The Financial Stability Committee of the Central Bank of Iceland

Minutes of the Financial Stability Committee meeting

Meeting held 6-7 December 2021 (11th meeting)

Published: 14 January 2022

The Act on the Central Bank of Iceland stipulates that decisions on the application of the Central Bank's financial stability policy instruments shall be taken by the Financial Stability Committee. "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." The Financial Stability Committee (FSN) has decided that, in general, it will publish the minutes of its meetings within four weeks.

At the meeting held 6-7 December 2021, the FSN discussed financial stability developments and prospects, recent economic development, developments in the domestic financial markets, the position of and risks in the financial system and in the operations of individual financial institutions, the real estate market, the financial cycle, financial market infrastructure, financial conglomerates, proposed amendments to the Act on Financial Undertakings, and the Bank's policy on minimum requirements for own funds and eligible liabilities (MREL policy). Prior to the meeting, members received information on developments and prospects since the FSN's late September meeting.

At the meeting, the Committee approved the Bank's MREL policy. It decided to hold the countercyclical capital buffer unchanged, but following the FSN's decision in September 2021, the buffer will rise from 0% to 2% as of end-September 2022. The Committee agreed to recommend that the Central Bank open a liquidity window through which financial institutions in need of liquiditymay obtain short-term collateralised loans. At the same time, the temporary collateralised lending facility established due to the pandemic in April 2020 would be closed down.

Analysis of financial stability

The FSN was of the opinion that risk to financial stability was generally low but that pandemic-related uncertainty remained. The three large banks' capital and liquidity ratios were well above regulatory minima, they had ready access to funding, and they were therefore highly resilient to adverse shocks. The strong economic recovery in recent months had supported households and businesses. Asset prices – equity securities and real estate in particular – had risen sharply, and the Committee was therefore of the view that systemic risk had continued to increase, especially due to household credit growth alongside rising house prices. In response to this, the monetary and macroprudential policy stance had been tightened in recent months.

GDP growth had been around 4% in 2021 to date, in line with the Bank's November forecast for the year as a whole. GDP growth is expected to gain pace in 2022 and measure just over 5%, driven mainly by tourism and the increased capelin quota, according to the Bank's November forecast. The labour market had recovered strongly, unemployment had eased, the number of job vacancies had continued to increase rapidly, and there was a growing shortage of labour. On the other hand, inflation had risen, driven by surging prices abroad as well as domestic cost pressures. Long-term inflation expectations had also risen by some measures.

In the FSN's opinion, the position of the three large commercial banks remains strong. In the first nine months of 2021, they recorded a combined profit of just over 60 b.kr. and a return on equity of 12.5%. Their capital position has grown stronger year-to-date, and they appear to have ready access to funding. Deposits held in the banks have increased substantially, or by nearly 10% in the first nine months of 2021. Even though credit growth has been relatively robust, the banks' liquidity position was strong, at 290 b.kr. above regulatory requirements as of end-October. Credit spreads on the banks' foreign bond issues had risen in recent weeks, however, in line with developments in foreign markets. The FSN considered it important to continue monitoring credit spread developements.

Developments in banks' loans classed as in default had changed little since the FSN's September meeting. The household non-performing loan (NPL) ratio had continued to fall, although the corporate NPL ratio was broadly unchanged. At the end of September, 15.1% of loans to businesses were frozen. The ratio was higher for loans to the services sector, at around 40%. In many cases, the borrowers were strong companies that, with increased revenues based on increasing activity in tourism, should be able to service their debt. Corporate insolvencies were still limited. The banks' impairment accounts had continued to shrink, owing in part to more favourable economic forecasts than before. In the FSN's opinion, uncertainty about loan quality has continued to recede even though the effects of the pandemic remain.

Household credit growth remained significant, measuring 11.2% year-on-year in nominal terms at the end of September, up from 7.8% at the same time in 2020. There were signs that credit growth would taper off in coming months. Favourable interest rates continue to drive demand for new mortgages, while refinancing of older debt has eased.

By the end of September, corporate debt had fallen in real terms by 5.5% year-on-year. In price- and exchange rate-adjusted terms, growth in corporate debt measured 0.1%. New corporate lending had increased marginally in recent months, but demand for business loans still appeared to be limited. There had been signs of a stronger shift in corporate lending from the banking system to other non-bank lenders, although the magnitude of the shift was still limited. The Committee considered it important to monitor this trend in particular.

The Committee discussed the situation in the real estate market and developments in new household mortgage lending in considerable detail. The rise in the capital area house price index had continued to accelerate, and at the end of October the year-on-year increase measured 12.1% in real terms (17.1% in nominal terms). As before, the year-on-year rise was greater for single-family homes than for condominium housing. The deviation of house prices from fundamentals such as building costs and wage developments had widened still further. Turnover in the market had been close to the average of the past few years, after having declined sharply in recent months. The number of purchase agreements had fallen by one-third year-on-year in September and October. The average time-to-sale for property in the greater Reykjavík area was close to its historical low, and the share of homes selling at a premium on the asking price had risen, particularly in the case of condominiums. The significant drop in the number of properties available for sale indicated a shortage of supply, and it was unclear when the market would rebalance. There were signs of an increase in average loan-to-value (LTV) and debt service-to-income (DSTI) ratios on mortgages issued to first-time buyers.

Real estate prices in the wider capital area had risen steeply, alongside price hikes in greater Reykjavík itself. Changes in the average price per square metre suggested that prices had risen by as much as 40% year-on-year in some areas. The number of registered purchase agreements had fallen in most localities in Q3, expect for the Árborg community.

The OMXI10 stock price index had held virtually unchanged since the FSN's September meeting. The deviation of share prices from their long-term trend had narrowed somewhat, to 19% above trend. Foreign equity markets had been shaken in the days just before the meeting, however, due to the rapid spread of the Omicron variant of the COVID-19 virus. Nominal Treasury bond yields had risen between FSN meetings, particularly on shorter maturities. Indexed bond yields had fallen marginally over the same period, and the breakeven inflation rate had therefore risen, especially at the short end of the yield curve.

The exchange rate of the króna had remained broadly unchanged since the FSN's September meeting, and turnover in the interbank foreign exchange market had declined. The Bank's trading in the market during the period was insignificant. The banks' forward derivative positions had increased somewhat in recent months, however, and the number of counterparties in such derivatives contracts had nearly doubled.

The financial cycle was estimated to be rising since the September meeting, which was considered to indicate increased cyclical systemic risk. The statistical presentation of the financial cycle was close to its long-term average, however. The composite indicator of cyclical systemic risk (d-SRI) was also close to its long-term average, after having risen continuously since the onset of the pandemic.

Financial market infrastructure

On the basis of information from the Central Bank's new interbank system, the Bank has been developing risk indicators for financial system infrastructure. The new interbank system better enables the Bank to carry out its oversight and risk assessment role in the field of financial market infrastructure. Committee members agreed that the risk indicators would be useful in assessing potential weaknesses and operational bottlenecks in domestic payment intermediation.

The planned reorganisation of the Icelandic Banks' Data Centre's (RB) activities was presented to the FSN. Greiðsluveitan ehf., which is owned by the Central Bank, will be a shareholder in RB and will sell both the ARK system and its SWIFT services to RB. A representative from the Central Bank will take over as chair of the board of RB.

Committee members agreed that it was important, concurrent with these changes, to attempt at all times to enhance the efficiency of payment intermediation, ensure operational security, and, as soon as possible, introduce an independent Icelandic retail payment solution that could function as an alternate route in the event of an interruption in operations along other channels. The Central Bank will establish a forum, called the Forum for the Future, for policy formulation in the area of financial market infrastructure in Iceland. The Bank will also oversee the activities of the Payment Council and the Rulebook Council. These three fora are important for the continued development of domestic financial market infrastructure.

MREL – policy

At the Committee's 5 November 2021 meeting, the Bank's Resolution Authority had presented a draft MREL policy, and the Committee had agreed to refer the matter to the banks concerned and solicit their comments. The results from the consultation process were presented to the Committee at the December meeting. FSN members agreed unanimously that the MREL policy represented a significant step forward. The policy ensures that financially distressed institutions (i.e., those that were failing or likely to fail) can be recapitalised without Government assistance, and with its adoption, the risk that a financial institution's insolvency would have to be covered by taxpayers should be negligible.

Following the discussion, the Governor presented the MREL policy for approval by the Committee, and it was approved unanimously.

Liquidity window and term deposits

In April 2020, the Central Bank established a special temporary collateralised lending facility for financial institutions, as part of the Bank's pandemic response measures. Because trading in the interbank market for krónur in Iceland is limited, it is considered important that financial institutions be able to obtain liquidity from the Central Bank against collateral in the event of a short-term liquidity shortage. The proposal for a permanent liquidity window was introduced to the Committee. The new liquidity window is intended to ensure that financial institutions experiencing short-term liquidity problems have access to liquidity. FSN members agreed that it was important for financial institutions in need of liquidity to be able to approach the Central Bank for such financing. The liquidity window would only be available to financial institutions that did not hold term deposits with the Central Bank, as this was considered a prerequisite for access to it. The special temporary collateralised lending facility from April 2020 will be closed at the same time as the new liquidity window will open.

Following the discussion, the Governor proposed that the Bank be authorised, after the turn of the year, to open a liquidity window for financial institutions on the basis of the proposals that had been presented to the Committee. The proposal was approved unanimously. The Central Bank was tasked with developing the structure of the liquidity window.

The Committee was informed that term deposits with the Central Bank would be made partially or fully redeemable during the commitment period, subject to a redemption fee. The redemption fee should be high so as to ensure that financial institutions would only opt for redemption when absolutely necessary, and it should vary directly with the number of days remaining in the commitment period. FSN members agreed with this proposal and the rationale for it. The purpose of this change was to remove all doubt that term deposits should be considered liquid assets for the calculation of financial institutions' liquidity ratios. The Central Bank's liquidity rules are identical in substance to Commission Delegated Regulation (EU) 2015/61 on liquidity coverage requirements.[1] Article 30.41 of the Basel Framework for liquidity ratios discusses the treatment of central bank deposits in the calculation of liquidity ratios, stating that central bank deposits shall be considered liquid assets to the extent that they can be drawn down in times of stress.[2]

Narrow banking

FSN members discussed the pros and cons of so-called narrow banking and whether such activities were consistent with the Central Bank of Iceland's main objectives, which are to promote price stability, financial stability, and sound and secure financial activities. The business model for narrow banking is based on depositing a large share of customers' bank deposits to a current account with the central bank. The Committee considered it appropriate to review and examine the rules applying to transactions and current accounts with the Central Bank, in order to safeguard the Bank's legally mandated objectives from the standpoint of financial stability.

Countercyclical capital buffer

FSN members agreed that the banking system was on a solid footing. Returns were strong, and capital and liquidity ratios were well above regulatory minima. Thus far, the pandemic had made only a limited impact on the financial system as a whole, and developments in loan quality suggested that there would not be large-scale write-offs, provided that the economic recovery evolved in line with forecasts. The actions taken by the Central Bank and the Government had done much to limit the impact of the pandemic on the economy.

Committee members expressed concerns about the limited supply of residential housing and steeply rising house prices. They agreed that the effects of the macroprudential tools adopted by the Committee had not yet come fully to the fore, but they were also of the view that the tools would be more effective at higher interest rates. A tighter monetary stance should therefore enhance the efficacy of the macroprudential tools.

The Governor proposed that the countercyclical capital buffer should be held unchanged, and the proposal was approved unanimously. Committee members agreed to continue the discussion of what the neutral rate of the countercyclical capital buffer should be and how it interacted with other capital buffers.

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[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN

[2] https://www.bis.org/basel_framework/chapter/LCR/30.htm

The Governor presented a calendar of FSN tasks and meetings for the upcoming year. The Committee also discussed its annual report to Parliament. It was assumed that the report would be approved [in the FSN's written handling] after the turn of the year.

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

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

Eggert Th. Thórarinsson wrote the minutes.