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Profitability and financial position of banks in 1999

The past year was characterized by record profits, expanded activities and a massive increase in the market value of finance companies. Because of various revenues which are subject to fluctuations, it cannot be concluded that operational efficiency is increasing permanently. Credit expansion and the banks' own investment exposure have led to increasing funding in domestic and foreign markets and lower equity ratios. The year was exceptionally good, but warning signs can be seen.

Record profits ...

A common feature of the commercial, investment and savings banks² in 1999 was that almost without exception they reported record profits. The main explanations are expanded activities with an unchanged interest rate margin, new sources of revenue and low loan losses due to the prevailing economic boom.

Return on equity³ has been increasing rapidly in recent years. The commercial banks produced an ROE of 19.3% last year compared with 16.6% in 1998 and 9.3% in 1997. The ROE at the savings banks was 13.5% last year but 8.7% in 1998 and 1.9% in 1997. Average ROE at the investment banks was 21.3%, as against 11.1% in 1998.

... on account of expanding activities ...

One of the main reasons for the banks' high profits has been their rapid expansion. Balance sheet totals at the commercial banks grew by 25.4% last year, provisional figures for the savings banks suggest their growth was 26.7% and the investment banks grew by 23.6%. This occurred at the same time as GDP increased by just under 9% in nominal terms.

... with unchanged interest rate margins ...

If interest rate margins had narrowed alongside the balance sheet growth, a smaller revenue increase would have taken place. This did not happen, and margins remained steady during the year after continuous reductions in recent years among the commercial banks and savings banks. The interest rate margin, i.e. net interest income as a ratio of the balance sheet average, was 3.6%. Although the average margin remained unchanged between the years, the pattern varied from one bank to another: It rose slightly at Landsbanki and Íslandsbanki, but fell at Búnaðarbanki. There is a special explanation for this pattern, in that these banks held different amounts of assets in indexed marketable securities. Rises in indexation on these securities, which were high last year, are entered in the accounts as interest income, while losses due to a rise in the required yield are posted to changes in trading income.

Between the years, the interest rate margin narrowed slightly at FBA, but rose at the Cooperative Fund. The average interest rate margin for investment banks as a whole has no informational value, because of the special position of Kaupthing with its negative margin. This was because Kaupthing borrows primarily to finance its own trading investments in bonds and equities, and lends for this purpose to customers on a much smaller scale. Almost half of its exposure at year-end was due to equity. Kaupthing's own share portfolio and the margin between selling and buying rates in its trading create an item which is

1. The author is Advisor to the Governors of the Central Bank of Iceland.

2. This article deals with the three commercial banks excluding Icebank for statistical reasons, and with the savings banks and three investment banks, i.e. the Icelandic Investment Bank (FBA), Kaupthing and the Cooperative Fund.

3. Return on equity is defined here as the ratio of profit to the average of equity between the beginning and end of the year, less profit.

Table 1 From the financial companies' annual accounts

	1995	1996	1997	1998	1999	% increase in 1999
<i>Commercial banks</i>						
<i>In m. kr.</i>						
Profit	709	1,233	1,510	2,975	4,493	51.00
Total assets at year-end	215,129	242,498	281,588	354,628	444,792	25.40
Stockholders' equity at year-end	14,870	16,164	17,685	23,332	27,604	18.30
<i>Ratios in %</i>						
Net interest income / average balance sheet total	4.37	4.15	3.93	3.44	3.42	-0.02
Operating expenses / net operating incomes	72.05	71.10	70.17	69.67	65.58	-4.09
Total equity ratio	9.97	9.73	9.03	9.25	9.73	0.49
Equity ratio (Tier 1)	9.53	8.82	8.12	8.49	8.26	-0.23
Equity ratio excl. subordinated loans	8.63	8.00	7.31	7.35	6.93	-0.42
<i>Savings banks</i>						
<i>In m.kr.</i>						
Profit	561	641	137	658	1,204	83.10
Total assets at year-end	52,050	58,201	70,415	91,839	116,373	26.70
Stockholders' equity at year-end	6,112	6,929	7,440	8,375	10,680	27.50
<i>Ratios in %</i>						
Net interest income / average balance sheet total	5.52	5.26	4.80	4.29	4.22	-0.07
Operating expenses / net operating incomes	65.64	67.65	69.58	71.17	60.64	-10.53
Total equity ratio	16.11	15.23	13.13	12.01	11.59	-0.42
Equity ratio (Tier 1)	17.79	17.31	15.48	12.94	12.14	-0.80
Equity ratio excl. subordinated loans	16.01	14.53	11.92	10.02	8.74	-1.28
<i>Investment banks¹</i>						
<i>In m.kr.</i>						
Profit .....	.	1,013	1,460	1,128	2,361	109.40
Total assets at year-end .....	.	52,511	66,189	101,771	125,808	23.60
Stockholders' equity at year-end .....	.	10,476	12,562	11,278	13,283	17.80
<i>Ratios in %</i>						
Net interest income / average balance sheet total .....	.	2.33	1.93	1.48	1.21	-0.27
Operating expenses / net operating incomes .....	.	36.13	34.66	48.72	40.32	-8.40
Total equity ratio .....	.	20.72	20.46	14.16	13.00	-1.16
Equity ratio (Tier 1) .....	.	21.21	20.42	13.87	12.47	-1.41
Equity ratio excl. subordinated loans .....	.	20.72	19.96	13.54	12.40	-1.14

1. Fisheries Investment Fund, Industrial Loan Fund and The Icelandic Export Guarantee Fund are included in 1996-1997.

Source: The Financial Supervisory Authority.

entered in the accounts as trading income rather than as interest income offsetting interest expenses.

... and rises in other income

Fluctuations in the profitability of commercial banks and savings banks used to depend on their perform-

ance in credit intermediation, i.e. deposits and lending. With the advent of new services and participation in operations outside the traditional realm of credit institution activities, Icelandic commercial, investment and savings banks have been broadening their revenue base. An analysis of net income by

Table 2 Breakdown of financial institutions' net income by source (%)

	1995	1996	1997	1998	1999
<i>Commercial banks</i>					
Net interest income.....	65.3	62.9	61.5	58.3	59.6
Other operating income	34.7	37.1	38.5	41.7	40.4
Dividends from shares, other holdings etc.	1.7	2.4	2.7	2.4	2.6
Net commissions	25.8	26.7	26.2	24.7	24.7
Value adjustm. of other.... financial operations.....	3.4	5.3	7.0	12.7	9.8
Other operating income ...	3.8	2.6	2.6	2.0	3.3
<i>Savings banks</i>					
Net interest income.....	70.7	69.5	68.2	64.8	56.8
Other operating income	29.3	30.5	31.8	35.2	43.2
Dividends from shares, other holdings etc.	4.3	6.4	6.8	10.5	22.4
Net commissions	21.5	20.9	20.7	19.6	17.1
Value adjustm. of other.... financial operations.....	0.7	0.8	1.9	3.2	1.0
Other operating income ...	2.8	2.3	2.3	2.0	2.7
<i>Investment banks¹</i>					
Net interest income.....	80.1	51.0	36.9	36.5	23.3
Other operating income	19.9	49.0	63.1	63.5	76.7
Dividends from shares, other holdings etc.	7.7	15.8	23.2	3.2	20.1
Net commissions	1.4	17.3	19.1	19.1	23.8
Value adjustm. of other.... financial operations.....	-0.7	8.1	13.8	39.3	31.1
Other operating income ...	11.5	7.8	7.0	1.9	1.8

1. Fisheries Investment Fund, Industrial Loan Fund and The Icelandic Export Guarantee Fund are included in 1996-1997.

Source: The Financial Supervisory Authority.

source reveals that almost 60% derives from interest income and just over 40% from other sources at the commercial banks and savings banks, while other income accounts for 77% of the total at the investment banks.

The largest factor in other income is fees for a wide range of services, charged according to tariffs. At commercial banks and savings banks, this item accounted for 23% of net operating income in 1999. Net income from trading activities accounted for a further 7.6% in 1999, having decreased by three percentage points between the years. This is explained by a reduction in the value of the banks' bond port-

folios in 1999, following a large income from trading in marketable securities the year before. During 1999, the required return on housing bonds remained unchanged at the beginning and end of the year at 4.7%, while the value of savings bonds dropped in inverse proportion to the required return on them. Thus the required return on 5-year savings bonds rose by just over 20 points, and on 10- and 20-year bonds by 40 points.

On the other hand, income from trading in equities and other holdings rose sharply. It accounted for 7.6% of other income, having grown by 3.4 percentage points between the years. This income item was particularly noticeable at the savings banks, on account of their holding in Kaupthing and liquidation of assets such as Scandinavian Holding S.A. Share prices rose substantially last year, and the market value of companies listed on the ICEX-15 index went up by 45%.

Foreign exchange trading has also grown exponentially in recent years. The banks' main sources of capital gains income in 1999 were foreign exchange and equity trading. This income is prone to fluctuations, and since it is based on turnover and particularly on exposure, it can just as easily produce a loss as a profit.

Costs are rising ...

Operating expenses rose by 15% at the commercial banks last year, 23% at the savings banks and 42% at the investment banks. Around half of operating expenses are accounted for by payroll, which increased at a slower rate than other expense items. A total of 159 new full-time positions were added at banks during the year, representing an increase of 5.5%. Staffing growth was particularly marked at investment banks and savings banks, while Landsbanki reduced staff.

... but the cost ratio is falling ...

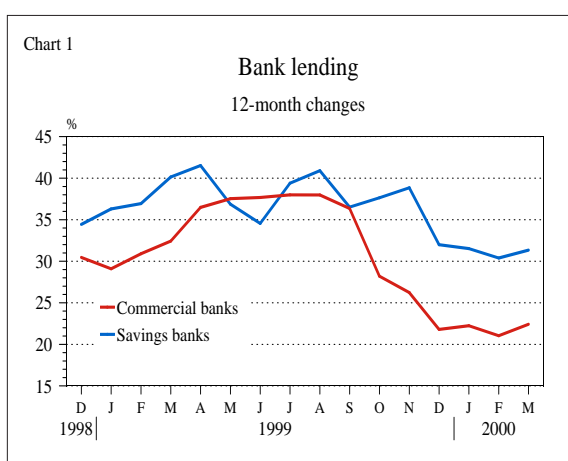
The ratio of operating expenses to net operating income amounted to 65.6% at commercial banks, 60.6% at savings banks and 40.3% at investment banks. It fell in all cases, but was especially noticeable at savings banks. Unlike the other banks, the savings banks had witnessed a continual rise in the cost ratio over the period 1995-1998. In 1995, their cost ratio of 65.6% was much lower than the 72.1%

average among the commercial banks, but it then rose annually to reach 71.2% in 1998, when the commercial banks had brought this figure down to 69.7%. It was more the large rise in income items which are prone to fluctuations, rather than cost-cutting, which enabled the banks to show an improvement in these ratios last year. Thus this reduction cannot be interpreted as a sign of a permanent improvement in the banks' operational efficiency.

... and provisions for loan losses are increasing

Provisions for loan losses increased last year, especially at the savings banks where they rose by 83% to 1,291 m.kr. from 1998. By comparison, the commercial banks posted 2,640 m.kr to loan loss accounts and the investment banks 1,922 m.kr. As a proportion of lending, accumulated loan loss provisions amounted to 2.1% at the end of 1999.

Despite the large sums involved here, neither the provisions for loan losses for the year nor the ratio of these accounts to lending can give an absolute indication of how well equipped the banks and savings banks are for withstanding shocks. This can only be done by assessing the quality of lending and other liabilities undertaken by each respective institution. One barometer of potential problems is customer defaults. A rough check suggests that these have fallen, but the Central Bank will begin collecting statistics about defaults on loans from the present year onwards.



Rapid growth in lending ...

During the year, lending grew by 20.9% at the commercial banks, 32% at the savings banks and 20.7% at the investment banks. Their total lending rose by 23.2%, or 75.3 b.kr, and the bulk of the increase was in corporate credit.

Excessively rapid credit growth represents a risk, and the continuing fast growth in lending this year, especially by savings banks, is a cause for concern. A rough benchmark to evaluate this risk is to see whether a credit institution's balance sheet grows by more than 15% in the course of a year. All the commercial banks, FBA and the savings banks exceeded this reference last year.

... in particular foreign-denominated lending ...

Credit expansion was particularly marked in foreign-denominated lending. Loans denominated in foreign currencies increased by 30.4 b.kr., or 32.8%, at the commercial banks and savings banks. As a proportion of their total lending, foreign-denominated loans now amount to 31%. Foreign-denominated lending by investment banks grew by 10.5 b.kr., or 26.4%, and now accounts for 56.7% of their total lending.

Last year a new line of business was undertaken by Icelandic credit institutions. To an increasing extent, they are lending overseas or purchasing foreign securities, both equities and bonds. This exposure is financed by foreign borrowing. Such business was particularly noticeable at FBA, which deployed 22% of its new lending during the year on such investments; two-thirds of this credit was granted to third parties not related to Iceland.

... and exposure has increased

The term "exposure" is used here for a bank's own net assets in financial contracts of any kind, which it has acquired to sell at a profit. Through large-scale market trading in domestic and foreign securities, the banks and savings banks have increased their exposure. In part this is the result of market-making activities whereby financial institutions oblige themselves to make buying and selling bids. The banks' portfolios of equities and marketable securities amounted to 60.8 b.kr. at the end of 1999, an increase of 20.8% between the years. This figure does not include their holdings in associated and related companies.

Customer deposits ...

Deposits have always been the main source of funding for commercial banks and savings banks. Ever since 1994, deposits have been falling as a proportion of the commercial banks and savings banks' total liabilities. At the same time, deposit forms have been changing and in part they have become more liquid. Just under one-third of deposits are now comprised of various types of market accounts which are linked to T-bill interest rates. In addition, large sums are invariably competitively bid for and it is often a matter of definition whether this is classified as a deposit or not. Both these factors make banks more sensitive to fluctuations in market interest rates and the yield on other investment options. Savers are increasingly changing into investors.

... are an insufficient source of funding ...

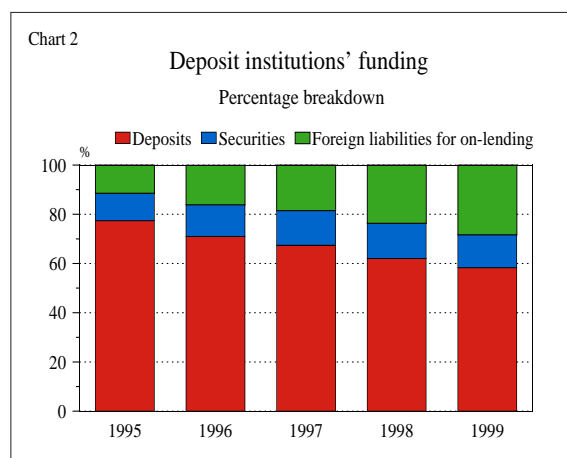
Deposits alone are insufficient to fund the credit institutions' activities. From the end of 1996 to the end of 1999 the commercial banks and savings banks' ratio of deposits to lending fell from 80% to 65%. Other funding has been needed to bridge the gap.

... so more capital is raised in the markets

Foreign borrowing and securities issues in the domestic and foreign markets have increasingly taken the place of deposits in recent years. Capital was raised in particular in foreign markets last year, as it was in 1998. Foreign borrowing grew by 51% at commercial banks and savings banks last year, and by 38% at investment banks. The ratio of foreign borrowing to lending and marketable securities was 35% at commercial banks and savings banks at the end of the year, and 70% at investment banks.

The heavy increase in foreign on-lending by Icelandic credit institutions is largely explained by lower interest rates on foreign loans than domestic ones. By way of comparison, the yield differential between domestic and international interbank markets was 3.45 percentage points at the beginning of 1999 and 5.90 at the end.⁴ Furthermore, the króna strengthened against the currency basket by the

4. The differential between yields on three-month interbank interest rates between Iceland and comparable rates among trading countries, weighted against the króna currency basket.



equivalent of 2.76% last year. In consequence, corporations, local government authorities and individuals have increased their foreign-denominated borrowing. One cause for concern is that a large number of new borrowers have entered the field who formerly obtained finance solely in Icelandic currency, and who have no revenues in foreign currency. They are thus taking an exchange rate risk at the same time as they benefit from reducing their interest expenses. The credit institutions themselves are subject to restrictions in rules on own foreign exchange risk set by the Central Bank, but could suffer loan losses if their customers later prove unable to meet repayments.

Off-balance sheet obligations have increased

Guarantees and other conventional off-balance sheet obligations have been boosted in recent years by derivatives involving currency and interest rates. The banks and savings banks' annual reports reveal the scope of assets and liabilities on account of such agreements and allow their equivalent value to be calculated in terms of lending. Lending equivalent is a risk parameter which gives an indication of the scope of activities, but is also determined by the length of the agreements. The longer the agreements, the more risk is involved and the higher the lending equivalent. Weighted by collateral risk, the lending equivalent of interest and currency derivatives rose between the years from 1,804 m.kr. to 3,265 m.kr. at the end of 1999 – an increase of 81%.

Equity grew ...

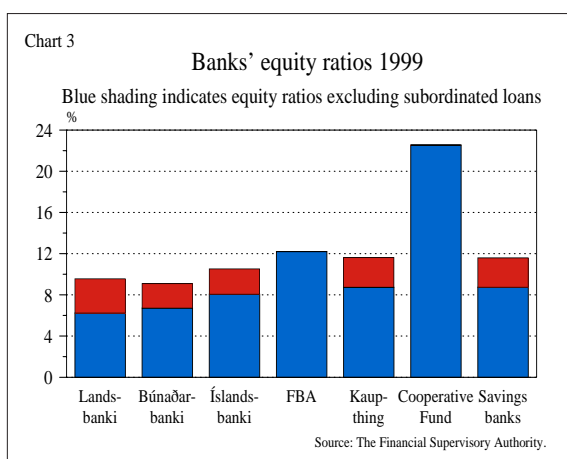
Stockholders' equity grew by 4,272 m.kr. at commercial banks, 2,305 m.kr. at savings banks and 2,005 m.kr. at investment banks. A reference for equity is provided by the risk base, which is a denominator of the equity ratio and includes total assets but also off-balance sheet items. This risk base has risen considerably in recent years in the climate of credit expansion and exposure in which the banks and savings banks have taken part.

... partly on account of subordinated loans ...

In order to offset expanded activities and their consequent raising of the risk base, credit institutions have taken advantage of the possibility for issuing subordinated loans which may be classified as equity under specific rules. Last year all the commercial banks took such loans, and Kaupthing made a new capital stock issue.

... but equity ratios keep on falling

The overall equity ratio of the commercial banks was 9.7%, while it was 11.6% for savings banks and 12.9% for investment banks. FBA has been reducing its equity ratio in order to boost its return on equity, but the other investment banks have strengthened their positions. Commercial banks' capital adequacy ratios have remained fairly stable in recent years, while a continual reduction has taken place at savings banks since 1994. Excluding subordinated loans, equity ratios have fallen significantly in recent years, as shown in Table 1 on p. 29.



One consequence of ongoing credit expansion is the fall in equity ratios, which leaves less leeway in the event of setbacks. A strong equity position is also a major factor in credit ratings, which is particularly important for credit institutions that rely increasingly on funding in foreign and domestic markets. Good profitability in recent years has not managed to counterbalance the expansion in activities which Icelandic credit institutions have chosen to undertake.

The market's assessment is ...

In examining the position of Icelandic banks, it is useful to take international credit ratings into account. All the commercial banks, plus FBA, are rated one category below the Treasury by Moody's with an A-3 rating for long-term liabilities and P-2 for short-term liabilities. This rating remained unchanged during the year.

At the same time, it is interesting to examine the equities market's assessment. While the ICEX-15 index rose by 45% last year, the index of financial and insurance companies showed even greater growth at 70%. The total market value of the listed banks amounted to 99 b.kr. at the end of the year, which is 2.5 times greater than their booked equity (Q-ratio).

... undervalued assets and ...

One explanation for this high Q-rate is the undervaluing of assets in the banks' accounts. It has been publicly stated⁵ that the equity of individual listed banks was undervalued by as much as 40% at the end of last year. A similar case for undervaluing may be argued for the unlisted investment banks and savings banks as well. This involves assessing the market value of holdings in other companies and the book or acquisition value of securities. Such an evaluation is not made in the financial statements, and hinges to a large extent on the volatile sales value of assets.

One factor in assessments of the value of banks until now has been the tax benefits of loss carry-forwards and dividend payments made in previous years. On account of large profits last year, the banks which have benefited from such tax concessions, i.e. Landsbanki, Íslandsbanki and FBA, have now uti-

5. Landsbanki Financial Consultancy, Presentation at Landsbanki on March 10, 2000.

lized them in full, so that all banks and savings banks will pay full tax on this year's operations.

... expectations of streamlining and greater profits

These large increases in the price of shares in the commercial banks and FBA last year reflect market expectations of streamlining and greater profitability. In króna terms, the banks and savings banks have produced record profits, yet the equities market

expects more. This implies confidence in a continuation to the economic boom and streamlining of operations, without allowing for any unforeseen loan losses or other operational setbacks. On the basis of the current price of shares in banks, the market is demanding an annual increase in their profits of 15-20% for the next 5-8 years. Such expectations imply that gains are thought possible through reorganization and mergers.