

**WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD**  
**of 27 June 2019**  
**on medium-term vulnerabilities in the residential real estate sector in Iceland**  
**(ESRB/2019/13)**  
(2019/C 366/10)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board <sup>(1)</sup>, and in particular Articles 3, 16 and 18 thereof,

Whereas:

- (1) Housing is a key sector of the real economy and represents a major part of household wealth and bank lending. Residential real estate properties make up a large component of households' asset holdings and loans for housing are often a large part of the balance sheets of credit institutions. Furthermore, housing construction is typically an important element of the real economy, being a source of employment, investment and growth.
- (2) Past financial crises and experience in many countries have demonstrated that unsustainable developments in real estate markets may have severe repercussions on the stability of the financial system and of the economy as a whole in a given country, which may also lead to negative cross-border spillovers. The effects on financial stability may be both direct and indirect. Direct effects consist of credit losses from mortgage portfolios due to adverse economic and financial conditions and simultaneous negative developments in the residential real estate market. Indirect effects relate to adjustments in household consumption, with further consequences for the real economy and financial stability.
- (3) Real estate markets are prone to cyclical developments. Excessive risk-taking, excessive leverage and misaligned incentives during the upturn of the real estate cycle may lead to severe negative implications for both financial stability and the real economy. Given the relevance of residential real estate (RRE) for financial and macroeconomic stability, seeking to prevent the build-up of vulnerabilities in residential real estate markets by the use of macroprudential policy is especially important, in addition to its use as a means of mitigating systemic risk.
- (4) While cyclical factors play an important role in fuelling the vulnerabilities identified in residential real estate markets in the European Economic Area (EEA) countries, there are also structural factors that have driven these vulnerabilities. These factors can include lack of housing supply — which has been exerting upward pressure on house prices and debt for households that buy their own property — or other public policies which may act as an incentive for households to overborrow. Given that these factors go beyond macroprudential policy, measures originating from other policy areas can complement and support the current macroprudential measures in addressing the vulnerabilities present in the residential real estate markets in the individual countries efficiently and effectively, without generating excessive costs for the real economy and the financial system.

<sup>(1)</sup> OJ L 331, 15.12.2010, p. 1.

- (5) In 2016, the European Systemic Risk Board (ESRB) conducted a Union-wide assessment of medium-term vulnerabilities relating to residential real estate <sup>(2)</sup>. This assessment enabled the ESRB to identify a number of medium-term vulnerabilities in several countries as sources of systemic risk to financial stability, which led to the issuance of warnings to eight countries: Belgium <sup>(3)</sup>, Denmark <sup>(4)</sup>, Luxembourg <sup>(5)</sup>, the Netherlands <sup>(6)</sup>, Austria <sup>(7)</sup>, Finland <sup>(8)</sup>, Sweden <sup>(9)</sup> and the United Kingdom <sup>(10)</sup>.
- (6) The ESRB has recently concluded a systematic and forward-looking EEA-wide assessment of vulnerabilities relating to residential real estate <sup>(11)</sup>.
- (7) In this context, the ESRB has identified in eleven countries, of which Iceland is one, certain medium-term vulnerabilities as sources of systemic risk to financial stability that have not been sufficiently addressed.
- (8) The ESRB's assessment of vulnerabilities highlights the following in relation to Iceland:
- a. Household indebtedness relative to household disposable income is high when compared with other countries, in spite of the substantial decline in this ratio from levels in previous years. Highly leveraged households are typically more sensitive to adverse economic and financial conditions or adverse developments in the residential real estate market, which can affect their debt-servicing capacity and lead to reductions by them in consumption. Indebted households are, however, less vulnerable to increases in interest rates, given the prevalence of fixed interest rate loans.
  - b. In terms of the structure of household debt, loans indexed to the consumer price index (hereinafter 'CPI-indexed loans') <sup>(12)</sup> have historically been common in Iceland, and may pose some risks for highly leveraged households. Even though the share of CPI-indexed loans as a proportion of new loans is decreasing, the share of these loans as a proportion of the existing stock of loans is, nevertheless high. Moreover, CPI-indexed loans typically have negative amortisation schedules early in the repayment period, depending on the level of inflation, which could further increase the accumulation of debt. Loans of this type can have both mitigating and amplifying effects on households' vulnerability to risk. In the event of high inflation, households would experience less impact on their ability to service mortgage debt in the short term — as the CPI-indexed loans would smooth out the debt service — whereas the monthly repayments on non-CPI-indexed loans would increase more steeply over the short term. However, over the long term, households with CPI-indexed loans may need to further constrain consumption, since in the event of economic distress coupled with increasing inflation they would not see their debt eroded by inflation. High indebtedness is partially explained by the indexation of annuity mortgage loans with maturities of up to 40 years, which allow low-income borrowers to borrow higher amounts at affordable debt service levels. However, during the last decade inflation has been close to the Central Bank of Iceland's target and consequently the share of non-indexed loans has been growing.
  - c. Housing credit has been growing moderately over recent years, and on average lending standards appear to be prudent. However, as regards the distribution of the debt-to-income (DTI) ratios of households which have taken out loans of this type, a significant share of households may be vulnerable to adverse economic and financial conditions or adverse developments in the residential real estate market. In spite of growing vulnerabilities in Iceland's RRE sector, the Icelandic credit institutions appear to be resilient. National authorities have conducted a number of stress tests on Iceland's three largest credit institutions; those stress tests included scenarios incorporating sharp price decreases in the housing market in conjunction with large negative shocks to the overall economy and the results indicated that those banks should be able to withstand such shocks.

<sup>(2)</sup> See 'Vulnerabilities in the EU Residential Real Estate Sector', ESRB, November 2016, available on the ESRB's website at [www.esrb.europa.eu](http://www.esrb.europa.eu).

<sup>(3)</sup> Warning ESRB/2016/06 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Belgium (OJ C 31, 31.1.2017, p. 45).

<sup>(4)</sup> Warning ESRB/2016/07 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Denmark (OJ C 31, 31.1.2017, p. 47).

<sup>(5)</sup> Warning ESRB/2016/09 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Luxembourg (OJ C 31, 31.1.2017, p. 51).

<sup>(6)</sup> Warning ESRB/2016/10 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of the Netherlands (OJ C 31, 31.1.2017, p. 53).

<sup>(7)</sup> Warning ESRB/2016/05 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Austria (OJ C 31, 31.1.2017, p. 43).

<sup>(8)</sup> Warning ESRB/2016/08 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Finland (OJ C 31, 31.1.2017, p. 49).

<sup>(9)</sup> Warning ESRB/2016/11 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of Sweden (OJ C 31, 31.1.2017, p. 55).

<sup>(10)</sup> Warning ESRB/2016/12 of the European Systemic Risk Board of 22 September 2016 on medium-term vulnerabilities in the residential real estate sector of the United Kingdom (OJ C 31, 31.1.2017, p. 57).

<sup>(11)</sup> See 'Vulnerabilities in the residential real estate sectors of EEA countries', ESRB, 2019, available on the ESRB's website at [www.esrb.europa.eu](http://www.esrb.europa.eu).

<sup>(12)</sup> The CPI-indexed loan is a contract where the loan amount is linked to the consumer price index and the interest rate is kept fixed (for more details see Eliásson, L., 'Indexation 101', *Economic Affairs*, Vol. 6, The Central Bank of Iceland, Reykjavik, Iceland, 2014).

- d. Furthermore, there is some concern related to house price overvaluation. House price appreciation has decelerated in recent quarters, following steady growth over the past eight years. House price growth over the medium-term has been high by international comparison. Given the high rate of home ownership in Iceland, a decrease in house prices could lead to households in negative equity. Nevertheless, potential direct credit losses from mortgage loans are expected to be contained, as the loan-to-value ratios of mortgages held by households are relatively low.
- e. Adverse economic and financial conditions or adverse developments in the residential real estate market may lead to the materialisation of direct and indirect risks to financial stability, given the vulnerabilities mentioned above. Potential direct risks to the banking system in Iceland relate both to the potential losses generated by default of loans granted in an environment of possibly overvalued house prices, and to competitive pressures that may lead to the loosening of lending standards. Moreover, households may experience a negative wealth effect or fall into negative equity if the decrease in house prices is significant. Given the low potential direct credit losses anticipated from mortgage loans and the prevalence of fixed interest rate loans with indexation to CPI, households are not expected to experience constraints on their debt servicing capacity that are large enough to lead to defaults. However, if, for example, unemployment increases and/or household income growth decreases, some households may find it more difficult to service their debts over the long-term. The associated negative household income and wealth effects may reinforce the initial shock if households are required to reduce spending in order to service their housing loans. This could lead to second-round effects and an increase in risks to credit institutions and the financial system.
- f. The ESRB takes note of the fact that Iceland has in place various mechanisms — limits to loan-to-value (LTV) ratios; creditworthiness assessments related to borrowers' incomes; and capital buffers — all of which are aimed at ensuring the resilience of both credit institutions and borrowers. The countercyclical capital buffer and the systemic risk buffer are expected to strengthen the resilience of credit institutions against the materialisation of vulnerabilities stemming from private sector indebtedness. Nevertheless, special attention should be also paid to the non-bank lenders (i.e. the pension funds and the government-owned Housing Financing Fund), which are more present in the housing sector in Iceland than in most other countries. The LTV ratios were applied in the expansionary phase of the financial cycle in order to strengthen the resilience of borrowers, prevent deterioration of lending standards and mitigate excessive credit and house price growth. As the LTV ratios are applied to all lenders, potential leakages across sectors are avoided. Moreover, microprudential requirements currently in place require the assessment of the credit-worthiness of borrowers taking out new loans. Therefore, any potential future borrower-based measures should also apply to all lenders, in order to avoid leakages.
- g. The current policy measures are assessed to be partially appropriate and partially sufficient to mitigate the identified systemic risks related to vulnerabilities in the residential real estate sector in Iceland. In particular, the high level of household indebtedness may not be sufficiently addressed by the current macroprudential measures. Though at the aggregate level, debt may have decreased, at the individual level, pockets of risk associated with highly leveraged households persist. While the ESRB acknowledges the initiatives taken as regards monitoring of residential real estate, further measures may be needed concerning lending to households with high DTI ratios. Iceland may consider a pre-emptive implementation of explicit guidelines on income-based measures, either in the form of a recommendation or of legally-binding borrower-based measures. Income-based measures may help to better prevent households from becoming overly indebted, should the strong growth in house prices persist. Such measures could be particularly relevant, as the growth in house prices may have reduced the effectiveness of the cap on LTV ratios.
- (9) When activating any measures to address the identified vulnerabilities, their calibration and phasing-in should take into account the position of Iceland in the economic and financial cycles, and potential implications as regards the associated costs and benefits.

- (10) ESRB warnings are published after the General Board has informed the Council of the European Union of its intention to do so and provided the Council with an opportunity to react, and after the addressees have been informed of the intention to publish,

HAS ADOPTED THIS WARNING:

The ESRB has identified medium-term vulnerabilities in the residential real estate sector of Iceland as 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 a high household indebtedness associated with the strong medium-term increase of house prices and potential overvaluation of house prices.

Done at Frankfurt am Main, 27 June 2019.

*Head of the ESRB Secretariat,  
on behalf of the General Board of the ESRB*  
Francesco MAZZAFERRO

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