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

[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.

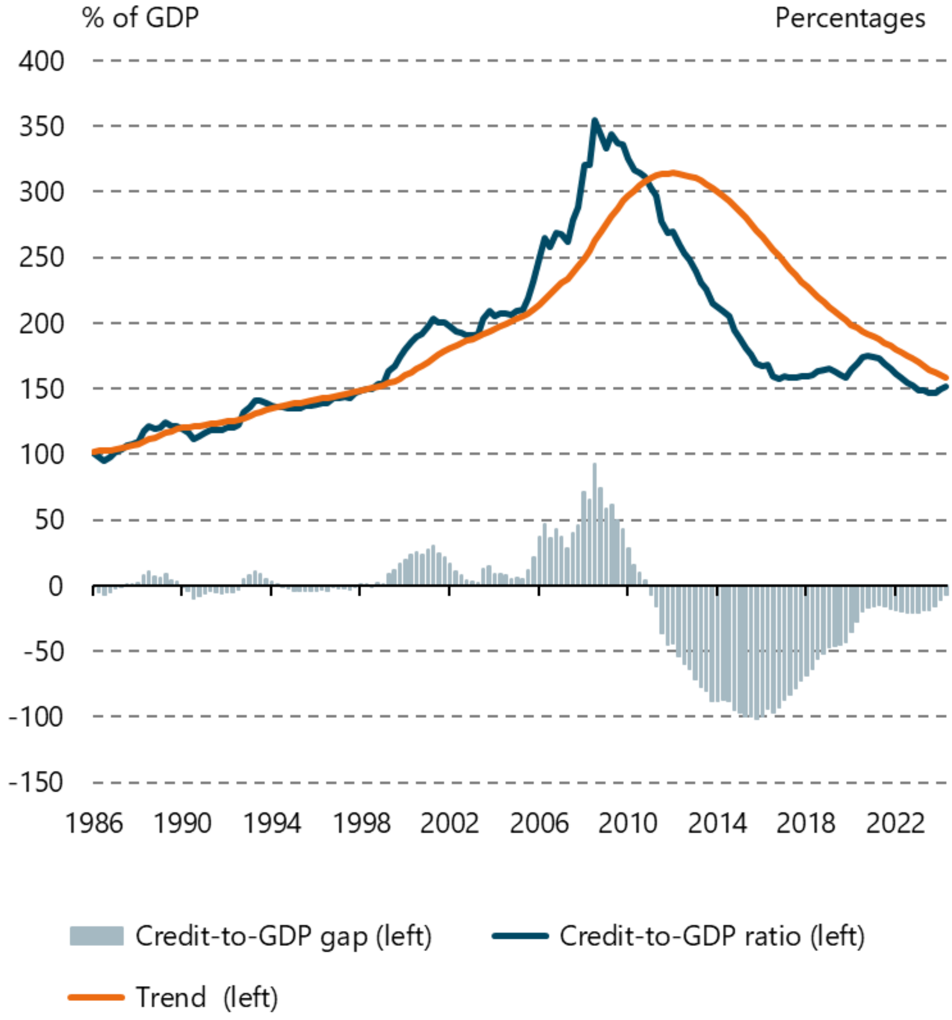
The combined effect of higher interest rates and tighter lending requirements appears to have impeded the rise in house prices and somewhat mitigated imbalances in the market. The number of homes for sale has risen, and the average time-to-sale has grown longer in recent months. Imbalances remain between 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

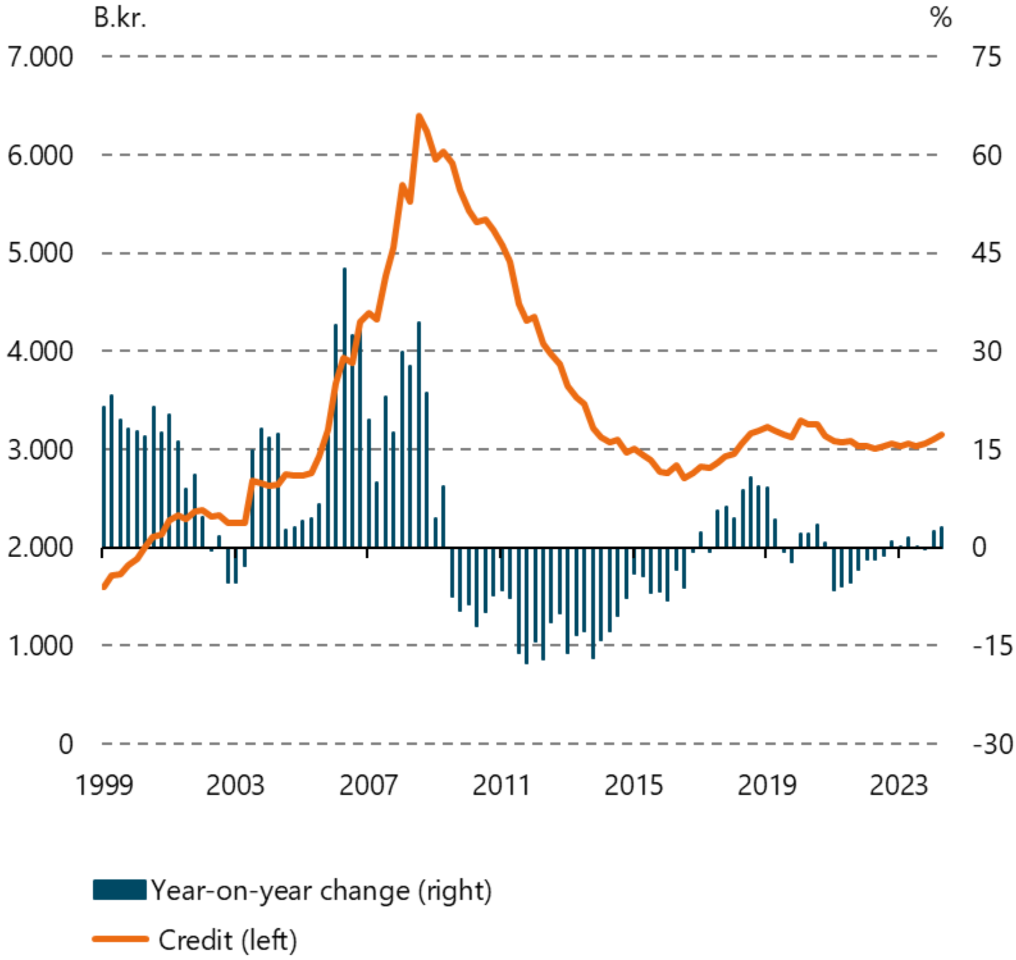
Credit-to-GDP ratio and gap[1]
Q1/1986 - Q2/2024



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]

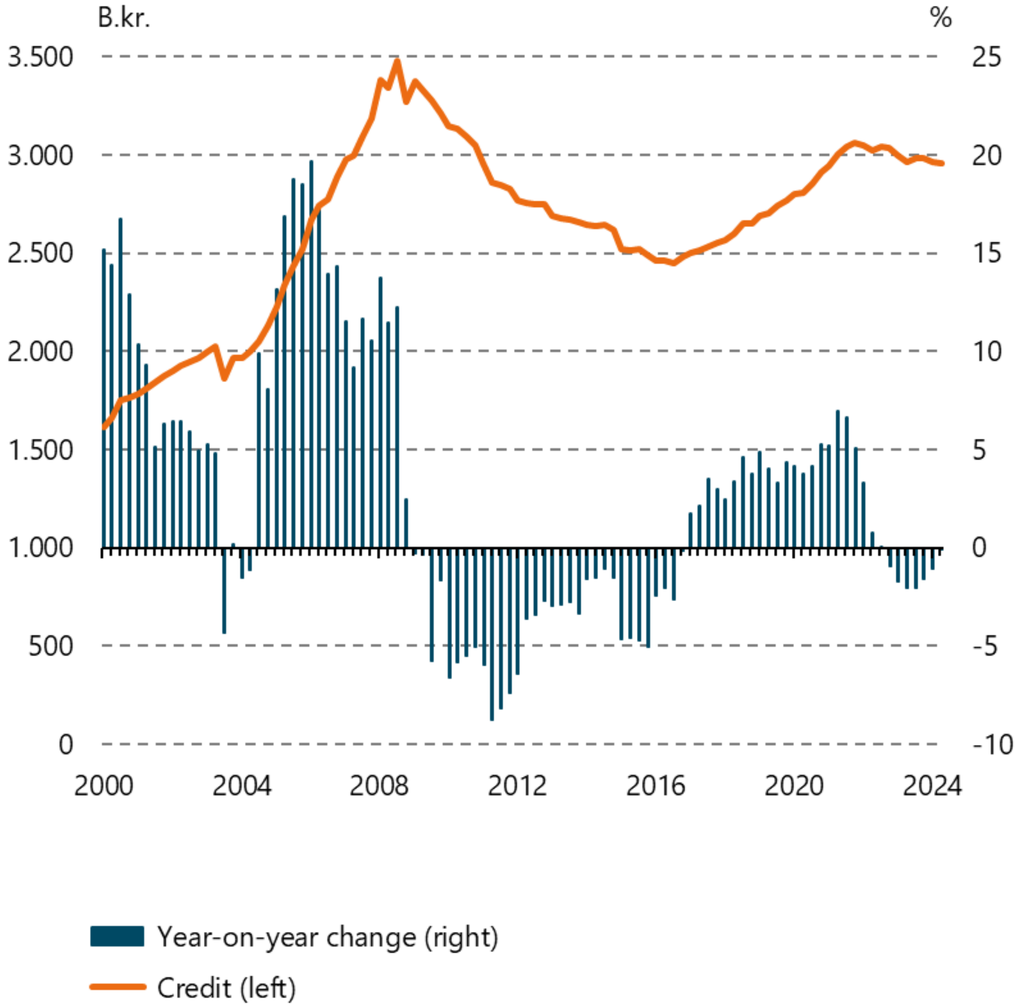
Q1/1999 - Q2/2024



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]

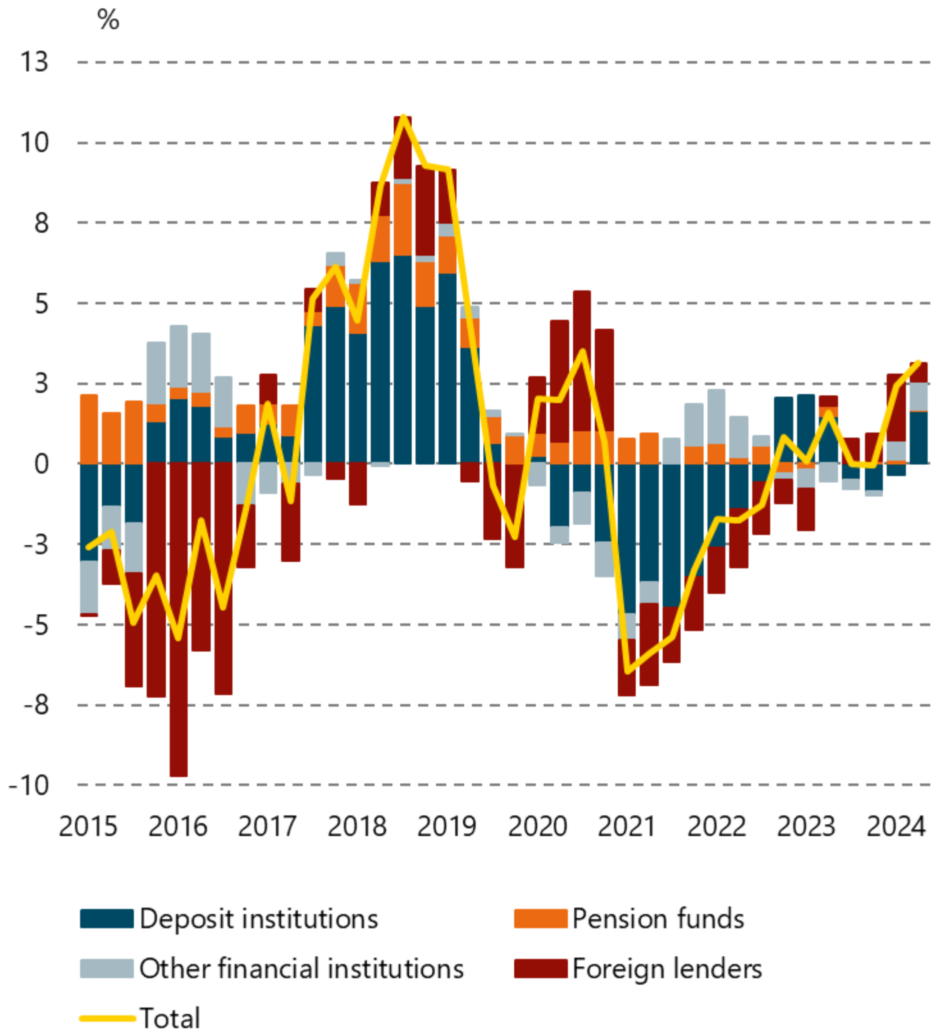
Q1/2000 - Q2/2024



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

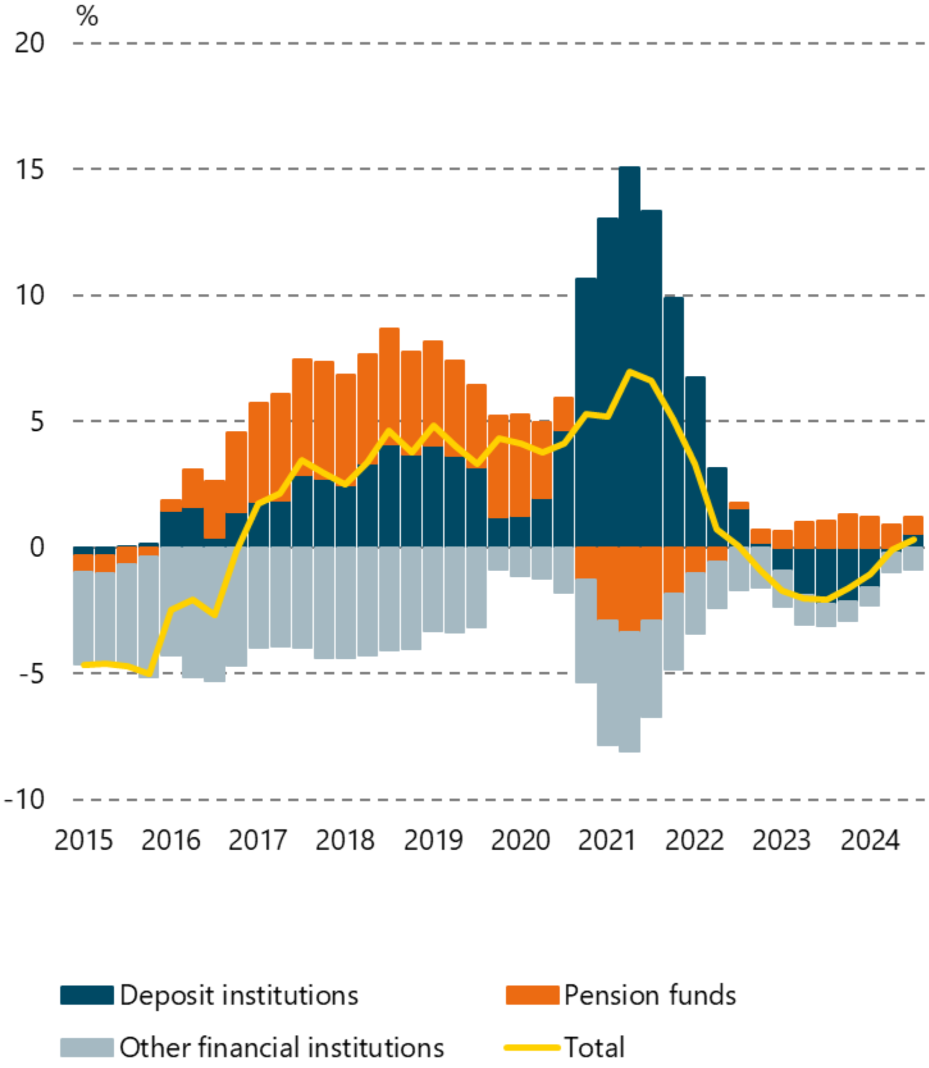


1. Debt to financial institutions and issued marketable bonds, deflated with the CPI. Real year-on-year change in aggregate and contribution of each lender type.

Sources: Statistics Iceland, Central Bank of Iceland.

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

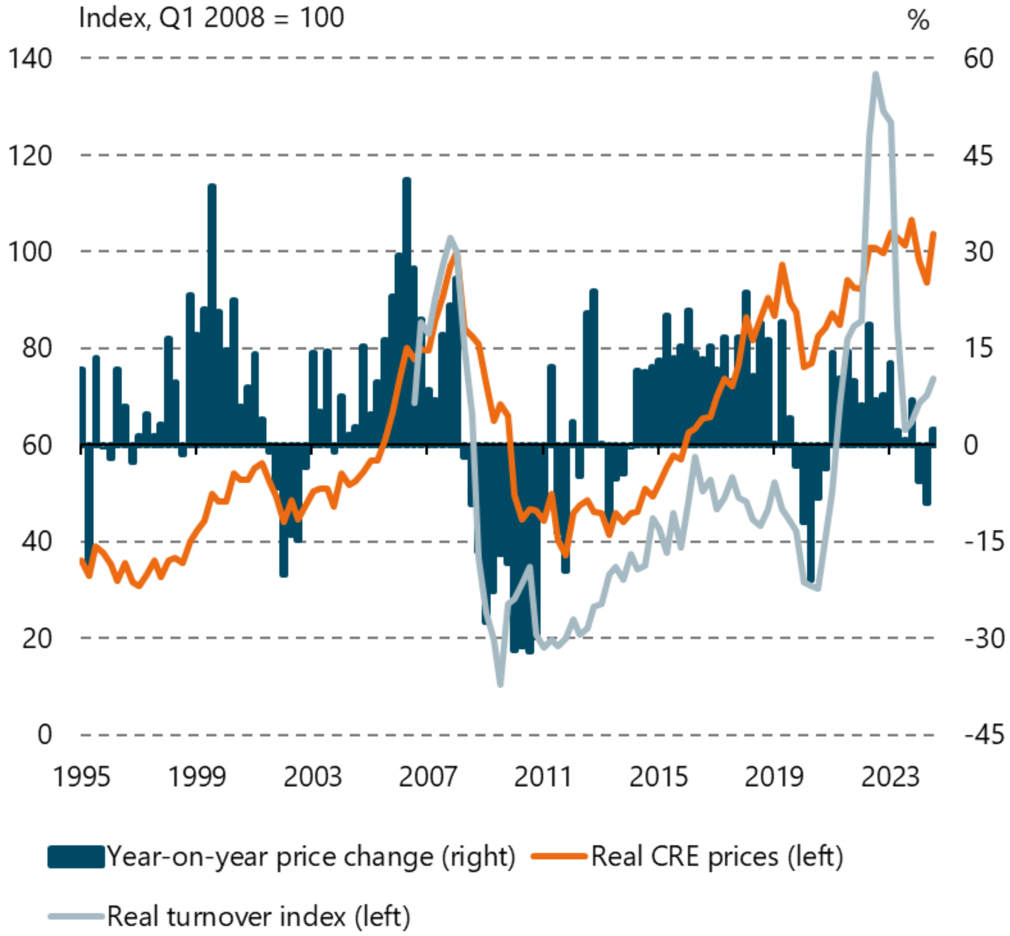
Q1/2015 - Q3/2024



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

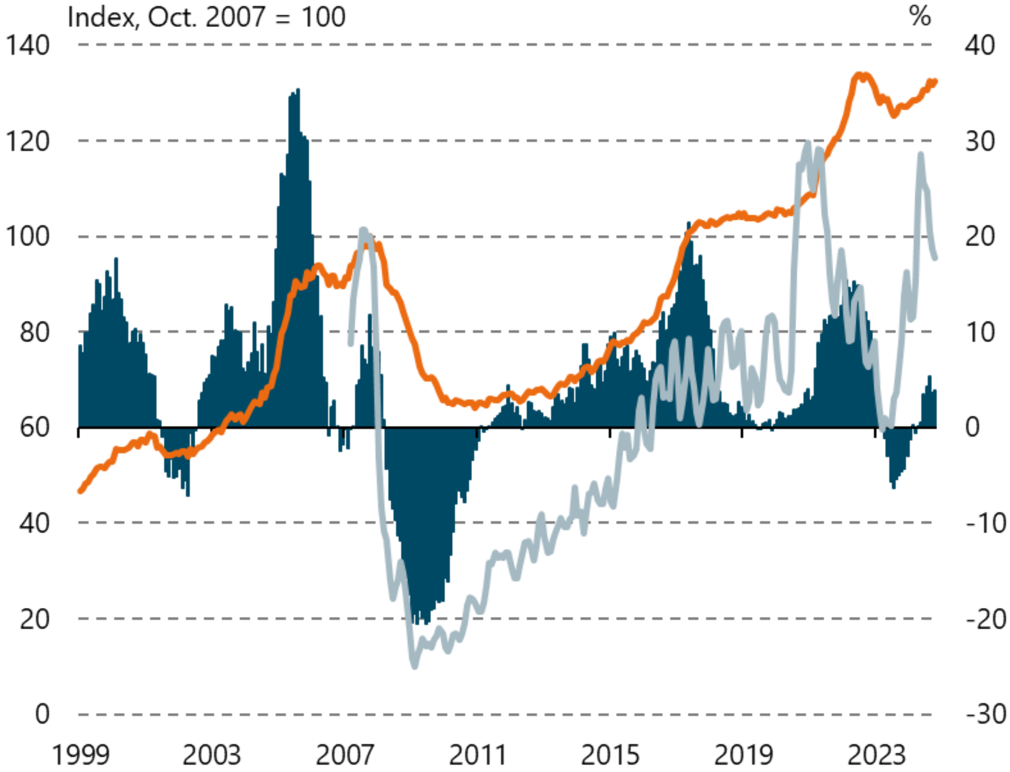


1. CRE price index, deflated with the CPI. The index shows the weighted average price of industrial, retail, and office space. The turnover index, deflated with the CPI, shows a four-quarter moving average. The most recent observations are preliminary.

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



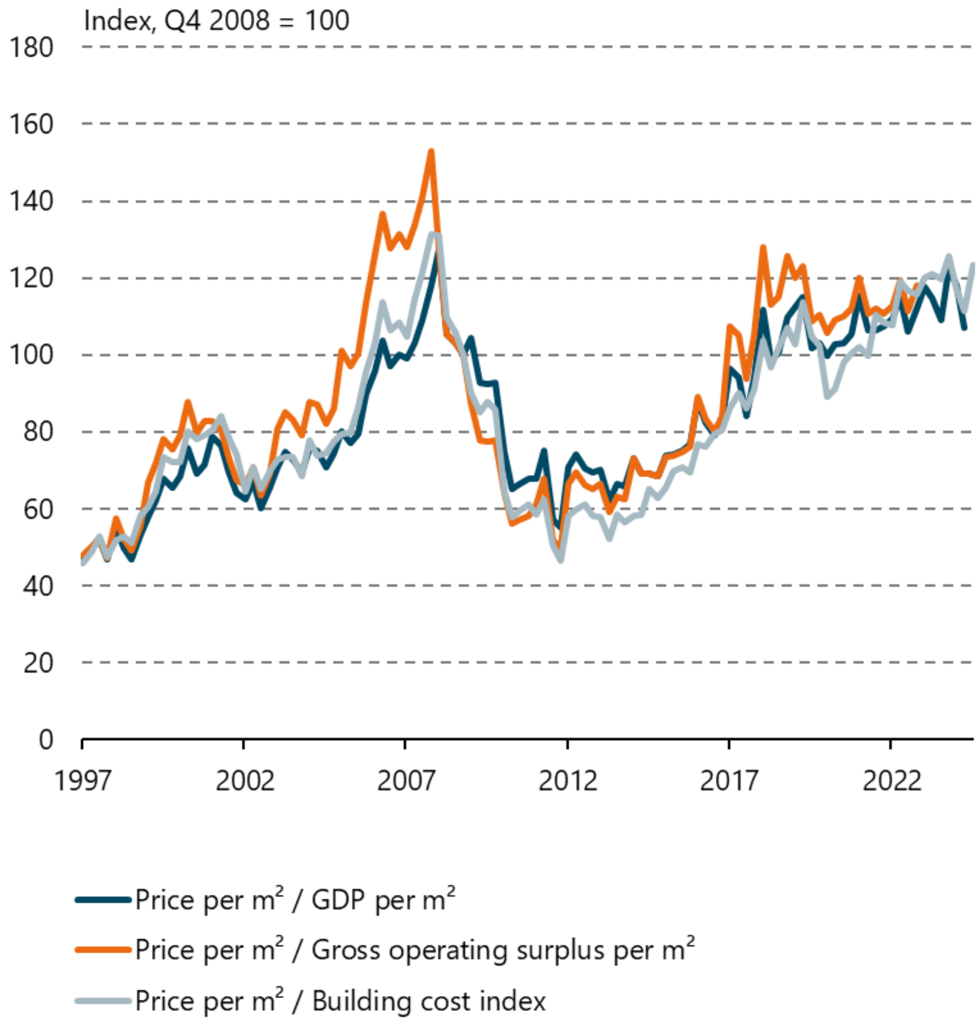
Year-on-year change (right) Price index (left) Turnover index (left)

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

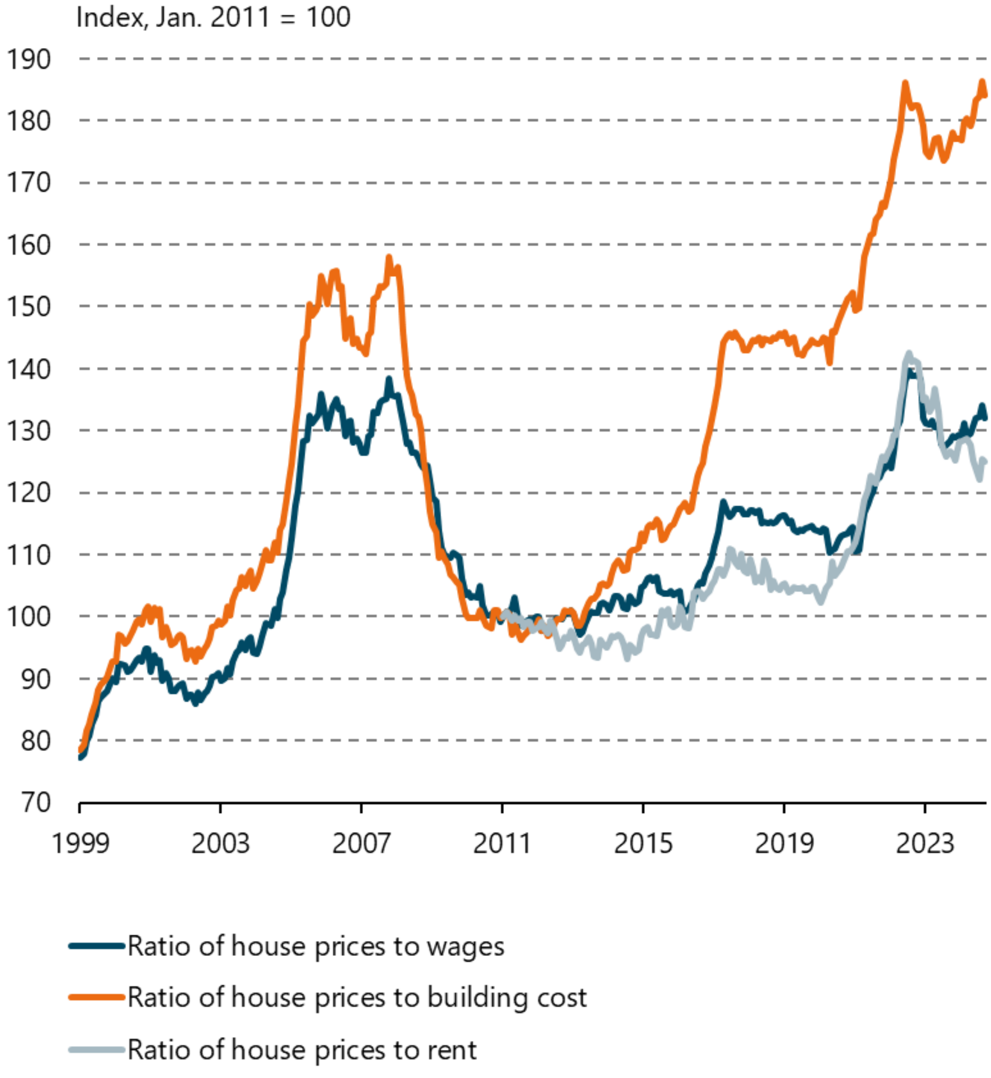


1. Annual data for gross operating surplus are non-linearly interpolated. Annual data for the CRE stock are linearly interpolated.

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

Capital area house prices and determining factors

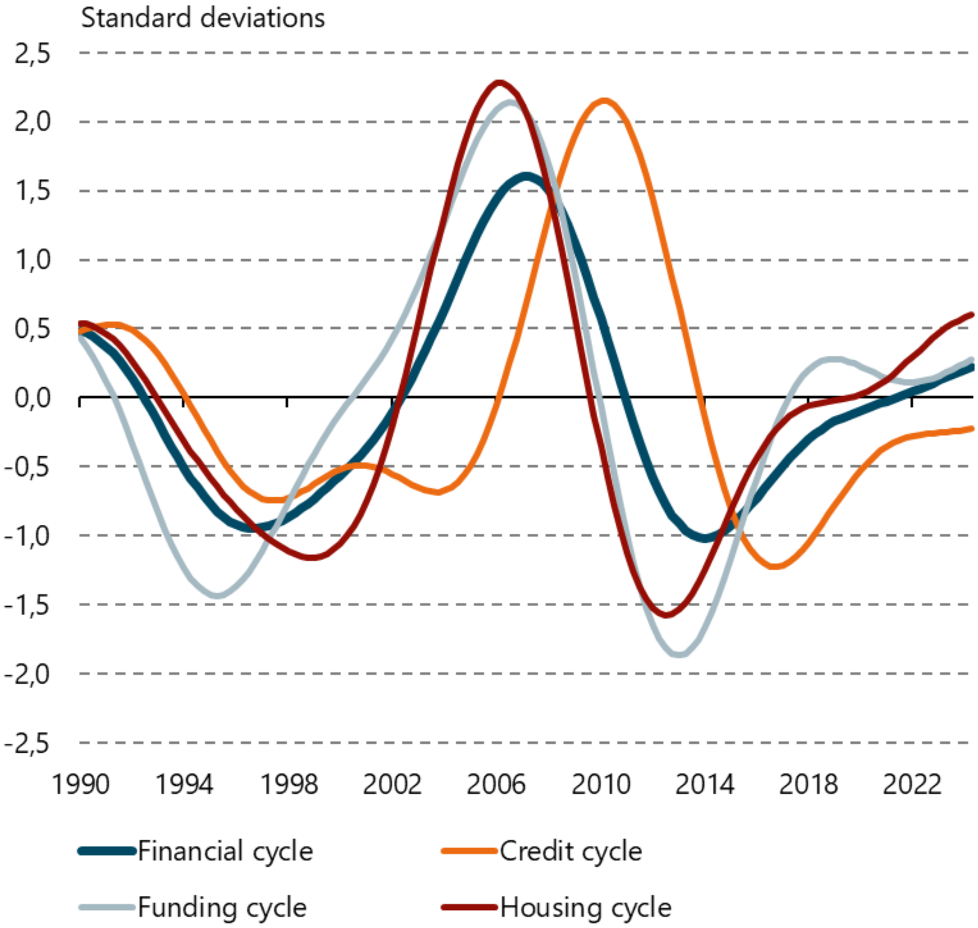
January 1999 - September 2024



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

Financial cycle and subcycles[1]

Q1/1990 - Q2/2024

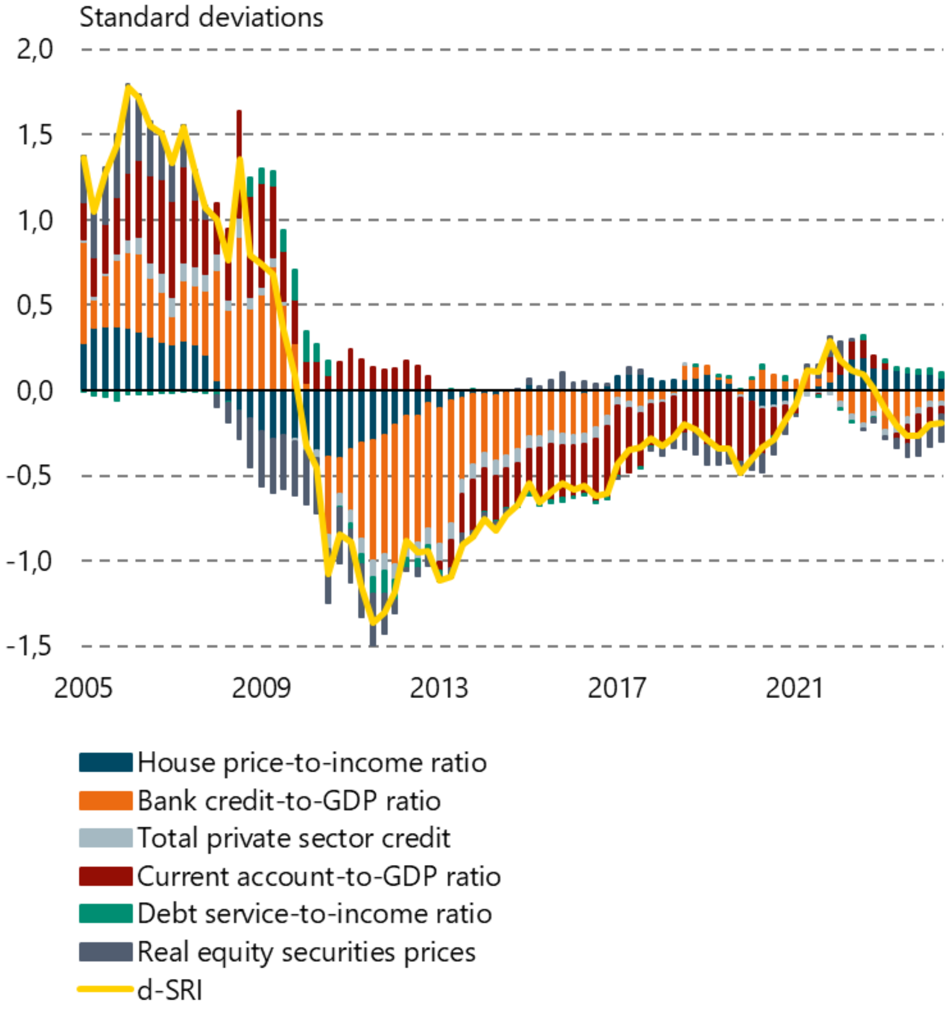


1. The financial cycle, the blue line, is a simple average of the subcycles. Each subcycle is a simple average of cyclical components from variables related to credit, housing, and bank funding, respectively. Cyclical components are obtained with a Christiano-Fitzgerald band-pass filter with a frequency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

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

Domestic systemic risk indicator (d-SRI)

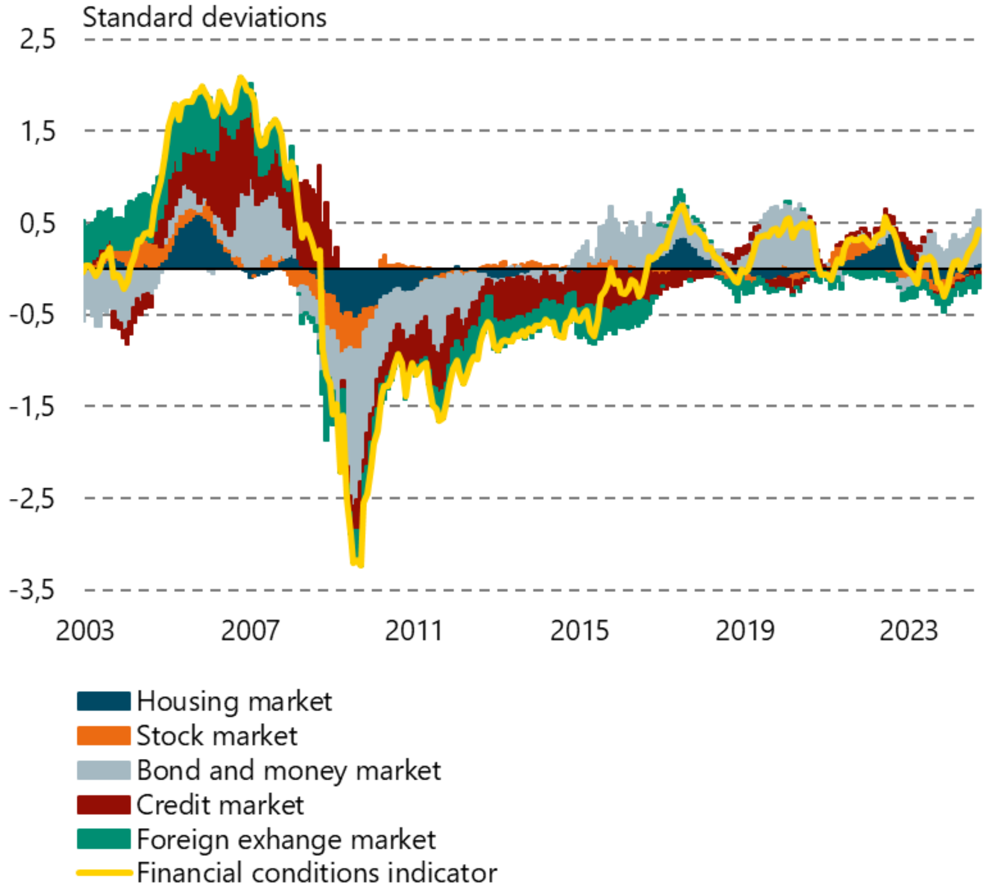
Q1/2005 - Q2/2024



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

Domestic financial conditions[1]

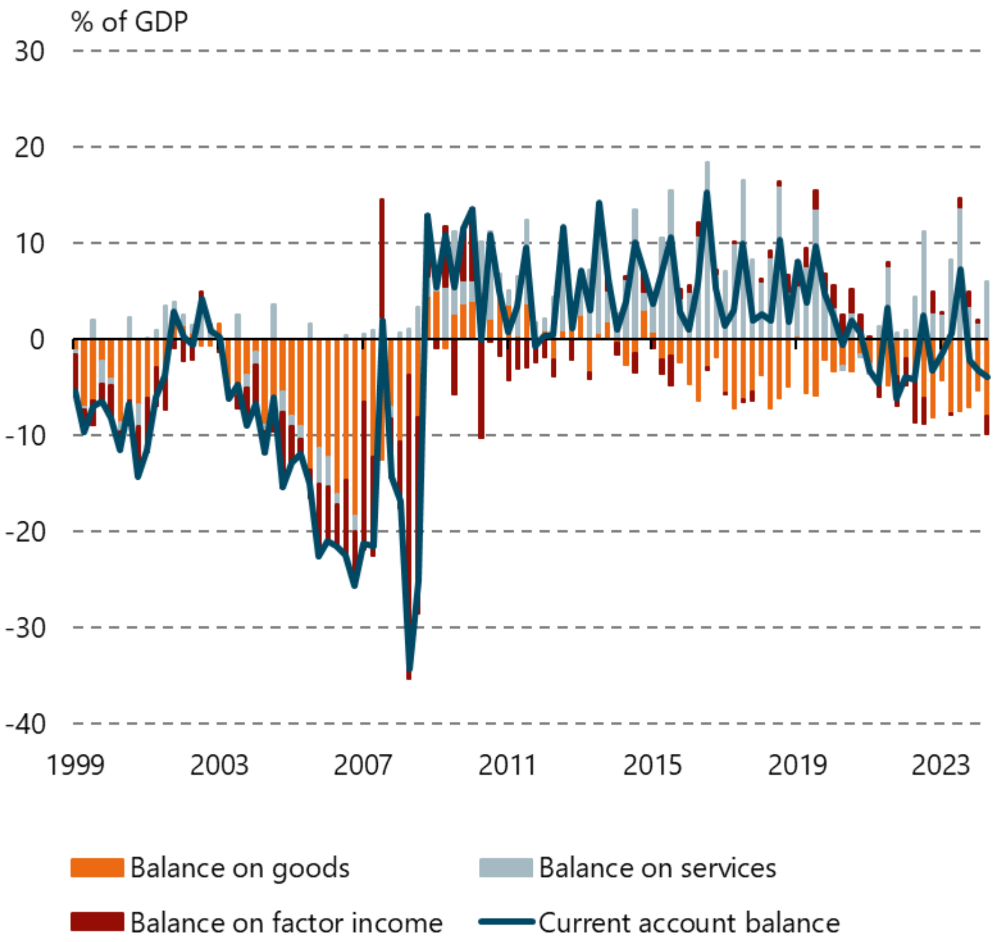
January 2002 - September 2024



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.

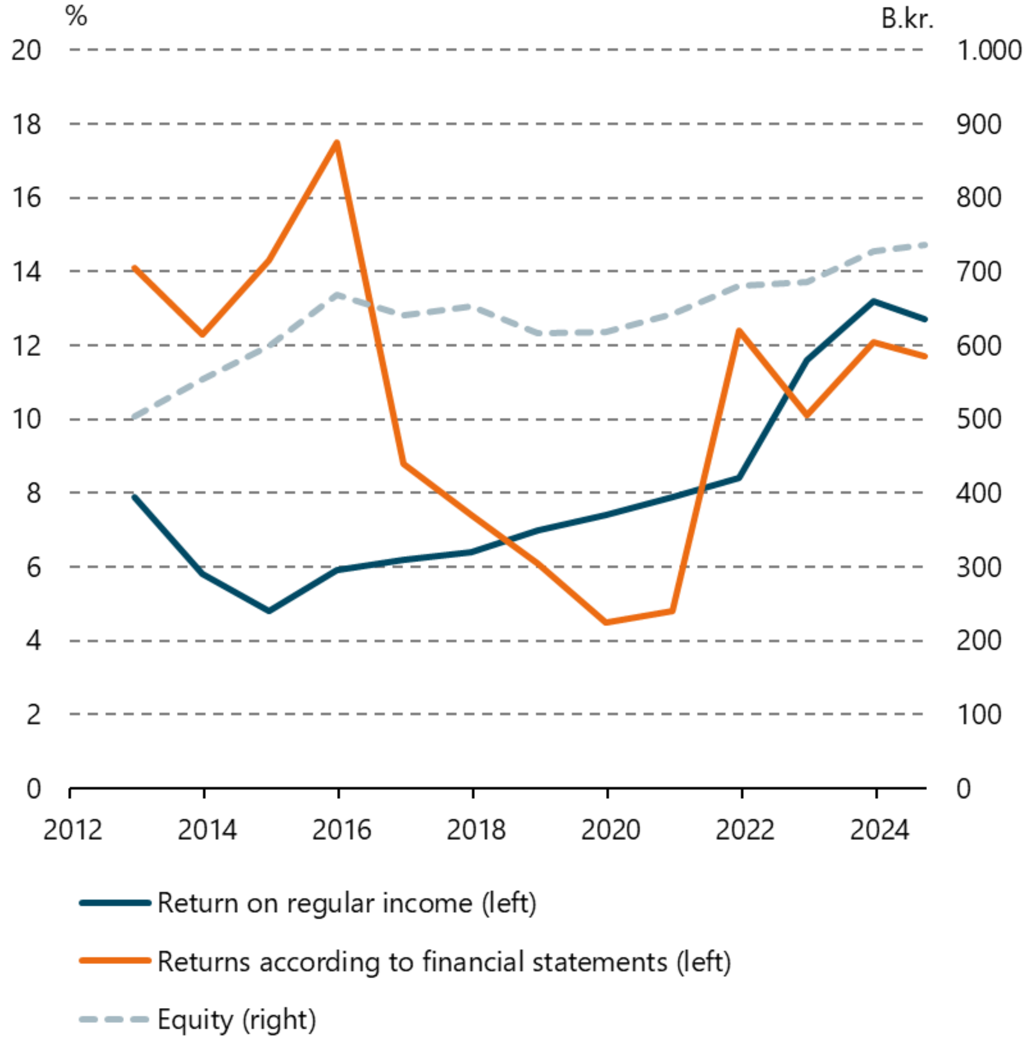
Current account balance[1]

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.

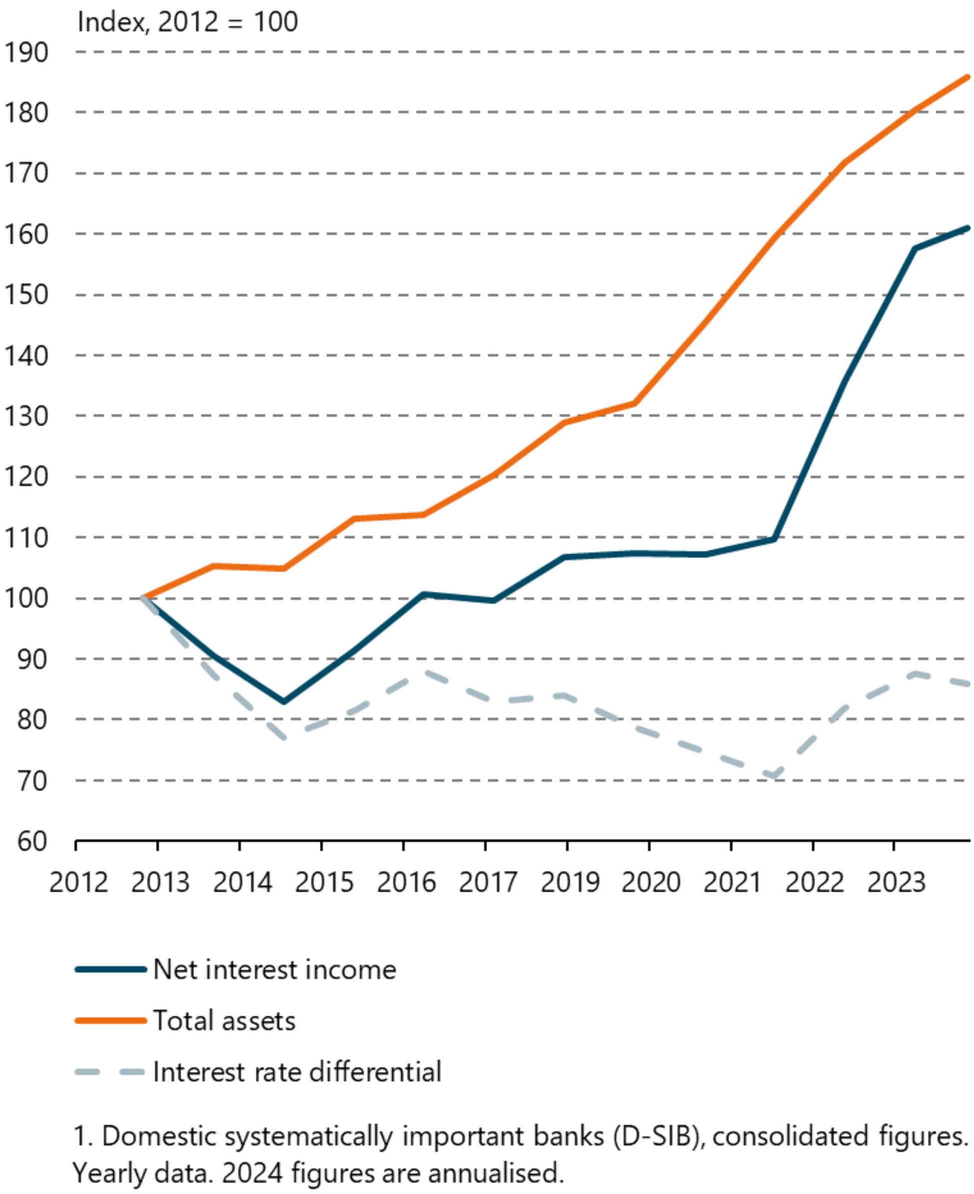
D-SIB: Returns[1]



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.

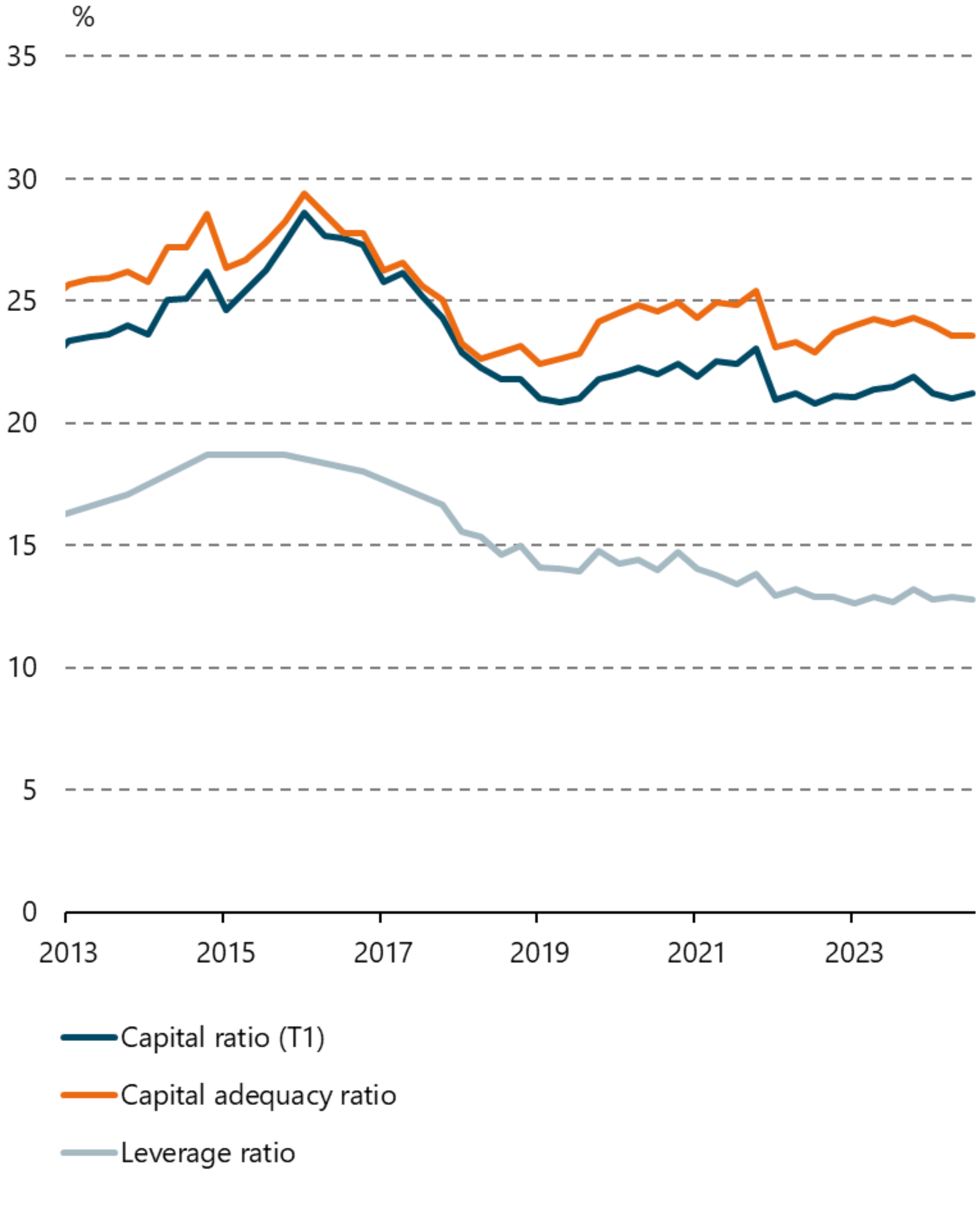
D-SIB: Net interest income, interest expense and interest rate differential[1]



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.