



FINANCIAL STABILITY

2012 • 2

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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.

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The Central Bank of Iceland, Kalkofnsvegur 1, 150 Reykjavík, Iceland

Tel: (+354) 569 9600, fax: (+354) 569 9605

E-mail: sedlabanki@sedlabanki.is

Website: www.sedlabanki.is

Editorial staff:

Sigríður Benediktsdóttir, Chairman

Gerður Ísberg

Guðmundur Kr. Tómasson

Guðríður Lilla Sigurðardóttir

Harpa Jónsdóttir

Jónas Þórðarson

Rannveig Sigurðardóttir

Sturla Pálsson

Tómas Örn Kristinsson

Þórarinn G. Pétursson

Þorsteinn Þorgeirsson

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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.

Foreword by the Governor

Little change in systemic risk

Four months have elapsed since the Central Bank published a detailed assessment of financial system risk in *Financial Stability 2012-1*. Despite a number of international developments, the picture presented there remains unaltered in major aspects. Financial system risk has declined in tandem with improvement in the economy, the progress of household and corporate debt restructuring, the stronger capital position of financial undertakings and their reduced balance sheet mismatch. Now as before, the main risk factors are linked to the uncertain global economic situation, including the eurozone crisis; the potential impact of capital account liberalisation on the króna exchange rate, the banks' liquidity and Treasury funding; the resolution of the banks currently in winding-up and its interaction with capital controls and effects on the new banks; the heavy debt service on foreign debt after 2014 of parties still lacking access to foreign capital markets; legal uncertainty; and the impact of possible political actions on financial undertakings and the quality of their loan portfolios.

Commercial banks' semi-annual reports for the first half of 2012 provide support for this picture. The capital ratios of the three large commercial banks, for instance, have risen still further from the beginning of this year until the end of June; in all three cases they are well above 20%, while the minimum set by the Financial Supervisory Authority (FME) is 16%. Their leverage ratio has also decreased and averages 4.8 compared to 30 prior to the financial collapse in 2008, after adjusting for that share of the banks' equity which was self-financed. At present a leverage ratio of 15-40 is the most common among large European banks. Mismatch in the banks' balance sheets has generally continued to decrease due to lower foreign currency imbalances. Restructuring of corporate and household debt has also progressed steadily, and non-performing loan ratios continue to decline, although more slowly for household debt as a result of rising defaults at the Housing Financing Fund (HFF). Non-performing loan ratios remain high, however, in both the historical and international context. This can be attributed in part to the uncertainty as to what loans are considered illegal exchange rate-linked loans and which are considered legal foreign currency loans, which has yet to be resolved. It is important to conclude household and corporate debt restructuring as soon as possible, and to reduce the banks' non-performing loan ratios to a more acceptable level. Without this, the possibility for the banks to regain access to foreign funding might be limited.

Other things remaining equal, debt service on FX loans by parties other than the Treasury will increase substantially in 2015, averaging 134 b.kr. annually in 2015-2018, or around 8% of GDP. The largest factor here is payments by the new bank Landsbankinn to LBI (the old Landsbanki), which average around 72 b.kr. annually during this period or 4% of GDP. Without either renegotiation of these debts or access by the debtors to refinancing from foreign credit markets, considerable pressure could develop on the króna exchange rate and the Central Bank's foreign reserves, making the removal of capital controls more difficult. Renegotiating a longer maturity of the debt owed by Landsbankinn to LBI would therefore in this light be helpful.

The risk posed to financial stability by the removal of capital controls can only materialise when definitive steps are taken which can threaten the exchange rate, the Central Bank's currency reserves, the banks' liquidity and Treasury financing. Such steps, however, are not likely to be taken until at the earliest next year. Until such time, the controls protect the domestic financial market from the risk of contagion from the eurozone crisis, although they naturally cannot prevent effects on national income through foreign trade and the

terms of trade. Efforts are underway on various fronts to prepare for the lifting of capital controls on residents. These include plans for a budget surplus in 2014, the drafting of prudential rules on FX-related risk in the banks' balance sheets and volatile capital flows, arrangements for bond swaps and an exit levy or fee, and the reduction and conversion to longer-term investment of non-residents' volatile króna assets, which has proceeded more slowly than hoped, however, in part due to unfavourable international developments. An examination is also being made of how the regulatory framework and other arrangements in connection with resolving the estates of the old banks can best be integrated with plans to remove capital controls.

A handwritten signature in black ink, appearing to read 'Mr. J. J. J.', is centered on the page.

Strong banks and good progress in restructuring

- In H1 2012 the performance of the large commercial banks was good, with their principal income items increasing in comparison to the same period of 2011. The equity of the large commercial banks rose by 34.8 b.kr. during the period, while their leveraging decreased slightly to 475% of equity. Commercial banks' liquidity is furthermore strong, even if unstable funding of non-residents and financial institutions in winding-up procedure are taken into account. During the first six months of this year, operating costs rose by 17% from the same period of the previous year, with salary costs rising 23%. A new Financial Activities Tax (FAT) equivalent to 5.45% of salaries explains this cost increase only to a small extent.
- Improvement in the domestic economy continues, with GDP growth of 3% expected this year. Unemployment has decreased and real wages have risen. Households' net asset position has also improved since 2010 and household debts relative to GDP continue to decrease.
- Good progress is being made in corporate and household debt restructuring, especially at the large commercial banks. Corporate defaults have fallen markedly in recent months, although the decrease in household defaults has slowed due to rising defaults at the Housing Financing Fund (HFF). Non-performing loan ratios have been rising sharply in many countries around the world, and the non-performing loan ratio in Iceland is now lower than in Ireland and similar to that in Spain.
- Corporate bankruptcies and unsuccessful distraint actions have decreased by 30% in H1 2012 compared with H1 2011. These are clear signs that corporate restructuring is continuing on track.

FX refinancing risk

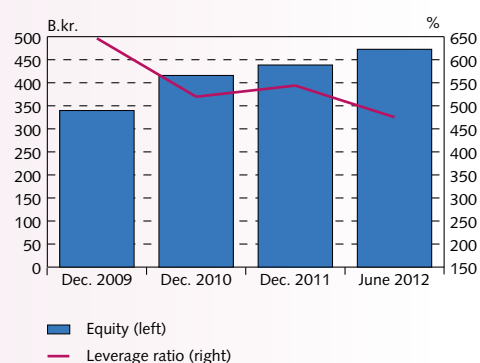
- Estimated instalments on foreign loans by parties other than the Treasury are high in coming years. Debt service increases substantially in 2015, when scheduled payments on bonds issued by Landsbankinn to LBI (the old Landsbanki) will begin in full. The magnitude of the debt service underlines the necessity of reaching agreements with creditors on extensions of current loans and ensuring access to foreign funding markets. Failing this, the instalments and interest due on these foreign loans could cause instability in the coming years.

European downturn deepens

- The outlook for growth in Europe has deteriorated yet again. In the UK the economy has been shrinking since the end of last year and the current outlook is for slight growth in Denmark and other Northern European countries. Prospects are especially dim, however, for Europe's southern periphery: in Spain, Portugal, Italy and Greece. Capital is flowing northwards, threatening the continent's financial stability. In tandem

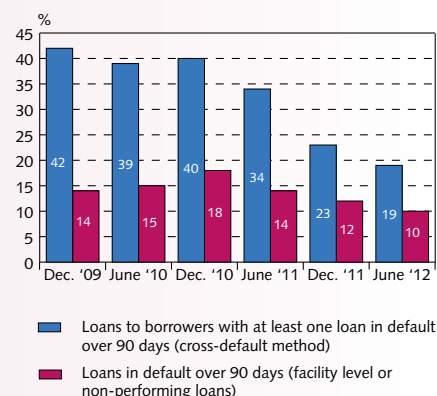
The financial system: outlook and main factors of uncertainty

Chart 1
Equity and leverage ratios of the three largest commercial banks¹



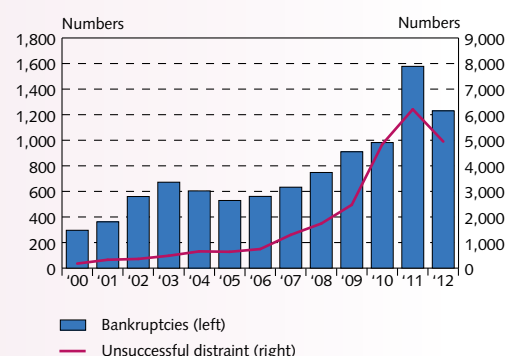
1. Consolidated accounts.
Sources: Commercial banks' interim financial statements.

Chart 2
Default ratios of the three largest commercial banks¹



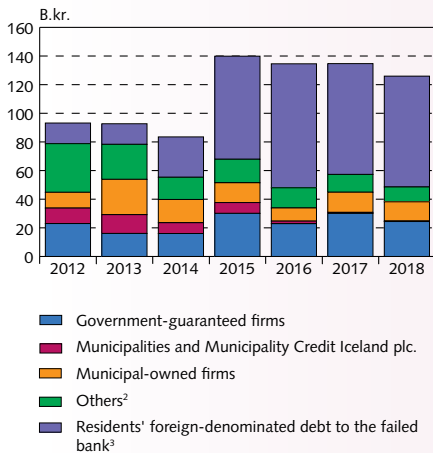
1. Parent companies, book value.
Sources: Financial Supervisory Authority, Central Bank of Iceland.

Chart 3
Corporate bankruptcies and unsuccessful distraint
Total for entire year; 2000-2012¹



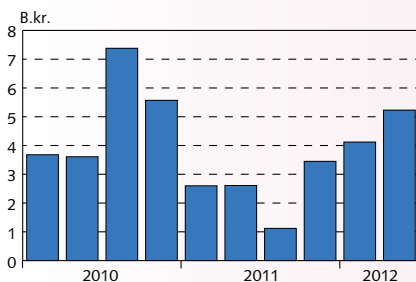
1. Total for 2012 is extrapolated from the first 6 months of the year.
Sources: Registers Iceland, Statistics Iceland.

Chart 4
Estimated instalments on
non-Treasury foreign loans¹



1. All figures in b.kr, based on 31.12.2011 exchange rates. 2. Excluding DMBs in winding-up proceedings and Actavis. 3. Debt service on around 20% of the portfolio is unknown and therefore estimated.
Sources: Municipality Credit Iceland plc. annual financial statements, Central Bank of Iceland.

Chart 5
Housing Financing Fund customers,
prepayments
Q1/2010 - Q2/2012



Source: Housing Financing Fund.

with this, ever-growing US sovereign debt and persistent fiscal account deficits are cause for concern. Central banks on both sides of the Atlantic have kept policy rates at a minimum level to combat the economic downturn, as well as applying untraditional measures which has resulted in their balance sheets ballooning. Prices for Iceland's exports are lower than otherwise due to the downturn in trading partner countries. Capital controls, however, shelter the domestic economy in many respects from the impact of international turmoil.

Legal uncertainty

- Uncertainty remains as to the extent of illegal exchange rate-linked loans and the proper methodology for their recalculation. An effort will be made to resolve a good number of the issues in dispute in coming months through accelerated judicial procedures. Several Supreme Court judge-ments in recent months give some indication that there is less likelihood of credit institutions needing to write down loans in accordance with FME's worst case scenario. Uncertainty in connection with exchange rate-linked lending has delayed the restructuring process somewhat, increased uncertainty as to household and corporate finances and possibly had a negative impact on borrowers' willingness to pay.

Removal of capital controls

- The removal of capital controls and the resulting impact on the exchange rate, the Central Bank's currency reserves, the banks' liquidity and Treasury funding may affect financial stability.
- Reducing the stock of unstable króna assets and drafting prudential rules is of key importance for lifting the controls, in addition to which it is necessary to instill overall confidence in the Icelandic economy. Otherwise major capital flight could occur as the controls are lifted. Capital flight could cause instability on the FX market, boosting inflation and thereby the corporate and household debt service burden if purchasing power drops concurrently. Instability could trigger capital flight by domestic parties, jeopardising financial stability. In the longer term lifting of capital controls will also result in higher domestic financing costs for the state, DMBs, corporates and households, reducing their leveraging incentive. Borrowers will have to adapt their balance sheets to market interest rates outside this sheltered environment, and make sure that the return on their investment is not merely contingent on the controls.

The Housing Financing Fund (HFF)

- HFF's capital ratio had dropped to 1.4% at the end of June this year and the fund's equity position is therefore extremely weak. Its lending dropped by almost half YoY during the first six months of this year, while prepayments increased. Defaults and freezing of loans at HFF has increased YtD, unlike the

trend at the commercial banks where defaults have decreased. The increasing number of non-performing loans at HFF adds to uncertainty as to the quality of the Fund's loan portfolio, while it has very little equity to absorb further losses. In addition, HFF has excess liquidity due to its persistent prepayment problem. This presents a risk which is manifest in operating losses when interest rates are low.

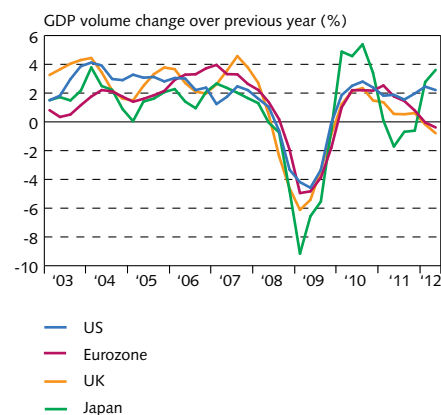
Domestic growth although the outlook abroad remains uncertain

Economic growth has increased and is forecast to be 3% this year and unemployment has decreased from the previous year. The current account deficit is still too high and refinancing of foreign debt is a pressing concern. Turnover on domestic capital markets is at a minimum, although some increase can be detected. Capital controls limit investment options. The European economy continues to deteriorate as consequences of the financial crisis are still appearing. Central banks in Europe and the US respond to the deteriorating macroeconomic outlook by increasing their intervention on securities markets and keeping interest rates low.

Uncertainty persists in the international economic outlook ...

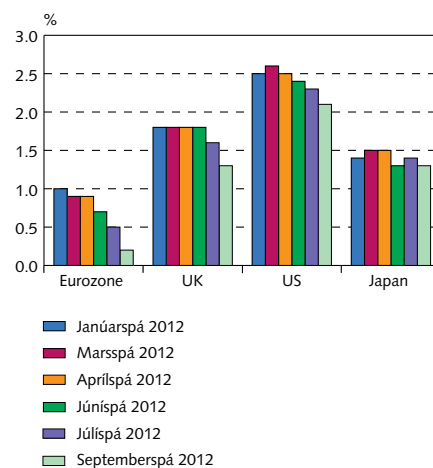
- Forecasts for growth in 2013 have been cut back in most of Iceland's main trading partner countries. Their average growth next year is forecast to be around 1.3%, and around 0.7% this year according to consensus forecasts.
- The eurozone economy as a whole contracted during the first half of this year, although the trend in the economic outlook varies from one country to the next. Further contraction is expected along the southern periphery, i.e. in Spain, Portugal, Italy and Greece. The UK has also struggled with a shrinking economy since the end of last year, Denmark's GDP fell between quarters this year and the current outlook is for slight growth in other Northern European countries.
- The European Union and ECB are wrestling with serious debt problems of the southern eurozone countries, together with forecast further contraction. *It remains a question whether the countries in worst shape will be able to work their way out of debt without further assistance*, as their debt following the financial crisis still continues to grow. During the spring months this year signs of non-confidence appeared, for instance, in rising CDS spreads and increased capital flight from Southern Europe.
- Capital flow from Spain from July 2011 until the end of July 2012 is estimated to amount to over 50% of the country's GDP. Excluding funding from central banks, deposits in banks in Spain decreased by 10%, in Greece by 19%, in Ireland by 9% and in Portugal by 8% during this period. At the same time deposits in German and French banks grew and yields on Treasuries of countries with high sovereign ratings have seldom been lower.
- Increased emphasis has been placed on co-ordinating and integrating banking supervision in the eurozone and increasing the ECB's authority. In June, eurozone states authorised a loan of 100 billion euros from the European Stability Mechanism (ESM) to Spanish banks, after previously authorising loans to Ireland and

Chart I-1
Growth in leading developed countries
Q1/2003 – Q2/2012



Source: Macrobond.

Chart I-2
Growth forecasts for 2013¹

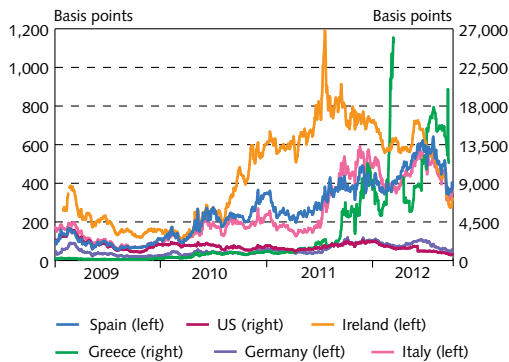


1. Based on weighted average monthly forecasts of 250 institutions.
Source: Consensus Forecasts.

Chart I-3

CDS spreads

Daily figures 1 January 2009 - 28 September 2012

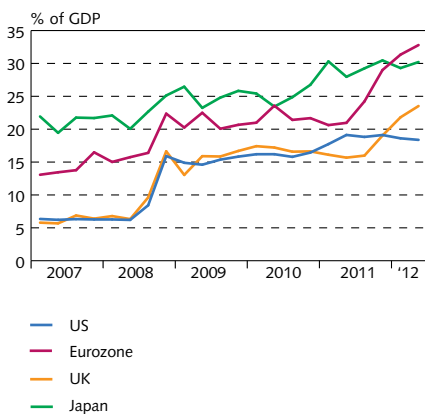


Source: Bloomberg.

Chart I-4

Central banks' balance sheets

Q1/2007 - Q2/2012

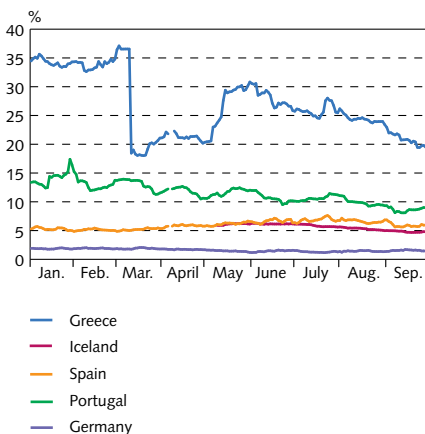


Sources: Bank for International Settlements.

Chart I-5

Yield on 10Y Treasury bonds

Daily figures 3 January - 28 September 2012



Heimild: Bloomberg.

Portugal.¹ Banks receiving assistance are expected to be under the surveillance of the ECB from January 2013 onward.

- *Central banks keep policy rates low and continue to apply unconventional measures.* At the beginning of September the ECB announced plans for direct purchases of Treasury bonds in unspecified quantity, expecting this to lower the yields and funding cost of the most indebted states. The purchases are subject to conditions and only concluded following a request for international assistance from EFSF/ESM.
- In July, the Bank of England announced an *increase in the size of its Asset Purchase Facility*. The Bank of Japan has also expanded its Asset Purchase Program.
- In September the US Federal Reserve announced it would *purchase mortgage-backed securities*. In this third round of bond purchasing, the Fed set no limit as to the quantity of its purchases. The balance sheets of many central banks have ballooned in recent quarters, and the trend looks set to continue (Chart I-4). Market response following the central banks' announcements has been for the most part positive, although some concerns have been expressed of growing inflation.
- *Yields on Treasury bonds of the most indebted states declined* following announcements in September, while those of more highly rated bonds rose. Yields on US mortgage bonds declined following the Fed's announcements of its actions. Equity indices have also risen once more on both sides of the Atlantic, after reaching the lowest level this year at the beginning of June. Instability still persists, however, and the situation is delicate.

... but as yet has had little impact on the domestic situation.

- Capital controls have up until now shielded the domestic economy to a large extent from the impact of international financial market fluctuations.
- *GDP growth has risen in Iceland* and unemployment has declined from the previous year. In 2011, GDP growth was 2.6% and the Central Bank's most recent forecast is for growth of 3% in 2012. The increase in growth is explained primarily by greater export growth than anticipated. Uncertainty as to the strength and permanence of the improvement in the domestic economy is considerable, especially in view of the ominous international outlook.
- *Inflation has subsided* during the year and measured 4.3% in September. Exchange rate movements will be decisive for inflation developments. Depreciation of the króna in September will result in higher inflation, other things equal.

1. The ESM will be created through the merger of the European Financial Stability Facility (EFSF) and the European Financial Stability Mechanism (EFSM). It is authorised to loan up to 500 billion euros with guarantees from Member States amounting to 700 billion euros. For more details on actions taken by the ECB and the above-mentioned funds see Box I-1 in *Financial Stability 2012/1*.

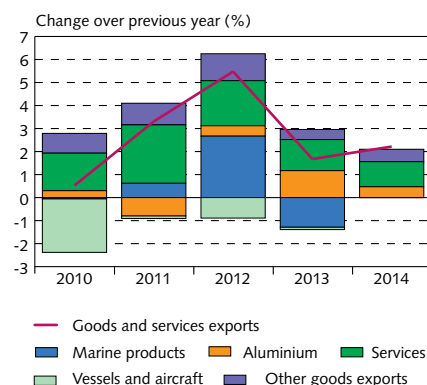
- *Commodity prices will increase during the latter half of this year but decrease next year, according to commodity market analysts. Commodity prices on world markets were at a low near the end of last year, then rose sharply during the first months of this year. The Central Bank expects average commodity prices this year to be 7% lower than last year. The average oil price this year is expected to be similar to that of the previous year but is forecast to drop by 4% next year.*
- *The outlook remains positive for prices for Iceland's main export goods. The price for leading marine products has increased from the beginning of the year and aluminium prices rose in September after decreasing since January. The price of aluminium is now at the same level as in the beginning of the year, although about 10% lower than at the same time last year. Mackerel has provided a growing share of the export value of Icelandic catches, or around 10% in 2011.*
- *The current account deficit in Q2 was higher than in the same quarter last year, with a decrease in the trade surplus in both goods and services. Even excluding the impact of the old banks on factor income, the current account deficit in the first half of this year was around 3.7% of GDP, or similar to that of last year.*
- *Calculated according to standards, the current account figures give a skewed picture due to the large debts of the failed commercial banks and other parties with large-scale foreign obligations, which will not be repaid in full. For this reason the Central Bank has shown the impact of the largest parties in the current account balance, in order to give a more realistic picture and attempt to assess the actual underlying balance.²*
- *Iceland's gross debt as a ratio of GDP is high compared to other countries. Households and corporates in the country have long been among the most highly indebted in developed countries.*
- *Treasury debt in August was equivalent to 85% of GDP; of this, foreign debt was 414 b.kr., or around 28% of total debt. One-third of the Treasury's foreign debt matures in 2016. Repayments on foreign borrowing by other parties will also be heavy in coming years. Fluctuations in the balance of payments in coming quarters could put pressure on the domestic FX market, independent of the progress of the Central Bank's plans for lifting capital controls.*

Difficulties in refinancing foreign debt are considerable ...

- *Uncertainty in the eurozone has affected foreign credit markets, although the Treasury and larger export companies with foreign*

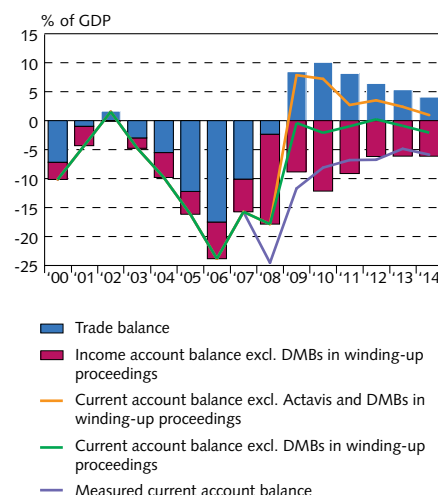
2. Because of how large financial undertakings and holding companies figure in the current account balance, considerable uncertainty remains as to the underlying current account balance once the winding-up proceedings, composition or restructuring of these companies has concluded. In addition, ownership of foreign holding companies has often been in the hands of domestic parties, which can distort the imputed current account balance. See the report "What does Iceland owe?" and an updated assessment in *Monetary Bulletin* 2012/2, as well as the discussion in *Financial Stability* 2012/1.

Chart I-6
Exports and contribution of export sub-categories
2010-2014¹



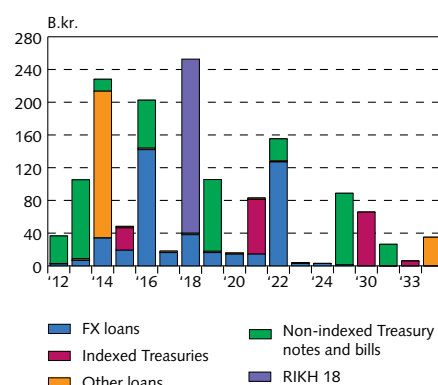
1. Grunnspá Seðlabankans 2012-2014 birt í *Peningamálum* 2012/3. Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-7
Current account balance¹
2000-2014²



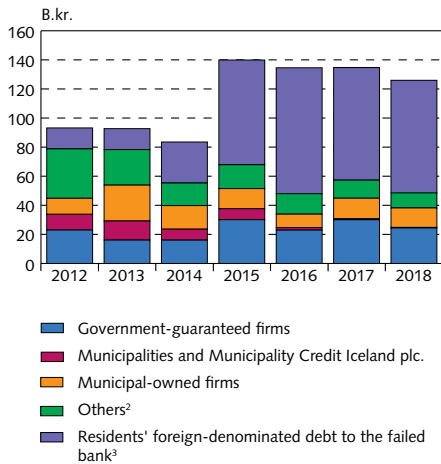
1. Net current transfers are included in the balance on income.
2. Central Bank baseline forecast 2012-2014. Sources: Statistics Iceland, Central Bank of Iceland.

Chart I-8
Treasury maturity profile
As of 31 August 2012



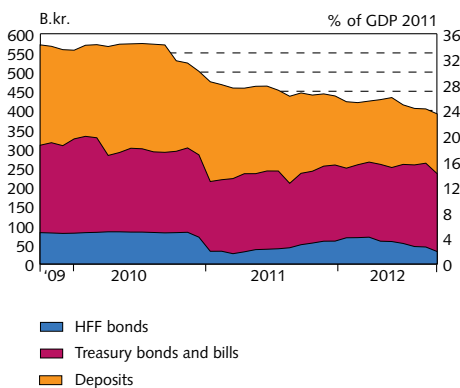
Source: Central Bank of Iceland.

Chart I-9
Estimated instalments on
non-Treasury foreign loans¹



1. All figures in b.kr., based on 31.12.2011 exchange rates. 2. Excluding DMBs in winding-up proceedings and Actavis. 3. Debt service on around 20% of the portfolio is unknown and therefore estimated.
Sources: Municipality Credit Iceland plc. annual financial statements, Central Bank of Iceland.

Chart I-10
Liquid ISK assets held by non-residents
September 2009 - August 2012



Source: Central Bank of Iceland.

currency income flows have secured access to foreign credit. The Treasury's CDS spreads have not been lower since the banking system collapse. Access to foreign credit markets by other domestic parties, however, is still limited.

- This summer the new bank Landsbankinn pre-paid one-quarter of its debt owed to the old bank, a total of 73 b.kr. The payment covers instalments due in 2014 and the first instalment of 2015. Through this action the bank saves on interest expense. Reykjavík Energy (OR) announced this spring that it had obtained extensions of two loan contracts. In addition, Arion Bank and OR concluded a currency swap, reducing the currency mismatch on the balance sheets of both entities.
- Despite this, planned instalments payable by domestic parties on foreign loans owed to foreign parties and the old banks are high relative to the adjusted current account balance in 2011, as is shown in Chart I-9. Debt service increases substantially in 2015, when scheduled payments on bonds issued by Landsbankinn to LBI (the old Landsbanki) will begin in full force. The estimated instalments are over 72 b.kr. annually, based on the current estimate.³ It should be borne in mind that refinancing is only part of normal corporate funding. Of prime importance is the creation of an environment to foster creditor confidence. The refunding efforts of domestic parties are currently especially challenging due to the situation on international credit markets.

... but non-residents' unstable króna assets have decreased

- The Central Bank of Iceland has continued its foreign currency auctions as part of its programme towards lifting capital controls. These provide owners of foreign currency which is not subject to repatriation under the Foreign Currency Act with an opportunity to purchase long-term Treasury bonds or *krónur* at auction rates for long-term investment in Iceland. At the same time, impatient non-residents with króna assets have an opportunity to sell the same for foreign currency.
- Unstable króna assets of non-residents amounted to an estimated 402 b.kr. at the end of July this year, which is a decrease of 21 b.kr. since the beginning of the year. Their króna assets now amount to around 25% of 2011 GDP. Of this amount, deposits with financial undertakings amounted to 121 b.kr., deposits with the Central Bank in connection with foreign clearing houses to around 35 b.kr., Treasury bonds and bills to around 203 b.kr. and HFF bonds to around 43 b.kr.
- In March this year, an amendment to the Foreign Currency Act stopped the outflow of instalments and indexation payments on bonds. Since that time holdings by non-residents of HFF14

3. As assessed by Landsbankinn in its annual financial statements. As the old bank's valuation of the contingent bond is higher, or 92 b.kr., payment could increase by as much as 4 b.kr. per year. In addition, the amount of the payments is dependent upon the exchange rate.

bonds, the shortest HFF bond series, have fallen rapidly, decreasing by over 40% since the end of February this year. Yields on these bonds became positive again, after falling to a low of -7%, as is shown in Chart I-11.

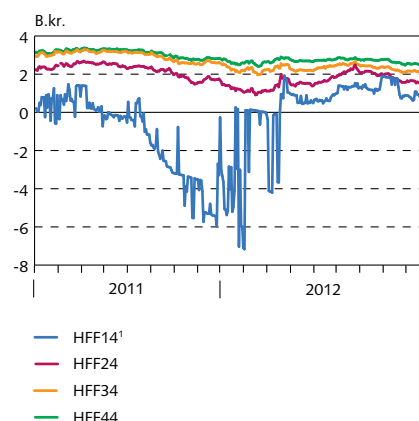
Securities market

- Monthly bond turnover on the NASDAQ OMX Exchange Iceland averaged 227 b.kr. during the first eight months of this year, compared to 207 b.kr. per month in the first eight months last year. Close to 99% of the turnover was in Treasuries or HFF bonds. Other bonds are primarily those issued by individual municipalities and Municipal Credit Iceland. During the first eight months of this year corporate bond turnover amounted to only 2.7 b.kr. and turnover in bonds of commercial banks and savings banks was only 3.7 b.kr. - it was nil during the first eight months of 2011.
- Capital controls significantly reduce securities market efficiency and depress the interest rate level, as both non-resident owners of króna assets and domestic investors do not have the option of moving their capital abroad. As a consequence, price formation on the bond market is distorted and interest rate decisions by the Central Bank are not reflected in the yield curve as effectively.
- A limited supply of listed bonds and equities on the market increases the likelihood of an asset bubble resulting from limited investment options. There are indications of price rises on the bond market fuelled by excess demand. Yields on the main benchmark series are at an historical low, in particular on indexed and non-indexed series with a short duration.
- Capital controls have aided the Treasury through a period requiring extensive borrowing following the banks' collapse, by enabling the Treasury to borrow at more favourable credit terms than else. Such terms are unlikely to persist once controls are lifted, resulting in higher financing cost in coming years. It is important that the Treasury take this into consideration and reduce its borrowing needs as far as possible.

FX market

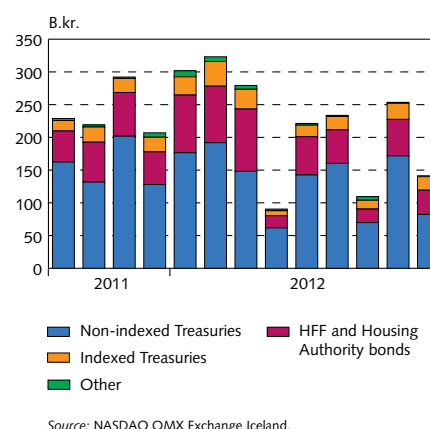
- Turnover on the interbank FX market is lower than prior to the banking system collapse. Although turnover has gradually increased in previous quarters, it is far from what it was prior to the collapse in 2008. Turnover in the first eight months of 2012 amounted to 106 b.kr. (666 m euros), which is more than double that of the same period last year, which was 44 b.kr. (268 m euros). The number of days without any FX market action is gradually decreasing.
- Residents may send FX payments abroad to pay regular instalments and interest on loans. Non-residents may also convert dividends to foreign currency, together with interest payments on certain domestic bonds and deposits.

Chart I-11
Indexed bond yields
2 May 2011 - 28 September 2012



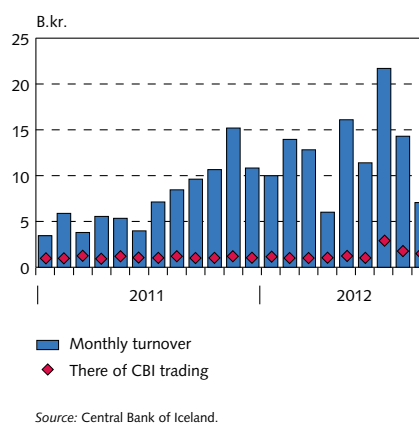
Following an amendment to the Foreign Currency Act in March 2012, installment payments and indexation cannot be converted and withdrawn from Iceland.
Source: NASDAQ OMX Exchange Iceland.

Chart I-12
Bond turnover on NASDAQ OMX
Exchange Iceland
Monthly turnover, September 2011 - September 2012



Source: NASDAQ OMX Exchange Iceland.

Chart I-13
The interbank foreign exchange market
January 2011 - September 2012



Source: Central Bank of Iceland.

Chart I-14

Exchange rate index¹

Daily data 5 January 2011 - 28 September 2012



1. Narrow trade-weighted index.
Source: Central Bank of Iceland.

- As capital transfers are limited, *seasonal fluctuations in goods and services trade have a greater impact on the exchange rate*. The inflow of foreign currency increases, for instance, in high summer at the peak of the tourist season. As visitors decrease in number in the autumn the inflow slows. Payments by larger borrowers on foreign loans also have a visible impact, exerting downward pressure on the exchange rate.
- *The Central Bank began weekly FX purchases in August 2010*. A total of 1.5 m.euros was purchased weekly from the three market makers. At the end of July 2012 a decision was taken to increase this amount to a total of 3 m.euros, i.e. 1 m. from each market maker. In 2011, the Central Bank was involved in 10% of FX market turnover, while during the first eight months of 2012 its share was 8%.
- *Transactions on offshore markets in Iceland krónur have been very infrequent in recent months*. Since the Central Bank began holding currency auctions in connection with its plans for lifting capital controls offshore transactions have dwindled. Transactions this year have been concluded at exchange rates of 230-250 krónur per euro.

Equity market

- *The equity market has not regained its vigour after the largest listed companies disappeared from the exchange following the banking collapse in October 2008*. Only one new company has been listed YtD, when shares of the real estate company Reginn were accepted for trading on the NASDAQ OMX Nordic market. During the first eight months of this year the Icelandic selected shares index (OMXI6) has risen from 910 to 1005 points, an increase of 10.4%. It peaked at 1092 in May.

II The scope of financial institutions' operations

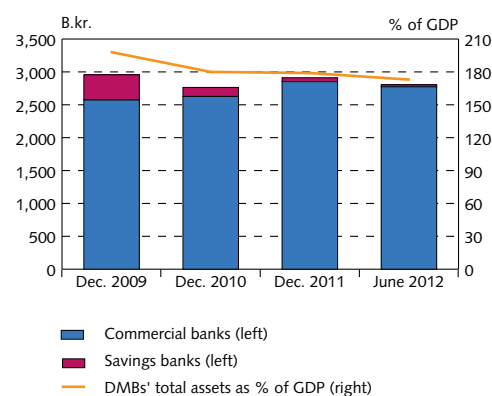
Restructuring almost complete but default ratios remain high

Total assets of the financial system, which were high at year-end 2011 due in part to the strength of the Central Bank's foreign currency reserves, have decreased this year, primarily due to early payments of foreign loans by the national Treasury, the Central Bank and one commercial bank. New lending by the Housing Financing Fund (HFF) has dropped in tandem with an increase in prepayments, and the fund's equity position is extremely weak. Restructuring of household and corporate loan portfolios continues and is making good progress. Loan default ratios at the three largest commercial banks have declined since the beginning of the year. Supreme Court judgements on exchange rate-linked loans in recent months indicate that the probability of write-downs by financial institutions according to Financial Supervisory Authority's worst-case scenario has decreased.

The financial system and credit institutions

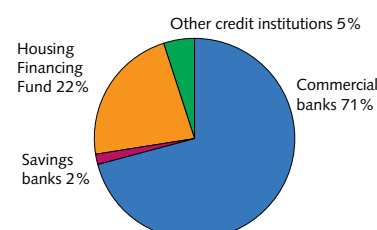
- Total assets of the financial system at the end of June amounted to 8,373 b.kr., decreasing by 108 b.kr. since the beginning of the year (Table II-1). This is due primarily to early payments of foreign loans by the national Treasury and the Central Bank of Iceland totalling 171 b.kr. in June. The decision on repayment was taken following the Treasury's USD 1000 million (125 b.kr.) bond issue on international markets last May, and in view of the relatively high FX liquidity position of the Treasury and Central Bank in subsequent quarters. The decrease also reflects prepayment by Landsbankinn hf. on its bond to the LBI (the old Landsbanki) of just over 73 b.kr. Among the main increases in total assets were increases in pension fund assets during the same period of 137 b.kr., or equivalent to almost 6% of their total assets as of the end of June 2012. Assets of mutual funds, investment funds and institutional investment funds rose by 28 b.kr., or the equivalent of 5% of their total assets as of the end of June.
- Since the beginning of this year, total assets of DMBs¹ have shrunk and at the end of June amounted to 2,835 b.kr., compared to 2,912 b.kr. at year-end 2011 (Chart II-1). As previously mentioned, this is primarily due to the change in Landsbankinn's balance sheet, as well as a slight decrease in the balance sheets of the other two large commercial banks. Assets of DMBs were equivalent to 174% of GDP² as of the end of June this year, or similar to that of the previous two years. Total assets of DMBs were equivalent to 71% of total assets of credit institutions as of the end of June; HFF's assets were 22%, savings bank's assets 2% and those of other credit institutions around 5% (Chart II-2).
- The risk-weighted asset base for credit risk of the three largest commercial banks has increased by 3% since the beginning of the year and amounted to 1,830 b.kr. at the end of June (Chart II-3).

Chart II-1
DMBs' total assets, % of GDP¹



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

Chart II-2
Credit institutions' total assets¹
June 2012

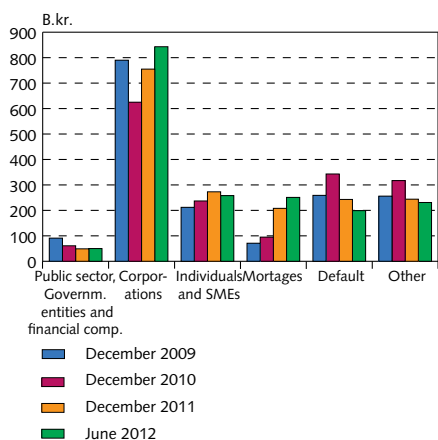


1. Parent companies.
Source: Central Bank of Iceland.

1. Deposit money banks (DMBs) are commercial banks and savings banks.

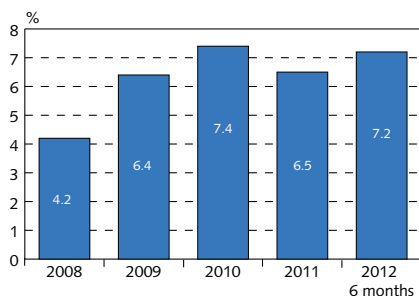
2. Using GDP figures for 2011.

Chart II-3
Risk base, credit risk of the three largest commercial banks¹



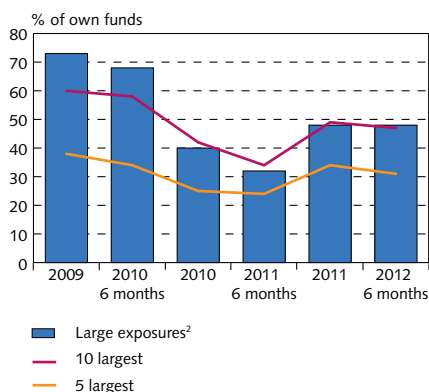
1. Consolidated figures
Source: Financial Supervisory Authority.

Chart II-4
Credit provisioning accounts of the three largest commercial banks¹



1. Consolidated figures. Credit provisioning accounts and claims against customers as % of total lending.
Sources: Financial institutions' annual and interim accounts.

Chart II-5
Large exposures¹



1. Consolidated figures. Large exposures to a client or group of clients may not exceed 25% of a financial undertaking's own funds. The total amount of large exposures may not exceed 400% of a financial undertaking's own funds. 2. An exposure incurred by a financial undertaking to a client or a group of connected clients the value of which amounts to 10% or more of the own funds of the undertaking.
Source: Financial Supervisory Authority.

Table II-1 Credit system assets

Assets, b.kr.	30/9 2008	31/12 2008	31/12 2009	31/12 2010	31/12 2011	30/6 2012	Change from 31/12 '11
Banking system ¹	15,087	4,632	3,967	3,878	4,378	4,107	-271
Due to Central bank of Iceland		192	447	1,011	1,114	1,272	-194
Due to commercial banks	14,153	3,417	2,573	2,627	2,852	2,774	-78
Due to savings banks	742	768	383	137	60	61	1
Other credit institutions	1,321	1,284	1,194	1,129	1,097	1,072	-25
Due to Housing Financing Fund	699	733	795	836	864	878	14
Pension funds	1,871	1,665	1,849	1,989	2,169	2,306	137
Insurance companies	161	122	131	138	145	157	12
Mutual, investment and institutional funds	667	212	195	284	521	549	28
Government credit funds	103	125	146	161	171	182	11
Total assets	19,209	8,040	7,483	7,579	8,481	8,373	-108

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.

The increase can be attributed for the most part to an increase in the risk-weighted asset base for housing mortgages and corporate lending, resulting primarily from reclassification in capital reporting, new lending, upward revaluation of loan portfolios and inflation. The risk-weighted asset base for loans in default has declined since the beginning of the year, in line with the decrease in corporate and household default rates.

- *Provisions for credit losses* by the three largest commercial banks as a ratio of total lending have risen since the beginning of the year and amounted to 7.2% at the end of June. (Chart II-4). This increase is primarily connected with fisheries undertakings, holding companies and household credit.
- *The total large exposures*, including the 5 to 10 largest exposures of each of the three large commercial banks, have decreased insignificantly. (Chart II-5). The systemic risk involved in large exposures, as reflected by this measure, does not therefore appear to be increasing. Total large exposures of the three largest commercial banks have also changed little since the beginning of the year and at the end of June were just under 48% of their capital base.
- *The book value of loans by DMBs* as of the end of June was 1,895 b.kr. after increasing slightly in nominal terms since the beginning of the year. The total amount of asset leasing contracts has increased by 17% or by 5 b.kr. Lending to holding companies declined sharply, falling by over 24% or by 46 b.kr., which can be attributed primarily to loan prepayments, although write-downs increased by 11% or by over 2 b.kr. Furthermore, the book value of mortgages by DMBs rose by 7% or by 30 b.kr. since the beginning of this year due to increased lending and inflation.
- According to information provided by DMBs, *new mortgages* amounted to 28.5 b.kr. during the first eight months of this

year compared to only 5.2 b.kr. in the same period last year, an increase of more than five-fold YoY. The average loan amount during this same period was 11.5 m.kr. The vast majority (around 86%) of this year's mortgages were non-indexed, although a slight decline in this proportion can be detected in recent months; in August 75% of new mortgages were non-indexed (Chart II-6). Customers of the commercial banks therefore appear to be still convinced that the loan terms are advantageous despite market interest rate increases in recent months. In all likelihood, the non-indexed loans have been taken in part to refinance indexed loans from HFF, DMBs and pension funds.

- *The amount of new loans by pension funds, however, has been falling, totalling only 2.2 b.kr. in the first half of 2012 compared to 5 b.kr. during the same period last year.*³ The average amount of new loans was 5 m.kr. The contraction in new lending by both the pension funds and HFF can likely be attributed in part to the fact that they offer only inflation-indexed loans.

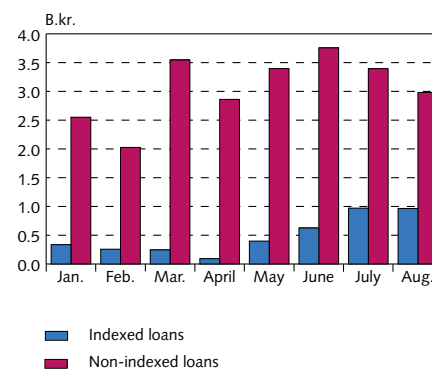
HFF defaults and frozen loans increase, and its equity position is weak

- *New lending by HFF continued to decrease while prepayments increased. In H1 2012 these were 9.4 b.kr. compared to 5.2 b.kr. during the same period last year (Chart II-7). A total of 611 mortgages for privately owned homes were disbursed during the first half of this year compared to 1,119 during the same period last year. Total lending during the first half of this year was just under 6 b.kr. compared to some 11.4 b.kr. during the same period of the previous year. The very sizeable decrease can be attributed partly to increased competition from commercial banks offering non-indexed loans and inflation-indexed loans on favourable terms. HFF's original forecasts for 2012 anticipated new lending of 27-35 b.kr. According to its revised forecast in July, this is now expected to be only 13-17 b.kr.*
- *HFF's capital ratio had dropped to 1.4% at the end of June this year, making the fund's equity position extremely weak. The Fund's operations are backed by a state guarantee, however, and no decision on a possible equity injection by the state is included in the 2013 budget.*⁴
- *HFF loans in default or frozen were 15.1% of total loans as of the end of June this year and have increased since the beginning*

3. Data on new lending by pension funds is based on a sample including the 20 largest pension funds. In the period under examination the number of pension funds in the sample has been increased from 18 to 20. Funds now included in the sample represent almost 97% of pension funds' net assets.

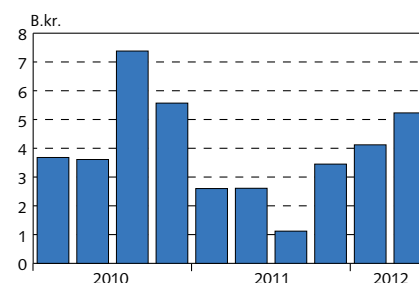
4. The 2013 budget states: "As the Fund has a state guarantee it is debatable whether it should be provided with an additional contribution in order to boost its equity position; a Regulation states that the long-term objective for the Fund is a capital ratio of at least 5%. This does not comprise a statutory obligation. Nonetheless, it is established that the Fund has full backing from the state which will provide it with additional equity as necessary and as deemed feasible." Parliamentary document 1 (2012-2013). 2013 *Fiscal Budget*, pp. 447-448. Ministry of Finance and Economic Affairs.

Chart II-6
New DMB mortgage lending¹
January - August 2012



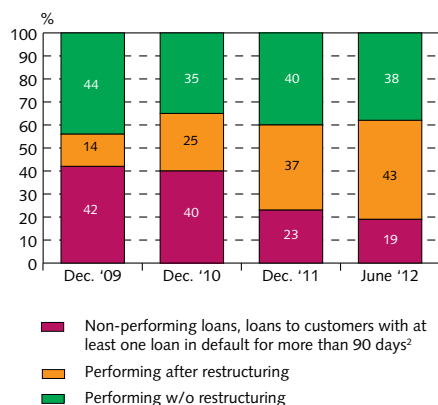
1. Commercial banks and savings banks.
Source: Central Bank of Iceland.

Chart II-7
Housing Financing Fund customers, prepayments
Q1/2010 - Q2/2012



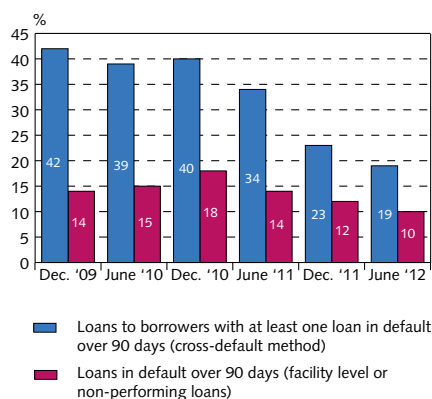
Source: Housing Financing Fund.

Chart II-8
Status of loans from three largest commercial banks¹



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.
Source: Financial Supervisory Authority.

Chart II-9
Default ratios of the three largest commercial banks¹



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

of the year, in contrast with those of commercial banks, whose defaults have been decreasing. The fund's real estate assets continue to increase: at the end of June it owned a total of 2,049 real estate units, an increase of 443 YtD. Results of a working group appointed to examine HFF's future role by the Minister of Welfare in September 2011⁵ are still awaited, as is the report of an investigation commission on the Fund's activities to be delivered in coming months.⁶

Restructuring continues and defaults decrease

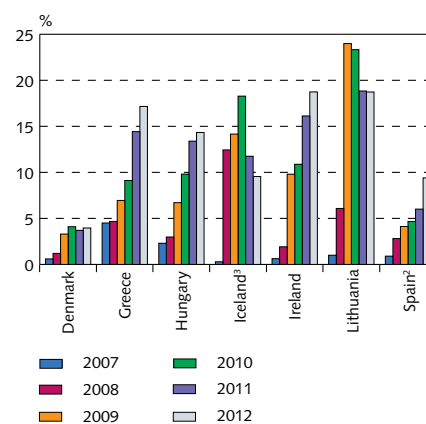
- *Restructuring of household and corporate debt* has continued and is making good progress, especially at the large commercial banks. The default ratios of the three largest commercial banks have dropped from 23% at year-end 2011 to 19% at the end of June this year (Chart II-8). These figures are based on book value and assume that all of a customer's loans are in default if one is in default or if payment is considered unlikely (cross-default). The pace of the decrease, however, has slowed somewhat recently, but is expected to pick up in coming quarters, once the outcomes of test cases following the Supreme Court's decision last February on the validity of receipts for full payment are available. The share of performing loans which have not been restructured has remained fairly constant in recent quarters; this was 38% at the end of June this year. At the same time, performing loans which have been restructured were 43% of the total, an increase of 6 percentage points since the beginning of the year.
- According to *another measure of default*, however, even though a customer has one loan in arrears by 90 days or more, that customer's other loans are not considered to be non-performing. If this measure is applied, just under 10% of loans of the large commercial banks were in default as of the end of June 2012, a decrease of over 2 percentage points since the beginning of the year (Chart II-9). Generally speaking, for banks with a good loan portfolio, this figure should be around 1-2%. Default ratios have been rising worldwide in recent months, especially in countries which are struggling with major economic difficulties. According to the most recent figures, the default ratio had risen to 17% in Greece (in March this year), over 9% in Spain (in June) and almost 19% in Ireland (in March). In recent quarters these ratios have risen rapidly in these countries (Chart II-10), while at the same time they have fallen in Iceland.⁷

5. Working Group on the Future Role of the Housing Financing Fund. The group's task includes examining HFF's participation in the housing mortgage market, finding ways to maintain and ensure a public service mortgage institution and discussing the Fund's impact on financial stability and its importance for the overall Icelandic economy.
6. Investigation Commission on the Housing Financing Fund. The commission is intended to investigate the Fund's activities from the period leading up to changes in its funding and lending rules implemented in 2004 until year-end 2010. Furthermore, the commission is to assess the impact of these changes, the Fund's strategy and specific decisions during this period on the Fund's financial situation and the overall housing market. It is also to assess the impact of HFF's activities on economic management in Iceland and, finally, to assess how well the Fund has performed its statutory role during the period.
7. IMF, *Financial Soundness Indicators (FSIs)*, <http://fsi.imf.org/>.

Uncertainty persists concerning exchange rate-linked loans

- A box in *Financial Stability 2012/1* discussed in detail the illegality of exchange rate-linked loan contracts. Legal uncertainty persists regarding the extent of these loans, while the proper methodology to be followed in recalculating illegal contracts is not fully clear. A verdict of the Supreme Court of Iceland on 15 February this year concerning the validity of receipts for full payment has necessitated the recalculation yet again of all exchange rate-linked loan contracts involving illegal exchange rate linking.
- The outcome of collaboration between lenders, the Debtors' Ombudsman, the Consumer Agency and the Consumers' Spokesman in response to the said Supreme Court judgements was to list some 20 issues needing resolution concerning the method used for recalculation before this could begin. These issues include, for instance, the original point in time at which contractual interest is no longer valid, the impact of defaults, the impact of payment relief remedies, the length of the loan term, collection of compound interest and whether it is of significance if the borrower is an individual or legal entity. Agreement was reached on a selection of 11 test cases aimed at testing these issues of dispute and accelerated judicial procedures have been requested. It is hoped that the Supreme Court will issue judgements in these cases before the end of this year. If an advisory opinion is sought from the EFTA Court on considerations of consumer issues, recalculation can be expected to be delayed well into 2014.
- Several Supreme Court judgements pronounced in recent months give some indication as to which contractual forms are considered lawful contracts for loans in foreign currencies and which contain illegal exchange rate linking. In 2010 financial undertakings were required to classify loan contracts including exchange rate linkage provisions in 6 categories, designated A to F.⁸ Contracts in category A were considered likely to be deemed legal foreign currency loans, there were certain doubts as to the legality of categories B to E, while loans in category F were considered the most likely to contain illegal exchange rate-linked provisions. On 24 May this year the Supreme Court pronounced financial leasing contracts concluded by the company Lýsing with a legal entity to be lawful.⁹ The Supreme Court reached the same conclusion on 7 June concerning a foreign currency loan contract between Íslandsbanki and two individuals.¹⁰ Furthermore, a foreign currency loan contract between Arion Bank and a legal entity was declared lawful by the Supreme Court on 15 June and on 27 September this year.¹¹ The likelihood of financial institutions being required to make write-downs in accordance with Financial Supervisory Authority's worst-case scenario has therefore decreased substantially, although a large number of disputed cases still remain. The total extent of illegal exchange rate-linked loan contracts in the financial system is still unclear.

Chart II-10
Default ratios in European comparison¹



1. Year-end figures 2007-2011. 2012 figures from 1st quarter unless otherwise stated. Banks' non-performing loans as a percentage of gross loan portfolio w/o write-downs. Non-performing loans are gross loans in default and not only the amount in default. 2. 2012: Figures from 2nd quarter. 3. Iceland, 2007: Figures estimated from the annual accounts of the failed banks. 2008: Central Bank estimates. 2012: Figures from 2nd quarter.
Sources: International Monetary Fund, World Bank, Financial Supervisory Authority, Central Bank of Iceland.

8. For more details, see Box V-2 in *Financial Stability 2012/1*.

9. Case No. 652/2011.

10. Case No. 524/2011.

11. Case No. 3/2012 and No. 50/2012.

III Borrowers and credit risk

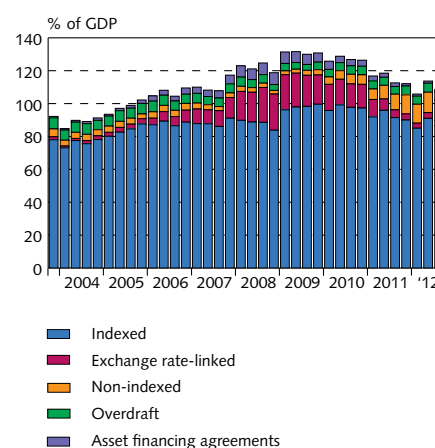
Household and corporate finances continue to improve, with the outlook generally positive

Household debt relative to GDP declines further and the trend can be expected to continue. Lower debt and higher housing prices have improved households' net asset position which has been increasing since 2010. The outlook for households is generally positive, as forecasts predict continuing GDP growth, increasing disposable income and falling unemployment. Households' default ratios have decreased from levels 6 or 12 months ago, but have held steady since April this year. The development can be attributed for the most part to increased defaults on HFF loans. Continued improvement in the economy can be expected to further reduce defaults. Corporate finances have improved YtD, export prices for marine products are high and all indications point to a record number of foreign visitors to Iceland this year. In tandem with this business investment is increasing, which is important in maintaining the improving economic trend. Corporate default ratios have continued to decline this year, together with unsuccessful restraint actions and corporate bankruptcies. The anticipated impact of lifting capital controls causes uncertainty in the corporate operating environment as well as for households' purchasing power and finances.

Households

- *Household debt* has changed little since the publication of the last report at the beginning of June. Debt peaked in Q1 and Q2 2009 at around 132% of GDP.¹ Since 2009, household debt has declined fairly steadily: at year-end 2011 it was estimated to be around 112% of GDP and around 109% of estimated GDP at the end of August 2012, compared to 115% of GDP at the end of August 2011.²
- *Household debt is expected to decrease further*, as it is evident that all exchange rate-linked loan contracts based on illegal exchange rate linking must be re-calculated yet again following the Supreme Court judgement of February this year on the significance of full payment receipts. Financial undertakings have already made precautionary write-downs or written off a total of 22 b.kr. in this respect, but household debt still has to be reduced accordingly. It is not clear what the final write-offs of financial undertakings will be and when these will be made, but interested parties have agreed on 11 test cases which should decide those issues of dispute which have arisen in the wake of the judgement, cf. Chapter II for more details.

Chart III-1
Household debt as % of GDP
December 2003 - August 2012

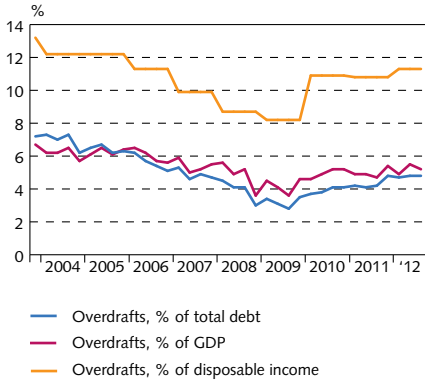


Source: Central Bank of Iceland.

1. The Central Bank's most recent estimate of private sector debt could differ from previously published figures. Since the collapse, it has proven more difficult to obtain this information, particularly information from financial institutions that have lost their operating licences and information on credit in the form of asset-backed securities issued by the banks before the collapse. The Central Bank of Iceland is making every effort to compile in-depth data on household and corporate debt for its statistical reporting.

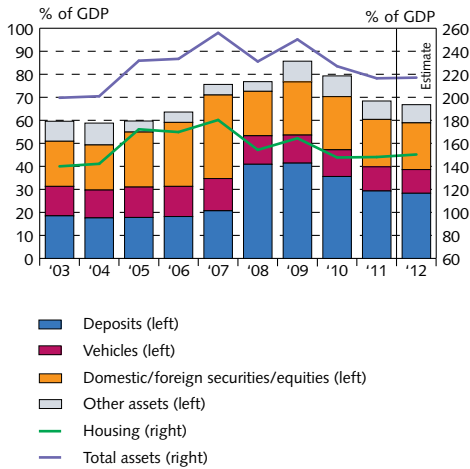
2. Chart III-1 shows the ratio of household debt to GDP increasing between Q1 and Q2 in 2010, 2011 and 2012. This results from seasonal adjustment to GDP which was lower in Q2 in these years than in Q1.

Chart III-2
Household overdrafts as % of total debt, GDP and disposable income¹
December 2003-August 2012



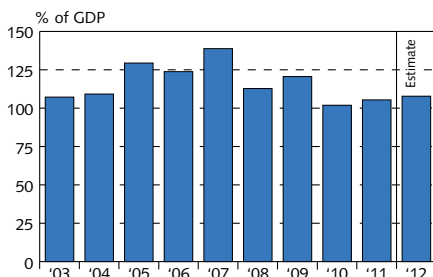
1. Disposable income are estimated for 2011 and 2012.
Source: Central Bank of Iceland.

Chart III-3
Household assets as % of GDP¹
2003 - Q2/2012



1. Without pension assets.
Sources: Directorate of Internal Revenue, Central Bank of Iceland.

Chart III-4
Net household assets as % of GDP¹
2003 - Q2/2012



1. Without pension assets.
Sources: Directorate of Internal Revenue, Central Bank of Iceland.

- *The composition of household debt* has changed in recent quarters, with the share of indexed and exchange rate-linked debt steadily decreasing while non-indexed borrowing has increased. At the end of August 2012 households' indexed debt was equivalent to 87% of GDP, exchange rate-linked loans were 3% of GDP, non-indexed loans 13%, overdrafts 5% and asset leasing contracts 1%. Households' demand for non-indexed loans has been strong and the banks have also made it their objective to increase their share of non-indexed lending, as their indexation balance has been positive. The results are evident in the fact that in the space of three years the share of non-indexed household debt, excluding overdrafts, has increased 4.5 times over. During recent months, however, households' demand for non-indexed loans has dropped somewhat following rate hikes by the Central Bank in the spring. Interest rates on the banks' non-indexed housing mortgages have risen generally by 1% since the beginning of April this year, keeping step with CBI rate rises. Last August, 75% of the banks' new housing mortgages were non-indexed while during the first 4 months of this year, for example, this proportion was 92%.

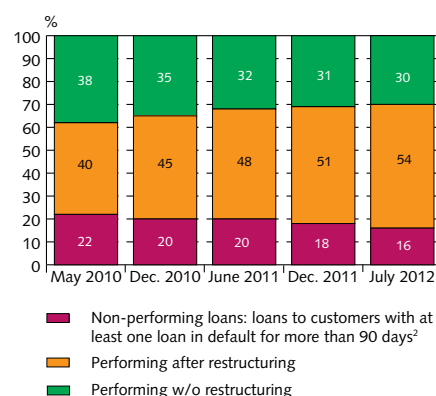
- The nominal value of *household overdrafts*, after taking mergers of financial institutions and reclassifications into consideration, has remained unchanged since the beginning of 2011. During the same period, nominal wages have risen by 13%. Official figures show that reported household overdrafts have increased since the banking system collapse. An examination of developments since the beginning of 2011 reveals that there was a considerable rise in the latter half of 2011 and then in April 2012. The increase in the latter half of 2011 can be attributed to the merger of Íslandsbanki and Byr; overdrafts were classified differently by these two institutions and reclassification resulted in an increase in reported overdraft figures. The rise in April is the result of the merger of Íslandsbanki and Kreditkort hf., which resulted in the latter's credit card debts being classified as overdrafts with DMBs. An examination of household overdrafts as a ratio of total debt, GDP and disposable income since year-end 2003 (Chart III-2) shows that the former decreased steadily from 2003 to 2009. From 2009 to year-end 2011, household overdrafts thus measured remained fairly steady. Their rise in proportion to disposable income in 2010 is primarily the result of a drop in disposable income. A survey of developments since 2003, taking into consideration the effects of financial institution mergers on reported overdrafts, indicates that the nominal value of overdraft credit relative to total household debt, GDP and disposable income is close to the minimum level.

- *Gross household assets* excluding pension savings rose considerably during the years preceding the banking collapse. They peaked in 2007, when it is estimated that gross household assets according to income tax returns totalled around 260% of GDP (Chart III-3). Since 2009, gross household assets as a ratio of GDP have fallen fairly steadily, which can be attributed primarily to

the decrease in deposits since 2009 and declining housing prices between 2009 and 2010. The contraction in household deposits is due in part to shrinking disposable income until mid-2011 and negative real returns on deposit accounts, which can be expected to encourage increased household consumption. The decline in deposits can also be attributed to debt repayment, investment in housing and, to some extent, transfers of capital to funds where somewhat higher returns can likely be expected. Such actions should not affect households' net asset position.

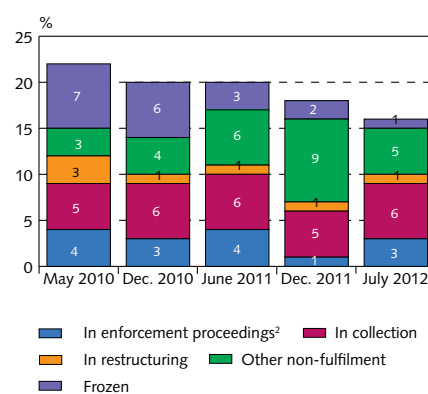
- *Net household assets* excluding pension savings fell to a low relative to GDP in 2010, when they were estimated to be 102% of GDP (Chart III-4). Since that time net household assets have been increasing and are now similar to their level prior to the asset bubble of 2005-2007. In the past two years net household assets have risen while gross assets have fallen, as the decrease in household debt has been relatively greater than the decrease in gross household assets. In addition, households' net assets in pension funds amounted to ISK 2,377 b.kr. as of the end of July 2012, or 136% of estimated GDP in 2012, of which private pension assets were 357 b.kr.
- *Ratio of non-performing loans decreases, although the trend has slowed.* At the end of July 2012, some 16% of total loans granted to households by the three largest commercial banks and the Housing Financing Fund (HFF) were in default, based on book value and using the cross-default method that is, categorising a customer as being in default if he or she has at least one loan in default. This figure was 18% at year-end 2011, 20% in December 2010 and 22% in May 2010 (Chart III-5). In April-July 2012 the proportion remained similar, after decreasing fairly steady in preceding months. The main reason for the steady ratio since April this year is the increase in the proportion of HFF loans in default, while default ratios of the large commercial banks have decreased or remained constant.
- *The lower default level at the end of July 2012* compared with year-end 2010 is due to the reduction in the share of frozen loans from 6% to 2%, whereas other non-performing loans rose from 4% to 5% (Chart III-6). At the end of last July 9% of loans were under enforcement or collection. This percentage has remained unchanged for about two years.
- *The number of individuals on the default register* appears to be reaching a balance, as at the end of August 26,525 individuals were listed and the average YtD is 26,485. Chart III-8 shows the number and proportion of individuals added to and delisted from the register, based on six-month averages. The chart shows that the number of individuals added to the default register is decreasing while the number being delisted from the register is growing. Based on six-month averages, these lines intersect at the end of August. Furthermore, the chart shows that while the number of individuals being added to the default register as a percent-

Chart III-5
Status of loans from the three largest banks and Housing Financing Fund to households¹



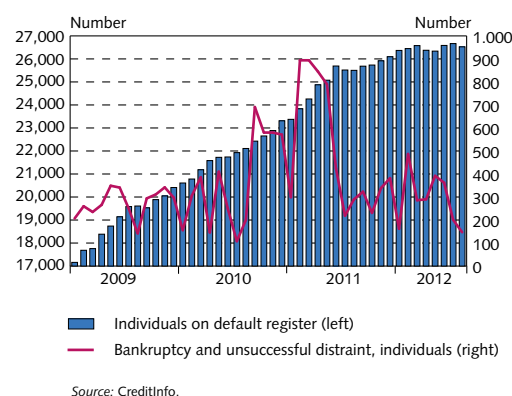
1. Parent companies, book value. 2. Non-performing loans are defined as loans in default for more than 90 days or deemed unlikely to be paid. The cross-default method is used; i.e., if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing.
Source: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

Chart III-6
Status of household loans in default from the large commercial banks and the Housing Financing Fund¹



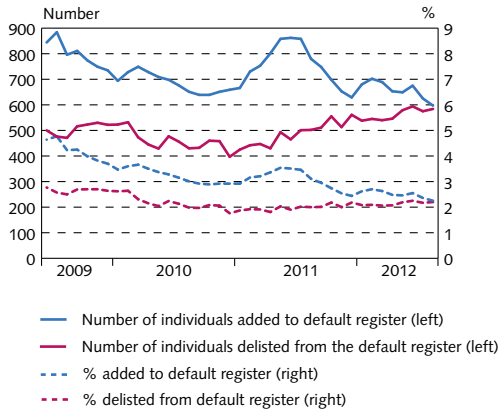
1. Parent companies, book value. Non-performing loans are defined as loans in default for more than 90 days or deemed unlikely to be paid. The cross-default method is used, i.e., if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing. 2. The share of loans in enforcement proceedings and collections declined in December 2011 because the HFF did not send out dunning letters or forced sale requests in the latter half of the month.
Source: Financial Supervisory Authority.

Chart III-7
Individuals on default register, bankruptcy, and unsuccessful distraint
Monthly data, January 2009 - August 2012



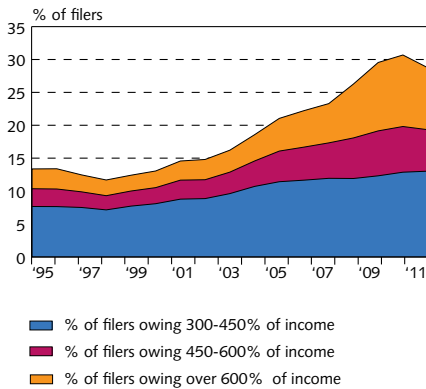
Source: CreditInfo.

Chart III-8
Number and % of individuals added to or removed from the default register
6 month average, June 2009 - August 2012



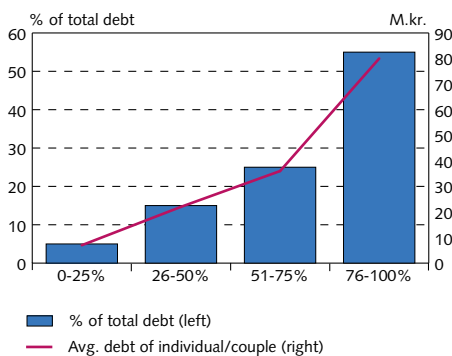
Source: CreditInfo.

Chart III-9
Filers owing over 300% of annual income



Sources: Statistics Iceland, Central Bank of Iceland.

Chart III-10
Breakdown of debtors seeking debt mitigation by the amount of claims



Source: Debtors' Ombudsman.

age of the total is decreasing, the percentage being delisted has remained almost constant for the past 2.5 years at around 2%.

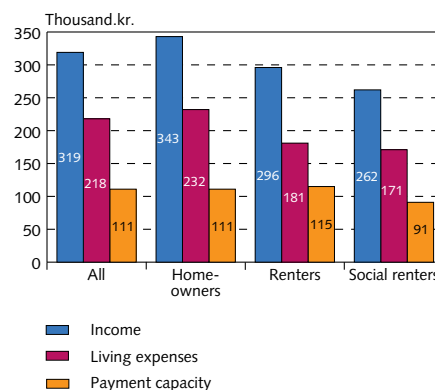
- The number of individuals on the default register maintained by CreditInfo is not a definitive indicator of the number of individuals with debt in arrears and/or in payment difficulties. Individuals undergoing debt mitigation by the Debtors' Ombudsman, for instance, and those whom the banks are handling in their problem debt resolution are not listed in the default register. Parties who have reached an agreement with their creditors on settlement of debts, freezing of loans or postponement of payment are in all likelihood not in the default register. This makes it difficult to obtain a comprehensive overview of the individuals in default and/or in payment difficulties. Furthermore, it must be borne in mind that there may be a time lag before individuals are added to or delisted from the default register. Some 60-400 days can elapse before defaults are recorded in the register and in the case of distraint actions or bankruptcies individuals remain in most cases on the default register for two years after liquidation concludes³ and for four years after unsuccessful distraint measures have been applied. This time lag explains to some extent differences in the development of numbers on the default register compared to default trends reported by the large commercial banks. For example, almost 16,000 individuals have been registered as the object of unsuccessful distraint or bankrupt since the beginning of 2009. It is not clear how large a portion of these individuals remain on the default register, but if most individuals are delisted from the register due to the fact that the limitation period has elapsed, the number of delistings from the register can be expected to rise in coming quarters, when four years have elapsed since the financial collapse and two years have passed from the reduction of the limitation period after liquidation concludes from four years to two.

- A turnaround in the frequency of unsuccessful distraint actions is visible in the autumn of 2011. During the first eight months of 2011, there were 5,266 unsuccessful distraint actions registered, whereas during the same period this year they numbered 2,327, a decrease of 50%. On the other hand, bankruptcies increased during this same period, from 96 during the first eight months of 2011 to 132 this year. It is noteworthy that in August 2012, 147 cases of bankruptcy and unsuccessful distraint were registered, the lowest number in three years, or since August 2009, when they numbered 142. The drop in the number of cases ending in legal collection, bankruptcy or unsuccessful distraint is in line with the decline in defaults at commercial banks.

3. Individuals whose liquidation conclusion has been registered are delisted two years after liquidation concludes, in accordance with amendments to the Act on Bankruptcy etc. (No. 21/1991) at year-end 2010 (amendments made by Act No. 142/2010). This applies to all liquidations concluding after the entry into force of the Act on 17 December 2010; four years must elapse for those liquidations concluded prior to the entry into force of the Act.

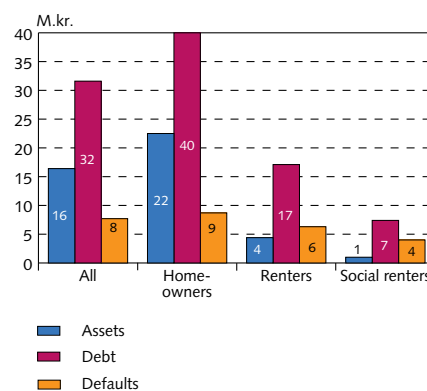
- *The proportion of income tax payers owing more than three times their annual income has decreased for the first time since 1998. In 2010, almost 31% of tax payers owed more than three times their annual income; this proportion dropped to 29% in 2011. This is a strong indicator that the debt service of the parties with the highest debt relative to their income is improving. A decrease in the proportion of tax payers owing more than three times their annual income between 2010 and 2011 resulted from a decrease in individuals owing more than six times their annual income from 10.9% to 9.4% and of individuals owing from 4.5 to 6 times their annual income from 7% to 6.3%.*
- At the end of August, 4,218 individuals had applied for debt mitigation to the *Debtors' Ombudsman*; of these, 387 were still being processed by the Ombudsman's office, 1,710 had been referred to supervisors and 2,121 had been concluded. Of the last-mentioned, 1,080 cases were concluded by voluntary agreements. Only 9% of applications are therefore still being processed by the Debtors' Ombudsman, while 51% have been closed. At the end of June 2011, however, 68% of applications were still being processed by the Ombudsman's office and only 6% had been concluded. Considerable success has therefore been achieved in processing applications by the Debtors' Ombudsman.
- *If applications for debt mitigation are classified in four categories by the amount of claims included in each application, it is noteworthy that the average amount owed by the quartile of individuals/couples with highest debts is around 80 m.kr. This group accounts for 56% of the total claims amount (Chart III-10). The quartile with the lowest debts, however, owes on average around 7 m.kr. and their debts comprise only around 5% of the total. The difference between the quartile with lowest debt and that with highest debt is therefore more than eleven-fold. The average debt of all individuals/couples applying for debt mitigation is around 36 m.kr.*
- An analysis of applications which have been approved for negotiation of debt mitigation, or whose processing has proceeded far enough to enable an assessment of *income, living expenses and debts*, shows that there is a considerable variation in applicants' situation depending upon their form of residence. Income of homeowners, for instance, is somewhat higher than of other applicants, while their debts are also as a rule considerably greater. Homeowners' and renters' payment capacity is similar since the living expenses of homeowners are higher than those of renters. It is noteworthy that renters owe, on average, 17 m.kr. and have an average negative asset position of around 13 m.kr. (Chart III-12).
- *Households' situation continues to improve.* The success of financial restructuring of household debt is reflected in the decrease in gross household debt, which is likely to continue to fall in coming quarters. Private consumption grew considerably in 2011 and this trend is expected to continue, rising by around 3%

Chart III-11
Income, living expenses and payment capacity of parties whose applications for debt mitigation have been approved¹



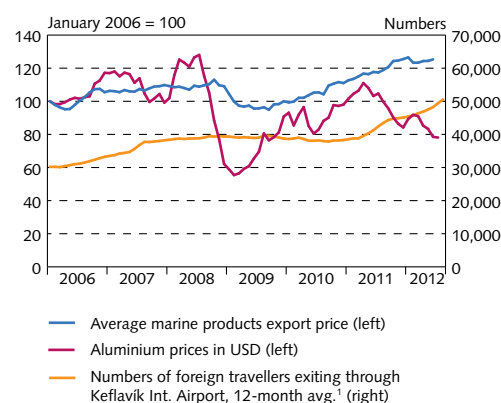
1. Data includes average income, living expenses and payment capacity of parties whose applications for debt mitigation have been approved by the Debtors' Ombudsman.
Source: Debtors' Ombudsman.

Chart III-12
Assets, debts and defaults of parties whose applications for debt mitigation have been approved¹



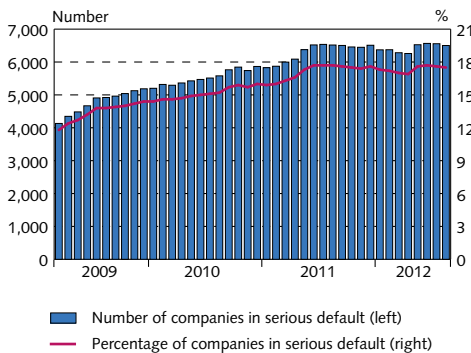
1. Data includes average assets, debts and defaults of parties whose applications have been approved by the Debtors' Ombudsman.
Source: Debtors' Ombudsman.

Chart III-13
Export prices for principal export products and number of foreign travellers



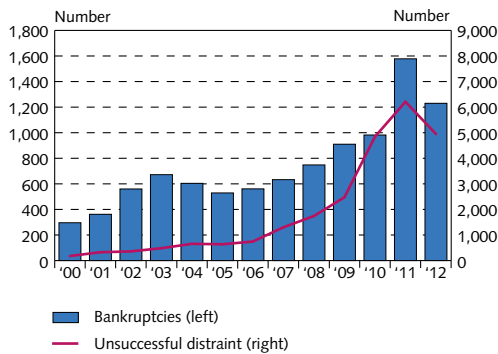
1. Monthly numbers are the average for the past 12 months.
Sources: Icelandic Tourist Board, Statistics Iceland and Macrobond.

Chart III-14
Companies in serious default
March 2009 - August 2011



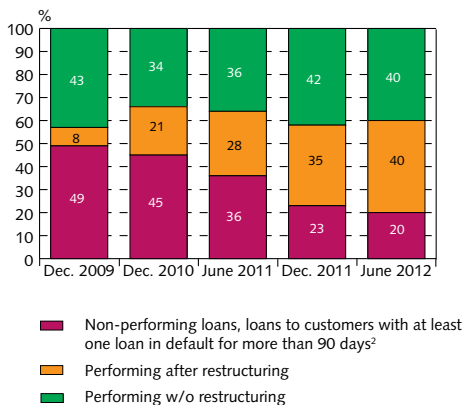
Source: CreditInfo.

Chart III-15
Corporate bankruptcies and unsuccessful distraint
Total for entire year; 2000-2012¹



1. Total for 2012 is extrapolated from the first 6 months of the year.
Sources: Registers Iceland, Statistics Iceland.

Chart III-16
Status of the three largest commercial banks' corporate loans¹



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.
Source: Financial Supervisory Authority.

this year. Real wages have continued to rise in 2012 after increasing by 3.7% in 2011. Purchasing power of disposable income is forecast to increase by 1% this year and by another 2.5% next year. Unemployment in August was 5.8%⁴ and is forecast to average 5.9% in 2012 and then decrease by 0.7% next year. Finally, households' net asset position has increased steadily since 2010 and this development is expected to continue as housing prices rise. The main factors of uncertainty regarding households' financial circumstances are the employment situation, the eurozone crisis and the lifting of currency controls. Generally speaking, however, the outlook for households is positive.

Corporates

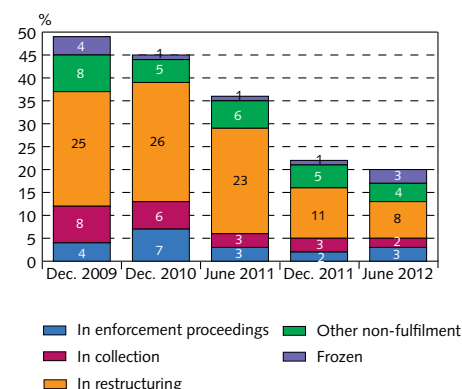
- The *operating environment of domestic undertakings* has in many respects been advantageous in recent months. Chart III-13 shows how export prices for aluminium and marine products have developed, together with the number of foreign visitors to Iceland in 2006-2012. Export prices for marine products are high, despite persistent uncertainty in the Eurozone. All signs point towards a record number of foreign visitors this year as well. On the other hand, aluminium prices have continued to slide, with a negative impact on the performance of energy companies.
- The *Supreme Court judgement* of 15 February this year on the validity of receipts for full payment of exchange rate-linked loan agreements has temporarily slowed corporate restructuring, increased uncertainty as to the situation of individual undertakings and possibly had a negative effect on debtors' willingness to make payments. Further discussion of the judgement and the uncertainty it entails is provided in Chapter II.
- Since May 2011, both the *number and proportion of companies on the default register* has changed only insignificantly. Around 6,500 or 17.5% of companies are currently on the default register. A very slight increase in defaults in May this year may be linked to the above-mentioned Supreme Court judgement of 15 February. The default register shows defaults with a time lag, i.e. often some time elapses before companies are delisted from the register after their debts are brought up to date or restructured or the company is wound-up (liquidated). Therefore actual defaults may be somewhat lower in number than indicated by the default register.
- Corporate bankruptcies and unsuccessful distraint actions* have decreased by 30% in H1 2012 compared with H1 2011. During the first six months of 2012, there were 572 corporate *bankruptcies*, compared to 841 in the first half of 2011. Unsuccessful distraint actions have also decreased in number, from 3,944 dur-

4. August unemployment was 5.8% according to the Labour Force Survey by Statistics Iceland and 4.8% according to figures from the Directorate of Labour.

ing the first half of 2011 to 2,475 in the same period this year, a decrease of almost 40%. These are clear signs that corporate restructuring is on the right track. The least viable undertakings have been wound up, while those with a better chance of success have been restructured.

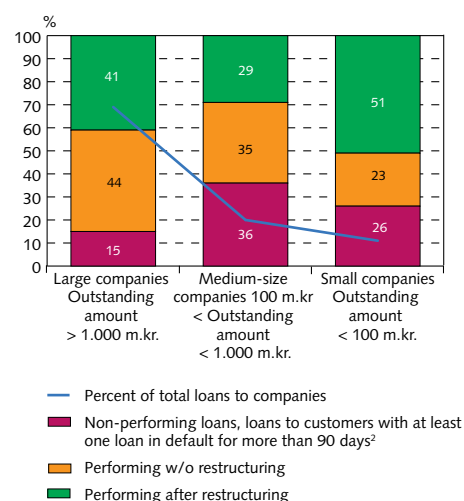
- Corporate loans in default* at the three large commercial banks dropped in the first half of 2012 (Chart III-16). The share of loans in default declined from 23% at year-end 2011 to 20% at the end of June this year, based on book value and assuming that all of a customer's loans are in default if one loan in default (cross-default). There are various indications that, in many instances, there is a legal dispute between financial institutions and companies in default concerning the validity of the loan agreements. Uncertainty prevails concerning the rules to be applied in settling exchange rate-linked loan contracts. Recalculation of loans to firms that have already been restructured or have paid on time will be time-consuming and will slow the restructuring process.
- By the end of 2011, 11% of non-performing loans were *undergoing restructuring*, and of those, 4% were in the documentation process. At the end of June this year, the proportion of non-performing loans being restructured had dropped to 8% (Chart III-17), of which 3% were in the documentation process. The proportion of non-performing loans under enforcement or collection has remained practically unchanged at around 5% of the total portfolio, since mid-2011. This may possibly be due to a reluctance to press forward with enforcement due to uncertainty as to the actual balance on and legality of exchange rate-linked loan contracts. Uncertainty concerning exchange rate-linked loan contracts needs to be eliminated as soon as at all possible, both for the sake of the economy and the financial undertakings.
- Things changed for the better* in 2011, when corporate debt restructuring progressed from consisting almost solely of loan extensions to including some write-offs. Around 40% of the large commercial banks' corporate loan portfolios have been restructured. Some 45% of these restructurings have been maturity extensions, another 45% have been written down and 10% converted to equity stakes.
- Restructuring of large corporations* is farther along than for smaller companies.⁵ At the end of June, for instance, around 15% of loans to large corporations were non-performing, as were 36% of loans to medium-size companies and 26% of loans to small companies. Furthermore, 44% of loans to large companies have been restructured but only around 23% of loans to small companies. Similarly, 21% of loans to large companies have been written down, but only 7% of loans to small companies (Chart III-19). In

Chart III-17
Status of non-performing corporate loans¹



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. Corporate loans include loans granted by the three largest commercial banks.
Source: Financial Supervisory Authority.

Chart III-18
Status of the three largest commercial banks' corporate loans, by amount of claim¹
June 2012



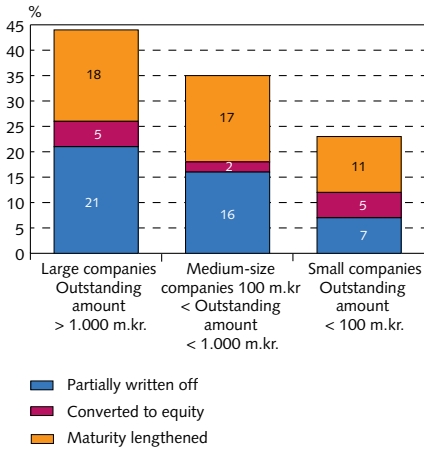
1. Parent companies, book value. 2. Non-performing loans are defined as loans in default for more than 90 days or deemed unlikely to be paid. The cross-default method is used; that is, if one loan taken by a customer is non-performing, all of that customer's loans are considered non-performing.

5. Large companies are defined as those having outstanding debts of over 1,000 m.kr. to individual banks, medium-size companies are those with outstanding debts of 100-1,000 m.kr. and small companies are those with outstanding debts of less than 100 m.kr.

Chart III-19

Corporate debt restructuring measures, by amount of claim¹

June 2012

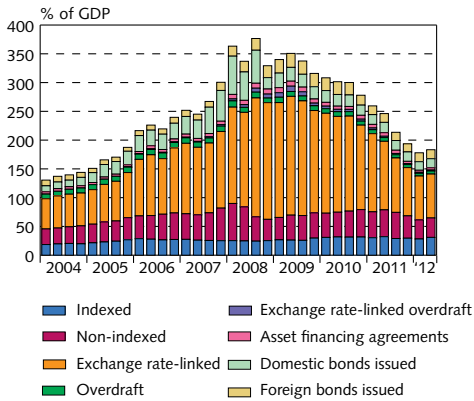


1. Parent companies, book value. Corporate loans include loans granted by the three largest commercial banks.
Source: Financial Supervisory Authority.

Chart III-20

Corporate debt as % of GDP¹

Q1 2004 - Q2 2012



1. Debt to domestic and foreign financial institutions and issued market bonds.
Source: Central Bank of Iceland.

addition, 18% of loans to large companies have been extended compared to 11% of loans to small companies.

- In June the *real estate company Reginn hf.* was listed on the equity market, only the second new listing since the banking system collapse. There has been a reluctance to list companies publicly, despite demand for domestic investment options. The banks have, however, disposed of a considerable portion of their holdings in companies with unrelated operations, and it is important that this trend continue.
- Companies have to an increasing extent obtained funding through bond issues. A large number of companies have issued and sold bonds in connection with the Central Bank's foreign currency auctions. In the spring the Concert Hall and Convention Centre Harpa was refinanced with a bond issue and additional companies have announced upcoming issues.
- Despite debt restructuring, write-downs and bankruptcies, the debts of Icelandic corporates are still high by international comparison. According to the latest assessment by the Central Bank, they were close to 185% of GDP at end of June 2012. In recent months the debt ratio has remained practically unchanged, after declining rapidly from its peak of 375% of GDP in 2008.⁶ Continuing growth is necessary if the private sector is to manage its high leverage.
- Business investment has been picking up - it increased by 25.1% in 2011 and is forecast to rise by over 10% this year. At the same time, further investment in power-intensive industry appears to be in sight, although energy companies' access to foreign financial markets needs to be ensured. Further increase in investment is important to maintain the improvement in the economy recently.
- Continuing uncertainty on leading export markets and declining prices for exports combined with interest rate rises abroad could have a considerably negative impact on domestic undertakings, especially in highly leveraged sectors where capital investment is high.
- Among other factors, capital controls and their lifting create uncertainty in the corporate operating environment. Icelandic companies are still highly leveraged, in part with exchange rate-linked debt. Substantial FX market instability could weaken the balance sheets of many companies. Lifting of controls could also result in higher domestic capital costs. In the longer term, undertakings will have to adapt their balance sheets to market interest rates outside this sheltered environment, with the return on investment options not determined by controls.

6. This refers to Icelandic companies' total debt owed to domestic and foreign financial institutions and issued market bonds.

IV Funding

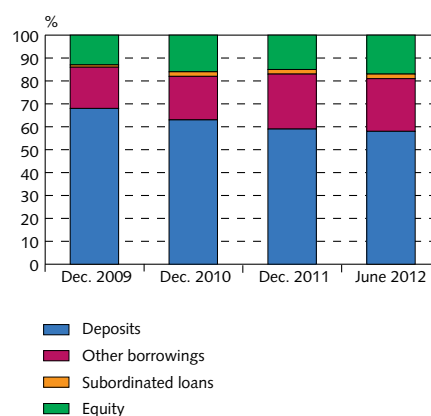
Demand deposits pose liquidity risk

The commercial banks are funded primarily by deposits, a major portion of which are deposits payable on demand. The banks' liquidity risk is primarily linked to possible withdrawals of deposits. According to the Central Bank's rules and Financial Supervisory Authority (FME) requirements the banks' liquidity is strong. Recently the banks' market funding has risen slightly with new covered bond issues by Arion Bank and Íslandsbanki to fund mortgage loans.

Funding of commercial banks and HFF

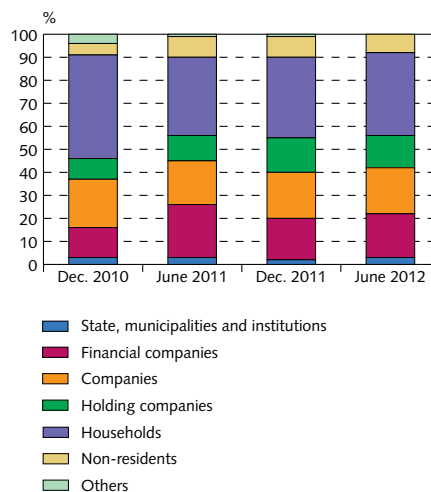
- In June 2012, deposits comprised around 58% of commercial banks' funding, with this proportion decreasing slightly in recent months. At the end of Q2 subordinated loans represented 2% of the commercial banks' funding, equity was 17% and other borrowing was still a relatively small proportion of their funding at around 23%.
- The banks' liquidity risk is primarily linked to potential withdrawals of deposits, a high proportion of which are demand deposits which the banks must be able to repay at any given time. The banks need to increase the share of term deposits in their funding to reduce liquidity risk. Capital controls prevent depositors from transferring funds out of Iceland, but the banks need to be prepared for the controls to be lifted.
- At the end of June this year, non-residents held around 8% of deposits with the commercial banks, compared with around 9% at year-end 2011; the decrease amounted to just over 17 b.kr. About 86% of non-residents' deposits are in krónur. The decrease in non-residents' deposits is attributable mainly to liberalisation-related measures by the Central Bank and to a transfer of deposits to other investment options. Other depositors' holdings have changed insignificantly since the beginning of the year (chart IV-2).
- Funding of commercial banks other than deposits has increased slightly recently with covered bonds issued by Arion Bank and Íslandsbanki to fund their mortgage loans. Since the publication of the most recent issue of *Financial Stability*, Arion Bank has expanded its non-indexed bond series by 1.3 b.kr. As of the end of June, covered bond issuance by Íslandsbanki and Arion Bank, which began in December 2011, totalled almost 14 b.kr. The contingent bond to be issued by Landsbankinn to LBI (the old Landsbanki) has also risen in value.
- The banks still lack access to foreign market funding. The banks must complete the restructuring of their loan portfolios and lower their default ratios to be able to seek market funding abroad on reasonable terms. The Treasury has already blazed a path, for instance, with a bond issue last May in USD on foreign credit

Chart IV-1
Commercial banks' funding¹



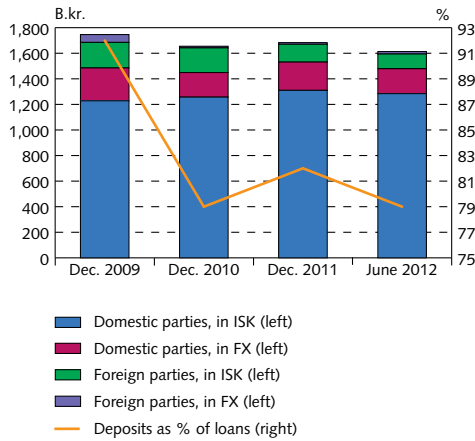
1. Parent companies.
Source: Central Bank of Iceland.

Chart IV-2
Deposit owners¹



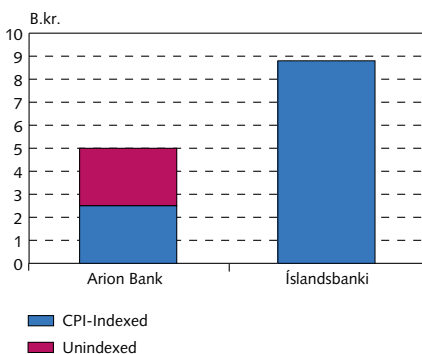
1. Parent companies, commercial banks.
Source: Central Bank of Iceland.

Chart IV-3
Deposits with commercial banks¹



1. Parent companies, commercial banks. Deposits of customers and financial institutions. Deposits with Byr hf. included as of 2010. Deposits with SpKef included as of 2011.
Source: Central Bank of Iceland.

Chart IV-4
Commercial bank's issuance of covered bonds last 12 months¹
June 2012



1. Arion Bank and Íslandsbanki.
Source: Nasdaq OMX Iceland, banks news.

markets. As Iceland's sovereign rating improves further, it will give the banks an opportunity to achieve an investment grade rating, which will further boost their funding efforts abroad.

- In the first half of 2012 an agreement was concluded between Landsbankinn and LBI on prepayment by the new bank of one-quarter of the principal of the A bonds issued to the old bank in return for assets transferred to the new bank. The prepayment was equivalent to 73 b.kr. in EUR, USD and GBP. As of the end of June 2012, the outstanding principal owed on the bonds was around 209 b.kr. At the end of March 2013, the new bank will issue a bond denominated in foreign currencies reflecting the change in value of the assets taken over from the old bank. Its value can be up to 92 b.kr.; at the end of June this year it was valued at 69 b.kr. in Landsbankinn's interim financial statements. The new bank's total debt to the old bank as of the end of June was therefore 278 b.kr.

- *The liquidity of the large commercial banks is well above the minimum prescribed by the Central Bank's rules and FME requirements.* By law, the Central Bank sets the rules on credit institutions' liquidity. Under those rules, liquid assets and liabilities are grouped according to maturity and weighted in terms of risk. According to the rules, credit institutions must have liquid assets exceeding their liabilities for the next three months. In addition to the rules set by the Central Bank, FME demands that the three large commercial banks hold liquid funds equivalent to at least 5% of their demand deposits and secure liquid assets equivalent to at least 20% of their total deposits.¹

- The Central Bank has decided to amend its liquidity rules to classify *deposits of financial undertakings in winding-up proceedings as liabilities to credit institutions (100% coverage)*. As many financial undertakings in winding-up proceedings have lost their banking licenses, in technical terms their deposits are transferred to a different classification of the Central Bank's liquidity rules, i.e. from the class liabilities to credit institutions (100% coverage) to the class of retail deposits (5-10% coverage). Generally speaking, deposits of credit institutions are less "sticky" than other traditional deposits, e.g. deposits of banks' regular customers, making it appropriate to give them higher coverage than traditional retail deposits. At the same time it is evident that deposits of financial undertakings in winding-up proceedings are merely awaiting distribution to creditors, making them more volatile than retail deposits generally. The Central Bank's liquidity rules are prudential regulations, aimed at providing the most reliable picture of liquidity. Therefore the Bank decided to amend its liquidity rules to take this risk into consideration. The amended liquidity rules came into effect on 1 October 2012, but credit institutions which so request

1. FME liquidity requirements are independent of other capital outflows, whether expected or unexpected.

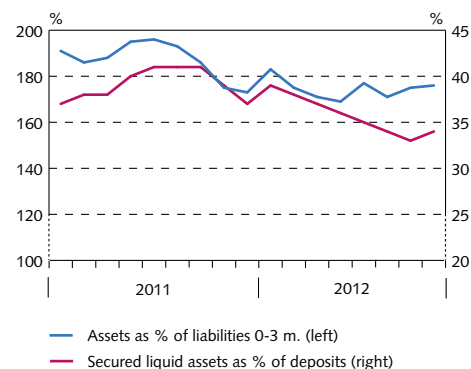
will be given the option of implementing the new classification in stages by the end of December 2012.

- *New liquidity rules are being drafted* which will be based on the work of the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA), adapted to circumstances in Iceland. New liquidity rules are expected to provide, firstly, a liquidity coverage ratio (LCR), which measures secure liquid assets as a percentage of the next 30 days' liquidity outflows and, secondly, a net stable funding ratio (NSFR), which is to ensure stable funding in proportion to long-term assets. Data gathering in connection with new liquidity rules is expected to begin at the end of this year, and the rules are intended to take effect around mid-2013.
- The Central Bank recently issued the report *Prudential Rules following Capital Controls*.² It discussed possible regulations and management tools to protect the financial system against the risks inherent in unrestricted capital movements. It makes five main proposals, four of which concern financial institutions to some extent: amendments to rules on liquidity and foreign currency balance; limits on deposit-taking abroad; limits on FX lending to parties without natural hedges; and measures to curb capital inflows. The implementation of the new liquidity rules next year presents an opportunity to simultaneously introduce these proposed prudential rules on liquidity.
- By far the greatest share of funding for the Housing Financing Fund (HFF) comes from issuing inflation-indexed HFF bonds in four series (HFF14, HFF24, HFF34, and HFF44). As of the end of June 2012 the outstanding stock of bonds issued by HFF amounted to almost 865 b.kr. Due to a decrease in the number of loans granted and *increase in prepayments by HFF customers* in recent quarters, only one HFF bond auction was held during the first six months of this year, of the HFF44 series, with a total market value of 5.8 b.kr. As large-scale prepayments could disturb the balance in the average duration of the Fund's assets and liabilities, it is important that HFF keep such mismatches under control despite increased prepayments.

Chart IV-5

The largest commercial banks' liquidity¹

Monthly data April 2011 - August 2012



1. Parent companies. According to Central Bank of Iceland liquidity rules and FME requirements.

Sources: Financial Supervisory Authority, Central Bank of Iceland.

2. For details see *Central Bank Report No. 6* or <http://www.cb.is/library/Skraarsafn---EN/Reports/Serit%20nr%20%206%20Prudential.pdf>

Sheltered by capital controls

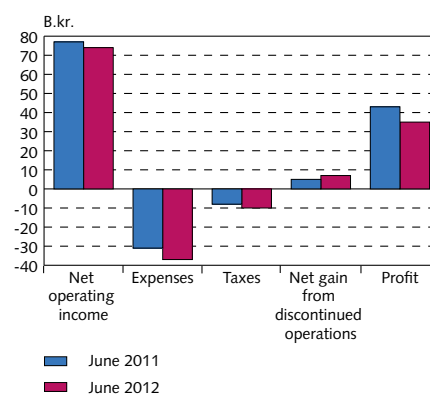
In H1 2012 the operating performance of the large commercial banks was good, with their core income items increasing over the same period of 2011. Some uncertainty persists on changes in loan valuations, in part due to questions concerning interpretation of court judgements. The banks' operating expenses have also risen. While commercial banks' currency imbalances have decreased, their indexation imbalances have grown. The capital ratio of the large commercial banks, calculated according to the relevant statutory provisions, was over 23% at the end of June 2012. In H1 2012, the Housing Financing Fund (HFF) lost around 1/3 of its equity and its capital ratio was only 1.4% at the end of June 2012.

Commercial banks perform well under capital controls

- The commercial banks published their 6M results at the end of August this year (H1 2012).¹ The results are reviewed but not audited. A number of changes occurred to the banks' groups between H1 2011 and H1 2012, including Íslandsbanki's acquisition of Byr and Arion Bank's takeover of its predecessor Kaupthing's housing mortgages, which were financed by covered bonds which the bank also assumed.
- Various legal and political uncertainties still characterise the banks' operating environment, including interpretation of Supreme Court judgements on FX loans and proposed changes to the system of fisheries management. Furthermore, the lifting of capital controls will create considerable uncertainties for banking operations, affecting their funding especially.
- In H1 2012, the Central Bank of Iceland raised interest rates three times, for a total of 1 percentage point. The CPI used for indexation rose by 3.5% during this period while the selected shares index of the NASDAQ OMX Exchange Iceland increased by almost 15%. The banks' results in part reflect the above developments.
- The aggregate profit of the commercial banks in H1 2012 amounted to 34.8 b.kr., decreasing by almost 8 b.kr. from the same period of 2011. Return on total assets (ROA) was 2.5% and ROE almost 16%, which is lower than in the same period of the previous year. Now as before, numerous extraordinary items mark the banks' results. The commercial banks' net interest income totalled 48.1 b.kr. in H1 2012, and their aggregate calculated interest differential was 3.5%. The interest differential of the individual banks developed differently, in part due to their

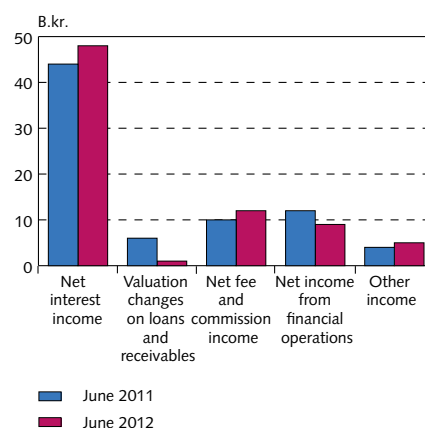
1. Discussion of their H1 2012 operations is based on the consolidated results of the three largest commercial banks; comparison figures are for H1 2011. Figures represent the aggregate outcome of the commercial banks unless otherwise stated. Discussion of their aggregate position may diverge from that of individual financial undertakings. As a number of changes occurred to the banks' groups between H1 2011 and H1 2012, this should be borne in mind in comparing the two periods.

Chart V-1
Three largest banks' income and expenses¹



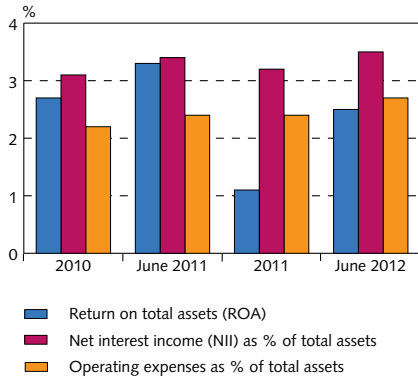
1. Consolidated accounts.
Sources: Commercial banks' interim financial statements.

Chart V-2
Three largest banks' net operating income¹



1. Consolidated accounts.

Chart V-3
Profitability, interest margin and cost ratio
2010 - June 2012



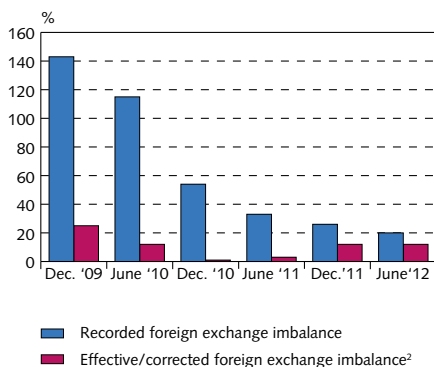
Sources: Commercial banks' annual and interim financial statements.

varying indexation imbalances, changes to their balance sheets from the previous period and revaluations to their loan portfolios. The rise in appraised value of their loan portfolios amounted to 900 m.kr., which is 5.3 b.kr. less than in the previous period. In general, corporate loans were revalued upward while household loans were written down. Some uncertainty persists concerning the revaluation of credit this year, in part due to uncertainty on interpretation of court verdicts.

- *Net fees and commissions* amounted to 11.9 b.kr. in H1 2012, increasing by 15% over the previous year. Part of the increase resulted from changes to the banks' groups, in addition to which commissions for asset management, payment cards and investment banking activities were considerable. All the commercial banks emphasise boosting fees and commissions in the near term. Commercial banks' income from financial activities amounted to 8.8 b.kr. in H1 2012. Trading gains on equities and bonds were around 7.3 b.kr., while profit on foreign currency imbalances amounted to over 1.5 b.kr. Other income items, including profit on discontinued operations, were sizeable. Profit on discontinued operations, for instance, amounted to 6.8 b.kr., increasing somewhat over the previous period. In H1 2012 the banks disposed of many companies taken over in part or in full.

- *Commercial banks' operating expenses* in H1 2012 amounted to 36.8 b.kr., increasing by 5.4 b.kr. or 17% over the previous period, and their cost-income ratios rose as well. Salary expenses, which increased by 23% over the previous period, comprise almost half of operating expenses. Salary expenses rose due to takeovers of other financial undertakings, contractual increases resulting from collective bargaining agreements, expensing of employment termination costs and a new Financial Activities Tax (FAT) on salaries of 5.45%, plus wage drift. In addition, various extra costs were incurred, such as consultancy and IT costs, as a result of mergers with other financial undertakings and price level increases. Taxation of financial undertakings has increased considerably recently. In addition to the FAT on salaries, financial undertakings pay 20% corporate income tax, 6% extra income tax on profit exceeding 1 b.kr., a special banking tax on gross liabilities and a temporary tax to cover supplementary interest benefits, which is also calculated on the basis of gross liabilities. The above-mentioned taxes (excluding the FAT) totalled 9.6 b.kr. in H1 2012 compared to 7.7 b.kr. in H1 2011. It should be pointed out that taxes expensed in the banks' annual results for 2011 amounted to just over 3 b.kr.

Chart V-4
Imbalance between the three largest commercial banks' foreign-denominated assets and liabilities¹



1. Consolidated figures. Imbalance as a percentage of capital base.
2. Method used to calculate foreign exchange balance, which takes account of whether value and recovery are dependent on exchange rate movements. This method has been called the delta correction, the balance has been called the effective foreign exchange balance, and the exchange rate-linked assets not included in the effective balance have been called ineffective exchange rate-linked assets (so-called FX/ISK assets). This balance should therefore be closer to the balance the bank would have if uncertainty were eliminated and restructuring of foreign assets entirely complete. Only the three largest commercial banks are authorised to use this method. Landsbankinn hf. stopped using an adjusted foreign exchange balance in June 2011 and considered its ineffective exchange rate-linked assets insignificant.
Sources: Financial Supervisory Authority, Financial institutions' annual and interim financial statements.

Foreign currency and indexation imbalance

- *Recognised foreign currency imbalance of commercial bank groups continues to decrease.* At the end of June 2012, foreign currency imbalance recognised by the three largest commercial banks' amounted to 20% of their capital base, after declining steadily in recent quarters. The banks' interim and annual finan-

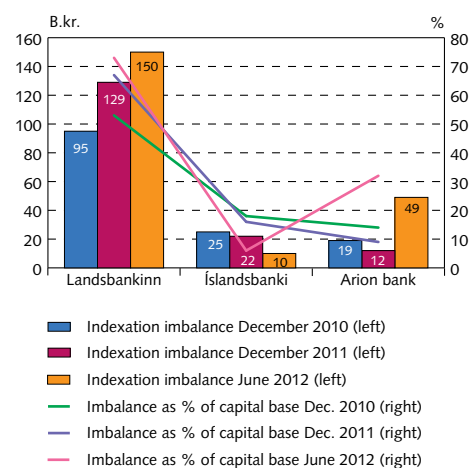
cial statements include adjustments to foreign currency balances resulting from ineffective exchange rate-linked assets, i.e. assets in the form of foreign-denominated loans taken by borrowers with income in Icelandic krónur. Their adjusted foreign currency balance has changed little since the beginning of the year and was around 12% at the end of June 2012. Because of circumstances which arose following the banking collapse, the Central Bank has a special authorisation to grant credit institutions temporary exemptions from rules on foreign balance until year-end 2012. At the end of June this year, six credit institutions exercised their exemptions from the 15% maximum.

- *Commercial banks' indexation imbalance has increased.* At the end of June 2012 the indexation imbalance of the large commercial banks was positive by over 208 b. kr., compared with a positive imbalance of 163 b.kr. at year-end 2011. The increase since the beginning of the year reflects an increase of over 36 b.kr. in the imbalance at Arion Bank (a fourfold increase) and of 21 b.kr. at Landsbankinn, while this was offset by a decrease in the indexation imbalance of over 12 b.kr. at Íslandsbanki. The indexation imbalance as a ratio of the capital base was proportionally greatest at Landsbankinn at 73%, 32% at Arion Bank and 6% at Íslandsbanki. The main explanation for the increase in indexation imbalances in H1 2012 is the conversion of exchange rate-linked loans to indexed loans as part of debt restructuring, in addition to which swaps and changes to banking groups raised the imbalances.

Equity position

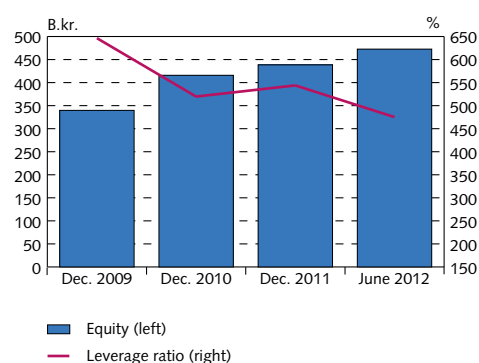
- The *equity* of the large commercial banks totalled 473 b.kr. as of the end of June 2012, increasing by the amount of their profit since last year-end. During the same period, their leverage ratio (ratio of net debt to equity) decreased somewhat to 475% at the end of June. The banks' capital base as a proportion of their risk-weighted asset base was 23.1% at the end of June 2012, which is well above the 16% minimum set by FME for the banks; their Tier 1 ratio was 20.8%.
- The equity of *MP Bank* amounted to 5.2 b.kr. at the end of June 2012, and its leverage ratio is therefore almost thirteen-fold. Its capital base as a proportion of risk-weighted asset base was 14.2% at the end of June, compared to 19.2% at year-end 2011. MP Bank's capital ratio is the lowest of the currently active commercial banks. Its total assets have grown by 43% since the beginning of this year, with loans to customers increasing by 56%. MP Bank, which is financed by deposits to a large extent, has a high ratio of deposits to lending, although this has decreased slightly due to lending growth. The bank has stated that its capital base has become a constraint to its growth and a new share capital offering by the bank is likely this winter.
- The *savings banks' position remains difficult.* In H1 2012, the majority of savings banks reported losses or minimal profit.

Chart V-5
CPI indexation balance of the three largest commercial banks¹
2010 - June 2012



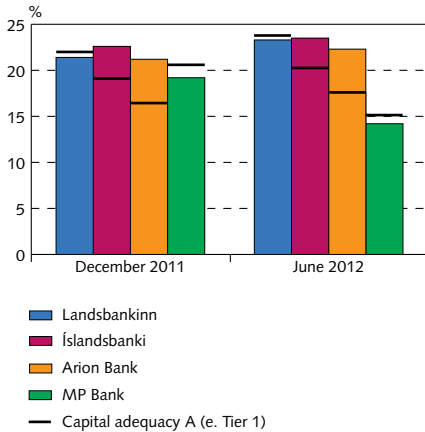
1. Consolidated accounts.
Sources: Commercial banks' interim financial statements.

Chart V-6
Equity and leverage ratios of the three largest commercial banks¹



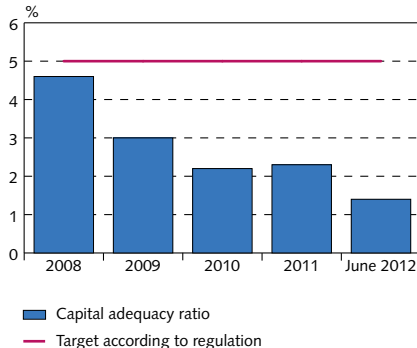
1. Consolidated accounts.
Sources: Commercial banks' interim financial statements.

Chart V-7
Commercial banks' capital adequacy ratios¹



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

Chart V-8
HFF capital adequacy ratios



Sources: HFF's annual and interim financial statements.

The savings banks Sparisjóður Vestmannaeyja and Sparisjóður Bolungarvíkur still fail to meet FME's capital requirement. The Savings Banks' Guarantee Fund had provided a new injection of guarantee capital and subordinated loan for Sparisjóður Svarfdæla, after Landsbankinn and the savings bank decided by mutual agreement not to proceed with a previously announced acquisition without penalty. As all the savings banks have not yet made precautionary provisions to their credit loss accounts reflecting possible losses on exchange rate-linked loans which are very likely unlawful, the capital ratios of some savings banks will likely fall still further.

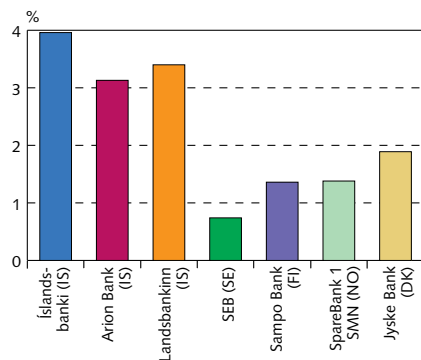
- The *equity of the Housing Financing Fund* (HFF) amounted to almost 6.5 b.kr. at the end of June 2012, decreasing by one-third since the beginning of the year. HFF's capital ratio was only 1.4%, whereas its long-term target is to maintain a capital ratio over 5.0%. In H1 2012, impairment of HFF's loans and real estate held for sale amounted to over 3 b.kr., explaining the Fund's half-year losses and equity impairment. HFF's defaults are high and the quality of its loan portfolio is uncertain. The government of Iceland has appointed a working group to assess the position and outlook for HFF. Furthermore, the government has repeated statements that HFF enjoys full state backing and that in the longer term the Fund's capital ratio will be at least 5% of its risk-weighted asset base.²
- *Uncertainty persists, however, as to the actual value of the banks' loans* owing to high default levels, continuing uncertainty as to the legality of loan contracts, political uncertainty concerning the fisheries management system and other factors. The relaxation of capital controls could also destabilise the króna and put pressure on their capital position. A temporary drop in the exchange rate could affect repayments of FX loans still held by borrowers with income in Icelandic krónur and the payment capacity of borrowers with indexed obligations could also be jeopardised if the pace of inflation outstrips that of wage increases. A substantial risk of impairment therefore remains which could have a major impact on the banks' capital ratios. This makes a strong capital position necessary until debt restructuring is concluded and the above uncertainty reduced. Furthermore, a strong capital position is a prerequisite for facilitating market refinancing.

2. Cf. a news announcement on the website of the Ministry of Finance on 30/08/2012.

Appendix

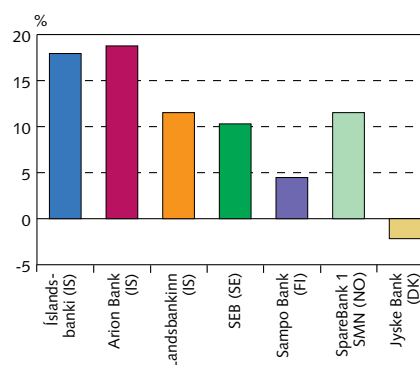
Nordic comparison

Chart 1
Interest rate differential¹
June 2012



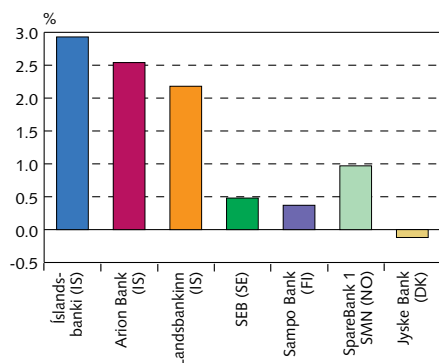
1. Interest rate differential = net interest income/ average of total assets. Islandsbanki's large net interest margin is due largely to a difference in financial reporting methods used by the banks; Islandsbanki uses a different method for redemption of interest income from transferred loans. Sources: Banks' annual and interim accounts.

Chart 2
Return on equity¹
June 2012



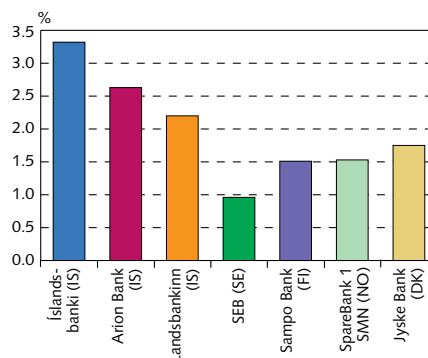
1. ROE = Net earnings/average of total equity. Sources: Banks' annual and interim accounts.

Chart 3
Return on total assets¹
June 2012



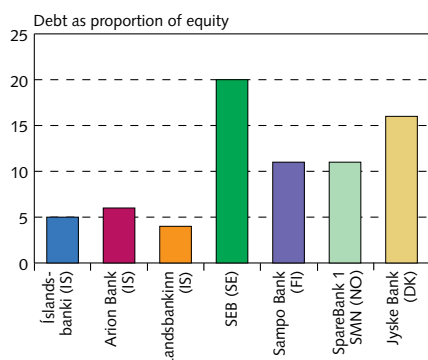
1. ROA = net earnings/average of total assets. Sources: Banks' annual and interim accounts.

Chart 4
Cost-to-assets¹
June 2012



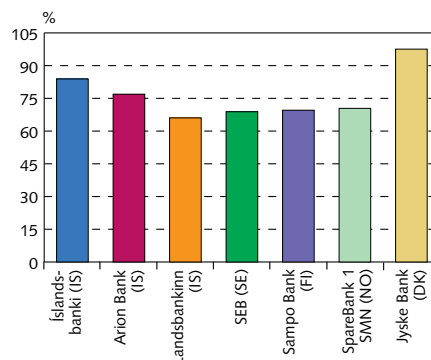
1. Cost-to-assets = operating expense/average of total assets. Sources: Banks' annual and interim accounts.

Chart 5
Leverage ratio¹
June 2012



1. Leverage ratio = debt/equity. Sources: Banks' annual and interim accounts.

Chart 6
Deposit-to-loan ratio¹
June 2012



1. Deposit-to-loan ratio = deposits from customers/loans and receivables to customers. Sources: Banks' annual and interim accounts.