



THE FINANCIAL STABILITY COUNCIL

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Recommendation to the Financial Supervisory Authority 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 stay unchanged at 1.25%. The financial cycle has continued upwards at a pace broadly similar to that projected at the Systemic Risk Committee's last meeting. The Financial Stability Council can therefore be expected to recommend that the build-up of the countercyclical capital buffer continue in the coming term, in line with the upward financial cycle.

Supporting arguments

The main purpose of the countercyclical capital buffer is to increase the resilience of the financial system, thereby mitigating financial fluctuations. Lifting the buffer gives credit institutions the scope to lend money during a downward financial cycle, thereby mitigating the impact of shocks on the real economy. It is therefore important to build up the buffer during the upward cycle. 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: real credit growth to households and businesses, real increases in residential and commercial real estate prices, credit intensity, 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. Because the impact of the last financial crisis still affects data series, it is unlikely that the deviation of the debt-to-GDP ratio from long-term trend gives an accurate view of the financial cycle position. It is therefore important to consider additional indicators and other information in assessing the position.

Developments in credit

Real credit granted to the private sector increased marginally in 2016, while the credit-to-GDP ratio declined. However, because of the appreciation of the króna during the year, an assessment of risk relating to the countercyclical capital buffer must take account of an additional indicator; i.e., growth in the price- and exchange rate-adjusted credit stock. The króna appreciated by 18.4% in 2016, causing a substantial reduction in the ISK value of foreign-denominated debt, which fell by 7.8% in nominal terms but rose by 8.1% at constant exchange rates. If price indexed debt is presented at constant prices and foreign debt at constant exchange rates, the overall growth rate in 2016 was 4.3%. It is therefore clear that, by this measure, households and businesses are taking on more debt, albeit at a rate below GDP growth.

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 to take on additional debt.

The financial cycle

The term financial cycle is generally considered to capture the co-movement of a number of financial variables.¹ Iceland's financial cycle has been assessed based on the co-movement of financial variables relating to private sector debt, 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.² The assessment indicates that the housing factor is a leading indicator of the financial cycle and the debt factor is an indicator of amplitude.

The upward financial cycle has begun, and the real economy is also in an upward cycle, with strong GDP growth, an output gap, and low unemployment. Furthermore, the banks have stepped up their foreign funding, and the terms offered to them have improved. As yet, the banks have largely used this foreign funding to refinance other foreign loans taken on less favourable terms. In terms of the interactions between the financial cycle and the business cycle, the conditions for continued credit growth are currently in place.

Real estate prices

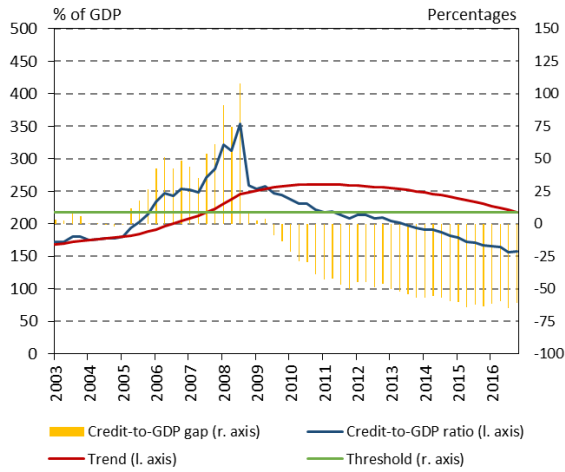
House prices are still rising rapidly and, at present, are the strongest sign of an upward financial cycle. The twelve-month rise in real house prices was 12.8% in December and 14.1% in January. They have risen virtually uninterrupted by more than 5% for nearly three years. The twelve-month rise in real commercial property prices in the capital area has been over 9% for nearly three years. It measured 13.3% in Q3/2016 and 14.3% in Q4. The aggregate increase since 2011 is far in excess of GDP growth, indicating that imbalances are beginning to develop in the commercial real estate market.

Real house prices in the greater Reykjavík area are now similar to those in early 2006. They have risen rapidly relative to construction costs but only marginally relative to rent. Furthermore, as a share of households' disposable income, they have remained broadly stable at roughly the ratio seen at year-end 2004. Moreover, housing market turnover has been growing steadily since 2010. The rise in real estate prices has led to reduced loan-to-value ratios for residential property.

¹ See, for instance, BIS 2014. 84th Annual Report, Basel, June.

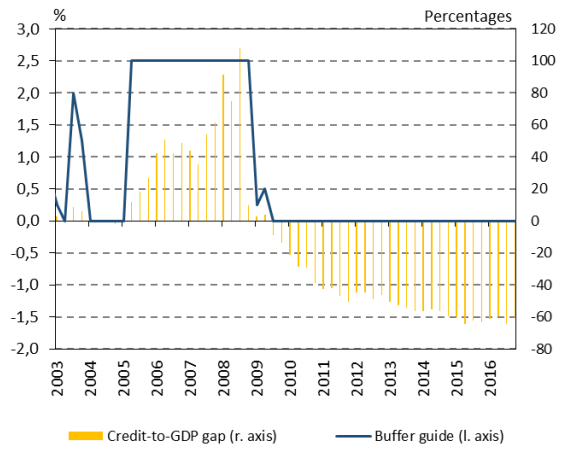
² A working group within the Central Bank is preparing an analysis of financial cycles in the Nordic countries, to be published soon. See also Einarsson *et al.* 2016. "The long history of financial boom-bust cycles in Iceland. Part II: Financial cycles." Central Bank of Iceland Working Paper, no 72.

Chart 1 Credit-to-GDP gap



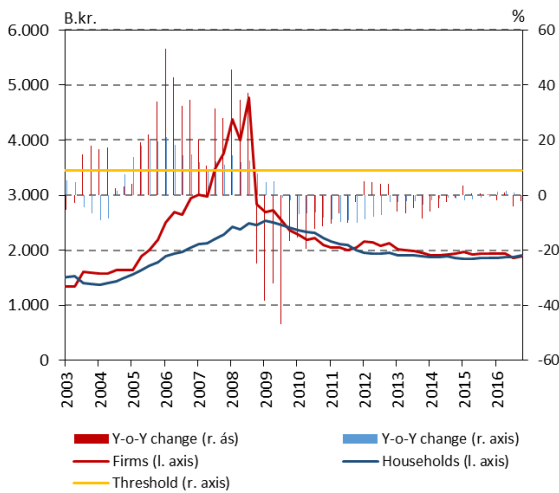
Credit to households and firms at book value, divided by the GDP of the last four quarters. The trend component is obtained with a one-sided HP-filter with a smoothing parameter $\lambda=400,000$ using data for the period 1976-2016. The 9% threshold is one standard deviation of the gap over the period 1991 - Q2 2004. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 2 Buffer guide



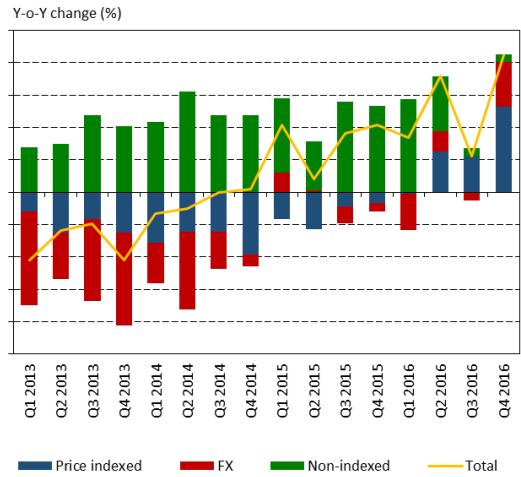
If the gap is negative or smaller than 2 percentage points the buffer guide prescribes a 0% buffer. If the gap is between 2 and 10 percentage points the guide prescribes a linear projection between 0 and 2,5%. With a gap larger than 10 percentage points the guide prescribes a 2,5% buffer. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 3 Real credit growth



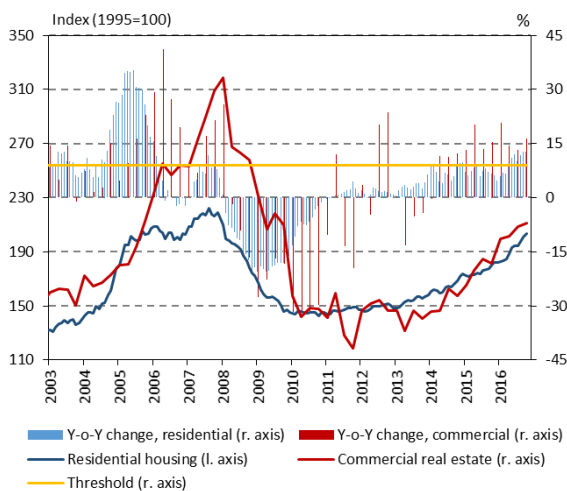
Total credit to households and firms, book value, at constant end-2016 prices. The 9% threshold value is from Laina, Nyholm & Sarlin (2015). Adjusted for government debt relief measures. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 4 Change in price and exchange rate corrected credit stock



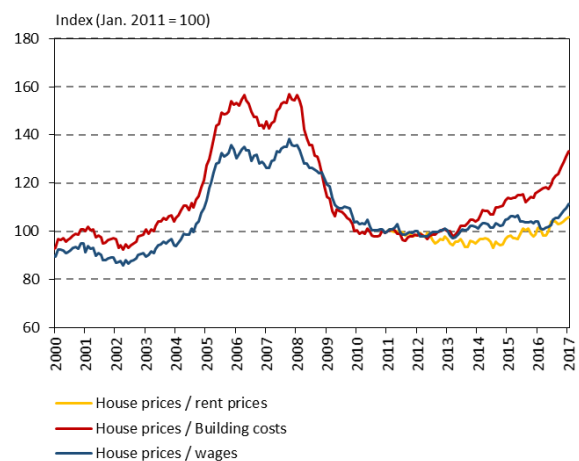
Price indexed credit at Q4 2016 prices, FX credit at Q4 2016 exchange rate, non-indexed credit at current prices. Book value. The division of write-downs between credit types is estimated by each type's share. Sources: Statistics Iceland, Central Bank of Iceland.

Chart 5 Real housing prices



Capital area housing price indices, at constant prices according to CPI. The index for commercial real estate is a weighted average of industrial-, retail- and office housing. The 9% threshold value is from Laina, Nyholm & Sarlin (2015). Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

Chart 6 House prices to wages, building costs and rent prices ratios



House prices are estimated with the residential housing price index for the capital area. Wages with the wage index and building costs with the building cost index. Sources: Statistics Iceland, Iceland Registers, Central Bank of Iceland.