



MINUTES

FINANCIAL STABILITY COMMITTEE



2022

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Minutes of the Financial Stability Committee meeting

September 2022 (14th 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 redistribute 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 elements, 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 the assessment of financial stability.

At the meeting of 22 and 26-27 September 2022, there were presentations and discussions of economic developments and prospects and the state of the financial system. The Committee discussed the current situation and outlook for financial stability and the principal risks to financial stability, such as economic developments, risks faced by 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 position.

In addition, the FSN discussed amendments to the Act on Financial Undertakings and the possible implications for decisions on capital buffers. The Committee was given a presentation on methodology used to assess systemically important financial institutions. The Committee then discussed the security and efficacy of financial market infrastructure and its importance for financial system stability. The FSN was also informed that the European Systemic Risk Board (ESRB) had decided to issue a warning on increased risk in the European financial system, which threaten financial stability.

In its quarterly review of the countercyclical capital buffer (CCyB), the FSN decided to hold the buffer unchanged, as it had decided in September 2021 to increase the buffer from 0% to 2%, effective 29 September 2022.

The Committee stressed the importance of bolstering security in domestic payment intermediation so as to guarantee business continuity, partly in view of growing cyberthreats. Steps have been taken towards developing an independent domestic retail payment solution.

Analysis of financial stability

The global economic outlook had deteriorated and grown more uncertain since the FSN's June meeting, particularly in Europe. Trading partner inflation had risen, and the monetary and macroprudential

stance had been tightened. Asset prices had fallen, and systemic risk had mounted and was still growing in Europe. Concerns had increased about the impact of energy shortages in Europe on households and businesses, and access to credit had tightened. As a result, market conditions had deteriorated, and credit spreads on the Icelandic banks' foreign bond issues had therefore risen. Furthermore, there was considerable uncertainty about how demand for travel to Iceland would develop during the coming winter, owing to the poorer economic outlook among Iceland's trading partners. As a result, risks to financial stability in Iceland had grown because of worsening external conditions – a trend that was likely to continue. In the FSN's opinion, however, the systemically important banks were highly resilient, pressures in asset markets had eased, and private sector debt was relatively low. On the other hand, increased external uncertainty highlighted the importance of maintaining the resilience of the Icelandic financial system.

ESRB warning

The FSN was informed of the European Systemic Risk Board's (ESRB) decision to issue a warning on increased risk in the European financial system, which was considered a potential threat to financial stability. The ESRB's warning focused in particular on three factors: First, rising energy prices and possible energy cutbacks could have a severely negative impact on the economic outlook and put significant pressure on households' and businesses' debt service capacity. Second, falling asset prices and increased price volatility could put strain on financial institutions' and other entities' liquidity and lead to an even further deterioration in financial conditions. Third, the worsening economic outlook could lead to loan losses for financial institutions and erode their profitability.

The Committee was of the view that the situation in Iceland was better in most respects than elsewhere in Europe, but that a high level of vigilance was required to preserve financial stability. The Icelandic financial system is well positioned with respect to the risks emphasised by the ESRB, although there was certainly the possibility of contagion if the risks identified in the ESRB warning should materialise in Europe.

Other risks mentioned in the warning included the increased frequency of cyberattacks and the high level of public indebtedness in many European countries. The warning was published after the ESRB meeting of 22 September 2022. It was the first time since its inception in 2010 that the ESRB had issued a warning on increased vulnerabilities in the European financial system.

Banking system resilience

In the FSN's opinion, the domestic systemically important banks (D-SIB) are highly resilient. Their capital and liquidity are above regulatory minima, giving them ample scope to support households and businesses. The banks' liquidity had declined during the year, particularly in foreign currencies, and as of August, their liquidity in excess of regulatory requirements was 213 b.kr., or 61 b.kr. less than at the beginning of the year. Increased lending, dividend payments, and bond maturities were the main causes of the decline in liquidity. The banks' domestic bond issuance had been limited in the first nine months of 2022, and net covered bond issuance had contracted year-on-year. Deposit growth had lost pace as well. Foreign funding conditions had deteriorated in the recent term, and credit spreads on the banks' foreign-denominated bonds had risen. There were no remaining foreign maturities in 2022, and year-2023 maturities totalled 144 b.kr.

The D-SIBs' operations were strong in H1/2022, and their return on equity was 10%, somewhat lower than for the same period in 2021. Their net interest income and commissions/fees increased by 18% year-on-year over this period, owing in part to wider interest rate spreads concurrent with rising interest rates. Income from interest, commissions, and fees totalled an all-time high of 80 b.kr. The D-SIBs'

operating expenses had declined marginally between years, and their core operations therefore strengthened markedly in H1/2022. The household non-performing loan ratio had continued to fall. It measured 0.8% and had seldom been this low. Corporate non-performing loan ratios had kept falling as well.

The results of the Central Bank's annual stress test of the systemically important banks showed that the banks are well equipped to withstand external shocks while continuing to provide financing to households and businesses.

Private sector debt

Growth in household debt had slowed down and, in real terms, was marginally negative in July. Nominal growth remained significant, however, at 9.8%, and was driven to an increasing degree by the effects of indexation on price-indexed loans. The ratio of household debt to disposable income had fallen to 155% in Q2, which is low in historical context. The household debt-to-GDP ratio was also low in historical context. Higher interest rates and tighter borrower-based measures had dampened demand for mortgage loans, and growth in net new mortgage lending was broadly similar to the pre-pandemic rate.

Households were generally well positioned, unemployment was low, and wages had risen steeply in the past two years. Growth in real disposable income had slowed to just over 1% at the end of Q2 (in terms of the CPI). Household arrears declined in Q2, although debt service had increased in line with rising interest rates, particularly on non-indexed loans, which constituted just over half of total household debt. About 27% of consumer mortgages were non-indexed and bore variable interest rates. It emerged that interest rates on just over 28% of household mortgages, which currently bear fixed rates and are non-indexed, will be up for review in 2024 and 2025. All else being equal, this will cause a significant increase in those households' debt service burden.

Household debt service had increased, particularly among those who had taken new mortgages loans after the beginning of 2020. Around 15% of borrowers who had taken new loans during that period had seen their debt service increase by more than 40,000 kr. per month relative to the initial amount, while in nearly 60% of cases, debt service had increased by less than 10,000 kr. per month. Several factors have prevented debt service from rising more for such a large group of borrowers, including fixed interest rates, a fixed-payment loan format, and composite loans featuring indexed and non-indexed components. These borrowers' debt service-to-income ratios had generally risen since they took their loans, but only modestly in comparison with wages over the period.

Real growth in corporate debt was negative for the sixth quarter in a row, by 2.5% at the end of Q2. Corporate debt measured 80.5% of GDP, its lowest since 1998. Nevertheless, nominal growth in the D-SIBs' corporate lending had gained momentum as the year progressed, while corporate bond issuance and corporate borrowing from alternative investment funds had grown modestly between years.

The Committee was therefore of the opinion that on balance, it appeared that households and businesses should be well equipped to withstand the uncertainty currently prevailing in the economy.

Asset prices

The first signs of cooling in the housing market emerged during the summer. The number of homes for sale nationwide grew rapidly, from 1,000 in May to over 2,000 by September. Price hikes had lost pace in recent months, the number of purchase agreements had fallen, and the average time-to-sale had grown longer. The deviation of house prices from fundamentals had widened significantly since the Committee's last meeting, however. The FSN was of the view that tighter borrower-based measures

and the interaction between those measures and interest rate hikes had eased tension in the real estate market.

As a result, systemic risk in the housing market was moderate given the current economic conditions. The FSN noted that in several countries, nominal house prices had fallen concurrent with rising mortgage lending rates and reduced market activity. Developments in these countries resembled those in Iceland in many ways. In the FSN's opinion, the likelihood of stagnation or a correction in house prices had increased significantly.

The commercial real estate (CRE) price index had risen rapidly and was close to its pre-pandemic peak. The index had risen 15.3% year-on-year at the end of Q2 and was now nearly 18% above its estimated long-term trend. The rise in the index still appeared to be driven by demand, partly as a result of increased corporate revenues. Turnover in registered CRE transactions had increased markedly, and as of end-June, twelve-month turnover was at its highest since measurements were introduced in 2006.

The price of listed Icelandic companies' shares had fallen, in keeping with the pattern seen widely abroad. The OMXI10 index had fallen by 18% since the Committee's last meeting, and by just over 25% year-to-date. The biggest drop, nearly 45% in 2022 to date, was in the price of Marel shares, which account for just over a fourth of the index. Turnover with listed shares had increased by 10% year-on-year over the first eight months of 2022, and the trade count had increased by 21.5% between years. Nominal Treasury bond yields had risen rapidly early in the year, particularly on short-term bonds, but they fell slightly after the Central Bank's June interest rate decision and had held broadly at that level over the summer. The breakeven inflation rate in the bond market had declined after the June interest rate decision and the FSN's June decision to tighten borrower-based measures.

Exchange rate of the króna and international reserves

The króna had depreciated by 0.5% since the FSN's June meeting, owing in particular to the appreciation of the US dollar versus the króna, as the króna had also appreciated against most other currencies. The foreign exchange market had been stable in recent months, but volatility increased somewhat in September, and the Central Bank intervened twice and sold foreign currency for a total of 6 b.kr. The Bank had last intervened in the market in May 2022.

The interest rate differential with abroad had widened, particularly the short-term differential, but was still far narrower than it had been in 2015-2016. Capital flows relating to foreign investment were well balanced, although a few large transactions had taken place in Q3. Inflows for new investment in Iceland therefore appeared to have been offset by outflows. The pension funds' foreign investment was broadly the same as in the same period of 2021, but because of falling asset prices abroad and the appreciation of the króna, their foreign asset ratio had fallen to 35% of total assets by July, as opposed to 38% at the end of 2021.

Iceland's net international investment position had fallen by 16 percentage points in 2022 to date, to 24% of GDP at the end of Q2. Although the decline was due mainly to the appreciation of the króna and falling foreign asset prices, there was also a current account deficit of 84 b.kr. in H1/2022. The international reserves totalled 25% of GDP at the end of June, and the ratio of the reserves to the IMF's reserve adequacy metric (RAM) was 136%, after falling by a total of 15 percentage points since end-2019.

The financial cycle and cyclical systemic risk

A composite measure of financial cycles indicated an average level of cyclical systemic risk at present, although risk had increased marginally since the FSN's last meeting. The financial cycle had been driven

by the housing cycle, owing to the steep rise in house prices in the recent term. The composite domestic systemic risk indicator (d-SRI) signalled that cyclical systemic risk was slightly above average after having risen in the previous two years, owing mainly to the flip from a large current account surplus to a deficit and to demand pressures in the real estate market. Countervailing factors were modest credit growth, strong GDP growth, and falling share prices. The d-SRI fell marginally in Q2, however, for the second quarter in a row. It was considered relatively likely to keep falling in coming quarters, owing to the decline in share prices in Q3 to date, reduced demand pressures in the real estate market, and the prospect of a smaller current account deficit.

Amendments to the Act on Financial Undertakings

The FSN was given a presentation on amendments made to the Act on Financial Undertakings, which now authorises an increase in the capital buffer for systemic importance (O-SII buffer) from 2% to 3%. With the passage of the amending legislation, the implementation of two Capital Requirements Directives (CRD IV and CRD V) was completed and Chapter X of the Act (on capital buffers) reorganised. Other substantive changes were of lesser importance.

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.

Indicators of the systemic risk level suggest that it is close to the average of recent years. Loan quality has generally improved and arrears have fallen for both households and businesses. Household indebtedness was very modest relative to disposable income, and the private sector debt level was low, both in historical context and relative to neighbouring countries. FSN members agreed that the banking system was on a solid footing. Banking system resilience appeared to be sufficient in terms of the systemic risk level. Returns were strong, and capital and liquidity ratios were well above regulatory minima. As a result, the banking system was well prepared to continue restructuring corporate debt where necessary.

The FSN discussed the ESRB's warning and the rapidly deteriorating economic outlook in trading partner countries. Market conditions were highly uncertain, and financing costs were rising swiftly. The banking system's market funding had become costlier than before. FSN members agreed that banking system liquidity and credit growth should be closely monitored. The Committee also agreed to discuss capital buffers and their interactions with one another at the December meeting.

Following the discussion, the Governor proposed that the countercyclical capital buffer be held unchanged, and the proposal was approved unanimously.

Systemically important financial institutions

Once a year, the FSN reviews its designation of systemically important financial institutions and the O-SII buffer. The European Banking Authority's (EBA) methodology for the identification of systemically important financial institutions was presented to the Committee, and at its December meeting, the Committee will determine the O-SII buffer and decide which financial institutions should be designated as systemically important.

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 Committee received information on risk indicators from the Central Bank's interbank system. The Bank uses the indicators to maintain an overview of and assess risk associated with financial market infrastructure. The indicators are also useful for assessing potential weaknesses and operational bottlenecks in domestic payment intermediation. The interbank system has operated smoothly, and no serious incidents have been recorded in 2022.

The results of a recent survey of individuals' payment behaviour were presented to the Committee. Over 98% of individuals use electronic payment instruments when they shop, with payment cards or solutions installed in smart devices still the dominant means of payment. Use of cash has declined since the previous survey. The FSN considered it important to continue working towards ensuring the operational security of electronic retail payment intermediation.

Efforts have been made to strengthen Iceland's framework for financial market infrastructure, and it was recently decided to adopt an Icelandic rulebook based on European standards from the European Payments Council, which is an important step towards further development of financial market infrastructure.

The FSN received information indicating that reported cyberattacks had grown in number and were increasingly directed at important infrastructure. It was noted that the Central Bank had broad authorisations to set policy and adopt rules on financial market infrastructure. The Bank would impose certain basic security requirements in order to guarantee the security of the infrastructure for payment intermediation. It was necessary to consider whether the statutory framework for financial market infrastructure should be strengthened and the Central Bank's power to set rules in this area augmented. The Committee agreed on the importance of bolstering security in domestic payment intermediation so as to guarantee business continuity, in view of growing cyberthreats, among other factors.

At the end of the meeting, the Committee approved the statement for publication on the morning of 28 September 2022.

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; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; and Rannveig Júníusdóttir, Director of the Bank's General Secretariat were present for the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.