

Reykjavík, September 30, 2016

Recommendation on the countercyclical capital buffer

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 1.25%, 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(d), 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 be expected to recommend that the build-up of the countercyclical capital buffer continue in line with the upward phase of the financial cycle.

Supporting arguments

The main purpose of the countercyclical capital buffer is to increase the resilience of the financial system, thereby mitigating the impact of the downward phase of the financial cycle. Lifting the buffer gives credit institutions the scope to maintain the flow of credit during a downward phase, thereby mitigating the impact of shocks on the real economy. It is therefore important to finish building up the buffer before the downward phase begins and the need to lift the buffer increases. The decision to recommend a countercyclical capital buffer in Iceland takes account of four core indicators plus additional 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.

According to Article 136, Paragraph 2 of EU Directive 2013/36/EU, the credit-to-GDP gap should be considered, together with other indicators, in determining the value of the countercyclical capital buffer. At the end of June 2016, total private sector debt amounted to 167% of GDP, and the credit-to-GDP gap, the deviation from long-term trend, was negative by 70%. The Basel Committee buffer guide therefore does not yet signal the activation of the countercyclical capital buffer. Because the impact of the last financial crisis still affects data series, it is uncertain whether the credit-to-GDP gap gives an accurate view of the financial cycle position. It is therefore important to consider additional indicators and other information in assessing the position. The European countries that have already activated a countercyclical capital buffer all emphasise that the credit-to-GDP gap should only be used as a guideline and that it is necessary to examine other factors as well.¹ Historical data for Iceland also show that the buffer guide has indicated a rapid increase of the countercyclical capital buffer to 2.5%.²

Households' and businesses' real credit from the financial system is still growing moderately, although the pace has accelerated recently. Households and businesses have increased collateral capacity because of debt correction measures and rising asset prices. Furthermore, their debt burden has been low in the recent term. Therefore, conditions are in place for both households and businesses

¹ See Finansinspektionen (2015), Amendment to regulations regarding the countercyclical buffer rate, Decision Memorandum and Czech National Bank (2015). Provision of a general nature on setting the countercyclical capital buffer rate for the Czech Republic No. IV/2015.

² Financial Stability Council (2016), Recommendation concerning countercyclical capital buffers: rationale.

to take on additional debt. Moreover, the Systemic Risk Committee's analysis indicates that raising the countercyclical capital buffer now will not restrict lending to the real economy at the present time.

The financial cycle

The term financial cycle is generally considered to capture the co-movement of a number of financial variables.³ Iceland's financial cycle has been assessed based on the co-movement of financial variables relating to private sector credit, the banks' funding, and house prices. Assessments of the financial cycle of Iceland and other Nordic countries indicate that the cycle's average length is 15-16 years, which is consistent with international research.⁴ The assessment indicates that the house price component is leading for the financial cycle while the credit factor is magnifying.

The financial cycle now appears to be in an upward phase, as the accompanying analysis suggests. In addition, the real economy is now in an upward cycle, with robust GDP growth, a widening output gap, and declining unemployment. Furthermore, the banks have stepped up their foreign funding, and the terms offered to them have improved. As yet, this increase has for the most part been used to pay off debt to the failed banks' estates and has not led to credit growth. Examination of the interaction between the financial and business cycles at present shows that the conditions for continued credit growth are in place and that it is desirable to keep building up the countercyclical capital buffer. Business cycles are generally much shorter than financial cycles, however.⁵ As a result, an economic contraction could occur before the financial cycle reaches a peak. In the event of such a contraction, it is possible to slow down the build-up of the countercyclical capital buffer so as not to impose undesirable restrictions on lending to the real economy.

Developments in credit

Total private sector credit from domestic and foreign lenders continues to fall, either in terms of real value or relative to GDP. Total private sector credit amounted to 167% of GDP at the end of June 2016, a decline of 8% in twelve months' time. In real terms, total credit fell by nearly 3% over the same period: corporate credit fell by 11%, while household credit grew by nearly 2%.

Private sector domestic credit has risen steadily in real terms since year-end 2014. In real terms, annual growth in the private sector's domestic credit, adjusted for the Government's household debt relief measures, was 1.3% in Q2/2016: 1.9% for households and 1% for businesses. When adjustments are made for price and exchange rate movements, however, credit growth shows more clearly, at 2.8%.

Real estate prices

Real estate prices are rising rapidly at present, which indicates that the upward phase of the financial cycle has begun. The twelve-month rise in real residential property prices measured 12.1% in August and has been over 5% almost without interruption for 2½ years. The twelve-month rise in real commercial property prices in the capital area was 14.3% in Q2 and has been over 9% for more than two years. Real estate prices are now similar to autumn 2005 prices in real terms. They have risen rapidly relative to construction costs and have remained rather stable, both as a share of households' disposable income and as a share of rent prices. Furthermore, housing market turnover has increased steadily since 2010 and is now similar to that in Q4/2006 in real terms. The rise in real estate prices

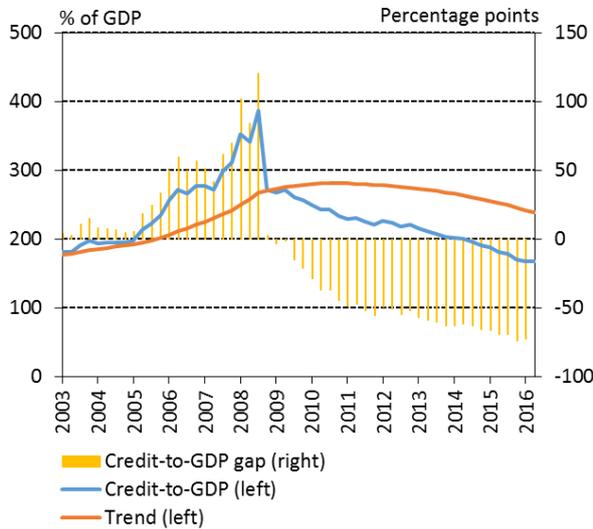
³ See, for example, BIS 2014. 84th Annual Report, Basel, June.

⁴ A working group within the Central Bank is preparing an analysis of financial cycles in the Nordic countries, to be published soon. See also Einarsson et al. 2016. "The long history of financial boom-bust cycles in Iceland. Part II: Financial cycles." Central Bank of Iceland Working Paper no. 72 and Borio, C. 2012. "The financial cycle and macroeconomics: What have we learnt?" BIS Working Paper no. 395.

⁵ See, for instance, Einarsson et al. 2016 and Borio, C. 2012.

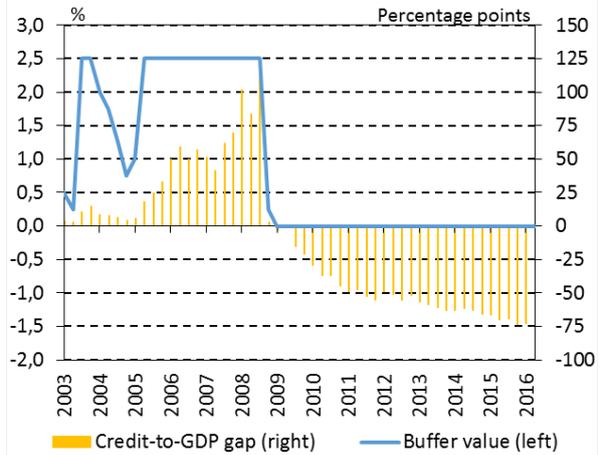
has led to reduced loan-to-value ratios for residential property, thereby giving households greater scope to take on additional debt.

Chart 1 Credit-to-GDP gap



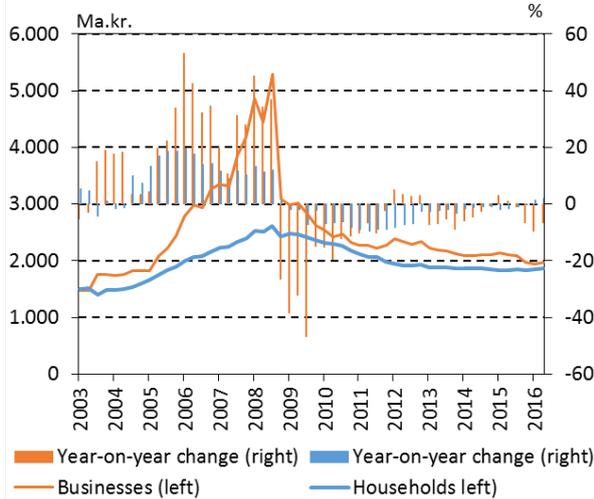
Household and corporate debt as a share of GDP. Trend is found using a one-sided HP-filter where $\lambda=400,000$. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2 Basel buffer guide



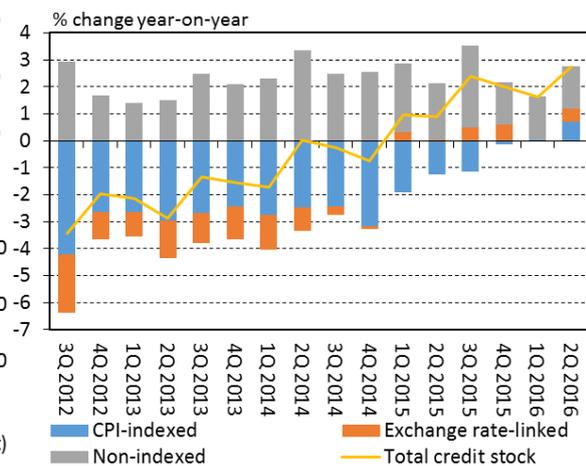
If the credit-to-GDP gap is less than 2 percentage points, the buffer guide is 0. If it is between 2 and 10 percentage points, the buffer guide follows a linear trajectory between 0% and 2.5% of risk-weighted assets. If it is more than 10 percentage points, the buffer guide is 2.5%. Sources: Statistics Iceland, Central Bank of Iceland

Chart 3 Real private sector credit



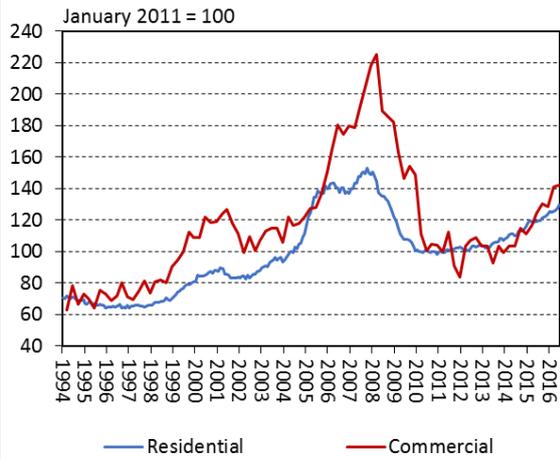
Total credit extended to households and businesses, deflated with the CPI. Adjusted for the Government's household debt relief measures. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4 Year-on-year change in private sector domestic credit stock



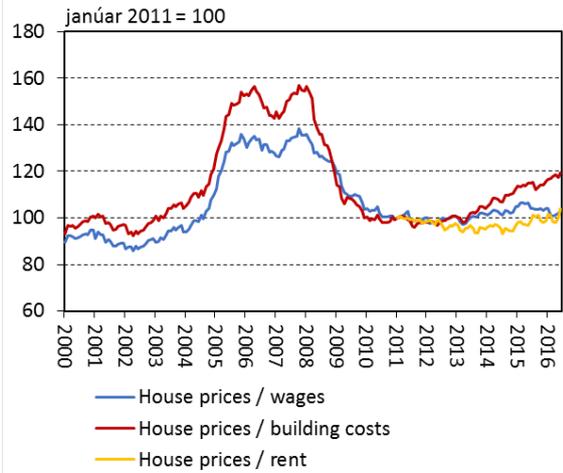
Indexed loans at Q2/2016 price level, exchange rate-linked loans at Q2/2016 exchange rate, non-indexed loans at the current price level. The distribution of write-downs by loan type is estimated based on the size of each type. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5 Real residential and commercial property prices in greater Reykjavík



Property price indices in the greater Reykjavík area, deflated with the CPI. Real commercial property prices based on the weighted average of industrial, retail, and office property.
 Sources: Statistics Iceland, Central Bank of Iceland.

Mynd 6 House prices relative to wages, building costs, and rent¹



House prices are based on the capital area house price index, wages on the wage index, and building costs on the building cost index.
 Sources: Statistics Iceland, Central Bank of Iceland.