Remarks by Deputy Governor of Financial Stability Tómas Brynjólfsson in a Panel Discussion at the Reykjavik Economic Conference

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As you may have noticed during your time here, Iceland is a small and highly volatile economy. Volatility has, however, diminished significantly over the past two decades as a result of substantial improvements to Iceland's policy framework.

The title of my presentation poses a simple question: Have risks genuinely been reduced, or have they merely been redistributed within the financial system? The theme of this panel *Financial stability: The big leap or a bubble?* – Offers an opportunity to use Iceland's experience as a lens through which to consider the question posed to the panel: *How should policymakers think about simplification and deregulation in financial regulation?*

Iceland's framework is not only being tested by the seismic shock currently reshaping the international system. We are also facing a literal seismic shift, as Iceland has entered an era of increased volcanic activity, with repeated eruptions occurring close to the capital area.

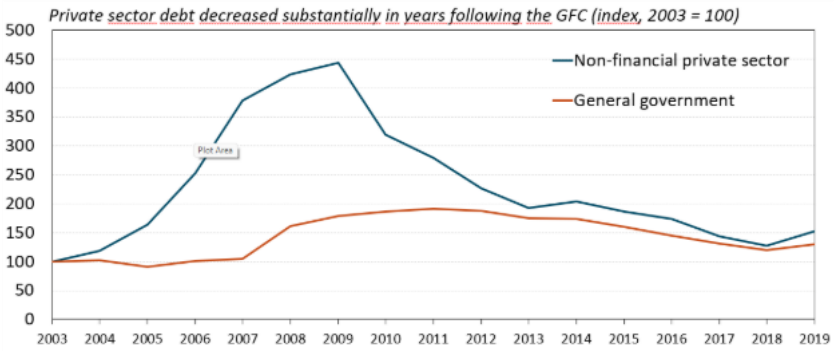
Fortunately, Iceland's geologists believe that this period of heightened volcanic activity is only medium-term in nature. Unfortunately, however, in their world "medium term" means no more than about 700 years.

Against that backdrop, let me turn to Iceland's experience.

The post-crisis policy framework has delivered a more stable financial system without imposing the economic costs that many feared. While it encompassed a broad set of reforms, including changes to the monetary and macro-prudential policy frameworks, I will focus on the financial stability aspect.

In the post-crisis period public and private balance sheets were repaired through extensive deleveraging until 2019, and Iceland moved from being a net debtor to the rest of the world to having a net positive international investment position. Macroprudential policy remained tight even as growth resumed. This applied both to limits on household bor-

rowing and to banks, which were required to operate with strong capital and liquidity buffers. Importantly, these buffers have been usable as they were released during the pandemic, allowing credit to continue flowing during a period of stress.



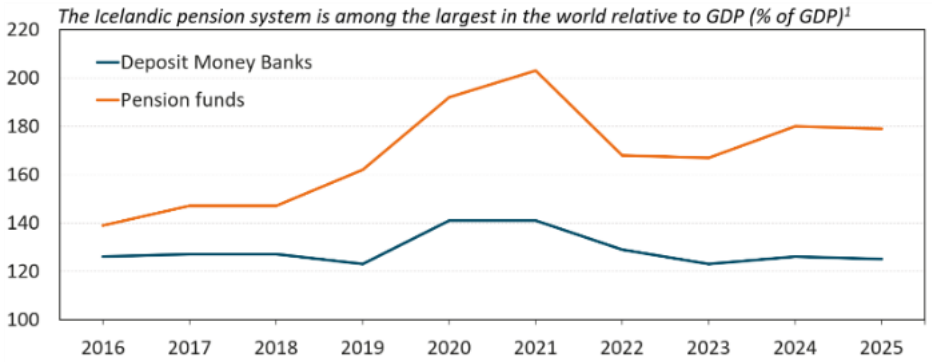
Sources: Statistics Iceland, Central Bank of Iceland.

This policy has not been without its critics, who have, in my view, focused on concerns that robust capital requirements undermine bank competitiveness. Yet, bank profitability has remained broadly in line with that of Nordic peers. There have also been concerns that this policy has weighted on the real economy. However, there is no compelling evidence to support such a view. In fact, investment has been growing to a relatively robust level and economic growth has been strong by European standards. Thus, we appear to have increased resilience at a fairly limited cost.

The question, then, is whether risks have genuinely been reduced – or simply moved elsewhere in the system.

At first glance, internationally published data suggests that non-bank financial institutions have increasingly replaced banks as providers of finance. Iceland, however, presents a rather different case.

While bank balance sheets have remained stable as a share of GDP, pension fund assets have expanded significantly. Iceland now has one of the largest pension systems in the world relative to GDP. At the level of individual institutions, these funds pose limited financial stability risks. They do not rely on short-term or wholesale funding. They benefit from stable and persistent contribution inflows and investment income, and their funding framework allows actuarial imbalances to be corrected over time, including through benefit adjustments if necessary.



Sources: Nasdaq Iceland, Central Bank of Iceland.

From a system-wide perspective, however, there are three reasons to remain vigilant.

First, the funds have large unhedged foreign currency exposures. Second, they are prone to herd behavior, which may become more problematic as the funds mature over the coming decade. Finally, and most importantly, the funds are deeply embedded in the domestic financial system. They are major holders of both bank equity and liabilities, including debt securities and deposits, and as such are an important funding source for banks.

The interlinkages between pension funds, markets and the banking sector lead to my third point – and perhaps the most important migration of risk we have observed. When shocks hit a small, interconnected system, the government balance sheet often ends up absorbing them. Reduced fiscal space should alter how we assess financial stability risks.

Following the extensive deleveraging in the last decade, government finances in Iceland were in relatively a strong position. That created room to smooth the impact of repeated shocks.

The costs of the pandemic were largely absorbed by the Government's balance sheet. Perhaps an even more interesting example is the volcanic eruptions of 2023–2024, which displaced around 1% of the population. The government financed the relocation of residents, supported firms, and invested in protective infrastructure. At the same time, losses for banks—and pension funds—remained limited. In fact, bank losses in the region where the volcanoes erupted were not materially different from those in other parts of the country.

The result is a familiar pattern: Risk has been cushioned in the private sector but has materialized on the government's balance sheet.

While government debt remains moderate in international comparison, they are higher than in many other small, shock-prone economies. Refinancing needs are significant, and interest costs are high. Governments, of course, have long planning horizons and a strong capacity to manage risk. But higher sovereign leverage reshapes systemic risk rather than

eliminating it—and reduces the fiscal space available to absorb future shocks.

As a result, historical private sector default rates may become a less reliable indicator to the possible costs of future shocks, potentially leading both banks' internal risk models and stress tests to underestimate risks.

Importantly, as risk increasingly resides on the Government's balance sheet – not only for Iceland but internationally – it is difficult to form a view on financial stability without also having a clear view of public finances. This more central role for the Government's balance sheet underscores the importance of resting the financial stability mandate with an independent institution that can assess risks candidly. It also has implications for central bank communication.

That context matters greatly when we assess proposals to simplify or reduce financial regulation. In a world of slow growth and limited fiscal space, the appeal of simpler rules is understandable. But Iceland's experience makes me sceptical of broad arguments for reducing core resilience requirements.

The financial sector therefore needs to be robust enough to weather shocks, not least because they have become more frequent while fiscal space has been reduced. This does not mean we should ignore unintended consequences in that area. Beyond the possibility that more stringent regulation shifts risks elsewhere, there are two issues that deserve attention.

First, the high fixed costs of fulfilling complex regulations for banks may encourage consolidation, reinforcing "too-big-to-fail" dynamics. Second, increasingly prescriptive regulation and supervisory guidance may lead banks to converge towards similar business models and risk profiles. These are important considerations.

But Iceland's experience also reminds us that resilience requirements have delivered tangible benefits. A stronger financial system has enabled banks to withstand repeated shocks while continuing to support the real economy. At the same time, an increasing share of those shocks has been absorbed by the public sector, reducing fiscal space. We should not assume that governments will always be able to play that role to the same extent.

If Iceland teaches us one lesson, it is that risks rarely disappear. They evolve, they migrate and, ultimately end up on someone's balance sheet. That should make us cautious before concluding that the resilience built into today's regulatory framework is no longer needed.

Thank you.