Financial Supervisory Authority

Unofficial translation

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The Standing of Icelandic Financial Companies

The financial market

Trends on the stock market in recent months, both in Iceland and abroad, have not been favourable for investors. There are many different reasons for what has happened, the main one probably being the international shortage of liquidity that the world financial system is facing.

If we examine the trend in individual company categories, we find that share prices in financial companies in the markets around us have fallen the most. In the second half of last year we can see that Iceland's banks were no exception to the general rule. Looking at what has happened so far in January this year – which I think is really too short a period to base any firm conclusions on – then we find that while the share price of financials has gone down, the Icelandic market has shown sharper declines.

Iceland's financial system has become very internationalised, and we can expect that difficulties on the world markets will result in a slower rate of growth in our financial companies' activities over the coming year or two.

As regards Iceland's financial market and financial stability, the country's three largest banks are the main players, so I shall be concentrating mainly on them in what I say here.

Performance

The banks' performance has been good over the past few years. Even allowing for other income, their core profit before taxes during the first 9 months of last year was of the order of 12-14%. But third-quarter profit was poorer than that in the previous quarter, and costs started to rise. Nevertheless, in comparison with other Nordic banks of a similar size, the Icelandic banks have been doing well.

Thus, we find that the Return on Equity (ROE) is far better at the Icelandic banks than those in their peer group, and if we look at core returns and the cost-income ratio in core operations, we find that Iceland's banks are fully comparable with the others in the group. Our banks' income from financial gains has been an "extra" on top of already satisfactory returns on their core activities. But these earnings can mean broader fluctuations in the banks' overall profits.

In the case of the savings banks, performance in core activities has not been satisfactory, and profit has been kept up mainly by earnings on market securities. For this reason, we can expect savings banks to show greater fluctuations in performance than the commercial banks.

From what I have said, we can assume that the overall results in the banking sector for 2007 will be reasonably good, even though they will be slightly worse than for the previous two years because other income will not account for as much as they did previously.

In terms of the situation on the markets, it would be unwise to expect high profit levels from other income this year, so the banks will have to turn their attention to their operating costs as a way of raising their profitability for the year.

CAD

Measured by the Basel rules, the banks' capital adequacy ratios have been strong for the past couple of years. CAD ratios at the end of September were between 11 and 12 per cent. Tier 1 ratios now lie between 8.5 and 10 per cent. These ratios are slightly higher at Iceland's banks than at other Nordic banks. This is necessary, because the business model of Iceland's banks is different, with loans to households playing a smaller role and loans to companies playing a larger one. Also, their market risk is higher than that of other Nordic banks. The result of this is that from a normal cautionary point of view, our banks should have higher capital ratios than their Nordic counterparts.

The three commercial banks perform well on the stress tests that the FSA has applied, both formal stress tests, in which allowance is made for a very severe setback, and an additional stress test in which special allowance is made for the influence of additional loan losses. The results of the formal stress test, and its criteria, are published on the FSA's homepage (www.fme.is).

Principal risk factors in financial companies' operations.

The principal risk factors faced by banks fall under the following headings:

- Credit risk
- Market risk
- Liquidity and refinancing risk
- Operational risk

Credit risk

Credit risk is one of the most important risk factors in banks' operations. In recent years we have seen a large growth in lending, especially to foreign parties. A large rise in lending can be a risk factor in itself, since it can mean that insufficient attention is paid to internal quality control procedures when assessing customers and taking decisions on loans.

In general, the credit risk at the three largest banks in Iceland must be regarded as reasonably well diversified when measured on most scales, e.g. by country, by sector, by the scale of large exposures and by the part played by housing mortgages and other loans to households. Defaults have been very low for last couple of years.

The FSA made a survey of the credit risk at Iceland's 6 largest financial companies last autumn, in which the aim was to assess it in terms of certain risk factors: risk concentration – borrowers, risk concentration – types of instruments, the corporate market, the private market and the results of stress tests.

Provisional findings indicate that credit risk is small or restricted in 70% of cases, and considerable in 30% of cases. In particular, it is in the category *risk concentration/spread – borrowers* where considerable, though not substantial, risk is to be found. In itself, this is nothing new in Iceland; on the other hand, it is good to have this established as a fact. Those involved are aware of the situation, and they make efforts to monitor and control this type of risk no less than others.

Concentration risk in the form of large exposures is a type of risk that the FSA keeps a very close watch on. According to the rules, large exposures to a client or a group of connected clients may not exceed 25% of the bank's equity base.

Exposures include all the risks associated with the client involved, whether these take the form of loans, shares or other commitments. The total of large exposures, i.e. those amounting to more than 10% of the equity base, amount to 95% of the equity base of the three largest commercial banks in Iceland. This ratio is permitted to be as high as 800%. In 2003 it was twice as high as it is now, at about 190%. The main reason for the reduction since 2003 is the substantial increase in the capital base over the period, and also a drop in the number of large exposures as compared with previous years.

Loans with securities pledged as collateral, forward contracts on securities and loans to connected parties constitute a certain concentration risk. Total loans with securities pledged as collateral, i.e. direct loans and forward contracts, came to 126% of the commercial banks' equity base at the end of June 2007, against 78% a year earlier. Loans to connected parties at the end of June 2007 were equivalent to 44% of the banks' equity base, against 39% a year earlier. At the savings banks, loans with securities pledged as collateral and loans to connected parties account for lower proportions than at the commercial banks.

In the closing months of the year, and particular from November, it became increasingly necessary for the banks to demand additional collateral (margin calls) in connection with loans where securities were pledged as collateral. This was done in 700 cases at the nine largest financial companies in Iceland during the period between 5 December 2007 and 4 January this year. In my opinion, the fact that the banks are demanding additional collateral shows that they are going about things in the right way. At the same time, data on the insurance coverage in the case of loans with securities pledged as collateral and forward contracts on securities indicates that it is generally in good order.

Thus, the financial companies maintain a safety margin, but obviously the financial strength of their individual clients is put to the test. In this context, however, it must be borne in mind that one aspect of the market economy is that when people take a risk, they may either win or lose. In general, equities are a long-term investment that should be assessed in terms of the expectations associated with the underlying operations and not the hope of a quick profit resulting from automatic price increases.

Market risk

The market risk faced by the largest banks in Iceland, and particularly Kaupthing Bank and Landsbanki, is considerable; this is in keeping with the business models according to which they operate. Market risk is measured as the risk involved with holding a position in marketable securities as calculated in the risk-weighted base in accordance with the capital adequacy requirements. For example, the market risk of equities is generally 150% of their book value, while the position risk of bonds depends to a large extent on their duration.

The market risk in equities is nearly 50% of the capital base at the two banks I mentioned (Kaupthing Bank and Landsbanki), but well under 20% at the third, Glitnir. The market risk in bonds at the first two lies between 50 and 60 per cent of their equity base, and is negligible at the third.

In this connection it should be borne in mind that domestic equity holdings at the banks generally amounts to about half of their marketable shares at own risk, so the effect of a drop in the domestic stock market is reduced.

In comparison with banks of similar size in the Nordic countries, the market risk at Iceland's banks is slightly higher, but on the other hand their capital adequacy ratio is higher, as I mentioned earlier. To reduce risk, they can either reduce their market risk or increase their capital base.

Liquidity and refinancing risk

The liquidity position of the commercial banks, assessed according to the rules issued by the Central Bank, has improved considerably from what it was in 2006. Following the unrest on the credit market in 2006, the banks took measures both to lengthen their funding, to spread their repayment dates over a longer period and to diversify their borrowings by location.

According to data gathered by the FSA on the banks' capacity, in terms of secured liquidity, to meet their obligations over the next 12 months without raising capital on the market, their position is satisfactory. The FSA also collects regular reports on the standing of long-term loans, changes in previous quarters and maturities falling in the coming 12, 24 and 36 months. According to the reports available at the end of September last year, the average maturity of loans taken by the banks was about three and a half years. Comparison reveals that the Icelandic banks are in similar position their Nordic peers in this respect.

In comparison with banks in Europe, deposits have accounted for a relatively small proportion of financing at Iceland's commercial banks. The deposit-to-loan ratio has risen substantially over the past two years or so; the results achieved by Landsbanki with its marketing of *Icesave* deposits in Britain are an example of this. The ratio for the Icelandic banks is not different from that at other Nordic banks. Deposits are generally regarded as a more stable form of financing than loan capital, even though they are not completely without risk. When assessing the stability of deposits, important factors include their spread according to various criteria, for example whether they are short- or long-term, their size and the proportions originating from households and commercial entities. Further analysis of these factors is in progress by the FSA.

Bearing in mind the state of affairs on the international markets, liquidity and financing are things that we must watch closely, since good results in these areas will be major factors determining the scope for growth in the next year or two.

Operational risk

This category includes, for example, integration risk. In the rapid development that has taken place in the banking sector, both in terms of internal and external growth, in recent years, there is a danger that adaptation to existing activities and structures will not be made in a timely or in a satisfactory manner. The banks seem to have succeeded well, overall, in integrating their overseas operations with other aspects of their activities. On the other hand, I believe there is room for improvement, especially as regards ensuring that various processes and support departments keep abreast of the rapid expansion.

Concentrated ownership is a conspicuous feature of the Icelandic banks, and this is an area in which they stand apart from their Nordic counterparts. It entails reputational risk, since market players regard it as more likely that a bank with a few large owners will be subject to undesirable influences than will be the case when ownership is spread widely. The FSA has emphasised that certain rules must be followed regarding relations between owners and financial companies, and that compliance is enforced in a credible manner.

Concluding remarks

There is certainly no doubt about the fact that financial markets, both in the world at large and in Iceland, have been going through a difficult time in the past few months, and the drop in the stock markets can be expected to have some effect on performance in the banking sector.

In conditions like these, it is important to keep calm and distinguish between short-term shocks and long-term problems.

The foundations of Iceland's commercial banks are sound.

- Performance by Iceland's banks in recent years has been good. Even leaving irregular income out of the picture and looking only at core activities, in terms of profitability, Iceland's banks do not yield anything in comparison with banks in the other Nordic countries.

- Iceland's banks have strong capital adequacy ratios (CAD ratios), and are able to withstand substantial setbacks.

- Most aspects of the credit risk is well diversified and market risk is offset by high capital base levels and active management.

- Margin calls and the collaterals demanded by the banks in relation to loans backed by securities shows that their vigilance is in order and their risk-consciousness is adequate.

- The drop in share prices in Icelandic financial companies in recent months has not been greater than in the case of companies in the same sector in our neighbouring markets.

While the situation is generally sound, there are plenty of tasks ahead in the financial sector. For the banks, the main challenges lie in financing and in integrating their activities in various countries.

Ladies and gentlemen,

CDS spreads for the Icelandic banks have risen substantially in the past few weeks. Analysts from Credit Sights said last week that CDS spreads did not give an accurate picture of the true standing of Iceland's commercial banks, and that the risk associated with them had been exaggerated.

I agree with that assessment, and this is something which we who work in the financial sector must bring to public attention. Even though we are going through a difficult phase, the Icelandic financial market has everything needed to weather the storm that is now shaking the international markets.