

Financial stability¹

The Central Bank's regular survey of financial stability, published in May in Monetary Bulletin 2001/2, discussed the conceivable strain that the financial system could come under and its capacity for meeting it. The following article mainly accounts for the changes that have taken place since the spring.

Summary of findings

The article on financial stability in *Monetary Bulletin* 2001/2 concluded that the risk posed to Iceland's financial system by changes in external conditions had grown last year. At the same time, the economic outlook among Iceland's main trading partner countries had worsened and the Icelandic economy had become more sensitive to such changes. In principle, this finding still applies. Iceland's economy is in the process of a landing which could not be avoided following a period of serious overheating, at the same time as the outlook among main trading partner countries has worsened still further. The exchange rate of the króna has depreciated and inflation has increased since the last survey, but the current account deficit is starting to narrow.

The weakening of the króna hit business profits during the first half of the year, most notably through financial expenses which were largely the result of exchange rate losses on foreign borrowing. In spite of this, many exporters appear to be fairly well placed, but smaller businesses operating in the domestic market face growing problems, particularly those which have borrowed abroad. Corporate debt as a proportion of GDP has increased still further this year, while the growth in household indebtedness has slowed down. Nonetheless, household debt is still

large and running at one of the highest levels known anywhere, at least compared with the major industrial countries. Equity prices appeared to reach a low in the autumn and have begun to pick up slightly. Real estate prices have started to fall after one of the sharpest peaks for decades.

First-half operational results of commercial banks and savings banks this year varied greatly from one institution to the next, but generally speaking showed an improvement from last year. The considerable weakening of the króna during that period did not have very much direct impact on their profitability, since their net foreign exchange exposures are subject to prudential rules. Lending growth has slowed down in real terms, but defaults with credit institutions have increased, partly because of the depreciation of the króna. Credit institutions are apparently starting to respond by making increased provisions to their loan loss reserves. The credit institutions' credit risk has therefore increased, as might be expected; higher loan losses could diminish their profits and weaken their equity positions. Most of them have boosted their capital ratios this year, however, mainly through subordinated loans. There is now less scope for raising such capital.

The study in *Monetary Bulletin* 2001/2 concluded that, if no further external shocks took place, the position of domestic credit institutions was hardly likely to be at risk. As pointed out elsewhere, external conditions have taken a turn for the worse, the króna has depreciated, the fishing quota was cut back

1. This article uses data available on October 31, 2001.

and the global economic outlook has worsened. However, the Icelandic economy is not in a worse position in all respects, since the fortunes of many export companies, not least in the fisheries sector, have improved as a result of the depreciation. Importantly, the necessary restoration of macroeconomic balance has begun. There are indications of more difficult times ahead. In this context it should be pointed out that reforms have been made to the legal and regulatory framework governing credit institutions, including measures that enable more active supervision. Internal risk management by credit institutions themselves has also become an increasingly important aspect of their day-to-day operations, and they are clearly beginning to prepare themselves to face tougher times. There are no grounds for doubting that, on the whole, the credit institutions will be able to handle such problems as may lie ahead.

Macroeconomic indicators

The economic situation has worsened in other countries but Iceland's main industries have not yet suffered seriously

The world economic outlook has continued to worsen, as briefly outlined elsewhere in this issue. A downturn has begun in the USA, several European countries are on the brink of one and the recession in Japan is generally predicted to continue. Furthermore, a downturn is looming or has already begun in many of the emerging market economies.

So far, Iceland's main industries have not yet suffered seriously from these upheavals. Aluminium prices have in fact fallen considerably and companies in the technology sector have suffered shocks, as elsewhere in the world, but neither has any significant effect on the Icelandic financial system. Much greater consequences could result from the inevitable landing that has begun in the economy following intense overheating in recent years.

The króna has continued to slide ...

From April, before the last study of financial stability was made, to the end of October the króna has depreciated by 10%. This weakening is on top of a 16% depreciation since the previous April. In all, the króna has therefore weakened by one-quarter since

April 2000, which corresponds to a rise in the price of foreign exchange amounting to almost one-third. It is obvious that such sharp exchange rate swings can have serious consequences for the finances of companies which are in debt and took foreign loans on the assumption that the high exchange rate prevailing for most of last year would remain fairly stable.

The last article on financial stability stated that before the exchange rate deviation band was abolished, the Central Bank's net foreign balance had dropped to 7 b.kr. Although the Central Bank is no longer obliged to defend a specific deviation band, it has several times felt itself compelled to respond to heavy pressure on the exchange rate by selling foreign currency for krónur. In June the Ministry of Finance announced the government's decision to open a 25 b.kr. loan facility which would be used to boost the Bank's external position. This loan facility was finalised in October and has strengthened the Bank's scope for intervening in the foreign exchange market, if it considers this to serve its inflation target or be necessary on the grounds of financial stability.

Despite the shrinking of the current account deficit, it is clear that Iceland's economy is still some way from achieving external balance. The declining deficit is matched by a reduction in credit inflows, which in fact may be contributing to it. Iceland's net external position deteriorated from 447.1 b.kr. at the end of 2000 to 591.8 b.kr. at the end of June. The downturn in the external position calls for more adjustment of domestic demand; for as long as this persists, Iceland's economy has little attraction for foreign capital from private sources, especially if the heavy investments of recent years have created a certain degree of saturation. The fact that the real exchange rate of the króna is at a historical low suggests that when a sufficient adjustment has been made, conditions will have been created for the nominal rate of exchange to rise. The precondition for achieving a swift adjustment is that the real exchange rate's path towards long-term equilibrium is not solely the result of rises in domestic prices.

... and hit business profits in the first half of the year

The foreign exchange upheavals are clearly reflected in first-half profit figures for companies listed on Iceland Stock Exchange (ICEX). Substantial losses,

equivalent to 4% of turnover, were posted by businesses as a whole, despite higher gross profits (EBITDA). The discrepancy between operating profits and net earnings after tax is primarily the result of an increase in the book value of financial expenses, which climbed from roughly 1% of turnover during the first half of 2000 to 9.5% over the same period this year. Some 80% of this increase was the result of exchange rate losses on foreign-denominated borrowing.

High earnings by solid companies suggest they are well equipped to withstand shocks ...

Despite this trend, the companies for which most information is available seem to be in a fairly good position to withstand it, since many of them are exporters and benefit from the lower exchange rate in the long run. EBITDA among fisheries sector companies, for instance, rose from just under 18% to 27% of turnover during the first half of this year. It also grew among industrial and manufacturing companies, service companies and contractors. Judging by financial companies' forecasts, business operations are expected to improve in the second half of this year and the profit margin after tax will be 1-2%. EBITDA is expected to remain good while financial expenses will show a relatively small increase since the change in the exchange rate has already been reflected in first-half statements. Product prices are also expected to rise in many cases, along with an improvement in competitive position on account of the low real exchange rate.

The contraction in the fish catch forecast this spring is likely to be smaller than originally assumed, at around 1.5%. As far as can be seen, fisheries companies are fairly well placed. Fuel prices, which can have a substantial effect on the results of some companies, e.g. in the transport and fishing sectors, have shown sizeable decreases recently. In this respect, the assumption made in the last article on financial stability, that the rise in oil prices during the first of the year would be reversed, has been borne out by events.

... but smaller firms in the domestic market face growing problems

These results and forecasts only tell half the story. Many companies listed on ICEX have considerable

foreign currency revenues and are fairly well hedged against exchange rate changes. The same does not apply to many smaller companies which have also taken foreign-denominated loans. To a growing extent, business performance is heading in two different directions, although information about the latter is still fairly scant. Sales and prospects are good in export sectors, in particular fisheries, pharmaceuticals production and other general export industries. On the other hand, there are both formal and informal signs of a contraction in various domestic sectors. The National Economic Institute's labour market survey invites the conclusion that a downturn is likely in various branches of industry and services. A survey conducted by the Federation of Icelandic Industries also points towards a considerable contraction in the construction and earthmoving industries in the near term. This is a sharp reversal from the spring, although not a complete surprise. Import statistics and other indicators show a drop in wholesaling, especially motor vehicle imports. Aviation and other transport activities have been struck hard by lower foreign trade volumes and upheavals in the foreign exchange market, and their problems were compounded by the events of September 11. Technology and software design sectors have suffered shocks from an international recession in these fields to which no end is yet in sight. The commerce sector needs to tackle greater competition at the same time as retailing is depressed and indebtedness high. A considerable number of bankruptcies have taken place in the catering sector and diminishing advertising revenues are squeezing media companies. In sectors where overinvestment, accumulation of foreign-denominated debt and a poor domestic market outlook go hand in hand, some risk of troubles can be assumed. This is particularly true of companies in services, commerce and construction.

Corporate debt has risen

The article on financial stability in *Monetary Bulletin* 2001/2 described heavy corporate indebtedness, which last year grew at its fastest rate ever apart from 1982. Estimated at 122% of GDP at the end of last year, these debts have grown even further since, to roughly 130% of estimated GDP this year. As far as companies listed on ICEX are concerned, this development takes the form of a considerable

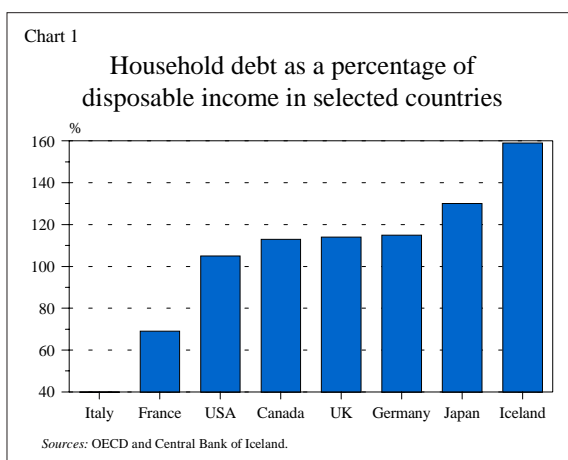
Table 1 Companies listed on ICEX:
Capital ratio, debt ratio and debt growth

	1999	2000	June 2001
Capital ratio	34%	30%	27%
Ratio of debt to equity.....	1.96	2.32	2.72
Debt growth.....	.	25%	25%

reduction in capital ratio and rise in the ratio of debt to equity.

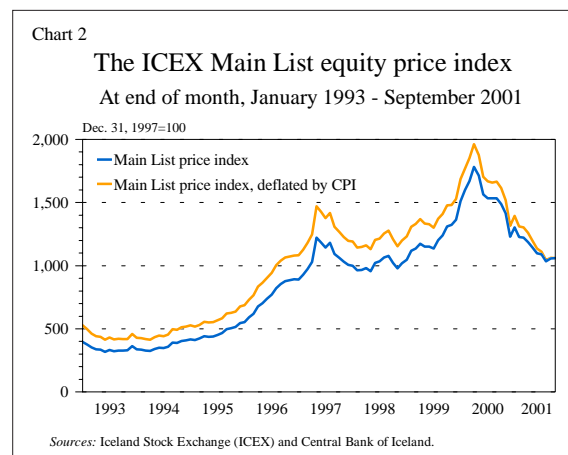
Household debt accumulation has slowed down

Household debt accumulation appears to have slowed down somewhat. Around the middle of the year, household indebtedness towards credit system institutions amounted to 645 b.kr. These debts had increased by 7.6% in nominal terms and 3.9% in real terms. This is half the rate of increase over the same period in 2000 and somewhat less than at the same time in 1998 and 1999. It should be added that preliminary figures show a 1.6% drop in private individuals' debt with the banking system and investment credit funds (including the Housing Financing Fund) in July and August. Nonetheless, household indebtedness is running high, and at a much greater level than is known at least in the major industrialised countries, as shown in Chart 1. At the end of 2000 this amounted to 159% of disposable income.



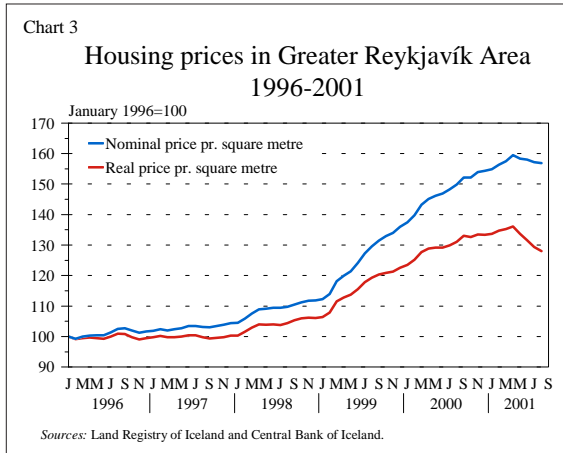
Equity prices picked up in the autumn after a three-year low, and real estate prices appear to have passed their peak

Asset prices are moving in two distinct directions. At the same time as equity prices have picked up somewhat after the greatest drop in ICEX's history, real estate prices have just begun to fall after one of the highest peaks for decades. Equity prices as measured by the ICEX main index fell by almost 10% from the May average until August, but following announcements about corporate tax cuts this decrease was won back. In real terms, recent equity prices have been close to those at the beginning of 1998, and are more than twice their level over the period 1992 to 1994.

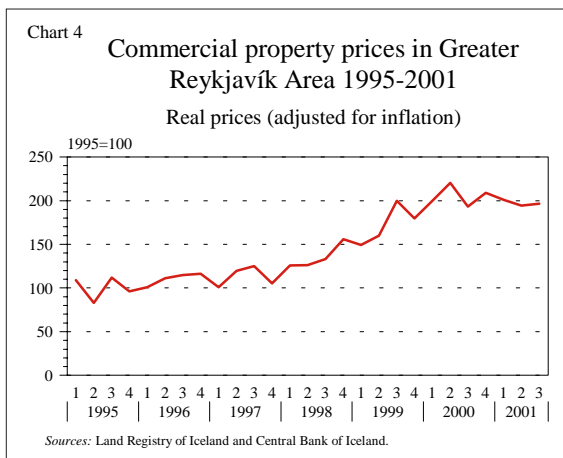


Prices of residential accommodation appear to have peaked in the spring. Since April, residential housing prices in the Greater Reykjavík Area have gone down by 1.6%, while consumer prices have risen by 4%.

Indications of changes in prices of business premises are much less reliable. Few deeds of purchase are entered in statistics and the properties sold are so different in character that it is impossible to draw conclusions except when substantial and lasting changes can be noted. Prices of business premises went down by 11% in real terms between the second quarter of 2000 and third quarter of 2001, but this needs to be interpreted with strong reservations since the peak in Q3/2000 deviates somewhat from the underlying trend, as Chart 4 shows. However, the huge wave of demand that led to an 83% rise in annual average real prices of business premises



between 1997 and 2000 clearly appears to have come to a halt. Prices are nonetheless still quite close to the historical record. Coupled with conceivable upheavals in the market for retail premises following the opening of the new Smáralind shopping mall, this entails the risk of a considerable drop in prices and poorer collateral.



Aggregate microprudential indicators

Marginal improvement in profitability ...

On the whole, profitability² of commercial banks, major savings banks and investment banks³ during

2. The ratio of net profit to the average between equity at the start and end of the period, less profit for the period. Annualised figure.
3. i.e. Íslandsbanki, Landsbanki Íslands, Búnadarbanki Íslands, Icebank and the 6 largest savings banks: Reykjavík Savings Bank (SPRON),

the first half of this year was higher than in 2000. Annualised return on equity was 11.5% compared with 9.9% in 2000.

However, performance varies greatly from one institution to the next. All showed a drop in profitability during the first six months with the exception of Íslandsbanki (20.3%) and Frjálsi Investment Bank (29.3%), which both recorded substantial gains.

... with qualifications ...

The main rule for evaluating bonds in the commercial and savings banks' investment portfolios is projected purchase price, i.e. based on the required rate of return on the day of purchase. There are two exceptions from this. If the real worth of the bonds is less than their book value and this is not considered to be due to temporary factors, cf. the provisions of Art. 53 of Regulation no. 692/2001 on the annual financial statements of credit institutions, their book value must be written down to match the lower worth. This provision also applies in the case of a decrease in price due to general rises in interest rates when the institution's investment bonds assets are not financed with a comparable interest rate commitment. The main rule for evaluation of investment equities is their cost price (projected) or market worth, whichever is lower. In the case of a shareholding in an associated company, the rule is that this shall be evaluated in accordance with their intrinsic value as per the annual accounts of the associated company in question.⁴ Thus a difference can clearly arise between market value and book value of equities in the investment portfolio.

There is some difference between the market value and book value of listed bonds in some banks' investment portfolios.⁵ Some savings banks show a considerable difference between the book value and

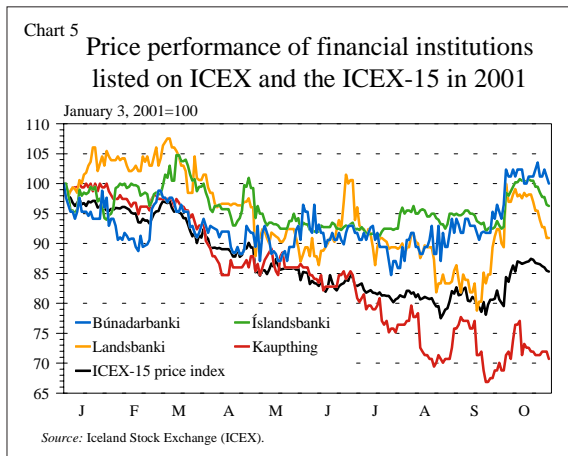
Hafnarfjörður, Sparisjóður vélstjóra, Keflavík, Kópavogur and Mýrarsýsla. Kaupthing and Frjálsi Investment Bank are the investment banks referred to.

4. Landsbanki enters its holding in Vátryggingarfélag Íslands hf. (VÍS insurance) as an asset in an associated company to the value 4,272.1 m.kr. (direct shareholding). Landsbanki intends to sell its employees part of this holding in VÍS at a rate of 20 times nominal. The plan is then to list VÍS on ICEX in the near future. No opinion as to the real value of VÍS will be expressed here but according to a press release from Landsbanki it can be assumed that the market value of this holding is considerably higher than its book value.

market value of their equity holdings, largely attributable to their shares in Kaupthing.⁶ Like last year, part of the profits posted by some savings banks originated in the sale of their shares in Kaupthing.

... and market value remains steady

Market value of the financial institutions listed on ICEX slipped slightly from 90 b.kr. since the last study in April to just over 88 b.kr. on October 31. Market value was lower in the summer, but rallied in the beginning of October, among other things when ideas for a reduction in corporate tax were presented, which had a positive impact on the position of finance companies. By the end of October, however, prices of shares in Íslandsbanki and Landsbanki had slipped again. Chart 5 shows the share price trend for commercial banks listed on ICEX, plus Kaupthing, during 2001. Shares in commercial banks have shown a more favourable trend than the ICEX-15 index since the beginning of the year, although with the exception of Búnadarbanki their prices have fallen. Shares in Kaupthing, on the other hand, have fallen by more than the ICEX-15 index since the beginning of the year, which is explained to some extent by its profit warning in mid-October reporting a negative result during Q3. Kaupthing nonetheless

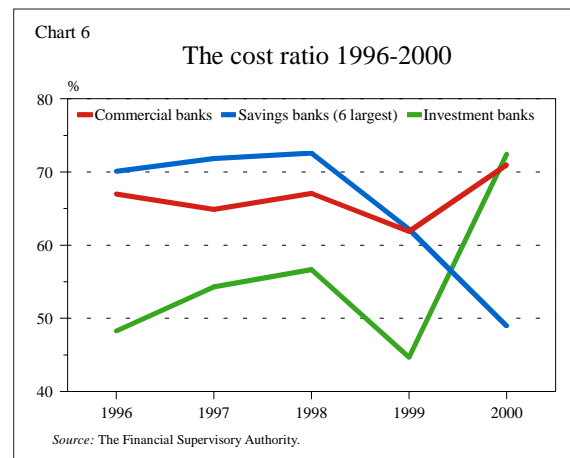


- Interim statements of the commercial banks, six largest savings banks, Kaupthing and Frjálsi Investment Bank reveal that the market value of listed bonds is around 1.1 b.kr. lower than the book value in their investment portfolios.
- For the six largest savings banks, the market value of listed shares in their investment portfolios is 952 b.kr. higher than book value.

expects to achieve its profitability target for the year as a whole. Íslandsbanki published its nine-month statements on October 30, in which profit for the year, after tax, is now estimated at 3 b.kr. instead of the 3.5 b.kr. assumed in its original forecasts.⁷

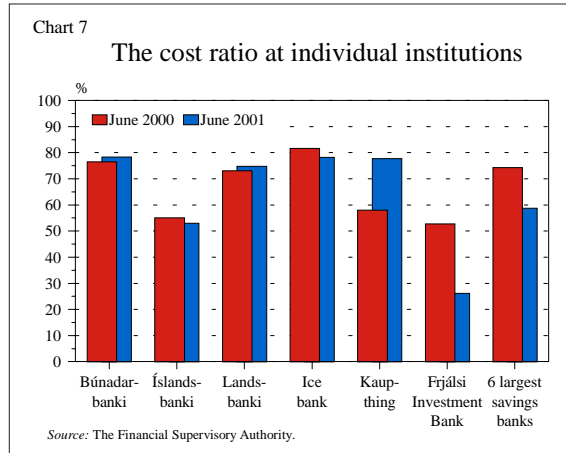
Cost ratio similar ...

The cost ratio, i.e. operating expenses as a proportion of net operating revenue, was marginally lower in the six-month statements (65.1%) than in 2000 (66.3%) for the commercial banks, six largest savings banks and two investment banks. Of the commercial banks, Íslandsbanki had the lowest cost ratio (53%), which was similar to that for 1999 (55.2%) if FBA, with which it is now merged, is included in Íslandsbanki's statements for that year.⁸ Búnadarbanki had the highest ratio (78.3%) but Landsbanki came close behind (74.8%). The total cost ratio of the six largest savings banks rose to 58.7%, from 48.9% for 2000 (although it was 62.1% for 1999). At Kaupthing the cost ratio rose significantly, from 66.9% in 2000 to 77.7% during the first half of 2001.⁹



Fluctuations in the cost ratio between different institutions since 1999 can primarily be attributed to

- The new forecast incorporates the expected impact of tax changes on the bank's deferred income tax liability. The profit figure is therefore effectively even lower than assumed in the original forecast.
- Íslandsbanki's cost ratio according to its nine-month statements is 54.5%.
- Kaupthing's acquisition of Frjálsi Investment Bank is also involved here.



revenue swings caused on the one hand by changeable exchange rate and portfolio gains and on the other hand by the savings banks' capital gains on their sales of holdings in Kaupthing both in 2000 and the first half of 2001. On the whole, commercial banks and savings banks have clearly had trouble in making operational economies in recent years. They face a major task in this area.

... and net interest earnings increase

Net operating revenues of commercial banks and the six largest savings banks were higher during the first six months of this year than in the first half of 2000. Growth in operating revenues can be almost entirely attributed to greater net interest earnings¹⁰ on account of higher inflation and a positive indexation balance, i.e. these institutions' indexed assets exceeded their indexed liabilities. As a ratio of total revenues in the six-month statements of the commercial banks and six largest savings banks, net interest earnings were 62.2% this year and 54.3% last year. Net interest earnings increased by 42.1% compared with the six-month results for 2000 for the commercial banks and by 32% for the six largest savings banks, but decreased by a combined 39% for Kaupthing and Frjálsi Investment Bank.

Service revenues also increased for the commercial and savings banks and the net ratio to total revenues in their six-month statements was 33% compared with 31.4% last year. Net service earnings

10. Net interest earnings are defined as interest income less interest expenses.

were up by 25.7% from last year's six-month results for commercial banks, by 11.8% for the six largest savings banks and by a combined total of 79% for Kaupthing and Frjálsi Investment Bank.¹¹

All the commercial banks apart from Íslandsbanki posted losses on their other financial activities,¹² which have been a steadily growing area of their operations in recent years. Landsbanki lost 1,102 m.kr. on its equities portfolio and Búnadarbanki 545 m.kr., while Íslandsbanki recorded a profit of 223 m.kr.¹³ Of the six largest savings banks, only Hafnarfjörður reported a loss on other financial activities, amounting to 265 m.kr. and mainly the result of losses on its equity portfolio.¹⁴ Reykjavík Savings Bank (SPRON) generated a profit of 615 m.kr. on other financial activities, of which just over 572 m.kr. was from its equities portfolio (although it should be noted that its shareholding in Kaupthing was transferred to the trading book with a revenue entry of 749 m.kr., which means that there was a loss on other equities in the portfolio). Kaupthing posted a loss of 288 m.kr. on other financial activities, headed by an equities portfolio loss of just over 745 m.kr. Frjálsi Investment Bank made a profit of 488 m.kr. on other financial activities, largely deriving from its equities portfolio (469 m.kr.).¹⁵

General banking operations are clearly the main source of revenue for commercial banks at the moment.¹⁶ It is also interesting to note the scale on which net service earnings have increased, which suggests that the revenue base of the commercial and savings banks has strengthened, even though equity portfolio losses have severely cut into the revenues of some of them.

11. The increase at Kaupthing was 102.9%.

12. Other financial activities comprise trading in equities, bonds and currency.

13. Íslandsbanki's nine-month statements report a loss on other financial activities as a result of negative equity price developments. The loss amounts to 231 m.kr. but the breakdown is not specified.

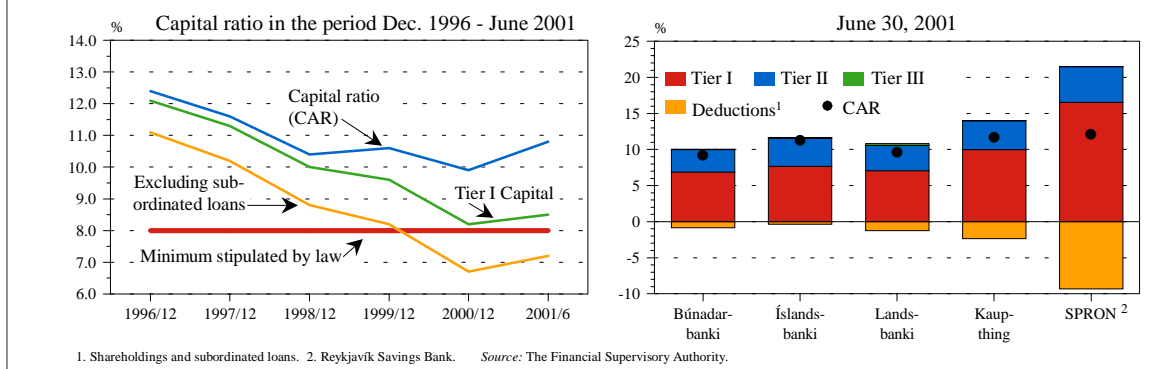
14. Offsetting this is a substantial profit on the sale of shares in Kaupthing which is entered under sundry operating revenues.

15. Frjálsi Investment Bank received payment in shares in Kaupthing when the latter bought a holding in it. These shares were posted at market price at the end of June, at a profit of 519 m.kr.

16. Interest revenues of DMBs can also be expected to have grown with higher risk premiums on interest on corporate and private lending. This is an indication that the DMBs are responding to higher credit risk.

Chart 8

The capital ratio of commercial banks, six largest savings banks and investment banks

*Capital ratio increases ...*

The capital ratio of commercial and savings banks has been decreasing on the whole in the past few years. At the end of 2000 it was 9.9% according to the legal definition of capital adequacy,¹⁷ having decreased from 10.6% the year before. That trend has been reversed this year, since the ratio had risen to 10.8% in the half-year statements for 2001. It was 9.2% for Búnadarbanki, 11.3% for Íslandsbanki (and according to the nine-month statements was 11.9% at the end of September), 9.7% for Landsbanki, 13% for the six largest savings banks and 12.2% for the two investment banks.¹⁸ The ratio was higher at all these institutions apart from Búnadarbanki and one of the savings banks.¹⁹

... partly because of more subordinated loans

At the end of 2000, the outstanding subordinated loan stock of DMBs and Kaupthing amounted to 20 b.kr. By the end of June this figure had risen to 35 b.kr. (an increase of 73.5%), of which 42% was exchange rate-linked. While this increase may to some extent be explained by the depreciation of the króna over the period, it is nonetheless clear that issues of new subordinated loans increased greatly in 2001. The bulk of these loans are ranked as Tier II

17. The minimum ratio stipulated by law is 8%.

18. It should be reiterated here that the two investment banks referred to here are Kaupthing and Frjálsi Investment Bank. There are other investment banks, including EFA, Greidslumidlun-VISA and Kreditkort.

19. The equity ratio fell by 0.5 percentage points at Búnadarbanki and 0.6 percentage points at Keflavík Savings Bank.

Capital, but this year Landsbanki and Búnadarbanki also issued subordinated loans that are classified as Tier I Capital (see *Monetary Bulletin* 2001/2). Íslandsbanki made the first issue of such bonds last year.

Capital ratio excluding subordinated loans other than Tier I Capital rose slightly from the beginning of the year, when it was 6.7%, to 7.2% at the end of June for the commercial banks, six largest savings banks and two investment banks. The ratio was 5.9% for Landsbanki, 7.4% for Íslandsbanki²⁰ and 6.1% for Búnadarbanki at the end of June. For the six largest savings banks the end-of-June ratio was 9.7%, having risen from 8.7% at the beginning of the year. Kaupthing had a 7.7% capital ratio excluding subordinated loans at the end of June and 7.1% at the beginning of the year.

No subordinated loan issues are known to have been made since the end of June but the planned merger of Búnadarbanki and the leasing company Lýsing could lead to a stronger capital ratio for both Búnadarbanki and Landsbanki. Under these plans, Landsbanki will be paid for its holding in Lýsing with shares in Búnadarbanki, which it intends to sell. The book value of Landsbanki's holding in Lýsing was 546.1 m.kr. but its estimated sales value 982.8 m.kr., according to an announcement made to ICEX.

Commercial banks and savings banks have boosted their capital ratios through subordinated loan issues, but their scope in this respect has diminished

20. This figure is now 8.2% according to the nine-month statement.

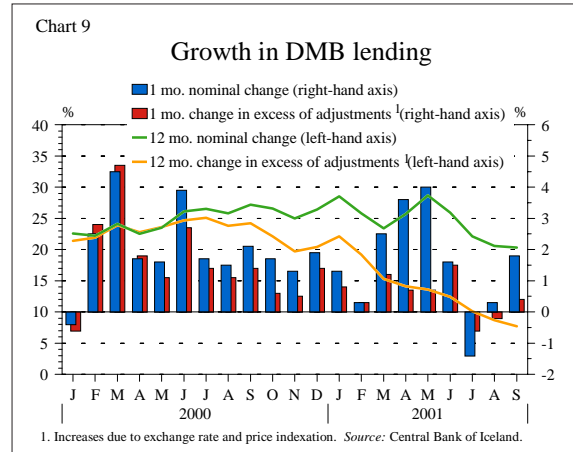
correspondingly.²¹ Thus the capital ratio will only be strengthened in the years to come by means of higher profits, new capital stock, financial institution mergers or sales of assets, including holdings in other financial institutions. The institutions' scope for expanding their balance sheets has therefore narrowed to some extent. For example, the depreciation of the króna has automatically inflated the banks' balance sheets, and thereby the risk base on which the capital ratio is calculated. Another effect of the depreciation is to raise the principal of foreign subordinated loans, which has the effect of softening the reduction in the capital ratio. It should be borne in mind, however, that subordinated loans may only account for a specific proportion of equity. If the subordinated loan authorisation is used in full, any depreciation of the króna is not transmitted as an increase in mandatory capital.

As mentioned in *Monetary Bulletin 2001/2*, new international capital adequacy standards could have a considerable impact on the operation of Iceland's financial institutions. Since only a small section of Icelandic credit institutions are likely to be able to take advantage of the more complex part of the planned rules, the overall capital adequacy requirement can be expected to increase on average from the current level. The new rules were supposed to take effect in 2004 but this has been postponed until 2005.

Lending growth slows down ...

The growth in lending by DMBs has been slowing down so far this year. The twelve-month rise in lending until the end of September was 20.3%. From the beginning of the year to the end of September the increase was 14.6%, or 88.1 b.kr., compared with 18.1% and 86 b.kr. at the same time last year. Some 44.9% of DMB lending is linked to the exchange rate and 28.4% indexed. Eliminating the exchange rate and price impact allows the real rate of increase to be assessed. The twelve-month increase in lending

would then be 7.7% instead of 20.3%, and the increase since the beginning of the year 5.1% instead of 14.6%.



Lending by investment credit funds increased by 13.8% or 48 b.kr. from the beginning of the year until the end of August. The lion's share of this growth, or 36.7 b.kr., was with the Housing Financing Fund, which is the single-largest provider within the credit system. Applying a similar method to that used for DMB lending above, the real growth in investment credit fund lending since the beginning of the year can be estimated at 12.6%.

...and foreign-denominated lending decreases

Foreign-denominated lending by DMBs grew considerably in recent years and stood at 41.6% (250.3 b.kr.) of total DMB at the end of last year (see *Monetary Bulletin 2001/2* for a more detailed analysis). As mentioned above, this ratio had risen to 44.9% (309.4 b.kr.) at the end of September. Foreign-denominated lending had therefore increased by 23.6% at the same time as the exchange rate index went up by 17.3%. Part of foreign-denominated lending is to foreign parties²², or just over 23 b.kr. Since this growth in lending to foreign parties has largely occurred this year, growth in foreign-denominated lending to domestic borrowers can be estimated at 15%, which is less than the amount by which the

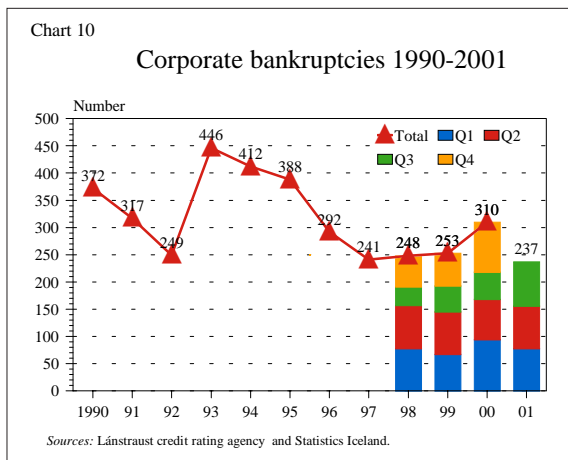
21. Assuming that all scope for subordinated loans is used on the basis of figures from the commercial and savings banks' interim statements, it can be seen that, all things being equal, the capital ratio for the whole could be raised from 10.8% to 13%. For the commercial banks the ratio could be increased from 10.3% to 11.2% and for the six largest savings banks from 13% to 19.6%.

22. It should be taken into account here that even though a loan may be classified as made to a foreign party, this may nonetheless be an Icelandic-owned company registered overseas.

króna has weakened. This suggests that companies and households have to some extent converted their foreign loans into domestic currency or amortised them in order to reduce their exchange rate risk.²³

Increasing defaults ...

Data from the Financial Supervisory Authority (FSA) show an increase in defaults on loans from commercial banks and savings banks. At the end of 2000 total defaults²⁴ by individuals and corporations amounted to 12.3 b.kr., or 2% of total lending. At the end of June defaults had risen to 16.8 b.kr. or 2.5% of total lending.



Defaults by individuals amounted to 7.1 b.kr., or 4.3% of lending to households, at the end of June (compared with 5.3 b.kr. and 3.3% at the beginning of the year) while corporate defaults were 9.7 b.kr., or 1.9% of total corporate lending (as against 7 b.kr. and 1.6% at the end of the year). Defaults are therefore on the increase, and at a proportionally faster rate among households.

... and non-performing loans...

Another yardstick for defaults is the ratio of non-performing loans²⁵ to total lending. This figure has risen this year to reach 2.2% for the commercial banks and

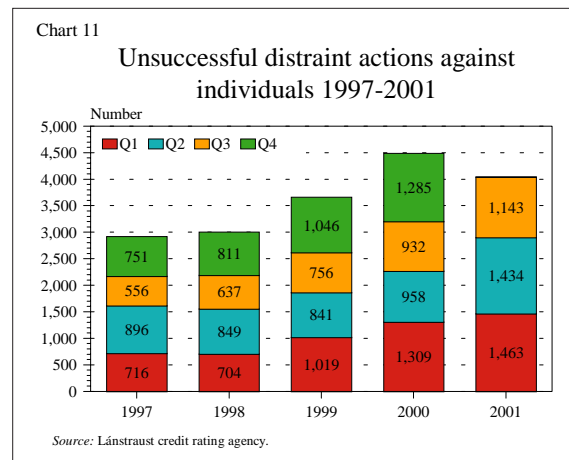
23. Loans may also have fallen due and not been re-financed.
 24. Defaults according to a survey covering 97% of total commercial bank and savings bank lending. Here, default refers to repayments and interest which are more than one month past their final due date.
 25. Loans for which special provisions have been posted, less the provi-

sions on the loan loss reserve but including other interest-frozen loans and redeemed assets on foreclosed mortgages.

six largest savings banks during the first half, having fallen to a low of 2% at the end of last year. This is still considerably lower than the 1995 ratio of 6.4%. Indications have thus emerged that the quality of loans made by commercial banks and savings banks is deteriorating.

... and more bankruptcy rulings and unsuccessful distraint measures ...

According to information from Lánstraust credit rating agency,²⁶ private and corporate bankruptcies and unsuccessful distraint actions have increased sharply this year compared with 2000.



Since 1997 there has been an annual increase in the number of corporate bankruptcies. Some 310 bankruptcies were recorded in 2000. From the beginning of this year until September, 243 bankruptcy rulings had been made.²⁷ Unsuccessful distraint actions have also increased, reaching 1,722 during the first nine months of this year compared with 1,309 for the whole of last year. These indicators reveal a worsening in corporate liquidity.

It is impossible to draw any conclusions from the trend for the number of private bankruptcy rulings, because some claimants (headed by the Directorate

26. This section is based on data from Lánstraust hf.
 27. This figure represents the number of rulings recorded from the beginning of the year until September. Since not all rulings have been recorded yet, this figure could rise further.

of Customs in Reykjavík) have decided that as from the beginning of this year they no longer stand to gain by filing bankruptcy proceedings against individuals. The number of unsuccessful distraint actions against individuals has grown since 1997 and reached 4,484 in 2000. By the third quarter of 2001 this figure had reached 4,050. This trend suggests worsening liquidity among private individuals.

... while provisions to loan loss accounts increase

According to information from the FSA, commercial banks and savings banks are beginning to increase their provisions to loan loss accounts. Provisions for bad debts amounted to 3.6 b.kr. in 1999, 4 b.kr. in 2000 and 3.1 b.kr. (or 80% of the total figure for 2000) during the first half of this year.

As a proportion of total lending, these provisions amounted to 0.9% in 2000 and the FSA forecasts a figure of 1.3% this year. The proportion of provisions peaked at 4.1% in 1992, then decreased steadily until 2000.

Total provisions put aside in loan loss reserves were 13 b.kr. at the end of last year and 15.3 b.kr. at the end of June 2001.

Commercial banks and savings banks will therefore clearly need to make greater provisions to their loan loss accounts in the near future, with a corresponding negative impact on their profits and capital positions. However, these institutions appear to have already begun to take contingencies against the risk

of greater defaults, and these efforts can be assumed to reflect an increased focus on risk management.

Similar levels of domestic and foreign funding

As reported in *Monetary Bulletin* 2001/2, the ratio of deposits and securities issues to DMB lending and their market bond stock fell last year, but at the end of September it stood at 76%, a sizeable increase from the year-end figure of 69% (this ratio was 87% at the end of 1996). Commercial banks and savings banks also tapped Central Bank repos as well as overnight credit²⁸ for their domestic financing. Such funding has been at one of its highest levels this year.

Foreign finance has been sought to offset diminishing domestic funding, and at the end of 2000 the DMBs' outstanding foreign borrowing amounted to 343 b.kr. By the end of September this figure had risen to just over 412.5 b.kr. Foreign borrowing by investment credit funds was 28 b.kr. at the end of last year but 42 b.kr. at the end of October. Foreign funding is apparently still being tapped, especially by investment credit funds.

These institutions face a limited direct exchange rate risk, partly because of rules governing the foreign balance for most of them. In many cases, however, this foreign funding has been on-lent to borrowers whose revenues are solely in domestic currency. Given the weakening that has taken place in the Icelandic króna, there is a risk that some on-lent loans will not perform and end up as losses.

28. Credit institutions trading with the Central Bank are entitled to overnight credit against securities which the bank accepts as collateral. These securities are the same ones which qualify for repo transactions. No ceiling is imposed on overnight borrowing for as long as credit institutions have securities which can be accepted as collateral.

Financial stability microprudential indicators 1996-2001

	1996	1997	1998	1999	2000	2001	Date
<i>Capital ratios</i>							
Capital adequacy ratio ¹							
by legal definition (%)	12.4	11.6	10.4	10.6	9.9	10.8	June
excluding subordinated loans (Tier II and III) (%)	11.1	10.2	8.8	8.2	6.7	7.2	June
CAR A (Tier I) (%)	12.1	11.3	10.0	9.6	8.2	8.5	June
<i>Quality of assets</i>							
<i>Credit institutions</i>							
Total lending (m.kr.) ²	275,323	308,459	385,742	475,784	601,522	689,638	Sept.
Thereof foreign-denominated (%)	29.0	31.8	34.4	36.5	41.6	44.9	Sept.
Sectoral breakdown of lending							
Households (% of total lending) ³	25.9	26.6	27.9	27.3	27.5	25.7	Sept.
Thereof foreign-denominated (%)	0.3	0.5	1.8	4.8	8.1	10.0	Sept.
Thereof residential housing-related (%)	22.8	21.3	18.7	20.2	18.3	16.2	Sept.
Businesses (% of total lending)	65.5	65.2	64.8	65.7	65.2	64.2	Sept.
Thereof foreign-denominated (%)	43.6	46.8	49.8	50.6	55.6	55.7	Sept.
Fisheries sector (% of total lending)	28.7	29.4	27.7	24.8	22.9	21.8	Sept.
Thereof foreign-denominated (%)	75.7	79.1	83.3	83.9	86.5	88.8	Sept.
Retail and services (% of total lending)	20.8	19.8	24.8	28.6	29.4	28.9	Sept.
Thereof foreign-denominated (%)	14.0	15.2	19.5	29.5	37.0	35.2	Sept.
Manufacturing, transportation, electricity and construction sectors (% of total lending)	16.0	16.0	12.3	12.2	12.9	13.4	Sept.
Thereof foreign-denominated (%)	24.5	26.7	35.5	32.4	43.0	46.0	Sept.
Foreign sector (% of total lending) .....	.	.	.	.	.	3.4	Sept.
Thereof foreign-denominated (%) .....	.	.	.	.	.	99.5	Sept.
Non-performing loans ⁴ (% of total lending)	5.2	4.1	2.4	2.2	2.0	2.2	June
Equity as a percentage of total assets	9.2	8.7	7.4	7.1	6.3	6.2	June
<i>Borrowers</i>							
Households							
Household debt (% of disposable income)	133.4	134.7	138.7	145.8	160.1	166.2	Forecast
Number of private bankruptcy rulings .....	.	333	463	421	483	214	Q3
Number of unsuccessful distraint actions .....	.	2,919	3,001	3,662	4,484	4,040	Q3
Businesses							
Debt as a percentage of equity							
All publicly listed companies (excluding commercial and investment banks)	1.82	1.96	1.85	1.96	2.32	2.72	1st half-year
Fisheries sector	1.95	1.67	1.75	1.87	2.57	3.41	1st half-year
Retail, construction and services .....	.	2.10	2.51	2.28	1.94	1.76	1st half-year
Manufacturing and production	1.14	0.41	1.11	1.40	1.52	1.63	1st half-year
Number of corporate bankruptcy rulings ⁵ .....	.	241	248	253	310	237	Q3
Number of unsuccessful distraint actions ⁵ .....	.	698	669	951	1,309	1,717	Q3
Profitability							
All listed companies .....	.	8.0	8.2	8.1	-1.7	-7.8	1st half-year
Fisheries	14.3	10.5	8.6	3.0	-16.5	-18.0	1st half-year
Retail, construction and services .....	.	9.3	2.2	13.6	10.3	-3.5	1st half-year
Manufacturing and production	17.7	10.7	7.2	4.6	6.2	3.4	1st half-year
<i>Management¹</i>							
Cost ratios (% of net operational revenues)							
Operating expenses	66.6	65.3	67.1	60.4	66.3	65.1	June
Labour cost	33.9	33.6	35.2	31.2	33.2	33.5	June

Financial stability microprudential indicators 1996-2001 (continued)

	1996	1997	1998	1999	2000	2001	Date
<i>Profits and profitability¹</i>							
Return on assets	0.8	0.9	0.9	1.3	0.6	0.7	June
Return on equity	9.5	10.3	13.5	19.3	9.9	11.5	June
Interest margin (% of total revenue).....	62.1	58.9	56.0	52.4	54.3	62.2	June
Commissions (% of total revenue).....	24.8	24.5	23.1	23.1	31.4	33.0	June
Value adjustments of other financial operations (% of total revenue).....	5.3	7.5	15.0	12.0	-1.4	-2.8	June
Dividends from shares, other holdings, etc. (% of total revenue).....	4.7	6.1	3.9	9.6	5.9	2.8	June
Other income (% of total revenue).....	3.1	3.1	1.9	2.9	9.8	4.8	June
<i>Liquidity position</i>							
Central Bank funding of financial institutions (b.kr., position at end of year).....	.	.	22.8	36.0	46.9	71.4	Oct. 30
Deposits as ratio of broad money (M3).....	0.97	0.97	0.97	0.97	0.98	0.98	Sept.
Lending as ratio of deposits.....	1.25	1.29	1.46	1.53	2.07	2.09	Sept.
Liquidity ratio (short-term assets as ratio of debts (< 3 months).....	.	.	.	.	1.18	1.40	Sept.
<i>Market risk</i>							
<i>Foreign exchange market</i>							
Effective exchange rate of Icelandic króna (% change between years).....	-0.6	-1.4	-0.7	-3.0	9.8	19.1	Jan-Oct.
Effective exchange rate of Icelandic króna (standard deviation).....	0.2	1.0	0.9	1.3	4.1	8.3	Jan-Oct.
Turnover (b.kr.).....	.	.	401.8	468.0	768.0	964.7	Jan-Oct.
<i>Equity market</i>							
ICEX-15 (% change between years).....	59.3	14.7	9.8	47.4	-19.3	-24.0	Oct.-Oct.
Market capitalisation (b.kr.) ⁶	94.8	151.0	231.9	369.8	393.0	403.1	Oct.
Market capitalisation (% of GDP) ⁶	19.5	28.5	39.9	57.6	57.7	54.3	Oct.
Turnover velocity (over latest 12 months).....	.	15.6	17.2	32.4	50.6	37.3	Oct.
<i>Bond market</i>							
Commercial banks' credit ratings							
Short-term (Moody's).....	.	.	.	.	P1-P2	P1-P2	Oct.
Long-term (Moody's).....	.	.	.	.	A2-A3	A2-A3	Oct.
Short-term (Fitch).....	.	.	.	.	.	F1	Oct.
Long-term (Fitch).....	.	.	.	.	.	A	Oct.
<i>Product prices</i>							
Marine product prices in foreign currency terms (1990=100).....	84.4	88.3	99.5	97.1	98.6	106.2	August
Fish quota prices (long-term cod quota, kr./kilo)	560	650	758	771	860	720	Oct.
Aluminium prices US\$/ton.....	1,504	1,592	1,336	1,364	1,551	1,281	Oct.
<i>Real estate market</i>							
Residential housing prices (January 1996=100).	101.0	103.0	109.1	125.1	147.4	158.0	Q2
Commercial property prices (1995=100).....	110.8	112.7	135.2	172.1	205.7	196.6	Q3

1. Commercial banks, six largest savings banks and investment banks. 2. Deposit money banks, adjusted for FBA and Commercial Loan Fund. 3. Item "miscellaneous" also includes individuals' private business operations. 4. Commercial banks and six largest savings banks. FBA included as of 1999. 5. Source: Lánstraust credit rating agency. Figures for third quarter 2001 are liable to increase. 6. Including equity mutual funds.