

FJÁRMÁLASTÖÐUGLEIKARÁÐ

Fjármála- og efnahagsráðuneyti, Armarhvoli, 150 Reykjavík

Sími: 545 9200

fjarmalastodugleikarad.is

Reykjavík, 9 October 2017

Recommendation concerning countercyclical capital buffer

Each quarter, 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 when it sets 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 loan losses following excessive credit growth 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 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 debt-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 debt-to-GDP ratio from its long-term trend. A number of other indicators are considered as well, so as to obtain a clear overview of the financial cycle.

In real terms, household debt grew in Q2, while corporate debt contracted because of the impact of the appreciation of the króna on firms' foreign-denominated loans. The year-on-year change in household and corporate debt in Q2, adjusted for price and exchange rate movements, amounted to 4.7%, as compared with 5.7% in the preceding quarter and 3.2% in Q4/2016. The ratio of private sector debt to GDP continues to fall, but the most recent data suggest that the situation is about to turn around. Real house prices have risen steeply in the recent term, but the pace of the increase has eased in the past few months. Since mid-2016, house prices have risen well in excess of wages, purchasing power, and rent, giving rise to more pronounced imbalances in the real estate market. In the past few months, however, these imbalances have not grown, as the rise in house prices has slowed down. The overall assessment of the financial cycle position indicates that the upward cycle has begun. House prices are the clearest indicator of this.

Demand pressures in the economy remain strong, with robust GDP growth, an output gap, and low unemployment, in addition to growing imbalances in the housing market, and could lead to financial imbalances further ahead. On the other hand, Iceland's external position has continued to improve, and the Central Bank forecasts a continued current account surplus through 2019, albeit a smaller surplus than previously projected.

Conclusion

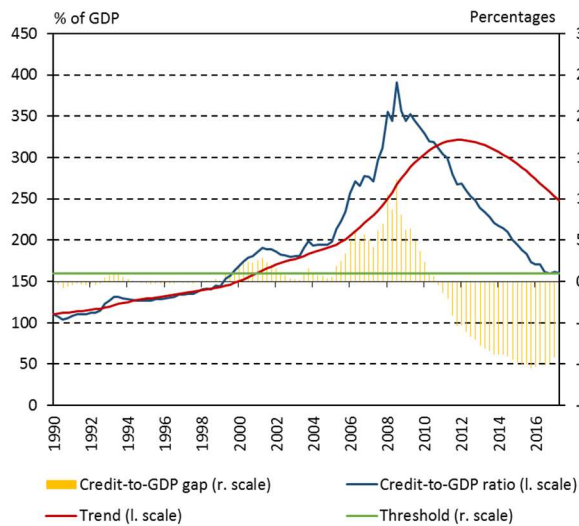
Developments in cyclical systemic risk have been broadly as was expected at the last meeting of the Financial Stability Council. With reference to the analysis conducted by the Systemic Risk Committee, the Financial Stability Council recommends to the Financial Supervisory Authority that the countercyclical 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 increased risk in the financial system.

Appendix to recommendation concerning countercyclical capital buffer

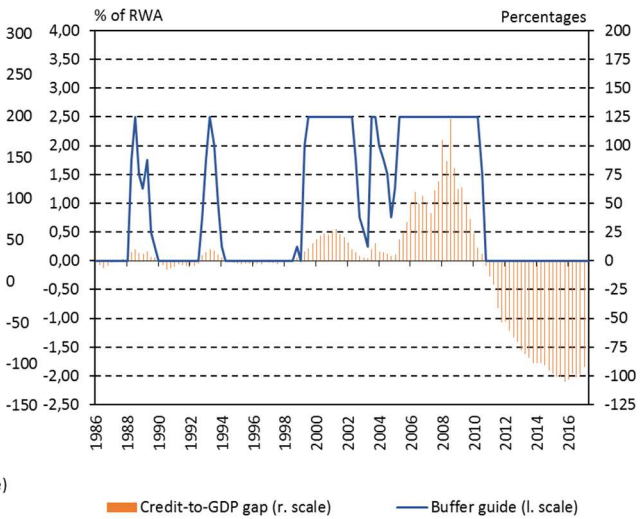
In accordance with official financial stability policy, the Financial Stability Council shall regularly disclose which indicators it takes into particular consideration in analysing systemic risk. Below are the indicators considered in the assessment of the countercyclical capital buffer at the Financial Stability Council meeting of 9 October 2017.

The credit-to-GDP gap



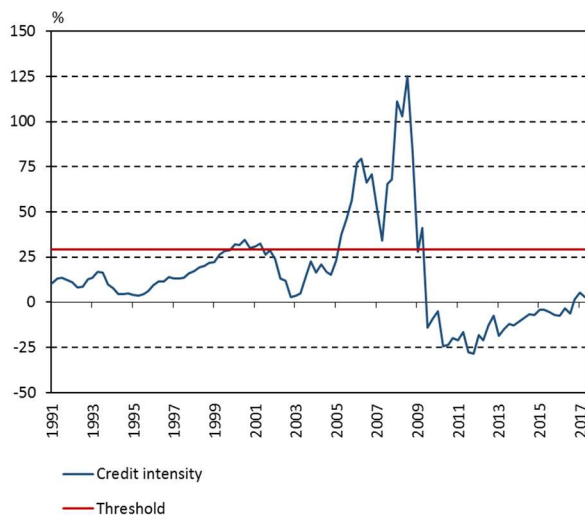
Total credit to households and firms in relation to GDP. The trend component is obtained with a one-sided HP-filter with $\lambda=400.000$. The 9% threshold value comes from Laina, Nyholm & Sarlin (2015).
 Sources: Statistics Iceland, Central Bank of Iceland.

The buffer guide



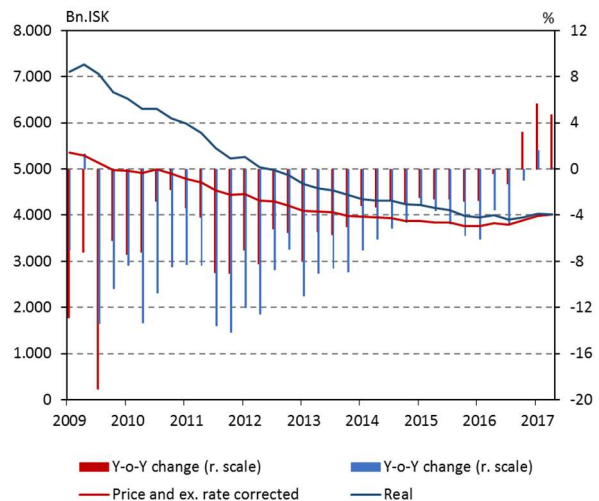
The buffer guide is a simple function of the credit-to-GDP gap, which is the deviation of the credit-to-GDP ratio from its long term trend.
 Sources: Statistics Iceland, Central Bank of Iceland.

Credit intensity



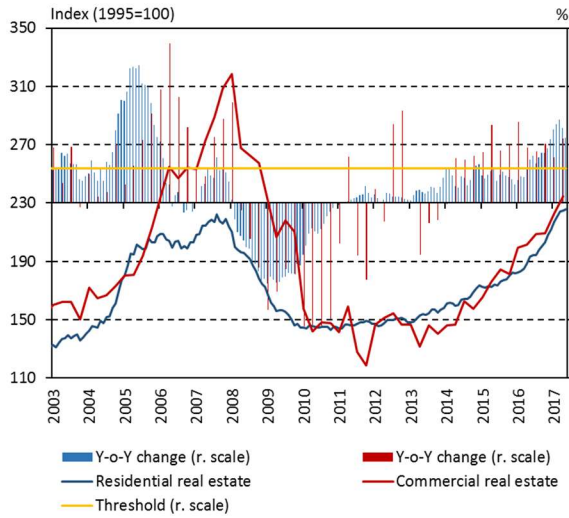
Nominal credit growth in relation to GDP. The 29% threshold value is the 75th percentile of the distribution of the data from 1976-2017.
 Sources: Statistics Iceland, Central Bank of Iceland.

Real credit growth and price and exchange rate corrected credit growth



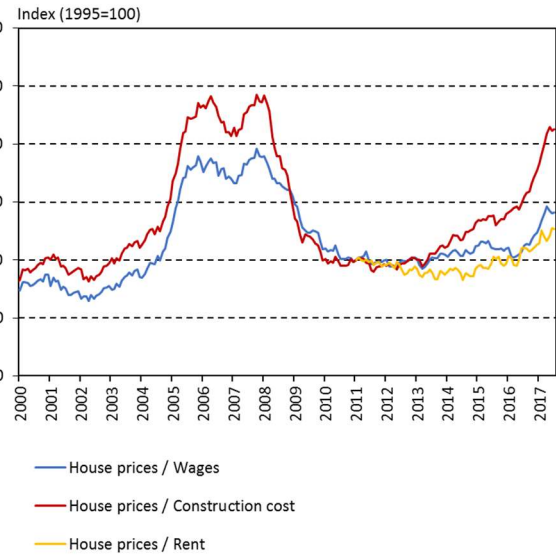
Total credit. Blue series at constant Q1 2017 prices. Red series has CPI-indexed credit at Q1 2017 prices, FX credit at a constant Q1 2017 exchange rate and non-indexed credit at current prices.
 Sources: Statistics Iceland, Central Bank of Iceland.

Real property prices in the capital area



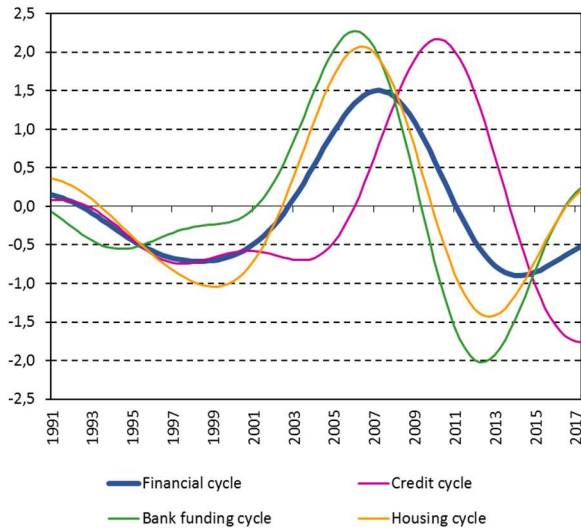
Price indices at constant prices according to CPI. Commercial property index is a weighted average of industrial, retail and office housing. The 9% threshold is from Laina, Nyholm & Sarlin (2015). Q1 2017 commercial property value is preliminary. Sources: Statistics Iceland, Registers Iceland, Central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

House prices, wages, construction cost and rent prices



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

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.