FINANCIAL STABILITY COUNCIL

Ministry of Finance and Economic Affairs, Arnarhvoli, 150 Reykjavik
Tel: (+354) 545 9200
www.ministryoffinance.is/financialstability

Reykjavík, 13 April 2018

Recommendation on systemic risk buffer

The purpose of the capital buffer due to systemic risk is to prevent or limit the impact of long-term non-cyclical systemic risk that could face the financial system and could have serious negative consequences for the financial system and the real economy.

The systemic risk buffer took effect on 1 April 2016, in accordance with a decision by the Financial Supervisory Authority on 1 March of that year. The decision was taken pursuant to a recommendation made by the Financial Stability Council on 22 January 2016. If a systemic risk buffer is imposed, the Financial Stability Council shall review its recommendations within two years of the time they were implemented; cf. Article 86(b), 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 systemic risk buffer; cf. the Act on a Financial Stability Council, no. 66/2014.

Assessment of systemic risk

Non-cyclical systemic risk has changed very little in Iceland in the past two years, as this type of risk tends to be inelastic. Iceland's capital flows, exchange rate, GDP growth, and private consumption are highly variable in comparison with other economies. Icelandic financial institutions' credit risk is affected by the homogeneous structure of the economy, which is dominated by relatively few sectors. These factors affect the frequency of bankruptcy and default. Icelandic financial institutions' capital requirements are based on the standards developed by the Basel Committee for Banking Supervision, which define minimum capital requirements for international banks, with respect to expected default and the correlation between default and GDP internationally. In economies with increased local risk, such as Iceland, there is reason to impose capital requirements over and above those stipulated in the regulatory framework so as to achieve the same mitigation of credit risk.

With reference to this, and to the rationale for the 22 January 2016 recommendation on a systemic risk buffer, the Financial Supervisory Authority is instructed to keep the systemic risk buffer unchanged so as to maintain the resilience of deposit-taking institutions operating in Iceland, owing to the risk associated with characteristics of the Icelandic economy. Because all domestic exposures are vulnerable to the systemic risk described in these recommendations and those from 22 January 2016, which the systemic risk capital buffer is designed to address, it is recommended that the capital buffer be imposed on all of the deposit-taking institutions' domestic exposures. The Financial Stability Council recommends that the Financial Supervisory Authority take note of the interactions between the systemic risk buffers and increased capital requirements that the Authority may stipulate pursuant to Article 86(g), Paragraph 4, Item (a) of the Act on Financial Undertakings.

Conclusion

The Financial Stability Council recommends that the Financial Supervisory Authority keep the systemic risk buffer unchanged at 3% of deposit-taking institutions' domestic exposures; cf. the Council's recommendation of 22 January

2016. The value of the systemic risk buffer on domestic institutions not considered systemically important,[1] currently 2%, shall rise in stages, however, to 3% as of 1 January 2020. The capital buffer shall also be imposed on these institutions at the group level as well as the parent company level.

[1]Kvika banki hf., Sparisjóður Austurlands hf., Sparisjóður Höfðhverfinga ses., Sparisjóður Strandamanna ses., and Sparisjóður Suður-Þingeyinga ses.