



FINANCIAL STABILITY COUNCIL

Ministry of Finance and Economic Affairs, Arnarhvoli, 150 Reykjavik

Tel: (+354) 545 9200

www.ministryoffinance.is/financialstability

Reykjavík, 26 June 2018

Recommendation on countercyclical capital buffer

On a quarterly basis, the Financial Stability Council shall submit recommendations to the Financial Supervisory Authority concerning the value of the countercyclical capital buffer pursuant to Article 86(d), 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 countercyclical capital buffer; 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 losses following excessive debt collection and accumulation of cyclical systemic risk. The buffer may 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 therefore changes with developments in cyclical systemic risk.

Systemic Risk Committee analysis

The decision to recommend a countercyclical capital buffer in Iceland takes account, among other things, of four core 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. A number of other indicators are considered as well, so as to obtain a clear overview of cyclical systemic risk. The credit-to-GDP ratio is not considered a precise indicator of the credit cycle in Iceland as the effects of the financial recession on time series is still considerable.

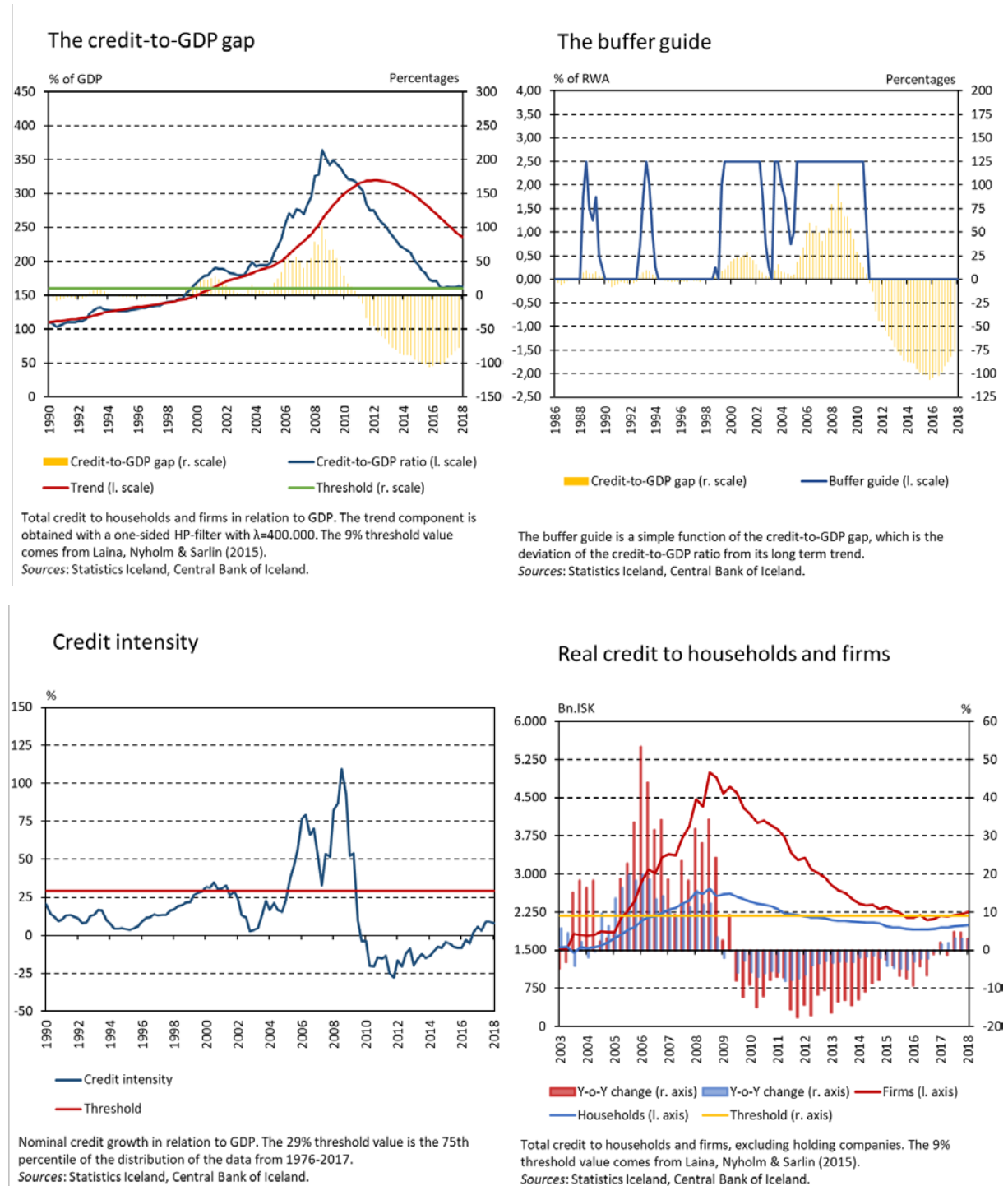
The financial cycle has developed upwardly as was expected, which is mainly reflected in high and growing real estate prices and a stable credit growth of households and firms. Real house prices is at historical highs but the growth has slowed down considerably in the last few months while commercial real estate prices have been on a rapid rise. Private sector debt relative to GDP reached its trough in Q4/2016 but has been on the rise since then. Real debt growth has been stable at around 3%. Growth in firm credit has been similar to GDP growth while household credit has been moderate. The improvement in household equity and a stronger purchasing power of disposable income, along with lowering interest rate, have given households much more scope to take on additional debt in the coming years.

Conclusion

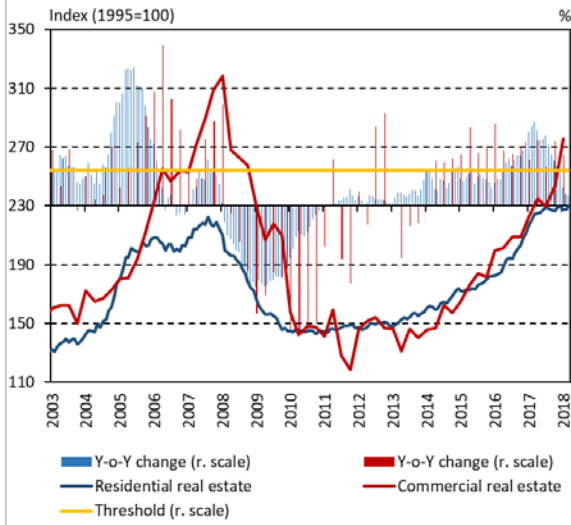
Developments in cyclical systemic risk have been broadly as was expected at the last meeting of the Financial Stability Council. With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical capital buffer be held unchanged. The Financial Stability Council can be expected to recommend that the build-up of the countercyclical capital buffer continue in line with increased cyclical systemic risk.

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 most important in the assessment of the countercyclical capital buffer at the Financial Stability Council meeting of 20 March 2018.

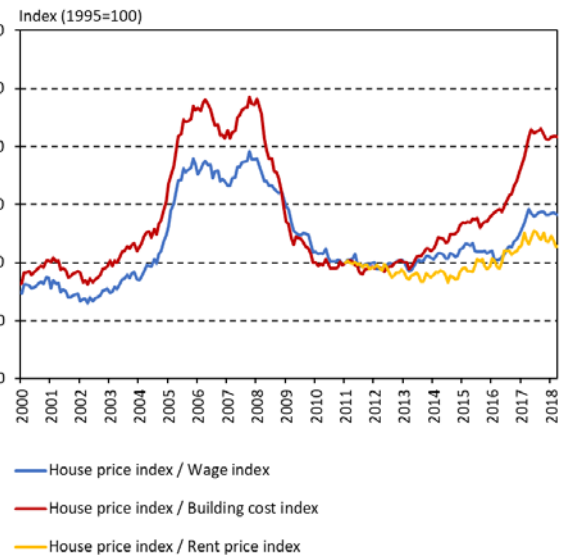


Real property prices in the capital area



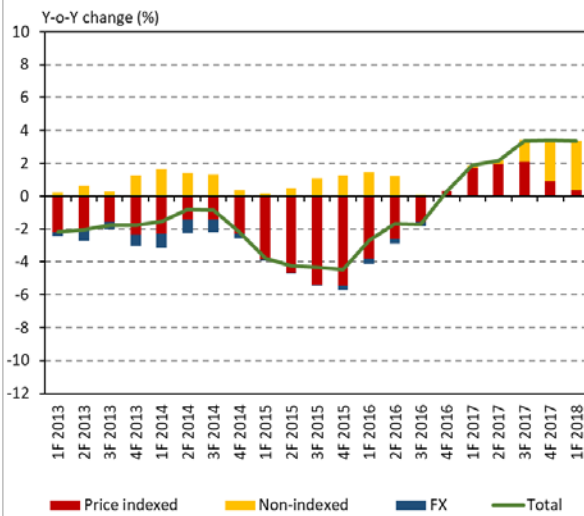
Price indices at constant prices according to CPI. Commercial property index is a weighted average of industrial, retail and office housing. The 9% threshold is from Laina, Nyholm & Sarlin (2015). Q1 2018 commercial property value is preliminary.
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

House prices, wages, construction cost and rent prices



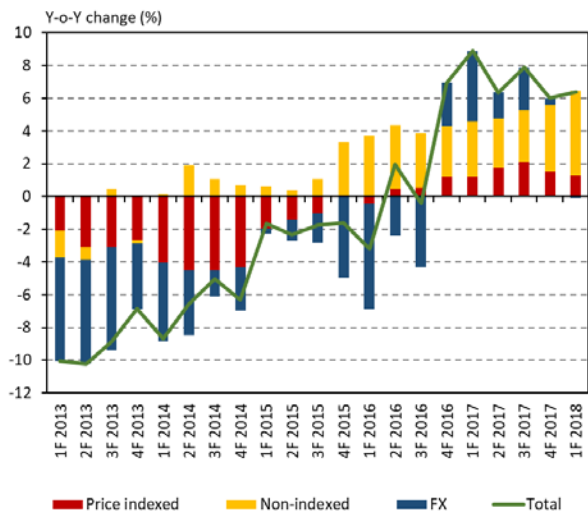
Sources: Statistics Iceland, Registers Iceland, Central Bank of Iceland.

Households credit growth Price and exchange rate adjusted



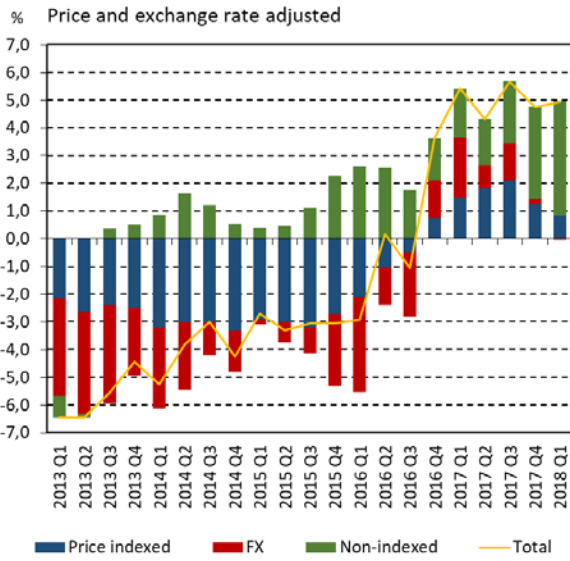
CPI-indexed credit at fixed prices. FX credit at fixed exchange rate. Non-indexed credit at current prices.
Sources: Statistics Iceland, Central Bank of Iceland.

Firms credit growth Price and exchange rate adjusted



CPI-indexed credit at fixed prices. FX credit at fixed exchange rate. Non-indexed credit at current prices.
Sources: Statistics Iceland, Central Bank of Iceland.

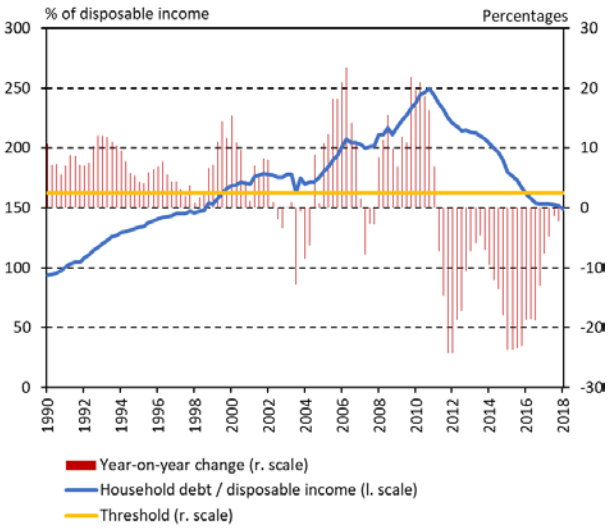
Total credit growth



Price-indexed credit at fixed prices, FX credit at fixed exchange rate, and non-indexed credit at current prices. Claim value.

Sources: Statistics Iceland, Central Bank of Iceland.

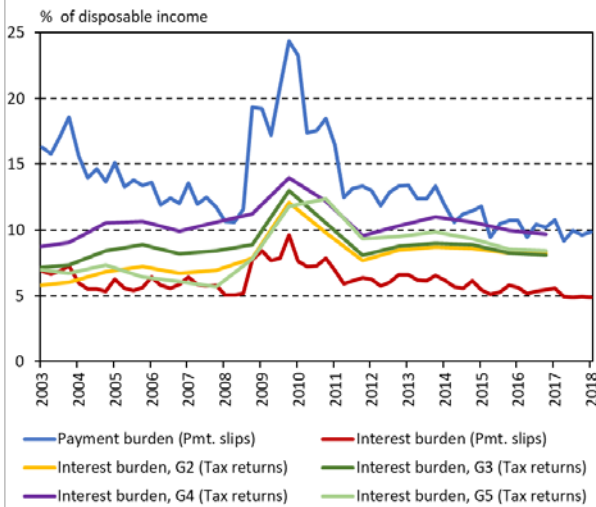
Household debt to disposable income



Disposable income data is obtained from the Central Bank's Quarterly Macroeconomic Model dataset. The value for 1Q 2018 is nowcasted. The threshold value is the avg. of the ratio's year-on-year change in the period 1989-2018.

Sources: Statistics Iceland, Central Bank of Iceland.

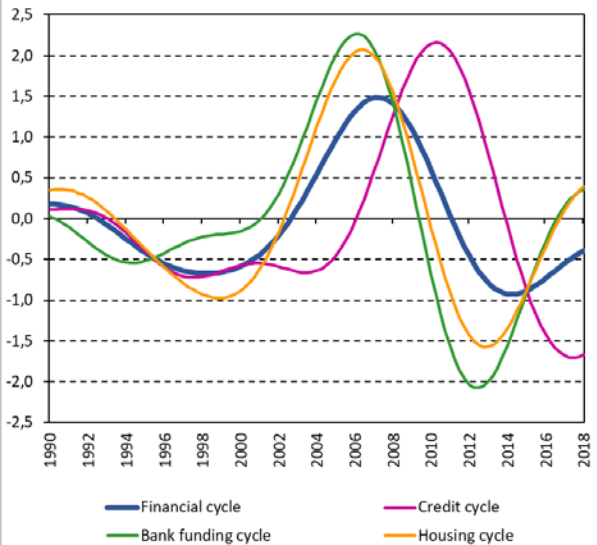
Household payment and interest burden



Payment burden is the sum of principal and interest payments according to payment slips, as a percentage of disposable income from to the Central Bank's QMM database. Interest burden is interest expenses net of interest benefits according to tax returns, as a percentage of disposable income. The lowest income group is left out of the tax return data.

Sources: Statistics Iceland, Central Bank of Iceland.

Financial cycle



Arithmetic mean of cyclical components from variables in each subcycle and the complete set of variables. Cyclical components are obtained using the Christiano-Fitzgerald band-pass filter with a frequency band of 8-30 years.

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