



THE FINANCIAL STABILITY COUNCIL

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Recommendation concerning countercyclical capital buffer

According to Article 86(d), Paragraph 1 of the Act on Financial Undertakings, no. 161/2002, the Financial Supervisory Authority is authorised, upon prior receipt of recommendations from the Financial Stability Council, to impose a special countercyclical capital buffer and set its value. Each quarter, the Council shall make such recommendation, based primarily on recommendations and analysis from the Systemic Risk Committee; 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 loan losses following excessive credit growth and accumulation of cyclical systemic risk. The buffer shall 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 can therefore change with the financial cycle position.

Systemic Risk Committee analysis

The decision to recommend a countercyclical capital buffer takes into account, among other things, four core indicators that the Financial Stability Council has defined for financial stability intermediate objective 1: growth in the credit-to-GDP ratio, real growth in lending to households and businesses, real increases in residential and commercial real estate prices, and the deviation of the credit-to-GDP ratio from its long-term trend. Another factor is the financial cycle position, which is estimated from the co-movement of the variables examined in an assessment of cyclical systemic risk: credit, house prices, and banks' funding.

Household and corporate debt has increased in real terms, and the ratio of credit growth to GDP is positive. On the other hand, the deviation of the credit-to-GDP ratio from its long-term trend indicates that it is not appropriate to build up the countercyclical capital buffer further. Growth in private sector debt is still modest, and corporate debt is mainly increasing in foreign currencies.

The interactions between debt and asset prices can amplify the credit cycle; therefore, the rapid rise in real house prices in the recent term give cause for caution. For a long time, real estate market prices rose more or less hand-in-hand with their economic determinants, but a gap has now begun to develop.

Rapid increase in non-core funding could amplify credit growth, which could cause asset prices to rise.¹ The ratio of core funding to total assets has remained virtually unchanged in the past year. On the other hand, the banks have stepped up their foreign funding as terms have improved. As yet, the banks have largely used foreign funding to refinance other foreign denominated loans taken on less favourable terms. Until now, developments in the banks' funding have seemingly had little impact on credit growth.

¹ The Systemic Risk Committee has defined core funding as deposits held by resident individuals and non-financial companies (which excludes pension funds), equity, subordinated loans, and issues of negotiable securities with a residual maturity of more than three years.

The assessment of the financial cycle position indicates that the expansionary phase has begun. House prices are the clearest indicator of this. Increased demand pressures in the economy, with strong GDP growth, an output gap, and low unemployment could give rise to financial imbalances further ahead. On the other hand, the external position of the economy has improved vastly in recent years, and the Central Bank of Iceland forecasts a continuing current account surplus through 2019.

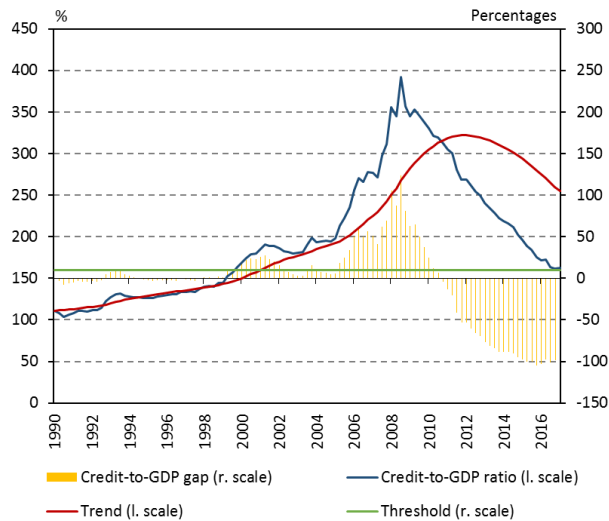
Conclusion

Developments in cyclical systemic risk have been broadly as was expected at the last meeting of the Financial Stability Council. 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 at 1.25%; cf. the Council's recommendation of 30 September 2016. The Financial Stability Council can therefore be expected to recommend that the build-up of the countercyclical capital buffer continue in line with the accumulation of imbalances in the financial system.

Appendix to recommendation concerning countercyclical capital buffer

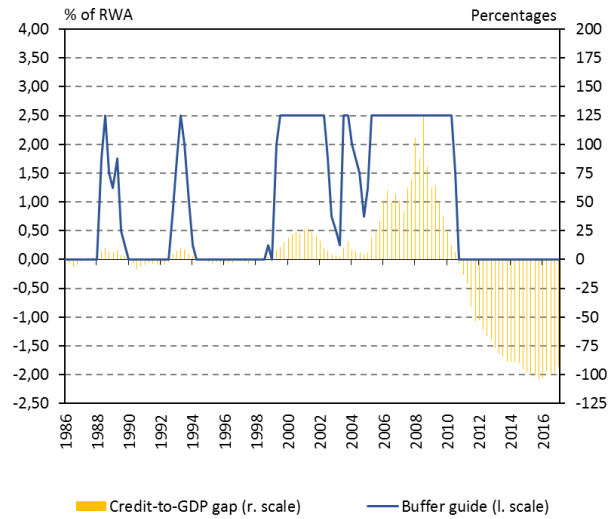
In accordance with official financial stability policy, the Financial Stability Council shall regularly disclose which indicators it takes into particular consideration in analysing systemic risk. Below are the indicators considered in the assessment of the countercyclical capital buffer at the Financial Stability Council meeting of 20 June 2017.

The credit-to-GDP gap



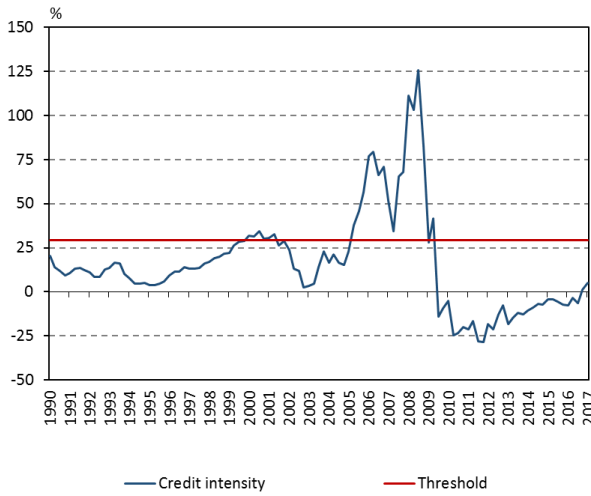
Total credit to households and firms in relation to GDP. The trend component is obtained with a one-sided HP-filter with $\lambda=400.000$. The 9% threshold value comes from Laina, Nyholm & Sarlin (2015).
Sources: Statistics Iceland, Central Bank of Iceland.

The buffer guide



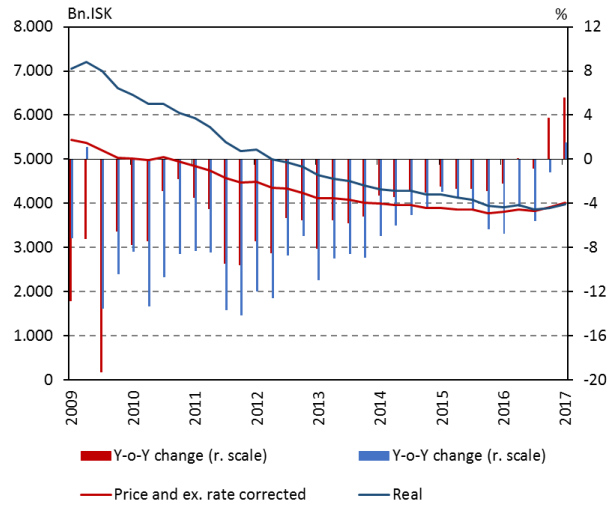
The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.
Sources: Statistics Iceland, Central Bank of Iceland.

Credit intensity



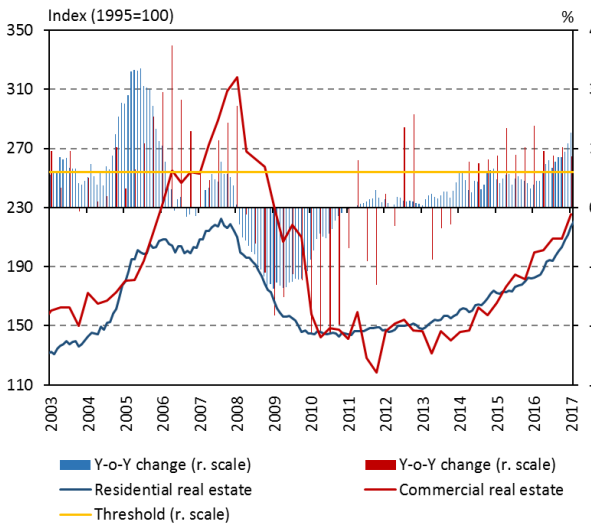
Nominal credit growth in relation to GDP. The 29% threshold value is the 75th percentile of the distribution of the data from 1976-2017.
Sources: Statistics Iceland, Central Bank of Iceland.

Real credit growth and price and exchange rate corrected credit growth



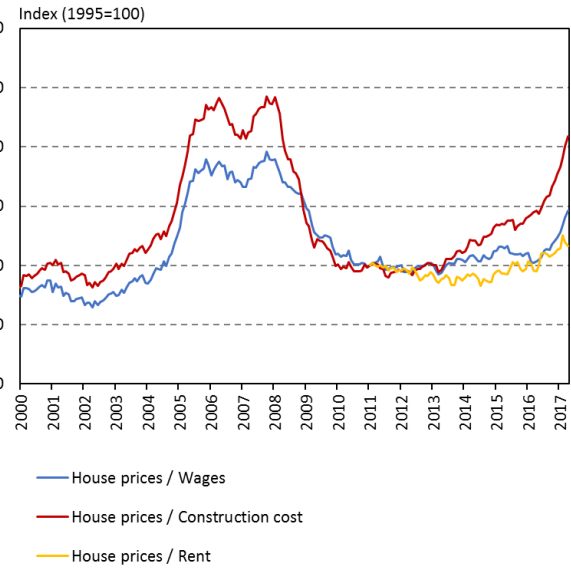
Total credit. Blue series at constant Q1 2017 prices. Red series has CPI-indexed credit at Q1 2017 prices, FX credit at a constant Q1 2017 exchange rate and non-indexed credit at current prices.
Sources: Statistics Iceland, Central Bank of Iceland.

Real property prices in the capital area



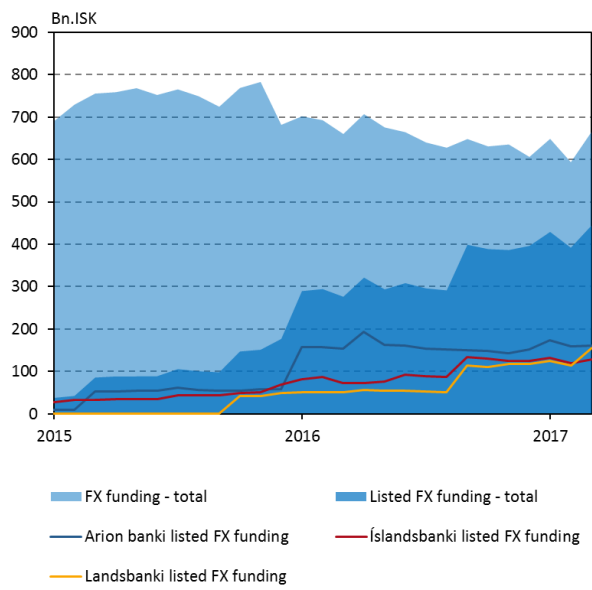
Price indices at constant prices according to CPI. Commercial property index is a weighted average of industrial, retail and office housing. The 9% threshold is from Laina, Nyholm & Sarlin (2015). Q1 2017 commercial property value is preliminary.
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

House prices, wages, construction cost and rent prices



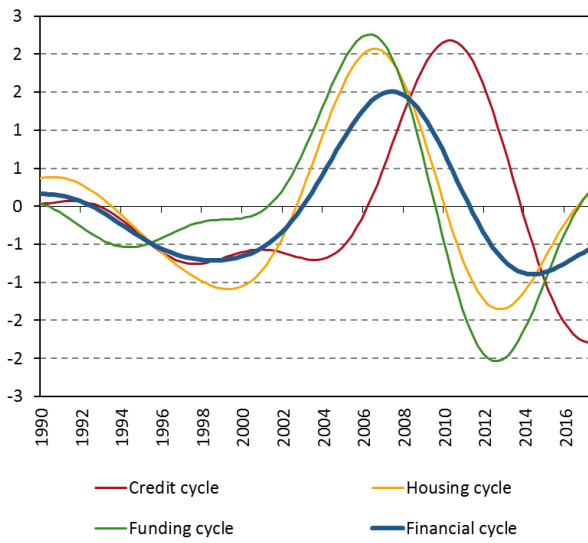
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

Banks' FX funding



Source: Financial Supervisory Authority, Central Bank of Iceland.

The financial cycle



Each subcycle shows the average of cycles in the variables it contains. The financial cycle is an average of cycles in all the variables in all the subcycles.
Source: Central Bank of Iceland.