



FJÁRMÁLASTÖÐUGLEIKARÁÐ

Fjármála- og efnahagsráðuneyti, Arnarhvoli, 150 Reykjavík

Sími: 545 9200

fjarmalastodugleikarad.is

Reykjavík, 22 January 2016

Recommendations to the Financial Supervisory Authority to introduce a capital buffer for systemically important financial institutions, a systemic risk buffer, and a countercyclical capital buffer

With the passage of Act no. 57/2015 Amending the Act on Financial Undertakings, no. 161/2002, capital buffers as provided for in Council Directive 2013/36/EU (CRD IV) were incorporated into Icelandic law. There are four capital buffers: a capital buffer for systemically important financial institutions, a systemic risk buffer, a countercyclical capital buffer, and a capital conservation buffer. The Financial Supervisory Authority is authorised to impose the first three of these upon receipt of recommendations from the Financial Stability Council, cf. Article 84(b), Paragraph 1 through Article 84(d) of Act no. 161/2002, whereas the capital conservation buffer is added to the capital requirements of specified financial undertakings without either a recommendation from the Financial Stability Council or a decision by the Financial Supervisory Authority; cf. Article 84(e) of the same Act.

With reference to analysis carried out by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that it impose a capital buffer on systemically important financial institutions, a systemic risk buffer, and a countercyclical capital buffer. The recommendations are based on Article 5 of the Act on a Financial Stability Council, no. 66/2014, and provisions on capital buffers in the Act on Financial Undertakings, no. 161/2002. If the Financial Supervisory Authority does not act on the recommendations, it is required pursuant to the “comply or explain” provision set forth in Article 5, Paragraph 2 of Act no. 66/2014 to support its decision by means of a written response submitted to the Financial Stability Council within a suitable deadline, which in this case has been set at thirty (30) days.

- a) The Financial Stability Council recommends that the Financial Supervisory Authority impose a 2% capital buffer on systemically important financial institutions, effective 1 April 2016. The capital buffer shall cover all of these institutions’ risk-weighted exposures at the group level.**

The Council confirmed the definition of systemically important supervised entities at its 14 April 2015 meeting, when Arion Bank hf., Íslandsbanki hf., Landsbankinn hf., and the Housing Financing Fund were classified as systemically important supervised entities. The capital buffer shall be imposed on the first three of these institutions, as the Housing Financing Fund is not classified as a financial undertaking in the sense of Article 116 of the Act on Financial Undertakings, no. 161/2002. The definition of systemically important supervised entities is based on Article 4, Paragraph 2, Subparagraph (d) of Act no. 66/2014; however, the decision of the Financial Stability Council also took account of the European Banking Authority guidelines on systemically important financial institutions (EBA/GL/2014/10). Among the factors considered in the assessment of systemic importance are the size of the institution concerned, its importance in the financial market, the complexity of its operations, the extent of its cross-border operations, and its interconnectedness with other financial undertakings. A detailed discussion of the capital buffer and the rationale for imposing it and other requirements due to systemic importance can be found in an appendix to these recommendations.

- b) **The Financial Stability Council recommends to the Financial Supervisory Authority that a systemic risk buffer, in the amount of 3% of risk-weighted domestic assets, be imposed on systemically important deposit-taking institutions – Arion Bank hf., Íslandsbanki hf., and Landsbankinn hf. – effective 1 April 2016. Other deposit-taking institutions¹ systemic risk buffer shall rise incrementally, as follows: to 1% of risk-weighted domestic assets as of 1 April 2016, to 1.5% as of 1 January 2017, to 2.0% as of 1 January 2018, and to 3% as of 1 January 2019. The capital buffer shall be imposed on these institutions at the group level.**

The purpose of the systemic risk buffer 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 European Systemic Risk Board (ESRB) has issued a handbook on operationalising macroprudential policy in the banking sector, in which the assessment of indicators for the systemic risk buffer is divided into three parts. Three types of indicators should be considered: first, indicators of the probability of shocks to the financial system and the real economy, with emphasis on structural risk factors; second, indicators of amplification channels, which can increase financial system losses owing to such shocks; and third, indicators of the importance of the financial system for the real economy.

There is increased probability of shocks in the Icelandic financial system because Iceland is a small, open economy. Capital flows, exchange rate, GDP growth, and private consumption are highly variable in comparison with other economies. The relative size of the Icelandic banking system is now close to the European average, but credit risk is affected by the homogeneity of the economy, where a few sectors dominate. These factors affect the frequency of bankruptcy and default. Icelandic financial undertakings' capital adequacy requirements are based on the standardised approach of the Basel Committee. The standards define minimum capital requirements for international banks, with respect to expected default and the correlation between default and GDP internationally. Because local risk is greater – as has been shown, for instance, by the joint stress tests carried out by the Central Bank of Iceland and the Financial Supervisory Authority – there is reason to impose capital requirements in excess of the minimum in order to increase the resilience to credit risk.

In order to enhance the resilience of the deposit-taking institutions operating in Iceland against the risks inherent in the Icelandic economy, it is recommended that the Financial Supervisory Authority impose a capital buffer for systemic risk. Because all domestic exposures are vulnerable to the systemic risk described here, which the systemic risk buffer is designed to address, it is recommended that the capital buffer be imposed on all of the deposit-taking institutions' domestic exposures. In order to meet the needs of smaller deposit-taking institutions – i.e., those not classified as systemically important – it is recommended that their systemic risk buffer be increased incrementally, as is described above. A more detailed description of the capital buffer and the rationale for its use can be found in an appendix to these recommendations.

- c) **The Financial Stability Council recommends to the Financial Supervisory Authority that a 1% countercyclical capital buffer be imposed on all financial institutions – 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 decision to recommend a countercyclical capital buffer in Iceland takes account of 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 deviations in the credit-to-GDP ratio from its long-term trend. In accordance with Article 136(2) of Council Directive 2013/36/EU, the last of these is an indicator that all countries must consider, together with the ESRB guidelines for decisions on countercyclical capital buffers and other factors. Therefore, all of the countries that have imposed this buffer have given consideration to this indicator, however both the ESRB and the Bank for International Settlements (BIS) in Basel have pointed out that it could be necessary to use indicators other than the

¹ Kvika banki hf., Sparisjóður Austurlands hf., Sparisjóður Höfðhverfinga ses. Sparisjóður Strandamanna ses., and Sparisjóður Suður-Þíngeyinga ses.

credit-to-GDP gap, particularly in small, volatile economies. In addition to the core indicators, consideration is given to additional indicators that could change from one time to another.

A comprehensive examination of all key indicators of the business cycle position reveals that the upswing has already begun. In this context, it is worth noting credit growth, rising asset prices, the improving condition of the financial market, and declining default. The slack in the domestic economy has given way to a positive output gap, and indicators imply that credit growth could be quite rapid in the near future. In this connection, households' and businesses' financial position, increased collateral capacity, and forecasted developments in economic variables are worth mentioning. The decision to recommend a 1% capital buffer takes into consideration the strong capital position of the financial system; therefore, it is unlikely to restrict credit growth in an undesirable way under current circumstances. This assessment is based on an analysis of the economy as a whole, an estimate of potential credit growth in coming months, and the capital position of each individual financial undertaking with respect to the capital buffers.

The Financial Stability Council can be expected to recommend at a later time that the countercyclical capital buffer be increased in line with the financial cycle position, possibly with shorter advance notice than in the current case. A more detailed description of the capital buffer and the rationale for its use can be found in an appendix to these recommendations.