*The Financial Stability Committee of the Central Bank of Iceland*

# Minutes of the Financial Stability Committee meeting

## Extraordinary meeting, 16 March 2020 (2nd meeting)

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The Act on the Central Bank of Iceland stipulates that the role of the Financial Stability Committee is to take decisions on the applications of the Central Bank of Iceland's financial stability policy instruments. "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." In accordance with the Act, the Financial Stability Committee (FSN) has decided that, in general, it will publish the minutes of its meetings within four weeks.

The following are the minutes of the FSN's extraordinary meeting held on 16 March 2020. At the meeting, the Committee decided to lower the countercyclical capital buffer from 2% to 0% and announced the decision on 18 March.

## I Financial stability developments and prospects

Committee members discussed financial stability developments and prospects, the economic situation, developments in the domestic financial markets, the position of and risks in the financial system and in the operations of individual financial institutions, and developments in cyclical systemic risk in the recent term. The Committee had information at its disposal on the current situation and developments in recent months.

### The economy

The novel coronavirus had spread from China to large parts of Asia, Europe, and North America. Countries had begun to close their borders or impose restrictions on cross-border travel. Many countries imposed restrictions on large gatherings. In Iceland, the economic outlook had deteriorated significantly in recent days, as the virus spread and widespread closures were introduced in Iceland's main trading partner countries. The principal uncertainty centres on how long the pandemic will last.

Reduced appetite for travel and the closure of borders had made a profoundly negative impact on tourism companies. The price of shares in European airlines had tumbled. Several European airlines had already announced a significant reduction in their activities for the coming weeks or had cancelled them altogether. Icelandair was not spared the effects of this and had cancelled a number of flights in previous days. It was assumed that air travel could contract even further in the weeks ahead. Iceland's tourism industry depends on the success of efforts to control the spread of the disease before the peak summer season. In recent years, a third of all tourist visits to Iceland have taken place in June, July, and August. In many instances, companies in the sector have limited resilience after the contraction in 2019.

**Financial markets**

Share prices had fallen steeply and fluctuated widely in foreign markets. Some days saw fluctuations of 10%, the most pronounced volatility since October 2008. Investors had increasingly sought out less risky assets. The yield on 10-year government bonds issued in the US, the UK, and Germany had fallen, and the price of gold had risen. Oil prices had fallen by nearly 50% since the turn of the year, owing both to the pandemic and to the price war between Saudi Arabia and Russia.

Domestic markets had developed in a similar manner. Shares in nearly all companies on the Nasdaq Iceland Main List had fallen in price, and the OMXI10 index was down nearly 20% since the turn of the year. Treasury bond yields had fallen somewhat, and the yield on indexed Treasury issues was close to zero. The króna had depreciated by 8% since the beginning of the year, and volatility had increased. The Central Bank had intervened in the market in order to maintain foreign exchange market equilibrium.

Inflows of foreign currency for new investment had subsided markedly in the recent term. New investment was negative in the amount of just over 7 b.kr. in the first two months of 2020. The current account had shown a sizeable surplus in recent years, but uncertainty about foreign currency flows had escalated, particularly about tourism-generated revenues. The pension funds' response will be an important determinant of foreign currency flows in coming months. In 2019, for example, the funds bought currency for 121 b.kr., or about 4% of GDP. The Central Bank's international reserves amount to 30% of GDP.

**Developments in private sector debt**

Growth in household debt had changed little in the recent terms, measuring 4% in real terms. Lending figures for the period through end-January 2020 indicated that the pension funds' and banks' share had remained broadly unchanged. The weight of non-indexed loans in total household debt had increased still further. Growth in corporate debt declined rapidly last year, however. This could stem in part from the poorer economic outlook, repricing of risk, and individual financial institutions' lending policies. There were signs that to some extent, intermediation of credit to companies may have shifted out of the banking system in recent months.

**The banking system**

The three large banks' capital ratios ranged between 22.4% and 28.4%, while the total capital requirement ranges from 18.8-20.4%. The liquidity position remains well above the Central Bank's required minimum, and the banks' liquid assets in excess of requirements totalled 260 b.kr. The banks' liquidity ratios in Icelandic krónur had also been rising in recent months.

Interest premia on the large banks' foreign bond issues had risen rapidly in the past few days, to about the level seen in mid-2019. Issues totalling some 2.5% of GDP are scheduled to mature in 2020, and another 4% are scheduled to mature in 2021. The banks' ample foreign liquidity would enable them to pay off at least all of their 2020 maturities. The spread between the banks' covered bond rates and Treasury bond rates had widened in recent weeks, indicating that funding terms in the domestic market were deteriorating.

There were no signs that credit risk had begun to materialise in the banking system. The cross-default non-performing ratio on corporate loans rose in Q3 and Q4/2019. The first signs of debt service difficulties among tourism and construction companies were beginning to come to the fore. The impact of the spread of the virus had yet to surface, however. Loans to tourism companies accounted for just over 9% of the banks' total customer loans, the impact would probably be greatest there.

**Cyclical systemic risk**

The household debt-to-GDP ratio had been relatively stable between years, while the corporate debt-to-GDP ratio had fallen somewhat. Real house prices in the greater Reykjavík area were historically high, at nearly 10% above their long-term trend in January 2020. Commercial property prices had been broadly unchanged between years in real terms.

Leading financial cycle risk indicators based on quarterly data on credit growth, house prices, and the banks' foreign funding did not indicate that the downward cycle had begun by the end of Q4/2019. Instead, they indicated that the upward cycle had hit a plateau.

Daily data suggested a significant rise in unrest. Payment card turnover had contracted, the króna had depreciated, share prices had fallen, premia on the banks' market issues had risen, and yields on domestic bonds had fallen.

The authorities in several countries had already lowered countercyclical capital buffer requirements. In Denmark and the UK, for instance, the buffer was lowered from 1% to 0%, while in Sweden it was lowered from 2.5% to 0% and in Norway it was lowered from 2.5% to 1%.

## II Decisions pertaining to financial stability

The Committee noted that it was important for financial institutions to have the scope to support the economy under current conditions, in terms of both capital and liquidity.

Members discussed the capital requirements made of financial institutions. Capital buffers had been built up during the upward cycle in order to boost financial system resilience. Under current circumstances, it was appropriate to examine the possibility of using the scope that the buffers had provided. Members discussed the risks that were likely to materialise during the ongoing crisis, and they agreed that it was important to respond decisively.

**Countercyclical capital buffer**

The Committee noted that lowering the countercyclical capital buffer would provide financial institutions the latitude to address increased loan losses and mitigate the negative impact on intermediation of credit.

Members considered two options: lowering the countercyclical capital buffer from 2% to 1% and lowering it from 2% to 0%. Releasing the buffer could prevent a negative chain reaction involving credit supply, economic activity, and asset prices. On the other hand, there were no clear signs that the downward financial cycle had begun. Lowering the buffer to 1% would leave the Committee some room for manoeuvre later on. Members agreed that it was important to keep the buffer unchanged for at least 12 months and issue forward guidance to this effect. It was also important to urge financial institutions to suspend all plans to pay dividends and buy back their own shares, in the interests of social responsibility and the banks' role and unique position in the economy.

The Committee noted that it was important to respond quickly to the situation that had developed. There would have to be incentives for the financial institutions to maintain the supply of credit. It would also be positive if the Committee's decisions could provide further support for transmission of monetary policy.

In view of the discussion, the Governor proposed that the countercyclical capital buffer be lowered from 2% to 0%. Furthermore, the Committee should provide forward guidance signalling that the buffer would not be changed again in the coming 12 months. All Committee members voted in favour of the proposal.

Members discussed the importance of using the scope provided by the reduction in the buffer to restructure loan portfolios and support businesses and households during the period of economic uncertainty that lay ahead.

It emerged at the meeting that the FSN would closely monitor developments in financial conditions and was prepared to apply the policy instruments at its disposal in order to preserve financial stability.

Committee members discussed the financial system position in general. They agreed that the banks were strong and the banking system well prepared to respond to shocks.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Financial Stability 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

Guðmundur Kr. Tómasson, external Committee member

Guðrún Þorleifsdóttir, 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, a number of Bank staff members attended part of the meeting.

Eggert Þ. Þórarinsson wrote the minutes.