CENTRAL BANK OF ICELAND

MINUTES
FINANCIAL STABILITY COMMITTEE

2024

MARCH
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The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

March 2024 (21st meeting)
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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.