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Reykjavík, 19. december 2018

Recommendation on countercyclical capital buffer

On a quarterly basis, the Financial Stability Council shall submit recommendations to the Financial Supervisory Authority concerning the value of the countercyclical capital buffer pursuant to Article 86(d), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002. In particular, the Council bases its recommendations on recommendations and analysis from the Systemic Risk Committee in determining the value of the countercyclical capital buffer; cf. the Act on a Financial Stability Council, no. 66/2014.

The main purpose of the countercyclical capital buffer is to enhance financial system resilience against potential losses following excessive debt collection and accumulation of cyclical systemic risk. The buffer may be built up concurrent with the accumulation of imbalances in the financial system. The buffer requirement is reduced or lifted during a concurrent downward financial and business cycle so as to enhance financial institutions' ability to maintain a sustainable supply of credit. The countercyclical capital buffer therefore changes with developments in cyclical systemic risk.

With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer be raised by 25 basis points, to 2%, for all financial undertakings – each institution individually and at the group level.

Systemic Risk Committee analysis

The decision to recommend a countercyclical capital buffer in Iceland takes account, among other things, of four core indicators that the Financial Stability Council has defined for the first intermediate objective of financial stability: growth in the credit-to-GDP ratio, real credit growth to households and businesses, real increases in residential and commercial real estate prices, and the credit-to-GDP gap. A number of other indicators are considered as well, so as to obtain a clear overview of cyclical systemic risk.¹

The financial cycle is according to all underlying indicators currently in an upswing stage. Due to persisting positive credit growth, increases in property prices and favorable economic conditions it is the view of the Financial Stability Council that the build-up of the countercyclical capital buffer should be continued.

Credit growth and private sector debt

The twelve-month growth in total private sector debt during Q3/2018 was 6.9% in real terms. Household debt increased by 4.6% in real terms and corporate debt by 9%. Private sector debt growth adjusted for inflation and exchange rate movements has been positive since the beginning of 2017. Most of the growth has been sustained by deposit institutions, their net private credit growth having been positive since the second half of 2015. The credit-to-GDP ratio rose by 4.4 percentage points between Q3/2017 and Q3/2018 and by 2.6% between April 2018, when the countercyclical capital buffer was last raised, and Q3/2018.

¹ The European Systemic Risk Board (ESRB/2014/1) recommends that when assessing quantitative information in regards to decisions on the appropriate countercyclical capital buffer that designated authorities should monitor a set of variables that indicate the build-up of cyclical systemic risk. This set should include the following: Measures of potential overvaluation of property prices, measures of credit developments, measures of external imbalances, measures of the strength of bank balance sheets, measures of private sector debt burden, measures of potential mispricing of risk as well as measures of derived from models that combine the credit-to-GDP gap and a selection of the above measures.

The private sector credit-to-GDP ratio has been decreasing during the last several years and is now comparable to its value at the turn of the century. Should households start to take advantage of their increased overall creditworthiness in order to increase their debt levels this could lead to further debt imbalances. Corporate debt has risen notably more than other debt during the last few years and at the end of October 2018 the twelve-month growth of deposit institution's credit to firm was 12.8% in real terms. It's therefore important that the resilience of credit institutions should continue to be closely monitored.

Real estate markets

Despite the fact that increases in housing prices in the capital area have slowed down during 2018, the real price of housing is still high from a historical perspective. Housing prices have grown at a similar rate as the spending power of households, but when viewed in terms of other fundamentals prices appear overvalued. Historically, periods of rapid increases in housing prices accompanied by more lenient lending policies have routinely led to periods of rapid debt growth.² Thus, that debt growth was up until recently relatively low compared to the rapid growth of housing prices and the fact that at the same time lending policies were loosened somewhat, may indicate that private sector debt will continue to rise during the coming months. Experience has also shown that such periods as described can stimulate an increase in debt driven consumption.³

Should housing prices and debt continue to grow at positive rates this might lead to households becoming more sensitive to sharp downswings in property prices, especially if households have taken out adjustable rate mortgages and most of their net worth is tied up in homes.⁴ This is the case with a sizable number of Icelandic households. Therefore, it is important to continue to monitor lender resilience in regards to both the impairment of housing loans as well as any possible indirect losses when widespread household financial difficulties lead to reduced demand and economic activity.

During crises commercial real estate prices have a tendency to fall much more rapidly than other real estate prices and historically credit institutions have experienced significant impairment losses on commercial real estate loans.⁵ Thus, credit institutions face higher credit risk during periods when commercial real estate prices increase rapidly accompanied by increased commercial real estate lending. There are some indications that the overall returns of Icelandic firms are decreasing. Should prices of commercial real estate keep increasing while firm profits continue to deteriorate it is possible that credit institution resilience would be negatively effected as loan portfolios become riskier.

Financial market equity and funding

The capital adequacy ratios of the three largest banks have decreased during the last several years. The banks' funding has also recently become more risky, with tier 2 capital having increased at the expense of Common Equity Tier 1 (CET 1) ratios. Raising the countercyclical capital buffer is thus expected to increase the quality of equity since the buffer requirement must be fulfilled exclusively with CET 1 capital.

The inflow of foreign capital can intensify the credit cycle and lead to current account imbalances. Private sector resilience to shocks is also reduced as the ratio of foreign denominated debt is increased.⁶ The three largest banks have increasingly been seeking funding from foreign credit markets. Furthermore, recently there has been an increase in the banks' foreign denominated lending to firms. Whether the banks' increased dependency on foreign denominated funding is further stimulating debt growth remains to be seen.

² Roy & Kemme (2012). Causes of banking crises: deregulation, credit booms and asset bubbles, then and now. *International Review of Economics & Finance*. 24. pp. 270-294.

³ Aoki et al. (2004). Housing prices, consumption, and monetary policy: A financial accelerator approach. *Journal of Financial Intermediation*. 13(4). pp. 414-435.

⁴ IMF (2017). *Household debt and financial Stability*. Global Financial Stability Report and Zabai (2017). Household debt: recent development and challenges. *BIS Quarterly Review*, December 2017. pp. 39-54.

⁵ Norges Bank (2018). *Financial stability report 2018: Vulnerabilities and risks*. and Kragh-Sorensen & Solheim (2014). *What do banks lose money on during crises?*. Norges Bank staff memo no.3/2014.

⁶ Giese et al. (2014). The credit-to-GDP gap and complementary indicators for macroprudential policy: Evidence from the UK. *International Journal of Finance & Economics*, 19(1), pp. 25-47 and Hahm, Shin & Shin (2013). Noncore bank liabilities and financial vulnerability. *Journal of Money, Credit and Banking*. 45(s1). pp. 3-36.

Economic outlook

The output gap has continued to narrow and during the next couple of years economic growth is likely to be in line with the equilibrium growth of potential output. While private consumption has grown considerably there is still a sizable trade surplus. The Króna has depreciated during the last few months, which improves the terms of trade and the position of exporters. The economic outlook therefore does not indicate any reason for slowing down the build-up of the countercyclical capital buffer.

The duration and magnitude of financial cycles are generally longer and higher than those of business cycles. Authorities should take this into account when making decisions on appropriate macroprudential policies in order to mitigate systemic risk.

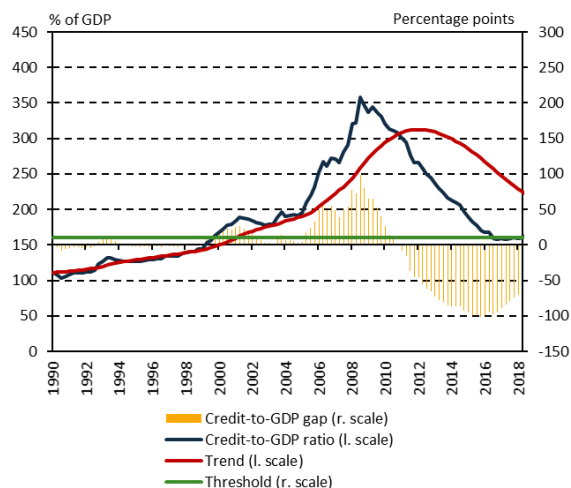
Conclusion

Developments in cyclical systemic risk since the last increase in the countercyclical capital buffer are considered to warrant continued build-up of the countercyclical capital buffer, as previous instructions from the Financial Stability Council have indicated that the countercyclical capital buffer is in an upward phase. With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer be raised by 25 basis points, to 2%, for all financial undertakings – each institution individually and at the group level – apart from those institutions that are exempt from capital buffers pursuant to Article 84, Paragraph 4 of the Act on Financial Undertakings, no. 161/2002, and that the buffer take effect twelve (12) months after the date of the Financial Supervisory Authority decision. The Financial Stability Council can therefore be expected to recommend that the build-up of the countercyclical capital buffer continue in line with increased risk in the financial system.

Appendix to recommendation concerning countercyclical capital buffer

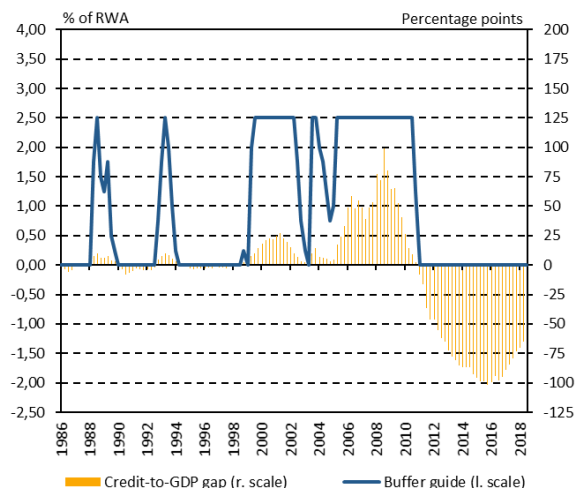
In accordance with official financial stability policy, the Financial Stability Council shall regularly disclose which indicators it takes into particular consideration in analysing systemic risk. Below are the indicators considered most important in the assessment of the countercyclical capital buffer at the Financial Stability Council meeting of 19. december 2018.

The credit-to-GDP gap



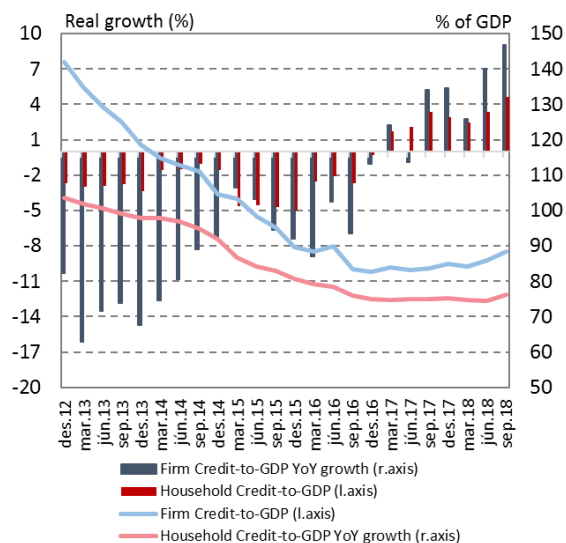
Total credit to households and firms in relation to GDP. The trend component is obtained with a one-sided HP-filter with $\lambda=400.000$. The 9% threshold value comes from Laina, Nyholm & Sarlin (2015).
Sources: Statistics Iceland, Central Bank of Iceland.

The buffer guide



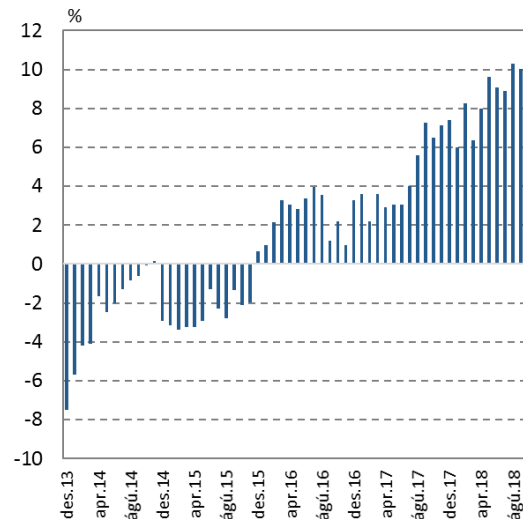
The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.
Sources: Statistics Iceland, Central Bank of Iceland.

Firm and household debt



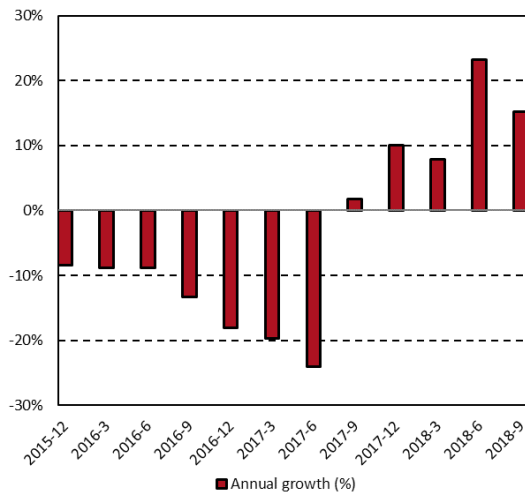
Real growth is year-on-year growth in constant prices.
Source: Central Bank of Iceland

Real private credit growth at deposit institutions



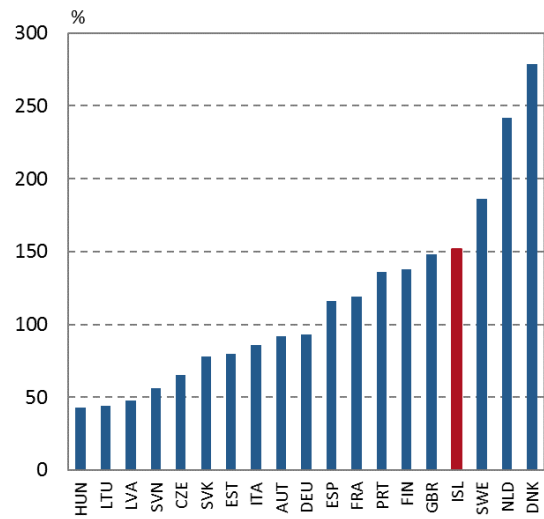
Sources: Statistics Iceland, Central Bank of Iceland

Domestic commercial banks' FX demominated loans to nonfinancial firms



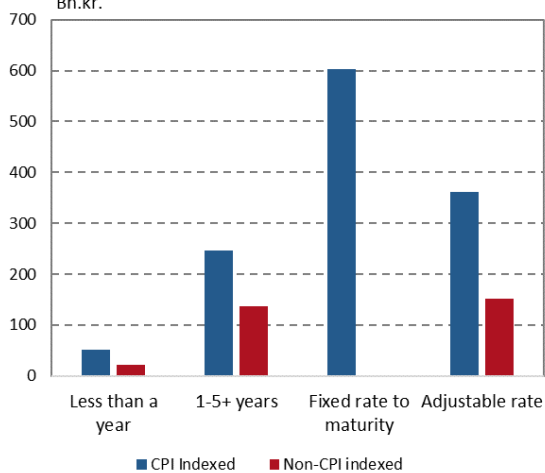
Numbers at constant exchange rates.
Source: Central Bank of Iceland.

Household debt-to-income in 2017



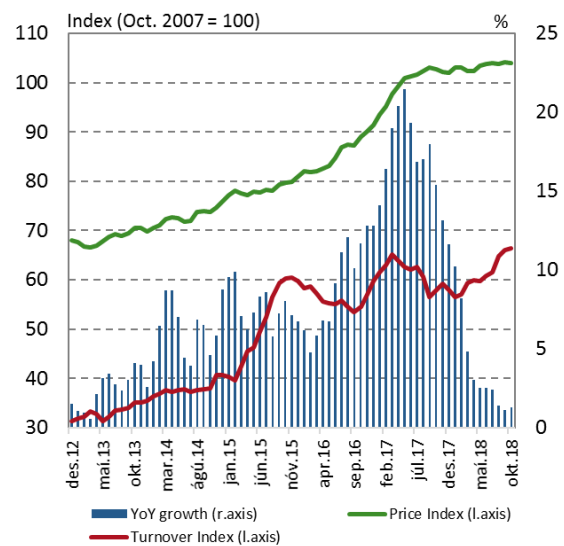
Source: OECD

Residential mortgages
By time until next rate reset
Bn.kr.

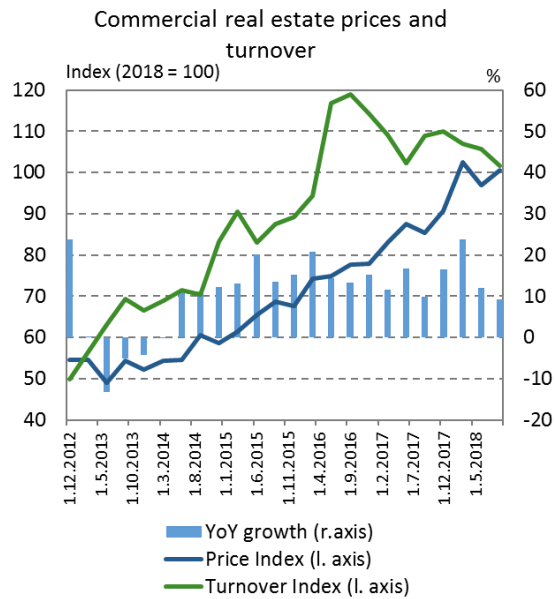


Numbers include all Icelandic retail banks as well as the eight largest pension funds.
Source: The Financial Supervisory Authority, Iceland

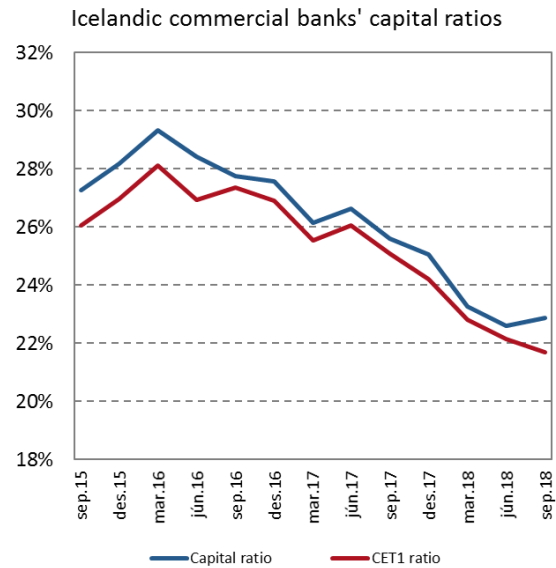
Residential housing prices and turnover



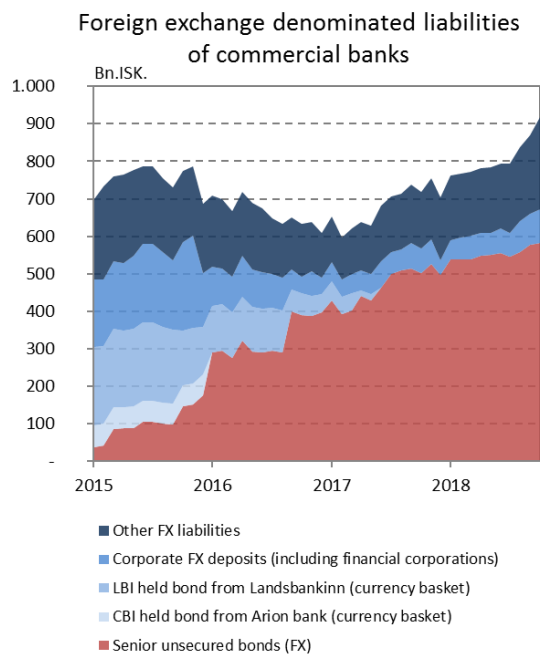
Turnover index is smoothed using a 6-month moving average.
Sources: Statistics Iceland and Registers Iceland



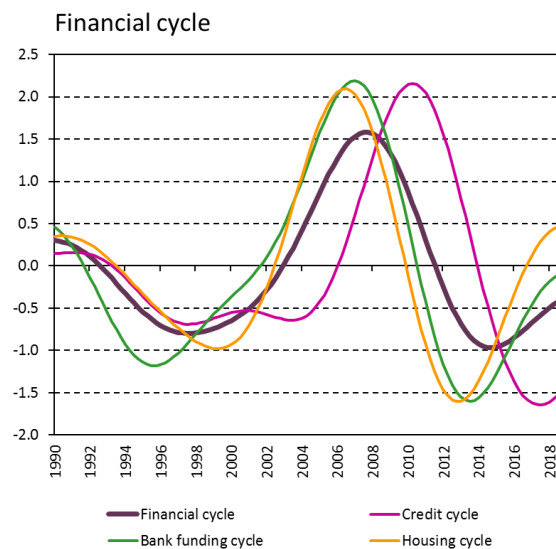
Sources: Statistics Iceland and Registers Iceland



Capital ratio includes Tier 1 and Tier 2 capital.
Sources: Commercial banks' financial reports



Source: NSFR reports



Arithmetic mean of cyclical components from variables in each subcycle and the complete set of variables. Cyclical components are obtained using the Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years.
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.