# Iceland

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## IN A NUTSHELL

→ The economy has rebounded from the pandemic.
→ Mortgage rates historically low, fuelling housing demand.
→ First-time-buyers accounted for more than 30% of sales.
→ The labour market has rebounded rapidly.
→ New mortgages are mostly financed by bank deposits and pension funds.

## MACROECONOMIC OVERVIEW

The economy was resilient during the COVID pandemic. The Government and Central Bank provided multiple measures to support the economy, businesses and local demand, by direct subsidies to support the labour market and increasing the liquidity of financial institutions. In addition, the Central Bank lowered key interest rates by 200 bps to a historic low of 0.75%. As elsewhere, liquidity and low mortgage rates fuelled demand in the housing market. This was in addition to high demand from first time buyers and a shortage of supply.

GDP is estimated to have increased by 4.3%, according to Statistics Iceland compared to a decrease of 7.1% in 2020. GDP growth was mainly driven by private consumption and investment. Compared to pre-pandemic GDP the output was still 3% lower than in 2019.

Unemployment increased, but not as much as expected at the beginning of the pandemic. The labour market has historically been flexible, which benefited the economy in these dire times. The tourist sector crowded out other sectors of the economy. The better skilled workers that became unemployed were absorbed by the emerging technology sector, e.g. gaming, pharmaceutical, software industry etc, which has developed as the fourth export pillar of the economy, alongside the historic ones: fisheries, energy intensive industries, i.e. aluminium and tourism. Tourism's share of GDP was on average 8.1% in the period from 2016 to 2019, but went down to 5% in 2021. It is expected that the tourist sector will rebound in 2022 and 2023 approximating 2019 levels.

Inflation was 3.7% by end 2021 , but inflationary pressure has mounted in 2022, mainly due to higher housing prices, labour costs, price changes in consumer goods and oil. Iceland is partially hedged against higher international energy prices due to the large share of geothermal heating, well insulated housing and competitively priced electricity, mainly generated with hydropower. In the first five months of 2022 the Central bank has raised its key interest rates by 1.75% to 3.75%.

The Government supported the economy with various programmes, which has put pressure on the budget. However, the post pandemic net debt of the Government is relatively low compared to other countries and currently represents around 60% of GDP for the General Government, i.e. the state and municipalities.

## LOOKING AHEAD

Geopolitical uncertainties have affected the Icelandic economy principally by imported inflation. Iceland has over the last decades focused on energy independence: most of the local electricity and heating comes from renewable sources of geothermal and hydro. The economy is still vulnerable to higher oil prices for its fishing fleet, and in transport on land, air and sea.

According to the Central Bank of Iceland the economy is expected to grow by 4.6% in 2022, 2.6% in 2023 and 2.5% in 2024. It is expected that higher key interest rates will curb domestic demand. Economic policy both at the monetary and fiscal level has seldom been so challenging since the 1980s when the economy suffered from high inflation.

Unemployment decreased faster in 2022 than anticipated. Demand for labour is still high and it is expected that domestic companies will seek workers from abroad. One of the variables hindering growth in the labour market is shortage of affordable housing.

In terms of the tourist sector, reports suggest it will rebound to levels prior to 2019 in 2024, depending on how the pandemic and the Ukrainian conflict evolves. The outlook for the other main sectors of the economy is promising. Iceland benefits from higher food prices internationally due to its export of seafood and aquaculture produce plus high aluminium prices that benefits the renewable energy sector. The emerging technological sector has relatively good future prospects as well. This is subject to the uncertainties and risks, due to the fact that Iceland is an open economy and relies on imports of oil and grain based food produce.

## HOUSING MARKETS

Investment in housing has increased substantially from its low point in 2010, following the GFC. Housing investments have been encouraged by policy makers due to a shortage of affordable housing and high numbers of first time buyers and imported labour. The Government implemented a strategy in cooperation with labour unions to increase affordable rental housing, as well as a help-to-buy programme, among other measures.

Investment in housing was 5.0% of GDP, from an average of 4.2% over the period of 1995-2021, with a low point of 2.1% in 2010, which explains partially the supply constraints that Iceland has experienced in recent years. House prices increased by 12.2% in the Reykjavik Capital Region.

Owner occupancy rate has historically been high at 73.1% of those over 18 years of age in 2021. The rental market is 13% and 11.2% live with their parents. The remaining 2.7% is defined as alternative accommodation.[1]

Causes of increasing house prices in 2021 and Q1 2022, are historically low mortgage rates (due to the pandemic policy response), a shortage of new housing despite record investments and large number of first time buyers. Artificially low mortgage rates, during the pandemic, allowed more first time buyers

[1] https://www.stjornarradid.is/library/01--Frettatengt---myndir-og-skrar/IRN/Frettatengd-skjol/Starfshópur%20um%20umbætur%20á%20húsnæðismarkaði%20-%20skýrsla%20-%20lokaeintak.pdf

to pass credit worthiness tests than in a normal interest rate environment. This has fuelled demand in the housing market.

Over the past decade there has been population increase in municipalities within 50 km of Reykjavik due to higher prices in the Capital Region and a shortage of detached housing.

Due to new data gathering methods, it is unclear how many housing units were completed in 2021, but it is estimated that 7,260 housing units were under construction in March 2022.[2]

## MORTGAGE MARKETS

The total mortgage debt of households increased by 11% between 2020 and 2021. The average was 63.9% of GDP over the past decade, but 68.5% at year-end 2021. Interest rates on mortgages, both nominal and indexed, were at an historic low in 2021. Indexed mortgage rates have decreased further in the first quarter of 2022. Average nominal interest rates on new mortgages (granted by banks and pension funds) were 3.7% on nominal mortgages and 2.4% on indexed mortgages in 2021. The market share of banks increased substantially at the expense of the pension funds that have reduced their lending.

Loan to value (LTV) rules were altered due to financial stability concerns from 2020 to 2021. The Central Bank of Iceland lowered the maximum LTV from 85% to 80% in June 2021. The bank took further steps in June 2022 when it lowered the LTV ratio for first-time buyers from 90% to 85%. At the same time the bank introduced a benchmark interest rate floor for calculation purposes of Debt-Service-to-Income ratio (DSTI).[3]

Arrears at the 90 days level for households (total debt) was 0.9% for systemically important banks at the end of 2021. This was a decrease from last year.[4]

In May 2022, a proposal on housing policy was published. It emphasises affordable housing both for rent and to buy. The report states that 4,000 new housing units will be needed every year over the next five years due to population growth. The report will be discussed by policy makers in the coming months.

## MORTGAGE FUNDING

Covered bond issuance is relatively new and developing in Iceland. According to data from the Central Bank of Iceland the stock of outstanding covered bonds in Icelandic krónur grew by ISK 63 bn. in 2021, compared to banks' net new lending to households totaled ISK 326 bn.[5]

Other funding sources are mostly deposits and direct lending from pension funds. The principal buyers of covered bonds are pension funds and insurance companies. Deposits by households and companies increased substantially during the pandemic. It is expected that covered bond issuance will become common after the pandemic, when short term interest rates are expected to increase.

## GREEN FUNDING

The Icelandic banks have been providing green funding for example for cars that are fuelled by electricity, methane or hydrogen.

In terms of the Icelandic housing stock, it is almost entirely heated with renewable energy, e.g. geothermal heating or electricity generated with hydro or geothermal power plants. In addition, all housing is well insulated and double glazed.

Foreign funding partners of Icelandic banks are encouraging green lending and want the balance sheet of banks to reflect this. Banks have therefore issued green bonds denominated both in ISK and EUR.

| | ICELAND 2020 | ICELAND 2021 | EU 27 2021 |
|---|---|---|---|
| **MACROECONOMIC VARIABLES** | | | |
| **Real GDP growth (%) (1)** | -7.1 | 4.3 | 5.4 |
| **Unemployment Rate (LSF), annual average (%) (1)** | 5.5 | 6.0 | 7.0 |
| **HICP inflation (%) (1)** | 1.2 | 3.7 | 3.0 |
| **HOUSING MARKET** | | | |
| **Owner occupation rate (%) (1)** | 73.6 | 73.6 | 70.0 |
| **Gross Fixed Investment in Housing (annual change)(1)** | 1.2 | -4.4 | 6.6 |
| **Building Permits (2015=100) (2)** | n/a | n/a | 134.0 |
| **House Price Index – country (2015=100) (2)** | 157.8 | 177.6 | 145.2* |
| **House Price Index – capital (2015=100) (2)** | 152.8 | 171.4 | 146.1* |
| **Nominal house price growth (%) (2)** | 6.4 | 12.5 | 10.3* |
| **MORTGAGE MARKET** | | | |
| **Outstanding Residential Loans (mn EUR) (2)** | 14,604 | 14,739 | 6,508,621 |
| **Outstanding Residential Loans per capita over 18 (EUR) (2)** | 51,647 | 51,471 | 17,782 |
| **Outstanding Residential Loans to disposable income ratio (%) (2)** | n/a | n/a | 62.8* |
| **Gross residential lending, annual growth (%) (2)** | 37.3 | 62.3 | 12.2 |
| **Typical mortgage rate, annual average (%) (2)** | 2.8 | 2.4 | 2.0 |

* Please note that this value is the simple average of the available values in 2021.

*Sources:*
*(1) Eurostat*
*(2) European Mortgage Federation - Hypostat 2022, Statistical Tables.*

2 Confederation of Industries

3 https://www.sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2021/06/30/Reglur-um-hamark-vedsetningarhlutfalls-fasteignalana-til-neytenda/
https://www.cb.is/publications/news/news/2022/06/15/Rules-on-maximum-LTV-and-DSTI-ratios/

4 https://www.sedlabanki.is/library/Skraarsafn/Fjarmalastodugleiki/FS/2022/Fjarmalastodugleiki_2022_1.pdf

5 Ibid

## ICELAND FACT TABLE

| | |
|---|---|
| **Which entities can issue mortgage loans in your country?** | Deposit taking corporations (banks) and Pension Funds, the Housing and Construction Authority. |
| **What is the market share of new mortgage issuances between these entities?** | In the year 2021 the market share of deposit taking banks was 95% and the pensions fund's share was 4% the remaining 1% was lent by the government's housing authority (HMS). |
| **Which entities hold what proportion of outstanding mortgage loans in your country?** | At year-end 2021 the deposit taking banks held 67% of the total outstanding mortgages to households, the pension funds 18% and IL – Fund (in winding-up) 15%. |
| **What is the typical LTV ratio on residential mortgage loans in your country?** | The maximum LTV in 2021 was 85%, but up to 90% for first time buyers (limit to price). This limited was lowered on 1 July 2022 80% and 85% respectively. |
| **How is the distinction made between loans for residential and non-residential purposes in your country?** | The Central Bank currently makes a clear distinctions between those loans in its accounts. Banks and pension fund require a pledge in the underlying property for a new mortgage. |
| **What is/are the most common mortgage product(s) in your country?** | Variable rate mortgage for 25 to 40 years (31% of outstanding mortgages at end of 2021, about 45% of new mortgages in 2021). |
| **What is the typical/ average maturity for a mortgage in your country?** | 25 to 40 years |
| **What is/are the most common ways to fund mortgage lending in your country?** | Covered bonds and deposits in the case of banks. Members funding in terms of pension funds. |
| **What is the level of costs associated with house purchase in your country (taxes and other transaction costs)?** | Stamp duty – 0.8% of the official property valuation (fasteignamat) for individuals and 1.6% for rental companies/legal entities. |
| **What is the level (if any) of government subsidies for house purchases in your country?** | The government has introduced help to buy programme and pays interest expense benefits to low income households. First time buyer pay half of the stamp duty. |