



FINANCIAL STABILITY COUNCIL

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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 maximum systemic risk buffer rate is 2.5% of total risk exposure. A higher rate can, however, be set if the risk factors underlying the buffer rate decision warrant it. The countercyclical capital buffer was first set in March 2016 (at 1%) and then increased by 0.25 percentage points in November of the same year, by 0.5 percentage points in May 2018 and finally by 0.25 percentage points in February 2019. Increases of the countercyclical capital buffer apply 12 months from the decision and thus the rate will be 2% in February 2020.

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 held unchanged.

The purpose of the countercyclical capital buffer

The main purpose of the countercyclical capital buffer is to enhance financial system resilience against potential losses during unstable conditions following excessive debt accumulation and the build-up of cyclical systemic risk.

Cyclical systemic risk may increase when substantial lending growth is concurrent with rapidly rising asset prices and low defaults and expectations of further growth are present. Tightening conditions can then have a significant impact on the value of the financial system's assets. Consequently, financial undertakings might respond by safeguarding their capital, e.g. by significantly reducing lending. Reduced supply of credit can cause a contraction in investment and economic activity, which in turn can lead to lower asset prices, an increase in corporate bankruptcy, increased unemployment and thus further deteriorate the quality of loan portfolios. When cyclical systemic risk is realized, a negative chain reaction between lending, economic activity and asset prices deepens the downturn. The purpose of accumulating a systemic risk buffer synchronously with the build-up of cyclical systemic risk and releasing the buffer when the risk recedes or is realized, is to give financial undertakings room to absorb losses on their loan portfolios, without restrictively reducing the supply of credit.¹ Releasing the buffer is not intended to affect economic cycles specifically, rather a financial downturn of the kind previously described, which could coincide with a

¹ Further information on the countercyclical capital buffer can be found in the Council's policy on the application of the buffer (available in Icelandic [here](#)) and in the Financial Supervisory Authority's web magazine (available in Icelandic [here](#)).

contraction in the economy. The buffer should therefore not be released in an economic downturn if cyclical systemic risk is not realized or does not recede at the same time.²

An analysis of cyclical systemic risk for a decision on the appropriate buffer rate

Increases in the countercyclical capital buffer rate have been supported by economic variables that have indicated the build-up of cyclical systemic risk, in accordance with the Financial Stability Council's policy on operating the countercyclical capital buffer. The build-up of cyclical systemic risk has slowed considerably according to recent assessments by the Systemic Risk Committee. As there are no indications that cyclical systemic risk has receded or been realized, a release of the buffer is not warranted at this time.

Cyclical systemic risk and property prices

The price of real estate is still historically high, even when compared with its predictive factors. The real price of residential real estate is still considerably far above its long term trend. In the capital area, prices have remained fairly stable after very sharp increases in 2016-2017. However, real estate prices outside the capital area have risen more rapidly in recent quarters. Commercial property prices have risen sharply in recent years and are still rising, although the pace has slowed considerably as demand for commercial real estate has slowed. The construction sector's debts are still growing very rapidly on an annual basis, although there are signs that growth has slowed somewhat in recent months. Lower property prices could test the commercial banks' resilience, both due to a fall in collateral value and through lower demand or a contraction in the economy.

Cyclical systemic risk and households

With respect to household indebtedness and their debt service capabilities, cyclical systemic risk has not declined recently. The imbalances associated with credit growth are largely dictated by household indebtedness: Other things being equal, credit growth poses a higher risk if households' indebtedness is already high than if their indebtedness is low. Household debt has been relatively stable in recent months as a ratio of GDP and disposable income. Real growth in total household debt was 3.4% in the third quarter of 2019, having fallen somewhat between quarters. However, debt relative to income is higher in Iceland than other countries and some Icelandic households are therefore vulnerable to income loss or an increased debt burden. Furthermore, the share of mortgages in total household credit is among the highest in Europe, and therefore Icelandic homes have greater exposure to the risks inherent in the interaction between housing prices and household debt.

Cyclical systemic risk and firms

Cyclical systemic risk related to firms has not changed much since the last meeting. Firms' debts have been on the rise during the recent economic expansion, but equity has also increased at the same time. At the end of the third quarter of this year, domestic corporate debt was 13% higher in real terms than at its lowest level three years earlier. Growth in credit granted by systemically important banks to domestic enterprises was high, or about 10% on average in real terms, from the fall of 2017 until the spring of this year. Growth in credit granted by domestic lenders to firms was almost 1.7% on an annualized basis in the third quarter of 2019, although the overall decline in corporate debt was 1.1% at the same time. Firms' resilience is still high, while uncertainty remains about the business environment due to a less favorable economic outlook for 2020, especially for the tourism industry.

Conclusion

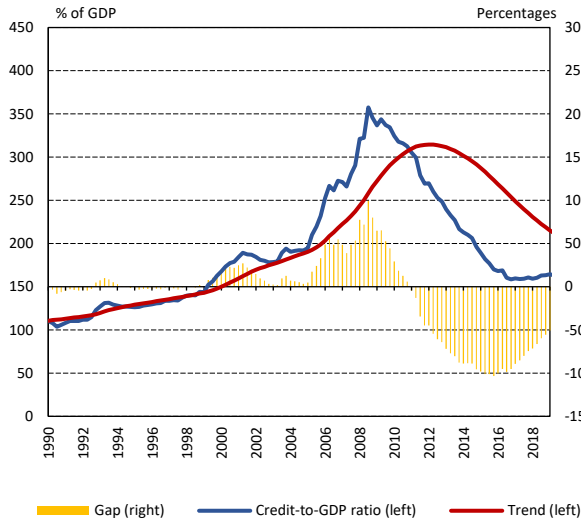
With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer remain unchanged for the time being.

² See for example a [recommendation](#) of the European Systemic Risk Board on guidance for setting countercyclical buffer rates and BIS [guidance](#) for national authorities operating the countercyclical capital buffer.

Appendix to recommendation concerning countercyclical capital buffer

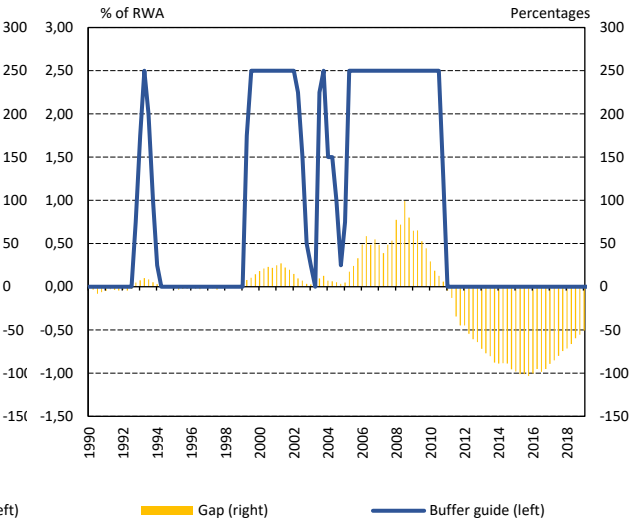
This recommendation is based on the Financial Stability Council's general guidelines of the application of the countercyclical capital buffer. In accordance with official financial stability policy, the Financial Stability Council shall regularly disclose which indicators it takes into particular consideration 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 17 december 2019.

Credit to GDP gap



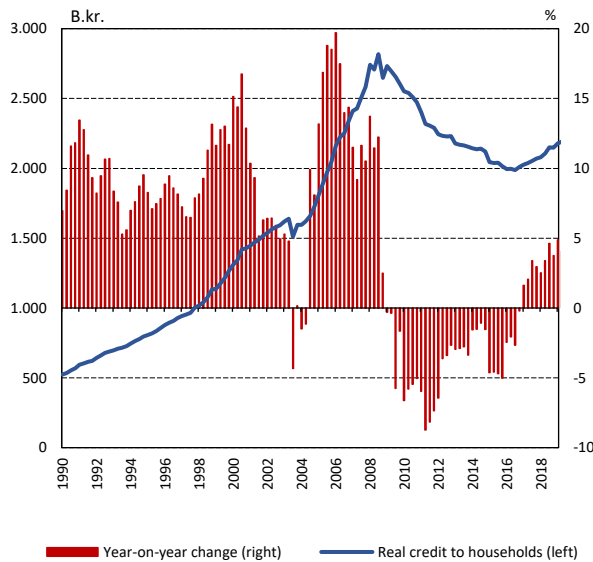
1. Total claim value credit to households and non-financial firms, excluding holding companies, over the sum of GDP for the last four quarters. The trend component is obtained with a Hodrick-Prescott filter with $\lambda=400.000$.
Sources: Statistics Iceland, Central Bank of Iceland.

The credit-to-GDP gap and the buffer guide



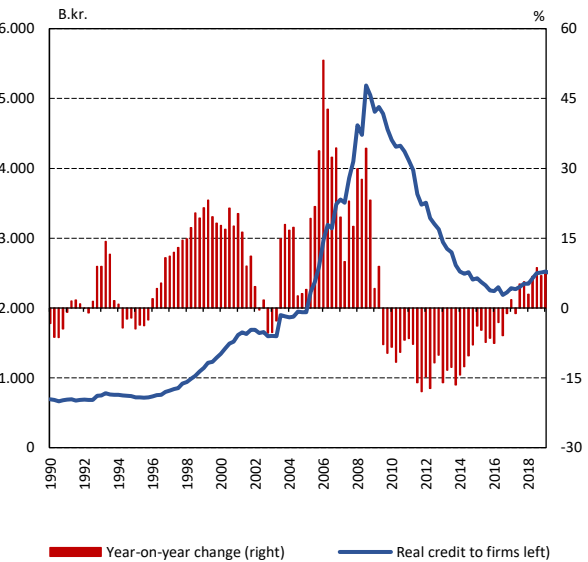
1. The Basel-Committee's countercyclical capital buffer guide follows a linear projection of the credit-to-GDP gap and is only calculated in multiples of 25 basis points.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit to households



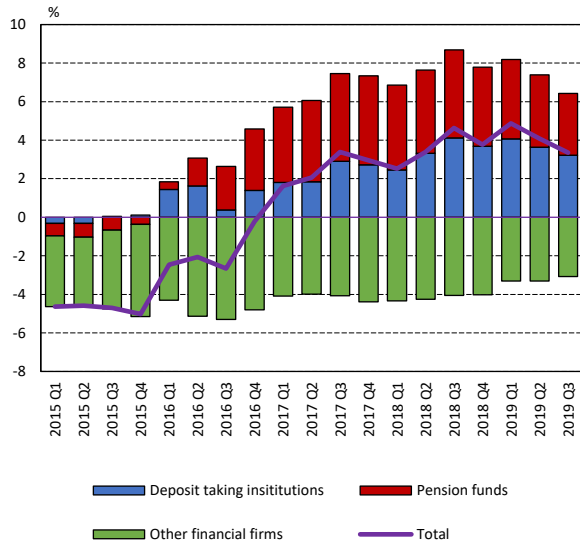
1. Total credit to households, claim value, deflated with the consumer price index. Fixed 2019 Q3 prices.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit to firms



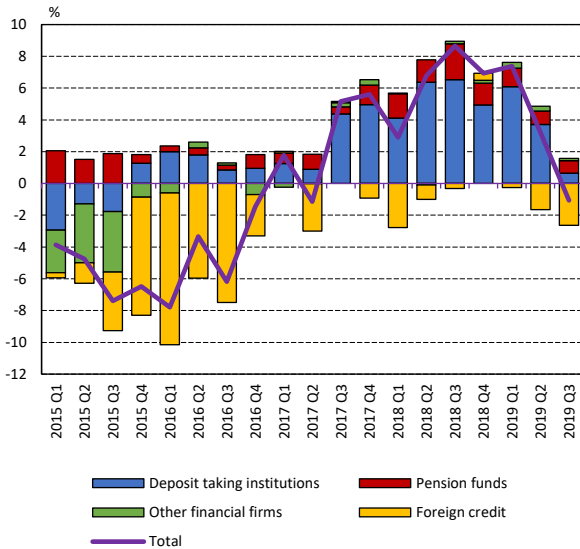
1. Total credit to non-financial firms, excluding holding companies, claim value, deflated with the consumer price index. Fixed 2019 Q3 prices.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit growth to households by type of lender



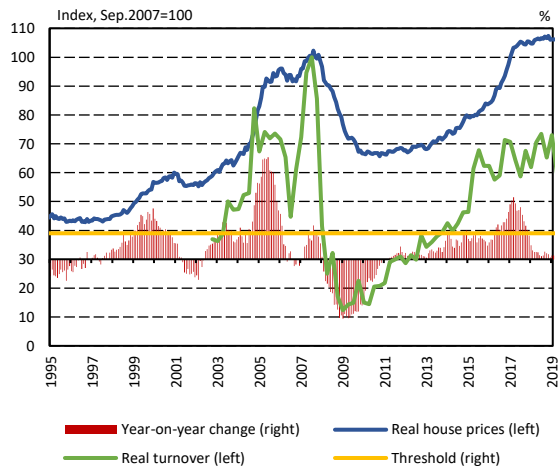
1. Total credit to households, claim value, deflated with the consumer price index. Year-on-year change of the total and contribution of each lender type. Sources: Statistics Iceland, Central Bank of Iceland.

Real credit growth to firms by type of lender



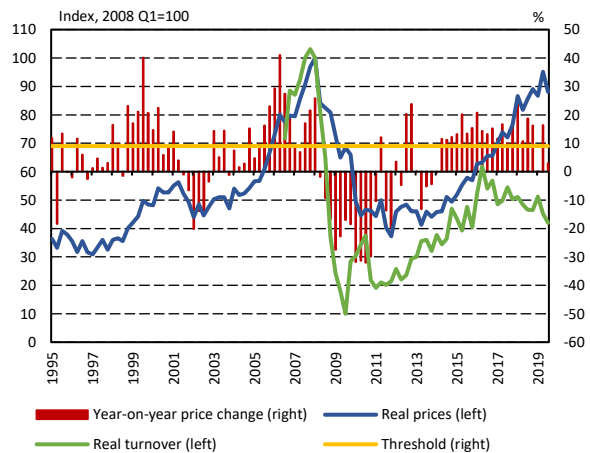
1. Total real credit to non-financial firms, claim value, deflates with the consumer price index. Year-on-year change og the total and contribution of each lender type. Sources: Statistics Iceland, Central Bank of Iceland.

Real house prices and turnover in the capital city area housing market



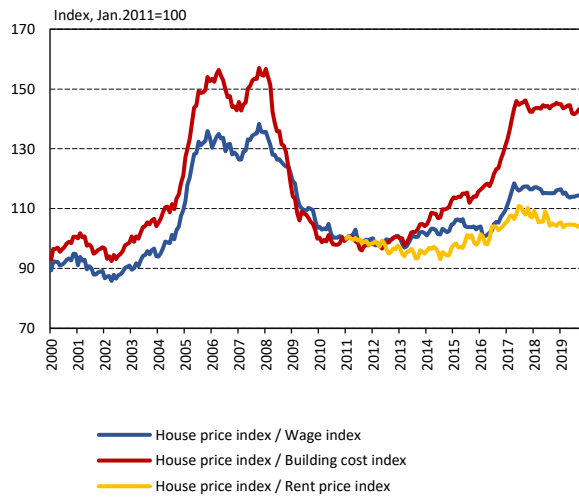
1. Capital city area house price index, deflated with the consumer price index.
 2. Turnover index is the quarterly sum of turnover, deflated with the consumer price index.
 3. Threshold value comes from Laina, P., Nyholm, J., og Sarlin, P. (2015). Leading indicators of systemic banking crises: Finland in a panel of EU countries. *Review of Financial Economics*, 24, bls 18-35.
 Sources: Registers Iceland, Statistics Iceland, Central bank of Iceland.

Real prices and turnover in the capital city area market for commercial property



1. CRE-price index for the capital city area, deflated with the consumer price index. The index shows a weighted average of industrial, retail and office prices
 2. Turnover index shows moving average four quarter turnover, deflated with the consumer price index. Latest values are preliminary.
 3. Threshold value comes from Laina, P., Nyholm, J., og Sarlin, P. (2015). Leading indicators of systemic banking crises: Finland in a panel of EU countries. *Review of Financial Economics*, 24, bls 18-35.
 Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

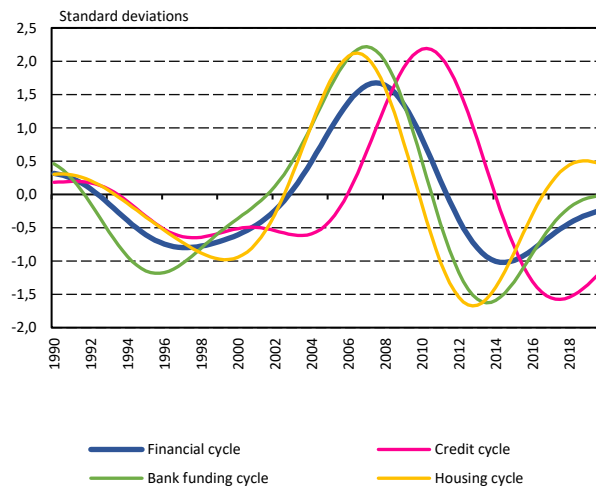
Capital city area house prices and determining factors



1. The price-to-wage ratio is an indicator of households' capacity to purchase housing. The price-to-building cost ratio indicates the feasibility of building new instead of buying used. The price-to-rent ratio indicates the feasibility of renting instead of buying.

Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

The financial cycle and its components



1. The Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years is applied to eight variables connected to total NFPS-credit, house prices and non-core bank funding, to obtain their cyclical component, which is then demeaned and standardized. The cycle's components show the arithmetic mean of the cycles pertaining to each component. The financial cycle shows the mean of all eight cycles. Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.