken to shore up resilience with Parliament's passage of amendments to the Act on the Central Bank of Iceland, which expanded the Bank's authorisations to strengthen security and bolster the resilience of domestic payment intermediation. Furthermore, work had been done towards establishing an independent domestic payment solution, and the FSN expected implementation of such a solution to begin in 2025. The Central Bank completed its contingency plan for operational disruptions in the financial system in 2024 and presented it to the FSN in December. The plan specifies the readiness measures the Central Bank must have at its disposal in the event of a threat or incident in financial market infrastructure that affects the operational security of payment intermediation, and it specifies which infrastructure components shall be considered core financial market infrastructure and must be given particular protection. Two TIBER cybersecurity tests were conducted in 2024, and three are planned for 2025. When the EU's Digital Operational Resilience Act (DORA) is implemented in 2025, companies in the financial market will be subject to far more stringent requirements than they are currently, which should bolster resilience in payment intermediation. The FSN was given a presentation on the Eurosystem's TARGET

4. TIBER-IS is a framework for cyberattack testing for institutions and companies that are important for the Icelandic financial system. The framework aims to enhance testing participants' understanding of the capability to defend against cyberattacks, thereby bolstering their resilience.

services. Payment intermediation has evolved rapidly in recent years, and the Bank's priorities have changed accordingly. Other Nordic central banks are planning to implement the TARGET system's TIPS and T2 services for interbank payment intermediation or have already done so. The cost of the current system has risen in recent years and cybersecurity risks have grown, which calls for increased preparedness. The TARGET services will be updated and developed further, in line with the standards and regulations whose implementation in Iceland the Bank has worked towards.

The Committee discussed the real estate market in detail at all of its meetings in 2024. The Committee decided at its February meeting to expand borrower-based measures for first-time buyers so that they would cover Grindavík residents who had been forced to evacuate their homes because of earthquakes and volcanic activity. A temporary provision to this effect was added to rules on borrower-based measures. It will expire on 1 March 2027. The Committee was of the view that the extraordinary circumstances prevailing in Grindavík – i.e., the temporary loss of income and the permanent loss of housing – created conditions beyond the scope of borrower-based measures, the goal of which was to safeguard borrowers' resilience. In addition, their position was comparable in many respects to that of first-time buyers.

The Committee made no other amendments to borrower-based measures during the year. After the measures were tightened in 2022, the maximum ratio of mortgage debt service to disposable income was 40% for first-time buyers and 35% for others. The rules afford lenders the scope to exceed the maximum debt service-to-income ratio for loans equalling 5% of the total amount of consumer mortgages issued each quarter. The maximum loan-to-value ratio is 85% of market value for first-time buyers and 80% for others. Furthermore, because of exemptions provided for in legislation on mortgage lending, rules on maximum LTV ratios, and rules capping debt service, borrower-based measures do not affect households' debt restructuring or refinancing options.

In March, the Committee expected population growth and the aftereffects of the seismic activity in the Reykjanes area to boost real estate market activity despite high interest rates and the restrictions due to borrower-based measures. According to the Committee's June statement, the equity position of households carrying mortgage debt had continued to strengthen, but their debt service burden had grown heavier. In September, the FSN assessed that borrower-based measures, together with rising wages and a high employment level, played an important role in households' resilience. Households' strong equity position gave them the scope to restructure their debt if necessary. Not least, they had turned again to inflation-indexed loans and had retired non-indexed variable-rate debt. At the end of 2024, indexed loans accounted for 60% of the total mortgage stock. This share had increased by 8 percentage points since end-December 2023 but was still lower than at the end of 2019, when it stood at 73%.

Each quarter, the FSN determines the countercyclical capital buffer (CCyB) rate. The Committee held the buffer rate unchanged in 2024, after having increased it from 2% to 2.5% of the domestic risk base in March 2023. The increase took effect in March 2024.

In December, the Committee approved benchmarks for the determination of the CCyB in addition to taking its regular quarterly decision on the buffer rate. The role of the CCyB is to strengthen financial institutions' resilience and ensure that their capital is sufficient to enable them to grant loans and absorb loan losses in the event of shocks. Since the pandemic, it has become clear to governmental authorities around the world that economic and financial shocks do not always announce their arrival in advance. For this reason, it can be macroeconomically beneficial to maintain a positive buffer rate when there are no signs that the level of risk in the financial system is unusually high or low. The International Monetary Fund (IMF) discussed this in its recent Financial Sector Assessment Program (FSAP) appraisal, stating that it considered it favourable that the FSN should determine what the CCyB rate should be under such circumstances. The Committee considered it appropriate that such a positive neutral buffer rate be set at 2-2.5% of the domestic risk base, as recent shocks showed that the current buffer rate was close to the level that would be needed in the event of possible financial shocks, and the Central Bank's stress tests had supported that conclusion. The FSN could increase the buffer rate when there were signs of elevated risk in the financial system. If the risk materialised, the Committee would lower the buffer rate or set it at zero to give financial institutions the scope to absorb loan losses and enable them to maintain an adequate supply of credit. The CCyB was thereby intended to support both financial institutions' resilience and the stability of the financial system.

In June, the Committee gave consideration to the Rules on Derivatives Transactions and discussed the opinion of the IMF mission that visited Iceland in

May 2024. The IMF had noted that the shallowness of the domestic foreign exchange market gave rise to the risk of excessive exchange rate volatility during shocks, and it proposed that consideration be given to imposing restrictions on the commercial banks' derivatives trading in order to deepen the market. In April 2022, the FSN had approved the Rules on Derivatives Transactions, no. 412/2022, which limited the total scope of financial institutions' derivatives trading so that the net forward FX position vis-à-vis any given counterparty may not exceed 10% of the capital base and the total forward FX position (the sum of the forward position vis-à-vis all counterparties combined) may not exceed 50% of the capital base. The Committee discussed the importance of using macroprudential tools to limit position-taking involving the Icelandic krónur. The experience of increased freedom in the derivatives market had been positive, however. The current scope was used mainly to serve customers in the import and export sectors with forward foreign currency contracts. A wider interest rate differential with abroad could affect position-taking in high-yielding currencies, however. The Committee considered it appropriate to exercise caution in amending rules on derivatives trading, and it was of the opinion that the rules should not be amended at the present time.

The FSN completed its annual review of systemically important financial institutions and the capital buffer for systemic importance (O-SII buffer) in December, and confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. Based on Central Bank methodology, each of the three large commercial banks is systemically important at the national level. The failure of any one of them would probably have a significant negative impact on financial stability in Iceland, as well as spreading to other financial institutions and to the economy more broadly. It decided to raise the O-SII buffer from 2% to 3% of the systemically important financial institutions' total exposures. The increase is in line with the expanded scope in the Act on Financial Undertakings, which is based on European law.

The Committee also decided in December to lower the systemic risk buffer from 3% to 2% of deposit institutions' domestic exposures. The buffer is applied on the basis of underlying risk in the Icelandic economy. Such systemic risk is considered non-cyclical, or built-in, and the buffer value is reviewed every two years. It emerged that volatility of economic variables had diminished since the systemic risk buffer was first introduced in 2016. In the FSN's assessment, Iceland's strong net international investment position (NIIP) and ample international reserves had boosted its economic resilience and fostered increased stability. Furthermore, financial system resilience had increased with the application of macroprudential tools. Capital buffers, liquidity rules, rules on net stable funding, rules on foreign exchange balance, and borrower-based measures were examples of macroprudential tools that had supported financial and economic stability.

The reduction of the systemic risk buffer and the increase in the O-SII buffer resulted in a virtually unchanged overall capital requirement on the three systemically important banks. The combined buffer requirement on the D-SIBs was 19.5% to 20.4% at the end of 2024 and was virtually unchanged year-on-year. For smaller deposit institutions not considered systemically important, however, capital requirements were reduced.

On behalf of the Central Bank of Iceland
Financial Stability Committee,

Ásgeir Jónsson

Governor of the Central Bank of Iceland
and Chair of the Financial Stability Committee

Statement of the Central Bank of Iceland Financial Stability Committee

22 February 2024

In view of the extraordinary circumstances in Grindavík resulting from volcanic activity in the area, the Financial Stability Committee (FSN) of the Central Bank of Iceland has decided to temporarily ease borrower-based measures for those individuals who owned residential property in Grindavík on 10 November 2023. The maximum ratio of debt service to disposable income will be 40% and the maximum loan-to-value ratio will be 85% for these individuals when they next purchase residential housing.

The FSN is of the opinion that this exemption is unlikely to have a material impact on lenders' resilience and will therefore not significantly affect financial stability.

Statement of the Central Bank of Iceland Financial Stability Committee
13 March 2024

The Icelandic financial system is on a solid footing. The systemically important banks' capital and liquidity are strong, and they have ready access to funding. Inflation has eased, and aggregate demand is rebalancing. Real interest rates have risen, and private sector demand for credit has subsided.

Debt ratios have fallen and are now lower than they have been for years. Households' equity position has improved with the rise in house prices and the real decline in debt. At the same time, borrowers' debt service burden has increased, but arrears remain limited. Higher real interest rates have tightened firms' operating environment and are likely to continue affecting it in the coming term. On the other hand, firms' equity is strong in most sectors, adding to resilience.

The outlook is for population growth and the aftereffects of the seismic activity in the Reykjanes area to boost residential real estate market activity despite current interest rates and the restrictions due to borrower-based measures. House prices are still high compared to fundamentals, and it is important that borrowers be cautious in taking on risk when buying real estate.

Heavier debt service burdens concurrent with weaker growth in economic activity exacerbate the likelihood of financial distress, with negative implications for financial stability. In order to maintain the banks' resilience, the Financial Stability Committee (FSN) has decided to keep the countercyclical capital buffer rate unchanged at 2.5%.

The FSN reiterates its support for the advancement of the bill of legislation on increased operational security in payment intermediation, which is currently before Parliament. It is important both to give comprehensive consideration to the resilience of payment intermediation with an independent domestic payment solution, and to bolster competition, strengthen cyber- and operational security, and ensure business continuity.

The Committee will continue to apply the policy instruments at its disposal so as to preserve financial stability, thereby enabling the financial system to mediate credit and payments and redistribute risks appropriately.

Statement of the Central Bank of Iceland Financial Stability Committee
5 June 2024

The Icelandic financial system is on a solid footing. The systemically important banks' capital and liquidity are strong, and they have ready access to funding. Arrears are still at a low level despite high interest rates. It is well to bear in mind, however, that persistent inflation concurrent with weaker economic activity will present challenges for the financial system in the coming term.

Real estate market activity has increased. Population growth, income growth, and the repercussions of earthquakes and volcanic eruptions near the town of Grindavík have stimulated demand. By the same token, growth in lending to construction and real estate firms is robust, and the construction sector labour force has expanded.

The private sector debt-to-GDP ratio has declined in the recent term and is low in historical context. The equity position of households carrying mortgage debt has continued to strengthen, but their debt service burden has grown heavier. The rise in real interest rates has weakened households' disposable income and firms' operating environment. The effects of this are likely to come even more strongly to the fore in the coming term. On the other hand, households' equity position is sound, as is that of companies in most sectors.

There are signs that the economy is slowing down alongside the rise in real interest rates. Heavier debt service burdens in tandem with weaker growth in economic activity exacerbate the likelihood of financial distress. In order to maintain the banks' resilience, the Financial Stability Committee (FSN) has decided to keep the countercyclical capital buffer rate unchanged at 2.5%. The Committee stresses the importance of a robust capital position under current circumstances.

The FSN emphasises the importance of operational security in payment intermediation. The resilience of payment intermediation should be addressed in a comprehensive way, including through harmonisation of financial market responses to operational incidents, contingency exercises, and cybersecurity testing. The FSN is of the view that the passage of the bill of legislation amending the Act on the Central Bank of Iceland as regards operational security in payment intermediation, which is currently before Parliament, will facilitate greater security and resilience.

The Committee will continue to apply the policy instruments at its disposal so as to preserve financial stability, thereby enabling the financial system to mediate credit and payments and redistribute risks appropriately.

See further:

Background to the decision on the countercyclical capital buffer, memorandum

Background to the decision on the countercyclical capital buffer, data

Statement of the Central Bank of Iceland Financial Stability Committee
25 September 2024

The Icelandic financial system is resilient. The systemically important banks' capital and liquidity positions are strong, they have ample access to funding, and the cost of foreign funding has declined. Persistent inflation and weaker economic growth can create challenges for the financial system.

Real estate prices are high. The repercussions of the seismic activity on Reykjanes peninsula and immigration to Iceland have played a role in price hikes in the recent past. Activity in the construction industry remains robust, as can be seen clearly in the labour market and growth in lending to firms in the construction sector. The strong equity position of many borrowers affords the scope to refinance if necessary.

There are few indications of general financial distress among households and businesses, even though high inflation and interest rates are challenging for many. Borrower-based measures, together with rising wages and a high employment level, play an important role in households' resilience. Households' and businesses' demand for indexed instead of non-indexed loans has caused the banks' indexation imbalances to grow, as the majority of their funding is non-indexed. This could become challenging for the financial system.

In its quarterly review of the countercyclical capital buffer, the Financial Stability Committee (FSN) decided to hold the buffer unchanged at 2.5%. The Central Bank's stress test of the systemically important banks indicates that the banks can withstand considerable adverse shocks. Risk in the financial system has not abated, and the FSN therefore considers it important that financial institutions maintain a strong equity position.

The Committee underscores the importance of enhancing operational security in payment intermediation and will promote measures aimed at reducing underlying operational risk. Progress has already been made, but the Committee considers it important to complete the coordination plan providing for prompt, coordinated, and efficient responses to operational incidents in the financial market.

As before, the Committee will apply the policy instruments at its disposal so as to preserve financial stability, thereby enabling the financial system to mediate credit and payments and redistribute risks appropriately.

Statement of the Central Bank of Iceland Financial Stability Committee
4 December 2024

The Icelandic financial system is resilient. The systemically important banks' capital and liquidity are strong, and they have ready access to market-based funding. High real interest rates, together with weaker growth in economic activity, could create challenges for the financial system in the coming term. Furthermore, elevated geopolitical risk could have unforeseen implications. As yet, there are few signs of arrears or financial distress among households and businesses.

The Financial Stability Committee (FSN) has completed its annual review of systemically important financial institutions and has confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn.

The FSN has also completed its regular review of the systemic risk buffer and the capital buffer for systemic importance financial institutions (O-SII buffer).

The Committee decided to lower the systemic risk buffer rate from 3% to 2%, on the grounds that it considers systemic risk to have subsided since the buffer was first introduced in 2016. The financial system has grown more resilient in recent years, as can be seen in reduced volatility of key economic variables despite various shocks. Furthermore, new macroprudential tools have proven their value, and the financial stability framework is sturdier than before.

In addition, the FSN decided to increase the capital buffer for systemic important financial institutions (O-SII buffer) from 2% to 3%. This increase aims to capture the risk facing the economy because of the size and scope of the systemically important financial institutions.

The reduction of the systemic risk buffer and the increase in the O-SII buffer result in a virtually unchanged overall capital requirement on the three systemically important banks. For smaller deposit institutions not considered systemically important, however, the capital requirement is reduced.

Moreover, the FSN approved and published a policy document outlining the criteria for the determination of the countercyclical capital buffer (CCyB). According to the policy, the CCyB will generally range between 2% and 2.5% of the domestic risk base. In setting a positive neutral CCyB, the Committee is following the precedent set by a number of other European countries. The Committee also decided, following its quarterly review, to keep the CCyB unchanged at 2.5%. The FSN reiterates the importance for financial institutions of maintaining a strong capital position to ensure resilience in times of stress.

The Committee underscores the importance of continued efforts to enhance operational security in payment intermediation. Positive steps have been taken towards an independent domestic payment solution, and the FSN expects implementation to begin in 2025.

As before, the Committee will apply the policy instruments at its disposal to preserve financial stability, thereby enabling the financial system to mediate credit and payments and redistribute risks appropriately.

Enclosed:

1. Criteria for the determination of the countercyclical capital buffer.

2. Memorandum – background to the decision on the countercyclical capital buffer.

    a. Excel-file with figures in the memorandum.

3. Memorandum - background to the decision on the systemic risk buffer.

4. Memorandum - background to the decision on systemically important financial institutions and capital buffers for systemic importance.

MINUTES
FINANCIAL STABILITY COMMITTEE

2024

FEBRUARY
20th meeting
Published 11 March 2024

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

February 2024 (20th meeting)
Published: 11 March 2024

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 diversify risks 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 components, or markets shall be considered systemically important. When warranted, the FSN may make 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 its assessment of financial stability.

At its meeting on 21 February 2024, the Committee discussed the extraordinary circumstances prevailing in the town of Grindavík, as residency in the town was prohibited due to the ongoing volcanic activity in the area. The Committee was given a presentation on the size of the residential community in Grindavík, the potential impact of Government support measures on the housing market in general, and the possible attendant systemic risk.

Financial Stability Committee decisions

Borrower-based measures

The meeting began with a presentation given to the Committee on a bill of legislation on the purchase by the Government of residential housing in Grindavík. The main aim of the bill is to protect Grindavík residents' financial position and welfare by giving residents the option of selling their homes for 95% of the fire insurance value to a State-owned asset management company. These actions were taken in light of the declaration of a state of emergency in Grindavík by Iceland's Civil Protection Department during the run-up to the 10 November 2023 eruption and its decision that the town be evacuated. As a result, Grindavík residents had to leave their homes at short notice, and it is highly uncertain whether the town will be inhabitable in the near future. Furthermore, commercial activities had by and large been discontinued in the town, with the result that many residents had suffered a substantial loss of income and were dependent on Government support.

It emerged that most of the roughly 1,200 households in Grindavík had loan-to-value ratios between 35% and 45%. Loans issued to Grindavík residents by the banks and the pension funds comprised a very small share of their loan portfolio, or 0.9% of the total portfolio. It is expected that most Grindavík residents will choose to settle in near-lying communities, boosting demand for housing on the Reykjanes peninsula and pushing prices higher.

In view of these extraordinary circumstances, the FSN considered it appropriate to grant owners of property in Grindavík increased scope within the current borrower-based measures for the purchase of new homes. According to current rules on debt service burdens, lenders also had some latitude to respond to extraordinary circumstances; i.e., that 5% of issued mortgage loans could exceed the maximum debt service-to-income ratio. Because of the highly unusual circumstances in Grindavík and the temporary income losses suffered by the town's residents, the Committee considered it appropriate to give lenders additional scope to assist households with a legal address in Grindavík as of November 2023, by granting them a special exemption. Furthermore, it was also important to ensure that Grindavík residents had the opportunity to acquire comparable housing, even in communities where property prices were higher than in Grindavík. In view of this, it was deemed appropriate to expand the rules on loan-to-value ratios.

The Committee was of the view that the extraordinary circumstances prevailing in Grindavík – i.e., the temporary loss of income and the permanent loss of housing – created conditions beyond the scope of borrower-based measures, the goal of which was to safeguard borrowers' resilience. These borrowers' situation was in many respects comparable to that of first-time buyers, and borrower-based measures for Grindavík residents should therefore reflect those applying to first-time buyers.

FSN members were of the view that providing such increased scope for Grindavík residents was unlikely to have a discernible impact on lenders' resilience and therefore should not materially affect financial stability.

Following the discussion, the Governor proposed that, for individuals who owned residential property in Grindavík on 10 November 2023, the maximum debt service-to-income (DSTI) ratio be set at 40% and the maximum loan-to-value (LTV) ratio at 85% in connection with their next home purchase. All Committee members voted in favour of the Governor's proposal and approved a temporary provision to this effect, which would be added to the relevant rules on borrower-based measures, with an expiry date of 1 March 2027.

At the end of the meeting, the Committee approved a statement for publication on the morning of 16 February 2024.

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, Central Bank of Iceland

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; Guðrún Sóley Gunnarsdóttir, Deputy Director of the General Secretariat; Kristjana Jónsdóttir, lawyer with the General Secretariat; Einar Jón Erlingsson, specialist with the Financial Stability Department; and Ása Dröfn Óladóttir, specialist with the Financial Stability Department were present for the entire meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2024

MARCH
21st meeting
Publ. 10 April 2024

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

March 2024 (21st meeting)
Published: 10 April 2024

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 diversify risks 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 components, or markets shall be considered systemically important. When warranted, the FSN may make 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 its assessment of financial stability.

At the meeting of 11 and 12 March 2024, the Committee was given a presentation on economic developments and prospects, 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 and liquidity position, and the financial cycle. Members also discussed financial stability in Europe and the key risks there. Furthermore, they discussed the criteria that should be borne in mind in setting the countercyclical capital buffer (CCyB) rate.

The FSN decided to keep the CCyB unchanged, but it had decided in March 2023 to increase the CCyB from 2% to 2.5%, effective 16 March 2024.

The FSN reiterated its support for the passage of the bill of legislation on increased operational security in payment intermediation, which is currently before Parliament. It was important to give comprehensive consideration to bolstering resilience in payment intermediation, including the establishment of an independent domestic retail payment solution.

Analysis of financial stability

Economic activity had eased in trading partner countries. Inflation had fallen; therefore, real interest rates had risen and the monetary stance had tightened. Market agents were of the opinion that interest rates had peaked, as could be seen, among other things, in asset markets, including the 10% rise in the S&P500 share price index in 2024 to date. War and an uncertain global economic outlook were considered factors that could increase the risk of a sudden adjustment in asset markets, which could reduce households' and businesses' resilience. Risks relating to financial stability in Europe were attributed in particular to the potential impact of higher interest rates on firms' access to liquidity and credit financing. In general, however, households' debt service capacity was considered sound, as employment was relatively strong, inflation had fallen, and the real estate market had apparently picked up again in Europe; furthermore, growth in household lending looked set to gain momentum after a two-year contraction.

The FSN agreed that the state of financial stability in Iceland was good on the whole. Domestic demand had eased, and a current account surplus had developed again. The outlook was for GDP growth to be positive in 2024 but weaker than in 2023, owing mainly to slower growth in private consumption and investment. Foreign funding conditions had improved further, and risk premia in foreign markets had continued to decline. Terms were more favourable on the banks' recent marketable bond issues than on comparable issues from H2/2023. The banks had sufficient capital and liquidity, and their profits had increased year-on-year in 2023, mainly because of wider interest rate spreads between assets and liabilities. The Committee considered cyber risk to be the main risk to financial stability. It reiterated the importance of increased operational security in payment intermediation and stressed its support for the related bill of legislation before Parliament. Members were also somewhat concerned about the impact of economic developments on financial stability. At the same time that debt service burdens had increased, real wages had been flat between years and demand had eased. High interest rates over a protracted period of time could put strain on those households and businesses that had not built up their resilience in recent years. Committee members agreed that borrower-based measures had preserved households' debt service capacity and had helped ensure that most households' financial situation was manageable. There was still some risk associated with the residential and commercial property markets. Prices were still high by most measures, and it was important that borrowers keep their risk within moderate limits when buying property. The point was also made that high interest rates could attract foreign capital, increase resident entities' foreign debt, and affect the balance of payments in the future.

Banking system resilience

In the Committee's opinion, the financial system is on a strong footing. The systemically important banks' capital and liquidity are well above regulatory minima. The banks' liquidity had increased by 80 b.kr. since the FSN's December meeting, particularly because of foreign-denominated bond issues, and was nearly 406 b.kr. above the mandated minimum at the end of January. The D-SIBs' combined liquidity ratio in all currencies was 232%, well above the 100% minimum required under Central Bank rules. Credit spreads on foreign bond issues had narrowed since the Committee's December meeting, after having widened somewhat in the autumn, alongside an overall increase in spreads in global markets. It emerged at the meeting that the banks' 2024 amortisation totalled roughly 100 b.kr. on foreign bonds and 50 b.kr. on domestic bonds. The D-SIBs had enough liquid assets to cover the year's repayments in both local and foreign currency without being in breach of liquidity ratios. Furthermore, liquidity stress tests showed that they could tolerate considerable outflows of liquid assets. It emerged that the systemically important banks' (D-SIB) ratio of deposits to total funding had risen to 53% in 2023, mainly because of an increase in króna-denominated deposits. About half of the banks' deposits were insured by the Financial Institutions' Insurance Fund (TVF). Other domestic funding was due mainly to covered bonds denominated in krónur and to foreign marketable bonds, which accounted for 29% of their total funding.

The D-SIBs' operations were strong in 2023, delivering a combined 84 b.kr. in profit. The return on equity was 12.1%, or 1.9 percentage points more than over the same period in 2022. Net interest income totalled 151 b.kr. and increased by 16% relative to the prior year. Net fees and commissions from financial activities also increased between years, while other operating income contracted slightly. The banks' operating expenses grew at the same time. The D-SIBs' capital ratios ranged between 23.6% and 25.3% at the end of 2023, or 2.9-5.0 percentage points above the minimum required by the Central Bank, after adjusting for next year's dividend payments and the CCyB increase in March 2024. Their leverage ratios lay in the 12.4% to 13.6% range, or a combined 13.2%. The D-SIBs' minimum required own funds and eligible liabilities (MREL) as determined by the Central Bank ranged between 29.4% and 31% of their risk base as of end-2023. The banks' MREL funding ranged between 37.8% and 41.3% of their risk-weighted assets.

Arrears had increased marginally among both households and businesses. The facility-level non-performing loan (NPL) ratio on the D-SIBs' loans to households was just under 1% at the end of 2023, after rising by 0.3 percentage points during the year. For corporate loans, the NPL ratio was 2.4%, an increase of 0.1 percentage points between years. As before, the NPL ratio was highest among companies in the hospitality industry, at 4.8%, although it fell by 0.8 percentage points in 2023. The share of loans classified as forborne and performing was 3% at the end of 2023, as compared with 7.3% at the end of 2022. The position of firms that had needed forbearance measures had therefore grown stronger.

Private sector debt

Households and businesses have built up considerable resilience in recent years, in tandem with strong economic activity. In January, household debt had increased by 5.7% year-on-year in nominal terms, which translates to a contraction of 0.9% in real terms. At that time, debt had declined in real terms for 14 consecutive months. The household debt-to-GDP ratio declined by nearly 3 percentage points year-on-year in 2023, to 73.1% at the year-end. The household debt-to-disposable income ratio also declined between years, by 5.4 percentage points, to 145.3% at the end of 2023. Household leverage therefore declined, and debt ratios were low, both in historical terms and relative to levels in neighbouring countries. Households' equity position has improved with the rise in house prices and the real decline in debt.

Inflation and high interest rates have pushed most borrowers' debt service burden higher. For households, the ratio of interest expense to disposable income rose by 1 percentage point in 2023, to 5.9% at the year-end, which was nevertheless just below its long-term average. Low unemployment, wage growth, and moderate debt levels among most households enable them to withstand increased debt service. It emerged, however, that although unemployment had risen marginally in recent months, it was still low in historical and economic context. Furthermore, households have taken a range of measures offered to them in order to lower their debt service. Many households have opted to refinance their non-indexed mortgages, either partially or fully, with new indexed loans. Furthermore, indexed loans have been chosen increasingly by individuals financing home purchases. The ratio of indexed loans to outstanding household mortgages had therefore risen to 52% in January, its highest in three years. Just over a fourth of outstanding household mortgages were non-indexed fixed-rate loans, and the fixed-rate clauses on a large share of these loans are set to expire in 2024 and 2025. It was foreseeable that households that had taken fixed-rate non-indexed mortgages would see their debt service rise when their mortgage rates came up for review.

Companies had also begun seeking out indexed financing in greater measure, particularly real estate firms and construction firms, but also companies in the services sector. In part, the increase in indexed loans is due to a shift from indexed market financing to indexed bank loans, as issuance of indexed corporate bonds declined slightly in 2023 relative to previous years. During the year, it contracted by 1.4% in real terms but grew by 6.2% in nominal terms. At the end of 2023, total corporate debt measured 74% of GDP, which is very low in historical terms, after declining by 2.8 percentage points during the year.

Asset prices

Housing market turnover had picked up since mid-2023, and the number of purchase contracts concluded in the final months of the year had been comparable to that before the pandemic. Indexed loans constituted a large share of purchasers' financing and, together with equity loans issued to first-time buyers, had supported housing market activity. In addition, Grindavík residents have been forced to find new homes, which will probably fuel increased demand in the market. When the volcanic eruptions started in November 2023, there were roughly 1,200 households in the town. The capital area house price index had risen in real terms since August 2023, yet the annual change in the index was still negative, or by 1.3% at the end of January. The number of homes advertised for sale had been relatively stable year-to-date, after having risen steeply in 2022 and 2023. The ratio of house prices to fundamentals had been unchanged since mid-2023. House prices were still high by nearly all measures, and it was uncertain whether the correction in the market was over. At the end of January 2024, prices were nearly 7% above their estimated long-term trend, down from 11% above trend a year earlier.

The CRE price index of real commercial property prices in greater Reykjavík rose by 6.2% in 2023. At the year-end, the index was at a historical high and was nearly 17% above its estimated long-term trend. The slow pace of commercial property development since the 2008 financial crisis, together with the past several years' GDP growth, had pushed CRE prices higher. In recent months, price increases had lost pace, in tandem with the contraction in private consumption and the slowdown in job growth. Turnover in registered CRE transactions in the capital area contracted year-on-year by about half in real terms in 2023, after having been historically strong in 2022. Deposit institutions' CRE-backed loans totalled about 980 b.kr. at the end of 2023, after increasing by 5.3% year-on-year in real terms. Growth in lending to companies in the construction and real estate sectors was strongest, at 14%. The non-performing loan ratio on CRE-backed loans fell in 2023, for the third year in a row, to 0.9% at the year-end.

A total of 3,400 new fully finished homes were put on the market in 2023, an increase of 18% year-on-year. It is expected that fewer newly finished properties will be put on the market in 2024. The number of residential properties in the first stages of construction has increased to about 7,200 at the beginning of March. This is about 1,100 above the average of the past five years. Lending to the construction sector grew by 18% in real terms in 2023, owing mainly to slower repayment of construction loans as a result of more sluggish sales of new homes. Arrears on the D-SIBs' loans to construction companies were limited, and the sector appears to remain strong, as it has built up significant equity in recent years with the steep rise in house prices.

Share prices of listed companies had risen since the Committee's December meeting, and turnover was up year-to-date. The OMXI15 index had risen by 8% since the December meeting, and by around 0.9% since the turn of the year. The increase was particularly strong among high-tech companies, whereas both of the domestic airlines had withdrawn their earnings projections in November, owing to setbacks in bookings caused by the seismic activity on the Reykjanes peninsula. Yields on indexed and nominal Treasury bonds had declined since December. Market agents' inflation expectations, which had fallen in the wake of the seismic activity in Grindavík, had eased at the beginning of the year, particularly short-term expectations, whereas the breakeven inflation rate was still high, and well above the Central Bank's inflation target. The D-SIBs' indexed mortgage lending rates had risen, and real market rates had therefore risen as well.

Exchange rate of the króna and international reserves

The króna had appreciated by about 1% since the FSN's late December meeting. The Bank bought foreign currency in February, in response to inflows from foreign investors that had bought Treasury bonds for approximately 0.5% of GDP during the month. A large share of the inflows stemmed from a relatively small number of non-residents, and these investors have been moving further out the yield curve by selling short-term Treasury bonds and buying bonds with longer maturities. At the end of February 2024, non-residents held Treasury bonds worth 86 b.kr., or 7% of the outstanding Treasury bond stock, a small percentage relative to the pre-pandemic share of 13%.

The pension funds' net foreign currency purchases totalled 83 b.kr. in 2023, or 20 b.kr. less than in 2022. Their foreign exchange transactions in the first two months of 2024 were about the same as in the same period a year earlier. The commercial banks' forward foreign currency position had increased by 5% since October 2023. Although it had been positive, on average, in the recent term, unlike the situation over the previous year, the banks are far from the maximum level of foreign exchange risk according to the Central Bank Rules on Foreign Exchange Balance.

The current account showed a surplus of 41 b.kr., or 1% of GDP, in 2023, after deficits in the two years beforehand. There was a year-on-year turnaround in the income account, which grew more positive by 2.5% of GDP, mainly because of weak operating results among aluminium companies, which in turn stemmed from falling global aluminium prices. The balance on combined goods and services trade was around zero in 2023, as in 2022, as the deficit on goods trade grew by nearly 90 b.kr. between years, while the services account surplus grew by a similar amount. The surplus on tourism grew by nearly 130 b.kr., as tourist numbers were up by 30% year-on-year. Indicators suggest that tourists stay in Iceland for a shorter time than before and that they spend less while in the country. Tourism began strongly in 2024, however, with a year-on-year increase in visitor numbers in both January and February. Commercial flights to Iceland are estimated to increase in number by about 14% between years in the first six months of 2024, and the number of tourists is projected to be the same as in 2023, or larger.

The Central Bank's international reserves totalled 792 b.kr. at the end of 2023, after increasing by 29 b.kr. in Q4. They exceed all key reserve adequacy benchmarks. The ratio of the reserves to the International Monetary Fund's (IMF) reserve adequacy metric was 114% at the end of 2023 and had risen by 5 percentage points between quarters. Iceland's net international investment position was positive by 38% of GDP at the end of 2023 and had increased by 14 percentage points year-on-year, owing mainly to foreign portfolio investment, which had grown by 13 percentage points. About three-fifths of that rise reflected an increase in the pension funds' foreign portfolio investment.

The financial cycle and cyclical systemic risk

Cyclical systemic risk can be estimated in a variety of ways, and the FSN uses more than one measure. A composite measure of financial cycles indicated that the cycle was still in an upward phase in Q4/2023. The cycle was driven by the housing cycle, which has risen the fastest and is the only sub-cycle above the historical average. The funding and credit cycles have risen less markedly. Most of the indicators on which the financial cycle is based have fallen recently, however, and the financial cycle as a whole can be expected either to turn or to plateau. The domestic systemic risk indicator (d-SRI) showed a decline in systemic risk for the eighth quarter in a row, and developments in Q4 were due primarily to positive changes in the current account balance and falling real equity securities prices. Taken together, indicators of cyclical systemic risk suggested a moderate risk level and an overall decline in systemic risk.

Benchmarks for the determination of the countercyclical capital buffer

Once every quarter, the FSN takes decisions on the CCyB rate. The FSN discussed the draft version of a benchmark for the determination of the CCyB and the fundamental principles behind the buffer. When the buffer is increased, it creates a counterweight to growing cyclical systemic risk, and the buffer rate is lowered when there is the risk that an economic downturn will lead to a significant contraction in financial institutions' credit supply. The FSN discussed the fact that the buffer rate should generally be above 0%, and that decisions on the buffer rate were based in particular on the scope of cyclical systemic risk, households' and businesses' access to credit, and the impact of the decision on financial institutions and the economy more broadly.

The Committee observed that financial institutions typically needed some time to build up capital, whereas it was possible to reduce capital with no advance notice. In this context, members discussed the reduction in the CCyB during the COVID-19 pandemic, when the Committee had issued a recommendation urging financial institutions to consider the high level of economic uncertainty when they took decisions on dividend payments and share buybacks. In that same recommendation, the FSN stated that it expected the scope created with the reduction in the CCyB to be used to support households and businesses. The FSN agreed that the banking system's responses to the reduction in the buffer and developments in financial conditions had been in line with expectations. Financial institutions' post-COVID profits had been stronger than had been assumed when the pandemic struck, which had also supported the banks' capital.

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. The Bank has been working in cooperation with deposit institutions to put in place a domestic retail payment intermediation solution with the aim of increasing the resilience of payment intermediation. This work takes place in the Strategic Forum, a forum for the development of future strategy for Iceland's financial market infrastructure. An idea centring on digital cash payments at retail outlets was presented to the Committee. This idea entails launching infrastructure to which payment intermediation entities can connect, upon satisfying specified requirements, whereupon they can offer individuals the opportunity to use it for payments at physical outlets. The payment itself would be executed using current infrastructure for transfers between bank accounts, but in addition, a system for payment orders would be set up as well, thereby opening up access to parties that offer payment solutions for individuals. Competition for the provision of services to individuals and merchants should therefore develop in payment intermediation.

The FSN discussed the bill of legislation on operational security in payment intermediation, currently before Parliament, which entails expanding the Central Bank's authorisation to set rules promoting operational security in payment intermediation. The Committee reiterated its support for the passage of the bill. The FSN noted that it was important both to give comprehensive consideration to the resilience of payment intermediation with an independent domestic payment solution and to bolster competition, strengthen cyber- and operational security, and ensure business continuity.

Financial Stability Committee decisions

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. By law, the CCyB may range from 0% to 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate. The FSN observed that the D-SIBs' capital ratios were comfortably high and that arrears on loans issued by them were low, although they had risen marginally in recent months. The banks' position was sound and their liquidity ratios ample, and their credit risk had declined. GDP growth had eased, and the current account balance had turned positive. Higher interest rates had yet not shown in increased arrears and loan losses to any discernible degree. Unemployment had begun to pick up slightly, however, and it was still unclear how long interest rates would have to remain high. It emerged that recent national accounts data had shown that the economy had been more overheated in 2023 than previous figures had indicated.

The longer interest rates remained high, the greater the potential impact on the banks. Loan quality could deteriorate and arrears could increase if the economic outlook deteriorated more than was currently envisioned and if unemployment rose higher than currently expected. Last year's decision to increase the buffer to 2.5% created even further scope to respond in the event of an economic contraction that could cause a decline in the supply of credit.

Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 2.5%. The proposal was approved unanimously.

At the end of the meeting, the Committee approved a statement for publication on the morning of 13 March 2024.

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, Central Bank of Iceland

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; and Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2024

JUNE

22nd meeting

Published 3 July 2024

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

June 2024 (22nd meeting)
Published: 3 July 2024

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 diversify risks 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 components, or markets shall be considered systemically important. When warranted, the FSN may make 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 its assessment of financial stability.

At its meeting of 4 and 5 June 2024, the Committee was given a presentation on developments and prospects for the economy and for financial stability. The Committee discussed 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, and financial institutions' capital and liquidity. The FSN was given a presentation on the deposit insurance system and on the financing of resolution or winding-up proceedings for financial institutions. The Committee also discussed payment intermediation infrastructure and operational security. Furthermore, it discussed the recent EFTA Court decisions on the banks' mortgage loans, the rules on derivatives trading, and financial stability and key risks in Europe. In addition, it discussed the criteria for determining the countercyclical capital buffer (CCyB) and was given a presentation on Icelandic financial institutions' capital requirements as compared with those in other European countries.

In its quarterly review of the CCyB, the FSN decided to hold the buffer unchanged at 2.5%.

Members emphasised the importance of operational security in payment intermediation and the need to address the resilience of payment intermediation in a comprehensive way. The Committee is of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation will enable the Bank to enhance the security and resilience of domestic payment intermediation.

Analysis of financial stability

The GDP growth outlook for Iceland's trading partners has improved slightly, and global economic uncertainty has receded. This can be seen, among other things, in underlying asset price volatility, which was at its lowest since 2019 in terms of the VIX implied volatility index. Global share prices had continued to rise. Trading partner inflation had declined, but more slowly than expected, particularly in the US. In Europe, risk relating to the potential impact of higher interest rates on asset prices, access to liquidity, and credit financing had diminished. Concerns about financial stability centred mainly on non-bank financial institutions' asset quality. The risk that economic developments in Europe could cut into households' and businesses' debt service capacity and even compromise stability was considered to be still in existence.

In Iceland, revised statistics had revealed even stronger economic activity in the previous two years than had previously been estimated. Investment had been stronger, productivity greater, and the corporate saving rate higher. Domestic demand had subsided quickly in recent quarters, however, and GDP had contracted by 4% in Q1/2024. As had been forecast, the contraction was due mainly to the failure of the capelin catch. The domestic labour market had eased, and some measures indicated that demand pressures had subsided, while other measures suggested that the labour market was tighter than before the pandemic. Unemployment had inched upwards, and the ratio of job vacancies to the number of unemployed persons had fallen. The disinflation process had proceeded more slowly than the Bank had forecast in February, however, and twelve-month inflation had risen month-on-month, to 6.2% in May. It was pointed out that persistent inflation and weaker growth in economic activity could create challenges for the financial system. It emerged that the Bank's forecast had assumed that inflation would recede to target without significant cost; i.e., without an economic contraction or a spike in unemployment.

The FSN agreed that the foundations for financial stability in Iceland were robust on the whole. The private sector debt-to-GDP ratio had declined in the recent term and was low in historical and international context. The banks' recent foreign bond issues showed that credit spreads had narrowed and that funding was readily available. The equity position of households with mortgages had continued to strengthen. The systemically important banks' (D-SIB) capital and liquidity remained strong, and the financial system should therefore be able to withstand significant shocks.

The FSN also discussed whether there was the possibility of a harder economic landing than was currently envisioned, and what impact it could have on financial stability. The Committee was of the opinion that economic uncertainty was one of the risks to financial stability, and that risks relating to residential and commercial real estate were still significant. Prices in those markets were still high by most measures, but economic activity had slowed down alongside rising real interest rates. Heavier debt service burdens in tandem with weaker growth in economic activity could exacerbate the likelihood of financial distress.

The Committee considered cyber risk to be one of the main underlying risk factors, and it reiterated the importance of increased operational security in payment intermediation and coordination of financial market responses to operational incidents via contingency exercises and cybersecurity testing. The Committee was of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation would enable the Bank to enhance the security and resilience of domestic payment intermediation.

Banking system resilience

In the Committee's opinion, the financial system is on a strong footing. The D-SIBs' liquidity had declined by 105 b.kr. since the FSN's March meeting, primarily because of payments on foreign-denominated and domestic loans. Their liquidity in excess of the required minimum totalled 301 b.kr. at the end of April and was slightly improved relative to the same time in 2023. The D-SIBs' combined liquidity ratio in all currencies was 181%, well above the 100% minimum required under Central Bank rules. Their combined foreign liquidity ratio was 414% in April, and the ratio for Icelandic krónur was 126%. Credit spreads on foreign bond issues had declined further since the FSN's March meeting, after having fallen at the beginning of 2024, and were at their lowest in over two years. All of the D-SIBs had issued eurobonds at terms that were better than the terms on their 2023 issues. The issues had been used to refinance upcoming maturities, thereby reducing their refinancing need. Year-2024 instalments on the banks' foreign bonds totalled less than ½% of GDP, and instalments in Icelandic krónur would equal close to 40 b.kr. (1% of GDP). The D-SIBs therefore had enough liquid assets to cover 2024 and 2025 repayments in both local and foreign currency without being in breach of liquidity ratios. Liquidity stress tests confirmed their resilience. Accordingly, their liquid assets were sufficient to cover both outflows of deposits and debt service for the year.

The D-SIBs' operating results for Q1/2024 were and their combine profit for the quarter totalled 17 b.kr. Their return on equity was 9.7%, or 2.8 percentage points less than over the same period in 2023. Net interest income increased by 3.5% between years, whereas income from fees and commissions and net income from financial activities declined by 1% year-on-year. In addition, operating expenses rose marginally during the quarter. The D-SIBs' combined capital ratio was 24% of their risk base at the end of March 2024, the same as at the end of March 2023. Individual banks' capital ratios were 3.4-4.2% above Central Bank requirements. In Q1/2024, dividends and share buybacks totalled 43.5 b.kr., but when the capital ratio was calculated at the end of the quarter, an additional 25 b.kr. were set aside from capital ratio calculations for proposed year-2024 share buybacks and Q1/2025 dividend payments. The banks' leverage ratio had declined by 0.4 percentage points since the end of 2023, to 12.8% at the end of March. The D-SIBs' minimum required own funds and eligible liabilities (MREL) as determined by the Central Bank ranged between 29.8% and 31% of their risk base as of end-March 2024. The banks' MREL funding ranged between 36% and 39.6% of their risk-weighted assets.

The household non-performing loan (NPL) ratio was 1% at the end of Q1 and was unchanged since the turn of the year, while the corporate NPL ratio rose quarter-on quarter by 0.1 percentage points, to 2.5%. The ratio of loans defined as forborne and performing was 2.4% at the end of Q1/2024 and had fallen by 0.6 percentage points during the quarter. The position of firms that needed forbearance measures had therefore grown stronger.

Private sector debt

In March 2024, private sector debt to domestic financial institutions had contracted in real terms by 0.4% year-on-year. Household demand for credit centred mainly on indexed mortgages. Households have continued to refinance non-indexed debt with new indexed loans in order to lower their debt service. As a result, inflation-indexed mortgage loans are still growing as a share of the total mortgage stock, measuring 53.7% at the end of April. A large stock of non-indexed fixed-rate mortgage loans are up for interest rate review in the next several months. Based on the outstanding balance at the end of March, loans due for an interest rate reset in 2024 total 207 b.kr., or 7.8% of the total outstanding mortgage stock. It can be assumed that a large proportion of these loans will be refinanced, either partly or in full, with new inflation-indexed loans, as they were granted at much more favourable interest rates than are currently available on non-indexed loans, and all else being equal, resetting interest rates would push many borrowers' debt service burden sharply upwards. Households' equity position has grown stronger in the recent term, and households in general are quite resilient, which gives them scope to respond to heavier debt service.

In spite of high interest rates, mortgage loan quality has improved in many respects in the past few months. For example, the share of outstanding mortgages with a loan-to-value ratio (LTV) ratio over 80% has declined markedly in the past two years. Among first-time buyers, average debt service-to-income (DSTI) ratios have fallen, and the share of new mortgages granted with a DSTI ratio over 30% is declining as well. Furthermore, Central Bank data indicate that the average maturity on new mortgage loans has grown shorter since mid-2022, for indexed and non-indexed loans alike. At the end of Q1/2024, household debt had fallen 1.1% year-on-year in real terms, and the ratio of household debt to disposable income was down as well, to 145.2% at the end of the quarter. The household debt-to-GDP ratio rose, however, from 73.1% at year-end 2023 to 73.8% at the end of Q1/2024, owing to a contraction in GDP during the first quarter of the year.

Businesses' demand for bank loans appears to remain robust, although corporate bond issuance in the market has subsided. Corporate debt owed to domestic financial institutions increased slightly in Q1/2024, measuring 0.5% year-on-year in real terms at the end of March, as compared with -1.1% at the end of 2023. Growth in debt varies from one sector to another. It is strongest among construction companies, followed by real estate firms. In other sectors, real growth was marginal or even negative, in part because companies refinanced some of their bank loans by borrowing abroad. Companies have increasingly sought out inflation-indexed loans, which have therefore been growing as a share of the total corporate loan stock in the past twelve months.

Asset prices

Housing market turnover had increased, and the number of contracts finalised in recent months had risen above its historical average. In the capital area, housing market turnover had increased by 47% year-on-year in the first four months of 2024, and turnover in regional Iceland had grown as well. The increase is due in part to demand home purchases by Grindavík residents who had been forced to evacuate their homes. As of mid-May, the real estate firm Þórkatla had signed nearly 500 purchase agreements for property in the town of Grindavík, whose population included about 1,200 households at the onset of the volcanic eruptions in November 2023.

In 2024 to date, approximately 2,000 properties have been on the market, including nearly 900 newly constructed homes as of end-May. New construction has accounted for a large share of sold properties in recent quarters. The increased tension in the housing market shows in a decline in the share of homes sold at below the asking price. The ratio had fallen below its pre-pandemic level. In April 2024, the capital area house price index had risen by 0.2% year-on-year in real terms. The ratio of house prices to fundamentals had held broadly unchanged since mid-2023, and home prices were still high in historical context. At the end of April, they were 6% above their estimated long-term trend.

According to the Housing and Construction Authority's (HMS) March 2024 tally, new construction projects have declined somewhat in number between years. At that time, the outlook was for roughly 3,000 new homes to reach completion in 2024, as compared with 3,400 completed projects in 2023. It appears that construction market activity (not limited to residential construction) is still increasing. Turnover in the market grew in real terms by nearly 9% year-on-year in the first two months of 2024. Furthermore, imports of construction materials have grown in recent months, as have jobs in the construction sector.

The index of real commercial property prices in greater Reykjavík (CRE price index) was down by nearly 9% year-on-year at the end of Q1/2024. The index is now about 4% above its estimated long-term trend, as compared with just over 17% above trend a year ago. Turnover with commercial property in greater Reykjavík increased in real terms by nearly one-fourth between years. The D-SIBs' loans to CRE companies, which account for around 20% of their total corporate lending, have increased somewhat, and there has been a significant shift towards inflation-indexed lending since end-Q3/2023. Despite high interest rates, it appears that the quality of loans to CRE companies has not worsened materially, as the non-performing ratio in the sector has held relatively stable at close to 2% since the beginning of 2023.

Share prices of listed companies had fallen since the Committee's March meeting, and turnover had increased by 20% year-on-year. In the previous half-year, there had been a number of share price offerings, which had accounted for 18% of total equity market turnover. The OMXI15 index had fallen by 8% since the March meeting and by 7% in 2024 to date. The market value of most companies listed on the exchange had fallen in the past year, led in the recent term by banks and transport/shipping companies. Yields on nominal Treasury bonds had risen since March. Inflation had eased more slowly than expected, and the Central Bank Monetary Policy Committee's (MPC) March decision to hold the Bank's policy interest rate unchanged had affected developments as well. The short-term breakeven inflation rate in the bond market had moved in line with measured inflation, but the long-term breakeven rate was still high, at over 4%, and had inched upwards since the FSN's last meeting. Indexed Treasury yields had risen since the March meeting, as had covered bond yields. The D-SIBs' indexed mortgage lending rates had risen, and real market rates had therefore risen as well.

Exchange rate of the króna and international reserves

The exchange rate of the króna had remained flat since the Committee's March meeting and was 1% higher than at the end of December. Interbank market turnover had diminished somewhat, and volatility had been historically low, in an indication of balanced inflows and outflows of foreign currency. The banks' net forward foreign currency position was positive by 161 b.kr. at the end of April and had declined since end-February, after increasing at the beginning of the year. Furthermore, the pension funds had bought foreign currency for 24 b.kr. in the first four months of the year, about the same as in the same period of 2022 but less than in the first four months of 2023. The D-SIBs' combined foreign exchange balance had declined between meetings and was broadly in balance, in that the banks' foreign assets were roughly equal to their foreign liabilities.

The balance on goods and services trade was negative by 42.7 b.kr. in Q1/2024, as compared with a deficit of 19.2 b.kr. over the same period in 2023. In the first four months of 2024, foreign tourist arrivals increased by 6.5% year-on-year, while hotel bed-nights declined during the same period. The real exchange rate had risen between years, and it emerged that the general price level in Iceland was about 20% higher at the start of 2024 than, for instance, in Norway, Finland, and the UK, which affected the competitive position of the tourism sector.

The Central Bank's international reserves totalled 912 b.kr. at the end of Q1/2024, after increasing by 122 b.kr. quarter-on-quarter, owing mainly to issuance of foreign-denominated Treasury bonds. The reserves exceeded all key reserve adequacy benchmarks. The ratio of the reserves to the International Monetary Fund's (IMF) reserve adequacy metric was 126% at the end of Q1/2024.

Benchmarks for the determination of the countercyclical capital buffer

Each quarter, the FSN determines the countercyclical capital buffer (CCyB) rate. The FSN discussed the draft version of a benchmark for the determination of the CCyB and the fundamental principles that should underlie decisions about the buffer rate. It was decided that the Committee would work together on formulating a policy on the CCyB before its next meeting, when members would discuss the range in which the buffer should generally lie and the conditions that should prompt an increase or decrease in the buffer rate. The FSN also noted that when the buffer rate was lowered during an economic downturn, it was important to keep it low for long enough to enable financial institutions to use the scope to maintain lending activity.

Capital requirements on financial institutions

A regular review of the capital buffer for systemically important financial institutions and the systemic risk buffer will take place later in 2024. The Committee discussed the role of the capital buffers and the risks the buffers were intended to address. Furthermore, members discussed the amendments made to the statutory framework for the buffers in recent years, which have increased in flexibility in their application, including the interactions between the buffers and the possibility of applying them to specific risks in the financial system. The FSN also discussed the various ways capital buffers were applied in other EEA countries.

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. The Committee was given a presentation on financial market infrastructure and operational security. The Central Bank has adopted TIBER-IS, which is a framework for cyberattack testing for institutions and companies that are important in the context of the domestic financial system. Testing has already begun within the Central Bank, with the aim of identifying vulnerabilities in its defences and thereby bolstering resilience. The TIBER project places emphasis on providing cyberdefence training to employees in the Icelandic financial system. The FSN was also given a presentation on the activities of the cooperation forum on operational security of financial market infrastructure (SURF). Work on mapping out service elements in payment intermediation has been underway, and a coordination plan is in preparation. A comprehensive policy on cybersecurity for the financial system is set for completion this autumn. The policy is prepared in accordance with recommendations from the International Monetary Fund (IMF) in its recent Financial Sector Assessment Program (FSAP) appraisal.

The Bank has been working in cooperation with deposit institutions to put in place a domestic retail payment intermediation solution with the aim of increasing the resilience of payment intermediation. This work takes place in the Strategic Forum, a forum for the development of future strategy for Iceland's financial market infrastructure. The FSN was given a presentation on work towards the implementation of an independent domestic payment solution for Iceland. The technical implementation is complete, and the next step is to select a developer for the infrastructure. It was also explained that the Governor had signed a memorandum of understanding with the European Central Bank (ECB), which entailed examining and assessing the possibility of using the ECB's interbank systems (TIPS and T2) in Iceland.

The FSN emphasised the importance of operational security in payment intermediation. The resilience of payment intermediation must be addressed in a comprehensive way, including harmonisation of financial market responses to operational incidents, contingency exercises, and cybersecurity testing. It emerged that the Committee was of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation would enable the Bank to enhance the security and resilience of domestic payment intermediation.

The Resolution Authority and the deposit insurance scheme

The FSN was given a presentation on the deposit insurance system and on the financing of resolution or winding-up proceedings for credit institutions. Recent developments in Iceland were discussed, including the division of the deposit insurance fund into two parts – the resolution fund and the deposit division – and were placed into the context of key variables in the deposit market. Developments in deposits and deposit insurance were discussed. At the end of 2023, the assets of the Financial Institutions' Insurance Fund (TVF) totalled 1.5% of insured deposits. The minimum according to the Act on Deposit Guarantees and an Investor Compensation Scheme, no. 98/1999, is 0.8%; therefore, the TVF is well financed relative to comparable funds in Europe. The FSN was given a presentation on the recommendations made by the IMF in its recent FSAP appraisal as regards deposit insurance and the resolution fund, as well as amendments to European legislation, which will soon take effect in Iceland.

Rules on Derivatives Transactions

The Committee discussed the opinion of the IMF mission that visited Iceland in May 2024. The IMF noted that the shallowness of the domestic foreign exchange market gave rise to the risk of excessive exchange rate volatility during shocks, and it proposed that consideration be given to imposing restrictions on the commercial banks' derivatives trading in order to deepen the market. In April 2022, the FSN approved the Rules on Derivatives Transactions, no. 412/2022, which limited the total scope of financial institutions' derivatives trading so that the net forward FX position vis-à-vis any given counterparty may not exceed 10% of the capital base and the total forward FX position (the sum of the forward position vis-à-vis all counterparties combined) may not exceed 50% of the capital base.

The Committee discussed the importance of using macroprudential tools to limit position-taking involving the Icelandic krónur. The experience of increased freedom in the derivatives market had been positive, however. The current scope was used mainly to serve customers in the import and export sectors with forward foreign currency contracts. A wider interest rate differential with abroad could affect position-taking in high-yielding currencies. Under current conditions, the FSN considered it appropriate to exercise caution in amending rules on derivatives trading, and it was of the opinion that the rules should not be amended at the present time.

EFTA Court judgments on mortgage loans to consumers

The Committee received information on the EFTA Court judgments of 23 May 2024, in which the Court handed down an advisory opinion and answered questions on the interpretation of specific provisions of EU directives pertaining to consumer mortgages, with reference to standard terms and conditions governing amendments to changes in interest rates on Icelandic banks' mortgage loans. Upon receipt of the EFTA Court opinion, the cases will be subject to conventional treatment in the Icelandic courts, and their progress will be monitored. The potential impact of the cases on the D-SIBs was discussed at the meeting, but it was not considered likely that financial stability would be undermined.

Financial Stability Committee decisions

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. By law, the CCyB may range from 0% to 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.

The FSN was of the opinion that the banks were on a solid footing. The D-SIBs' capital ratios were ample and their liquidity strong. Stress tests on the banks' liquidity suggested that they could withstand considerable strain. As yet, higher interest rates had not resulted in increased arrears and loan losses, which were still below their pre-pandemic level. Economic activity had lost pace, which had shown in reduced Q1/2024 profits, among other things. Inflation had been higher and more persistent than expected, and the longer interest rates remained high, the greater the likelihood of a hard landing, which could test the banks' resilience. The rise in real interest rates puts pressure on households' disposable income and firms' operating environment. These effects are likely to show more strongly in the coming term, although they will be mitigated by the strong overall equity position of households and of companies in most sectors. Loan quality could deteriorate and arrears could increase if the economic outlook and the employment level deteriorated more than was currently envisioned. Last year's decision to increase the buffer to 2.5% created important scope to respond in the event of an economic contraction that could cause a decline in the supply of credit.

Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged at 2.5%. The proposal was approved unanimously.

At the end of the meeting, the Committee approved a statement for publication on the morning of 5 June 2024.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Arnór Sighvatsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy, Central Bank of Iceland

Björk Sigurgísladóttir, Deputy Governor for Financial Supervision

Axel Hall, external Committee member

Bryndís Ásbjarnardóttir, external Committee member

Gudmundur Kr. Tómasson, external Committee member

Tómas Brynjólfsson, 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 Financial Stability Department at the Central Bank; Rannveig Júníusdóttir, Director of the General Secretariat; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department; and Steinn

Fridriksson, expert in the General Secretariat, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2024

SEPTEMBER
23rd meeting
Published: 23 October 2024

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

September 2024 (23rd meeting)
Published: 23 October 2024

The Financial Stability Committee (FSN) of the Central Bank of Iceland takes decisions on the application of the Bank's financial stability policy tools. 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 diversify risks 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, or markets shall be considered systemically important. When warranted, the FSN may make 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 its assessment of financial stability.

At its meeting of 19, 23, and 24 September 2024, the Committee was given a presentation on developments and prospects for the economy and for financial stability. The Committee discussed 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, and financial institutions' capital and liquidity. The Committee also discussed payment intermediation infrastructure and operational security. The FSN received a presentation on the supervisory review and evaluation process (SREP) carried out on the commercial banks in 2024, the results of which are used to determine their Pillar II-R capital requirements. Committee members discussed criteria for the determination of the countercyclical capital buffer (CCyB) rate.

In its quarterly review of the CCyB, the FSN decided to hold the buffer unchanged at 2.5%.

The Committee underscored the importance of continuing to enhance operational security in payment intermediation and emphasised that it would promote measures aimed at reducing underlying operational risk. It was noted that progress had already been made but that it was important to complete the coordination plan providing for prompt, coordinated, and efficient responses to operational incidents in the financial market.

Analysis of financial stability

Although trading partners' GDP growth had picked up slightly in Q2, global economic uncertainty and concerns about the possibility of an imminent contraction had grown somewhat, starting in early summer. Global equity prices had fallen, particularly in Japan, alongside volatility in global interest rates. Trading partner inflation had continued to ease, and the US Federal Reserve and the European Central Bank had both lowered their interest rates. The key risks to financial stability in neighbouring countries centred on cybersecurity; i.e., the possibility that cyberattacks could have a severe impact on society and financial system stability. Furthermore, there are widespread concerns about economic developments and prospects, including high public debt and persistent fiscal deficits. It is expected that the effects of high interest rates and weaker output growth could give rise to increased arrears among borrowers in the housing and commercial property markets.

In Iceland, economic activity had lost pace, and the outlook for tourism, the country's largest export sector, had deteriorated somewhat, as could be seen in a poorer booking status for the months ahead and in reduced flight offerings to and from Iceland. Inflation had fallen but had been persistent, and driven to a large extent by rising house prices. The Committee discussed the increase in indexed interest rates, which could possibly lead to a rapid decline in housing demand and cause a slowdown in house price inflation. Activity in the construction industry remained robust, as could be seen clearly in the labour market and growth in lending to firms in the construction sector. The banks had increased their indexed lending rates, which would lead to heavier debt service burdens. This supported monetary policy in the fight against inflation, but from a financial stability perspective, the change had been fairly abrupt.

There are few indications of general financial distress among households and businesses, even though high inflation and interest rates are doubtless challenging for many. Borrower-based measures that put caps on households' debt service-to-income (DSTI) ratios and loan-to-value (LTV) ratios, together with rising wages and a high employment level, play an important role in households' overall resilience. The private sector debt-to-GDP ratio had risen to 152%, from 147% at the end of 2023. Nevertheless, it remains low in historical and international context, and well below the Nordic average of 176% at year-end 2023. The FSN agreed that the foundations for financial stability in Iceland were robust on the whole.

The Committee discussed the effects of persistent inflation, high interest rates, and declining economic activity on financial stability. Members considered uncertainty about economic developments one of the key risks to financial stability and were of the view that heavier debt service burdens and weaker growth in economic activity would increase the probability of financial distress. In the Committee's opinion, risks relating to the commercial property market were still considerable, while risks relating to the housing market had subsided. Population growth had eased alongside slower economic activity, and there were signs that the housing market was rebalancing as the temporary demand-side effects of the seismic activity on Reykjanes peninsula tapered off.

The FSN considered cyber risk one of the main underlying risks to financial stability and underscored the importance of continued efforts to enhance operational security in payment intermediation. Governmental authorities all over the world are also placing strong emphasis on operational security of payment infrastructure in response to increased cyberattacks. The FSN would promote measures aimed at reducing underlying operational risk. Committee members were of the opinion that significant progress on financial system security had already been made, but it was important to complete the coordination plan for the financial market providing for prompt, coordinated, and efficient responses to operational incidents.

Banking system resilience

In the Committee's opinion, the financial system is well capitalised. The domestic systemically important banks' (D-SIB) liquidity was well above all of the Central Bank's minimum requirements, whether in foreign currencies or in Icelandic krónur. Credit spreads on the banks' foreign bond issues had narrowed slightly between meetings, and the banks had had ready access to foreign capital markets. The banks have continued to refinance upcoming foreign currency maturities, and their 2025 refinancing need has therefore continued to ease.

The majority of the D-SIBs' funding is in the form of deposits, covered bonds, and unsecured marketable bonds. Deposits continue to grow, particularly retail deposits, and now constitute about half of the banks' funding. Their domestic funding comes primarily from deposits. Term deposits with maturities of more than 30 days account a quarter of the banks' total deposits, and deposits insured by the Financial Institutions' Insurance Fund's (TVF) deposit division account for about half. Both ratios have been stable in recent years. The D-SIBs have continued to expand their unsecured króna-denominated issues. These issues satisfy MREL requirements, and as the market for unsecured bonds in Iceland grows larger, the banks become less dependent on foreign market funding. In addition, the D-SIBs have added to their indexed funding, as their inflation-indexed assets have grown substantially. The banks' indexation mismatch had increased by 196 b.kr. since the turn of the year, to 489 b.kr. by the end of June.

According to stress tests of their liquidity position, the D-SIBs are highly resilient. They have enough liquid assets to cover 2024 and 2025 repayments in both local and foreign currency without breaching Central Bank liquidity rules.

The D-SIBs' profitability declined by 1.7 percentage points year-on-year in H1/2024, to 10.3% of own funds. Their income grew slightly more slowly than their expenses during the period. The banks' combined capital ratio was 23.6% of risk-weighted assets at the end of June, which represents a marginal decline relative to both year-end 2023 and end-June 2023. Individual banks' capital ratios were 3.3-4.0% above Central Bank requirements. In H1/2024, dividends and share buybacks totalled 53 b.kr. The D-SIBs' leverage ratio was unchanged year-on-year, at 12.9% at the end of June. The financial institutions also have sufficient own funds and eligible liabilities to satisfy the Resolution Authority's MREL requirements.

The household non-performing loan (NPL) ratio was 1% at the end of June and was unchanged since the turn of the year, while the corporate NPL ratio rose by 0.2 percentage points, to 2.7%. The number of individuals on the CreditInfo default register has risen very little in the recent term but declined sharply between 2018 and 2022, and is historically low. The number of companies on the CreditInfo default register has fallen somewhat in 2024 to date. At the end of June, some 2.6% of the D-SIBs' corporate loans were defined as forborne and performing. This is a slight increase since March but a decline relative to both year-end 2023 and end-June 2023. The share of forborne loans to households was unchanged year-on-year at 1.1% as of end-June 2024.

The results of the Central Bank's 2024 stress test of the systemically important banks were presented to the Committee. The stress test focused primarily on three risks: a setback in tourism, falling prices in key asset classes, and financial distress among borrowers because of high interest rates and inflation. In the stress scenario, the D-SIBs' common equity Tier 1 capital (CET1) declined by 1.3 percentage points, bottoming out at 19.6%, which is well above the required level of 15.2%. The banking system is therefore highly resilient and well able to supply credit and support the economy, even if conditions should deteriorate.

Private sector debt

Household debt had contracted in real terms by 0.8% year-on-year as of end-July, and the ratio of debt to disposable income had fallen to 144% by the end of June. Demand for residential mortgages had increased, and around 70% of new mortgages issued in June and July were inflation-indexed. Indexed mortgages now account for a larger share of outstanding mortgage debt than non-indexed loans do, although the indexed share is lower than before the pandemic. At the end of July, the stock of non-indexed mortgages with fixed-rate clauses set to expire in the last five months of 2024 totalled 129 b.kr., which comes to 4.8% of outstanding household mortgages. At the same time as household demand for mortgage loans has increased, the stock of loans not backed by real estate has contracted somewhat. This could indicate that some households that have refinanced their mortgages have taken advantage of the past few years' rise in home prices to convert other loans to mortgage debt. Because property prices have risen, however, this shift has not had a negative effect on households' loan-to-value ratios. In the recent term, banks have shortened the maximum maturity on indexed mortgage loans, which has caused the average maturity on new loans to fall over the past two years from 35 years to 31. The average loan-to-value (LTV) ratio on new consumer mortgages was relatively stable early this year but has fallen marginally in the past few months, particularly for first-time buyers. The average debt service-to-income (DSTI) ratio for new consumer mortgage has been similarly stable. Nevertheless, the share of loans granted with a high DSTI ratio (over 30%) has increased year-to-date. Tax data from Statistics Iceland show that households' equity position has strengthened significantly in recent years, and indebtedness is historically low. Furthermore, households' overdraft loans have contracted in the past year, and indicators imply that payday loans and deferred payments have declined in

2024 to date. Therefore, homeowners who have accumulated substantial housing equity in recent years are generally well positioned.

The corporate debt-to-GDP ratio was 78% at the end of June and had risen by nearly 4 percentage points since the turn of the year. The increase is due both to a rise in real corporate debt and a slowdown in GDP growth. Real growth in corporate debt measured 3.1% year-on-year at the end of June. Demand for credit has primarily been met by deposit institutions. The stock of corporate loans from professional investment funds has grown as well, although part of the increase stems from the funds' purchases of loans from banks or other lenders. Debt owed to foreign entities has also increased. The private sector debt ratio was still below its long-term trend.

As households have, companies have been turning increasingly to indexed loans. About 40% of net new loans issued to companies in the first seven months of 2024 were indexed, while another 20% were non-indexed. There has also been an increase in foreign currency lending, mainly to companies in the fishing industry, although firms in the transport and shipping, manufacturing, and services sectors that are protected against exchange rate risk have also sought out foreign currency loans. A sectoral breakdown of data on net new corporate loans shows that in the recent term, growth has been strongest in lending to real estate firms. Only a small proportion of the increase can be traced to the real estate firm Þórkatla. Lending to companies in the services, construction, and fishing sectors increased as well.

The FSN was given a presentation on forthcoming changes in risk weights on real estate-backed loans following the implementation of the CRR III regulation, which is set to take effect in January 2025. Risk weights on residential mortgages will be changed in two ways: the weight of loans with a low LTV ratio (55% or lower) will decline, and the ratio will be calculated based on the six-year average price according to the official property valuation or the market price at the time the loan was granted. Under current rules, when credit institutions calculate the LTV ratio, they may take account of property value increases after a loan is granted. Taken together, these changes are expected to reduce the amount of capital banks must hold in connection with their mortgage loan portfolio, as a large share of the portfolio has a low LTV ratio. Furthermore, risk weights on commercial property-backed loans will be slightly higher after CRR III is implemented.

Asset prices

Housing market turnover was strong in Q2/2024, partly because of property purchases by Grindavík residents. In addition, the number of first-time buyers jumped 50% year-on-year in H1/2024. Turnover slowed in July and August, although it remained higher than at the same time in 2023.

House prices are still high by most measures. The influx of foreign workers in response to strong labour demand has fuelled demand for housing and pushed property prices higher. In Q2 and Q3, a larger share of homes sold at a premium on the asking price than over the same period in 2023. An increasing proportion of home purchases were financed with inflation-indexed loans, which also contributed to price hikes. In real terms, property prices rose by 3.5% in Q2, after having fallen year-on-year for the previous five quarters, as inflation had exceeded the nominal increase in house prices.

The outlook was for the number of newly built homes completed in 2024 to be similar to that in 2023, when about 3,400 fully finished new properties were put on the market. It appears that construction market activity (not limited to residential construction) is still increasing. The ratio of construction industry turnover to total turnover in the economy was close to 9% in H1/2024, the largest share on record.

The index of real commercial property prices in greater Reykjavík (CRE price index) was down by nearly 9% year-on-year at the end of Q2/2024. The index is at its long-term trend level but was 13% above trend over the same period in 2023. Over the first seven months of 2024, turnover in commercial real estate was up slightly year-on-year in real terms. The D-SIBs' lending to commercial real estate companies, which accounts for roughly 20% of the banks' corporate loan portfolio, had increased somewhat, and the companies' market financing had declined correspondingly. There had been a shift towards indexed financing from the end of

Q3/2023 onwards. The NPL ratio on loans to the sector has been relatively stable at 2-3% since the beginning of 2023.

Share prices of listed companies had risen since the Committee's June meeting, and turnover had increased by 21% year-on-year. Nominal Treasury bond yields were broadly unchanged since the June meeting, as market agents considered sizeable Central Bank interest rate cuts unlikely in the near future. Indexed Treasury bond yields on two- and five-year maturities had fallen steeply since the FSN's June meeting, however. Inflation had fallen more rapidly than expected, and the announcement that fuel taxes would be replaced at the end of this year with a per-kilometre charge on motor vehicle use gave rise to uncertainty about the effect of the change on Statistics Iceland's inflation measurements. The Central Bank's real policy interest rate, which is calculated from various measures of inflation and one-year inflation expectations, had therefore risen and was at its highest since 2009.

Yields on the banks' indexed covered bonds had developed in a similar manner, jumping to 4.24% in September, compared to e its 2024 average of 3.6%. Thereafter, the D-SIBs raised their indexed lending rates. The banks announced that variable rates on indexed loans would rise by 0.25-0.6 percentage points, effective in October. The D-SIBs have also tightened the borrowing requirements in several ways in addition to the aforementioned shortening of maximum indexed loan maturities; for instance, by offering equal instalments only and by lowering LTV ratios. It is worth noting that interest rates on indexed corporate loans averaged 5.3% in August (13.2% on non-indexed loans), and rates on indexed residential mortgages averaged 3.9% (11% on non-indexed).

Exchange rate of the króna and international reserves

The foreign exchange market had been stable in 2024 to date, exchange rate volatility well below its long-term average, and interbank market turnover relatively limited. The króna began to depreciate in late summer and, by the time of the FSN meeting, had weakened by 1.2% since end-July. The banks' net forward foreign currency position declined significantly in July and August, and the number of derivatives contracts involving the króna fell by one-fourth over the same period. Foreign currency flows for new investment had tapered off sharply after having surged in late 2023 and Q1/2024, but net inflows had been close to zero since March 2024. The pension funds had bought foreign currency for 51 b.kr. in the first eight months of the year, about 17 b.kr. less than in the same period of 2023.

The Central Bank's international reserves totalled 888 b.kr. at the end of Q2/2024 and exceeded all key reserve adequacy benchmarks. The ratio of the reserves to the International Monetary Fund's (IMF) reserve adequacy metric was 119% at the end of Q2/2024.

Benchmarks for the determination of the countercyclical capital buffer

Each quarter, the FSN determines the countercyclical capital buffer (CCyB) rate. Members discussed draft benchmarks for determination of the CCyB and its interaction with other buffers. The Committee decided to return to the topic at its next meeting, including a discussion of what the buffer value should be when there were no signs of particularly high or low risk levels in the financial system, and what conditions could warrant lowering or raising the CCyB.

Financial market infrastructure

One of the Central Bank of Iceland's principal tasks is to promote a safe and effective financial system, including domestic and cross-border payment intermediation. Nearly all payment intermediation in Iceland is digital, and use of cash is limited. Operational and cyber threats have increased, and strong emphasis is therefore placed on operational security in financial market infrastructure and payment intermediation. According to the 2023 annual report of Iceland's Computer Emergency Response Team (CERT-IS), the number of incident reports rose sharply relative to the prior year, from 700 in 2022 to 1,266 in 2023. In both years, most reports fell into the category of swindling or fraud involving phishing and attempts to access sensitive information such as payment card numbers or passwords. It was noted that the number of incidents reported to CERT-IS had increased between 2023 and 2024. The FSN was given a presentation on work being done, both within the Central Bank and in other fora, on bolstering the operational security of payment intermediation. It was noted that work groups on behalf of the cooperation forum on operational security of financial market infrastructure (SURF) had been mapping out service elements in payment intermediation and preparing the coordination plan for the financial market on responses to operational incidents. The objective of such a plan would be to ensure streamlined responses and communications among the relevant parties in a dedicated incident centre, thereby shortening lines of communication and improving organisation, so as to minimise disruption of the financial system.

The Act on the Central Bank of Iceland had recently been amended and the Bank authorised to set rules on operational security in payment intermediation and on the levy of sanctions. Furthermore, work is underway on the implementation of European legislation on digital operational resilience, called the Digital Operational Resilience Act (DORA); cf. the draft bill of legislation on the digital operational resilience of the financial market. The legislation will impose harmonised requirements concerning financial market entities' risk management frameworks and contingency measures and concerning cyber- and information security.

The FSN agreed that it was important to continue working on increased operational security in payment intermediation. It emerged that the FSN would promote measures aimed at mitigating underlying operational risk. Progress had already been made, but the Committee considered it important to complete the coordination plan providing for prompt, coordinated, and efficient responses to operational incidents in the financial market.

The financial cycle and cyclical systemic risk

Cyclical systemic risk can be estimated in a variety of ways, and the FSN uses several measures. A composite measure of the financial cycle indicated a continued upward phase. The financial cycle was still driven by the housing cycle, which had risen the fastest. The domestic systemic risk indicator (d-SRI) has risen slightly but is still somewhat below its long-term average. The main sub-indicator underlying the assessment and showing a recent increase is bank lending to private sector borrowers. Taken together, indicators of cyclical systemic risk suggested that risk was moderate overall and was greatest in the housing market.

Supervisory Review and Evaluation Process (SREP)

The FSN was given a presentation on the assessment of the minimum capital requirements imposed on the commercial banks. In this context, the supervisory review and evaluation process (SREP) is an important element in assessing the minimum capital requirement imposed on financial institutions. The results of the SREP produce an estimate of the Pillar II-R capital requirement for 2024, which depends on risk factors for the bank in question as regards capital, liquidity and funding needs, business plan assessments, governance, and internal controls. The Pillar II-R capital requirement declined year-on-year for all four commercial banks, while the overall capital requirement was virtually unchanged, as the CCyB had been increased by 0.5 percentage points in March 2024, to 2.5% of risk-weighted assets.

Financial Stability Committee decisions

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. By law, the CCyB shall range from 0% to 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.

The FSN was of the opinion that the banks were resilient. Their capital ratios were ample and their liquidity strong. Stress tests on the banks suggested that they could withstand considerable strain. As yet, higher interest rates had not resulted in increased arrears and loan losses, which were still below the pre-pandemic level. Economic activity had lost pace, which had shown in reduced H1/2024 profits, among other things.

Inflation was high but had fallen more rapidly than expected, and the breakeven inflation rate in the bond market had fallen significantly. Real interest rates had shifted upwards, as could be seen in the banks' indexed funding, which prompted them to raise rates on indexed mortgages and indexed corporate loans. Interest rates on non-indexed loans to households and businesses were high, and among both groups there had been strong demand for indexed loans, which offered lower debt service. In August, the average rate on new non-indexed mortgages was 11%, and the average rate on non-indexed corporate loans was 13.2%. The D-SIBs' stock of indexed assets had therefore surged, causing a rapid increase in their indexation imbalance. This could possibly pose a risk to the banks' operations further ahead. If inflation falls quickly and nominal interest rates remain high, the banks' profitability could be temporarily eroded. Loan quality could deteriorate and arrears could increase if the economic outlook and the employment level deteriorated more than was currently envisioned. Last year's decision to increase the buffer to 2.5% created important scope to respond in the event of an economic contraction that, all else being equal, could cause a decline in the supply of credit.

Following the discussion, it was proposed that the countercyclical capital buffer be held unchanged at 2.5%. The proposal was approved unanimously.

At the end of the meeting, the Committee approved a statement for publication on the morning of 25 September 2024.

The following Committee members were in attendance:

Tómas Brynjólfsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy, Central Bank of Iceland

Björk Sigurgísladóttir, 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 Financial Stability Department at the Central Bank; Rannveig Júníusdóttir, Director of the General Secretariat; Gísli Óttarsson, Director of the Microprudential Supervision Department; Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department; and Steinn Fridriksson, expert in the General Secretariat, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

CENTRAL BANK OF ICELAND

MINUTES

FINANCIAL STABILITY COMMITTEE

2024

December
24th meeting
Published 2 January 2025

The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

December 2024 (24th meeting)
Published: 2 January 2025

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 intermediate credit and payments, and to diversify risks 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 components, or markets shall be considered systemically important. When warranted, the FSN may make 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 its assessment of financial stability.

At its meeting of 26 November and 2 and 3 December 2024, the Committee was given a presentation on developments and prospects for the economy and for financial stability. The Committee discussed 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, and financial institutions' capital and liquidity. It also discussed global uncertainties. The Bank's work on the premises underlying the 2025 stress tests was presented to the Committee. Members discussed operational security in payment intermediation and were given a presentation on a contingency plan relating to operational disruptions in the financial system and to liquidity and capital adequacy problems. They were also given a presentation on the pension funds' position and investments, asset composition, and returns. Thereafter, they discussed the policy on the countercyclical capital buffer (CCyB) and the neutral buffer rate.

The FSN decided to lower the *systemic risk buffer* rate from 3% to 2% of the risk base on domestic exposures. The reduction was based on the Committee's assessment that systemic risk had receded and financial system resilience had grown since the buffer was first introduced in 2016. The FSN decided to hold the CCyB rate unchanged at 2.5% of the risk base on domestic exposures, and it approved a policy on the application of the CCyB, which entails, among other things, generally maintaining a buffer rate between 2% and 2.5%. The Committee reiterated the importance for financial institutions of maintaining a strong capital position so as to ensure resilience against shocks.

The FSN completed its annual review of systemically important financial institutions and the *capital buffer for systemic importance* (O-SII buffer) and confirmed the systemic importance of Arion Bank, Íslandsbanki, and Landsbankinn. It decided to increase the O-SII buffer from 2% to 3% on all exposures.

The reduction of the systemic risk buffer and the increase in the O-SII buffer result in a virtually unchanged overall capital requirement imposed on the three systemically important banks. For smaller deposit institutions not considered systemically important, however, capital requirements are reduced.[1]

[1] For more details on capital buffers, see https://www.cb.is/financial-stability/macroprudential-policy/capital-buffers/

The FSN underscored the importance of continuing to work towards greater operational security in payment intermediation, and it expects the implementation of an independent domestic payment solution to begin in 2025.

Analysis of financial stability

GDP growth among Iceland's trading partners had developed in line with expectations in Q3, and inflation had fallen as projected. On both sides of the Atlantic, policy interest rates had been lowered since the FSN's previous meeting, held in September. Share prices had risen in the US but softened in Europe, where the political situation is uncertain in some countries and there have been significant concerns about Europe's debt levels and waning competitiveness. Key risks to financial stability in Iceland´s neighbouring countries centred on the economic impact of political uncertainty, on the one hand, and security matters, including cybersecurity, on the other. Furthermore, there are widespread concerns about high public debt levels and persistent fiscal deficits coupled with weak GDP growth. Increased uncertainty about the international political situation and fiscal policies could lead to higher long-term interest rates and risk premia and lower asset prices. Weak GDP growth and high interest rates could also result in increased arrears on residential and commercial real estate loans.

In Iceland, domestic economic activity had been broadly in line with expectations. GDP had shrunk by 1% year-on-year in the first three quarters of 2024. Indicators from the tourism sector – including hotel booking status, flight availability to and from the country, and corporate expectations – suggested that growth would be subdued in the near term. Labour market tightness had eased, and unemployment had inched up to 3.6% in October. Inflation had fallen to 4.8% (2.7% excluding housing) in November, after measuring 6% before the FSN's September meeting and 8% in November 2023. Inflation had fallen somewhat more than expected. The Central Bank's key interest rate had been lowered by 0.75 percentage points in two increments since the FSN's previous meeting. The Committee agreed that there was cause for optimism that inflation would fall further without a substantial increase in non-performing loan (NPL) ratios. There were few indications of financial distress among households and businesses, even though high inflation and interest rates had pushed many borrowers' debt service higher.

The FSN agreed that the foundations for financial stability in Iceland were robust. The foreign exchange market remained stable. Real disposable income had risen, and the most recent figures showed that it had increased more than previous numbers had indicated. Nevertheless, the FSN considered economic uncertainty to be one of the risks to financial stability, and while the outlook for Iceland was favourable in many respects, a high real interest rate concurrent with slower growth in economic activity could affect the financial system. The Committee was of the opinion that elevated geopolitical risk could have unforeseen implications. Economic developments would also depend on fiscal policy in other parts of the world, the impact of increased protectionism, and developments in ongoing wars. Financial stability could be strongly affected if more pessimistic scenarios for political risk should materialise.

Governments worldwide place strong emphasis on the operational security of financial market infrastructure, owing to the rise in cyberattacks and vandalism. The Committee underscored the importance of continued efforts to enhance operational security in payment intermediation. Positive steps had been taken towards an independent domestic payment solution, and the FSN expected implementation of such a solution to begin in 2025.

Banking system resilience

In the Committee's opinion, the financial system is on a strong footing. The domestic systemically important banks' (D-SIB) liquidity was well above the Central Bank's minimum requirements, whether in foreign currencies or in Icelandic krónur. Interest premia on the banks' foreign bond issues have continued to fall, and banks have ready access to foreign markets. They have issued foreign-denominated bonds on better terms than in 2023, and at the same time they have bought back foreign issues maturing in 2025. As a result, their foreign refinancing risk continues to decline. It is important that the banks maintain strong foreign liquidity.

Deposits are still growing, retail deposits in particular, and now account for about half of the banks' funding. The banks' króna-denominated funding comes primarily from deposits and covered bonds. The D-SIBs have continued to build up and expand their unsecured króna-denominated bond issues, but the buyer group is still small. The issues satisfy MREL requirements, and with a growing market for unsecured bonds in Iceland, the banks will become less dependent on foreign markets.

According to liquidity stress tests, the D-SIBs are highly resilient. They have enough liquid assets to cover 2024 and 2025 repayments in both local and foreign currency without being in breach of liquidity rules.

The D-SIBs' operations were strong in the first nine months of 2024. Their profits grew year-on-year to nearly 63 b.kr., while their return on equity was virtually unchanged between years, at 11.7%. There were few changes in individual income items during the period, with the exception of income from financial activities, which increased by 6.5 b.kr. year-on-year, to 7.8 b.kr. The D-SIBs' total income for the first nine months of 2024 was 157 b.kr. and was unchanged year-on-year in real terms. Their operating expenses totalled 61 b.kr. over the same period, a year-on-year increase of 1.4% in real terms. At the end of September, the D-SIBs' combined capital ratio was 23.6% of the risk base, which represents a slight increase year-to-date and relative to September 2023. Each of the three banks' capital ratio was 3.7 percentage points above the Central Bank's overall requirement. Dividends and share buybacks totalled 61 b.kr. during the first nine months of the year. The leverage ratio was unchanged between years, at 12.8% as of end-September. The financial institutions have sufficient own funds and eligible liabilities to satisfy the Central Bank Resolution Authority's minimum requirements for own funds and eligible liabilities (MREL requirements).

The most recent figures on households' NPL ratios show that arrears measured 1% at the end of September were virtually unchanged from the beginning of the year. The corporate NPL ratio rose over the same period by 0.3 percentage points, to 2.7%, but was unchanged quarter-on-quarter. As before, arrears were most pronounced among companies in the hospitality industry, at 8.4%, and had increased by 3.6 percentage points since the beginning of the year. The rise was due to a few large loans in the sector, however. The NPL ratio in the construction sector had risen by 2 percentage points over the same period, to 3.2% as of end-September.

Private sector debt

By end-September, household debt had increased by 0.3% in real terms over the previous twelve months. Households' debt ratios were still low in historical and international context. The debt-to-GDP ratio was 73% at that time and had risen marginally between years. The debt-to-disposable income ratio had continued to fall, however. In September it was 136%, its lowest since 1995. Revised household disposable income figures published recently by Statistics Iceland indicate that real disposable income grew far more in 2022, 2023, and 2024 to date than was previously estimated.

Demand for mortgage loans remains strong despite high interest rates, and about 70% of new mortgages issued in Q3 were inflation-indexed. In recent months, interest rates on new non-indexed mortgage loans have fallen in tandem with Central Bank rates, while interest rates on new indexed mortgages have risen to their highest level since 2012. At the same time, the banks have amended their lending terms and conditions and shortened the maximum maturity on new indexed mortgages. They have also lowered the maximum loan-to-value (LTV) ratio on base loans. This has made it more difficult for households to lighten their mortgage debt service burden. The impact has yet to surface, as NPL ratios have been unchanged, as has the share of first-time buyers. However, the share of indexed mortgages has fallen since the beginning of the year, when it reached 75%.

At the end of September, firms' debt to domestic financial institutions had increased by 5.2% year-on-year in real terms. Debt owed to domestic financial institutions equals roughly 82% of total corporate debt.

Growth in debt owed to domestic financial institutions has been strongest among real estate firms thus far in 2024, although debt among companies in the services, fishing, and construction sectors has increased as well. Lending growth has eased in recent months, however, perhaps indicating that corporate credit growth has peaked. Companies have increasingly sought out indexed loans, mainly real estate firms, and foreign-denominated loans, primarily fishing companies with foreign-currency revenues.

The private sector debt-to-GDP ratio was still well below its historical average at the end of September, despite increasing by 3.8 percentage points between years. Growth in lending to companies has exceeded GDP growth in 2024, which explains the year-on-year rise in the credit-to-GDP ratio.

Asset prices

The housing market has cooled in recent months as the effects of the seismic activity on the Reykjanes peninsula have tapered off. Furthermore, the monetary stance is tight. Housing market turnover contracted in Q3, and the number of purchase contracts declined, after a marked increase during the buy-up of homes in Grindavík in Q2. Over the first ten months of 2024, however, the number of purchase agreements nationwide grew by 53% year-on-year. Excluding Grindavík-related transactions – Þórkatla's[2] buy-up and Grindavík residents' subsequent purchase of new homes – the increase measured 30% year-on-year. The number of first-time buyers has risen in 2024, partly because of an increase in allocation of equity loans from the Housing and Construction Authority early in the year. Furthermore, households' sizeable accumulated savings have enabled first-time buyers to enter the market despite the limitations posed by tight borrowing requirements and high interest rates, and there are signs that increased parental assistance has helped as well.

The nationwide house price index was up 3.5% year-on-year in real terms at the end of October, and the rate of increase had slowed in the previous two months. The number of homes advertised for sale has risen in the recent term, especially newly built properties. House prices remain high relative to fundamentals, indicating that imbalances remain in the market. Although net inward migration has slowed, population growth has remained robust. In Q2, just under 20% of properties nationwide sold at a premium on the asking price, down from nearly 60% at the beginning of 2022. The outlook is for 3,400 fully finished new homes to be put on the market in 2024. New construction also gained steam from mid-year onwards, and by the end of November a record 8,000 homes were under construction or in the planning phase.

The commercial real estate (CRE) price index, which measures real prices in greater Reykjavík, was up more than 2% year-on-year at the end of Q3. Over the first nine months of 2024, turnover with commercial property had increased between years by nearly a fifth in real terms. Measures of demand for commercial property suggest that it has eased in 2024 to date, in line with the slowdown in economic activity. The stock of D-SIB loans to CRE companies, which accounts for around 20% of their total corporate lending, had grown in real terms by 16% year-on-year as of October, with nearly 60% of the loans inflation-indexed. Financing costs had risen with the increase in indexed lending rates. The real estate firms' market financing had increased in H2, after having been very limited in previous quarters. In Q3, the companies issued indexed bonds exclusively. The NPL ratio on D-SIB loans to the sector was 2.1% at the end of Q3, or nearly 1 percentage point lower than at the same time in 2023.

Share prices of listed companies had risen since the Committee's September meeting, and turnover had increased by 33% year-on-year. The OMXI 15 index was up 26% year-on-year, with most of the increase occurring the previous two months. The stock market was characterised by strong turnover and increased optimism in October. Turnover came to 130 b.kr. during the month, the largest single-month total since the 2008 financial crisis, apart from March 2022, when Íslandsbanki was listed on the exchange. Central Bank interest rate cuts and strong turnover with shares in Marel affected the market. Because of US firm John

[2] The Icelandic Government established asset management company Þórkatla in February 2024. Its purpose is to buy and manage residential real estate in Grindavík while earthquakes and volcanic eruptions make it impossible for residents to live there safely.

Bean Technologies' (JBT) takeover bid for Marel, foreign investors have seen an opportunity for profit by buying Marel shares on the Nasdaq Iceland exchange and short-selling JBT shares in the US.

Nominal Treasury bond yields had fallen since the FSN's September meeting. Indexed two- and five-year yields had peaked in early October, when the five-year indexed yield reached its highest since 2009. Indexed Treasury bond yields had fallen, however, and on the whole, the breakeven inflation rate had declined marginally between meetings. The breakeven rate had fluctuated somewhat, however, particularly because of uncertainty about the effect the new per-kilometre charge on motor vehicle use would have on the CPI. Yields on indexed covered bonds issued by the banks had fallen to 3.44% just before the FSN meeting, after peaking at 4.59% in October. Together with the decline in indexed Treasury yields, this indicates that the same pattern will show in rates on new indexed mortgage loans. None of the banks is offering indexed rates below 4%.

Exchange rate of the króna and international reserves

After a temporary dip in August, the króna began to appreciate again in the autumn and was 2.9% stronger at the end of November than at the time of the FSN's September meeting. Foreign currency inflows for new investment by non-residents were positive by 37 b.kr. in the first ten months of 2024, as compared with 24 b.kr. over the same period in 2023. Non-residents have bought Treasury bonds for 39 b.kr. this year. Inflows into Treasury bonds increased in September and October, totalling 12 b.kr., primarily for investment in long-term bonds.

The long-term interest rate differential with the US and the eurozone is smaller than the short-term differential and has narrowed recently because of rising long-term interest rates abroad. The short-term differential between Germany and Iceland is sizeable, however, and larger than in 2015, when non-residents invested heavily in Icelandic bonds. Although non-residents have stepped up their investments in Icelandic Treasury bonds, their share of outstanding Treasury issues is still small in historical and international context.

Tourism sector activity has supported the króna since the summer, as have inflows for investment. The services account surplus was large in Q3, and the balance on combined goods and services trade was positive by 0.2% of GDP over the first three quarters of 2024. On the other hand, the net forward position continued to decline in the autumn, and derivatives trading with the króna shrank by 17%, perhaps reflecting market expectations that the króna will not continue to appreciate. The pension funds bought foreign currency for 71 b.kr. in the first ten months of the year, about 5 b.kr. less than in the same period of 2023.

At the end of Q3, the Central Bank's international reserves totalled 899 b.kr., which is above all key reserve adequacy metrics. The Bank has not intervened in the foreign exchange market since February 2024.

Stress test for 2025

The Committee was given a presentation on a draft of the stress scenarios for the Central Bank's 2025 stress test on the D-SIBs. Scenario design takes account of developments in domestic and foreign risks, as well as the main drivers of the banks' returns. The stress scenario for 2025 will include unfavourable developments in unemployment, wages, GDP growth, inflation, and interest rates. The purpose of the stress test is to determine the D-SIBs' resilience and their ability to intermediate credit to households and businesses over a period characterised by such shocks, taking account of developments in asset markets and private sector debt.

Pension funds

The FSN was given a presentation on the pension funds' position and investments. Mutual pension divisions' combined real returns over the first nine months of the year were positive by 3.6% and were sustained primarily by favourable developments in foreign share prices. At the end of Q3, the pension funds' assets totalled 8,000 b.kr. and had increased by 630 b.kr. since the turn of the year. Of that total, mutual pension divisions' foreign assets accounted for 41% and had increased by just over 2% year-to-date. The maximum permissible ratio of foreign assets held by mutual pension divisions is set to increase by 1.5 percentage points on 1 January 2025, to 53%. The pension funds' investment strategies assume that foreign assets will continue to grow in 2025, to about 43% of total assets. The increased weight of foreign investment has mitigated concentration and helped diversify the pension funds' investment portfolios. The funds still play an important role in financing in Iceland. As of end-Q3, about 830 b.kr., or 17.5% of their domestic assets, took the form of deposits, bonds, or equities issued by the commercial banks. Covered bonds accounted for the largest share, at 338 b.kr.

Central Bank contingency plan for deposit institutions' liquidity and capital adequacy problems

The FSN was given a presentation on a draft version of the Central Bank's contingency plan for deposit institutions' liquidity and capital adequacy problems. The plan, which focuses on the Bank's powers to respond to such liquidity and capital adequacy problems, also contains provisions on communications within the Bank, with relevant Governmental authorities, and with stakeholders. The plan defines critical levels or response levels, roles and responsibilities, a contingency management team, and indicators and criteria for various response levels. Furthermore, it outlines the legal authorisations held by the Central Bank as competent financial supervisory body, lays down requirements and processes for decisions on loans of last resort, and describes how decisions that a credit institution is failing or likely to fail shall be taken. Finally, the plan focuses on how a credit institution's resolution plan shall be activated and how an institution with liquidity and capital adequacy problems shall be wound up. The FSN has an important monitoring role pursuant to Article 13 of the Act on the Central Bank of Iceland, no. 92/2019, in addition to taking decisions on the capital buffers imposed on financial institutions.

The contingency plan was tested at a joint Nordic-Baltic crisis simulation exercise in the autumn, where responses to liquidity and capital adequacy problems in a cross-border bank were tested. About 450 representatives from the relevant countries' central banks, financial supervisors, and government ministries participated.

Central Bank contingency plan for operational disruptions of financial market infrastructure and information technology risk

Operational risk and cyber risk have grown, and as a result, strong emphasis is placed on the operational security of financial market infrastructure and payment intermediation. It is important that the Bank analyse and assess which financial market infrastructure is critical from the standpoint of financial stability and should be classified as *core infrastructure*. This entails assessing which infrastructure components are of such a nature that a disruption in their activities could affect the intermediation of payments in the financial system, thereby affecting financial stability. The Bank's contingency plan for financial market infrastructure, which was presented to the Committee, includes a plan for essential preparedness by the Bank in the event of a threat or incident involving financial market infrastructure that jeopardises the operational security of payment intermediation. It also contains the Central Bank's assessment of which infrastructure components should be classified as core infrastructure. Furthermore, the financial system services that are significant for core infrastructure and payment intermediation are defined, a risk assessment for them is presented, and potential contingency measures identified. Finally, a coordination plan for core infrastructure is presented, and the relevant roles and responsibilities within the Central Bank are defined. Among other things, it is recommended that the Central Bank establish a financial market infrastructure incident centre for the financial system.

In its role as competent financial supervisory authority, the Central Bank collects data and monitors information technology risk in the financial system, in accordance with rules from the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA) and guidelines from the Bank. The FSN was given a presentation on the process that the Bank's supervisory departments have designed to build on internal deviation analysis in order to assess the security of information and communications technology among supervised entities throughout the market. The assessment is, among other things, part of the Bank's supervisory review and evaluation process (SREP), which underlies the determination of the Pillar II-R capital requirements made of financial institutions.

Operational security in payment intermediation

The FSN was given a presentation on the work done by the Bank to enhance resilience in payment intermediation. Work is underway on a self-assessment and appraisal, based on the Principles for Financial Market Infrastructures (PFMI), of the Central Bank's interbank payment system, which is designated as systemically important financial market infrastructure. The appraisal is expected to conclude in 2025. The Central Bank has implemented a framework for TIBER cybersecurity testing. Two tests were conducted in 2024, and three are planned for 2025. When the EU's Digital Operational Resilience Act (DORA) is implemented in 2025, companies in the financial market will be subject to far more stringent requirements than they are currently, which should bolster resilience. The financial system is faced with growing external threats, including hybrid threats and cyberattacks. It is therefore important to consider a wide range of measures to enhance resilience in the system.

The Bank has begun a feasibility assessment of the possible use of the eurozone's TARGET services in Iceland. The assessment is expected to be complete before the end of 2025. An assessment will be made of the European Central Bank's TIPS real-time settlement system, on the one hand, and its T2 system for real-time gross settlement and centralised liquidity management, on the other. The Bank's main incentive for undertaking the feasibility study is that payment intermediation has evolved rapidly in recent years and the Bank's priorities have changed accordingly. As a result, the Bank has placed increased emphasis on operational security and resilience of payment intermediation, partly in response to increased cyberattacks and elevated geopolitical risks. Furthermore, the Nordic central banks are planning to implement TIPS and T2 for interbank payment intermediation or have already done so. The cost of the current system has risen in recent years and cybersecurity risks have grown, which calls for increased preparedness. The TARGET services will continue to evolve in line with the standards and regulations whose implementation in Iceland the Bank has worked towards.

An element in bolstering the operational security of financial market infrastructure is to establish a centralised infrastructure component for payment orders in Iceland. The Bank has published an advertisement inviting interested parties to submit proposals and cost estimates for such centralised infrastructure. Information on the investment expense and operational cost of the infrastructure is one of the premises for a determination of whether the requirements of the Competition Act are fulfilled. It is expected that this information on the cost of investment and operations will be available at the end of January 2025, whereupon it will be possible to carry out an assessment in accordance with the Competition Act.

Financial Stability Committee decisions

Criteria for the determination of the countercyclical capital buffer

The Committee discussed the benchmarks for determining the CCyB, which has the role of strengthening financial institutions' resilience and ensuring that their capital is sufficient to enable them to grant loans and absorb loan losses in the event of shocks. In its Financial Sector Assessment Program (FSAP) appraisal from 2023, the International Monetary Fund (IMF) had stated that it was desirable for the FSN to determine what the CCyB rate should be when it considered the level of financial system risk to be neither particularly high nor particularly low.

When the buffer was first introduced under Basel III, it was considered best that it followed the domestic financial cycle, particularly to include developments in non-financial private sector debt. Countries had actually been applying the CCyB in various ways, however. After the COVID-19 pandemic, many European countries had reviewed their CCyB policies and set a benchmark for a positive neutral buffer. This entails that the buffer is positive early in the financial cycle. It can be said that the identification of a positive neutral buffer value was European countries' response to their experience of the pandemic, as only some of them had activated the CCyB prior to the outbreak and those that had not done so had no scope to ease capital requirements on financial institutions when the pandemic struck. Institutions such as the European Systemic Risk Board (ESRB), the Basel Committee for Banking Supervision (BCBS), and the IMF have supported the determination of a positive neutral buffer rate that makes it possible to lower capital requirements on financial institutions in the event of unforeseen shocks that undermine financial stability, irrespective of the financial cycle position before that time. Such shocks can also affect subsequent developments in the business cycle and the financial cycle.

FSN members agreed that the CCyB should be positive under conditions indicating neither a high nor a low level of risk in the financial system. The buffer rate would generally need to be somewhere close to its current level, and developments in financial institutions capital ratios during the Central Bank's stress tests supported that conclusion. The Governor proposed that the positive neutral buffer rate should be between 2% and 2.5% of the domestic risk base. All members voted in favour of the Governor's proposal, and the Committee also decided to review the positive neutral buffer rate at regular intervals. The FSN discussed benchmarks for the determination of the CCyB and noted that it could increase the buffer rate when there were signs of elevated financial system risk. If the risk materialised, the Committee would lower the buffer rate or set it at zero to give financial institutions the scope to absorb loan losses and enable them to maintain an adequate supply of credit. The CCyB was thereby intended to support both financial institutions' resilience and the stability of the financial system. Following the discussion, the Committee's policy document on criteria for the determination of the CCyB was approved unanimously.

Systemically important financial institutions

The assessment of systemically important financial institutions, based on European Banking Authority (EBA) methodology, was presented to the Committee. The Central Bank's methodology, which was also used in 2023, is also based on additional indicators that measure foreign exchange market turnover. The importance of individual financial institutions was examined as well, with respect to whether their activities were of such a nature as to affect financial stability. This included an examination of whether specific indicators in the assessment of systemic importance are important for the functioning of the Icelandic financial 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), first 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.

Based on Central Bank methodology, each of the three large commercial banks is systemically important at the national level. The failure of any one of them would probably have a significant negative impact on financial stability in Iceland, as well as spreading to other financial institutions and to the economy more broadly. The Committee therefore considered it appropriate to use the full scope afforded it by law in setting the buffer rate, which may range up to 3% following amendments made in 2022, upon the implementation of the CRD V directive. The buffer rate may be higher, however, subject to approval by the Standing Committee of the EFTA States. The Governor proposed that the O-SII buffer be raised from 2% to 3% on all exposures at the parent company level and the group level. The proposal was approved unanimously.

Systemic risk buffer

The systemic risk buffer is applied on the basis of persistent systemic risk relating to underlying risk in the Icelandic economy. Such systemic risk is considered non-cyclical, or built-in, and the buffer value is reviewed every two years. The Committee was given a presentation on developments in Iceland's business cycle, and it emerged that volatility of economic variables had diminished since the systemic risk buffer was first introduced in 2016. In the FSN's assessment, Iceland's strong net international investment position (NIIP) and ample international reserves had shored up its economic resilience and fostered increased stability. Furthermore, financial system resilience had increased with the application of macroprudential tools after the 2008 financial crisis. Capital buffers, liquidity rules, rules on net stable funding, rules on foreign exchange balance, and borrower-based measures were examples of macroprudential tools that had supported financial and economic stability.

Following the discussion, the Governor proposed that the systemic risk buffer be lowered from 3% to 2% on the domestic exposures of financial institutions authorised to accept deposits. The proposal was approved unanimously.

The reduction of the systemic risk buffer and the increase in the O-SII buffer result in a virtually unchanged overall capital requirement on the three systemically important banks. For smaller deposit institutions not considered systemically important, however, capital requirements are reduced.

Countercyclical capital buffer

The FSN was of the opinion that the banks were resilient. The framework for the financial system was sound and had delivered stability. The D-SIBs' capital ratios were ample and their liquidity position strong. Indicators of cyclical systemic risk suggested that risk was moderate, and greatest in the housing market. As yet, high interest rates had not led to an increase in arrears and loan losses. Economic activity had slowed down, and inflation had fallen more rapidly than expected. The breakeven inflation rate in the bond market had fallen and real interest rates had risen, and the effects had already begun to show in the housing market, where price increases had slowed and activity had cooled. It looked as though inflation would fall without significant side effects; i.e., neither an economic contraction in 2025 nor a surge in unemployment was expected. The foreign exchange market was stable, and the combined goods and services balance was in surplus. The long-term interest rate differential with abroad had narrowed. It was positive that the outstanding amount of derivatives had fallen concurrent with inflows for investment by non-residents. Committee members agreed that the financial position of most households in the mortgage lending market appeared good, debt ratios were low overall in historical and international context, households' equity position was sound, real disposable income had risen, and the employment situation was good.

Increased international political instability gave cause for concern, however, and loan quality could deteriorate and arrears could increase if the economic outlook worsened and unemployment rose. Last year's decision to increase the buffer to 2.5% had created important scope to respond in the event of an economic contraction that, all else being equal, could cause a decline in the supply of credit. Following the discussion, the Governor proposed that the countercyclical capital buffer rate be left unchanged at 2.5% of the risk base for domestic exposures, and the proposal was approved unanimously.

The Committee discussed the effects of incorporating amendments to the EU Capital Requirements Regulation (CRR) into Icelandic law in H1/2025. Implementing the amendments would result in significant changes in the calculation of financial institutions' exposures, particularly as regards risk weights for residential mortgage loans and real estate-backed corporate loans. In general, the amendments were conducive to making the standardised approach to risk weight calculation more risk-sensitive, as low-risk loans would generally be assigned a lower risk weight than under the current regulatory framework, while higher-risk loans would be assigned a higher risk weight.

At the end of the meeting, the Committee approved a statement for publication on the morning of 4 December 2024.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Tómas Brynjólfsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Björk Sigurgísladóttir, 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. Hermann Sæmundsson, Permanent Secretary of the Ministry of Finance and Economic Affairs, attended part of the meeting.

Haukur C. Benediktsson, Director of the Financial Stability Department at the Central Bank; Rannveig Júníusdóttir, Director of the General Secretariat; Gísli Óttarsson, Director of the Microprudential Supervision Department; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; and Steinn Fridriksson and Thröstur Bergmann, specialists in the General Secretariat, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.

Skilaáætlanir fyrir sparisjóði samþykktar

5. janúar 2024

Skilavald Seðlabanka Íslands hefur samþykkt skilaáætlanir fyrir fjóra sparisjóði, þ.e. Sparisjóð Austurlands, Sparisjóð Höfðhverfinga, Sparisjóð Strandamanna og Sparisjóð Suður-Þingeyinga. Áætlanirnar ná til ákvarðanatöku ef til þess kæmi að fjárhagsstaða sparisjóðanna yrði svo slæm að þeir teldust vera á fallanda fæti.

Skilaáætlanir sparisjóðanna fela í sér greiningu á því hvort mögulegt verði að endurreisa þá hratt og örugglega, án opinbers fjárstuðnings frá ríkissjóði eða Seðlabankanum, með beitingu skilaaðgerða eða að sparisjóðunum verði slitið. Áætlununum er ætlað að tryggja óheftan aðgang almennings og fyrirtækja að nauðsynlegri starfsemi (e. critical function) og að aðgerðir hafi ekki áhrif á fjármálastöðugleika í landinu.

Með samþykkt skilaáætlananna tók skilavaldið ákvarðanir um lágmarkskröfu um eiginfjárgrunn og hæfar skuldbindingar fyrir sparisjóðina (MREL), í samræmi við lög um skilameðferð lánastofnana og verðbréfafyrirtækja, nr. 70/2020. MREL-kröfurnar eru byggðar á lögum um skilameðferð og MREL-stefnu Seðlabankans.

Skilaáætlanir sparisjóðanna eru unnar í samræmi við lög um skilameðferð lánastofnana og verðbréfafyrirtækja, auk reglugerða og reglna sem settar eru á grundvelli laganna. Hver skilaáætlun byggir á mati á skilabærni viðkomandi sparisjóðs en í matinu felst greining á starfsemi viðkomandi sparisjóðs og rökstuðningur fyrir þeirri leið sem fara ber, ef hann fellur, með hliðsjón af markmiðum laga um skilameðferð. Á meðal helstu markmiða er að tryggja að fall sparisjóðs hafi sem minnst áhrif á viðskiptavini hans, að lágmarka hættu á að veita þurfi fjárframlög úr ríkissjóði auk þess að lágmarka neikvæðar afleiðingar fjármálaáfalls.

Nánari upplýsingar um starfsemi skilavaldsins og skilameðferð lánastofnana má finna á vef Seðlabankans.

Amendments to rules on borrower-based measures

22 February 2024

In view of the extraordinary circumstances prevailing in Grindavík, the Financial Stability Committee of the Central Bank of Iceland (FSN) has approved amendments to the Bank's rules on borrower-based measures. New Rules on Maximum Loan-to-Value Ratios for Mortgage Loans to Consumers, no. 217/2024, and new Rules on Maximum Debt Service-to-Income Ratios for Mortgage Loans to Consumers, no. 216/2024, have been published in the Law and Ministerial Gazette [Stjórnartíðindi] and will take effect tomorrow, 23 February 2024. At the same time, the previous Rules on Maximum Loan-to-Value Ratios for Mortgage Loans to Consumers, no. 550/2023, and the previous Rules on Maximum Debt Service-to-Income Ratios for Mortgage Loans to Consumers, no. 701/2022, shall cease to apply.

The new Rules grant individuals who owned residential real estate in Grindavík on 10 November 2023 increased flexibility in connection with their next home purchase. When these property owners buy their next home, the maximum loan-to-value ratio will be 85% instead of the previous 80%, and the maximum ratio of debt service to disposable income will be 40% instead of the previous 35%. The changes described above will expire on 1 March 2027.

5 June 2024

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) March 2023 decision to increase the countercyclical capital buffer (CCyB) from 2.0% to 2.5% took effect on 16 March 2024. Raising the CCyB gives the FSN greater scope to lower it again later if warranted.

An analysis of the cyclical systemic risk level indicates that it is on the decline, largely because credit system lending to the private sector has declined once again as a share of GDP, owing to slower credit growth and strong GDP growth in recent years. Other factors include favourable developments in the current account balance and falling equity prices. Cyclical systemic risk appears to persist in the housing market, however. Conditions in foreign credit markets have improved in recent months, however, after having been tight for a period of time. The domestic systemically important banks' (D-SIBs') returns contracted in Q1, owing in part to costlier funding, reduced income from fees and commissions, and increased impairment and tax payments. Their capital and liquidity position are still very strong. Increased capital shores up financial system resilience and better enables the system to withstand shocks.

According to the Act on Financial Undertakings, the CCyB for exposures in Iceland shall generally range between 0% and 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.[1]

[1] cf. Article 85(a), Paragraph 3 and Article 85(b), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002.

Recent economic developments and outlook

GDP shrank by 4% year-on-year in Q1/2024, after a growth phase of over three years. The contraction was driven mainly by destocking due to the failed capelin catch, and by a larger deficit on goods and services trade. Private and public consumption increased between years. Pressures in the labour market appear to be easing, and unemployment has risen again after having been close to its historical low in the recent term. The short-term inflation outlook has worsened slightly, even though measured inflation has fallen. Inflation is still high, and economic uncertainty has grown in the wake of the earthquakes and volcanic eruptions on the Reykjanes peninsula. Financial conditions have improved in recent months but are still rather tight in historical context. Year-on-year house price inflation lost pace in H1/2023, but prices have turned upwards again in recent months. The stock market has been in a lull, long-term bond market interest rates have fallen, and the interest rate differential with abroad has narrowed.

The global output growth outlook has improved marginally. Inflation has eased, real interest rates have risen, and GDP growth has been weak in most advanced economies in the recent term. Nevertheless, nearly all of the world’s leading central banks have held their policy interest rates unchanged thus far.

Private sector debt

At the end of March 2024, household debt had fallen 1% year-on-year in real terms, although nominal growth is still relatively robust, at 5.7%. Although the impact of price indexation on nominal lending rates has declined with falling inflation, it is offset in part by the past few months’ rise in indexed loans as a share of total household debt. Higher debt service on non-indexed mortgages has prompted more households to take indexed loans. New non-indexed loans net of non-indexed loan retirement have measured negative since May 2023, while net new indexed loans have increased. This trend can be expected to continue while nominal interest rates remain high. Indexed mortgages now account for a larger share of outstanding mortgage debt than non-indexed loans do, although the non-indexed mortgage share is still far above its pre-pandemic level. Net new lending to households increased in H2/2023, which may reflect reduced uncertainty and increased expectations that interest rates and inflation have peaked. Nevertheless, the total stock of new loans is still somewhat below its long-term average, as new lending was sharply lower from year-end 2022 through spring 2023.

Household debt measured at the end of March 2024, at 73.8% of GDP, as opposed to 73.1% at the end of December 2023. The household debt-to-GDP ratio had been falling since around mid-2021. Household debt as a share of disposable income has been on the decline, measuring 145% as of end-March. Debt ratios are low in historical terms and in comparison with those in neighbouring countries.

At the end of March, firms' debt to domestic financial institutions had increased by 0.5% year-on-year in real terms, as compared with a 1.1% contraction at the end of December. In nominal terms, it had grown by 7.3%, up from 6.5% as of end-December.[2] Financial institutions' new corporate lending has been strong in the recent term, and companies' demand for bank loans still appears robust despite high interest rates. Companies took advantage of favourable non-indexed lending rates during the pandemic and scaled down their indexed debt accordingly. In the recent past, they have turned increasingly to indexed loans, while their bond issuance in the market has declined. As of end-April, institutional investment funds' corporate loans had increased by 27 b.kr., or 15.4% year-on-year in real terms. About half of the increase was due to the funds' purchases of corporate loans from the banks.

On the whole, private sector debt has held relatively stable in real terms in the recent past. As of year-end 2023, it equalled 147% of GDP, its lowest since 1998. The past few years' changes in the debt ratio have been driven primarily by fluctuations in GDP.

Arrears on loans from the D-SIBs to individuals and businesses are historically low. At the end of March, the non-performing loan ratio on loans to individuals was unchanged year-to-date at 1%. Frozen loans have risen marginally as a share of the household

[2] Debt owed to domestic financial institutions equals roughly 82% of total corporate debt.

credit stock, to 1.7% at the end of March. This is an increase of 0.7 percentage points since March 2023. Corporate non-performing ratios have risen slightly in 2024, measuring 2.5% at the end of March. As before, NPL ratios were highest among companies in the accommodation and food service sector, at 4.8%, the same as in the quarter beforehand, although they had fallen by 1.5 percentage points year-on-year. In the construction industry, the NPL ratio had risen by nearly a percentage point in Q1. The share of frozen corporate loans had increased slightly in 2024 to date, to 3% at the end of March, but had fallen by nearly 2 percentage points year-on-year. It is assumed that higher financing costs will show sooner or later in the form of increased arrears, but in this context, it should be noted that arrears can come to the fore with a time lag.

Real estate market

Housing market activity has picked up again. In April 2024, the capital area house price index had risen in real terms by 0.2% year-on-year, as compared with a decline of 2.9% in December 2023. Condominium prices had risen by 1.1%, while single-family home prices fell by 1%. The number of homes on the market has held relatively stable in 2024 to date, after surging in 2023. Furthermore, housing market turnover has increased alongside a rise in the number of purchase agreements, owing in part to real estate firm Þórkatla's purchases of homes in Grindavík and to an increase in equity loans from the Housing and Construction Authority (HMS). In the first four months of the year, turnover rose in real terms by 52% year-on-year in the capital area and by 66% nationwide.

House prices remain high relative to fundamentals, indicating an imbalance in the market. Near-term developments in house prices will probably be determined by inflation and interest rates, allocations to HMS equity loans, developments in wages, and the impact of Government support for Grindavík residents.

The commercial real estate (CRE) price index declined 8.6% year-on-year in Q1/2024. At that time, it was 4.2% above its estimated long-term trend, as compared with 14.7% above trend at the end of December 2023. At the same time, turnover in registered CRE transactions in the capital area increased by 24% in real terms.

Demand for commercial property has grown in recent years but is expected to ease in the coming term. Domestic economic activity has subsided, and job growth has lost pace. The three large CRE firms' operations are affected by high financing costs.[3] Returns on investment assets measured 5.6% in Q1 and were virtually unchanged between years. The calculated risk premium declined slightly during the same period, however, owing to higher yields on indexed Treasury bonds. Positive valuation adjustments in investment assets are still a large item in the firms' profit and loss accounts, at around 60% of operating revenues in Q1. The CRE firms' combined equity ratio measured 31.9% at the end of Q1 and increased by a percentage point between years. The companies will face limited refinancing risk in coming years.

D-SIBs

The D-SIBs' interest income has continued to increase, mostly because of balance sheet growth and stronger returns on liquid assets. Higher interest rates, credit growth, limited impairment, and a real decline in expenses have strengthened the D-SIBs' operating performance in the recent term. Their return on equity was 9.7% in Q1/2024, as compared with 12.5% a year earlier. The poorer outcome is due in part to higher funding costs, reduced income from fees and commissions, and increased impairment and tax payments. The D-SIBs' impairment accounts grew marginally during the quarter, to 0.84% of their loan portfolio. Their NPL ratio was 1.7% at the end of Q1, an increase of 0.1 percentage points during the quarter.[4] The rise is attributable to corporate loans, as is discussed in the section on private sector debt. Higher debt service has generally had a negative impact on loan quality, although arrears are still limited.

The D-SIBs' domestic market-based funding is relatively homogeneous and is limited almost entirely to covered bonds. Conditions in foreign credit markets have been challenging for quite a while, but in the past few months they have been developing favourably, and credit spreads on the D-SIBs' foreign bond issues have narrowed. In the past few months, the D-SIBs'

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[3] Eik, Heimar og Reitir.

[4] The facility-level non-performing loan ratio is calculated in accordance with EBA standards.

have issued foreign-denominated bonds on more favourable terms than before, thereby reducing their refinancing risk to a significant degree. In order to limit their refinancing risk still further, it would be beneficial for the D-SIBs to increase their króna-denominated funding in unsecured bonds that satisfy the Central Bank's MREL requirements.

The D-SIBs' capital ratio was 24% at the end of Q1 and is unchanged relative to Q1/2023. Following the increase in the CCyB to 2.5%, the D-SIBs' capital ratios are 3.4-4.2% above the required overall ratio.

Overall assessment of cyclical systemic risk

Financial conditions have improved in recent months. From mid-2022 through end-2023, they tightened in line with rising interest rates, but the trend reversed this year. The improvement in financial conditions is due to several factors: house prices are up again after the year-on-year rise lost pace in H1/2023, long-term interest rates fell early in 2024, and the interest rate differential with abroad narrowed. Even though financial conditions have started to improve, they remain slightly tight in historical context.

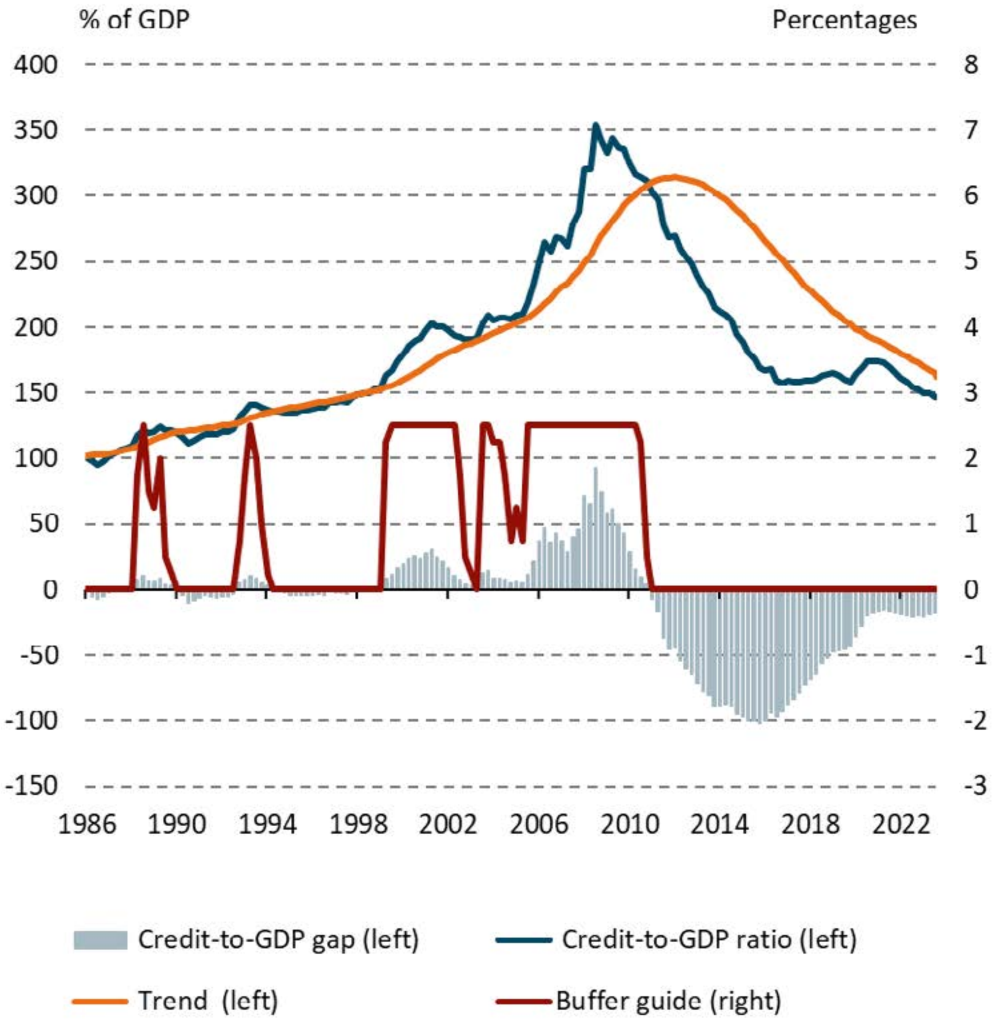
The combined effect of higher interest rates and tighter borrower-based measures has impeded the rise in house prices and somewhat mitigated imbalances in the market. The number of properties for sale has held virtually unchanged in 2024 to date, but the average time-to-sale has fluctuated in recent months. Imbalances remain between house prices and fundamentals, however, and it is not yet clear whether the housing market correction is at an end.

Even though the D-SIBs' profits contracted in Q1/2024, their core operations have been strong and their access to credit markets has eased in recent months. Interest premia on the D-SIBs' foreign-denominated bonds have been falling year-to-date, and if the trend continues, it will have a positive impact on foreign-denominated lending rates.

The statistical presentation of the financial cycle indicated that the cycle was still rising in Q4 of last year. All of its sub-cycles have risen in the recent term: the credit cycle and funding cycle are up slightly, while the housing cycle has risen rather briskly. The domestic systemic risk indicator (d-SRI) has fallen uninterrupted since year-end 2021. Declining systemic risk during the quarter can be attributed primarily to positive developments in the current account balance and falling real equity securities prices, but also to the turnaround in deposit institutions' private sector lending relative to GDP. Most indicators imply that cyclical systemic risk is falling rather than rising.

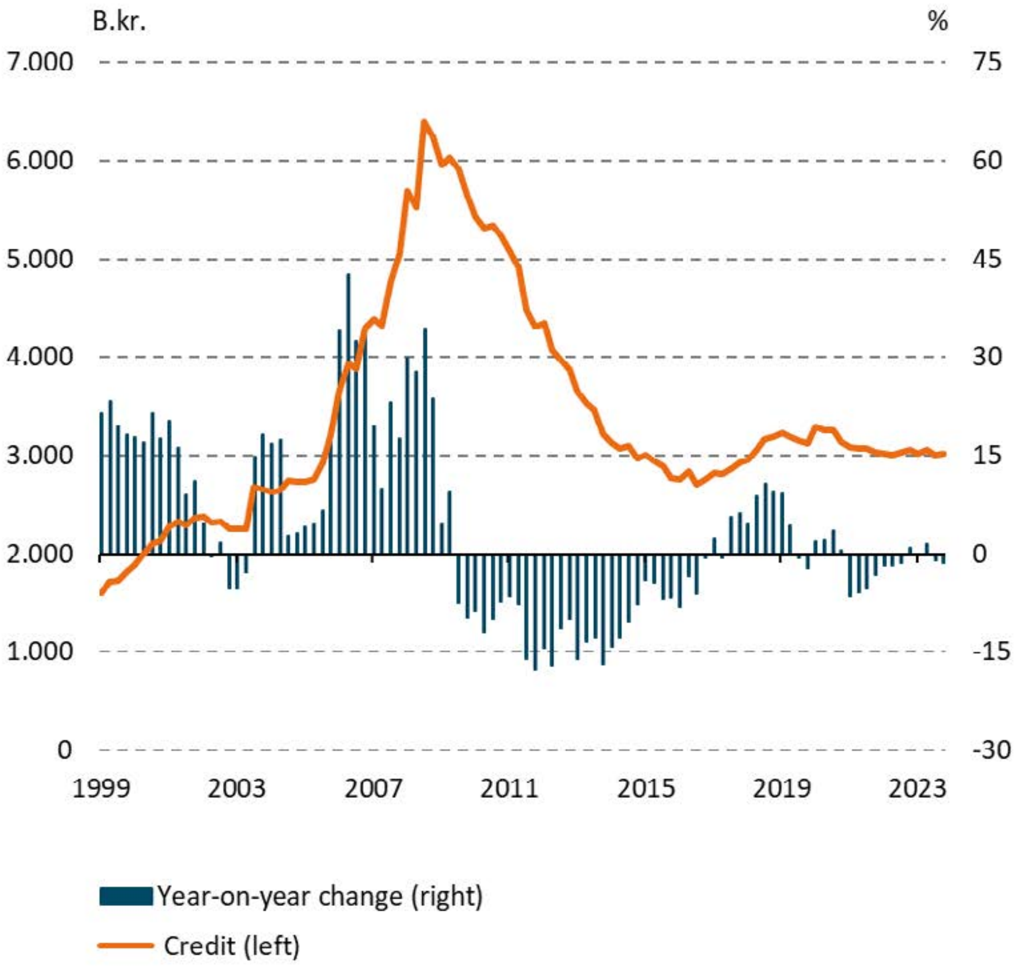
Appendix – Charts

Credit-to-GDP ratio, gap and buffer guide



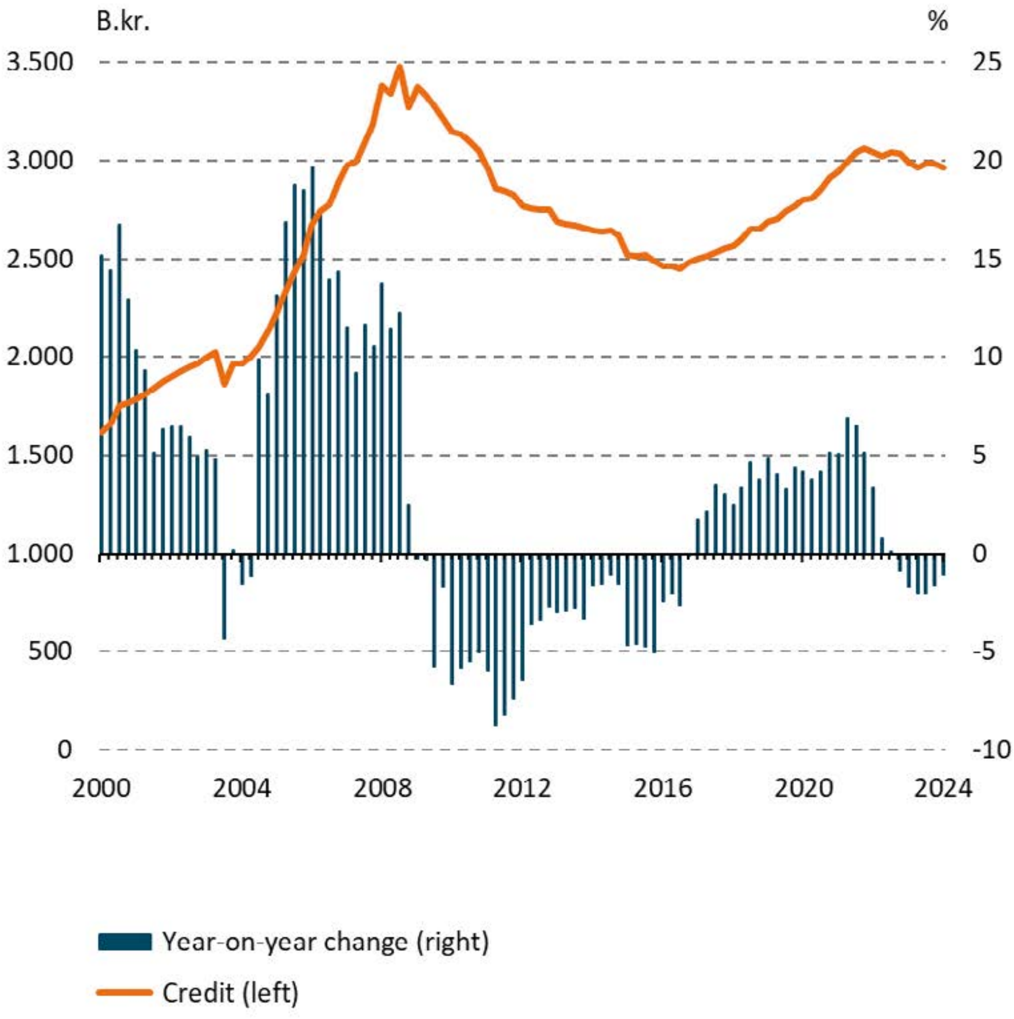
Total credit to households and firms, at claim value, as a percentage of the last four quarters GDP. The trend component is obtained with a one-sided Hodrick-Prescott filter with λ=400.000.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit to non-financial corporations



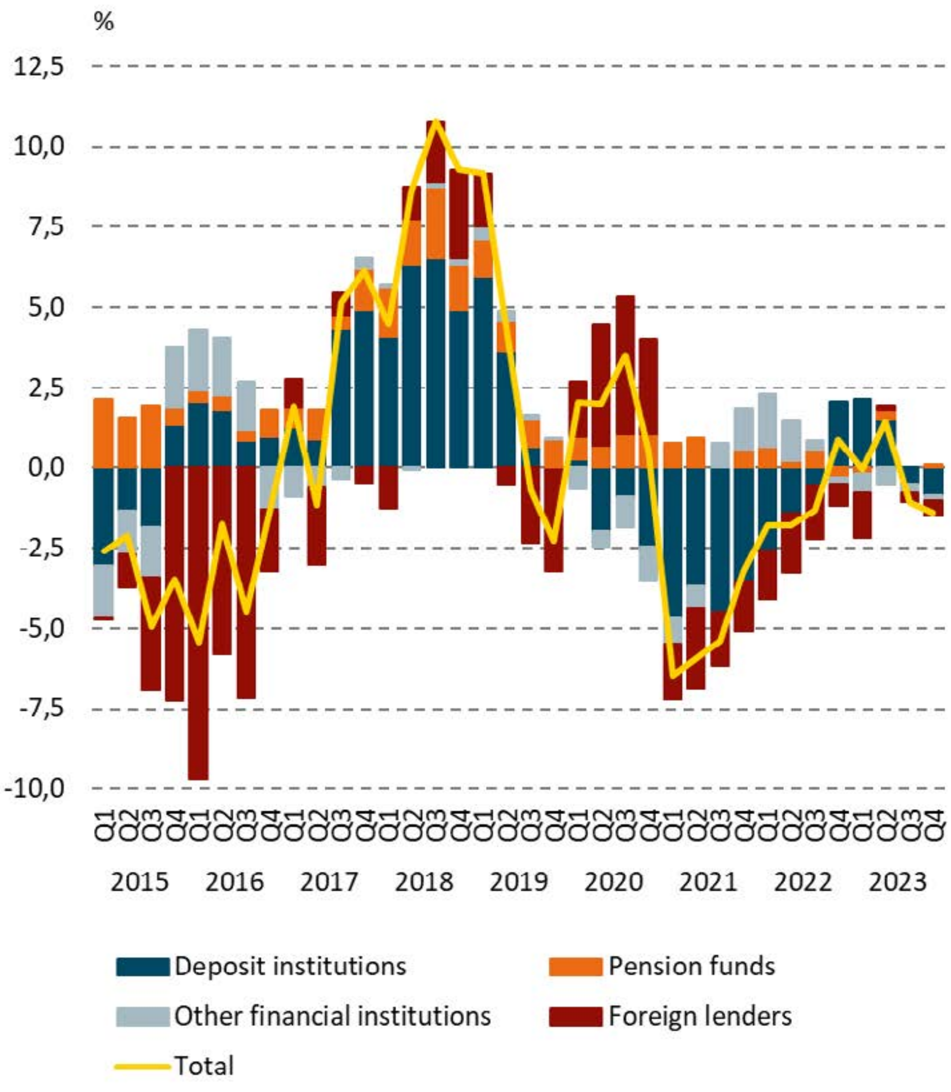
Claim value of non-financial corporations' debt to domestic and foreign financial institutions and marketable bonds issued, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Real household credit



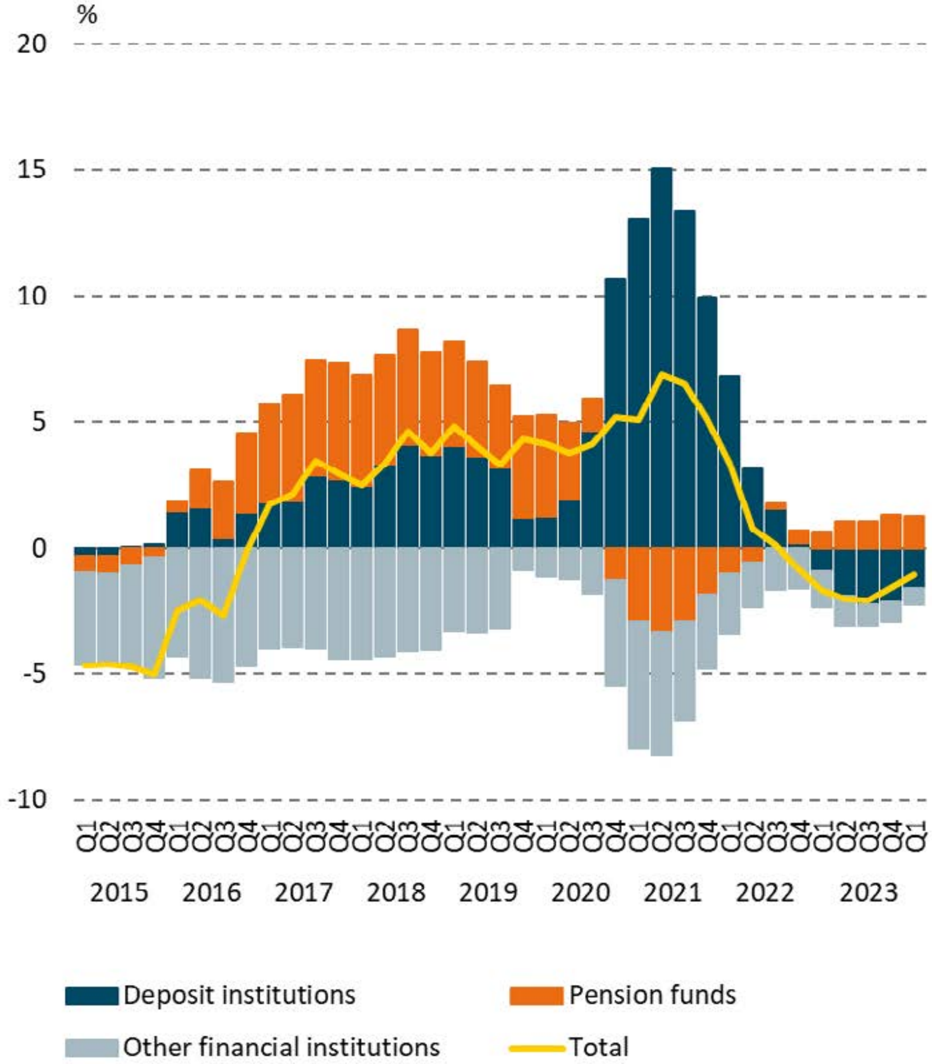
Claim value of household debt to financial institutions, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Corporate debt real growth disaggregated by lender type



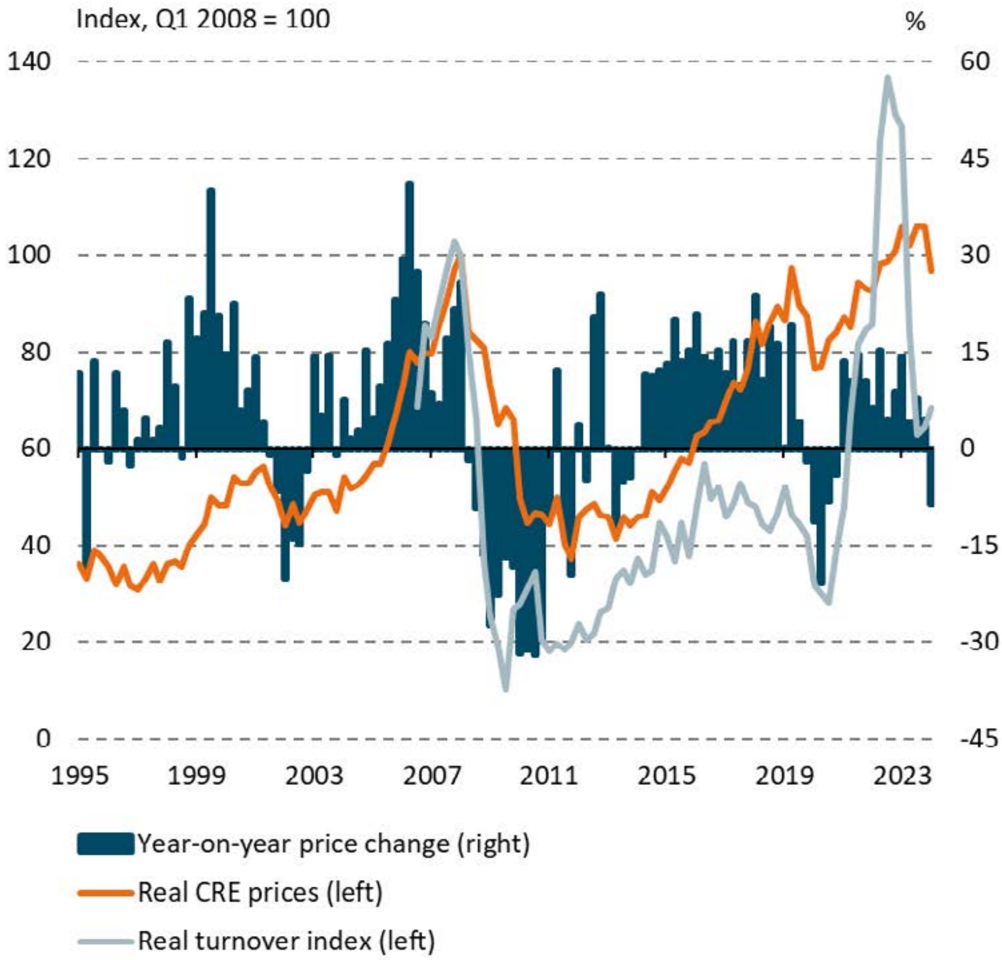
Debt to financial institutions and issued marketable bonds, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.
Sources: Statistics Iceland, Central Bank of Iceland.

Developments in real credit to households, disaggregated by lender type



Household debt to financial institutions, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.
Sources: Statistics Iceland, Central Bank of Iceland.

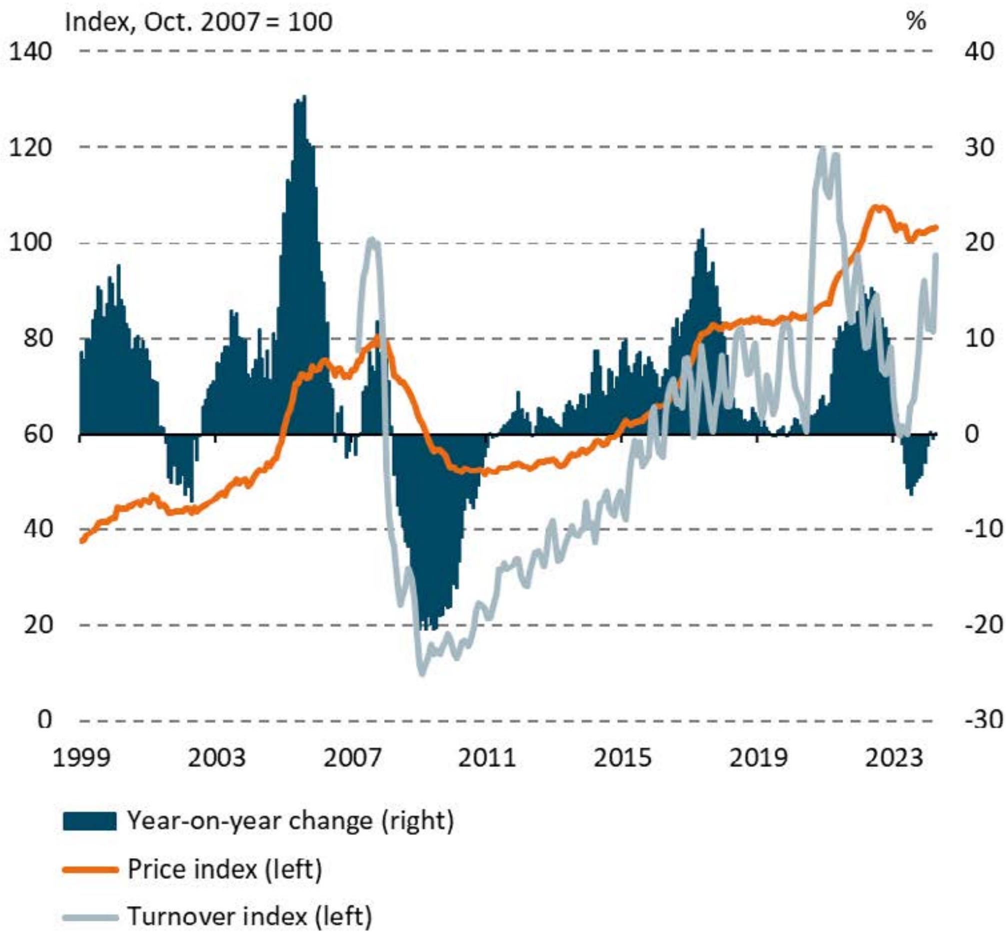
Real commercial property prices and turnover in the capital area



CRE price index, deflated with the CPI. The index shows the weighted average price of industrial, retail, and office space. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminary.

Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Real house prices and turnover in the capital area

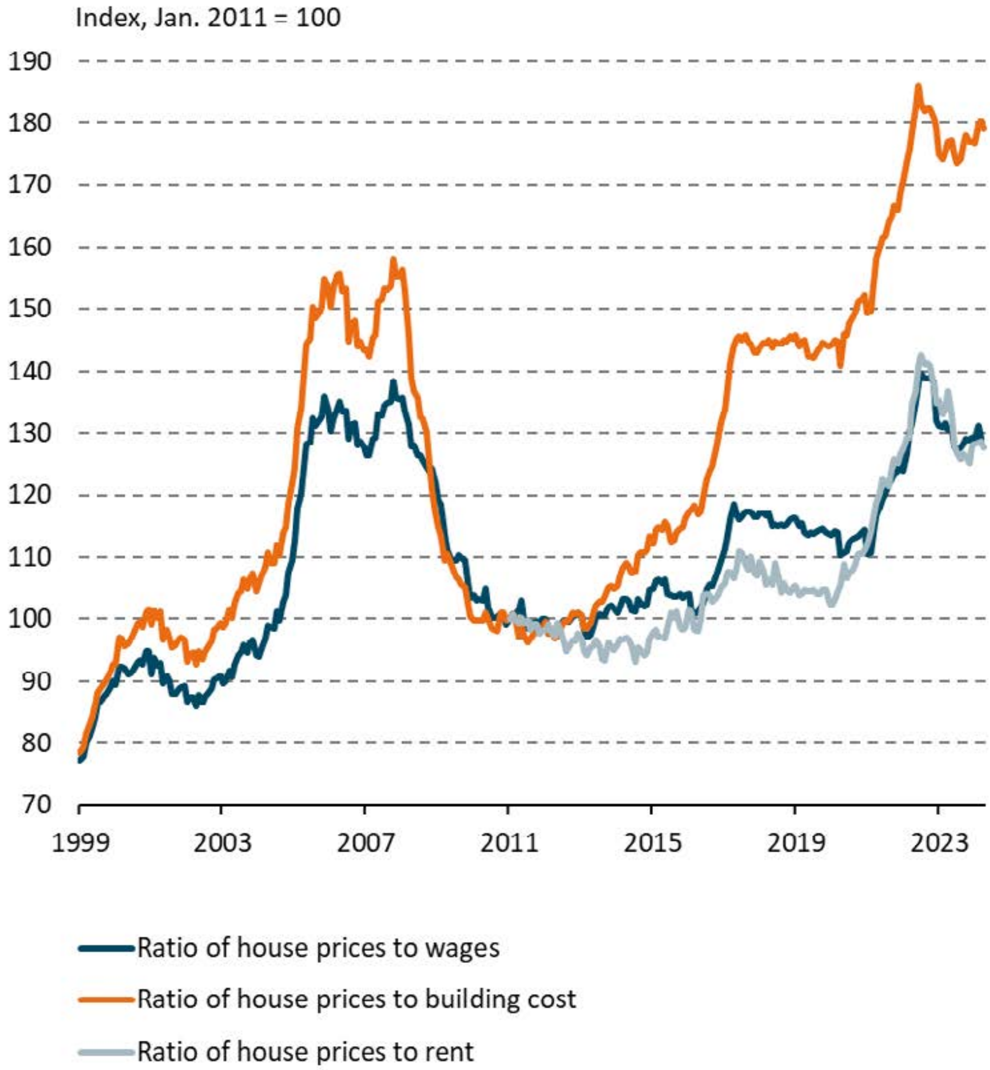


The combined index of capital area house prices is based on a new sub-index for January 2024 and previous indices prior to that time. The index is deflated with the CPI. The turnover index shows a three-month moving average of turnover, deflated with the CPI.
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Commercial property price ratios

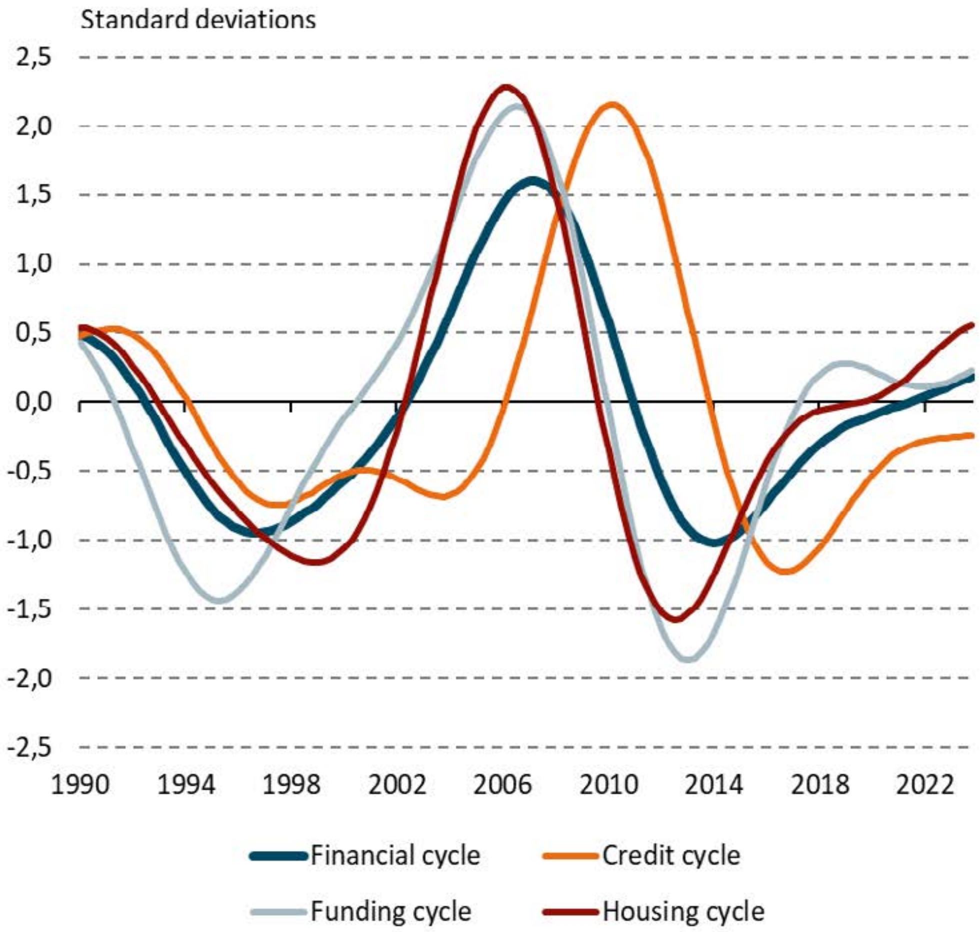
Annual data for gross operating surplus are non-linearly interpolated.
Annual data for the CRE stock are linearly interpolated.
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Capital area house prices and determining factors



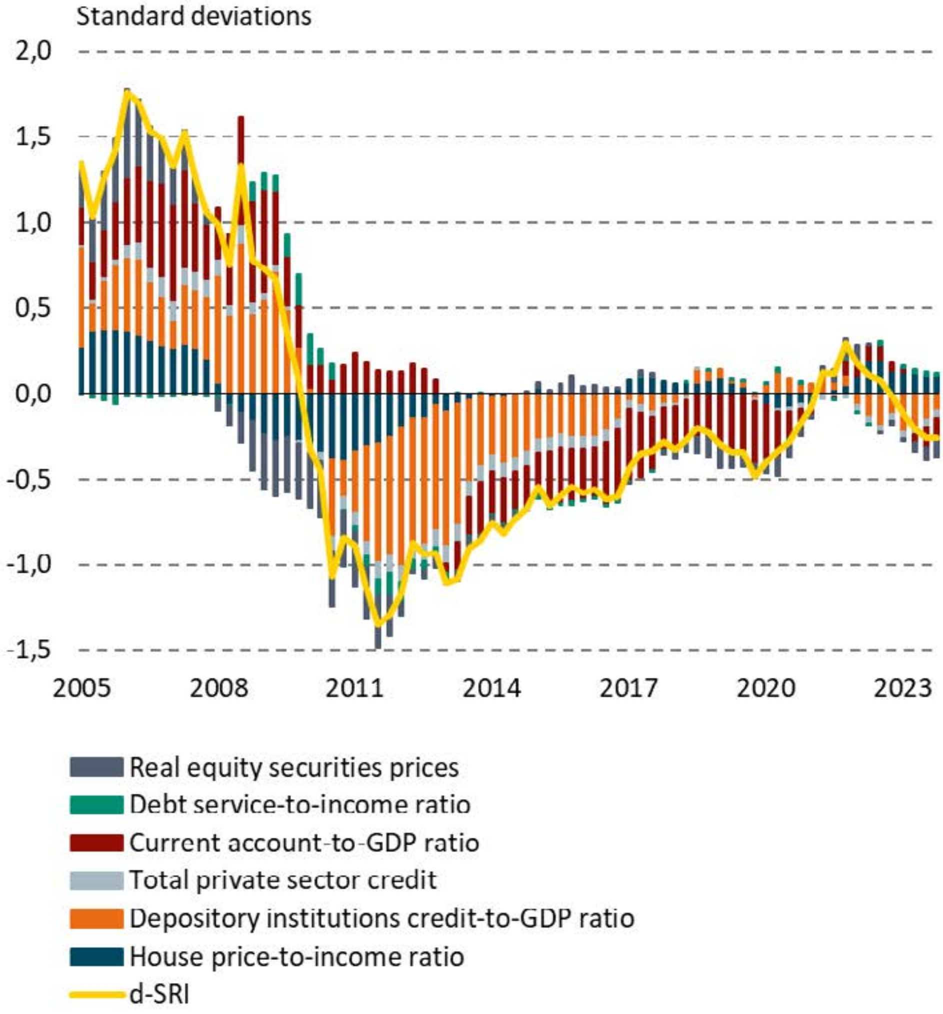
Sources: Housing and Construction Authority, Statistics Iceland, Central bank of Iceland.

Financial cycle and subcycles



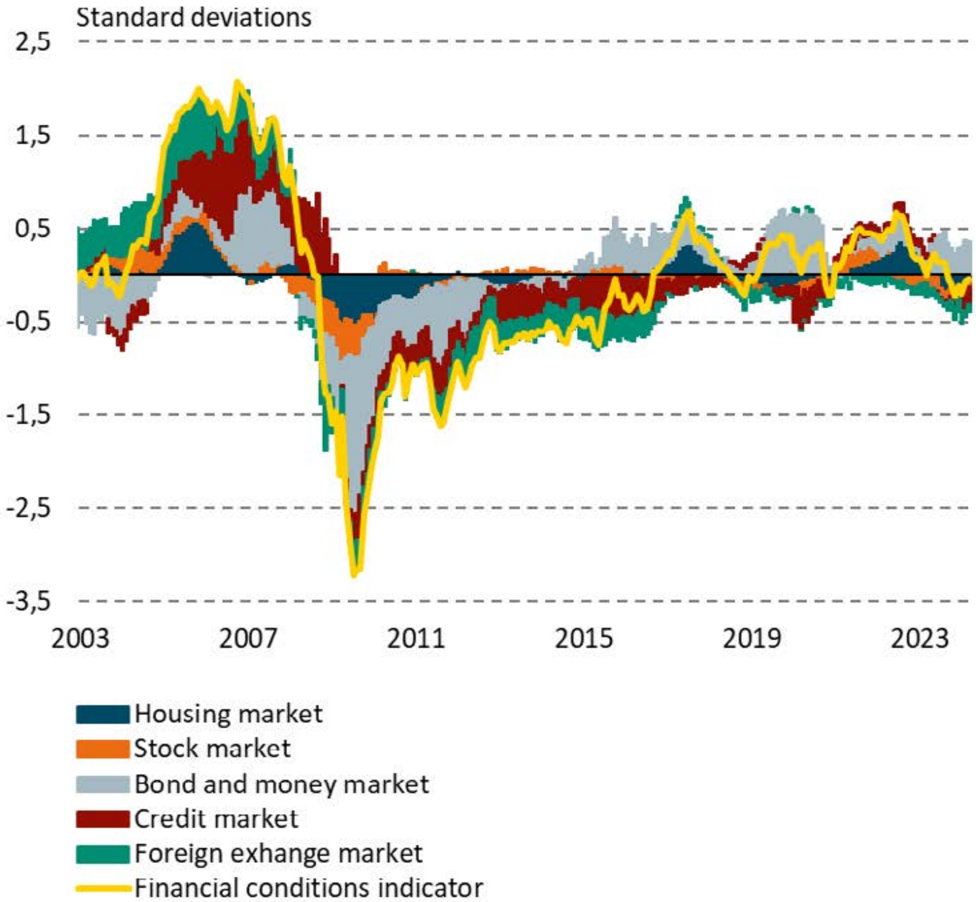
The financial cycle, the blue line, is a simple average of the subcycles. Each subcycle is a simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with a frequency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

Domestic systemic risk indicator (d-SRI)



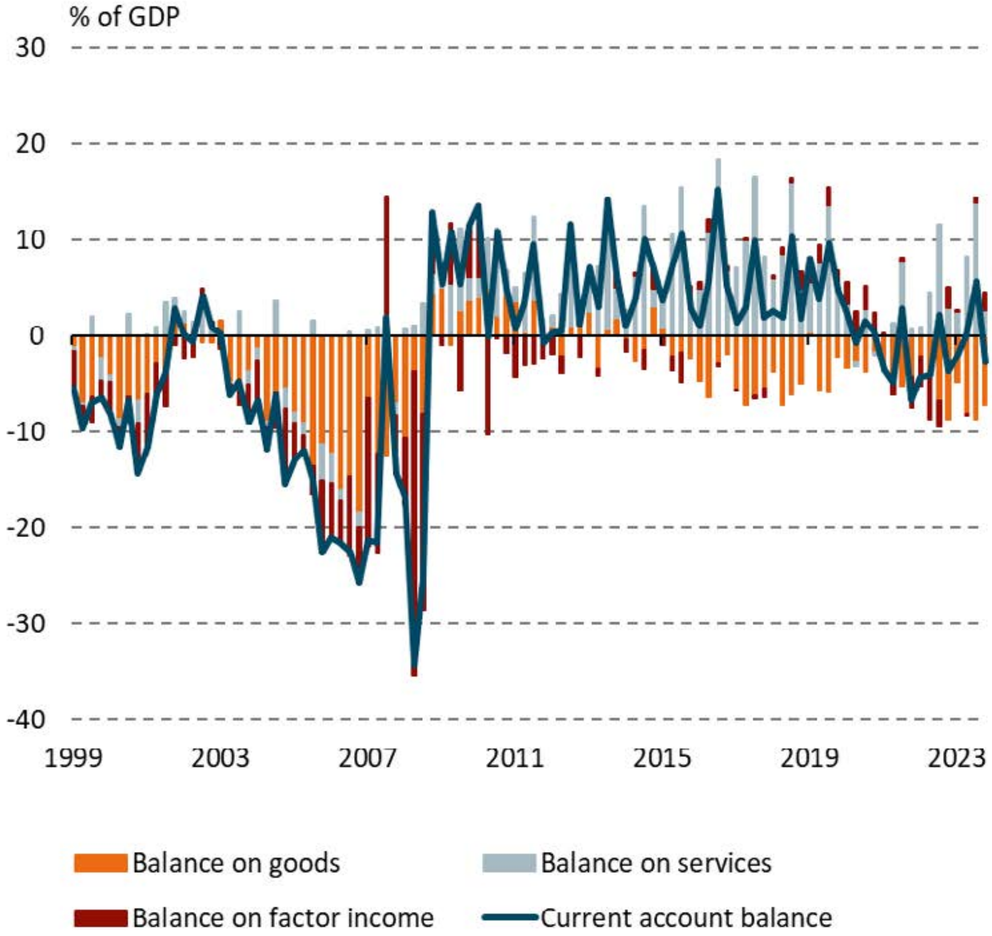
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Domestic financial conditions



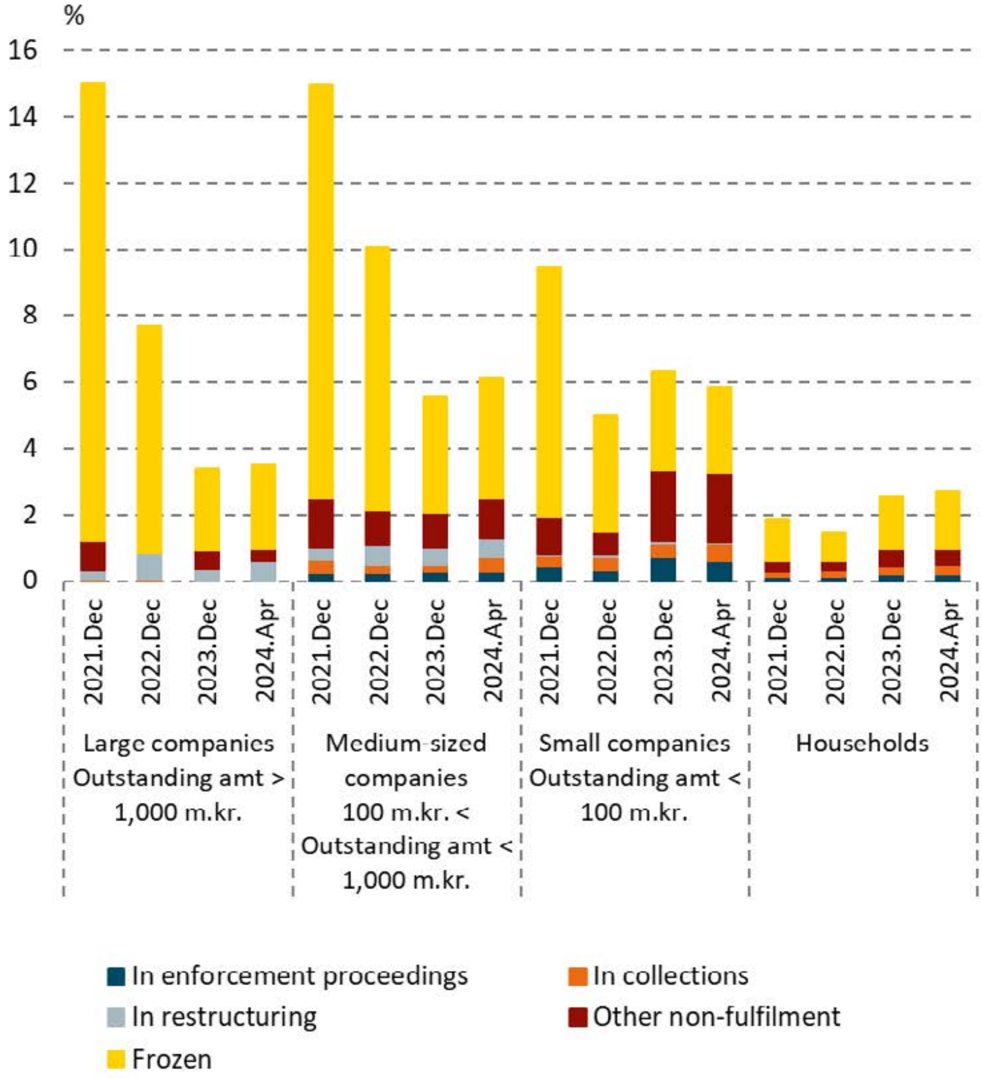
The financial conditions indicator consists of the first three principal components of selected indicators of financial conditions, scaled so that the mean is 0 and the standard deviation is 1. A lower index value indicates a deterioration in financial conditions. The estimation period is 2002-2023. *Sources*: Housing and Construction Authority, Nasdaq OMX Iceland, Statistics Iceland, Central Bank of Iceland.

Current account balance



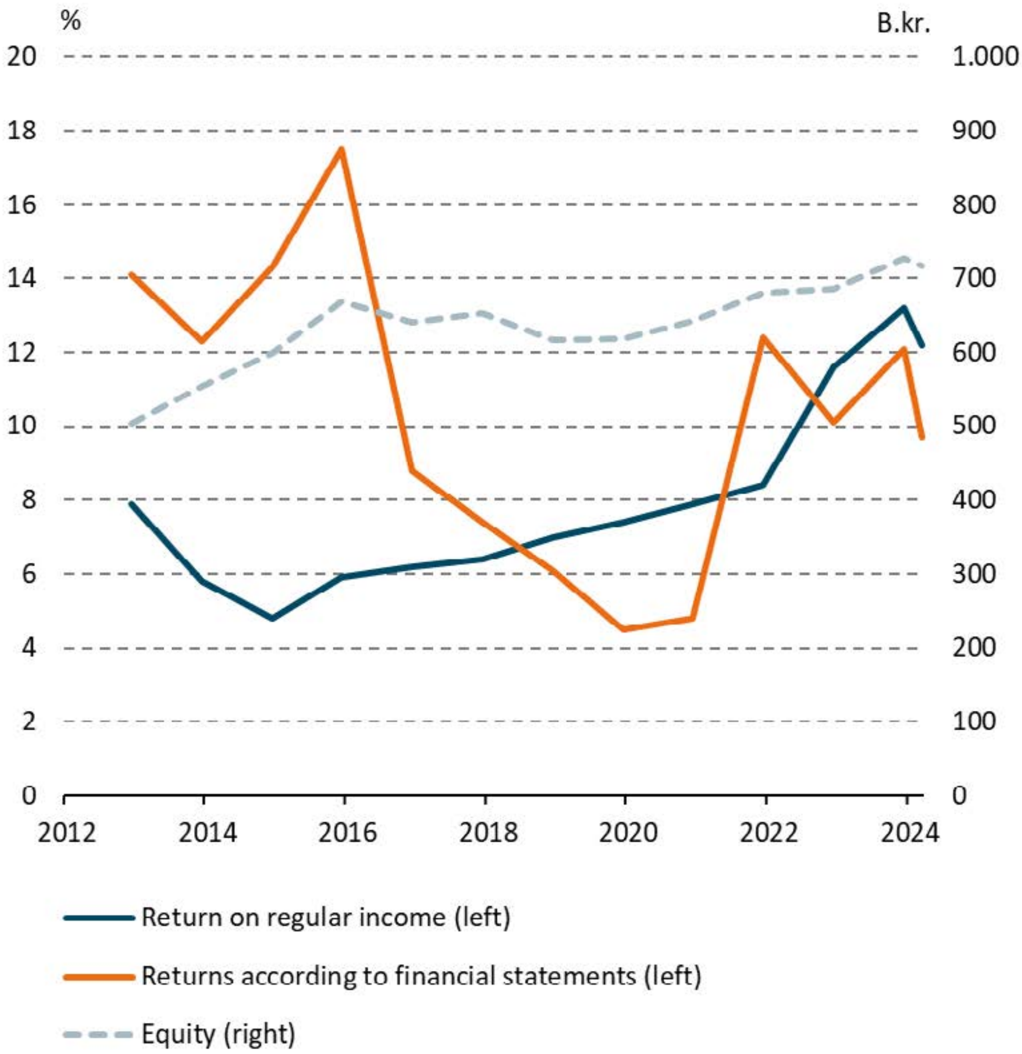
The effects of failed banks on factor income and the balance on services from Q4/2008 to Q4/2016 are ignored. From 2009 through 2012, the effect of Actavis on the balance on income is also ignored, owing to inaccurate data during the period. Secondary income is included in factor income.
Sources: Statistics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

Status of non-performing loans, by borrower and type of impairment

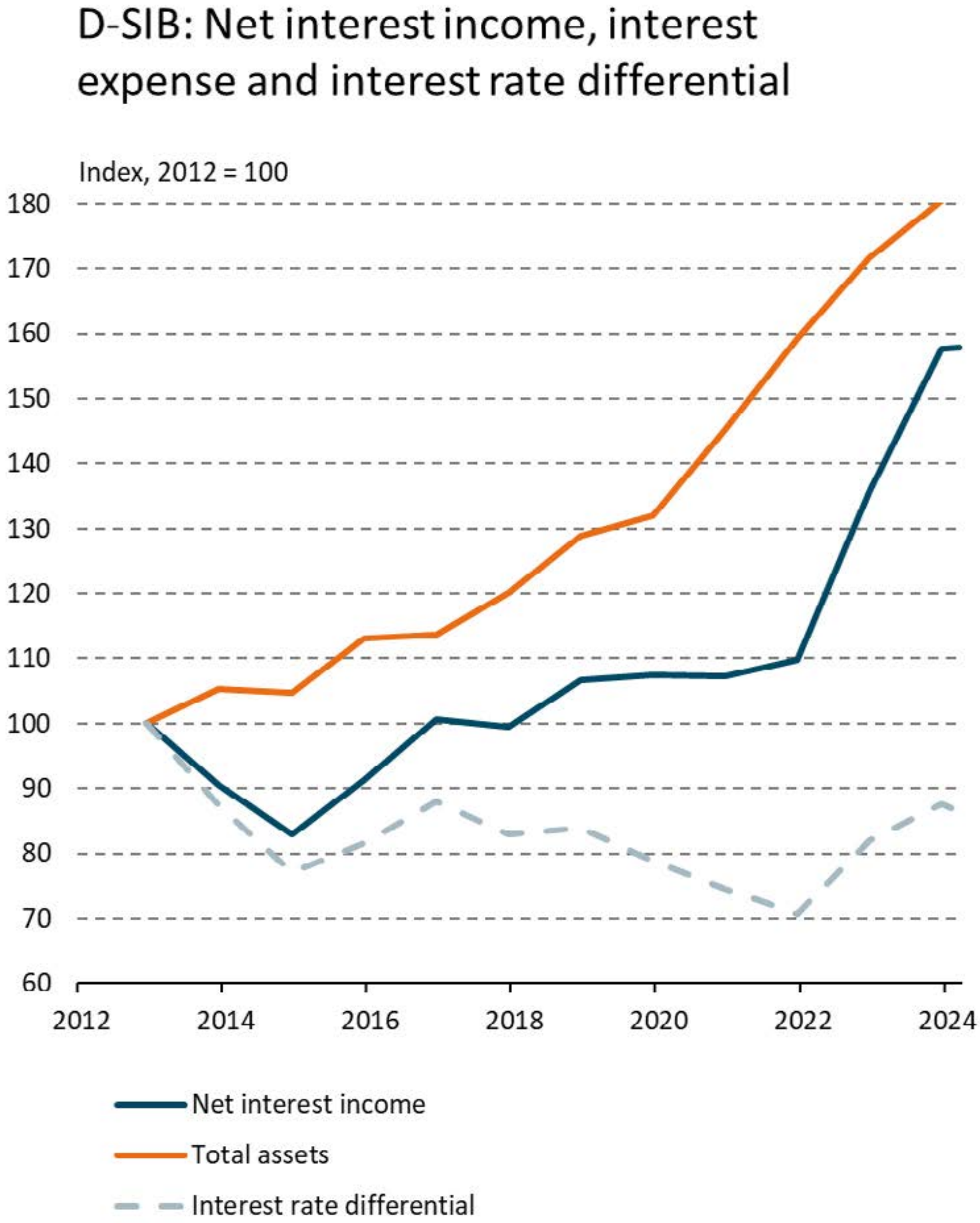


Cross-default non-performing loans, share of loans within each category.
Domestic systemically important banks, parent companies, book value.
Source: Central Bank of Iceland.

D-SIB: Returns



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



Domestic systematically important banks, consolidated figures. Yearly data. 2023 figures are annualised Q3 data.
Sources: Commercial banks' financial statements.

D-SIB: Capital and leverage ratios

Domestic systemically important bank, consolidated figures.
Sources: Commercial banks' financial statements.

The Central Bank of Iceland launches a feasibility assessment on implementing Eurosystem's TARGET Services for payments

9 September 2024

The Central Bank of Iceland (CBI) has begun analysing and assessing the possibility of implementing the Eurosystem's TARGET Services, specifically the TARGET Instant Payment Settlement (TIPS) and T2 interbank payment services. TIPS is an instant payment system, while T2 is a system for real-time gross settlement (RTGS) and central liquidity management (CLM). The Central Bank will focus first on TIPS and then follow with T2.

The Central Bank of Iceland's objective with this analytical work is based on its legally mandated roles, one of which is to promote a safe and effective financial system, including domestic and cross-border payment intermediation. The Bank owns and operates an interbank payment system that is the prerequisite for executing both RTGS and instant payments in central bank money, as well as securities settlement and payment card settlement. The interbank system is therefore the foundation for effective payment intermediation in the Icelandic króna. It consists of two components: the real-time gross settlement component, or RTGS, and the instant payment component, EXP.

The Central Bank's decision to begin analysing and assessing the TARGET Services is based on the objective of promoting resilience, security, and increased efficiency of domestic payment infrastructure in the long run.

Adopting the TARGET Services would ensure that the infrastructure for settlement of Icelandic instant payments is consistent with development in Europe. Adherence to joint standards can contribute to a larger selection of system solutions for instant payments in Iceland, would benefit consumers and bolster resilience. Implementing the TARGET Services would not affect the Central Bank's role vis-à-vis participants in the current payment system.

A final decision on the adoption of the TARGET Services will be taken after a thorough analysis, with focus on the Central Bank's technological, operational, statutory, and security requirements.

Costs, contingency measures, and the ability to support country specific needs that the Icelandic financial system may have will be important factors in the decision-making process.

CBI will engage with participants in Icelandic payment intermediation while the analysis is ongoing and will invite stakeholders to participate in working groups to examine specific issues that may arise.

Nordic Baltic Crisis Simulation Exercise, 2024

20 September 2024

To test the preparedness for a potential crisis situation, authorities from the Nordic-Baltic countries responsible for financial stability during this week conducted a financial crisis simulation exercise in the Nordic-Baltic region, involving three fictitious banks with cross-border activities. Nearly 450 participants took part in the exercise, representing authorities from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden, as well as the relevant European Union authorities: European Commission, ECB, Single Resolution Board (SRB) and European Banking Authority (EBA). A staff member of the International Monetary Fund was also invited to participate as an observer.

The purpose of the exercise was to test communication, information sharing and collaboration between the authorities during crisis management in a highly uncertain and time pressured environment. The exercise was designed in line with a crisis scenario where the fictitious banks went through three phases that could be foreseen in a bank crisis management process: 1) the transition from normal business to recovery including addressing liquidity issues, 2) the movement from recovery to resolution, with resolution authorities assuming control of the bank and 3) after resolution, the return of the restructured bank to the market. During the exercise, authorities applied the tools and powers at their disposal according to the EU regulatory framework for banking supervision and crisis management.

Following the successful conclusion of the exercise, authorities will document and share the lessons learnt, and will integrate them into their existing crisis management routines. This will strengthen their crisis preparedness and further enhance the crisis management framework in the Nordic-Baltic region.

A preparation team established under the Nordic Baltic Stability Group (NBSG) and led by the Danish resolution entity Finansiel Stabilitet was formed in 2023 to prepare the exercise. The team was advised by Oliver Wyman in the preparation of the exercise. The NBSG consists of government ministries, central banks, supervisory authorities, and resolution authorities in the eight Nordic and Baltic countries. In the context of the NBSG, the Nordic and Baltic authorities have agreed to conduct regular financial crisis simulation exercises.

Seðlabanki Íslands hefur uppfært skilaáætlanir fyrir kerfislega mikilvæga banka

4. október 2024

Skilavald Seðlabanka Íslands hefur uppfært skilaáætlanir fyrir kerfislega mikilvægu bankana þrjá – Arion banka, Íslandsbanka og Landsbankann. Áætlanirnar ná til framkvæmdar skilameðferðar bankanna ef til þess kæmi að fjárhagsstaða þeirra yrði svo slæm að þeir teldust vera á fallanda fæti.

Komi til falls kerfislega mikilvægs banka felur skilaáætlun í sér að mögulegt verði að endurreisa hann hratt og örugglega, án opinbers fjárstuðnings frá ríkissjóði eða Seðlabankanum. Skilameðferðin á að tryggja að almenningur og fyrirtæki hafi áfram óheftan aðgang að nauðsynlegri starfsemi (e. critical function) og styðja með því við fjármálastöðugleika í landinu.

Við uppfærslu skilaáætlananna tók skilavaldið ákvarðanir um lágmarkskröfu um eiginfjárgrunn og hæfar skuldbindingar bankanna (MREL), í samræmi við lög um skilameðferð lánastofnana og verðbréfafyrirtækja, nr. 70/2020. MREL-kröfurnar eru byggðar á lögum um skilameðferð og MREL-stefnu Seðlabankans, en þeim er ætlað að styðja við skilaáætlanirnar og tryggja að hægt verði að endurreisa banka sem er á fallanda fæti. Kerfislega mikilvægu bönkunum ber ávallt að uppfylla MREL-kröfur sem gerðar eru til þeirra.

Skilaáætlanir kerfislega mikilvægu bankanna eru unnar í samræmi við lög um skilameðferð lánastofnana og verðbréfafyrirtækja, auk reglugerða og reglna sem settar eru á grundvelli laganna. Hver skilaáætlun byggir á mati á skilabærni viðkomandi banka en í matinu felst greining á starfsemi viðkomandi banka og rökstuðningur fyrir þeirri leið sem fara ber, ef hann fellur, með hliðsjón af markmiðum skilameðferðar. Á meðal helstu markmiða skilameðferðar er að tryggja að fall banka hafi sem minnst áhrif á viðskiptavini hans, að lágmarka hættu á að veita þurfi fjárframlög úr ríkissjóði auk þess að lágmarka neikvæðar afleiðingar fjármálaáfalls.

Nánari upplýsingar um starfsemi skilavaldsins og skilameðferð bankanna má finna á vef Seðlabankans.

SEÐLABANKI ÍSLANDS

Efnahagsmálin og horfurnar framundan

Fjármálaráðstefna sveitarfélaga

Hilton Reykjavik Nordica 10. október 2024

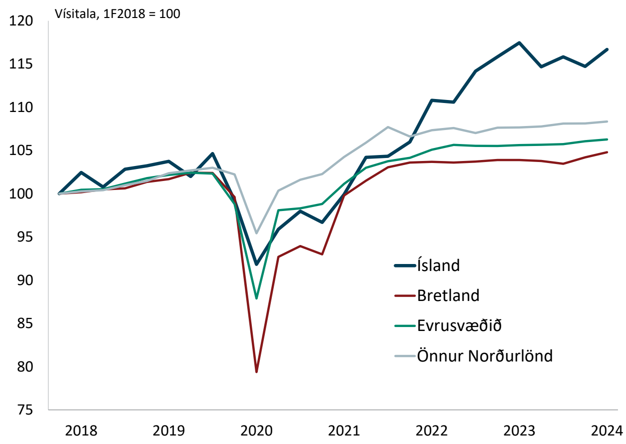
Ásgeir Jónsson

Seðlabankastjóri

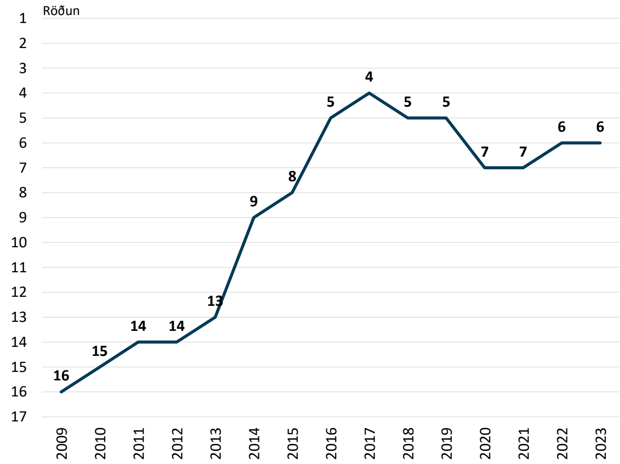
Ísland í dag

Ísland – land hagvaxtarins

Landsframleiðsla[1]



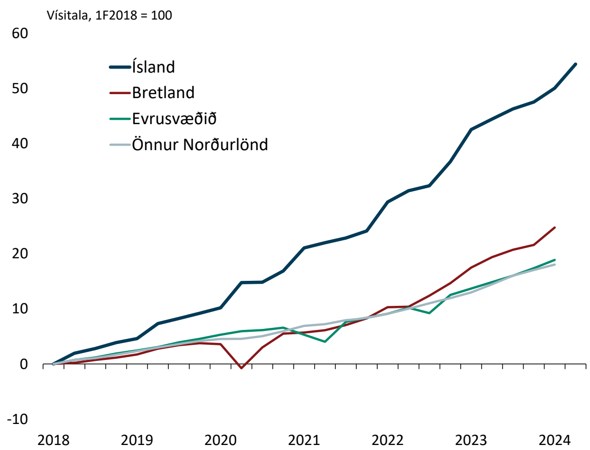
Landsframleiðsla á mann, röðun Íslands meðal OECD landa



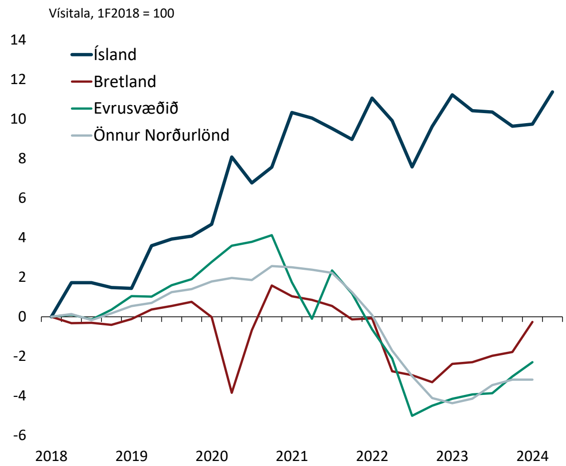
1. Árstíðaleiðrétt gögn. Olía og jarðgas eru undanskilin fyrir Noregur.
Heimildir: Hagstofa Íslands, OECD, Seðlabanki Íslands.

Land launahækkana og vaxandi kaupmáttar …

Þróun nafnlauna[1]



Þróun raunlauna[1]

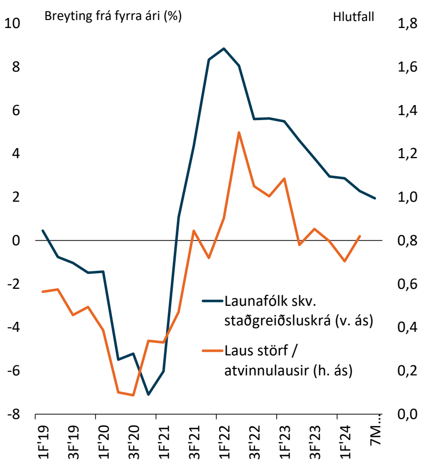


1. Árstíðaleiðrétt tímakaup (e. hourly earnings) í framleiðslu. Vegna gagnaskorts eru tölur fyrir Ísland framreiknaðar með launavísitölu í framleiðslu frá og með 1. ársfj. 2023.
Heimildir. Hagstofa Íslands, OECD, Seðlabanki Íslands.

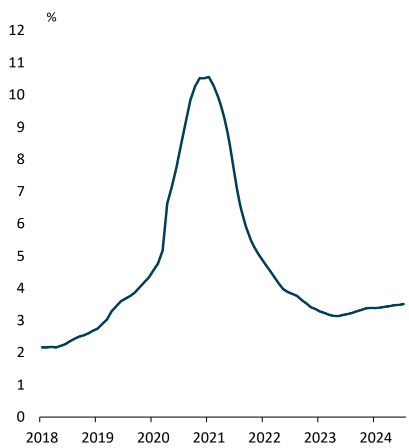
… og land mikillar atvinnu

Fólk á vinnufærum aldri[1]

Avinna og laus störf[2]



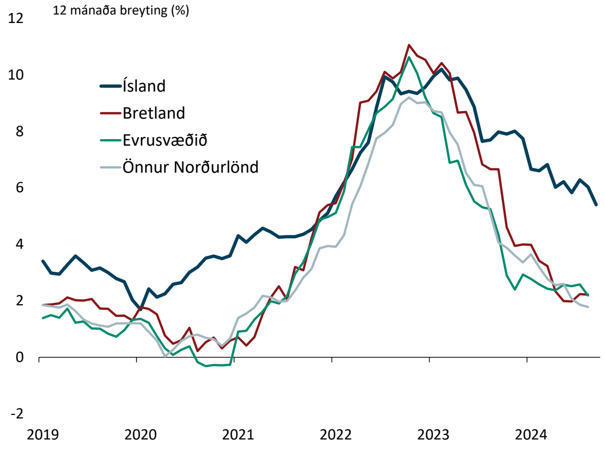
Skráð atvinnuleysi[3]



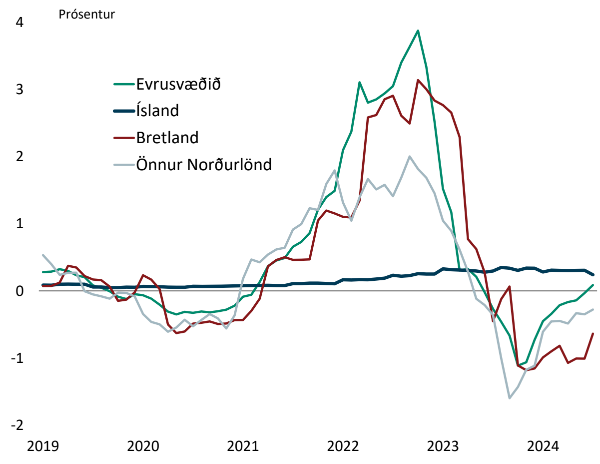
1. Fólk á aldrinum 16-74 ára. 2. Launafólk á aldrinum 16-74 ára samkvæmt tölum úr staðgreiðsluskrá ríkisskattstjóra. Laus störf skv. fyrirtækjakönnun Hagstofu Íslands og fjöldi atvinnulausra samkvæmt vinnumarkaðskönnun sömu stofnunar. Hlutfall lausra starfa og fjölda atvinnulausra er árstíðarleiðrétt. 3. Án fólks á hlutabótum frá og með mars 2020. Árstíðarleiðréttar tölur.
Heimildir: Hagstofa Íslands, Vinnumálastofnun, Seðlabanki Íslands.

En einnig – land þenslu og verðbólgu

Alþjóðleg verðbólga



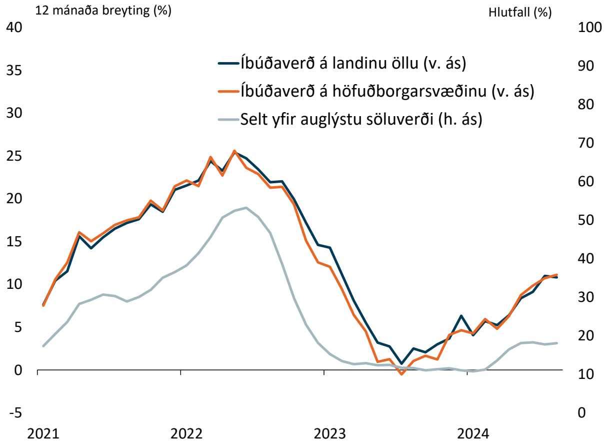
Framlag orkuverðs til verðbólgu[1]



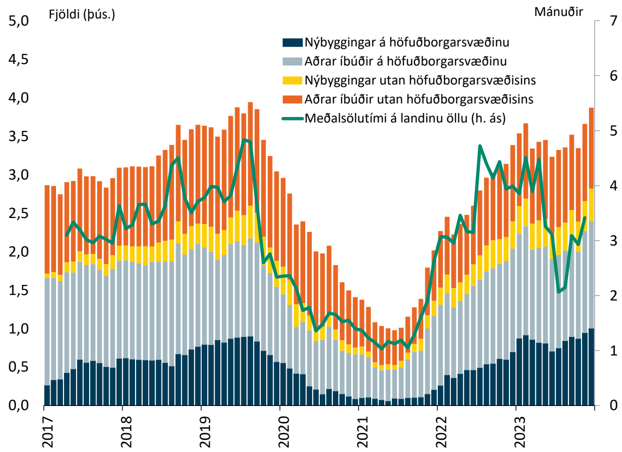
1. Framlag rafmagns, gass og annarra orkugjafa (utan bensíns og olíu) til ársverðbólgu.
Heimildir: Hagstofa Íslands, OECD, Seðlabanki Íslands.

Fólksfjölgun og launahækkanir hafa kynt undir eftirspurn eftir húsnæði

Húsnæðisverð[1]



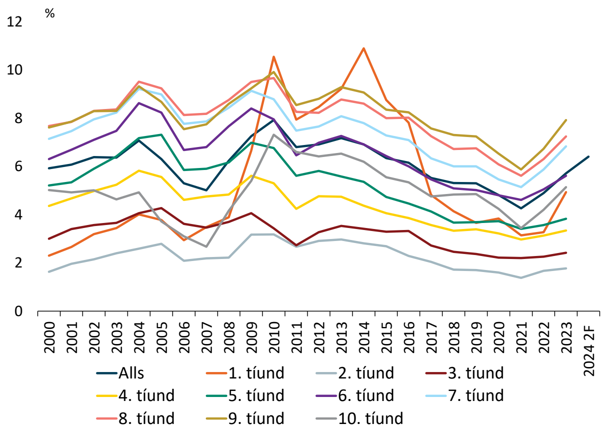
Fjöldi íbúða á sölu og meðalsölutími á landinu öllu[1]



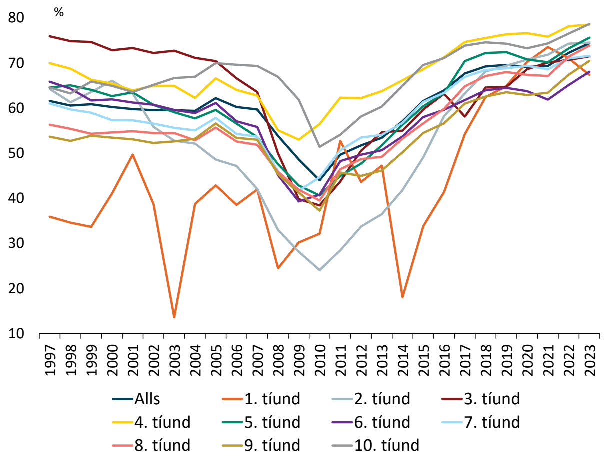
1. Vísitalan er gæðaleiðrétt m.v. fasteignamat og byggir á kaupsamningum sl. mánaðar. Hlutfall íbúða sem seldar eru yfir auglýstu söluverði af heildarfjölda seldra íbúða (þriggja mánaða hlaupandi meðaltal). 2. Fjöldi íbúða á sölu og meðalsölutími á landinu öllu.
Heimildir: Fasteignavefur Vísis (fasteignir.is), Húsnæðis- og mannvirkjastofnun, Seðlabanki Ísland.

Greiðslubyrði heimila þyngist en eiginfjárstaða þeirra hefur styrkst að miklum mun

Hlutfall vaxtagjalda vegna íbúðalána af ráðstöfunartekjum heimila[1 2]



Eiginfjárhlutfall heimila[1 3]

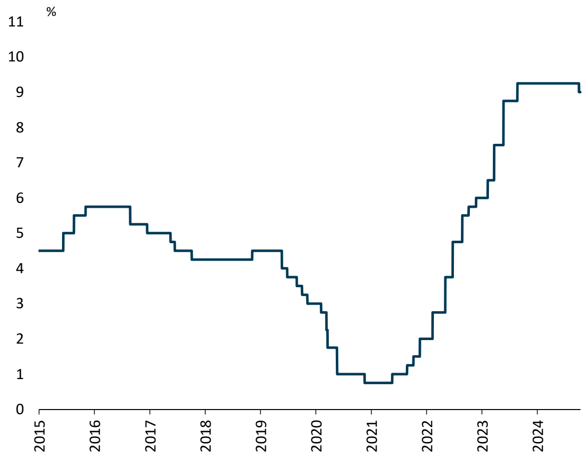


1. Tíundir miða við ráðstöfunartekjur heimila, þar sem ráðstöfunartekjur eru heildartekjur að frádregnum sköttum. 2. Gildi fyrir 2024 er mat Seðlabankans fyrir 2. ársfjórðung. 3. Hlutfall samtölu eiginfjár af heildareignum heimila innan hverrar tíundar.
Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

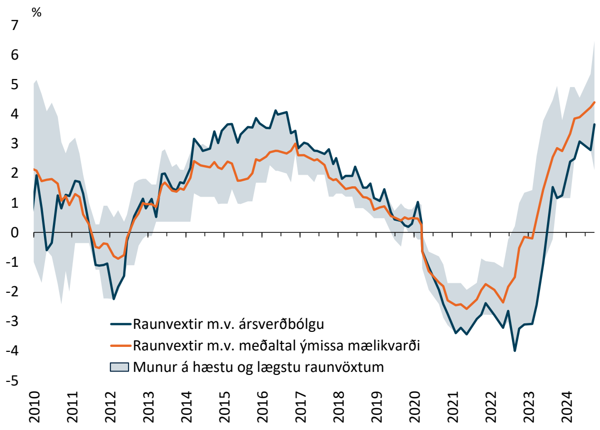
Stefna Seðlabankans

Númer 1: Þétt peningalegt aðhald til þess að kæla hagkerfið og ná verðbólgu aftur í markmið

Meginvextir (7 daga bundin innlán)



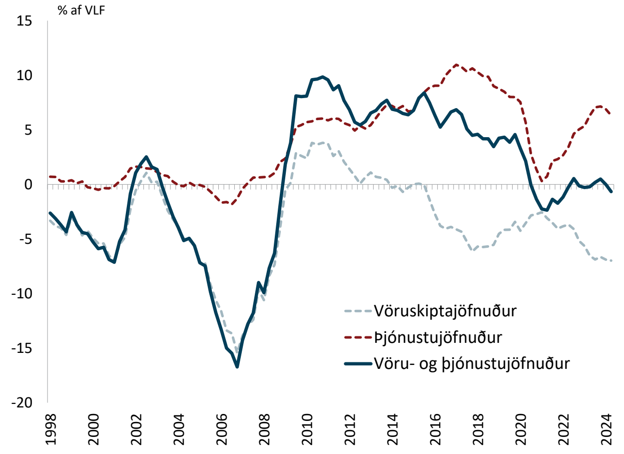
Raunvextir Seðlabankans í kjölfar vaxtaákvarðana peningastefnunefndar[1]



1. Miðað er við meginvextir hverju sinni og 12 mánaða verðbólgu, 1 árs verðbólguvæntingar fyrirtækja, 1 árs verðbólguvæntingar heimila, 1 árs verðbólguálag á skuldabréfamarkaði og spá Seðlabankans um ársverðbólgu eftir fjóra ársfjórðunga. Frá mars 2012 er einnig miðað við 1 árs verðbólguvæntingar markaðsaðila samkvæmt ársfjórðungslegri könnun Seðlabankans.
Heimildir: Gallup, Hagstofa Íslands, Seðlabanki Íslands.

Númer 2: Beiting þjóðhagsvarúðartækja – koma í veg fyrir lánabólu og tryggja stöðugleika í greiðslujöfnuði

Vöru- og þjónustujöfnuður[1]



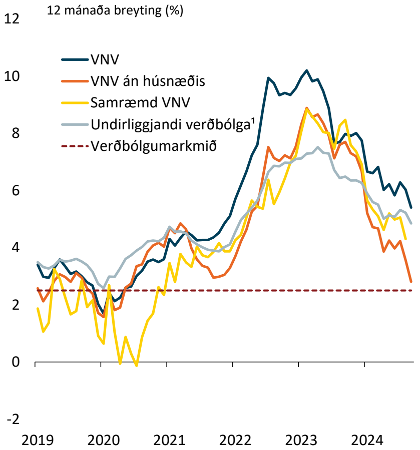
Gengi íslensku krónunnar

1. Fjögurra fjórðunga hlaupandi samtala.
Heimildir: Hagstofa Íslands, Seðlabanki Íslands.

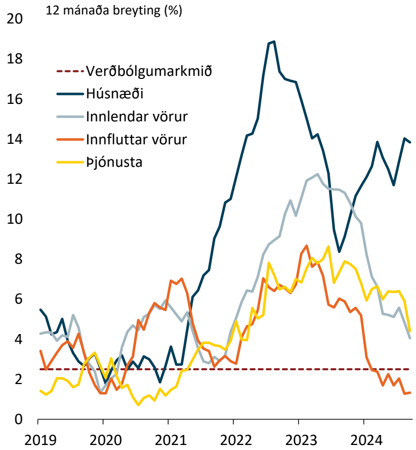
Dregið hefur úr verðbólgu og ef húsnæði er tekið út fyrir sviga er hún nálægt markmiði

- Verðbólga var 5,4% í september en 2,8% án húsnæðis

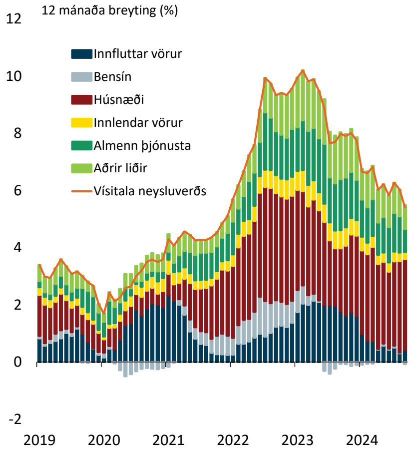
Verðbólga á ýmsa mælikvarða



Innlend og innflutt verðbólga



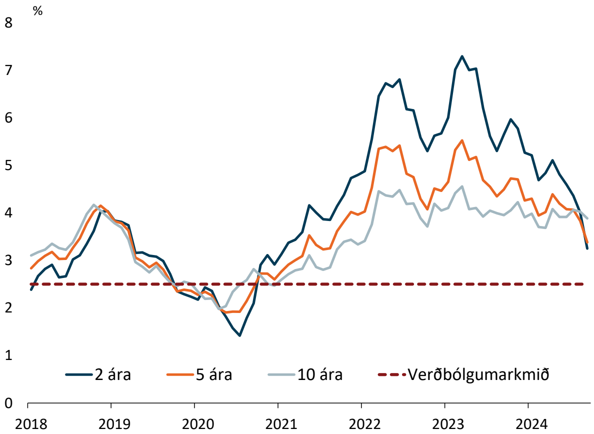
Undirliðir verðbólgu



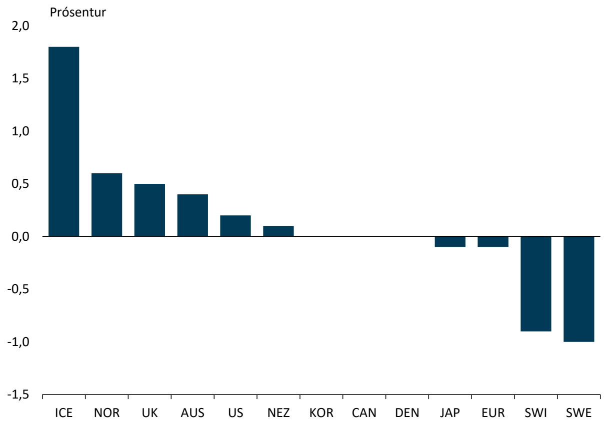
1. Undirliggjandi verðbólga sýnir meðaltal fimm ólíkra mælikvarða. Frá og með júní 2024 er kjarnavísitala 2 notuð þar sem kjarnavísitala 3 er ekki lengur birt.
Heimildir: Hagstofa Íslands, Seðlabanki Ísland.

Meginvandinn: Verðbólguvæntingar umfram verðbólgumarkmið en þær fara samt lækkandi

Verðbólguálag á skuldabréfamarkaði[1]



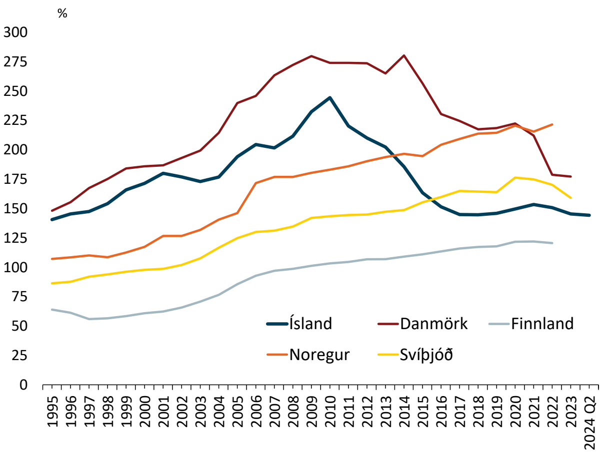
Frávik eins árs verðbólguvæntinga frá verðbólgumarkmiði[2]



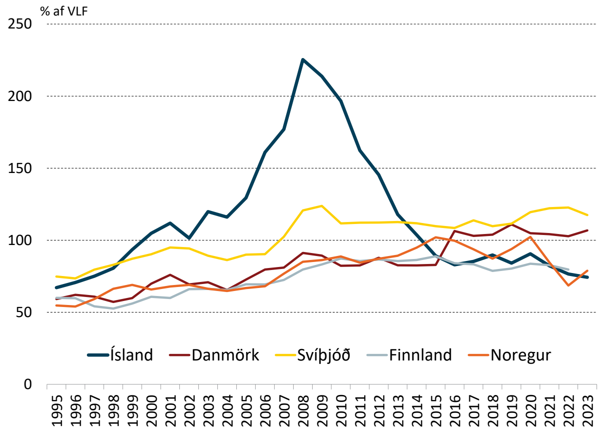
1. Verðbólguálag á skuldabréfamarkaði er mánaðarlegt meðaltal. 2. Væntingar sérfræðinga og markaðsaðila um verðbólgu eftir 1 ár (þ.e. í ágúst 2025 eða á 3.ársfj. 2025) nema fyrir Danmörku sem sýnir vænta meðalverðbólgu ársins 2025.
Heimildir: Consensus Forecast, Refinitive Datastream, Seðlabanki Ísland.

Engin lánabóla þrátt fyrir efnahagslegan uppgang og hækkun fasteignaverðs

Skuldir heimila sem hlutfall af ráðstöfunartekjum[1]



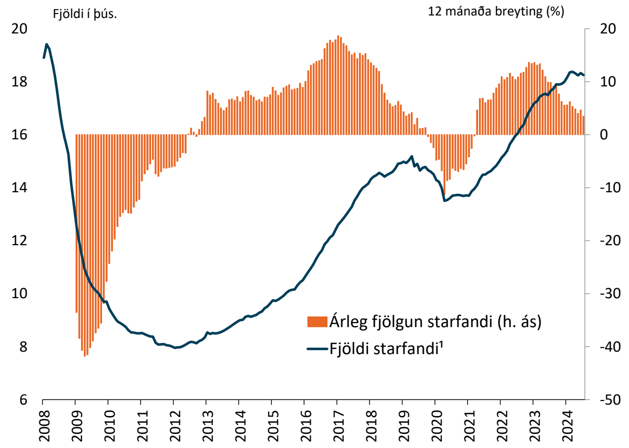
Skuldir fyrirtækja sem hlutfall af landsframleiðslu



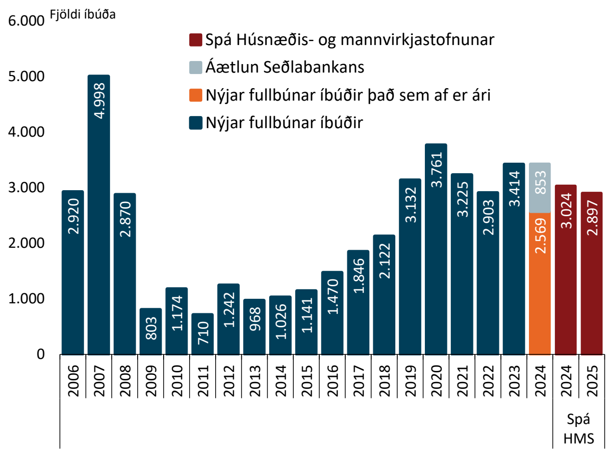
1. Skuldir heimila við innlend fjármálafyrirtæki. Ráðstöfunartekjur frá 1F 2021 eru byggðar á mati Seðlabankans.
Heimildir: Eurostat, Macrobond, Hagstofa Íslands, Seðlabanki Íslands.

Fólki fjölgar í byggingar- og mannvirkjageiranum og framboð mun halda áfram að vaxa

Fjöldi starfandi í byggingastarfsemi og mannvirkjagerð



Nýjar fullbúnar íbúðir á landinu öllu[2]



1. Fjöldi starfandi á aldrinum 16-74 ára. Árstíðaleiðrétt gögn. 2. Fullbúnar íbúðir eru taldar sem íbúðir á matsstigi 7 og 8. Fjöldi fyrir árið 2024 í heild er metinn út frá fjölda íbúða sem lokið var við að byggja í lok september. Spá HMS um nýbyggðar íbúðir innihaldur ekki fjölgun íbúða í eldri fasteignum og ekki íbúðir sem skráðar eru á matsstigi 7-8 á árinu en voru teknar í notkun fyrir einhverju síðan.
Heimildir: Fasteignavefur Vísis (fasteignir.is), Húsnæðis- og mannvirkjastofnun, Seðlabanki Ísland.

Litið til framtíðar

Litið til framtíðar …

- Frá 2020 hefur landsframleiðsla vaxið um 20% að raunvirði – samhliða hefur fólki fjölgað um 8% á vinnumarkaði
- Síðustu ár hafa verið miklir uppgangstímar á Íslandi
- Seðlabankinn hefur fengið það verkefni að viðhalda stöðugleika – og beitt bæði peningastefnu og þjóðhagsvarúðartækjum
- Þetta eru bitur meðul
- Það hillir undir árangur – að við getum náð fram mjúkri lendingu og komist í verðbólgumarkmið án kreppu, viðskiptahalla eða fjárhagsvandræða
- Gangi þetta eftir lækka vextir

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Litið til framtíðar …

- Á síðustu árum hafa opnast nýir möguleikar til fjármögnunar fasteignakaupa á nafnvaxtakjörum
- Lán á nafnvaxtakjörum hafa varið heimili landsins fyrir verðbólgu að einhverju marki og aukið bit peningastefnunnar
- Þessum breytingum þarf að fylgja eftir til að tryggja stöðuga og hagstæða fjármögnun fyrir heimili landsins til lengri tíma
- Það sem vantar nú er að huga betur að framboðshliðinni og tryggja húsnæði til samræmis við þarfir þjóðarinnar

18

Takk fyrir

4 December 2024

Memorandum

Re: Background to the decision on the countercyclical capital buffer

In March 2023, the Central Bank of Iceland Financial Stability Committee (FSN) decided to increase the countercyclical capital buffer (CCyB) from 2.0% to 2.5%. The decision took effect twelve months later, or in March 2024, as is provided for by law.

Cyclical systemic risk as measured in terms of the domestic composite systemic risk indicator (d-SRI) appears to have held broadly unchanged in the recent term. Developments in foreign credit markets have been favourable, and the banks have had ready access to funding. Strong returns on liquid assets in a high-interest-rate environment, expansion of the loan portfolio, and increased income from financial activities have strengthened the systemically important banks' (D-SIB) performance in 2024. On the other hand, indexation imbalances on the banks' balance sheets are growing, and impairment is still moderate despite the seismic activity on the Reykjanes peninsula and high interest rates and inflation. The banks' capital and liquidity are still strong. A sound capital position bolsters financial system resilience.

According to the Act on Financial Undertakings, the CCyB for exposures in Iceland shall generally range between 0% and 2.5%. It may exceed 2.5%, however, if the risk factors underlying the FSN's assessment warrant a higher buffer rate.[1]

Recent economic developments and outlook

GDP growth has slowed markedly in Iceland. GDP is estimated to have contracted by 1% year-on-year in the first nine months of 2024. According to the Central Bank's new macroeconomic forecast, output growth is projected to remain flat in 2024 as a

[1] cf. Article 85(a), Paragraph 3 and Article 85(b), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002.

whole.[2] Growth in private consumption has subsided recently, although indicators imply that it picked up again in Q3. Revised statistics suggest that real disposable income grew considerably more than previously estimated and that the household saving rate is higher as well. Labour market tightness has eased, and unemployment continues to inch upwards. The outlook is for the pressures in the labour market to subside further in the coming term. Inflation continues to fall. At the same time, the short-term inflation outlook has improved, although prospects are uncertain because of wars, possible trade disputes due to increased tariffs, and a highly uncertain geopolitical situation. Wage agreements are still outstanding for part of the public sector, and the positive output gap could be underestimated. Inflation expectations have begun to fall recently by most measures, particularly among market agents. The stock market has gained strength, nominal bond market rates have fallen, short-term indexed rates have risen, and long-term indexed rates are broadly unchanged.

In most of Iceland's trading partner countries, GDP growth is well below the average of recent decades. The situation differs from one country to another, however. The International Monetary Fund (IMF) forecasts global GDP growth at 3.2% in both 2024 and 2025. However, the Fund has warned of the economic impact of a possible trade war arising from tariff hikes in the US. Global inflation has continued to fall, and central banks in nearly all advanced economies have lowered their policy rates recently. Both nominal and real rates are still considerably above the pre-pandemic level, however. There are widespread concerns about fiscal debt levels and persistent deficit operations. The long-term interest rate differential with abroad has narrowed against both the US dollar and the euro. The short-term spread versus the dollar has widened, though, while the spread against the euro is more or less unchanged.

Private sector debt

At the end of September 2024, household debt had grown by 0.3% year-on-year in real terms and by 5.7% in nominal terms. Price indexation on indexed loans accounts for a large share of

[2] For further discussion, see *Monetary Bulletin* 2024/4.

the nominal increase. Heavier debt service burdens on non-indexed mortgage loans has prompted households to seek out indexed loans in greater measure. However, indexed mortgage rates have risen recently, as have other real rates, and are now at their highest since 2012. At the same time, the weighted average maturity on new mortgages has grown shorter, particularly for indexed loans. Shorter maturities go hand-in-hand with the banks' decision to reduce the maximum maturity on indexed mortgages. Furthermore, the banks have lowered the maximum loan-to-value (LTV) ratio on base loans, and they now offer indexed annuity loans only to first-time buyers. New non-indexed loans net of non-indexed loan retirement have contracted since May 2023, while indexed loans have increased. Indexed mortgages now account for 59% of outstanding mortgage debt. The share is lower than before the pandemic, however, when 70% of outstanding mortgages were indexed. Net new lending to households has increased in 2024 to date, perhaps reflecting reduced uncertainty and expectations of continued interest rate cuts. Household debt ratios are low in historical and international context. At the end of September, household debt equalled 73% of GDP, an increase of 0.4 percentage points year-on-year. The ratio of debt to disposable income fell by 4.7 percentage points between years, to 136% in September. It has been written down to accord with revised figures on disposable income, as is noted above, and is now at its lowest since 1995.

At the end of September, firms' debt to domestic financial institutions had increased by 5.2% year-on-year in real terms and by 10.9% in nominal terms.[3] Financial institutions' new corporate lending has been strong in the recent term, and companies' demand for bank loans still appears robust. The pace of lending has eased in recent months, however, perhaps indicating that corporate credit growth has peaked. In the recent past, companies have increasingly sought out indexed loans (mainly in the case of real estate firms) and foreign-denominated loans (primarily in the case of fishing companies).

The private sector credit-to-GDP ratio, which had been falling since 2020, was 151% at the end of Q2/2024 and had risen by 3

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[3] Debt owed to domestic financial institutions equals roughly 82% of total corporate debt.

percentage points year-on-year. Nevertheless, it remains well below its historical average. Growth in lending to companies has exceeded GDP growth in 2024, which explains the year-on-year rise in the credit-to-GDP ratio.

Arrears on loans from the D-SIBs to individuals and businesses are low in historical and international context. At the end of September, the facility-level non-performing loan ratio on loans to individuals was unchanged year-to-date at 1%. The share of frozen loans to individuals was 1.1% at the end of September and had declined by nearly 0.5 percentage points since year-end 2023. Corporate non-performing ratios have risen slightly in 2024, measuring 2.7% at the end of September. As before, arrears were most pronounced among companies in the hospitality industry, at 8.4%, and had increased by 3.6 percentage points since the beginning of the year. The rise is attributable to a few large companies in the sector, however, and does not indicate widespread default. The non-performing loan ratio in the construction sector had risen by 2 percentage points over the same period, to 3.2% as of end-September. The share of frozen corporate loans had fallen slightly since the beginning of the year, to 2.5% at the end of September.

Real estate market

Housing market activity picked up during the spring, with real estate firm Þórkatla's buy-up of homes in Grindavík and Grindavík residents' purchases of new homes elsewhere. The market has shown signs of a slowdown in the past few months, however. In October 2024, the capital area house price index had risen by 3.4% year-on-year in real terms. Condominium prices had risen by 3.3%, while single-family home prices rose by 3.5%. The number of properties for sale has increased significantly this year, particularly in the case of newly built properties. Furthermore, housing market turnover has contracted again and the number of finalised purchase agreements has fallen, after a marked increase during the Grindavík buy-up in Q2. Over the first ten months of 2024, however, the number of purchase agreements nationwide grew by 53% year-on-year. Excluding Grindavík-related transactions, the increase measured 30%. The number of first-time buyers has risen in 2024, partly because of an increase in allocation of equity loans from the Housing and Construction Authority early in the year. Furthermore, households' sizeable accumulated savings and indicators of increased parental assistance have enabled first-time buyers to enter the market despite the limitations posed by tight borrowing requirements and high interest rates.

House prices remain high relative to fundamentals, indicating an imbalance in the market. Nevertheless, twelve-month house price inflation has eased since August. Reduced inflationary pressures are doubtless due in large part to the fact that most of the direct impact of the seismic activity in and around Grindavík has already come to the fore, after peaking in April and May. Furthermore, the effects of a tighter monetary stance have begun to show in greater measure in the recent term.

The commercial real estate (CRE) price index, which captures real prices in the capital area, rose by 2.3% year-on-year in Q3 and was about 9.5% above its estimated long-term trend, down from 15% above trend at the end of 2023. Turnover in registered contracts for commercial property in greater Reykjavík increased in real terms by nearly one-fifth year-on-year over the first nine months of 2024. Measures of demand for commercial property suggest that it has eased in 2024 to date. Domestic economic activity has subsided, and job growth has lost pace. Returns on the three large CRE firms' real estate assets measured 5.6% over the first nine months of 2024 and were virtually unchanged between years.[4] The calculated risk premium declined slightly during the same period, however, to 3.2% over the first three quarters of 2024, owing to higher yields on indexed Treasury bonds in H2/2023. The combined equity ratio was all but unchanged year-on-year, measuring 31.6% at the end of Q3. The companies' refinancing risk is limited for the next few years.

The systemically important banks (D-SIB)

The D-SIBs' interest income has continued to increase, mostly because of balance sheet growth and stronger returns on liquid assets. Increased returns on liquid assets, loan portfolio expansion, and growth in income from financial activities have

[4] Eik, Heimar, and Reitir.

strengthened the D-SIBs' operating performance in 2024. Return on equity measured 11.7% over the first nine months of the year and was unchanged relative to the same period in 2023. Income from fees and commissions declined 5% between years, but the outlook is now more favourable than before.

The banks' expenses grew over the first nine months of 2024, partly because of expanded staffing levels, but on the whole, costs have risen only slightly in excess of inflation. Impairment increased year-on-year, partly due to the seismic activity on Reykjanes peninsula, but is considered moderate given the high interest rate level and the cooling economy.

The facility-level non-performing loan ratio was unchanged at 1.8% in Q3, and the ratios for both households and businesses were unchanged as well.[5] The share of household and business loans defined as forborne and performing declined during the quarter: in the case of households, it fell by 0.1 percentage points, to 1.0%; and for businesses it fell by 0.8 percentage points, to 1.8%.

The D-SIBs' indexation imbalance – i.e., the difference between indexed assets and liabilities – was 79% of capital at the end of September, or 581 b.kr., and had increased by 286 b.kr. since the beginning of the year. Demand for new indexed loans has been strong, and in most cases such loans are funded with non-indexed deposits. This situation is likely to turn around as nominal interest rates decline.

The D-SIBs' liquidity position remains very strong. Their main source of domestic market funding is covered bonds; however, they have stepped up their issuance of unsecured bonds in Icelandic krónur in the past year. Furthermore, developments in foreign credit markets have been favourable for the banks, and interest rate spreads on their foreign bond issues have been falling more or less uninterrupted since year-end 2023. Thus far in 2024, the D-SIBs have issued foreign-denominated bonds on far more favourable terms than were offered in 2023. Their refinancing risk is therefore limited at present.

[5] The facility-level non-performing loan ratio is calculated in accordance with EBA standards.

The D-SIBs' capital ratio was 23.6% at the end of Q3, or 0.4 percentage points lower than at the same time in 2023. In all three cases, individual banks' capital ratios were 3.7% above the overall capital requirement.

Overall assessment of cyclical systemic risk

The financial conditions index suggests that households' and businesses' financial conditions have improved but are not especially favourable in historical context. But the index is an imperfect measure that, for instance, does not directly capture financial institutions' tightened lending requirements. It is therefore wise to avoid drawing sweeping conclusions from the financial conditions index alone. The improvement in financial conditions can be attributed mainly to expectations of a decline in real interest rates, although developments are affected by higher house prices, a narrower long-term interest rate differential with abroad, and the appreciation of the króna.

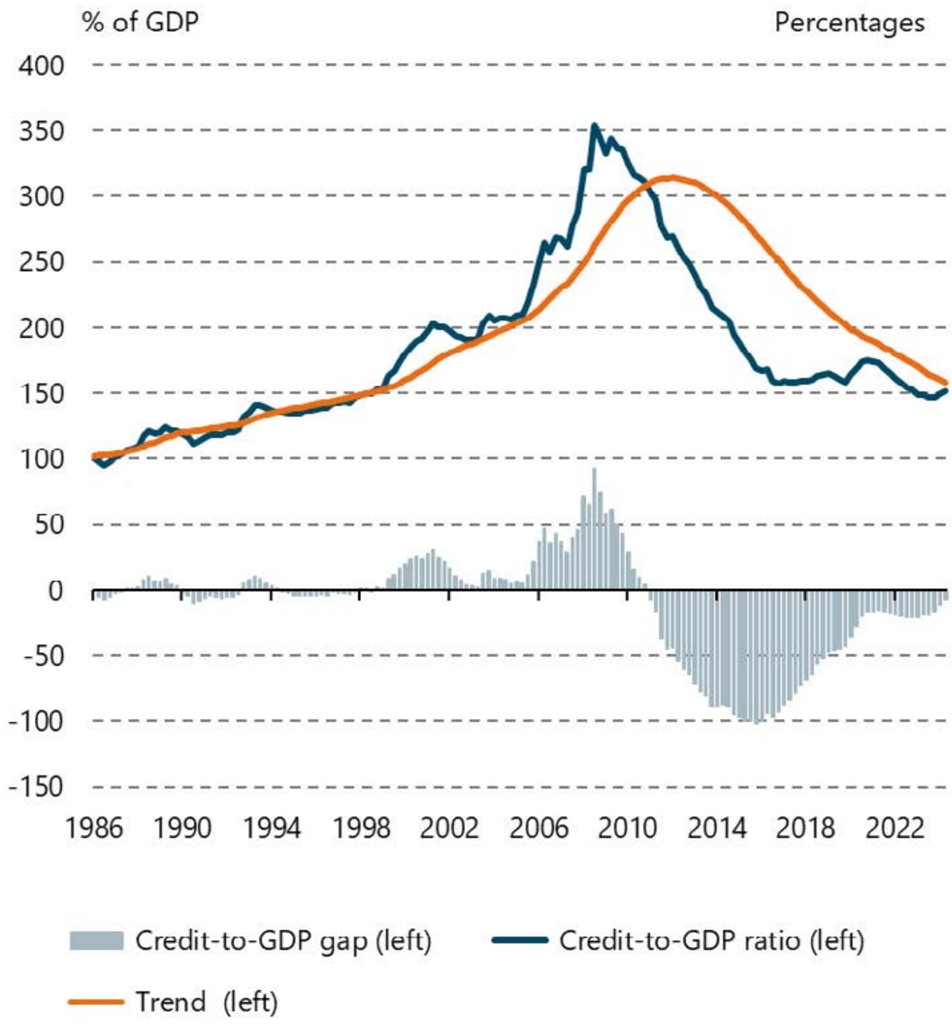
The combined effect of higher interest rates and tighter lending requirements appears to have impeded the rise in house prices and somewhat mitigated imbalances in the market. The number of homes for sale has risen, and the average time-to-sale has grown longer in recent months. Imbalances remain between house prices and fundamentals, however. The risk of a further correction of house prices is therefore largely unchanged, as prices remain high by most measures.

The D-SIBs' core operations have been successful. Developments in foreign credit markets have been favourable, and interest rate spreads on the banks' foreign bond issues have been falling more or less uninterrupted since year-end 2023. Their liquidity and capital are very strong.

The statistical presentation of the financial cycle indicated that the cycle was still rising in Q2. All three sub-cycles of the financial cycle have risen in 2024 to date, although the housing cycle has risen the most. The domestic systemic risk indicator (d-SRI) has held broadly unchanged thus far in 2024, after having fallen steadily since year-end 2021. In H1, the three-year change in the ratio of house prices to income (sub-indicator 1) fell somewhat, even though house prices remain high by most measures. This leads to a decline in the d-SRI. On the other hand, the two-year change in the ratio of bank credit to GDP (sub-indicator 2) has grown larger, which leads to a rise in the d-SRI. In general, though, the indicator suggests that cyclical systemic risk is below its long-term average and that all of the sub-cycles are close to their long-term averages.

Appendix – Charts

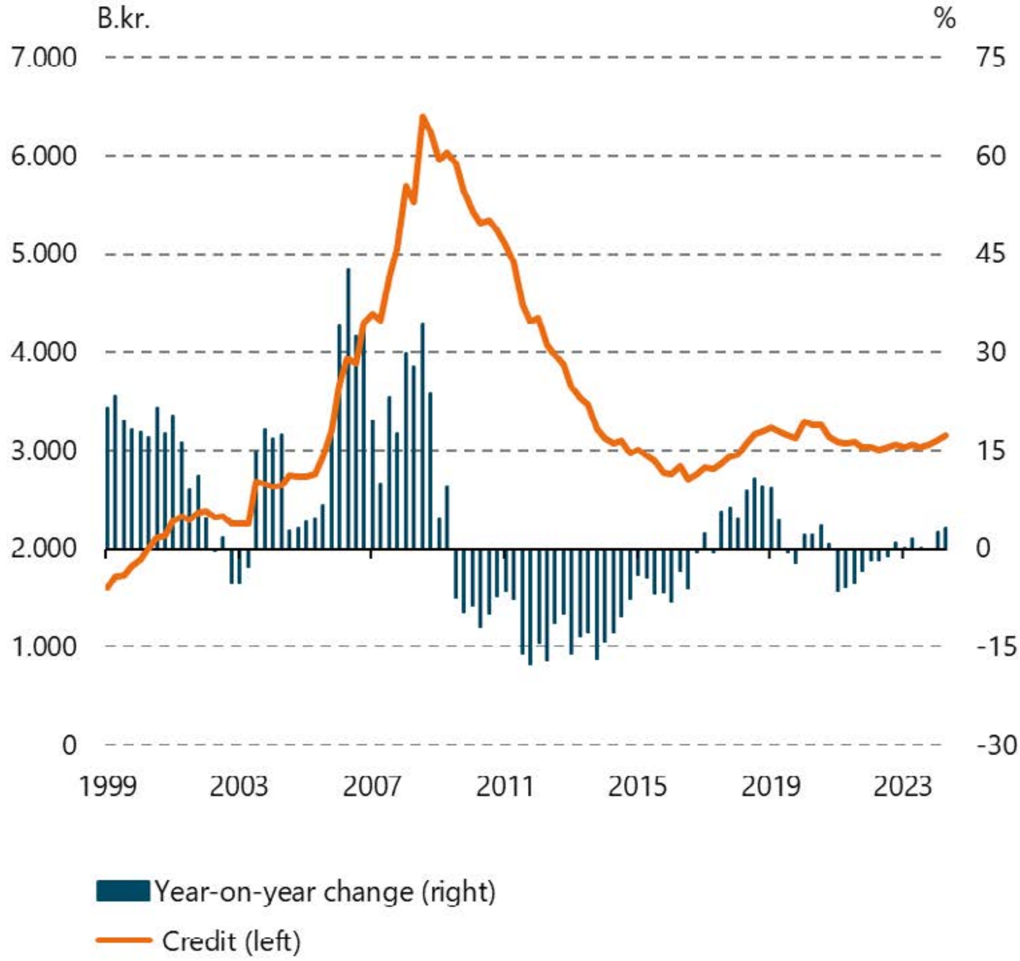
Credit-to-GDP ratio and gap[1]
Q1/1986 - Q2/2024



1. Total credit to households and firms, at claim value, as a percentage of the last four quarters GDP. The trend component is obtained with a one-sided Hodrick-Prescott filter with λ=400.000.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit to non-financial corporations[1]

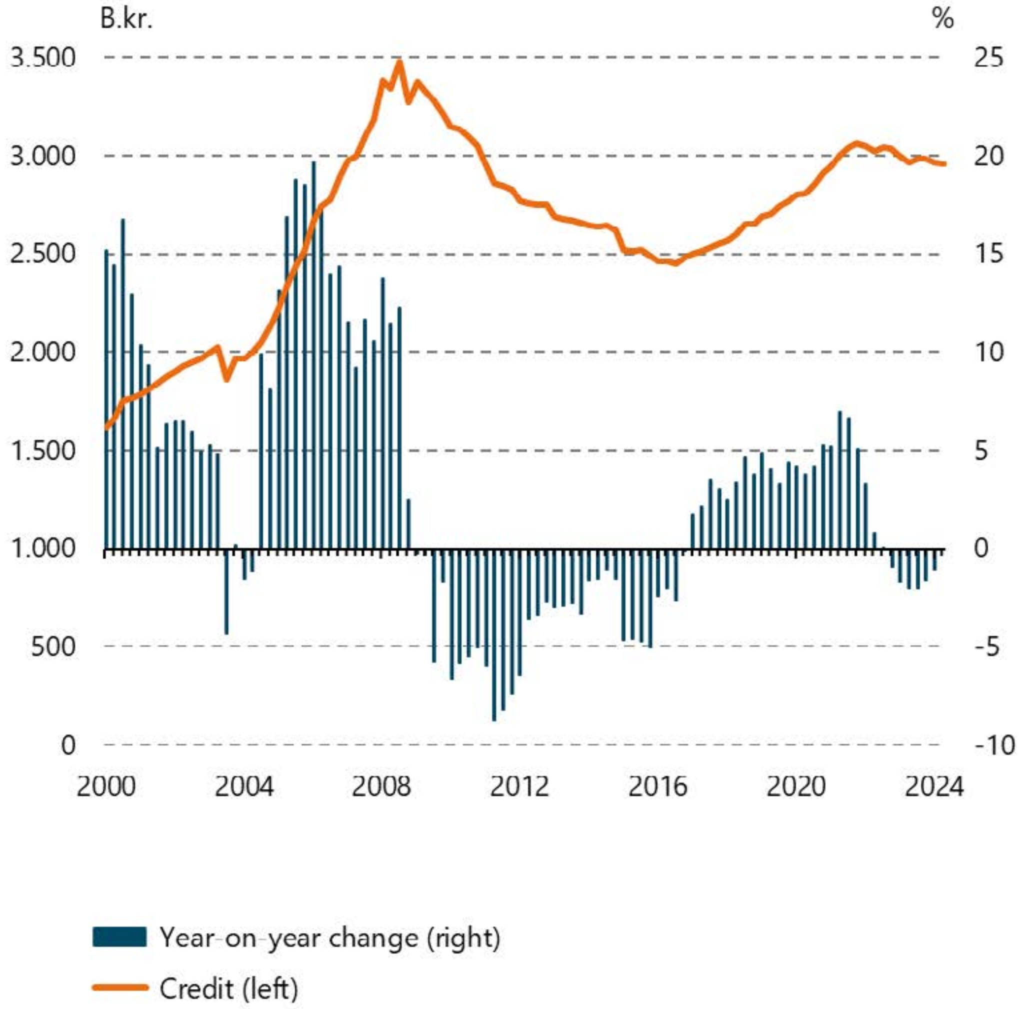
Q1/1999 - Q2/2024



1. Claim value of non-financial corporations' debt to domestic and foreign financial institutions and marketable bonds issued, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Real household credit[1]

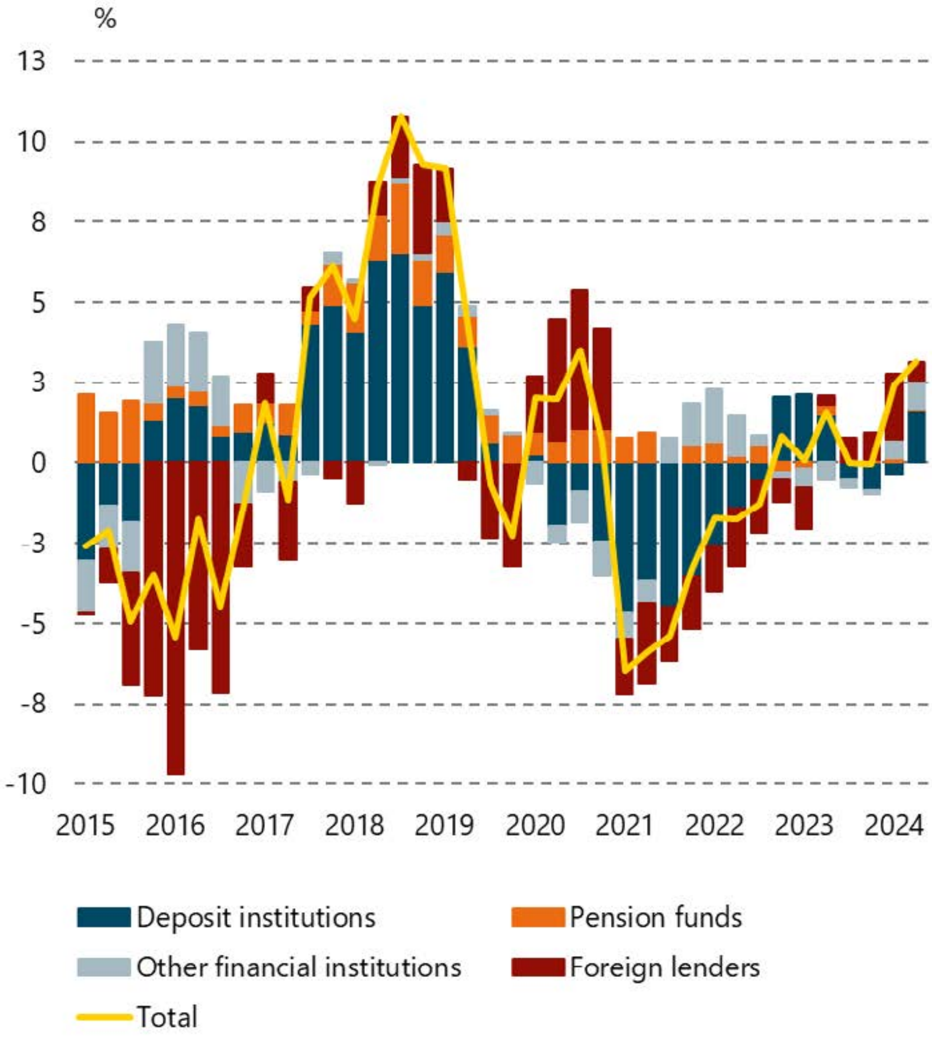
Q1/2000 - Q2/2024



1. Claim value of household debt to financial institutions, at constant prices. Deflated with the consumer price index.
Sources: Statistics Iceland, Central Bank of Iceland.

Corporate debt real growth disaggregated by lender type[1]

Q1/2015 - Q2/2024

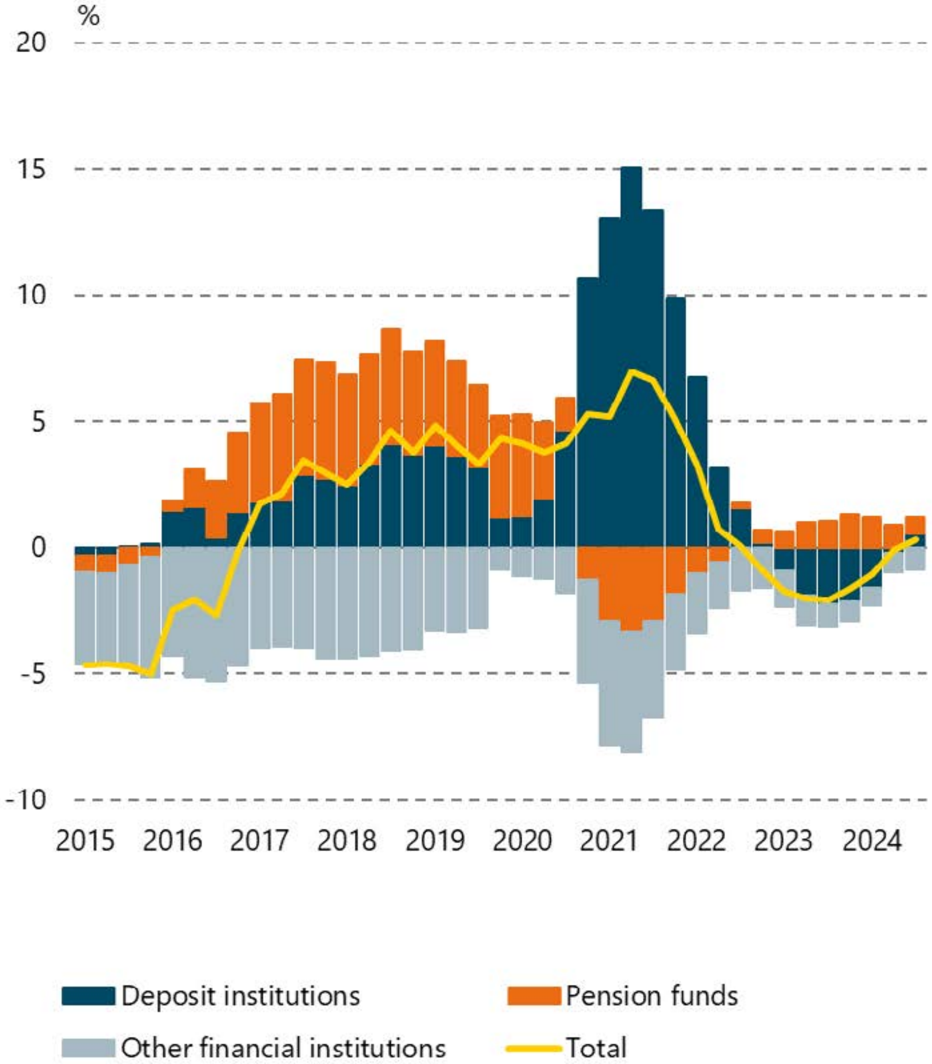


1. Debt to financial institutions and issued marketable bonds, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.

Sources: Statistics Iceland, Central Bank of Iceland.

Developments in real credit to households, disaggregated by lender type[1]

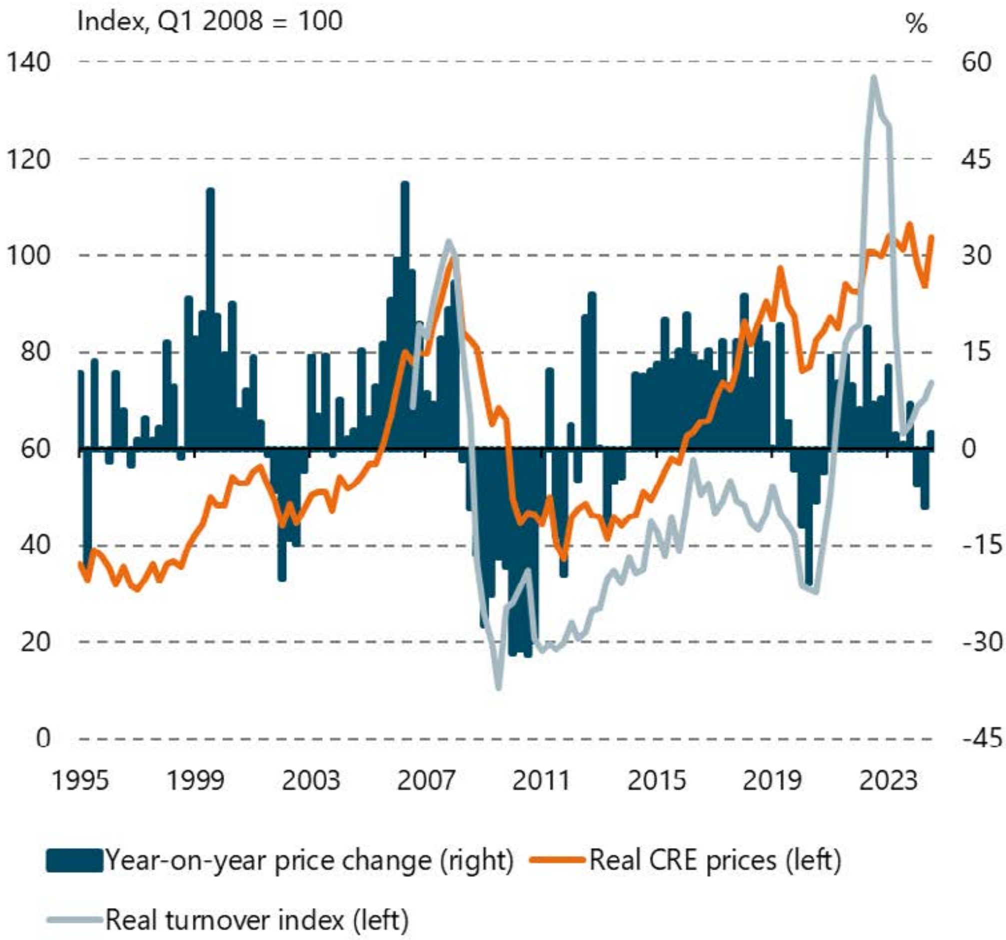
Q1/2015 - Q3/2024



1. Household debt to financial institutions, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.
Sources: Statistics Iceland, Central Bank of Iceland.

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

Q1/1995 - Q3/2024

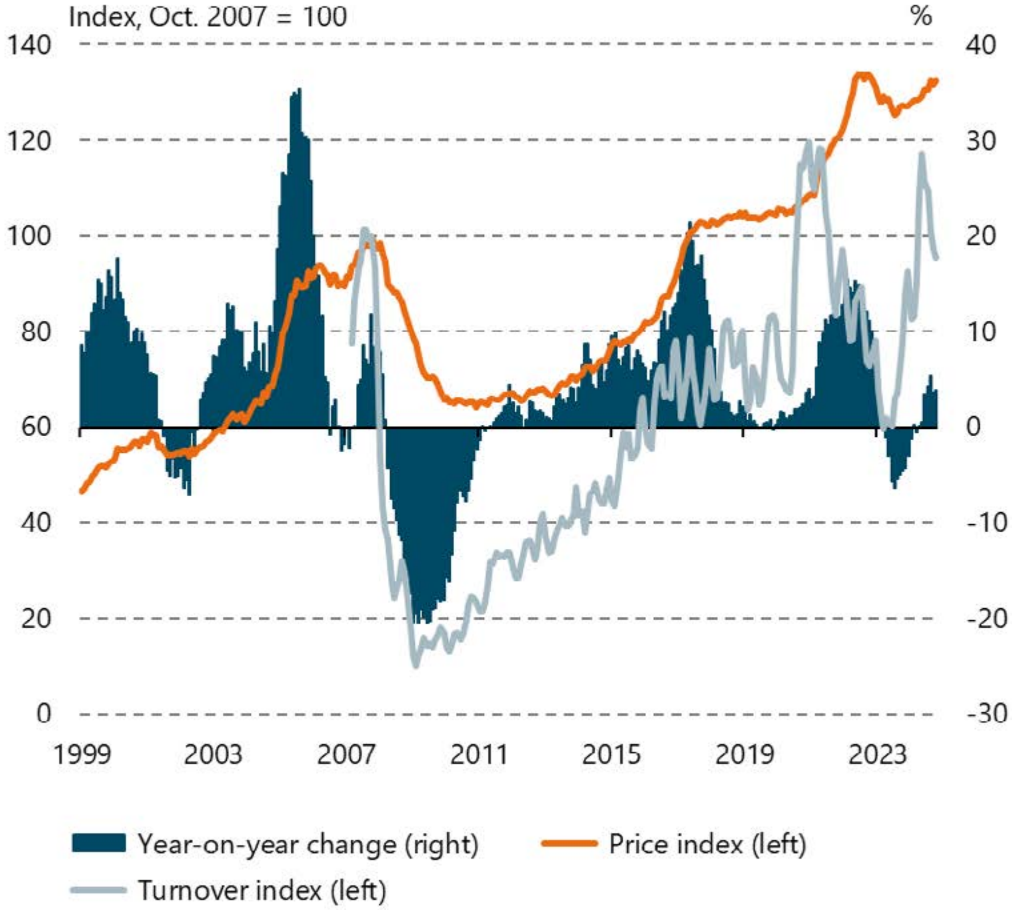


1. CRE price index, deflated with the CPI. The index shows the weighted average price of industrial, retail, and office space. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminary.

Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

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

January 1999 - October 2024



1. The combined index of capital area house prices is based on a new sub-index for January 2024 and previous indices prior to that time. The index is deflated with the CPI. The turnover index shows a three-month moving average of turnover, deflated with the CPI.

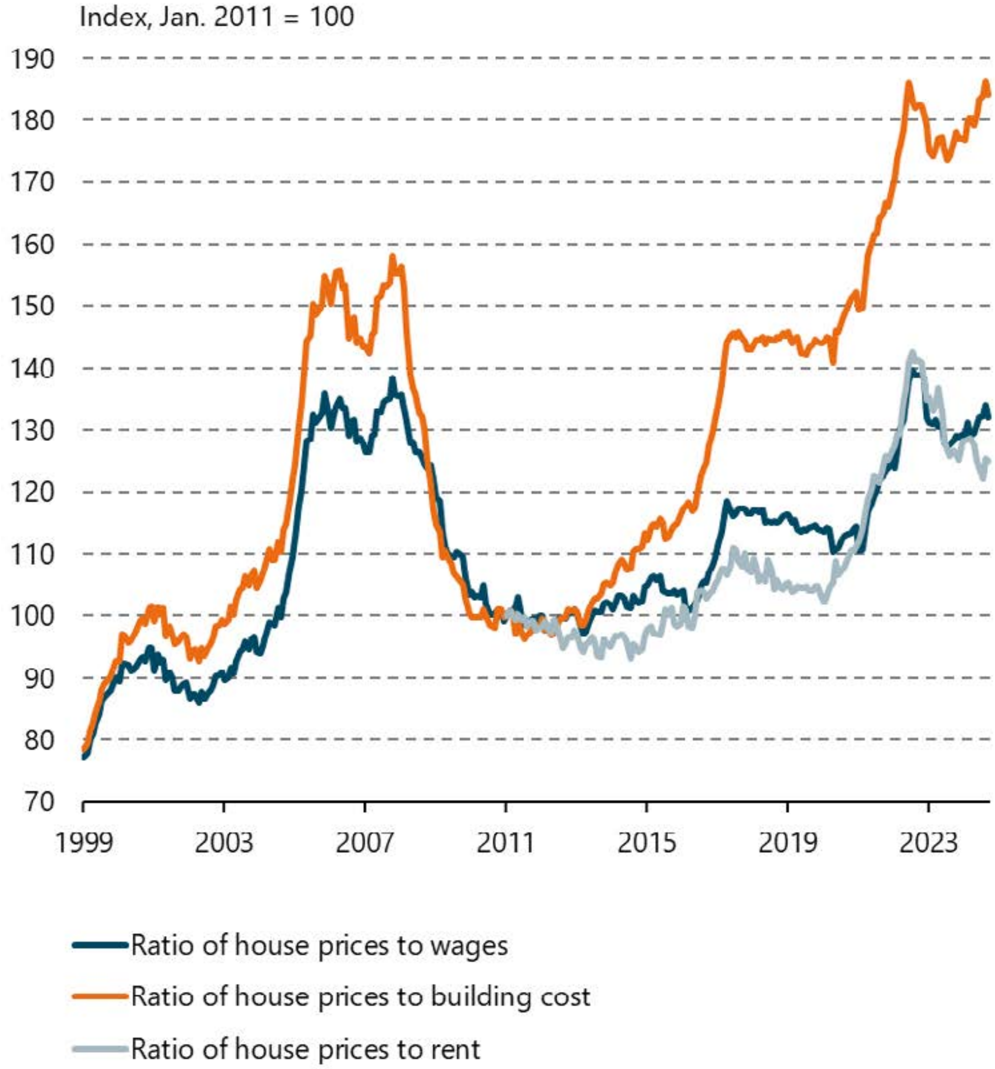
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Commercial property price ratios[1]
Q1/1997 - Q3/2024

1. Annual data for gross operating surplus are non-linearly interpolated. Annual data for the CRE stock are linearly interpolated.
Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Capital area house prices and determining factors

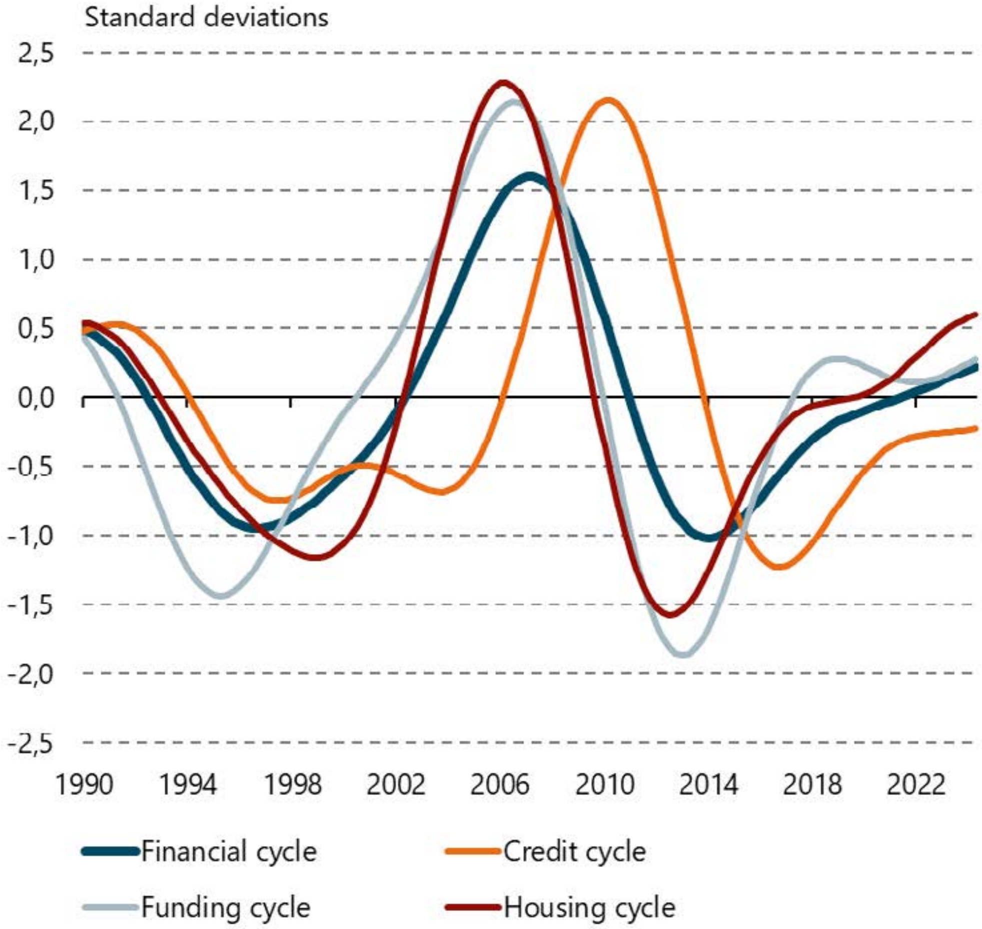
January 1999 - September 2024



Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Financial cycle and subcycles[1]

Q1/1990 - Q2/2024

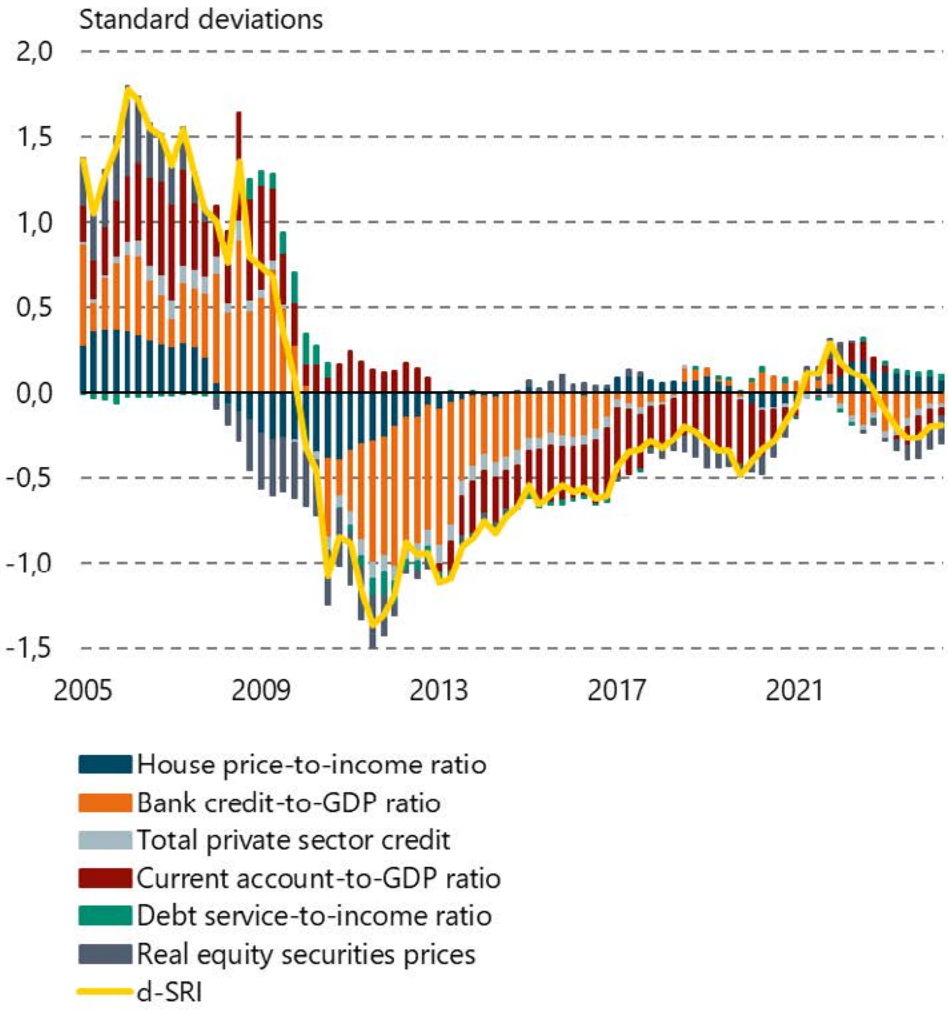


1. The financial cycle, the blue line, is a simple average of the subcycles. Each subcycle is a simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with a frequency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

Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Domestic systemic risk indicator (d-SRI)

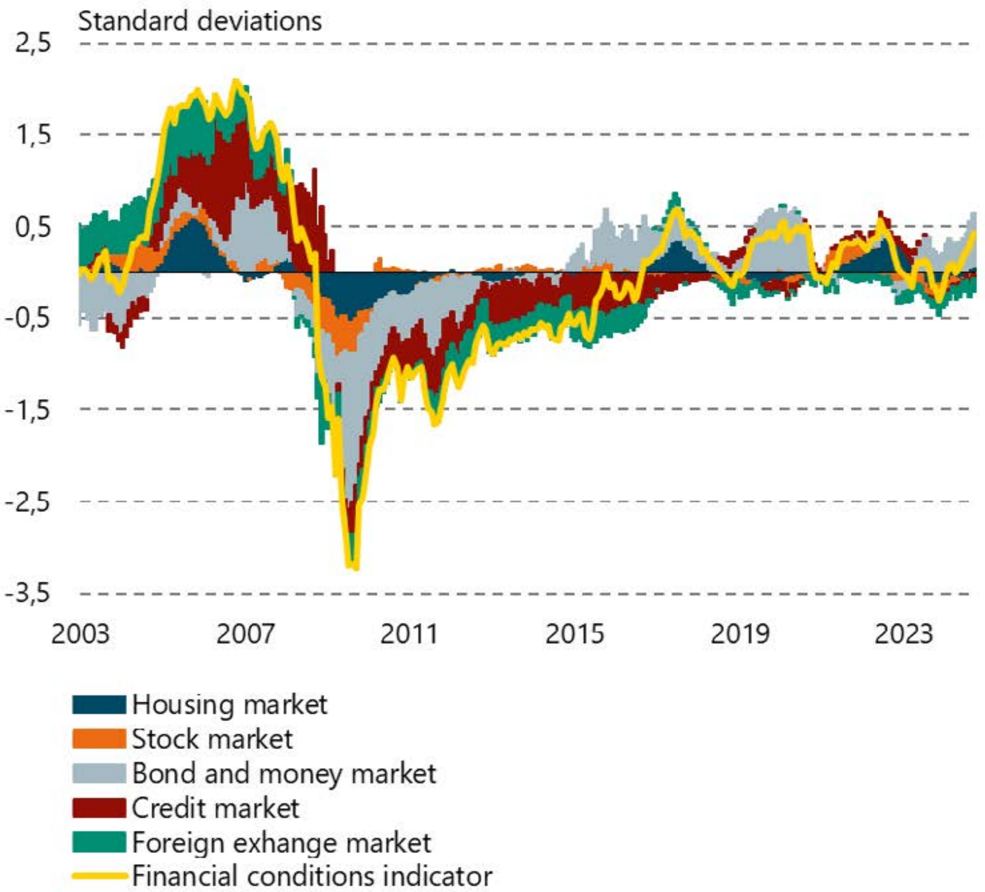
Q1/2005 - Q2/2024



Sources: Housing and Construction Authority, Statistics Iceland, Central Bank of Iceland.

Domestic financial conditions[1]

January 2002 - September 2024

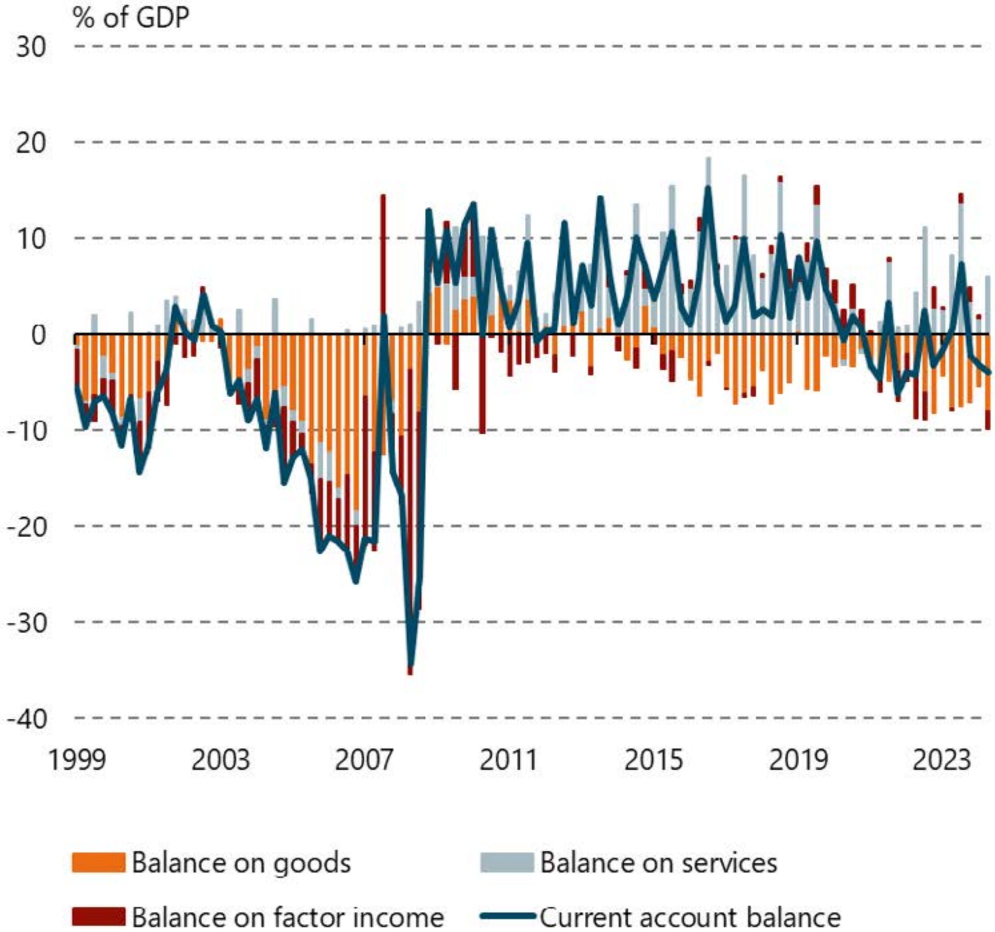


1. The financial conditions indicator consists of the first three principal components of selected indicators of financial conditions, scaled so that the mean is 0 and the standard deviation is 1. A lower index value indicates a deterioration in financial conditions.

Sources: Housing and Construction Authority, Nasdaq OMX Iceland, Statistics Iceland, Central Bank of Iceland.

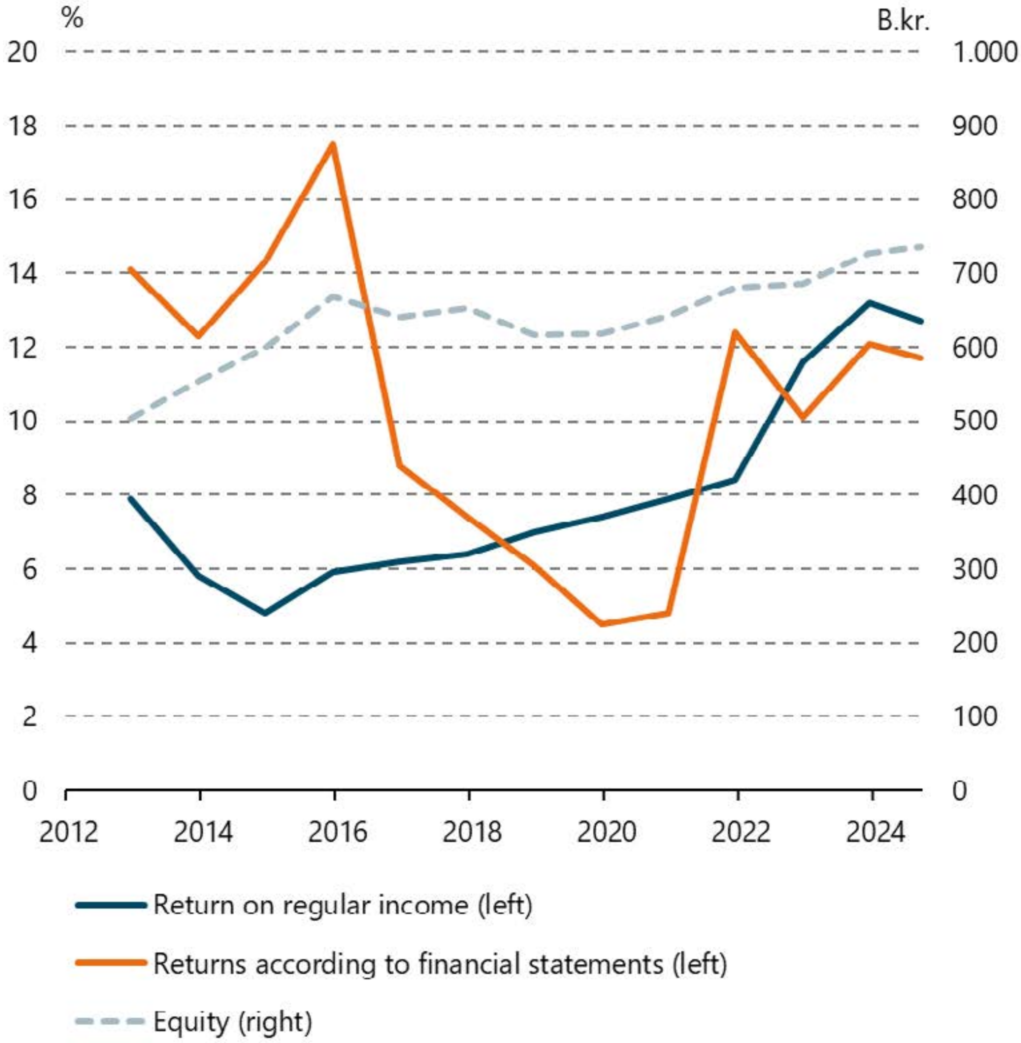
Current account balance[1]

Q1/1999 - Q2/2024



1. The effects of failed banks on factor income and the balance on services frc 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. Secondary income is included in factor income.
Sources: Statistics Iceland, Central Bank of Iceland.

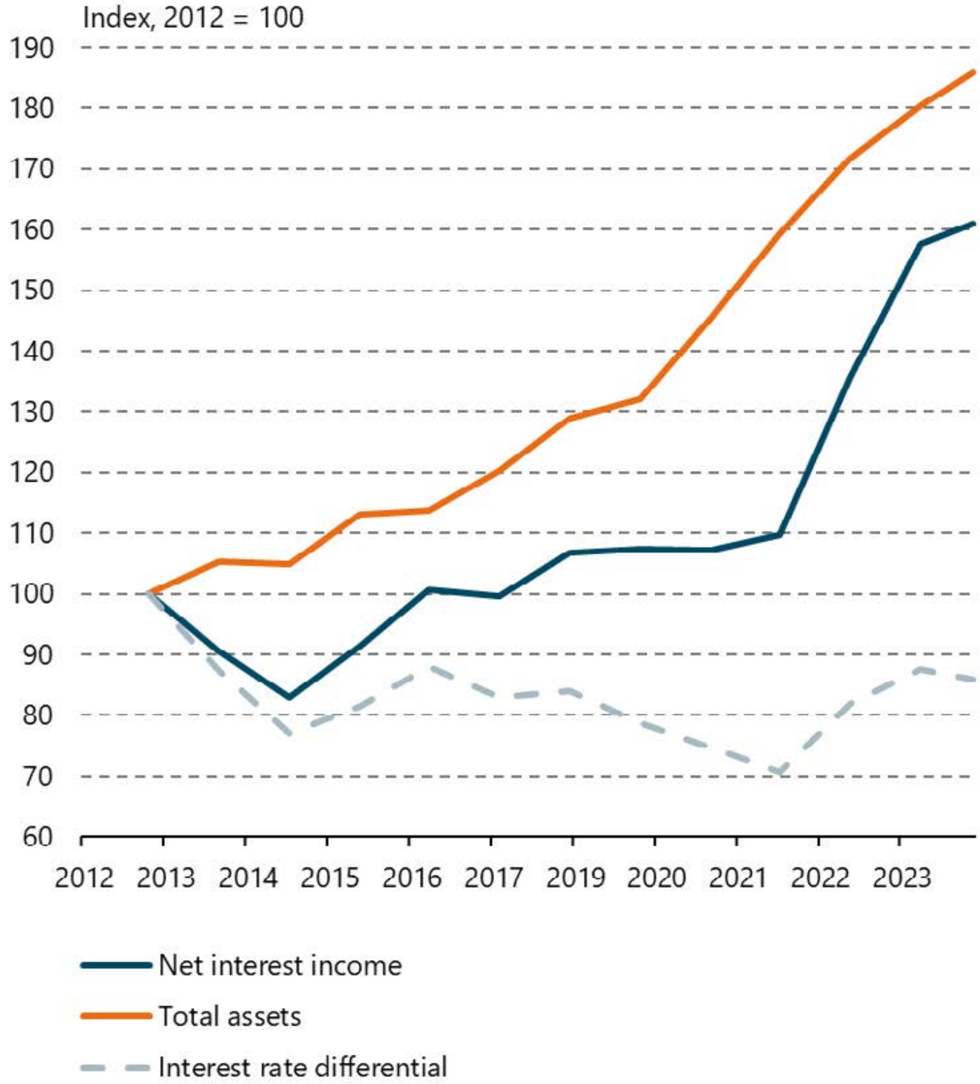
D-SIB: Returns[1]



1. Domestic systemically important banks (D-SIB), consolidated figures. Valitor is excluded in 2017-2020. Returns are calculated on average equity. The return on regular income is based on net interest income and fee/commission income net of regular expenses. The tax rate is 20% and is based on average equity.

Sources: Commercial banks' financial statements.

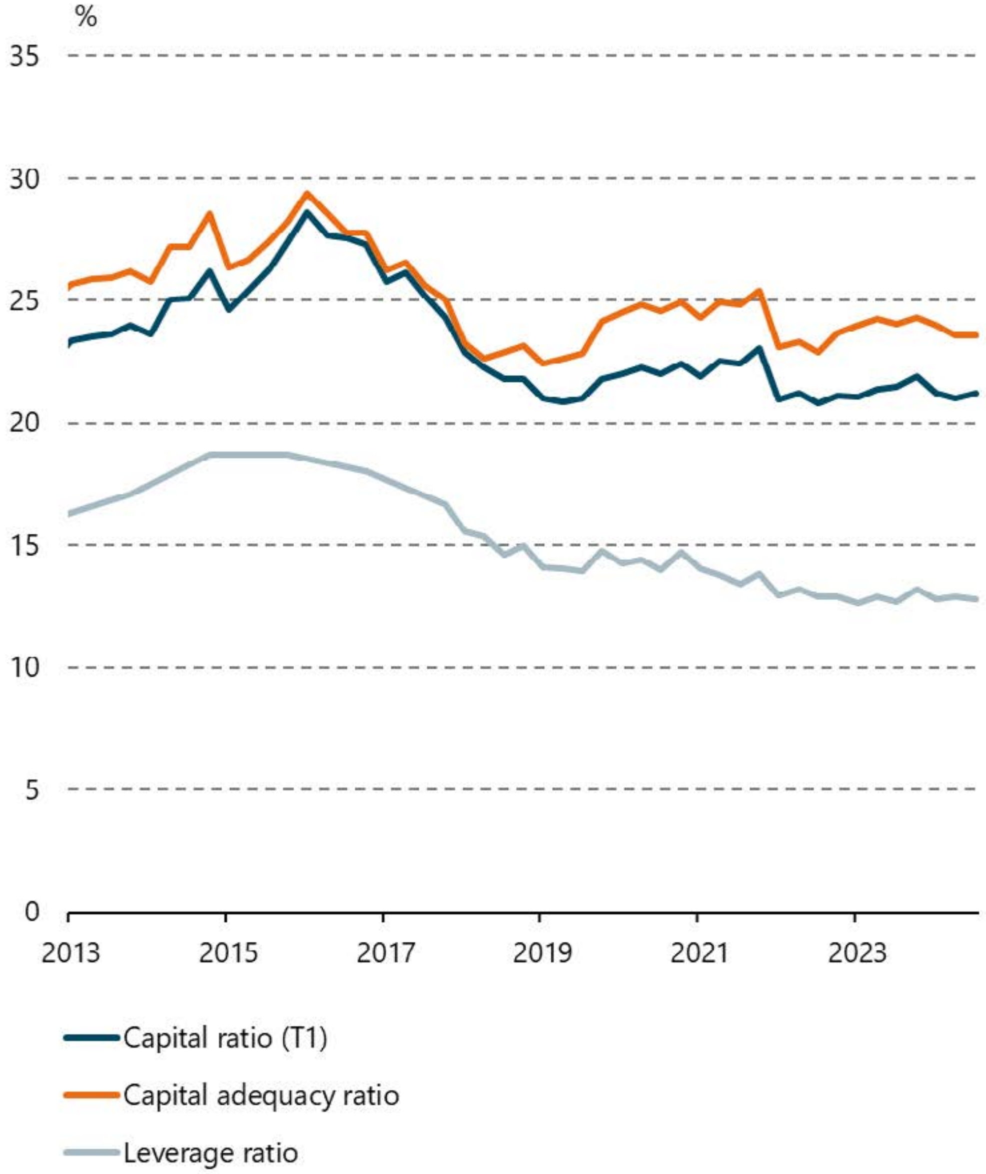
D-SIB: Net interest income, interest expense and interest rate differential[1]



1. Domestic systematically important banks (D-SIB), consolidated figures. Yearly data. 2024 figures are annualised.
Sources: Commercial banks' financial statements.

D-SIB: Capital and leverage ratios[1]

Q4/2012 - Q3/2024



1. Domestic systemically important bank (D-SIB), consolidated figures.
Sources: Commercial banks' financial statements.

4 December 2024

Memorandum

Re: Background to the decision on systemically important financial institutions and capital buffers for systemic importance

Each of Iceland's three large commercial banks – Arion Bank, Íslandsbanki, and Landsbankinn – accounts for 27-30% of the financial system as measured using systemic importance methodology. In all likelihood, financial stability would be severely threatened if one of these banks should fail, with probable spillovers to other financial institutions and the economy as a whole.

Since the capital buffer for other systemically important institutions (O-SII) first took effect in Iceland in 2016, Arion Bank, Íslandsbanki, and Landsbankinn have maintained a 2% capital buffer for systemically important financial institutions. This was the maximum provided for by law at that time. The maximum was increased to 3% in 2022, when the Capital Requirements Directive (CRD-V) was incorporated into Icelandic law. Because of how important these three banks are for the Icelandic financial system, it is deemed appropriate to impose the maximum O-SII buffer provided for by law.

Assessment of Icelandic financial institutions' systemic importance

Article 86(e), Paragraph 2 of the Act on Financial Undertakings lays down the criteria on which the Financial Stability Committee (FSN) must base its methodology for determining which supervised entities shall be considered to be of national systemic importance, and which financial institutions shall maintain O-SII capital buffers. The Committee uses the methodology provided for in the EBA Guidelines.[1] The assessment entails assigning a score to each financial institution based on its share in the domestic system according to a set of predefined indicators. Table 1 shows the indicators used in each category. Furthermore, the FSN takes account of specifically Icelandic circumstances and considers expert opinion when making the assessment. Expert opinion is important because some of the indicators provided for in the EBA Guidelines are based on markets that have limited applicability in Iceland. It is also important as the law stipulates that institutions shall only be designated as being of national systemic importance if they can affect financial stability.

[1] EBA/GL/2014/10

Table 1 Categories and indicators in EBA methodology for assessment of national systemic importance

Category	Indicator	Weight
Size	Total assets	25%
Importance	Domestic retail payment transactions	8.33%
	Private sector deposits	8.33%
	Private sector loans	8.33%
Complexity	Value of OTC derivatives (notional)	8.33%
	Cross-jurisdictional liabilities	8.33%
	Cross-jurisdictional claims	8.33%
Interconnectedness with the financial system	Intra financial system liabilities	8.33%
	Intra financial system assets	8.33%
	Debt securities outstanding	8.33%

Table 2 shows the scores assigned to the three large banks and other financial institutions in the 2024 assessment of systemic importance, in accordance with EBA Guidelines but with consideration given to specificities of the Icelandic economy. The total number of points assigned is 10,000. The three large banks combined received 86% of points assigned, with each of them receiving 27-30%. In terms of total assets, the banks' share in the size of the financial system was 80%. Their share in private sector deposits was 94%, and their share in private sector lending was just under 90%. The three banks also held a substantial share of the financial system's cross-border assets (88%) and liabilities (95%). It is therefore clear that each of the banks is systemically important at the national level, as the failure of any one of them would probably have a severely negative impact on financial stability in Iceland, as well as spreading to other financial institutions and to the economy more broadly. The other eleven entities included in the assessment received a combined 14% of total points, and it is unlikely that any of them could be considered of national systemic importance.

Table 2 Results of assessment of systemic importance of domestic financial institutions based on Financial Stability Committee methodology and the 2023 annual accounts of the financial institutions concerned

Category	Arion Bank	Íslandsbanki	Landsbankinn	Others
Size (2,500 points)	606	629	779	485
Importance (2,500 points)	720	726	880	173

Complexity (2,500 points)	807	740	692	261
Interconnectedness with the financial system (2,500 points)	742	951	323	484
Total (10,000 points):	2,876	3,046	2,675	1,403

Assessment of O-SII capital buffer value

According to Article 86(d), Paragraph 1 of the Act on Financial Undertakings, the O-SII buffer value shall range between 0% and 3% of risk-weighted assets, although it may be higher if the Standing Committee of the EFTA States gives its approval. Since 2016, when the O-SII first took effect in Iceland, Arion Bank, Íslandsbanki, and Landsbankinn have maintained a buffer rate of 2%, the maximum provided for by law at that time. The maximum was increased to 3% in 2022, when the Capital Requirements Directive (CRD-V) was incorporated into Icelandic law. Because of how important these three banks are for the Icelandic financial system, it is deemed appropriate to use the maximum scope afforded by law and impose an O-SII buffer rate of 3% on all of the banks' exposures.

4 December 2024

Memorandum

Re: Background to the decision on the systemic risk buffer

Volatility of economic variables in Iceland has receded since the global financial crisis of 2008. Furthermore, volatility has diminished proportionally relative to comparison countries. An analysis of concentration in the Icelandic economy suggests that concentration has not been reduced overall, but that the relative importance of individual sectors has changed over time. Other systemic changes that have taken place since the financial crisis, which centre mainly on increased economic resilience, could explain why economic variables are more stable. Among them are Iceland's positive net international investment position (NIIP) and strong international reserves. Also worth considering is the change that has taken place in the financial system with the implementation of the European CRD IV/CRR regulatory framework. The CRD IV/CRR framework is based on the international Basel III standard and the application of macroprudential tools, which are designed to bolster financial system resilience and reduce the likelihood of shocks and their adverse effects. There are strong indications that structural, or built-in, systemic risk in Iceland has diminished since the systemic risk buffer was first activated in 2016.

Application of the systemic risk buffer in Iceland

The systemic risk buffer is imposed in Iceland in order to offset risk that can be attributed to the unique characteristics of the Icelandic economy. Iceland is a small open economy with an independent currency. External trade and a small number of export sectors are an important pillar of the domestic economy. Furthermore, the Icelandic economy is relatively homogeneous, and there is a high level of concentration in a few large sectors. Its small size and homogeneity make the Icelandic economy more vulnerable to economic shocks than it would be otherwise, as is reflected in greater economic volatility than is generally seen in neighbouring countries. This affects credit risk and the probability of loan losses. For these reasons, it is deemed necessary to ensure that deposit institutions are highly resilient against the structural systemic risk in the Icelandic economy.

The systemic risk buffer was first activated in Iceland on 1 April 2016. At that time, a 3% systemic risk buffer was imposed on the entire domestic portion of the deposit institutions' risk-weighted assets, or risk base.[1] The rationale behind the imposition of the systemic risk buffer was published concurrent with the decision to activate it, and

[1] Financial Stability Council (2016).

the buffer value has been held unchanged since. According to Article 86 of the Act on Financial Undertakings, no. 161/2002, the buffer is reviewed at least every other year. The rationale is based primarily on analysis of historical data on business and financial cycles, volatility of economic variables, and concentration in economic sectors. Furthermore, volatility of economic variables in Iceland has been reviewed against a sample of comparison countries. The comparison has shown that volatility is generally greater in Iceland than in the other countries, which is consistent with the findings from studies conducted on the Icelandic business and financial cycles.[2]

An updated assessment of the volatility of economic variables in Iceland suggests that volatility has been declining in recent years. The summarised results of the comparison of volatility over two periods can be seen in Table 1. A comparison of developments in Iceland and abroad also indicates that measured volatility in Iceland was closer to that in the comparison countries during the latter part of the period, and that developments were more positive in Iceland than in most of the other countries. The summarised results of the comparison between Iceland and the full sample can be seen in Table 2.

Table 1: Comparison of economic volatility in Iceland over two periods

(percentage points)	1996-2023	2011-2023	Difference
Gross domestic product	3,9	3,7	-0,2
Private consumption	5,3	3,4	-1,9
Public consumption	2,6	2,1	-0,6
Investment	17,1	9,2	-7,9
Export	9,4	12,4	3,0
Import	12,7	11,7	-1,0
Consumer price index	3,0	2,3	-0,6
Inflation (Average, %)	4,5	3,9	-0,7
Real exchange rate	8,4	6,3	-2,1
St.dev of unemployment	1,6	1,4	-0,2

Volatility is calculated as the standard deviation of the year-on-year change in each economic variable. The values show standard deviation in percentage points unless otherwise stated.

Table 2: Country comparison of economic volatility

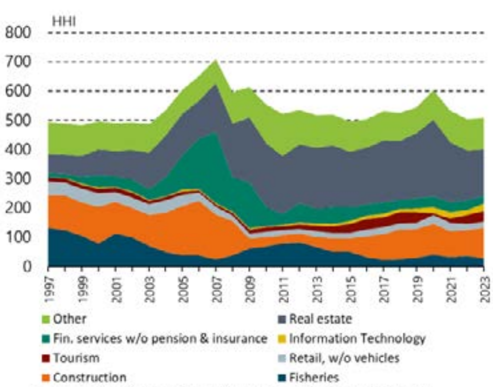
(rank)	1996-2023	2011-2023	Difference
Gross domestic product	18	17	-1
Private consumption	20	15	-5
Public consumption	18	15	-3
Investment	20	15	-5
Export	20	23	3
Import	23	22	-1
Consumer price index	18	10	-8
Inflation (Average, %)	19	20	1
Real exchange rate	20	20	0
St.dev of unemployment	11	12	1

The values show the rank of Iceland in a country comparison of economic volatility. The sample includes 23 countries. An increase in the value corresponds to a relative increase in volatility compared to other countries in the sample. *Data on real exchange rate only covers 20 states.

[2] See Central Bank of Iceland (2012), Einarsson *et al.* (2013), and Einarsson *et al.* (2015).

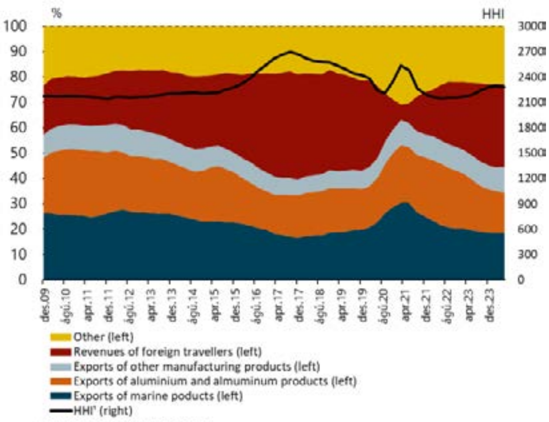
The rationale for imposing a systemic risk buffer in Iceland has included a discussion of the country's homogeneous economy and high level of concentration, particularly in export sectors. The Herfindahl-Hirschman index (HHI) is commonly used to measure market concentration. Statistics Iceland publishes a range of descriptive statistics on the importance of individual sectors in the economy, including their share in GDP, their production value, their employee compensation costs, and the number of workers they employ. Taken together, developments in the HHI for these variables do not indicate that concentration has diminished in the Icelandic economy in recent decades, but they do suggest that the relative importance of sectors has changed over time. In terms of contribution to GDP, the fishing industry has receded in in the past ten years, as have the financial services and real estate sectors, while tourism and IT services have gained in importance. Furthermore, the construction sector has gained considerable ground, although its weight in GDP generally fluctuates with the business cycle. In the labour market, developments have been broadly comparable, but also with an increase in the weight of public sector jobs such as in healthcare and education. Iceland's export revenues are highly concentrated, with around ⅔ of revenues coming from only three sectors: tourism (32%), fishing (18%), and aluminium manufacture (16%). The HHI for concentration in goods and services exports shows little change overall since 2009, apart from temporary spikes in connection with the tourism boom (2015-2017) and the pandemic (2020-2021).

Gross Domestic Product by industries[1]



1. Herfindahl-Hirshman index. Yearly data. Public administration, education, health and social work activities not included.
Sources: Statistics Iceland, Central Bank of Iceland.

Concentration of exports of goods and services



1. Herfindahl-Hirshman index.
Sources: Statistics Iceland, Central Bank of Iceland.

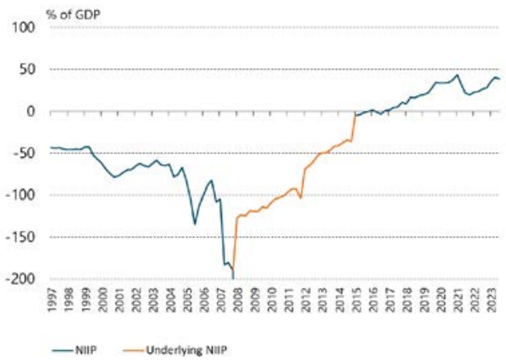
Resilience has grown

In the wake of the financial crisis of 2008, supervision of the Icelandic financial system was tightened significantly, including the implementation of the European CRD IV/CRR) regulatory framework, which is based on the international Basel III standard. Furthermore, the macroprudential requirements made of the banks have been increased materially. In Iceland, financial crises have often occurred in the wake of shocks to the real economy and have had an amplifying effect on economic crises.[3] The application of macroprudential tools such as capital buffers, liquidity rules, and restrictions on

[3] Einarsson *et al.* (2015).

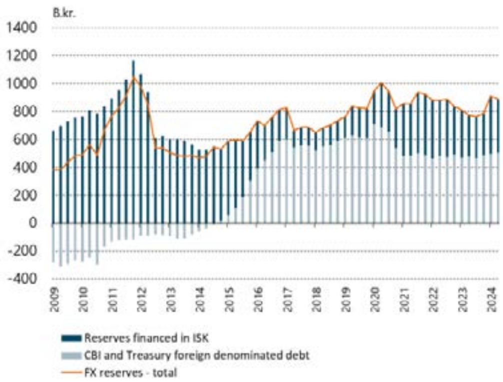
mortgage lending are intended to bolster financial system resilience, reduce the likelihood of financial crises and the associated repercussions, and thereby support financial and economic stability. Increased national saving can be seen, for instance, in the fact that Iceland's net international investment position (NIIP) has improved vastly since 2008 and has been positive since 2016. A sustained current account surplus was used to build up the Central Bank's international reserves, which grew substantially over this period and have been above key reserve adequacy benchmarks ever since. A strong NIIP and ample international reserves have shored up Iceland's economic resilience and fostered increased stability.

Net international investment position[1]



1. Based on underlying position from 2008 through end-2015; i.e., adjusted for the effects of settling the failed banks' estates and assuming equal distribution of assets to general creditors. Ársfjórðungslegar tölur.
Sources: Statistics Iceland, Central Bank of Iceland.

Central Bank of Iceland foreign exchange reserves



1. Reserves financed in ISK are foreign exchange reserves net of Central Bank and Treasury foreign-denominated debt.
Sourcesr: Hagstofa Íslands, Seðlabanki Íslands.

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Reduction in systemic risk buffer and increase in capital buffer for systemically important financial institutions

4 December 2024

Published yesterday in the Law and Ministerial Gazette are new Central Bank of Iceland Rules on Systemic Risk Buffers for Financial Undertakings, no. 1414/2024, and new Rules on Capital Buffers for Systemically Important Financial Undertakings, no. 1415/2024. Both sets of rules were approved at a meeting of the Financial Stability Committee (FSN) on 3 December 2024.

With Rules no. 1414/2024, the systemic risk buffer (SyRB), which applies to all domestic exposures of deposit-taking financial institutions, is reduced from 3% to 2%. With Rules no. 1415/2024, the capital buffer for other (non-global) systemically important financial institutions (O-SII) has been increased from 2% to 3% of all exposures.

In the FSN's opinion, systemic risk in the domestic economy has subsided since the systemic risk buffer was first introduced in 2016. The financial system has grown more resilient, as can be seen in reduced volatility of key economic variables despite various shocks. Furthermore, new macroprudential tools have proven their value, and the financial stability framework is sturdier than before. As a result, the Committee decided to lower the systemic risk buffer rate.

According to the FSN, the increase in the O-SII buffer rate aims to capture more effectively the risk facing the economy as a result of the size and scope of systemically important financial institutions.

The systemic risk buffer is reviewed every two years, and the O-SII buffer is reviewed annually.

More detailed information on the background to the FSN's decisions can be found here:

Memorandum – Background to the decision on the systemic risk buffer
Memorandum – Background to the decision on the capital buffer for other systemically important financial institutions

4 December 2024

Criteria for the determination of the countercyclical capital buffer

Introduction

The countercyclical capital buffer (CCyB) is intended to underpin financial institutions' financial strength and attempt to ensure that access to credit is not seriously curtailed during distressed periods, which could exacerbate the impact of economic shocks on the financial system and the economy.[1]

The risk facing the financial system is uncertain at any given time. The Central Bank of Iceland Financial Stability Committee (FSN) therefore considers it appropriate, all else being equal, to maintain a CCyB rate of 2-2.5% of the domestic risk base. This provides the scope to lower the CCyB when unexpected shocks strike, thereby affording financial institutions the flexibility to absorb loan losses during a downturn. This is referred to as a positive neutral CCyB. If signs of elevated financial system risk emerge, the FSN can increase the buffer rate. If the risk materialises, however, the Committee will lower the buffer rate or set it at 0%. This gives financial institutions the leeway to address loan losses and maintain a sufficient supply of credit. The CCyB is thereby intended to support both financial institutions' resilience and the stability of the financial system. The FSN will endeavour to provide guidance on when, and under what circumstances, the buffer rate will be increased again. Account will be taken of the macroeconomic cost of increasing capital requirements and the impact it will have on economic recovery.

The FSN will review the positive neutral CCyB rate on a regular basis.

Statutory provisions on the imposition of the CCyB

According to Article 85 of the Act on Financial Undertakings, no. 161/2002, the Central Bank is authorised, subject to Financial Stability Committee approval, to lay down rules requiring financial institutions to maintain a CCyB. The buffer is among widespread changes in international financial institutions' capital requirements, which have been adopted in Europe with Council Directive 2013/36/EU (CRD IV) and Regulation (EU) no. 575/2013 (CRR), with subsequent amendments. Both of these have been incorporated into Icelandic law in the Act on Financial Undertakings.

The FSN determines the CCyB rate on at least a quarterly basis; cf. Article 85(a), Paragraph 5 of the Act on Financial Undertakings. The buffer shall be a multiple of 0.25 percentage points and shall generally range between 0% and 2.5% of the domestic risk base, unless

[1] A detailed discussion of capital requirements and financial stability can be found (in Icelandic) in a Central Bank *Special Publication* from 2021: https://www.sedlabanki.is/utgefid-efni/rit-og-skyrslur/rit/2021/06/16/Ser-rit-15-Eiginfjarkrofur-og-fjarmalastodugleiki/

risk factors underlying the FSN's assessment give particular cause to set a higher rate; cf. Article 85(a), Paragraph 3 of the Act.[2]

A reduction in the CCyB takes effect at the time the decision is made to lower it; cf. Article 84(d), Paragraph 3 of the Act on Financial Undertakings. The minimum length of time before the buffer will be increased again must be specified. This provides financial institutions with a given amount of certainty that the leeway afforded them with the reduction in the buffer will not be taken away again without advance notice. An increase in the CCyB takes effect twelve months after a decision to that effect is announced, unless extraordinary circumstances require otherwise; cf. Article 85(d), Paragraph 1.

According to Article 85(a), Paragraph 4 of the Act on Financial Undertakings, the CCyB rate shall take account of cyclical systemic risk. The assessment of cyclical systemic risk shall take account of the debt cycle, particularly the credit-to-GDP gap, risk stemming from excess credit growth in Iceland, and other relevant factors. Consideration shall also be given to the characteristics of the Icelandic economy. The Committee's decision and the underlying rationale shall be published on the Central Bank of Iceland website, in accordance with Article 85(e) of the Act on Financial Undertakings.

Positive neutral CCyB

The FSN's policy of maintaining a positive CCyB when there is no indication of a particularly high or low level of risk in the financial system is based primarily on general uncertainty about the risk facing the financial system at any given time. The COVID-19 pandemic is an excellent example of such uncertainty. Furthermore, the macroeconomic cost of building up capital is lower during an economic upswing than it is when risk has materialised.

In determining the positive neutral buffer rate, the FSN considers developments in financial institutions' capital ratios in the Central Bank's stress tests, among other things. Another factor considered is Iceland's exposure, as a small open economy, to external shocks and to policy decisions made by other comparable economies.

Reducing the CCyB

The FSN lowers the buffer rate or sets it at 0% if there is a significant likelihood of a shock that will lead to sizeable losses in the financial system due to reduced economic activity and a decline in asset prices when risk materialises.

Overall, shocks that require or warrant a change in the CCyB may be of two types. On the one hand are shocks that can materialise at a turning point in the financial cycle, after risk has accumulated over time due to, for instance, excess indebtedness, overheated asset markets, and insufficient resilience among lenders and borrowers. The FSN is obliged to respond to elevated risk of this type by increasing the CCyB and applying other macroprudential tools. The second type includes shocks that can materialise when unexpected events – such as global pandemics or large-scale natural disasters – cause

[2] The risk base is the sum of credit risk, market risk, and operational risk. The share of the risk base considered domestic in the sense of Article 85(a) of the Act on Financial Undertakings is determined solely by the geographical distribution of credit risk. The CCyB requirement imposed by foreign countries is added to Icelandic financial institutions' risk base in proportion to the institutions' credit risk within the countries concerned.

the economic outlook to deteriorate markedly. The severity of the impact the shock will have, all else being equal, on the economy and on financial institutions' capital is of vital importance to the FSN's decision to lower the CCyB.

When the CCyB is lowered, capital requirements made of financial institutions are reduced. All else being equal, this gives financial institutions the scope to work through loan losses, thereby supporting their lending capacity and appetite. Lowering the buffer therefore mitigates the risk of a tightening of lending conditions that would exacerbate the effects of the shock and deepen the downturn.

If the CCyB has been raised above the positive neutral level without straining financial institutions' capital, the FSN will lower the buffer again when there are clear signs of an ongoing decline in systemic risk and a better balance in the domestic economy and financial system.

Increasing the CCyB

When the FSN announces a reduction in the CCyB, it provides guidance on the conditions that could cause the buffer to be raised again. With this increased predictability, the Committee attempts to maximise the positive economic impact of the flexibility provided by lowering the buffer rate. An increase in the buffer takes effect twelve months after the increase is announced unless extraordinary circumstances require otherwise.

The FSN raises the CCyB above the positive neutral level when there are indications that cyclical systemic risk is above average and rising. This creates greater scope to lower the buffer later, if conditions deteriorate or a shock strikes the financial system. Ensuring that financial institutions are adequately capitalised reduces the probability of financial shocks and the social cost accruing from them, in part by mitigating the risk that the financial system will amplify the effects of the shocks. Increasing the CCyB can also stave off growth in systemic risk. However, a decision to raise the buffer rate must take account of the macroeconomic costs as well as the benefits.

Umræðuskýrsla um TARGET-þjónustur Evrukerfisins

19. desember 2024

Seðlabanki Íslands hefur gefið út sérrit um TARGET-þjónustur Evrukerfisins. Það er umræðuskjal þar sem settar eru fram spurningar til hagaðila og annarra sem vilja láta sig málið varða.

Seðlabankinn tekur við ábendingum og svörum á póstfangið sedlabanki@sedlabanki.is, en þau þurfa að berast í síðasta lagi fyrir 1. mars 2025.

Svörin verða nýtt við hagkvæmnismat sem nú fer fram vegna mögulegrar innleiðingar á TARGET-þjónustunum.

Sérritið er aðgengilegt hér: Sérrit nr. 19. Umræðuskýrsla. Target-þjónustur Evrukerfisins.

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