



# FINANCIAL STABILITY

2014 • 2

## Contents

- 3** *Foreword by the Governor*  
Economy and financial system are sound, but the balance of payments problem remains  
*Box:*  
Financial system: outlook and key risks **5**
- 9** *The economic environment*
- 11** *Domestic markets*
- 13** *External position*
- 17** *Operations and equity*
- 19** *Funding*
- 21** *Deposit institutions' assets*
- 23** *Households*
- 27** *Companies*
- 29** *Financial market entities*
- 32** *Settlement of the failed banks' estates*  
*Appendices:*  
Appendix I: FSI core indicators for the three largest commercial banks **35**  
Appendix II: Nordic comparison **36**

Financial stability means that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks appropriately.

The purpose of the Central Bank of Iceland's *Financial Stability* report is:

- To promote informed dialogue on financial stability, i.e. its strengths and weaknesses, the macroeconomic and operational risks that it may face, and efforts to strengthen its resilience;
- To provide an analysis that is useful for financial market participants in their own risk management;
- To focus the Central Bank's work and contingency planning;
- To explain how the Central Bank carries out the mandatory tasks assigned to it with respect to an effective and sound financial system.

Published by:

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Vol. 15 8 October 2014

This is a translation of a document originally written in Icelandic. In case of discrepancy or difference in interpretation, the Icelandic original prevails. Both versions are available at [www.cb.is](http://www.cb.is).

ISSN 1670-584X, print

ISSN 1670-8156, online

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Icelandic letters:

ð/Ð (pronounced like th in English this)

þ/Þ (pronounced like th in English think)

In *Financial Stability*, ð is transliterated as *d* and þ as *th* in personal names, for consistency with international references, but otherwise the Icelandic letters are retained.

## Economy and financial system are sound, but the balance of payments problem remains

In many respects, economic conditions in Iceland are favourable at present. GDP growth is among the highest in developed countries, and the slack in the economy is disappearing rapidly. As a result, the employment situation is greatly improved. Real wages have risen markedly and are up about 4% year-on-year, according to the most recent measurements. This is a rapid rate of growth in both historical and international context.

Robust output growth has been accompanied by greater economic stability than Iceland has generally enjoyed in the past, as can be seen in inflation, which has subsided to target, and a surplus on external trade. Inflation has been close to the Central Bank's inflation target for eight months and appears likely to remain there in the months to come. Iceland's underlying current account surplus was substantial in 2013. The most recent measurements and forecasts indicate that it will be considerably smaller this year; however, this could be an underestimation, given that the króna has remained relatively stable during the year, even though the Central Bank has been a net purchaser of foreign currency in the amount of some 4½% of GDP and foreign debt payments have totalled another 3½% of GDP.

Households' and businesses' financial conditions have improved in tandem with the economic upswing, as is reflected in reduced debt service, an improved asset position, and lower default ratios.

Favourable economic conditions and the improvement in borrowers' situation have made a positive impact on financial institutions' performance and financial position, as is usually the case. The three large banks' capital ratios have therefore continued to rise, and their liquidity position is relatively good. Credit growth is still moderate, and as yet there are no signs of substantially increased competition for lending. The Central Bank monitors these developments closely, however, and will recommend responses through the newly established Systemic Risk Committee and Financial Stability Council if the need arises.

As has been pointed out previously in *Financial Stability*, it is important under current conditions that the banks' dividend payments not undermine their resilience. In this context, it should be noted that the majority of their profits for the first half of 2014 derived from irregular items and non-core operations. Furthermore, the banks must be prepared for possible shocks in connection with capital account liberalisation. Iceland's balance of payments problem is the main reason the capital controls are in place. In essence, this means that, without the controls, Icelanders would be forced, by a lack of access to foreign credit markets on sustainable terms, to pay down their debt much more rapidly than they are able, and much more rapidly than can be considered desirable. Contractual instalments on exchange rate-linked loans, which are independent of the capital controls, will be heavy in coming years, not least because of the debt service burden on Landsbankinn's foreign-denominated debt to the old bank (LBI). The two parties have reached an agreement to extend the repayment profile of the debt, but that agreement is subject to broad-based exemptions from the capital controls and is therefore under examination by the relevant authorities. Other things being equal, Iceland's current account balance will not provide scope in coming years to release non-residents' short-term króna-denominated assets and the failed banks' króna-denominated assets. Therefore, the solution must go through the capital and financial account – for example, with new capital inflows and/or substantial write-downs of such assets, measured in foreign currency.

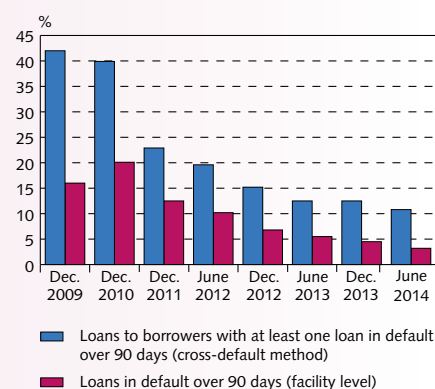
In recent weeks, important changes have taken place in the structure of financial stability-related work in Iceland. Both a Financial Stability Council and a Systemic Risk Committee tasked with working for the Council have been established, and the first meetings have already been held. Furthermore, considerable preparation and strategy formation have been carried out in connection with the liberalisation of the controls, both by the Central Bank and by other authorities. A Steering Committee led by the Minister of Finance and Economic Affairs and including the Governor of the Central Bank, as well as representatives of the Prime Minister's Office and the Ministry of Finance and Economic Affairs, has been working on strategies related to liberalisation. Working for the Steering Committee is a Task Force of experts and foreign advisors. The objective is to produce a well-grounded strategy that, together with synchronisation of effort, is the prerequisite for successful capital account liberalisation and preservation of financial stability.



- Financial system risk has remained broadly unchanged in recent months. The lengthy tenure of the capital controls, the risks attached to both the controls and their liberalisation, and foreign refinancing risk are the main risks facing the financial system at present. Financial institutions continue to gain resilience. The large commercial banks' combined capital ratio is now above 27%, default ratios are on the decline, and the banks' liquidity is strong, particularly in foreign currency.
- The large commercial banks' interim financial statements for H1/2014 show strong profits for the period. Returns on total assets were 3.2%, which is high in international context. Various estimated and irregular items affect the earnings reports, however. Total income from loan write-ups and the sale and write-up of the banks' largest holdings in companies and discontinued operations amounted to 37 b.kr., or 80% of the profit for the period (see also p. 17).
- The most important measures of households' financial position indicate that recent developments have been favourable, and the outlook is good. Unemployment has fallen, and real wages have risen markedly this year. Net household wealth has increased and is at its highest since the turn of the century, excluding the peak upswing years of 2005-2007. Household debt problems have subsided, although young borrowers' situation is still difficult (see also p. 23).
- In the past two years, house prices in Iceland have risen in line with income growth and declining unemployment. So far in 2014, however, they have risen somewhat more rapidly in the greater Reykjavik area, or by about 6.7% in real terms. The Central Bank will continue to track developments in house prices, motivated, among other things, by the potential effects of the capital controls on asset prices (see also p. 11).
- The underlying current account surplus<sup>1</sup> has contracted year-on-year, measuring 0.8% of GDP (just over 7 b.kr.) in H1/2014, as opposed to 2.8% in H1/2013. In the first half of 2012, the current account balance was negative by 0.6% of GDP. Resident borrowers have paid down foreign loans in the amount of almost 70 b.kr. year-to-date, and the Central Bank bought foreign currency for 85 b.kr. over the first nine months of the year. The discrepancy suggests either that there may be error in the measurement of the balance on services or that the services balance is a poor reflection of actual foreign exchange flows (see also p. 13).
- In many respects, the economic outlook is better for Iceland than for its main trading partners. Foreign interest rates are at a historical low, Iceland's interest rate differential with its main trading partners is positive, GDP growth is stronger in Iceland than in most trading partner countries, domestic inflation is

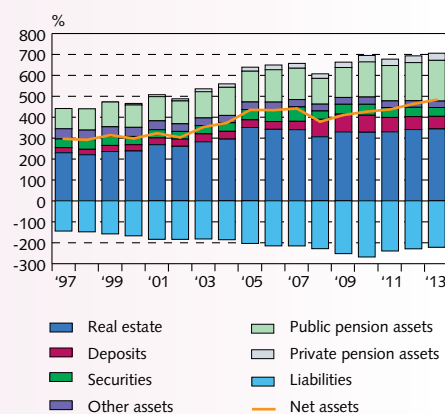
## Financial system: outlook and key risks

Chart 1  
Default ratios of the three largest commercial banks<sup>1</sup>



1. Parent companies, book value.  
Sources: Financial Supervisory Authority, Central Bank of Iceland.

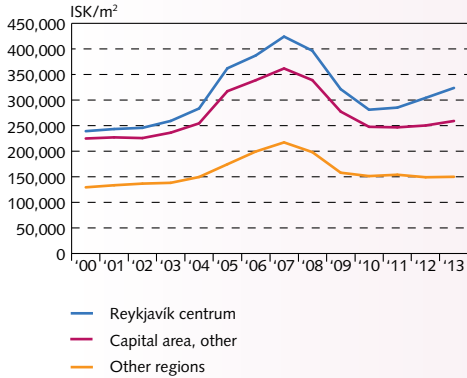
Mynd 2  
Household assets and liabilities  
as a share of disposable income<sup>1</sup>



1. Pension fund assets are based on payouts after deduction of 30% income tax.  
Sources: Statistics Iceland, Central Bank of Iceland.

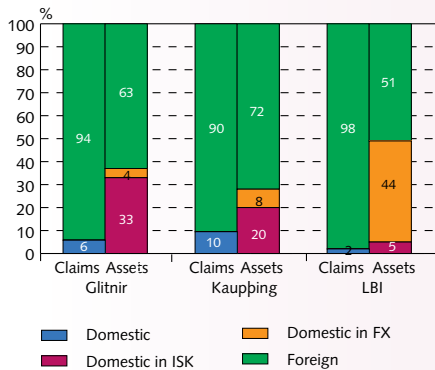
1. Excluding the effects of the DMBs in winding-up proceedings and Actavis.

Chart 3  
Developments in house prices, by region  
At 2013 prices



Sources: Registers Iceland, Central Bank of Iceland.

Chart 4  
Estimated domestic/foreign breakdown of assets and claims of DMBs in winding-up proceedings  
Book value of assets 30.06.2014



Sources: Claims lists and financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

close to target, and Iceland has an established trade surplus. The fiscal budget is estimated to be in surplus next year, and the Treasury has demonstrated repeatedly that it has access to foreign credit markets on acceptable terms. In addition, the spread between the official exchange rate of the króna and the offshore rate has narrowed sharply in recent months. Therefore, it appears that current economic conditions are conducive to successful liberalisation of the capital controls.

## Key risks

- The settlement of the failed banks' estates and the interaction between the settlement and the liberalisation of the capital controls is the most important risk to financial stability at present. Other risks include non-resident investors' króna-denominated assets, which are locked in by the controls, and the heavy debt service burden on Iceland's foreign debt. Other things being equal, the debt service burden will remain heavy through 2018, but this risk factor is independent of the capital controls.
- *The next steps in winding up the failed banks' estates* are highly uncertain. Based on the current classification of assets and claims as foreign and domestic, and after adjusting for the bank tax, the settlement of the estates will have a negative effect on Iceland's international investment position (IIP) of roughly 690 b.kr., or 35% of GDP, other things being equal. The impact on the balance of payments will be somewhat less, at about 400 b.kr., or 20% of GDP, adjusted for the bank tax. This amount is comparable to the estates' ISK assets net of the bank tax. Domestic claims account for an insignificant share of claims against the LBI estate, as do the estate's króna-denominated assets net of the bank tax. Glitnir and Kaupthing's króna-denominated assets constitute a somewhat larger share than the share of domestic claims net of the bank tax, as the estates' holdings in Arion Bank and Íslandsbanki are recognised in krónur. In order for the capital controls to be lifted without substantial instability, a solution must be found to the balance of payments problem stemming from payouts of domestic ISK-denominated assets to creditors (see also p. 32).
- *Non-residents' short-term króna assets* totalled 307 b.kr., or just under 16% of GDP, at the end of August, after having declined by nearly 35 b.kr. over the previous twelve months. Over the same period, the spread between the onshore and offshore exchange rates contracted by about half, to 17%. This could be a sign that non-resident owners of short-term króna assets are less likely to sell them once the controls have been lifted (see also p. 15).
- *The debt service burden on Iceland's foreign debt* has been heavy since 2011, but in the last four years foreign loans have been paid down in the amount of 6.5% of GDP per year, on average. Other things being equal, the burden will remain

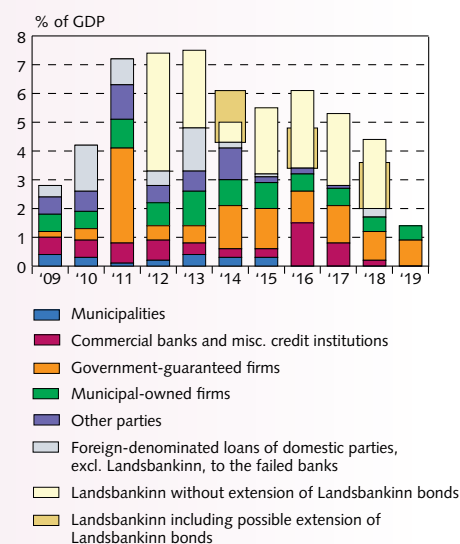


heavy over the next four years, at about 5% of GDP per year. Extending the Landsbankinn bonds would greatly reduce residents' foreign debt service in the years to come, thereby reducing Iceland's refinancing need and supporting the exchange rate of the króna. If the bonds are extended, the ratio of contractual foreign loan payments to GDP will be half as much in the next four years as it was in the past four years.

- Other things being equal, if the Landsbankinn bonds are not extended, domestic demand would have to contract and the currency would have to depreciate in order for the domestic economy to generate enough additional foreign currency to service the debt. Analysis using the Central Bank's macroeconomic model indicates that, in comparison with a scenario providing for the lengthening of the bonds, the exchange rate would have to decline temporarily by up to 8%, private consumption would contract by up to 2%. Inflation would rise and, according to the model, Central Bank interest rates would have to be kept higher in the near future in order to bring it back to target. In order to prevent this, the State or the Central Bank would have to provide Landsbankinn with long-term foreign-denominated funding, with the associated implications for the Treasury debt position and the Bank's foreign exchange reserves.
- If the bonds are lengthened and external conditions remain unchanged, it is likely that the trade surplus will suffice to cover resident entities' unfunded debt service burden in foreign credit markets in coming years (see also p. 14).

Chart 5

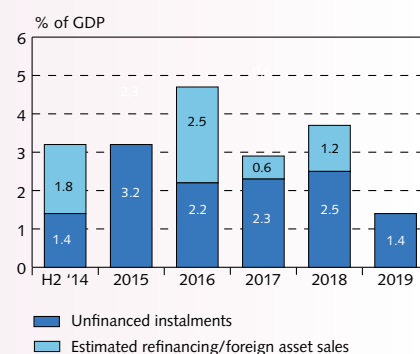
Estimated payments by parties other than the Treasury and CBI on foreign loans and foreign-denominated loans to the failed banks, including possible extension of Landsbankinn bonds<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 6

Refinancing needs on foreign-denominated loans of borrowers other than the Treasury and Central Bank, including possible extension of Landsbankinn bonds<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.



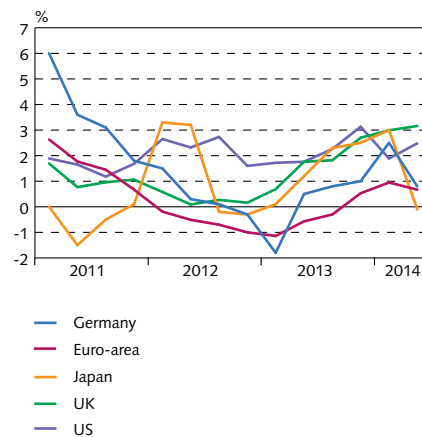


## The economic environment

### Systemic risk escalates as low-interest period grows longer

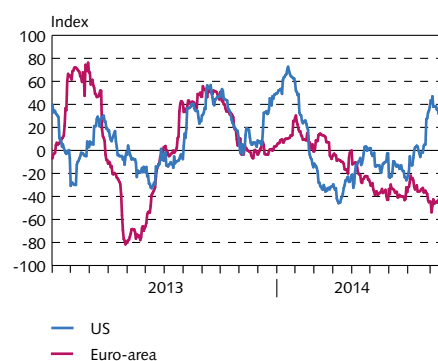
- According to the International Monetary Fund (IMF), global GDP growth looks set to measure 3.3% this year.<sup>1</sup> This is slightly below previous projections, owing to weaker growth in the first quarter of the year. The short-term outlook deteriorated this summer, and owing to increased global political tensions, interest rates and interest rate premia have risen anew.
- In the UK, GDP growth is forecast at 3.1%, in line with measurements for the first half of the year. Forecasts for Germany and Japan have been revised downwards this autumn, however, as GDP growth lost pace in Q2 (Chart 1). *In emerging countries, GDP growth has lost pace in recent years, a trend that appears likely to continue.* In many emerging economies, growth was quite rapid, both during the prelude to the 2007 financial crisis and during the early part of the post-crisis recovery.
- *In the first half of the year, statistics for the UK and the US indicated a generally weaker situation than had previously been assumed.* That trend has continued in Europe in recent months, but the situation has turned around in the US (Chart 2). Weaker statistics caused unrest in the European financial markets, particularly after trading was stopped with the Portuguese Banco Espírito Santo's shares on 10 July.
- *The outlook is for continued low interest rates in developed economies, the aim of which is to stimulate economic activity.* The longer the low-interest episode continues, the likelier investors will be to seek out riskier assets, with the associated impact on prices. A rapid turnaround in asset prices exacerbates the risk of financial system instability. Furthermore, the longer interest rates remain low, indebtedness of the private sector is bound to increase. In many European countries, household indebtedness has risen, while it has declined in Iceland (see Chart 36, which illustrates household debt).
- *Share prices have risen sharply during the year.* In mid-September, Germany and Japan's main share price indices were up 10% year-on-year and the UK's FTSE350 was up 6%. Stock prices in the US rose nearly 20% over the same period (Chart 3). Rising asset prices in major markets and declining interest rate risk premia are due in part to low interest rates in developed countries. European share prices fell temporarily, however, when the EU announced new economic sanctions against Russia.
- *Companies in the US have stepped up investment in the recent past, but little investment growth can be seen in the eurozone*

Chart 1  
GDP growth in selected countries<sup>1</sup>



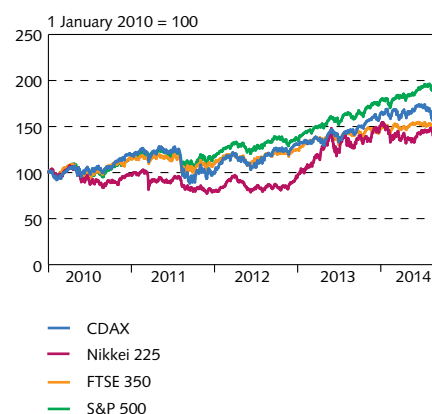
1. Year-on-year change in GDP.  
Source: Macrobond.

Chart 2  
Macroeconomic surprises



Source: Macrobond.

Chart 3  
Share price indices



Source: Macrobond.

1. International Monetary Fund, *World Economic Outlook*, October 2014.

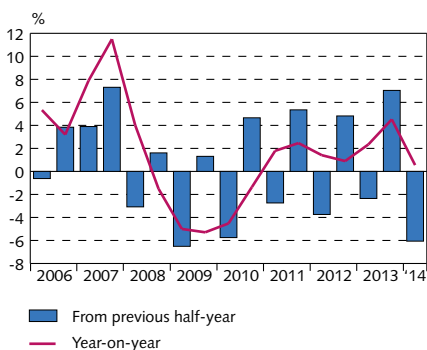
despite low interest rates. The European Central Bank (ECB) has cut its policy interest rate twice this year, to the current 0.05%, and interest rates on banks' deposits with the ECB have been negative since June. The ECB also adopted other measures to stimulate the financial markets, including announcing the purchase of asset-backed bonds and a new covered bond purchase programme.

- *Other financial companies and funds have become more prominent lenders in many markets, and the shadow banking system's provision of venture capital has doubled since 2007. Furthermore, fund management is growing more concentrated worldwide. Market risk and liquidity risk are on the rise in major credit markets, where capital is seeking returns and asset prices have generally risen, while risk premia have fallen.*<sup>2</sup>

#### Growing private consumption and investment erode the current account surplus

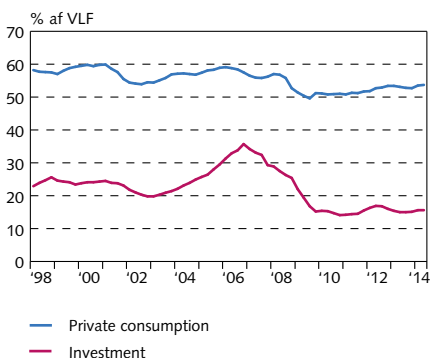
- *It is now estimated that GDP growth in Iceland measured 3.5% instead of the previously assumed 3.3%. Statistics Iceland has published its first estimate of Q2/2014 GDP and its subcomponents, together with revised national accounts figures for 2013. For the first time, the national accounts are being published according to new standards. The new standards also lead to a slight increase in the estimate of GDP. The first GDP growth figures for H1/2014 indicate that growth has slowed markedly. In real terms, GDP grew by 0.6% between H1/2013 and H1/2014, the slowest rate of growth by that measure since 2010, when GDP contracted year-on-year (Chart 4). The contribution of net trade to output growth was strongly negative in the first half of the year, particularly in Q1.*

Chart 4  
Half-year GDP growth



Source: Statistics Iceland.

Chart 5  
Private consumption and investment<sup>1</sup>



1. Four-quarter average.  
Source: Statistics Iceland.

- *The Central Bank assumes the GDP growth will continue in coming years, and according to its most recent forecast, published in the August Monetary Bulletin, GDP growth is projected at 3.4% for 2014 and 3.9% for 2015, which is well above that in the countries mentioned above.*
- *The ratios of private consumption and investment to GDP have remained low for over five years (Chart 5). The forecast of nearly 3-4% growth in coming years is based in part on the assumption that investment and private consumption will grow significantly. The most recent Central Bank forecast assumes that investment will continue to grow in 2014 and the years following. Developments in the first half of this year were in line with this assumption. There was much stronger growth in expenditure (private consumption, public consumption, and gross capital formation) than in GDP because domestic demand growth was met largely with imports.*

2. International Monetary Fund, *Global Financial Stability Report*, October 2014.

- In Q2, the real exchange rate was 5% higher than in the same quarter of 2013 and had risen by 25% from its 2009 trough. It is still about 11% below the average since 1980 (Chart 6). *Poor terms of trade have hindered growth in export revenues.* Terms of trade have deteriorated markedly in the last three years, but the slide now appears to have come to a halt. Furthermore, at the beginning of the year, the capelin catch was only a fourth of the catch from the same time a year earlier. However, in H1/2014, imports were up by 9% year-on-year in real terms.

### Declining yields on Treasury foreign issuance

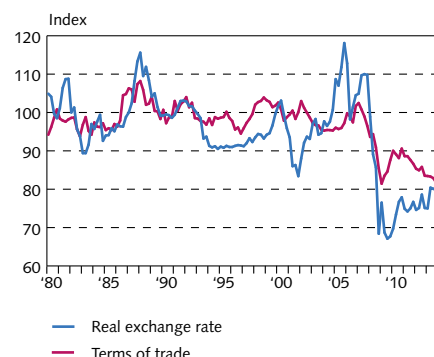
- *At the end of August, Treasury debt was virtually unchanged year-to-date*, measuring 1,472 b.kr. (79% of year-2013 GDP). The Government has paid down its loans from the Nordic countries during the year, mainly through the issuance of a Eurobond. The division between domestic and foreign debt has remained broadly unchanged during the year. At this writing, 24% of domestic debt is indexed. The 170 b.kr. bond to recapitalise the Central Bank was converted to a non-indexed bond during the year.
- *Yields on Treasury foreign issuance have declined during the year.* As of mid-September, the yield on the Republic of Iceland's 10-year US dollar bonds was 1.35 percentage points higher than on comparable bonds issued by the US Treasury. This is the narrowest spread since the bonds were issued in mid-2012 (Chart 7). The spread was widest (4.74 percentage points) right after the bonds were issued. Yields on comparable bonds issued by the Lithuanian government have also been falling since mid-2013, although the Icelandic bond yields have fallen more rapidly and are now only 0.25 percentage points above those on the Lithuanian bonds.
- *This summer, the Republic of Iceland issued a six-year Eurobond* at a yield 2% above that on a six-year bond issued by the German government. The premium on the Icelandic bonds has declined somewhat since then, and by the end of September it had fallen to 1.8%. Six-year Eurobonds issued by the Latvian government have developed similarly, although the premium has not fallen quite as quickly.

## Domestic markets

### Rising house prices

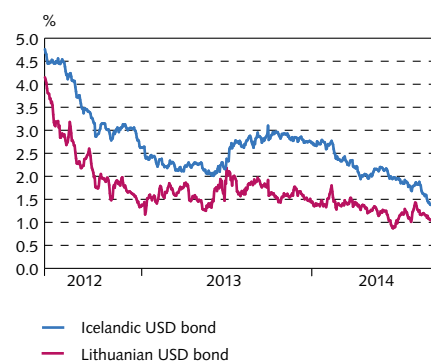
- *House prices have continued to rise in recent months.* The capital area house price index has risen by 6.7% year-to-date (condominium prices by 7.8% and detached housing by 3.1%). House prices in greater Reykjavík have risen by 9.3% in the past twelve months, and the twelve-month change in real condominium prices in the greater Reykjavík area peaked at 10.3% in April 2014.
- *For condominium housing in greater Reykjavík, the price per square metre differs greatly from neighbourhood to neighbour-*

Chart 6  
Real exchange rate and terms of trade  
Q1/1980 - Q2/2014



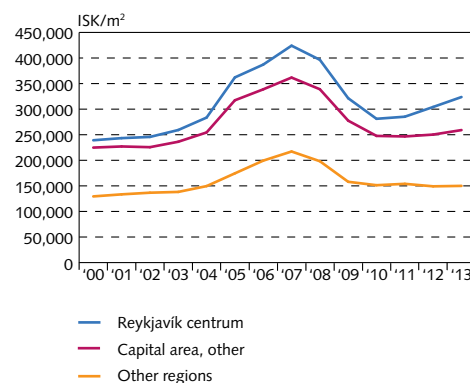
Source: Central Bank of Iceland.

Chart 7  
Interest rate spreads over the US bonds  
10-year government bonds



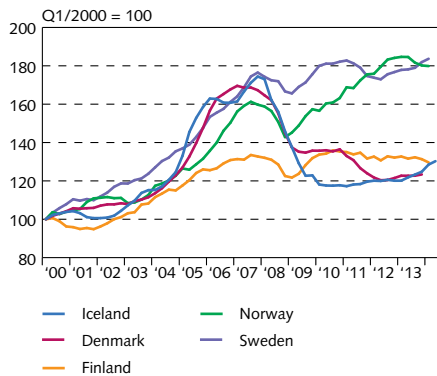
Source: Bloomberg.

Chart 8  
Developments in house prices, by region  
At 2013 prices



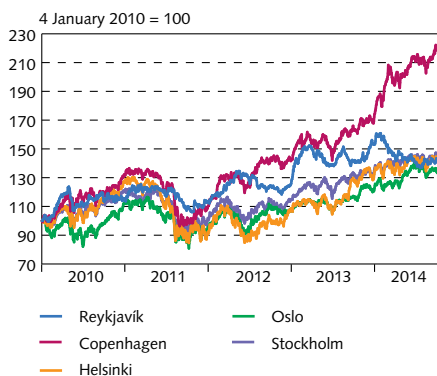
Sources: Registers Iceland, Central Bank of Iceland.

Chart 9  
Real house prices in the Nordic countries<sup>1</sup>



1. Seasonally adjusted price indices.  
Sources: OECD, Statistics Iceland.

Chart 10  
Nordic stock price indices  
4 January 2010 - 30 September 2014



Source: Nasdaq OMX Nordic.

hood, and the difference has continued to grow. Prices have risen more sharply in neighbourhoods close to the centre of the area – close to the city centrum (Chart 8) – and also in Seltjarnarnes and the newer neighbourhoods in Garðabær and Kópavogur.

- In the other Nordic countries, house prices did not fall as steeply in the wake of the crisis as they did in Iceland, but in the Nordic region house prices began to fall again in 2011, on the heels of the euro crisis (Chart 9). Low, variable interest rates, mortgages for up to 70 years, and loans with deferred payment of principal have supported real estate prices in Denmark and Sweden. Household indebtedness has remained very high in Denmark and has increased in recent years in Sweden and Norway, whereas it has declined in Iceland.
- In the past two years, the rise in house prices in Iceland has been in line with real wage growth and declining unemployment. So far 2014, however, house prices have risen somewhat more rapidly in the greater Reykjavik area, and the Central Bank tracks price developments closely, partly in view of the possible effects of the capital controls on asset prices.

#### Equity market

- In the first three quarters of 2014, equity market turnover was lower than over the same period in 2013. At the end of Q3, turnover totalled 184 b.kr., down from 191 b.kr. for the same period last year. Two new companies – HB Grandi and Sjóvá – were admitted for trading on the NASDAQ OMX Iceland Exchange (OMXICE) during the period. More companies have declared an interest in listing, but it is not clear whether their plans will materialise this year. In July 2014, the number of companies on the index was increased from six to eight, and the index is now called the OMXI8. At the end of Q3, the OMXI8 stood at 1,152 points, a drop of 8.6% since the beginning of the year, as compared with a 7.5% increase over the same period in 2013 (Chart 10).
- Share price indices in the other Nordic countries have risen steeply in 2014. Iceland's accumulated rise in share prices since 2010 is similar to that in Norway, Sweden, and Finland, all of which have risen by about 40% since the beginning of 2010. Share prices in Denmark have more than doubled over the same period.
- The market capitalisation of OMXICE companies was 598.3 b.kr. at the end of September 2014. Prices have developed differently from company to company over this period, with Össur leading with a 47% increase and TM leading at the other end, with a decline of 27%.

#### Bond market

- Bond market yields rose sharply in Q1, but the increase reversed in Q2, and yields have been relatively stable since then (Chart

11). In mid-September, yields on most Treasury bond series were very similar to those at the beginning of the year.

- *Bond market turnover was about down 25% year-on-year in the first eight months of 2014, in keeping with the pattern seen since 2012.*
- *Of Government Debt Management's 50 b.kr. issuance target for the year, Treasury bonds for some 44 b.kr. have already been issued. One bond, RIKB 14, matured during the year, and a new bond maturing in 2020, RIKB 20 0205, was issued. There are no plans for further issuance of Housing Financing Fund (HFF) bonds in 2014 or 2015.*

### Foreign exchange market

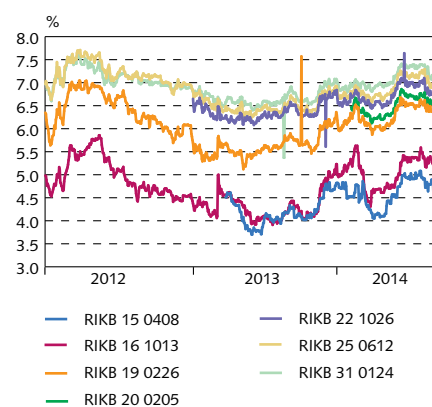
- The Central Bank was active in the interbank foreign exchange market during the first three quarters of the year (Chart 12). Turnover in the market totalled 199.7 b.kr. during the period, some 43% of it due to Central Bank trading, whereas turnover totalled 125 b.kr. over the same period in 2013, with just under 10% due to the Central Bank. The Bank's net foreign exchange purchases totalled 85.4 b.kr., whereas it was a net seller in the amount of 5.7 b.kr. during the period in 2013. Exchange rate volatility has diminished concurrent with the Bank's increased intervention in the foreign exchange market. The Bank has therefore followed the policy, announced by the Monetary Policy Committee on 15 May 2013, of stepping up its foreign exchange market activity with the aim of mitigating volatility and smoothing out fluctuations. The Bank resumed its regular foreign currency purchases in the market in June and now buys 6 million euros per week from market makers.

## External position

### Modest surplus on external trade

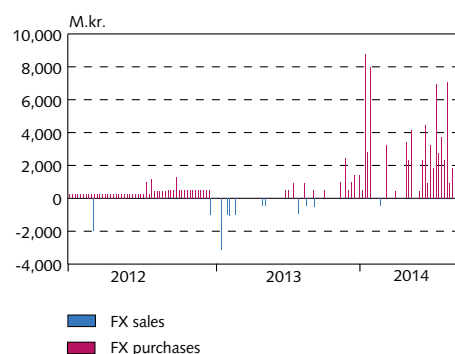
- *The surplus on goods and services trade measured 2.7% of GDP in H1, as opposed to 5.5% in the first half of 2013. The trade balance was much poorer than in 2013, mainly because of a contraction in marine product exports. The real exchange rate has also risen somewhat, but terms of trade are broadly unchanged year-on-year. The deficit in the underlying balance on income has diminished gradually in recent years as foreign interest rates fall and foreign debt declines. This supports the underlying current account balance in spite of the smaller trade surplus. The underlying current account balance (without DMBs in winding up proceedings and Actavis) measured 0.8% of GDP in H1, as compared with 2.8% in H1/2013 and -0.6% in H1/2012.*
- As is discussed in the section entitled *Domestic markets*, the Central Bank's net foreign exchange purchases totalled 85 b.kr. in the first nine months of the year. At the same time, residents

Chart 11  
Nominal government bond yields



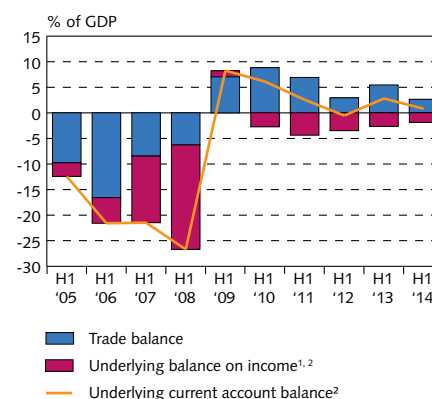
Source: Macrobond.

Chart 12  
Central Bank's FX market transactions<sup>1</sup>  
2 January 2012 - 30 September 2014



1. Weekly data.  
Source: Central Bank of Iceland.

Chart 13  
Trade balance; underlying income and current account balances

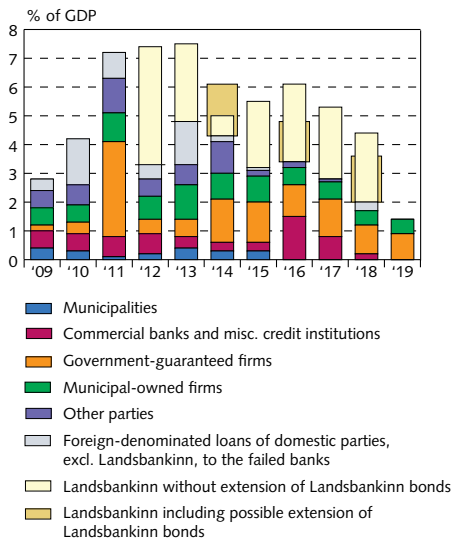


1. Secondary income included in income account 2. Excluding the effects of the pharmaceutical company Actavis on the income account and DMBs in winding up proceedings on balance of payments.  
Sources: Statistics Iceland, Central Bank of Iceland.



Chart 14

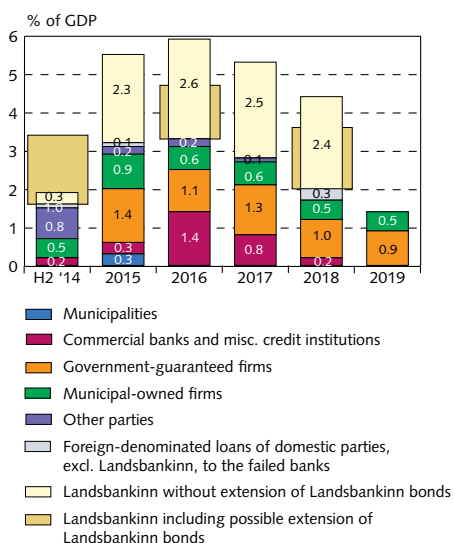
Estimated payments by parties other than the Treasury and CBI on foreign loans and foreign-denominated loans to the failed banks, including possible extension of Landsbankinn bonds<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 15

Estimated payments by parties other than the Treasury and CBI on foreign loans and foreign-denominated loans to the failed banks, including possible extension of Landsbankinn bonds<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

paid down foreign loans in the amount of nearly 70 b.kr., financing a very small portion with foreign asset sales. Of the inflows into the foreign exchange market, about 60 b.kr. are due to a contraction in the commercial banks' foreign exchange balances, the Central Bank's foreign currency auctions, foreign refinancing, and an increase in foreign accounts payable. There is also some new foreign investment in Iceland. *Nonetheless, foreign currency inflows appear to be considerably larger than the underlying current account balance indicates.* Figures imply that actual foreign exchange flows from external trade are not fully reflected in the trade balance. This could be due in part to the fact that large domestic firms' services imports do not follow foreign exchange flows but are intra-group accounting entries. Furthermore, travel-related services exports may have been underestimated.

### Extension of Landsbankinn loan reduces refinancing need

- *The estimated foreign loan payments of resident entities other than the Treasury and the Central Bank, independent of the capital controls, are shown in Charts 14 and 15. Comparable charts have been published in previous Central Bank reports. The main change from previous charts, apart from exchange rate movements, is the increased debt service burden from Íslandsbanki's Eurobond issue in May 2014, which totals 100 million euros, or just under 16 b.kr. The refinancing need is shown in Chart 16. Estimated refinancing/asset sales have been revised upwards from previous publications, due to updated data and more detailed data compilation. As before, refinancing estimates are extremely cautious; for instance, it is not assumed that the energy companies will refinance any of their outstanding foreign debt in the next six years.*
- *The annual debt service on Iceland's foreign debt will peak at up to 6% of GDP in 2015-2017. Chart 17 shows residents' refinancing need, adjusted for the possible extension of the Landsbankinn bonds. With the extension of the bonds, the debt service burden will decline from 5.4% of GDP (Chart 16) to 3.6% (Chart 17) in 2015-2018. The unfunded debt service burden is also lightened significantly with the extension, declining from an average of 3.8% of GDP (Chart 16) to 2.6% (Chart 17). In comparison, over the last three years, the underlying current account balance has averaged 4.1% of GDP.*
- *The possible extension of the Landsbankinn bonds would greatly reduce residents' need for refinancing in foreign credit markets in coming years, thereby reducing Iceland's refinancing risk. If the bonds were lengthened, the ratio of contractual foreign loan payments to GDP would be half as much in the next four years as they were in the past four years. Reduced foreign refinancing risk would enhance the likelihood that resident entities could obtain financing in foreign credit markets and would support the exchange rate of the króna.*

- Other things being equal, if the Landsbankinn bonds are not extended, domestic demand would have to contract and the currency would have to depreciate in order for the domestic economy to generate enough additional foreign currency to service the debt. *Analysis using the Central Bank's macroeconomic model indicates that, in comparison with a scenario providing for the lengthening of the bonds, the króna could weaken temporarily by about 8%, private consumption would contract and inflation would rise. Central Bank interest rates would have to be kept higher than it would otherwise in the near future in order to bring it back to target, according to the model.* In order to prevent this, the Treasury or the Central Bank would have to provide Landsbankinn with long-term foreign-denominated funding, with the corresponding implications for the Treasury debt position and the foreign exchange reserves.
- If the bonds are lengthened and if external conditions remain unchanged, it is likely that the trade surplus will suffice to cover resident entities' unfunded debt service burden in foreign credit markets. *In recent years, residents have paid down foreign debt rapidly, and reduced indebtedness increases the likelihood of their gaining access to foreign credit markets on manageable terms.* Both Íslandsbanki and Arion Bank have obtained foreign credit in recent months, and the Treasury has repeatedly demonstrated that it has access to the market, most recently in July, with a Eurobond issue amounting to 750 million euros.

#### Growing stability in non-residents' short-term ISK assets

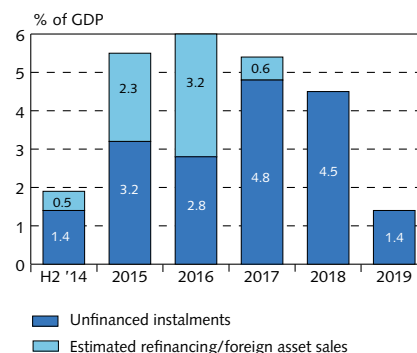
- *Non-residents' short-term króna assets totalled 307 b.kr., or just under 16% of GDP, at the end of August, after having declined by nearly 35 b.kr. over the previous twelve months.* The reduction is attributable almost entirely to the foreign currency auctions held by the Central Bank, which acted as an intermediary in the transfer of 41 b.kr. in short-term króna assets over this period.
- *Both the exchange rate in Central Bank foreign currency auctions and the offshore exchange rate have risen somewhat in recent months. Over the past twelve months, the appreciation measures 20%.* The most probable explanation of the rise in the offshore exchange rate is Iceland's high interest rates in comparison with most other industrialised countries. The difference between the official Central Bank exchange rate and the offshore rate is now about 17%, about half what it was twelve months ago. Foreign owners of short-term króna assets are now investing in longer Treasury bonds than they were before, and the offshore exchange rate has risen simultaneously. This could be a sign that non-resident owners of short-term króna assets are more patient than before.

#### Original objectives achieved

- The capital controls were imposed in order to hinder capital outflows that could weaken the króna, stimulate inflation, and erode

Chart 16

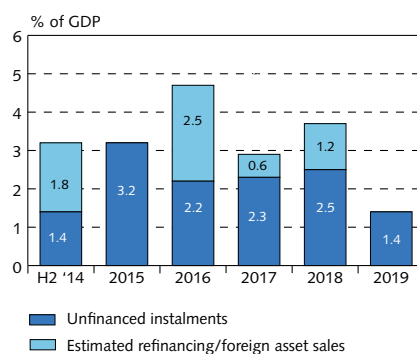
Refinancing needs on foreign-denominated loans of borrowers other than the Treasury and Central Bank<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 17

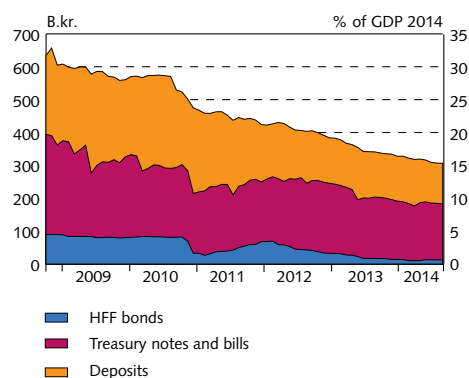
Refinancing needs on foreign-denominated loans of borrowers other than the Treasury and Central Bank, including possible extension of Landsbankinn bonds<sup>1</sup>



1. Based on position and exchange rates of 27 August 2014.  
Sources: Statistics Iceland, Central Bank of Iceland.

Mynd 18

Short term króna assets held by non-residents  
October 2008 - August 2014

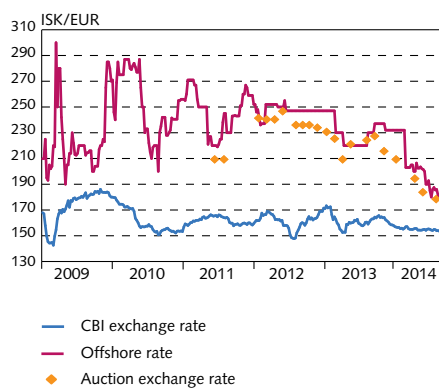


Sources: Statistics Iceland, Central Bank of Iceland.



Mynd 19

Official Central Bank exchange rate, offshore rate, and auction exchange rate



Sources: Reuters, Central Bank of Iceland.

the balance sheets of households and businesses with foreign-denominated debt in excess of their foreign assets or income. *The risk of household balance sheet erosion has been eliminated, and the risk for businesses has diminished significantly.* The capital controls have also provided the shelter needed to restructure the financial system and public sector finances.

### The cost of the capital controls is steadily increasing

- There are numerous costs associated with the capital controls. The most obvious is the direct expense involved in enforcing and complying with them. But more onerous are the indirect costs, which can be difficult to measure. The controls affect the decisions made by firms and individuals, including investment decisions. Over time, the controls distort economic activities that adapt to them, ultimately reducing GDP growth. *The direct costs associated with liberalisation centre primarily on the possible lack of confidence in liberalisation and the associated risk of disorderly capital outflows, which would weaken the króna, stimulate inflation, and result in higher interest rates.*
- If liberalisation is not carried out successfully, these costs will make themselves felt quickly. On the other hand, liberalisation will lead to increased efficiency over time, as decisions will be made without consideration of the capital controls. *Measures aimed at making it easier for some parties in the economy to tolerate the controls reduces the incentive to lift them, with the associated expense for the general public.*

### Economic conditions favourable for liberalisation

- *At present, economic conditions are favourable for large steps in liberalisation.* The economic outlook is better in Iceland than in its main trading partner countries, interest rates abroad are at a historical low, Iceland's interest rate differential with its main trading partners is positive, GDP growth is stronger in Iceland than in most trading partner countries, domestic inflation is close to target, Iceland has an established trade surplus, the fiscal budget is estimated to be in surplus next year, the spread between the official Central Bank exchange rate and the offshore exchange rate has narrowed significantly in recent months, and the Treasury has demonstrated repeatedly that it has access to foreign credit markets. Therefore, it appears that current economic conditions are conducive to successful liberalisation of the capital controls. It is important to remember, however, that these conditions could change for the worse later on.
- The main problems relating to liberalisation have been identified as the stock of offshore krónur owned by non-residents, Iceland's balance of payments, and the settlement of the failed banks' estates. The narrowing of the spread between the Central Bank's official exchange rate and the offshore rate, increased access to foreign credit markets, deleveraging of foreign loans, and the

persistent trade surplus diminish the effects of the first of these two risks. *The remaining problem, the settlement of the failed banks' estates, is the largest factor complicating the liberalisation process.*

## Operations and equity

### Commercial banks' operations

- Iceland's commercial banks recorded reasonably strong profits in the first half of 2014.<sup>3</sup> *Their earnings reports were affected by various estimated and irregular items, such as valuation increases in loans, write-ups of equity securities, and income from the sale of holdings in companies.* These factors should be considered in any assessment of operating results and financial ratios.
- The commercial banks' combined profits increased by more than 14 b.kr. year-on-year in H1, to 46.9 b.kr. Their return on total assets was 3.2%, and return on equity was just over 17%, a substantial increase over the same period in 2013. Calculated returns on estimated core operations amounted to 0.9% of total assets in H1, as opposed to 0.7% in H1/2013.<sup>4</sup>
- Net interest income totalled 40.8 b.kr., and the combined interest rate margin fell 0.3 percentage points year-on-year, to 2.8%. *In the first half of 2014, and particularly in the first quarter, inflation was down somewhat year-on-year, leading to a smaller interest rate margin.* The banks' combined indexation imbalances totalled 273 b.kr. at the end of the half. Allocated discounts on interest income from purchased loan portfolios declined markedly. Net commission income rose by over 13% year-on-year in H1, to 15.2 b.kr., due in part to market transactions, asset management, and subsidiaries.
- The net rise in loan values totalled 18.5 b.kr., up from 10.9 b.kr. over the same period in 2013.<sup>5</sup> The increase in loan values, corporate loans in particular, totalled 19.1 b.kr., whereas impairment was only 0.6 b.kr. *The item "loan valuation changes" has grown much less volatile,* reflecting the progress made in restructuring of transferred loan portfolios and, to some degree, a reduction in default. The difference between claims and book value is diminishing, but some scope for additional restructuring remains.

3. The discussion of commercial bank operations in H1/2014 is based on the consolidated accounts of the three largest commercial banks and comparison figures for H1/2013. Figures represent the aggregate operating results of the commercial banks unless otherwise stated. The aggregate position may diverge from that of individual financial companies.

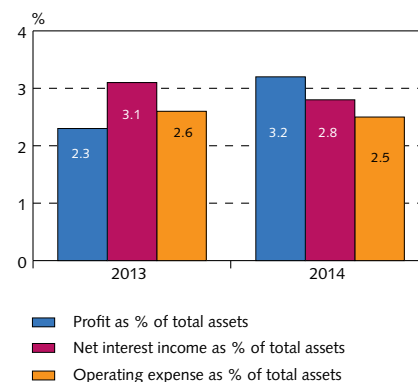
4. Estimated core operations based on a 3% calculated interest rate differential and 1% net loan impairment on an annualised basis, and commission and fee income and operating expenses, adjusted for the largest irregular items (cf. Scenario II in Financial Stability 2014/1, pp. 32-33). It should be noted that scenarios for core operations can vary.

5. Loan value changes in H1/2013, less Landsbankinn's valuation increase of 4.7 b.kr., in connection with the receipt of shares in the bank.

Chart 20

Three largest banks' returns, interest rate differential, and expense ratio<sup>1</sup>

H1/2013 and H1/2014

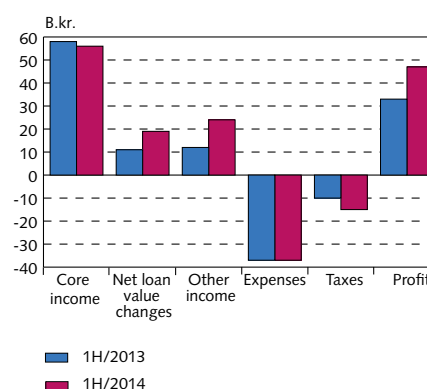


1. Consolidated accounts. Operating expense, excluding largest irregular items.  
Sources: Commercial banks' interim financial statements.

Chart 21

Three largest banks' income and expenses<sup>1</sup>

1H/2013 and 1H/2014

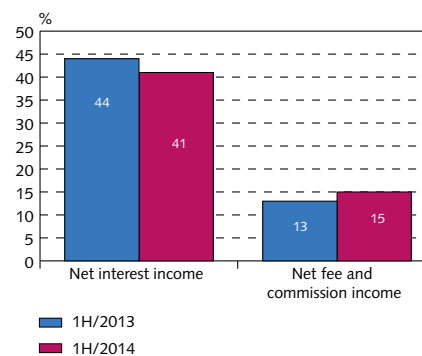


1. Consolidated accounts, income and expense in 2013 adjusted for Landsbankinn's 4.7 b.kr. due to receipt of shares.  
Sources: Commercial banks' interim financial statements.

Chart 22

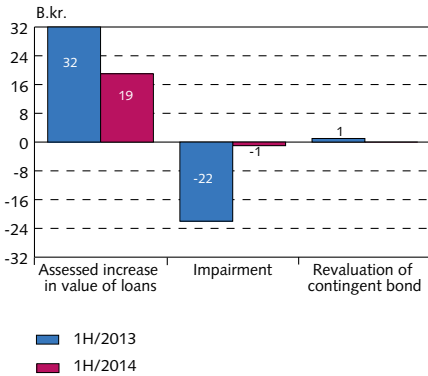
Three largest banks' core income<sup>1</sup>

1H/2013 and 1H/2014



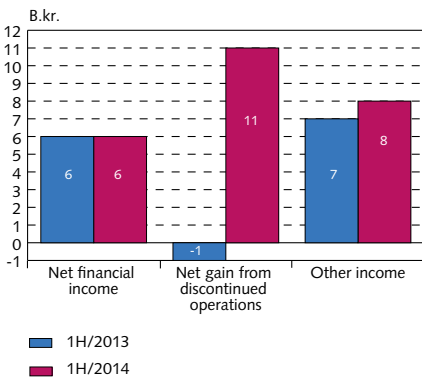
1. Consolidated accounts.  
Sources: Commercial banks' interim financial statements.

Chart 23  
Largest banks' income and expenses due to changes in valuation of loans and receivable<sup>1</sup>  
1H/2013 and 1H/2014



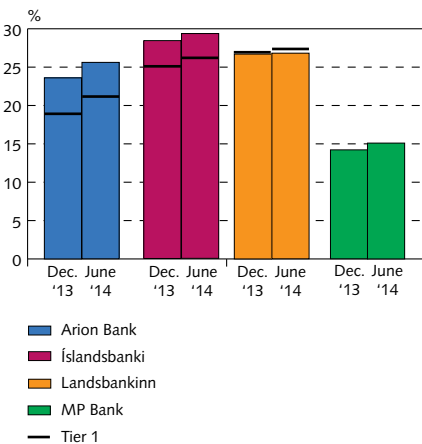
1. Consolidated accounts. Revaluation increase in loan values in H1 2013 adjusted for Landsbankinn's 4.7 b.kr. increase due to receipt of shares.  
Sources: Commercial banks' interim financial statements.

Chart 24  
Three largest banks' other income items<sup>1</sup>  
1H/2013 and 1H/2014



1. Consolidated accounts.  
Sources: Commercial banks' interim financial statements.

Chart 25  
Commercial banks' capital adequacy ratios<sup>1</sup>



1. Consolidated accounts.  
Sources: Commercial banks' annual and interim financial statements.

- Net income from financial activities was virtually unchanged between years, measuring 5.6 b.kr. in H1. Equity securities generated 6.7 b.kr. in income, while there were losses on debt securities and derivatives, as well as exchange rate losses on currency mismatches. *The profit on equity securities was due largely to write-ups of holdings* to market value, following market listing or sale. Most prominent in this category were Arion Bank's stake in HB Grandi and Landsbankinn's stake in the Enterprise Investment Fund. The profit on the sale of Landsbankinn's stake in the Enterprise Investment Fund was also entered under other income. Profits on discontinued operations were considerable, at 10.8 b.kr. Weighing heaviest in this category were profits on the sale of companies with unrelated operations and the sale of Arion's stake in HB Grandi.

- As is stated above, various irregular items affected first-half earnings reports. Total income from loan write-ups and the sale and write-up of the banks' largest holdings in companies and discontinued operations amounted to 37 b.kr., or 80% of the profit for the period.

- Operating expenses for the first half of 2014 were virtually unchanged year-on-year, at 37 b.kr.<sup>6</sup> Wage costs, the banks' largest expense item, rose by nearly 800 m.kr. between periods in spite of downsizing, albeit to varying degrees from one bank to another. Contractual wages increased 2.8% in Q1/2014, plus one-time payments, whereas administrative taxes levied on wages have declined year-on-year (6.75% in 2013, 5.5% in 2014). Excluding the largest irregular items, expenses as a share of net interest and commission/fee income totalled 66%, an increase of just over 2 percentage points from the previous period. The above-described expenses constituted 2.5% of total assets, a decline of 0.1 percentage point between periods. The banks have announced that they intend to continue to streamline and cut costs.

- Taxes totalled 15.2 b.kr. in H1/2014, an increase of 5 b.kr. between periods. Income tax totalled 11 b.kr., and the bank tax amounted to 4.2 b.kr. In addition, the banks pay an administrative tax on wages, which is recognised under wage-related expenses in their accounts.

### Commercial banks' equity

- The large commercial banks' equity totalled 568 b.kr. at the end of June 2014. It increased by only 14.5 b.kr. from the beginning of the year because of dividend payments. Their capital ratio was 27.2%, after rising by 1 percentage point since the beginning of the year, and Tier 1 capital was 25%. The large banks' risk

6. Operating expenses excluding bank tax. Operating expenses in H1/2014 less Íslandsbanki's reverse transaction/capitalisation in the amount of 510 m.kr. Operating expenses in H1/2013 net of Landsbankinn's charge of 4.7 b.kr. related to the receipt of shares in the bank, and Arion Bank's charge of the 500 m.kr. fine imposed by the Competition Authority on its subsidiary, Valitor.

base contracted by 32 b.kr. from year-end 2013, primarily due to reduced credit risk, but also due to declining foreign currency mismatches. MP Bank's equity amounted to just over 4.8 b.kr. at the end of June 2014, and its capital ratio was 15.1%.

- The large commercial banks' capital ratios are currently at their highest since the banks were established, and they are well above the level required by the Financial Supervisory Authority (FME).<sup>7</sup> In the first half of the year, the banks paid out nearly 32 b.kr. in dividends on their year-2013 profits. The upcoming liberalisation of the capital controls and the prominence of estimated and irregular items in the banks' accounts highlight the importance of maintaining the resilience of the banking system, and ideas concerning sizeable dividend payments by the banks should be examined in this light.

## Funding

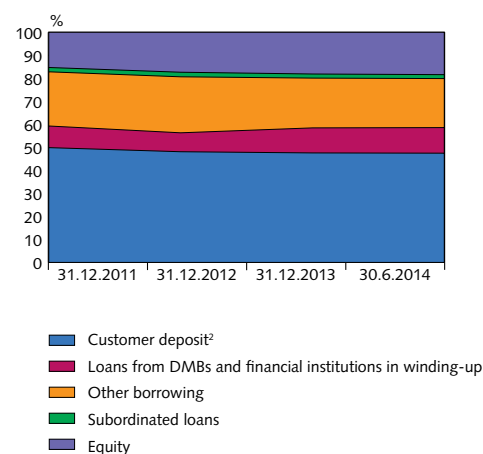
### New rules limit foreign maturity mismatches

- As before, the commercial banks are funded largely with deposits. The weight of customers deposits has declined slightly year-to-date and now constitute just under half of the banks' funding. The banks' capital continues to accumulate and has increased by 14.5 b.kr. year-to-date.<sup>8</sup> At the end of July, equity accounted for 18.4% of their funding and subordinated loans about 2%. Short-term debt to deposit money banks (DMB) and financial institutions in winding-up proceedings total about 340 b.kr. and have increased by 12 b.kr. since the beginning of the year.
- Non-residents' deposits contracted by about 10 b.kr., or 8%, in the first half of the year. Non-residents own about 6% of deposits, about a percentage point of which are in currencies other than the Icelandic króna. Roughly 18% of residents' deposits are in foreign currencies. The ratio of deposits to loans is just over 70%.
- The commercial banks' own foreign-denominated liquid assets in excess of all foreign-denominated deposits. Their liquidity is well above the minimum specified in the Central Bank's liquidity rules, which took effect in December 2013. Their liquidity ratios in foreign currency have averaged 346%, whereas the regulatory minimum is 100%. Overall – that is, for Icelandic krónur and other currencies combined – the commercial banks' liquidity ratios have averaged 123%, while the regulatory minimum is 70%. On 1 January 2015, the total minimum liquidity ratio will rise to 80%.

7. The Act on Financial Undertakings, no. 161/2002, stipulates that a financial undertaking's capital base shall be at least 8% of its risk base; however, based on the authority contained in the Act, the FME has set a higher minimum. The commercial banks have conducted their own internal capital adequacy assessment process (ICAAP) and the FME has then conducted its supervisory review and evaluation process (SREP), after which it has determined the banks' minimum capital ratios. Landsbankinn is the only bank that has published the FME's SREP-based capital requirement, which is 16.7%, based on the bank's position as of end-2012.

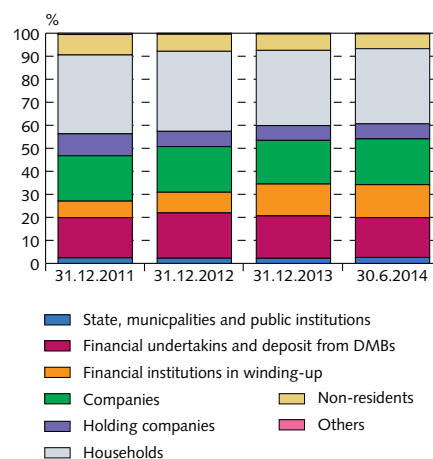
8. Based on consolidated figures. On a parent company basis, the increase in capital totals 17.2 b.kr.

Chart 26  
Commercial banks' funding<sup>1</sup>



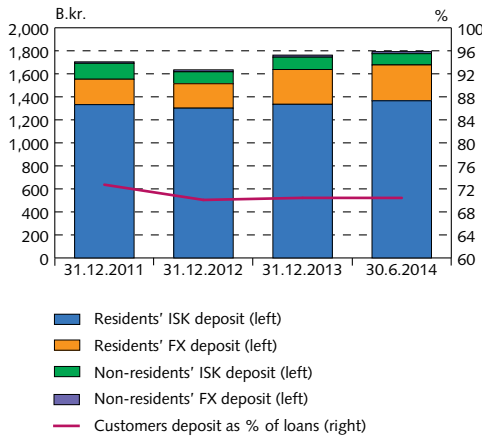
1. Parent companies. 2. Pension funds deposit are included.  
Sources: Central Bank of Iceland.

Chart 27  
Deposit holders<sup>1</sup>



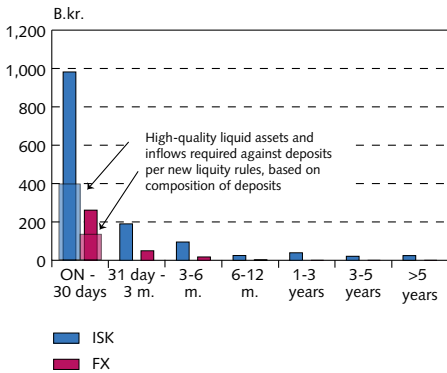
1. Parent companies, commercial banks.  
Source: Central Bank of Iceland.

Chart 28  
Deposits with commercial banks in FX and ISK<sup>1</sup>



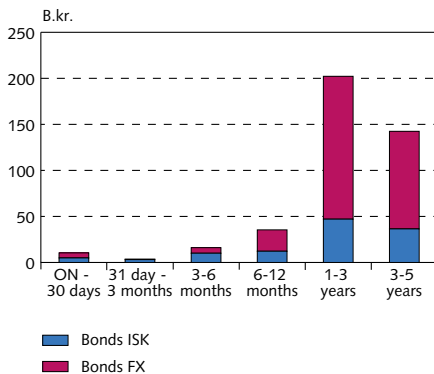
1. Parent companies. Deposit of customers and financial institutions. Source: Central Bank of Iceland.

Chart 29  
Deposit with commercial banks in FX and ISK and liquidity requirements  
The three large commercial banks<sup>1</sup> as of 30 June 2014



1. Consolidated figures. Source: Central Bank of Iceland.

Chart 30  
Bond maturities<sup>1</sup>  
The three large commercial banks<sup>2</sup> as of 30 June 2014



1. Instalments and interest. 2. Consolidated figures. Source: Central Bank of Iceland.

- The liquidity requirements according to the Central Bank rules assume that the banks will have liquid assets to offset a portion of their deposits and other obligations can be withdrawn within 30 days. Based on the composition of the banks' deposit portfolios and the current liquidity rules, the banks must have liquid assets amounting to 34% of all deposits or 46% of all deposits that can be withdrawn within 30 days. About 73% of deposits can be withdrawn within a month, 87% within three months, and 93% within six months.

- The commercial banks' market funding has been relatively limited so far this year. Covered bond issuance totalled only 2.5 b.kr. in the first half, as compared with 14.5 b.kr. in H1/2013. In July, Arion Bank sold 10 b.kr. in non-indexed covered bonds, in connection with its purchase of contractual covered bonds, and Íslandsbanki issued covered bonds in September. The banks' combined outstanding bonds amount to about 54 b.kr., or only 1.8% of their total funding. The bonds are listed on the NASDAQ OMX Iceland exchange but have seen little secondary market trading. Íslandsbanki has continued to issue bills, at the end of June, some 7 b.kr. were outstanding, as compared with 8.5 b.kr. at the beginning of the year.

- Arion Bank and Íslandsbanki issued bonds abroad in 2013. In March 2014, Íslandsbanki expanded its issue by SEK 300m at STIBOR plus a 330-point premium, which is 70 points less than the premium on the 2013 issue. In May, Íslandsbanki issued a two-year bond in the amount of EUR 100m.

- In the next three years, payments of instalments and interest on the bonds will total 268 b.kr., including 190 b.kr. in foreign currencies. The vast majority of foreign-denominated instalments and interest payments, or 157 b.kr., are due to Landsbankinn's collateralised bonds with the old bank. The bonds were issued as part of the settlement between Landsbankinn and LBI, due to the mismatch in the value of assets and liabilities transferred to Landsbankinn. The bonds stood at 222 b.kr. as of end-August. Payments are made quarterly from 2014 until the bonds mature in 2018.

- Of all the commercial banks, Landsbankinn has the largest share of non-deposit funding, owing to its debt to the old bank. Arion Bank's other borrowings consist mainly of the takeover of a covered bond portfolio related to Arion Bank's purchase of a Housing Financing Fund bond portfolio from Kaupthing at year-end 2011. The bonds amounted to 122 b.kr. at the end of June.

- The commercial banks' encumbrance ratios have fallen slightly since the beginning of the year. About 28% of Landsbankinn's assets were hypothecated for funding at the end of June, and its encumbrance ratio has fallen by a percentage point year-to-date. Arion Bank has a similar ratio, or 26%, and it declined by about

3 percentage points in the first half of the year. Roughly 10% of Íslandsbanki's assets are hypothecated for funding, and the ratio fell by about 2 percentage points in the first half of 2014.

- *The rules on foreign funding ratios that the Central Bank intends to implement have been sent to the commercial banks in draft form for commentary.* The aim of the rules is to limit the maturity mismatches between the banks' foreign assets and liabilities.<sup>9</sup> The rules restrict the degree to which the banks can depend on unstable short-term funding to finance long-term assets that could prove difficult to sell. Such maturity transformation between assets and liabilities is an important contribution made by the banks to the economy, but it is also risky. Liquidity facilities and last-resort loans are intended to limit the risk that can derive from such maturity transformation. On the other hand, the Central Bank is restricted in its ability to provide liquidity facilities or last-resort loans in foreign currency. The rules on liquidity ratios in foreign currency have already been implemented and cover a period of one month, but it is important to consider longer periods as well. This is the purpose of the funding ratios. In the Central Bank report "Prudential Rules Following Capital Controls", it is stated explicitly that the Bank's objective is that domestic financial institutions be able to withstand the closure of foreign capital markets for up to three years. The Bank is also considering implementing foreign funding ratios that take account of this.

## Deposit institutions' assets

### Total DMB assets decline relative to GDP

- *Total assets held by deposit money banks (DMB) have increased in real terms since the beginning of the year.* As of end-June, assets held by DMBs (four commercial banks and seven savings banks) totalled 3,116 b.kr., up from 3,103 b.kr. at year-end 2013 and 3,075 b.kr. at the end of June 2013.<sup>10</sup> In real terms, they have grown by 1.4% in the past twelve months. As a share of GDP, however, they have declined somewhat, from 165% as of end-June 2013 to 161% at the end of June 2014. Total DMB assets have therefore declined significantly relative to GDP since 2009, when the ratio stood at 187%.
- *Assets held by miscellaneous credit institutions – that is, credit institutions other than deposit money banks (DMB) – declined to approximately 1,064 b.kr. as of end-June, as opposed to 1,077 b.kr. at year-end 2013.<sup>11</sup> The vast majority of the assets are*

9. See, for example, "Prudential Rules Following Capital Controls" (2012) and *Financial Stability* 2014-1.

10. In June 2014, the Financial Supervisory Authority approved the merger of Sparisjóður Bolungarvíkur and Sparisjóður Norðurlands, leaving a total of seven savings banks in operation.

11. Miscellaneous credit institutions are the Housing Financing Fund, Valitor hf., Borgun hf., Lýsing hf., Straumur Investment Bank hf., the Icelandic Regional Development Institute, and Municipality Credit Iceland Plc.

Chart 31  
FX loans to FX stable funding  
The three large commercial banks<sup>1</sup> as of 30 June 2014

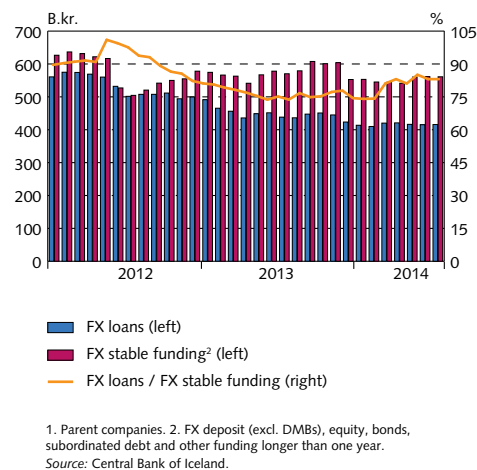


Chart 32  
DMBs' total assets, % of GDP<sup>1</sup>

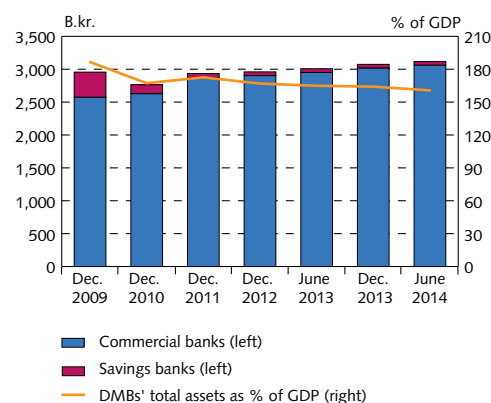
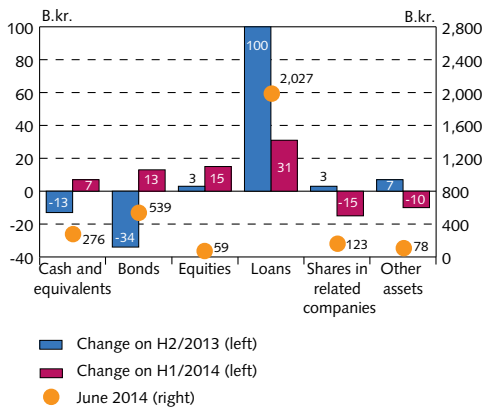


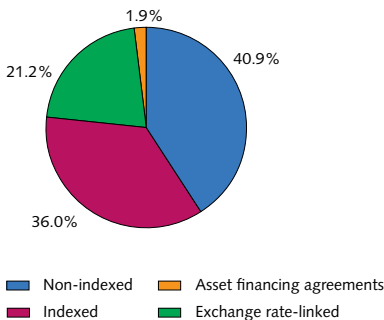


Chart 33  
DMBs' total assets<sup>1</sup>



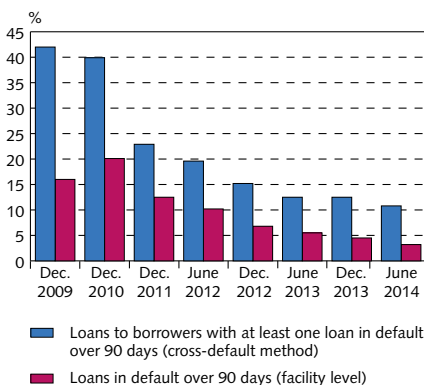
1. Parent companies.  
Source: Central Bank of Iceland.

Chart 34  
DMBs' loans<sup>1</sup>  
June 2014



1. Parent companies.  
Source: Central Bank of Iceland.

Chart 35  
Default ratios of the three largest commercial banks<sup>1</sup>



1. Parent companies, book value.  
Sources: Financial Supervisory Authority, Central Bank of Iceland.

owned by the Housing Financing Fund (HFF), which held assets worth 847 b.kr. at the end of June, including mortgage loans in the amount of 754 b.kr. (for further information on miscellaneous credit institutions, see the section entitled *Financial market entities*).

- *Loans constitute the vast majority of the DMBs' asset portfolio.* As of end-June 2014, they totalled 2,027 b.kr., or 65% of the total. The book value of loans was up 131 b.kr. year-on-year and by 31 b.kr. since the beginning of 2014. Loans as a share of total assets have increased by 2% in the past twelve months. In real terms, the book value of loans has risen by 4.4% in the past twelve months. The increase in the second half of 2013 was due partly to Arion Bank's takeover of household loans previously owned by Drómi hf., Frjálsi hf. (a Drómi subsidiary), and the Central Bank of Iceland Holding Company ehf. (ESÍ), which increased the book value of Arion's loans by roughly 50 b.kr. Excluding the takeover, the book value of loans has risen by 1.9% in the past twelve months. The write-downs in the banks' credit provisioning accounts have declined by 30% year-on-year, partly because debt restructuring is largely complete and the uncertainty about recoveries has subsided.

- *Bonds are the second-largest class of DMB assets, at 17.5% of the total, and cash is the third-largest, at 9%.* DMBs increased their bond holdings by 13 b.kr. and their cash holdings by 7 b.kr. in the first half of 2014. Equity holdings in related companies declined by 15 b.kr. in H1/2014, in part due to Arion Bank's sale of an 18.8% stake in HB Grandi hf. and Landsbankinn's sale of a 9.9% stake in the Enterprise Investment Fund. Their equity securities holdings rose by 15 b.kr., however.

- *In H1/2014, the weight of non-indexed loans and asset financing agreements rose and the weight of indexed and exchange rate-linked (foreign) loans fell.* Non-indexed loans accounted for 40.9% of loans at the end of June, after increasing by 1.7% since the beginning of the year. Over the same period, the share of indexed loans rose by 1.5%, to 36% by end-June. The share of non-indexed loans has never been higher, and it exceeds that of indexed loans by 5%.

- *As of end-June, 3.2% of the banks' loans were 90 days in arrears, a decline of about 2.3 percentage points year-on-year.<sup>12</sup>* The decline since the beginning of 2014 measures 1.3 percentage points. In June 2012, the default ratio was 10.2% according to the same criteria, but it is not possible to expect it to fall at the same pace as before in terms of percentage points. The banks' default ratios are approaching the level that is considered nor-

12. Including only those loans that are 90 days in arrears or more, which is the most common measure of non-performing loans used in international financial reporting and annual accounts.



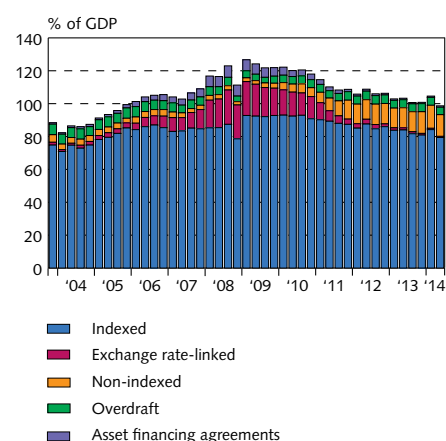
mal in banking operations. In terms of the more conservative cross-default method, however, which includes all loans taken out by borrowers in arrears, the default ratio was 10.8% at the end of June 2014, as opposed to 12.5% a year earlier. Although the decline in default rates has slowed down, it should be noted that the cases being processed in 2014 have been the more difficult ones, and the amount classified as non-performing, which includes frozen loans and those that are legally disputed, has declined by 1.2% during the year. In mid-2013, however, default on loans classified as non-performing was broadly unchanged year-on-year.

## Households

### Household balance sheets continue to improve

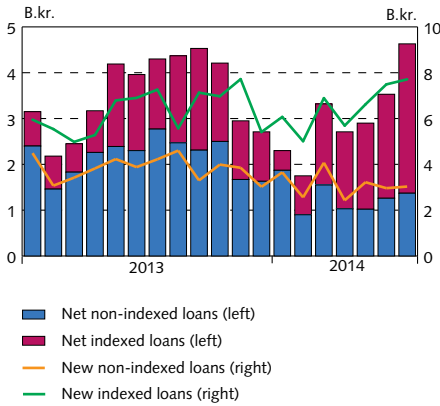
- Household debt amounted to 99% of GDP in June 2014, after having fallen by 4.6 percentage points year-on-year. In real terms, it has declined by 1.7% over the same period. So far in 2014, the ratio of household debt to GDP has declined by nearly 2.1 percentage points, and in real terms it has fallen 1.1 percentage points. The most recent figures indicate that the household deleveraging that began early in 2009 is still underway. The year-to-date reduction in the household debt-to-GDP ratio is primarily due to GDP growth and increased loan payments, which have exceeded new loans granted.*
- The Government's measures to reduce indexed mortgage debt will increase collateral capacity significantly. The planned write-down of indexed mortgages by 72 b.kr. and the authorisation to allocate third-pillar pension savings towards mortgage payments will improve households' debt position. The Central Bank estimates the increased collateral capacity that can be used for further borrowing at about 65% of the amount of the debt reduction. The write-down will enhance household wealth and increase the proclivity to spend, thereby stimulating private consumption. It is likely that a large share of this increased collateral capacity will be channelled into increased consumption and borrowing.
- At the end of June, indexed household debt amounted to 79.4% of GDP, while non-indexed debt totalled 13.2%, overdraft loans 4.5%, exchange rate-linked loans 0.7%, and asset financing agreements 0.9%. The principal change in the composition of the debt, whether over the last six months or the last twelve months, is the reduction in indexed loans. In the first half of 2014, indexed loans declined by 1.5% of GDP, and in the past twelve months they have declined by 4.6 percentage points. Non-indexed loans remained unchanged relative to GDP in the first six months of the year but have increased by 1 percentage point over the past twelve months. The status of other loan forms is virtually unchanged.*

Chart 36  
Household debt as % of GDP  
Q4/2003 - Q2/2014



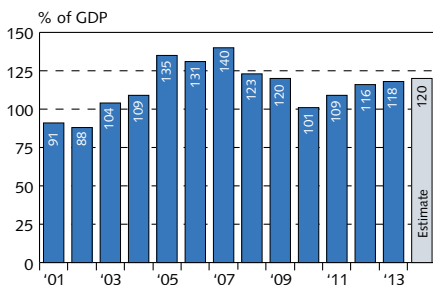
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 37  
New mortgage lending by the large commercial banks  
January 2013 - July 2014



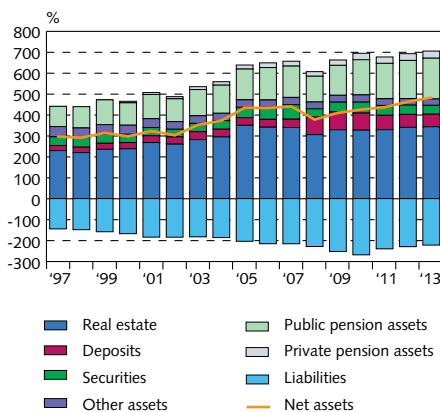
Source: Central Bank of Iceland.

Chart 38  
Net household assets as a share of GDP  
2001- Q2/2014



1. Excluding pension assets.  
Sources: Directorate of Internal Revenue, Central Bank of Iceland.

Mynd 39  
Household assets and liabilities  
as a share of disposable income<sup>1</sup>



1. Pension fund assets are based on payouts after deduction of 30% income tax.  
Sources: Statistics Iceland, Central Bank of Iceland.

- Demand for indexed mortgages is on the rise.* When the banks began to offer non-indexed mortgage loans in the latter half of 2009, demand for them was strong. Many borrowers took advantage of the cancellation of stamp fees for refinanced debt and converted from indexed to non-indexed mortgages. In 2013, demand for non-indexed mortgages eased, presumably because the borrowers who were interested in them and could afford them had already converted from indexed to non-indexed debt. In 2014, demand for indexed mortgages has outpaced demand for non-indexed mortgages. There could be many reasons for this, including the decline in inflation and inflation expectations, as real interest rates on non-indexed loans have risen because their nominal rates have remained unchanged in the recent past. Forty-year indexed annuity loans have increased in prominence once again, as they offer the lowest debt service available. Rising real estate prices could be either the cause or the effect of the proportional increase in long indexed loans. Furthermore, the findings of the Prime Minister's expert group on abolition of indexation on new consumer loans could affect demand for long indexed loans. In the first seven months of 2014, the large commercial banks' new mortgage loans totalled 67.4 b.kr., whereas the total net of prepayments came to 21.9 b.kr. About 68% of new loans were indexed, and 32% were non-indexed (Chart 37). Prepayments of indexed mortgages exceeded prepayments of non-indexed loans, as there are more indexed mortgages outstanding. After adjusting for prepayments, these proportions change little, however: indexed mortgages account for 58% of the total net amount, and non-indexed mortgages account for 42%. It is noteworthy that since the banks began to offer non-indexed mortgages, indexed loans have not been as popular as they were in last July, when they accounted for 70% of new loans, while non-indexed loans accounted for the remaining 30%.

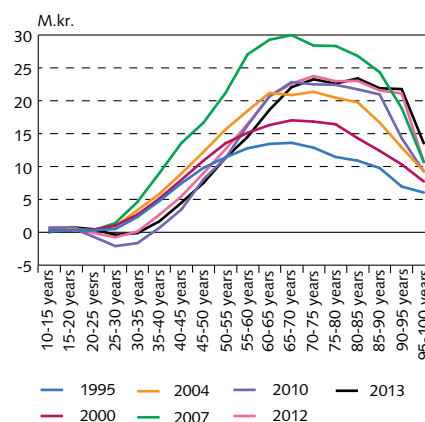
- Households' net assets excluding pension savings continue to grow, increasing by 2% in 2013, to 118% of GDP by the year-end.* Because house prices have risen sharply this year and debt has remained broadly unchanged in nominal terms, net household wealth has grown still further, to an estimated 120% of GDP by end-June. The ratio of net household assets to GDP has risen markedly in recent years and is at its highest since the turn of the century, excluding the boom years 2005-2007 (Chart 38). Households' disposable income has risen significantly in the past few years. In terms of household assets and liabilities relative to disposable income and net pension assets, households' position has never been stronger than at year-end 2013 (Chart 39).<sup>13</sup> For instance, households' net assets totalled 484% of disposable income as of end-2013, an increase of 105 percentage points since year-end 2008. The improvement seen in recent years is due both to increased assets and reduced debt. On the assets side, the great-

13. The calculation of net pension assets assumes 30% income tax on the gross amount.

est difference is in increased real estate prices and pension assets. At the end of 2013, households' real estate holdings totalled 344% of disposable income, joint pension assets totalled 195%, and private assets held by pension funds and custodians totalled 34%.

- *Young people's debt position remains difficult, although it has improved markedly in recent years.* According to tax return data from the Directorate of Internal Revenue, processed by Statistics Iceland for the Central Bank, the age groups around age 30 are the most heavily indebted relative to both assets and income. At year-end 2013, the 25-35 age group had negative equity; i.e., they owed more than they owned (Chart 40). The situation has improved greatly since bottoming out in 2010, however. By year-end 2013, the 25-35 age group's negative equity amounted to roughly 12 b.kr., whereas in 2010 it was about 104 b.kr. at year-2013 prices. Not all age groups have seen an improvement over these three years, though: the 45-50 and 55-70 age groups had a weaker equity position at year-end 2013 than at the end of 2010. There is no single explanation of the difference, but it should be borne in mind that the groups in question do not represent the same individuals, as there are three years between the two reference values. The movement of individuals between age groups is a probable cause; i.e., those who are added to the age groups are in a weaker position than those who drop out of them. The status of old-age pensioners – those aged 70 and over – was stronger at the end of 2013 than at the end of 2010. Since 1995, the increase in assets has been greatest in this group, both proportionally and nominally.
- *Household debt problems have subsided.* At year-end 2013, some 29.9% of households owed 95% or more of the value of their assets, as opposed to 31.3% in 2012, 32.8% in 2011 and 35.3% in 2010. This ratio was much lower before the collapse, however. For instance, it was about 17% each year during the period 2004-2007. These households can be defined as having negative equity (a leverage ratio of 95% or higher). Most of them were in the second-highest income group in both 2010 (42.4%) and 2013 (35.1%). Official data and research show, however, that only a fraction of these households are having difficulty servicing their debt.<sup>14</sup>
- Households with negative equity owed a total of 963 b.kr., or 50% of total household debt, at year-end 2013. *The position of this most-leveraged group has improved dramatically since bottoming out 2010, when 65% of household debt fell into this category* (Chart 41). In comparison with year-end 2010, the

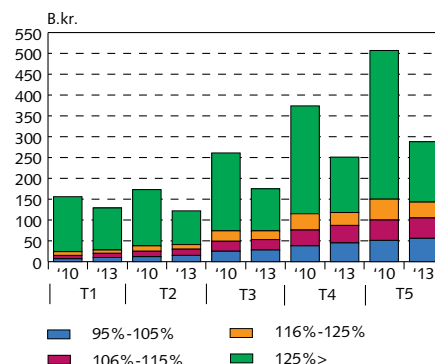
Chart 40  
Net asset position by age group,  
2013 price levels<sup>1</sup>



1. The chart shows the average net asset position per individual in the age group concerned.

Sources: Statistics Iceland, Central Bank of Iceland.

Chart 41  
Debt ratio of individuals owing more  
than 95% of assets<sup>1</sup>  
2013 price level

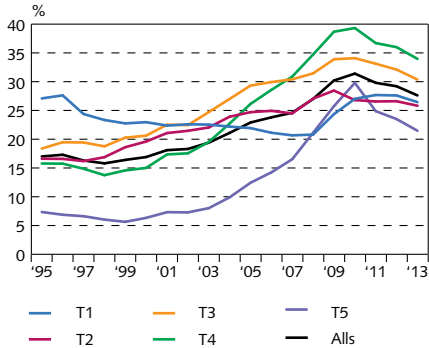


1. As of year-end 2010 and 2013, by income group. The chart shows the distribution of households owing more than 95% of assets by period and income group.

Sources: Statistics Iceland, Central Bank of Iceland.

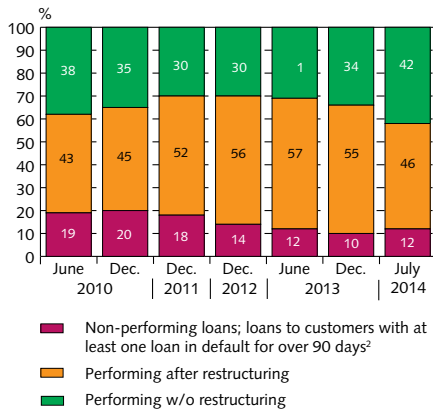
14. See, for example, Central Bank *Working Paper* no. 59, by Thorvardur Tjörvi Ólafsson and Karen Áslaug Vignisdóttir, entitled "Households' position in the financial crisis in Iceland": ([http://www.cb.is/library/Skráarsafn---EN/Working-Papers/Working%20Paper%2059.pdf](http://www.cb.is/library/Skráarsafn---EN/Working-Papers/Working%20Paper%20Paper%2059.pdf)).

Chart 42  
% of taxpayers owing more than 300% of disposable income  
By income group



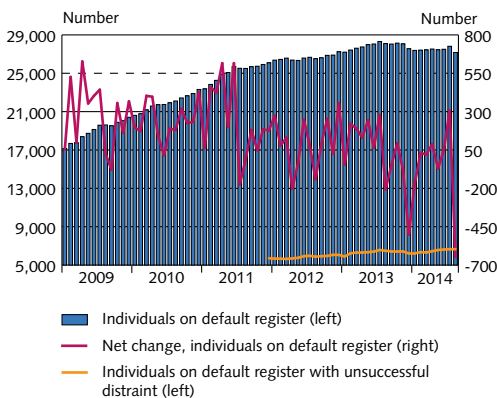
Sources: Statistics Iceland, Central Bank of Iceland.

Chart 43  
Status of loans to households from the Housing Financing Fund and the three largest commercial banks<sup>1</sup>



1. Parent companies, book value. 2. Non-performing loans are defined as loans in default for over 90 days or deemed unlikely to be paid. The cross-default method is used; i.e., if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing.  
Source: Financial Supervisory Authority.

Chart 44  
Individuals on default register, bankruptcy, and unsuccessful distraint  
Monthly data, January 2009 - August 2014



Source: CreditInfo.

improvement is greatest by far for the highest-income quintile, which has deleveraged in the amount of 220 b.kr. (at 2013 prices), whereas the other four quintiles combined have reduced their debt by a total of 282 b.kr.

- *The proportion of income tax filers who owe more than three times their annual income continues to decline.* It fell by 1.6% in 2013 and measured 27.6% by the year-end. This ratio peaked at 31.4% at year-end 2010 and has fallen by 3.8 percentage points since then. It remains high in historical context, however. As of year-end 2013, 11.3% of filers owed 300-450% of their annual income, 6.0% owed 450-600% of their income, and 10.4% owed more than 600%. Since 2010, over 75% of the reduction has been among households owing more than 600% of their annual income. Closer scrutiny of individual income groups reveals that the proportion has declined the most in higher-income groups, and since 2010 the reduction has been greatest in the top group (8.3%), as opposed to about 1% in the two lowest-income groups (Chart 42).

- *Household non-performing loan ratios have risen.* At the end of July 2014, about 12% of total loans granted to households by the three largest banks and the Housing Financing Fund (HFF) were in default (in terms of book value and using the cross-default method), as opposed to 10% at year-end 2013.<sup>15</sup> The increase is due primarily to improvements made by the HFF to its loan portfolio reports, as the Fund's information systems did not previously meet the loan classification requirements for the report. As a result, the rise in non-performing loan ratios according to the report and using the cross-default method is not due to an actual increase in default but to an improvement in documentation. Another result of the improvement in documentation is that, between December 2013 and July 2014, the proportion of HFF loans classified as performing without restructuring rose from 34% to 42%, and the percentage of loans that are performing after restructuring fell from 56% to 46%. Further analysis of non-performing loans reveals that 3% are frozen, 1% are undergoing restructuring, 3% are in collections, 2% are undergoing enforcement proceedings, and 3% are classified as other non-fulfilment.

- *At the beginning of 2014, the number of individuals on the default register declined for the first time since the beginning of 2009.* That trend has continued. At the end of August 2014, there were 27,166 individuals on the default register (Chart 44), a decline of 1,141 from the end-July 2013 peak. The number of individuals on the default register as of end-August is the lowest in nearly two years.

15. According to the cross-default method, if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing.

- The outlook for households is good. The most important indicators of households' position have moved in a positive direction in the recent term, and the outlook is good. The labour market has strengthened, unemployment has fallen, and net household wealth has increased in line with rising asset prices and declining debt. The Government's debt relief measures will strengthen households' financial position still further, as household equity will rise and debt service will fall. Real wages have risen markedly in 2014. As of end-August, the real wage index was up 4% year-on-year, the strongest increase since mid- 2007. The outlook is good, as real wages are projected to continue rising in coming years.

## Companies

### Increased optimism about Icelandic firms' operating environment

- *The price of Iceland's main export products has risen somewhat in recent months.* Marine product prices rose 5% in the first half of the year, and aluminium prices have increased sharply in the past few months, measuring 17% in the first eight months of 2014. If this trend continues, the twelve-month average price can be expected to rise, after declining from autumn 2012 onwards. *The number of foreign visitors to Iceland is higher than ever before.* As of end August, about 700,000 tourists had come to the country, an increase of roughly 23% year-on-year.<sup>16</sup> In line with the rise in visitor numbers, the payment card turnover balance has continued to improve. It was positive by nearly 27 b.kr. for the first eight months of the year, about 50% more than the surplus for the same period in 2013.

### Debt declining and general business investment on the rise

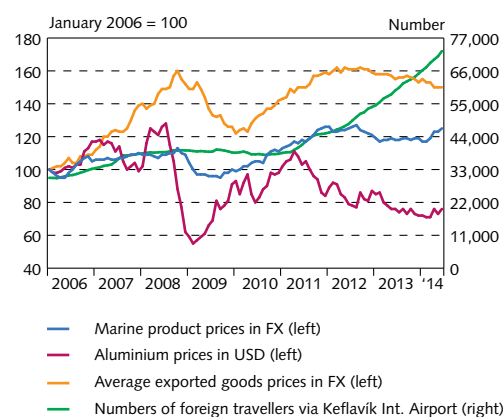
- *Icelandic firms' debt has declined markedly in the past year.* Corporate debt amounted to 122% of GDP in June 2014, after having fallen by 23 percentage points year-on-year. Although the decline is due in part to GDP growth, debt has fallen by nearly 14% in real terms. Iceland's corporate debt situation therefore appears to be on the right track, unlike that in countries such as Ireland and Cyprus, where corporate debt-to-GDP ratios are still rising, according to year-end 2012 figures. Icelandic firms' debt-to-GDP ratios are now similar to those in Sweden.
- Net new corporate loans granted by the three largest commercial banks were negative by nearly 3 b.kr. in Q1/2014, which means that prepayments exceeded new loans. *Substantial amounts were prepaid on indexed loans* during the period.<sup>17</sup> In Q2, however, net new corporate loans totalled 35 b.kr., most of them non-indexed and exchange rate-linked loans. Most net new lending in

16. Not included in these numbers are tourists arriving on the Smyril Line ship *Norræna* or on cruise ships, or those arriving via airports other than Keflavik Airport. Therefore, based on the recent average, the total number of foreign tourists could be as much as 14% higher.

17. The term prepayment refers to payment in excess of the contractually required amount.

Chart 45

Developments in exported goods prices and number of foreign visitors<sup>1</sup>

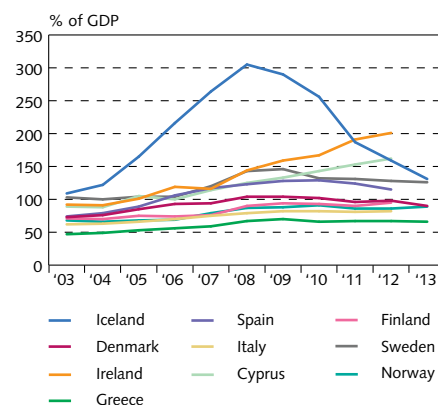


1. The average price for export products and the price for marine products in foreign currency are calculated by dividing their prices in Icelandic krónur by the export-weighted trade basket. Monthly data are used for marine products and the twelve-month average for export products and number of foreign visitors. LME aluminium prices are in US dollars and show monthly averages and the most recent aluminium price.

Sources: Icelandic Tourist Board, London Metal Exchange, Statistics Iceland, Central Bank of Iceland.

Chart 46

Corporate debt as a percentage of GDP<sup>1</sup>

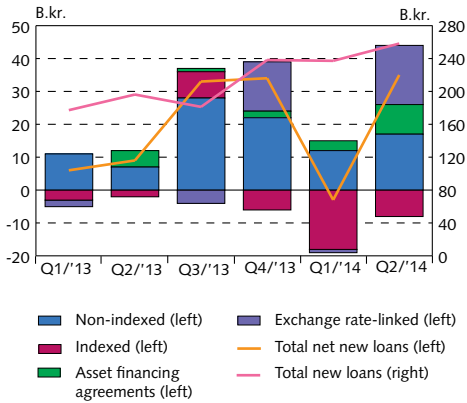


1. Data on Icelandic corporate debt include debt owed to domestic and foreign financial undertakings and issued market bonds. They are overestimated in this international comparison because they include financial holding company debt. Work is in progress to segregate financial holding companies from the data.

Sources: Eurostat, Statistics Iceland, Central Bank of Iceland.

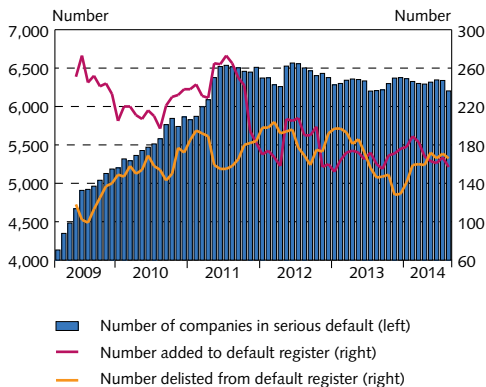


Chart 47  
Net new corporate lending from the three commercial banks, by loan form<sup>1</sup>  
Q1/2013 - Q2/2014



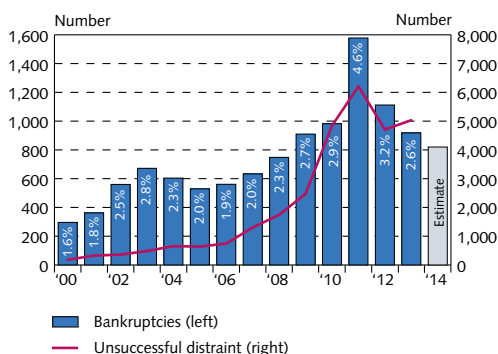
1. New loans net of prepayments. Prepayments are payments in excess of contractual payments.  
Source: Central Bank of Iceland.

Chart 48  
Companies in serious default<sup>1</sup>  
Monthly data, March 2009 - August 2014



1. In August 2014, 16% of firms were on the CreditInfo default register.  
Source: CreditInfo.

Chart 49  
Corporate bankruptcies and unsuccessful distraint  
Total for entire year; 2000-2014<sup>1</sup>



1. The percentages show bankruptcies as a percentage of all firms. The total for 2014 bankruptcies is extrapolated from the first six months of the year.  
Sources: Registers Iceland, Statistics Iceland, Central Bank of Iceland.

Q2 was to fisheries, although a considerable amount was loaned to transport and transportation companies and construction firms.

- *General business investment – i.e., investment excluding energy-intensive industry and ships and aircraft – appears to be recovering, as it rose by almost 15.7% year-on-year in H1/2014. The year-on-year increase in H1/2013 measured 14.2%. Furthermore, investment related to energy-intensive industry can be expected to pick up in the near future, as construction has begun on the Helguvík silicon plant, and the outlook is favourable for the construction of a silicon plant at Bakki, near Húsavík, and a solar silicon plant at Grundartangi. Increased general business investment appears to be in line with the overall optimism about the economy reported by executives from Iceland's 400 largest firms. According to the Capacent Gallup survey from September, 32% of executives considered economic conditions good – an increase of 25 percentage points year-on-year. About 46% were of the opinion that conditions would improve in the next six months, as opposed to 30% in September 2013. Executives were also optimistic about domestic demand for goods and services in the next six months, with 40% indicating that they expected demand to increase, up from 30% a year earlier.*

**Default register listings have fallen only marginally, but bankruptcies are on the decline.**

- There has been virtually no change in the number of firms on the CreditInfo default register in the past three years. In August 2014, about 6,200 companies, or roughly 16% of all firms in Iceland, were on the register.<sup>18</sup> Registered corporate bankruptcies continue to decline, however. In the first seven months of 2014, a total of 507 companies were declared bankrupt, or about 13% fewer than over the same period in 2013. *If the historical trend continues, corporate bankruptcies can be expected to fall this year to over 800.* As in 2012 and 2013, companies in construction and wholesale/retail are prominent among those that have been declared bankrupt so far this year.<sup>19</sup>
- There were 3,146 unsuccessful distraint measures in the first eight months of the year, about 20% more than during the same period in 2013. Presumably, unsuccessful distraint and bankruptcy should go hand-on-hand because, if a district commissioner has attempted distraint without success, petitioners and other creditors are authorised to request that the respondent be subjected to bankruptcy proceedings in court. This authorisation remains

18. Because there is often a time lag between resolution of arrears and delisting from the default register, actual default numbers could be lower than the register indicates.

19. Firms are classified as bankrupt when they are listed as bankrupt in official data. There may be additional companies that are technically bankrupt but have yet to be officially listed. Such companies are those that are unlikely to fulfil their short-term obligations and whose assets do not cover their liabilities but have not yet been officially listed as bankrupt.

valid for three months from the time the unsuccessful distraint measure is recorded. *The diverging developments in unsuccessful distraint and bankruptcy* could arise because the claims against the respondent are small-scale and no request for bankruptcy proceedings has been made. Furthermore, it could be that a greater number of respondents and petitioners are reaching agreements than before.

### Default among small and medium-sized companies similar to that among large firms

- In terms of book value and using the cross-default method, non-performing corporate loans from the three largest commercial banks continue to decline. They now account for about 10% of total loans, a decline of some 2 percentage points since December 2013. About 42% were performing without restructuring, and another 48% were performing after restructuring. Of non-performing corporate loans, 3% are frozen, 1% in enforcement proceedings, 1% in restructuring, 1% in collections, and 4% are classified as other types of non-fulfilment. *Default among small and medium-sized companies is now similar to that among large firms*, but as has been reported in previous issues of *Financial Stability*, the banks prioritised large firms at the beginning of the restructuring process.

## Financial market entities

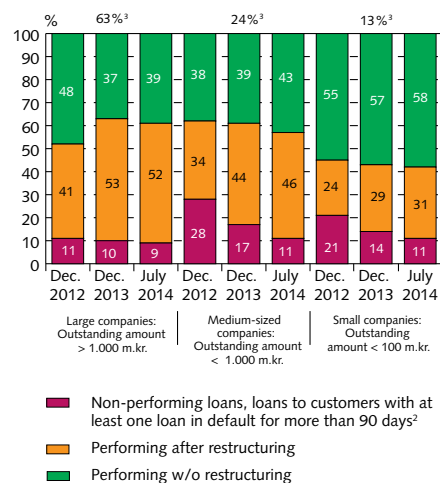
### Financial system structure

- Total financial system assets<sup>20</sup> have increased slightly (0.4%) in real terms year-to-date, to 8,755 b.kr. as of end-June.* Earlier in this report is an analysis of the operations of Iceland's commercial banks, which constitute 35% of the financial system, as well as a discussion of their assets and liabilities. This section discusses savings banks, the Housing Financing Fund (HFF), and pension funds, whose combined assets comprise about 42% of the financial system.
- In June 2014, the stock of loans granted by resident entities to households and businesses was 3,659 b.kr., or 189% of GDP, after declining 6 percentage points since year-end 2013.* In real terms, the loan stock declined by 2.1% in the first half of the year. Private sector debt is therefore still declining, although there is a discernible increase in net DMB lending. Since the beginning of 2013, there has been virtually no change in real and nominal interest rates on indexed and non-indexed loans, but the real cost of non-indexed loans has increased because of declining inflation and inflation expectations.

20. The financial system consists of the banking system, miscellaneous credit undertakings (including the Housing Financing Fund), pension funds, insurance companies, mutual funds, investment funds, and institutional investment funds, and Government credit funds.

Chart 50

Status of the three largest commercial banks' corporate loans, by claim amount<sup>1</sup>

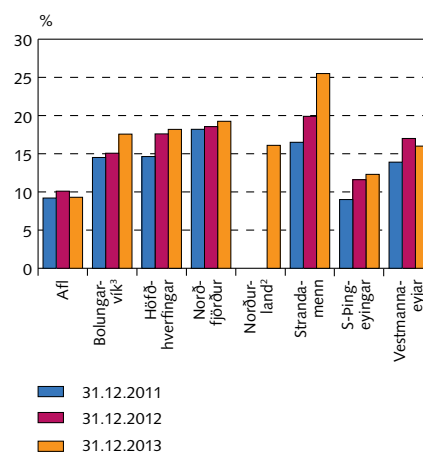


1. Parent companies, book value. 2. Non-performing loans are defined as loans in default for more than 90 days or deemed unlikely to be paid. The cross-default method is used; that is, if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing. 3. Percentage of total loans for each size category.

Source: Financial Supervisory Authority.

Chart 51

Saving banks' capital adequacy ratios<sup>1</sup>



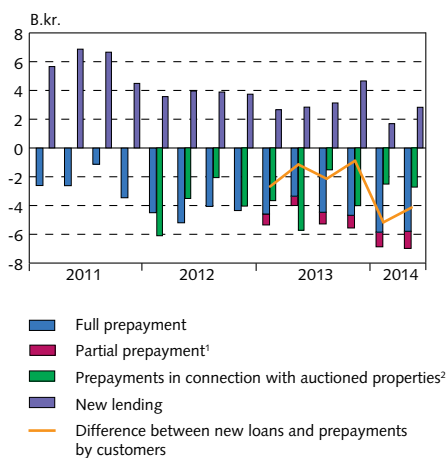
1. Consolidated figures. Capital base as % of risk-weighted base. 2. Sparisjóður Svarfdæla and Sparisjóður Þórshafnar og nágrennis merged with Sparisjóður Norðurlands in 2013. 3. In July 2013, the Financial Supervisory Authority approved the merger of Sparisjóður Bolungarvíkur and Sparisjóður Norðurlands.

Sources: Saving banks' annual financial statements.



Chart 52

Prepayments by HFF customers and new loans

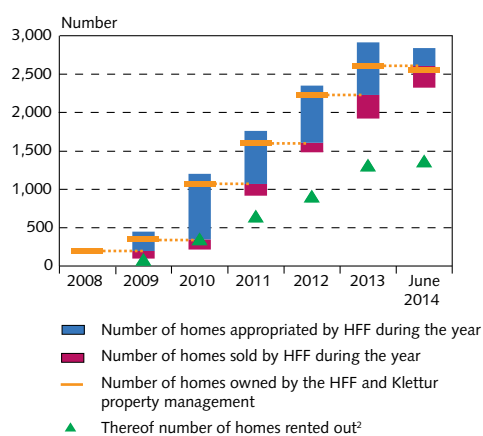


1. Data for 2011 and 2012 not available. 2. Data for 2011 not available.

Source: Housing Financing Fund.

Chart 53

Residential properties owned by the Housing Financing Fund¹



1. Consolidated accounts. 2. The Housing Financing Fund began renting out residential property in March 2009. Klettur property management began renting out residential property in the beginning of 2014.

Sources: HFF annual financial statements and monthly reports.

Table 1 Table Financial system assets

	31.12. 2010	31.12. 2011	31.12. 2012	31.12. 2013	30.6. 2014	Change from 31.12. 2013
<b>Assets, b.kr</b>						
<b>Banking system¹</b>	3,878	4,402	3,862	3,888	3,898	10
thereof Central bank of Iceland	1,114	1,466	902	815	782	-33
thereof commercial banks	2,627	2,875	2,903	3,015	3,060	44
thereof savings banks	137	60	57	58	56	-2
<b>Other credit institutions</b>	1,129	1,097	1,076	1,067	1,064	-4
thereof Housing Financing Fund	836	864	876	863	847	-16
<b>Pension funds</b>	1,989	2,169	2,437	2,696	2,773	77
<b>Insurance companies</b>	138	145	155	165	169	5
<b>Mutual funds, investment and institutional funds</b>	284	516	583	618	634	16
<b>State loan funds</b>	161	171	192	210	217	7
<b>Total assets</b>	7,579	8,500	8,304	8,643	8,755	111

1. The banking system consists of commercial banks, saving banks and the Central Bank of Iceland. Internal trades between the Central Bank of Iceland and other parties are excluded.

Source: Central Bank of Iceland

### Savings banks continue to decline in number

- At the end of June, the savings banks' total assets amounted to just under 56 b.kr., after declining by nearly 2.4 b.kr. in real terms since year-end 2013. In June 2014, the *Financial Supervisory Authority approved the merger of Sparisjóður Bolungarvíkur and Sparisjóður Norðurlands, leaving a total of seven savings banks in operation*. According to the savings banks' interim financial statements for 2014, four of them were operating at a profit, with returns on assets (ROA) ranging from 0.2% to 0.8%. Their capital ratios range from 9.9% to 25.2%, according to their H1/2014 interim accounts. According to the Act on Financial Undertakings, their capital ratios must be at least 8%, but based on the Supervisory Review and Evaluation Process (SREP), the Financial Supervisory Authority requires a higher ratio of those savings banks that have been evaluated.

### HFF loan portfolio continues to contract

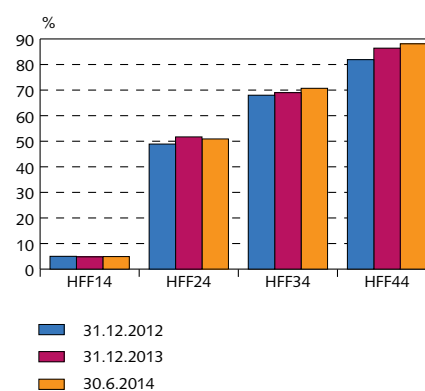
- At the end of June 2014, HFF assets totalled 847 b.kr. Loans accounted for 89% of that total, or 754 b.kr. In real terms, the Fund's assets have declined by just over 24 b.kr. year-to-date, largely due to a 21 b.kr. reduction in lending. At the same time, the Fund's prepayment problems have continued to escalate, with prepayments totalling 13.8 b.kr. in the first half of the year, as opposed to 10.8 b.kr. in H2/2013. *Concurrent with increased prepayments in the first half of the year, new HFF lending contracted by over 3 b.kr. in comparison with H2/2013*. In mid-September, the Minister of Social Affairs and Housing approved regulatory amendments raising the ceiling on HFF loans to individuals from 20 m.kr. to 24 m.kr., raising the maximum loan-to-value ratio from 40% to 60% of the official property value, and authorising lending to individuals for the purchase of property with a maximum official property value of 40 m.kr.

- In January, Klettur Property Management was established as a subsidiary of the HFF. *The establishment of the leasing company separated the operation of 450 rental properties from other HFF activities.* In the first half of the year, the HFF sold 283 properties but appropriated 234. The number of properties appropriated by the Fund has fallen slightly since H2/2014, although property sales are relatively unchanged. At the end of June, 2,557 properties were owned by the HFF and its subsidiaries. This number is broadly unchanged from the beginning of the year.
- Bonds issued by the HFF totalled 820 b.kr. as of end-June, after declining by 14 b.kr. in the first half of the year. *No HFF bonds have been issued since January 2012, and there are no plans to issue bonds this year, other things being equal.*
- According to the Fund's monthly report for July, *10.9% of loans were frozen or in default*, down from 12.6% in December 2013. Further analysis of default can be found in the section entitled *DMB assets*.
- In H1/2014, the Housing Financing Fund recorded a loss in the amount of 1.3 b.kr., in spite of positive changes in real estate valuations in the amount of just over 443 m.kr. *The accumulated loss on HFF's operations since 2008 is now 57 b.kr.* According to the fiscal budget proposal for 2015, contributions to the HFF will be cut by 1.2 b.kr. The contribution to offset the accumulated problems due to the Fund's financial position has been reduced from 4.5 b.kr. to 2 b.kr.; however, the contribution to compensate for the Fund's deteriorating interest differential in the wake of the Government's indexed debt relief package has been increased by 1.3 b.kr.

#### The pension funds' investment need remains substantial<sup>21</sup>

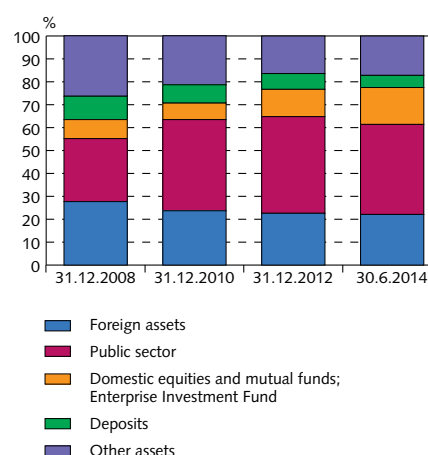
- *At the end of June, net pension fund assets totalled 2,742 b.kr., or 141% of estimated year-2014 GDP.* In the first half of 2014, net assets increased by 2.1% in real terms, about the same as in H1/2013.
- *Marketable bonds, which account for 46% of pension fund assets, appreciated by just over 2.4% in real terms in the first half of the year, to a total of 1,268 b.kr. at the end of June.* HFF bonds account for half of the marketable bonds, but the share of HFF bonds declined by about a percentage point from the beginning of the year, even though the pension funds' proportional holdings in HFF34 and HFF44 bonds rose over the same period. Holdings of other marketable bonds increased markedly in H1/2014, specifically to include bonds issued by investment funds and institutional investment funds.

Chart 54  
Pension funds' share of outstanding HFF bonds



Source: Housing Financing Fund.

Chart 56  
Pension funds' assets<sup>1</sup>



1. Figures are based on the pension funds' balance sheet summaries, which are gathered by the Central Bank of Iceland. Monthly data are collected from a sample of the largest Icelandic pension funds, and total pension fund assets are estimated from these data. Based on preliminary figures.

Source: Central Bank of Iceland.

21. Based on pension funds' balance sheet summaries, collected by the Central Bank of Iceland. Monthly data are compiled from samples from the largest pension funds in Iceland and total assets are estimated from these data. Based on preliminary figures.

- *The pension funds' foreign assets totalled just over 612 b.kr. in June, after increasing by about 16 b.kr. since the beginning of the year, in spite of a 2% appreciation of the króna over the same period. Since 2008, the funds' foreign assets have declined somewhat as a percentage of total assets.*
- *In recent years, the pension funds' opportunities for investment in equities have increased as the equity market has grown, and domestic shares and mutual funds (including holdings in the Enterprise Investment Fund) now account for just over 16% of total assets. As a result of this increase in investment options, indexed assets and deposits have contracted as a share of total assets. The pension funds' investment options are still limited by the capital controls, however, and their positive cash-flow creates the risk of excessive increases in the price of the assets in which they are permitted to invest.*

## Settlement of the failed banks' estates

### Increase in book value of estates' ISK assets

- *As of end-June, the book value of Glitnir, Kaupthing, and LBI's assets was estimated by their winding-up committees at 2,563 b.kr., in addition to 26 b.kr. held in escrow for payment of priority claims that are still disputed. *The estates' assets and escrow balances totalled 2,589 b.kr., an increase of 37 b.kr., or 1.5%, from the beginning of the year, owing to the appreciation of their foreign assets and their holdings in the new banks.**
- *The book value of their domestic assets has increased 26 b.kr. in H1, and are now booked at 991 b.kr. Of that total, the estates' króna-denominated assets have appreciated by 26 b.kr., while foreign-denominated asset values are unchanged. The rise is due almost entirely to an increase in the value of their holdings in the*

Table 2 Book value of Glitnir, Kaupthing, and LBI assets as of 30 June 2014

B.kr.	Domestic assets			Foreign assets	
	in ISK	in FX	Total	in FX <sup>1</sup>	Total assets
Liquid assets	124	158	282	1,114	1,396
Loans to customers	38	17	55	297	352
Loans to financial institutions	0	0	0	39	39
Securities	36	45	81	92	173
Derivatives	11	0	11	13	24
Compensation bonds from new bank for asset transfer	0	229	229	0	229
Holdings in subsidiaries and affiliates	305	9	314	12	326
- thereof stakes in the new banks	305	0	305	0	305
Other assets	7	10	17	6	23
Total	521	468	989	1,574	2,563
Position in escrow accounts	2	0	2	24	26
Assets and position in escrow accounts	523	468	991	1,598	2,589
Domestic assets backed by foreign collateral	11	35	46	0	0

1. An insignificant portion of foreign assets are in ISK.

Sources: Financial information from Glitnir, Kaupthing and LBI; Central Bank of Iceland.

new banks. Domestic assets recognised in krónur are recorded at 523 b.kr., and foreign-denominated assets are valued at 468 b.kr. The estates' definitions of domestic foreign-denominated assets are not entirely comparable from one estate to another, but they are based primarily on the balances on foreign currency accounts in domestic financial institutions as of the end of the day on 12 March 2012, the date the estates were subjected to the Foreign Exchange Act, and outstanding foreign-denominated domestic assets at the same time. A portion of the estates' foreign-denominated deposits in Iceland could stem from recoveries on foreign assets, and recoveries on domestic assets recognised in foreign currency could be held abroad.

### Liquid funds comprise over 70% of the estates' foreign assets

- *The estates' liquid funds and escrow account balances, which are the equivalent of liquid funds, total 1,423 b.kr., or 55% of their total assets. About 24% of the estates' króna-denominated domestic assets are classified as liquid funds, as are 34% of foreign-denominated domestic assets and 71% of foreign assets. Two of the estates hold all of their liquid funds in deposit accounts with financial institutions in Iceland and abroad, and the third holds a portion of its liquid funds in domestic and foreign government bonds and bills. In part because they have abundant liquidity, all of the estates have requested exemptions from the Foreign Exchange Act in order to make payments to creditors. LBI has requested authorisation to pay a total of 399.2 b.kr. to priority creditors, and in autumn 2012 Glitnir and Kaupthing requested exemptions in order to negotiate composition agreements.*
- *The majority of the estates' assets that have not been converted to liquid funds are invested in a few assets. A large share of the estates' loans have been paid off or refinanced through currently operating financial institutions. In most instances, the remaining assets are difficult to sell or are assets for which the estates function as both owners and lenders. The book value of the estates' holdings in Arion Bank and Íslandsbanki accounts for roughly 77% of their domestic króna-denominated fixed assets, and the Landsbankinn bonds and the Avens bond issued by the Treasury account for over 86% of their domestic foreign-denominated fixed assets. Comparable concentration has taken place in the estates' foreign fixed assets, particularly in the case of Kaupthing.*

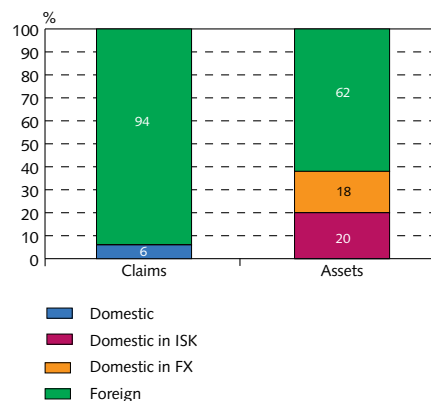
### Uncertainty about the next steps in winding-up proceedings slows down asset sales

- The book value of the estates' shareholdings excluding subsidiaries and affiliated companies was 122 b.kr. at year-end 2012 and is now 113 b.kr. At the same time, the book value of their holdings in subsidiaries and affiliates has risen from 254 b.kr. to 325 b.kr., in part because of valuation changes in the holdings in the new banks. Although there are significant payments and refinancing of the estates' loans, which increases their liquidity position, the fig-

Chart 57

Estimated domestic/foreign breakdown of assets and claims of DMBs in winding-up proceedings

Book value of assets 30.06.2014

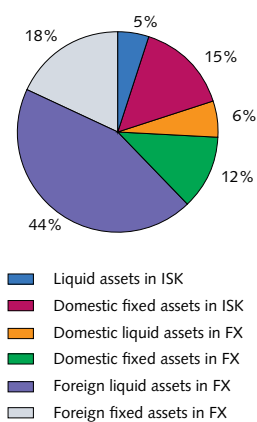


Sources: Claims lists and financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

Chart 58

Assets DMBs in winding-up proceedings

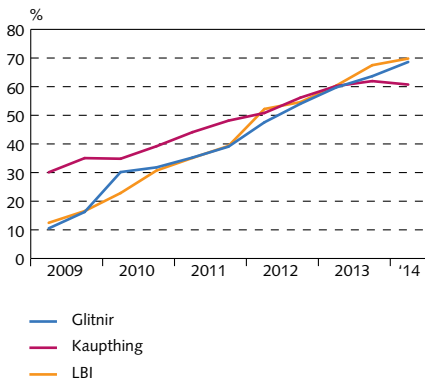
Book value 30.06.2014



Sources: Financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

Chart 59

Estimated rate of liquid assets against total assets, adjusted for payments to creditors<sup>1</sup>

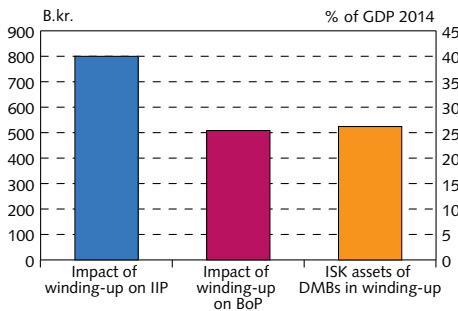


1. The estates' financial statements are not fully comparable between periods or estates. Early in the period estimated set-off were not included in the financial statement. No consideration is given to exchange rate changes of payments after they have been disbursed. Sources: Financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

Mynd 60

Impact of calculated settlement of DMBs in winding-up proceedings on the IIP and balance of payments and estates' ISK assets<sup>1</sup>

Book value of assets 30.06.2014

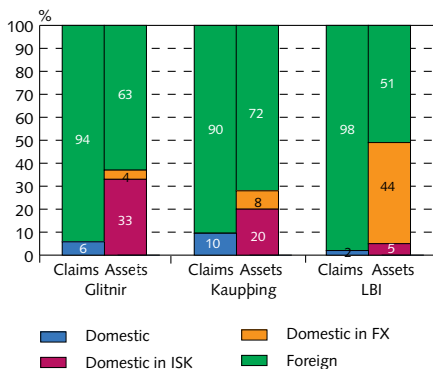


1. Assuming equal distribution of assets among creditors; no consideration is given to future tax payments or other issues pertaining to the settlement of the estates. Sources: Claims lists and financial informations Glitnir, Kaupthing and LBI; Statistics Iceland; Central Bank of Iceland.

Chart 61

Estimated domestic/foreign breakdown of assets and claims of DMBs in winding-up proceedings

Book value of assets 30.06.2014



Sources: Claims lists and financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

ures above show that the estates have been hesitant to sell assets because liquid assets, particularly those denominated in foreign currency, generate very limited returns at present. *The uncertainty about the next steps in the winding-up of the estates appears to have dampened the winding-up committees' interest in selling assets.*

- *Glitnir and LBI have now converted about 70% of the estates' original asset portfolios to liquid funds, and Kaupthing has converted roughly 60%. As Chart 59 shows, asset conversion is moving faster at Glitnir and LBI than at Kaupthing and has done so from the beginning of the winding-up proceedings, as Glitnir and LBI have converted an average of nearly 6% of their original asset portfolios per six-month period, as opposed to just over 3% for Kaupthing. The asset portfolios differ from one another, however, and there is more market risk in the Kaupthing portfolio than in the other two, which may explain the difference in conversion rates.*

#### A solution must be found for the estates' ISK assets

- The calculated settlement of the estates – assuming that fixed assets will be sold for book value and that the ratio of domestic to foreign claims will remain unchanged, and ignoring other factors such as possible payment of bank taxes – shows that settling the estates will have a negative impact on Iceland's international investment position in the amount of just under 800 b.kr., or about 41% of GDP. This is equivalent to the difference in the value of domestic assets that will revert to foreign creditors, on the one hand, and foreign assets that will revert to domestic creditors, on the other. The impact on the balance of payments is somewhat less, at 510 b.kr., or 26% of GDP, because a portion of the estates' foreign-denominated domestic assets are backed directly or indirectly by foreign assets. Residents with foreign-denominated debts to the estates own substantial foreign assets that could be sold upon settlement. Furthermore, the estates' foreign-denominated sight deposits are backed by foreign liquid assets, according to the Central Bank's liquidity rules. *The impact of the estates' settlement on the balance of payments is virtually the same as their ISK assets.* All of the above amounts will decline by 110 b.kr., or 6% of GDP, with the payment of bank taxes.

- *The composition of assets and the ratio of domestic to foreign claims differ from one estate to another. Domestic claims account for an insignificant share of claims against the LBI estate, as do the estate's króna-denominated assets net of bank taxes. Glitnir and Kaupthing's króna-denominated assets constitute a somewhat larger share than the share of domestic claims net of bank taxes, as the estates' holdings in Arion Bank and Íslandsbanki are recognised in krónur.*

## Appendix I

### FSI core indicators for the three largest commercial banks (FSI)<sup>1</sup>

%	2011		2012		2013		2014
	Q2	Q4	Q2	Q4	Q2	Q4	Q2
Regulatory capital to risk-weighted assets <sup>2</sup>	23.5	21.6	23.1	25.0	25.9	26.2	27.2
Regulatory Tier 1 capital to risk-weighted assets <sup>2</sup>	21.0	19.4	20.9	22.6	23.6	24.0	25.0
Return on assets <sup>2</sup>	3.3	1.1	2.5	2.4	2.3	2.2	3.2
Return on equity <sup>2</sup>	20.2	6.7	15.5	13.8	13.0	12.1	17.5
Interest margin to gross income <sup>2</sup>	47.1	53.9	50.3	48.8	41.7	45.2	46.5
Non interest expenses to gross income <sup>2</sup>	88.8	108.1	79.0	79.9	77.2	77.5	66.4
Liquid assets to total assets <sup>3</sup>							24.7
Net open position in foreign exchange to capital <sup>3</sup>	61.1	22.6	18.2	7.7	3.6	6.3	4.1

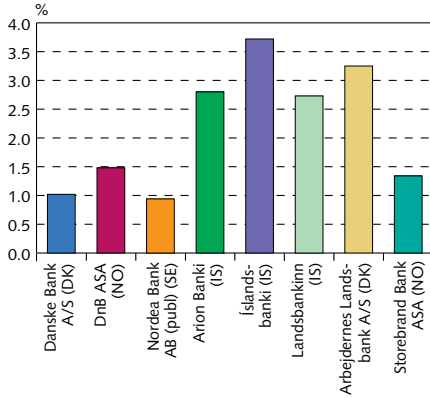
1. The Central Bank intends to publish core indicators of financial stability in collaboration with the IMF. All definitions used by the Central Bank accord with IMF definitions or have been approved by the IMF. These are still provisional figures, which could change, and comprise only part of the indicators. 2. Consolidation, operating expenses and net operating income calculated in accordance with definitions of the European Banking Authority (EBA). 3. Parent company, definitions differ from those in the Central Bank's rules.

Sources: Financial Supervisory Authority, Central Bank of Iceland.

## Appendix II

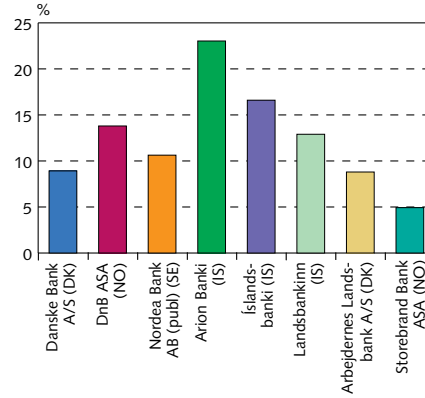
### Nordic comparison

Chart 1  
Net interest margin June 2014<sup>1</sup>



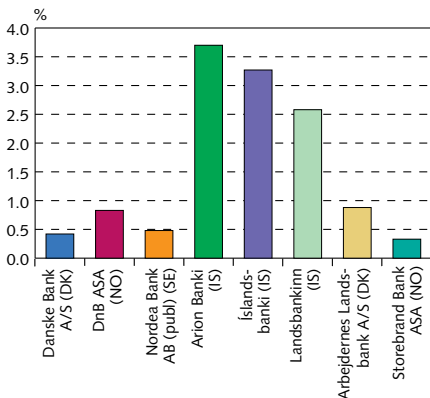
1. Islandsbanki's large net interest margin is due largely to a difference in financial reporting methods used by the banks; Islandsbanki uses a different method for redemption of interest income from transferred loans.  
Source: Bankscope.

Chart 2  
Return on equity June 2014



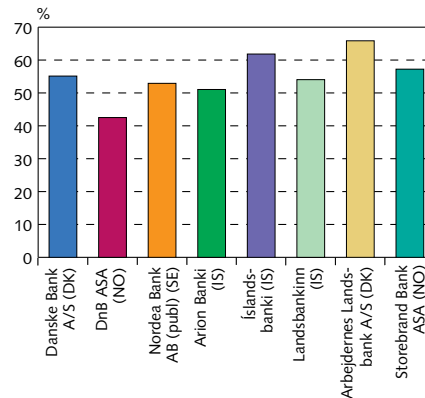
Source: Bankscope.

Chart 3  
Return on total assets June 2014



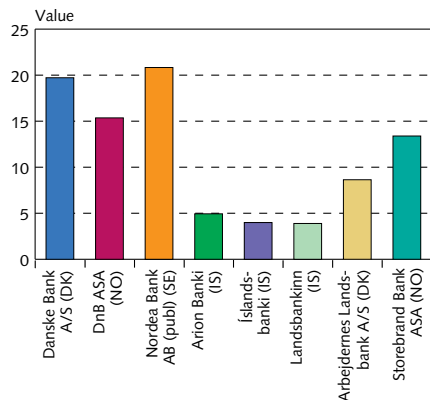
Source: Bankscope.

Chart 4  
Cost-to-income June 2014



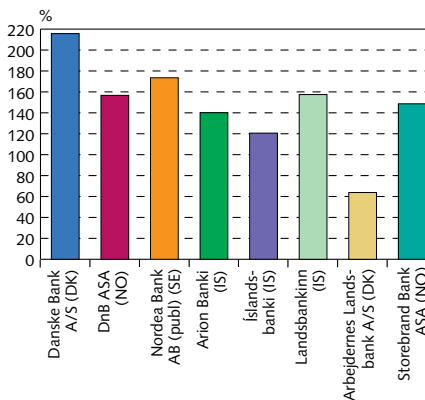
Source: Bankscope.

Chart 5  
Leverage June 2014  
Debt as proportion of equity



Source: Bankscope.

Chart 6  
Loans/ customer deposits June 2014



Source: Bankscope.