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.