The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 22-23 June 2020 (4th meeting)

Published: 21 July 2020

The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the applications of the Central Bank of Iceland's financial stability policy instruments. "The Financial Stability Committee's decisions on the application of financial stability policy instruments shall be published and an account given of the rationale for the decisions, together with an assessment of the situation, and minutes on the topic shall be published unless such publication can be expected to have an adverse impact on financial stability." In accordance with the Act, the Financial Stability Committee (FSN) has decided that, in general, it will publish the minutes of its meetings within four weeks.

The following are the minutes of the FSN meeting held on 22 and 23 June 2020. Part of the meeting on 23 June was a joint meeting of the Financial Stability Committee and the Monetary Policy Committee. Members decided at the meeting to hold the countercyclical capital buffer unchanged. The FSN also agreed that the Central Bank should implement a special temporary collateralised loan framework to finance support loans bearing a 100% Treasury guarantee.

I Financial stability developments and prospects

Committee members discussed financial stability developments and prospects, the economic situation, developments in the domestic financial markets, the position of and risks in the financial system and in the operations of individual financial institutions, the financial cycle, the real estate market, powers of resolution, and support loans. Underlying the discussion was information on developments and prospects since the Committee's last meeting, held in late March.

The economy

The COVID-19 pandemic and the associated public health measures have had a profound impact on the domestic economy. According to the Central Bank's most recent macroeconomic forecast, published in *Monetary Bulletin* 2020/2, GDP will contract by 8% this year, the deepest single-year contraction in a century. The airline and tourism industries have borne the brunt of the damage, and the largest contraction in exports in the history of measurements is in the offing. This has been partially offset by a contraction in imports and an improvement in terms of trade. Private consumption contracted sharply year-on-year in March and April but rebounded in May. Job numbers have fallen steeply, and unemployment has risen. Unemployment is forecast to peak in Q3 and to measure just under 9% in 2020 as a whole. Inflation has not risen despite the depreciation of the króna, as lower oil prices and a worldwide decline in food and commodity prices have held inflation in check. Furthermore, inflation expectations have remained at target.

Financial markets

Foreign equity markets had rallied significantly since the Committee's March meeting, supported by government measures aimed at expanding access to capital and lowering financing costs. There were also expectations that the pandemic might be on the wane.

Comparable trends could be seen in the domestic equity market. The OMXI10 index had risen by over a fifth between FSN meetings, largely because of shares in Marel, which account for over half of the index in terms of market capitalisation and rose in price by nearly 30% during the period. Bond market yields had fallen in line with the decline in Central Bank interest rates, more on the short end of the yield curve than on the long end. This could be due to financial institutions' interest in buying short Treasury bonds and Treasury bills for liquidity management purposes after the Central Bank stopped offering one-month term deposits in May. Market yields had fallen to historical lows, and real rates on indexed one- and five-year Treasury bonds had turned negative.

The exchange rate of the króna was broadly the same as at the time of the FSN's previous meeting. The market appeared to be relatively shallow. The statement published by the Icelandic Pension Funds Association, urging the pension funds to refrain from purchasing foreign currency, supported the exchange rate but simultaneously reduced market depth, particularly on the buying side. The Central Bank has intervened in the foreign exchange market several times in order to mitigate volatility. The Bank's transactions year-to-date accounted for 17% of total market turnover. There had been no signs of capital outflows from Iceland. In the first five months of the year, new investment was negative by 5 b.kr., whereas from March through May it was positive by 2 b.kr.

Developments in private sector debt

Growth in household debt has held broadly unchanged in the recent term and measured 4% in real terms at the end of March. The weight of non-indexed debt has increased even further, to nearly a third of total household debt. Growth in corporate debt was negative by 0.3% at the end of March, however, after adjusting for price and exchange rate movements. This trend has been building up for quite a while, with corporate credit growth starting to slow in 2019, partly because of the poorer economic outlook and credit institutions' repricing of risk.

The banking system

Both the Central Bank and the Government have adopted broad-based measures aimed at mitigating the shock to households and business and supporting the financial system. Central Bank measures have aimed at easing the monetary stance and ensuring increased liquidity in circulation in order to support demand and enable financial institutions to cover loan losses.

The three large banks' liquidity position remains strong, although they may well have to tap their liquidity buffers when the full impact of the pandemic has emerged. On 10 June 2020, the banks' liquid assets in excess of liquidity requirements totalled 270 b.kr. an increase of nearly 20 b.kr. between FSN meetings. Stress tests of their liquidity suggest that the banks can tolerate large-scale outflows.

Premia on the banks' foreign bond issues had fallen by nearly 50 basis points since the FSN's last meeting. The banks' generous foreign liquidity position gives them continued flexibility to respond to these challenging market conditions without seeking foreign market funding. The credit spreads on the banks' covered bonds relative to Treasury bonds had fallen between FSN meetings and were back roughly to where they were at the beginning of the year.

The three large banks' operating losses in Q1/2020 totalled just over 7 b.kr. Their Q1 accounts were affected by an increase in impairment, which totalled nearly 12 b.kr. during the quarter. Further impairment is expected in the quarters to come. In spite of this, the banks' capital position is very strong, and their average capital ratio was 24.5% at the end of March, as compared with 22.4% at the end of December 2019. Stress tests carried out on the banks suggest that their capital position is very strong. A strong capital position and the suspension of the countercyclical capital buffer gives the banks the scope they need to withstand increased loan losses while simultaneously maintaining lending activity.

As of 10 June 2020, some 380 b.kr., or 12% of the three large banks' loans to customers, were in moratorium because of the pandemic. Moratoria are more common among corporate borrowers, at about 16% of the banks' corporate loan portfolios, than among households, some 9% of which are in moratorium. Nearly half of loans to tourism companies are in moratorium, as well as a fifth of loans to services companies and 10% of loans to businesses in retail and wholesale trade. The ratio is lower among companies in other sectors. There are signs that arrears (0-90 days) are on the rise.

Real estate market

The real increase in capital area house prices measured 1.1% year-on-year in May. Condominium prices were up by 1.7%, while detach housing prices were down 1.4%. In regional Iceland, prices had increased by 7.8% in May. Turnover shrank significantly in April but picked up again in May, most likely in reflection of public health measures. Capital area house prices have moved generally in line with their economic determinants in recent years. Indicators implied that households were refinancing their mortgages as a result of lower interest rates and moving increasingly from indexed to non-indexed mortgages. There also appeared to be a shift in household mortgage financing from the pension funds to the banks, which are now offering lower non-indexed interest rates than most of the pension funds do.

The commercial real estate price index in the capital area continued to fall in Q1/2020. By the end of March, the year-on-year decline measured 12% in real terms, up from just over 2% at the end of December. The effects of the pandemic will probably show even more clearly in

Q2. The supply of hotel and guesthouse space continues to increase, with some 51,000 square metres — about a fifth of the current total space available — now under construction in greater Reykjavík. The amount of commercial bank loans secured by lodging-based property and bearing a loan-to-value ratio of over 70% increased by nearly 15% in real terms in 2019.

The financial cycle

Quarterly data indicate that the upward financial cycle had peaked by end-2019 and Q1/2020. The private sector debt cycle was still rising, while the housing and financing cycles had by and large plateaued. The pandemic response measures taken by the Central Bank and the Government could reboot the housing cycle, and the debt cycle is likely to start rising again, particularly because of increased mortgage lending to households and bridge loans and support loans to businesses. All of this could revive the financial cycle. In general, though, risk appetite in the financial system appears to have diminished in recent years, which could have a negative impact on the upward financial cycle if this situation persists.

Resolution authority

The Committee received a presentation on the contents of the new Act on Recovery and Resolution of Credit Undertakings and Securities Firms, passed by Parliament on 15 June 2020. The Act enters into force on 1 September 2020. The Act incorporates the bulk of EU Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms (the bank recovery and resolution directive, or BRRD) into Icelandic law. Powers of resolution entail the administrative authority to adopt and implement measures and tasks relating to the preparation and execution of resolution measures for financial undertakings; i.e., dealing with individual entities' operational difficulties and shocks with the aim of minimising the adverse impact on the financial system as a whole. According to the new Act, this resolution authority will be part of the Central Bank.

Support loans

On 25 May 2020, the Central Bank of Iceland and the Ministry of Finance and Economic Affairs made an agreement under which the Bank will handle the granting of Treasury guarantees vis-à-vis credit institutions. The aim of support loans is to maintain employment and economic activity by supporting small businesses that have suffered a temporary drop in revenues because of the pandemic and the associated public health measures. This both reduces the likelihood that these businesses will default on their loans and boosts financial system loan quality. The loans fall into two categories: on the one hand, loans in amounts ranging up to 10 m.kr. and bearing a 100% Treasury guarantee, a loan period of up to 30 months, and interest rates equal to the Central Bank's seven-day term deposit rate as current at any given time; and on the other hand, loans ranging from 10-40 b.kr., bearing an 85% Treasury guarantee, a loan period of 30-48 months, and interest rates equal to the Central Bank's seven-day term deposit rate plus a premium charged by the lending institution concerned.

II Decisions pertaining to financial stability

The Committee discussed, in general, the easing of the policy stance as a result of the pandemic. Low — and even negative — interest rates have been in place in many economies for quite some time, and this, together with a more accommodative financial stability policy stance, has fuelled concerns about the status of financial stability. In Iceland, however, the situation is different, and the more relaxed stance is a recent development stemming from the bleak economic outlook. In spite of the more accommodative stance, the FSN is not yet worried about the status of financial stability. The increase in financial system liquidity does not appear to have led to increased corporate lending, and businesses' access to financing through the banking system may be limited to a degree. In recent months, private sector credit growth seems to have been restricted almost entirely to household mortgage lending. As a result, excessive growth in debt and unsustainable asset market price hikes do not yet give cause for concern in Iceland. Committee members considered it important, however, that all should be well aware that the current situation was a temporary one. The policy stance would have to be tightened again once the effects of the pandemic and associated public health measures had tapered off.

Countercyclical capital buffer

The Governor proposed that the countercyclical capital buffer be held unchanged at 0%, in accordance with the Committee's March 2020 statement announcing that it would keep the buffer unchanged until at least March 2021. All Committee members voted in favour of the proposal.

Financing of support loans

The Committee discussed the importance of encouraging credit institutions to grant support loans— among other things, because these loans could help viable small companies avoid insolvency, thereby improving financial system loan quality and supporting financial stability. It emerged at the meeting that, other things being equal, the loans would lower credit institutions' liquidity ratios and liquid assets, just as other loans do.

The Committee discussed the advantage of implementing a special temporary collateralised lending framework to guarantee credit institutions access to short-term funding at lower interest rates, so as to finance the support loans with a 100% guarantee. These loans were also the premise for the provision of support loans with an 85% guarantee. Such a framework would support lending appetite in the financial system, which was desirable under the current circumstances.

In view of the discussion, the Governor proposed that, because of the uniqueness of support loans bearing a 100% Treasury guarantee and the circumstances currently prevailing due to the pandemic, the Central Bank would develop a separate temporary collateralised lending framework for support loans, subject to the terms offered at any given time on seven-day term deposits with the Central Bank. All members voted in favour of the proposal.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Financial Stability Committee

Gunnar Jakobsson, Deputy Governor for Financial Stability

Rannveig Sigurdardóttir, Deputy Governor for Monetary Policy

Unnur Gunnarsdóttir, 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 Bank's Financial Stability Department, was present for the entire meeting. In addition, a number of Bank staff members attended part of the meeting.

Eggert Th. Thórarinsson wrote the minutes.