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Subject: Warning of the European Systemic Risk Board of 27 June 2019 on medium-term vulnerabilities in the residential estate sector in Iceland (ESRB/2019/13)

The Icelandic authorities appreciate the analysis performed by the European Systemic Risk Board (ESRB) on the vulnerabilities in the residential real estate (RRE) sector in Iceland that underpins its warning dated 27 June 2019. Both the Central Bank of Iceland and the Financial Supervisory Authority are grateful for the opportunity to collaborate with the ESRB on this analysis and are of the opinion that the work has been very insightful.

The ESRB's report on the vulnerabilities in the residential real estate sectors of the EEA countries outlines important factors to consider in the Icelandic context. These include i) a high share of home ownership compared to many other European countries, ii) the prevalence of 40-year CPI-linked annuity mortgages where a negative amortisation schedule is common in the first years. This serves to insulate households from interest rate risk to a certain degree and therefore smooths out debt service in times of elevated inflation and iii) an allowance for households to withdraw private pension funds to service RRE debt or pay down the principal without having to pay income tax on the withdrawn amount.

As noted in the ESRB's warning, Icelandic banks are by any measure resilient to shocks in the RRE sector. Relevant national authorities have conducted stress tests on Iceland's three largest credit institutions which show that they should be able to withstand severe shocks, including a severe drop in the price of residential real estate in conjunction with a severe scenario for the real economy. Moreover, RRE portfolios are spread between the three largest banks (56%), pension funds (26%), that have no leverage, and the government backed Housing Financing Fund (18%). The pension funds and the Housing Financing fund thus have limited scope to directly affect financial stability in terms of RRE risks.

The ESRB takes note of the various mechanisms in place in Iceland to mitigate risk in the RRE sector by strengthening the resilience of both lenders and borrowers. LTV limits were implemented in 2017 in response to the rapid increase in housing prices and to strengthen the resilience of borrowers, prevent deterioration in lending standards and mitigate excessive credit growth. There are also harmonised legal requirements for creditworthiness assessments before new mortgages are issued, including a borrower's affordability test, which constitutes a soft DSTI limit. A countercyclical capital buffer and a systemic risk buffer have been applied to the banks, totalling 5%. The banks' leverage ratios are also significant, or at an average of 14%.

The Government considers housing security, independent of people's financial standing, to be one of

the fundamental preconditions for a well-functioning society, although financial stability also plays an important role. The Government has announced policies to increase the supply of housing for the lower-income brackets and reduce the prevalence of long-maturity indexed linked annuity mortgages. To this effect, the government has put forward a draft bill for consultation introducing a general maximum maturity of 25 years on CPI-indexed annuity loans, with certain exceptions. Such measures could lower the average LTI ratios in Iceland. Also, non-index linked mortgages, have grown from 0% of the banks' mortgage stock in 2008 to 34% in July 2019.

The ESRB believes that there is some concern related to house price overvaluation. It is true that house prices rose steeply, especially in 2016-2017. The price increases are largely attributed to fundamental factors, including strong population growth and insufficient supply of housing. However, after a steady growth over the past eight years, house price appreciation has decelerated in recent quarters. In fact, the nominal y-o-y increase in house prices in July 2019 was 2,9% which is the lowest increase since 2011. In real terms, housing prices have contracted in the same period as inflation was measured at 3,1%. As signals of overvaluations are receding, possible effects of a sudden depreciation of housing prices on the financial system are contained. The Icelandic authorities will continue to closely monitor the development of house prices and credit standards in the real estate market.

The ESRB warns that there are medium-term vulnerabilities in the RRE sector in Iceland that could become a source of systemic risk to financial stability, which may have the potential for serious negative consequences for the real economy. From a macroprudential perspective the ESRB considers the main vulnerability to be high household indebtedness associated with the strong medium-term increase of house prices and potential overvaluation of house prices. However, the distribution of DTI-ratios improved significantly between 2010 and 2017 and the proportion of households with DTIs over 4,5 diminished by half over the period. Strong household balance sheets and prudent LTV ratios serve to mitigate the potential risk of an unanticipated house price correction.

The ESRB believes that income-based measures would be a logical next step in case RRE-related vulnerabilities continue to build up in the financial system. The belief is that such measures could be particularly relevant as the growth in house prices may have reduced the effectiveness of the cap on LTV ratios. However, as pointed out, potential implementation of income-based measures needs to consider the macroeconomic outlook and the position in the financial cycle.

The Government agrees with the ESRB that income-based measures could be considered to target household indebtedness. The authorities have gained more experience implementing macroprudential tools in recent years and data gathering and monitoring has improved to make it more feasible to implement such limits than it was when it was considered concurrently with the LTV requirement in 2017. Macroprudential authorities in Iceland will continue to monitor and assess the identified vulnerabilities and will take appropriate measures in a timely manner, considering the position of the economy, the financial system and the effect of policy measures underway.

Yours sincerely

A handwritten signature in blue ink, reading "Bjarni Benediktsson". The signature is fluid and cursive, with the first name "Bjarni" and the last name "Benediktsson" clearly distinguishable.

Bjarni Benediktsson, Minister of Finance and Economic affairs