



# MINUTES

## FINANCIAL STABILITY COMMITTEE



## Minutes of the Financial Stability Committee meeting

June 2024 (22nd meeting)

Published: 3 July 2024

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 its meeting of 4 and 5 June 2024, the Committee was given a presentation on developments and prospects for the economy and for financial stability. The Committee discussed 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, and financial institutions' capital and liquidity. The FSN was given a presentation on the deposit insurance system and on the financing of resolution or winding-up proceedings for financial institutions. The Committee also discussed payment intermediation infrastructure and operational security. Furthermore, it discussed the recent EFTA Court decisions on the banks' mortgage loans, the rules on derivatives trading, and financial stability and key risks in Europe. In addition, it discussed the criteria for determining the countercyclical capital buffer (CCyB) and was given a presentation on Icelandic financial institutions' capital requirements as compared with those in other European countries.

In its quarterly review of the CCyB, the FSN decided to hold the buffer unchanged at 2.5%.

Members emphasised the importance of operational security in payment intermediation and the need to address the resilience of payment intermediation in a comprehensive way. The Committee is of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation will enable the Bank to enhance the security and resilience of domestic payment intermediation.

### Analysis of financial stability

The GDP growth outlook for Iceland's trading partners has improved slightly, and global economic uncertainty has receded. This can be seen, among other things, in underlying asset price volatility, which was at its lowest since 2019 in terms of the VIX implied volatility index. Global share prices had continued to rise. Trading partner inflation had declined, but more slowly than expected, particularly in the US. In Europe, risk relating to the potential impact of higher interest rates on asset prices, access to liquidity, and credit financing had diminished. Concerns about financial stability centred mainly on non-bank financial institutions'

asset quality. The risk that economic developments in Europe could cut into households' and businesses' debt service capacity and even compromise stability was considered to be still in existence.

In Iceland, revised statistics had revealed even stronger economic activity in the previous two years than had previously been estimated. Investment had been stronger, productivity greater, and the corporate saving rate higher. Domestic demand had subsided quickly in recent quarters, however, and GDP had contracted by 4% in Q1/2024. As had been forecast, the contraction was due mainly to the failure of the capelin catch. The domestic labour market had eased, and some measures indicated that demand pressures had subsided, while other measures suggested that the labour market was tighter than before the pandemic. Unemployment had inched upwards, and the ratio of job vacancies to the number of unemployed persons had fallen. The disinflation process had proceeded more slowly than the Bank had forecast in February, however, and twelve-month inflation had risen month-on-month, to 6.2% in May. It was pointed out that persistent inflation and weaker growth in economic activity could create challenges for the financial system. It emerged that the Bank's forecast had assumed that inflation would recede to target without significant cost; i.e., without an economic contraction or a spike in unemployment.

The FSN agreed that the foundations for financial stability in Iceland were robust on the whole. The private sector debt-to-GDP ratio had declined in the recent term and was low in historical and international context. The banks' recent foreign bond issues showed that credit spreads had narrowed and that funding was readily available. The equity position of households with mortgages had continued to strengthen. The systemically important banks' (D-SIB) capital and liquidity remained strong, and the financial system should therefore be able to withstand significant shocks.

The FSN also discussed whether there was the possibility of a harder economic landing than was currently envisioned, and what impact it could have on financial stability. The Committee was of the opinion that economic uncertainty was one of the risks to financial stability, and that risks relating to residential and commercial real estate were still significant. Prices in those markets were still high by most measures, but economic activity had slowed down alongside rising real interest rates. Heavier debt service burdens in tandem with weaker growth in economic activity could exacerbate the likelihood of financial distress.

The Committee considered cyber risk to be one of the main underlying risk factors, and it reiterated the importance of increased operational security in payment intermediation and coordination of financial market responses to operational incidents via contingency exercises and cybersecurity testing. The Committee was of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation would enable the Bank to enhance the security and resilience of domestic payment intermediation.

### **Banking system resilience**

In the Committee's opinion, the financial system is on a strong footing. The D-SIBs' liquidity had declined by 105 b.kr. since the FSN's March meeting, primarily because of payments on foreign-denominated and domestic loans. Their liquidity in excess of the required minimum totalled 301 b.kr. at the end of April and was slightly improved relative to the same time in 2023. The D-SIBs' combined liquidity ratio in all currencies was 181%, well above the 100% minimum required under Central Bank rules. Their combined foreign liquidity ratio was 414% in April, and the ratio for Icelandic krónur was 126%. Credit spreads on foreign bond issues had declined further since the FSN's March meeting, after having fallen at the beginning of 2024, and were at their lowest in over two years. All of the D-SIBs had issued eurobonds at terms that were better than the terms on their 2023 issues. The issues had been used to refinance upcoming maturities, thereby reducing their refinancing need. Year-2024 instalments on the banks' foreign bonds totalled less than ½% of GDP, and instalments in Icelandic krónur would equal close to 40 b.kr. (1% of GDP). The D-SIBs therefore had enough liquid assets to cover 2024 and 2025 repayments in both local and foreign currency without being in breach of liquidity ratios. Liquidity stress tests confirmed their resilience. Accordingly, their liquid assets were sufficient to cover both outflows of deposits and debt service for the year.

The D-SIBs' operating results for Q1/2024 were and their combine profit for the quarter totalled 17 b.kr. Their return on equity was 9.7%, or 2.8 percentage points less than over the same period in 2023. Net interest income increased by 3.5% between years, whereas income from fees and commissions and net income from financial activities declined by 1% year-on-year. In addition, operating expenses rose marginally during the quarter. The D-SIBs' combined capital ratio was 24% of their risk base at the end of March 2024, the same as at the end of March 2023. Individual banks' capital ratios were 3.4-4.2% above Central Bank requirements. In Q1/2024, dividends and share buybacks totalled 43.5 b.kr., but when the capital ratio was calculated at the end of the quarter, an additional 25 b.kr. were set aside from capital ratio calculations for proposed year-2024 share buybacks and Q1/2025 dividend payments. The banks' leverage ratio had declined by 0.4 percentage points since the end of 2023, to 12.8% at the end of March. The D-SIBs' minimum required own funds and eligible liabilities (MREL) as determined by the Central Bank ranged between 29.8% and 31% of their risk base as of end-March 2024. The banks' MREL funding ranged between 36% and 39.6% of their risk-weighted assets.

The household non-performing loan (NPL) ratio was 1% at the end of Q1 and was unchanged since the turn of the year, while the corporate NPL ratio rose quarter-on quarter by 0.1 percentage points, to 2.5%. The ratio of loans defined as forborne and performing was 2.4% at the end of Q1/2024 and had fallen by 0.6 percentage points during the quarter. The position of firms that needed forbearance measures had therefore grown stronger.

### **Private sector debt**

In March 2024, private sector debt to domestic financial institutions had contracted in real terms by 0.4% year-on-year. Household demand for credit centred mainly on indexed mortgages. Households have continued to refinance non-indexed debt with new indexed loans in order to lower their debt service. As a result, inflation-indexed mortgage loans are still growing as a share of the total mortgage stock, measuring 53.7% at the end of April. A large stock of non-indexed fixed-rate mortgage loans are up for interest rate review in the next several months. Based on the outstanding balance at the end of March, loans due for an interest rate reset in 2024 total 207 b.kr., or 7.8% of the total outstanding mortgage stock. It can be assumed that a large proportion of these loans will be refinanced, either partly or in full, with new inflation-indexed loans, as they were granted at much more favourable interest rates than are currently available on non-indexed loans, and all else being equal, resetting interest rates would push many borrowers' debt service burden sharply upwards. Households' equity position has grown stronger in the recent term, and households in general are quite resilient, which gives them scope to respond to heavier debt service.

In spite of high interest rates, mortgage loan quality has improved in many respects in the past few months. For example, the share of outstanding mortgages with a loan-to-value ratio (LTV) ratio over 80% has declined markedly in the past two years. Among first-time buyers, average debt service-to-income (DSTI) ratios have fallen, and the share of new mortgages granted with a DSTI ratio over 30% is declining as well. Furthermore, Central Bank data indicate that the average maturity on new mortgage loans has grown shorter since mid-2022, for indexed and non-indexed loans alike. At the end of Q1/2024, household debt had fallen 1.1% year-on-year in real terms, and the ratio of household debt to disposable income was down as well, to 145.2% at the end of the quarter. The household debt-to-GDP ratio rose, however, from 73.1% at year-end 2023 to 73.8% at the end of Q1/2024, owing to a contraction in GDP during the first quarter of the year.

Businesses' demand for bank loans appears to remain robust, although corporate bond issuance in the market has subsided. Corporate debt owed to domestic financial institutions increased slightly in Q1/2024, measuring 0.5% year-on-year in real terms at the end of March, as compared with -1.1% at the end of 2023. Growth in debt varies from one sector to another. It is strongest among construction companies, followed by real estate firms. In other sectors, real growth was marginal or even negative, in part because companies refinanced some of their bank loans by borrowing abroad. Companies have increasingly sought out

inflation-indexed loans, which have therefore been growing as a share of the total corporate loan stock in the past twelve months.

### **Asset prices**

Housing market turnover had increased, and the number of contracts finalised in recent months had risen above its historical average. In the capital area, housing market turnover had increased by 47% year-on-year in the first four months of 2024, and turnover in regional Iceland had grown as well. The increase is due in part to demand home purchases by Grindavík residents who had been forced to evacuate their homes. As of mid-May, the real estate firm Þórkatla had signed nearly 500 purchase agreements for property in the town of Grindavík, whose population included about 1,200 households at the onset of the volcanic eruptions in November 2023.

In 2024 to date, approximately 2,000 properties have been on the market, including nearly 900 newly constructed homes as of end-May. New construction has accounted for a large share of sold properties in recent quarters. The increased tension in the housing market shows in a decline in the share of homes sold at below the asking price. The ratio had fallen below its pre-pandemic level. In April 2024, the capital area house price index had risen by 0.2% year-on-year in real terms. The ratio of house prices to fundamentals had held broadly unchanged since mid-2023, and home prices were still high in historical context. At the end of April, they were 6% above their estimated long-term trend.

According to the Housing and Construction Authority's (HMS) March 2024 tally, new construction projects have declined somewhat in number between years. At that time, the outlook was for roughly 3,000 new homes to reach completion in 2024, as compared with 3,400 completed projects in 2023. It appears that construction market activity (not limited to residential construction) is still increasing. Turnover in the market grew in real terms by nearly 9% year-on-year in the first two months of 2024. Furthermore, imports of construction materials have grown in recent months, as have jobs in the construction sector.

The index of real commercial property prices in greater Reykjavík (CRE price index) was down by nearly 9% year-on-year at the end of Q1/2024. The index is now about 4% above its estimated long-term trend, as compared with just over 17% above trend a year ago. Turnover with commercial property in greater Reykjavík increased in real terms by nearly one-fourth between years. The D-SIBs' loans to CRE companies, which account for around 20% of their total corporate lending, have increased somewhat, and there has been a significant shift towards inflation-indexed lending since end-Q3/2023. Despite high interest rates, it appears that the quality of loans to CRE companies has not worsened materially, as the non-performing ratio in the sector has held relatively stable at close to 2% since the beginning of 2023.

Share prices of listed companies had fallen since the Committee's March meeting, and turnover had increased by 20% year-on-year. In the previous half-year, there had been a number of share price offerings, which had accounted for 18% of total equity market turnover. The OMXI15 index had fallen by 8% since the March meeting and by 7% in 2024 to date. The market value of most companies listed on the exchange had fallen in the past year, led in the recent term by banks and transport/shipping companies. Yields on nominal Treasury bonds had risen since March. Inflation had eased more slowly than expected, and the Central Bank Monetary Policy Committee's (MPC) March decision to hold the Bank's policy interest rate unchanged had affected developments as well. The short-term breakeven inflation rate in the bond market had moved in line with measured inflation, but the long-term breakeven rate was still high, at over 4%, and had inched upwards since the FSN's last meeting. Indexed Treasury yields had risen since the March meeting, as had covered bond yields. 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 exchange rate of the króna had remained flat since the Committee's March meeting and was 1% higher than at the end of December. Interbank market turnover had diminished somewhat, and volatility had been

historically low, in an indication of balanced inflows and outflows of foreign currency. The banks' net forward foreign currency position was positive by 161 b.kr. at the end of April and had declined since end-February, after increasing at the beginning of the year. Furthermore, the pension funds had bought foreign currency for 24 b.kr. in the first four months of the year, about the same as in the same period of 2022 but less than in the first four months of 2023. The D-SIBs' combined foreign exchange balance had declined between meetings and was broadly in balance, in that the banks' foreign assets were roughly equal to their foreign liabilities.

The balance on goods and services trade was negative by 42.7 b.kr. in Q1/2024, as compared with a deficit of 19.2 b.kr. over the same period in 2023. In the first four months of 2024, foreign tourist arrivals increased by 6.5% year-on-year, while hotel bed-nights declined during the same period. The real exchange rate had risen between years, and it emerged that the general price level in Iceland was about 20% higher at the start of 2024 than, for instance, in Norway, Finland, and the UK, which affected the competitive position of the tourism sector.

The Central Bank's international reserves totalled 912 b.kr. at the end of Q1/2024, after increasing by 122 b.kr. quarter-on-quarter, owing mainly to issuance of foreign-denominated Treasury bonds. The reserves exceeded all key reserve adequacy benchmarks. The ratio of the reserves to the International Monetary Fund's (IMF) reserve adequacy metric was 126% at the end of Q1/2024.

### **Benchmarks for the determination of the countercyclical capital buffer**

Each quarter, the FSN determines the countercyclical capital buffer (CCyB) rate. The FSN discussed the draft version of a benchmark for the determination of the CCyB and the fundamental principles that should underlie decisions about the buffer rate. It was decided that the Committee would work together on formulating a policy on the CCyB before its next meeting, when members would discuss the range in which the buffer should generally lie and the conditions that should prompt an increase or decrease in the buffer rate. The FSN also noted that when the buffer rate was lowered during an economic downturn, it was important to keep it low for long enough to enable financial institutions to use the scope to maintain lending activity.

### **Capital requirements on financial institutions**

A regular review of the capital buffer for systemically important financial institutions and the systemic risk buffer will take place later in 2024. The Committee discussed the role of the capital buffers and the risks the buffers were intended to address. Furthermore, members discussed the amendments made to the statutory framework for the buffers in recent years, which have increased in flexibility in their application, including the interactions between the buffers and the possibility of applying them to specific risks in the financial system. The FSN also discussed the various ways capital buffers were applied in other EEA countries.

### **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 was given a presentation on financial market infrastructure and operational security. The Central Bank has adopted TIBER-IS, which is a framework for cyberattack testing for institutions and companies that are important in the context of the domestic financial system. Testing has already begun within the Central Bank, with the aim of identifying vulnerabilities in its defences and thereby bolstering resilience. The TIBER project places emphasis on providing cyberdefence training to employees in the Icelandic financial system. The FSN was also given a presentation on the activities of the cooperation forum on operational security of financial market infrastructure (SURF). Work on mapping out service elements in payment intermediation has been underway, and a coordination plan is in preparation. A comprehensive policy on cybersecurity for the financial system is set for completion this autumn. The policy is prepared in accordance with recommendations from the International Monetary Fund (IMF) in its recent Financial Sector Assessment Program (FSAP) appraisal.

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. The FSN was given a presentation on work towards the implementation of an independent domestic payment solution for Iceland. The technical implementation is complete, and the next step is to select a developer for the infrastructure. It was also explained that the Governor had signed a memorandum of understanding with the European Central Bank (ECB), which entailed examining and assessing the possibility of using the ECB's interbank systems (TIPS and T2) in Iceland.

The FSN emphasised the importance of operational security in payment intermediation. The resilience of payment intermediation must be addressed in a comprehensive way, including harmonisation of financial market responses to operational incidents, contingency exercises, and cybersecurity testing. It emerged that the Committee was of the opinion that the passage of the currently pending bill of legislation amending the Central Bank Act as regards operational security of payment intermediation would enable the Bank to enhance the security and resilience of domestic payment intermediation.

The Resolution Authority and the deposit insurance scheme

The FSN was given a presentation on the deposit insurance system and on the financing of resolution or winding-up proceedings for credit institutions. Recent developments in Iceland were discussed, including the division of the deposit insurance fund into two parts – the resolution fund and the deposit division – and were placed into the context of key variables in the deposit market. Developments in deposits and deposit insurance were discussed. At the end of 2023, the assets of the Financial Institutions' Insurance Fund (TVF) totalled 1.5% of insured deposits. The minimum according to the Act on Deposit Guarantees and an Investor Compensation Scheme, no. 98/1999, is 0.8%; therefore, the TVF is well financed relative to comparable funds in Europe. The FSN was given a presentation on the recommendations made by the IMF in its recent FSAP appraisal as regards deposit insurance and the resolution fund, as well as amendments to European legislation, which will soon take effect in Iceland.

Rules on Derivatives Transactions

The Committee discussed the opinion of the IMF mission that visited Iceland in May 2024. The IMF noted that the shallowness of the domestic foreign exchange market gave rise to the risk of excessive exchange rate volatility during shocks, and it proposed that consideration be given to imposing restrictions on the commercial banks' derivatives trading in order to deepen the market. In April 2022, the FSN approved the Rules on Derivatives Transactions, no. 412/2022, which limited the total scope of financial institutions' derivatives trading so that the net forward FX position vis-à-vis any given counterparty may not exceed 10% of the capital base and the total forward FX position (the sum of the forward position vis-à-vis all counterparties combined) may not exceed 50% of the capital base.

The Committee discussed the importance of using macroprudential tools to limit position-taking involving the Icelandic krónur. The experience of increased freedom in the derivatives market had been positive, however. The current scope was used mainly to serve customers in the import and export sectors with forward foreign currency contracts. A wider interest rate differential with abroad could affect position-taking in high-yielding currencies. Under current conditions, the FSN considered it appropriate to exercise caution in amending rules on derivatives trading, and it was of the opinion that the rules should not be amended at the present time.

EFTA Court judgments on mortgage loans to consumers

The Committee received information on the EFTA Court judgments of 23 May 2024, in which the Court handed down an advisory opinion and answered questions on the interpretation of specific provisions of EU directives pertaining to consumer mortgages, with reference to standard terms and conditions governing amendments to changes in interest rates on Icelandic banks' mortgage loans. Upon receipt of the EFTA Court opinion, the cases will be subject to conventional treatment in the Icelandic courts, and their progress

will be monitored. The potential impact of the cases on the D-SIBs was discussed at the meeting, but it was not considered likely that financial stability would be undermined.

## 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 was of the opinion that the banks were on a solid footing. The D-SIBs' capital ratios were ample and their liquidity strong. Stress tests on the banks' liquidity suggested that they could withstand considerable strain. As yet, higher interest rates had not resulted in increased arrears and loan losses, which were still below their pre-pandemic level. Economic activity had lost pace, which had shown in reduced Q1/2024 profits, among other things. Inflation had been higher and more persistent than expected, and the longer interest rates remained high, the greater the likelihood of a hard landing, which could test the banks' resilience. The rise in real interest rates puts pressure on households' disposable income and firms' operating environment. These effects are likely to show more strongly in the coming term, although they will be mitigated by the strong overall equity position of households and of companies in most sectors. Loan quality could deteriorate and arrears could increase if the economic outlook and the employment level deteriorated more than was currently envisioned. Last year's decision to increase the buffer to 2.5% created important 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 5 June 2024.

The following Committee members were in attendance:

Ásgeir Jónsson, Governor and Chair of the Committee

Arnór Sighvatsson, 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

Tómas Brynjólfsson, 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 Financial Stability Department at the Central Bank; Rannveig Júníusdóttir, Director of the General Secretariat; Eggert Th. Thórarinsson, Deputy Director of the Financial Stability Department; Vigdís Ósk Helgadóttir, Head of Unit in the Financial Stability Department; and Steinn



Fridriksson, expert in the General Secretariat, attended the entire meeting. In addition, several other Bank staff members attended part of the meeting.

Rósa Björk Sveinsdóttir wrote the minutes.