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SM/08/274
Correction 1

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December 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Financial System Stability Assessment—Update**

The attached corrections to SM/08/274 (8/20/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 1, Text Box, para. 2, line 1: for "staff met with one of the three Governors of the Central Bank of Iceland (CBI)" read "staff met with Mr. Ingimundur Fridriksson, a Governor of the Central Bank of Iceland"

Page 6, para. 1, line 7: for "Banks plan to augment their liquidity" read "Banks have been augmenting their liquidity"

Page 17, para. 20, line 4: for "…triggers early repayment." read "…triggers additional collateral calls or early prepayment."

Page 22, para. 34, line 5: for "…price of the property." read "…price of the property, subject to a loan limit of ISK 20 million."

Questions may be referred to Mr. Hoelscher, MCM (ext. 37046).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Financial System Stability Assessment Update

Prepared by the Monetary and Capital Markets and European Departments

Approved by Jaime Caruana and Ajai Chopra

August 19, 2008

The Financial Sector Assessment Program (FSAP) Update for Iceland was conducted in Reykjavik in June 2008. The FSAP team comprised David S. Hoelscher (team leader, IMF), Joerg Genner, Peter Hayward (both consultants), Iryna Ivaschenko (IMF), Paul Kupiec, Felice Marlor (both consultants), and Luisa Zanforlin (IMF).

During the mission, ~~staff met with one of the three Governors of the Central Bank of Iceland (CBI)~~staff met with Mr. Ingimundur Fridriksson, a Governor of the Central Bank of Iceland, the Director General of the Financial Supervisory Authority (FME), and senior officials from both institutions. In addition, it met with representatives of private financial institutions and the stock exchange. The main findings include:

- The banking system's reported financial indicators are above minimum regulatory requirements.
- Notwithstanding current strengths, vulnerabilities are high and increasing, arising from funding and credit risks and limited access to wholesale credit markets.
- The banks are adopting steps to address these vulnerabilities, including diversification of funding and selected asset sales, but it remains uncertain if these adjustments are sufficient in today's financial environment.
- In light of concerns about market access, stronger capital and liquidity buffers appear appropriate.
- The supervisory framework has been improved and the supervisor's capacity to supervise banks has been enhanced, but the bank resolution framework should be strengthened.
- Given the significant size of cross-border activities, continued and strengthened cooperation with host supervisors is warranted.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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EXECUTIVE SUMMARY AND OVERALL ASSESSMENT

The Icelandic financial system is dominated by three large banking groups (Glitnir, Kaupthing, and Landsbanki). In 2004, these banks began a period of explosive expansion, with consolidated assets of the banks expanding from 100 percent of Icelandic GDP in 2004 to almost 900 percent at end-2007. By end-2007, over 50 percent of the banks' assets were held abroad in branches and subsidiaries, principally in the Nordic countries and the U.K. This expansion was funded in global wholesale markets, allowing banks to overcome domestic resource constraints but doubling their foreign debt. This dependence on wholesale market funding became a source of concern at the onset of the global turbulence in mid-2007, and caused banks' counterparty risk, as evidenced by CDS spreads, to increase sharply.

The banking system's reported financial indicators are above minimum regulatory requirements and stress tests suggest that the system is resilient. Bank capital averaged almost 13 percent of risk-weighted assets between 2003 and 2006, dropped to 12 percent in 2007 and to approximately 11 percent in the first half of 2008, but remain above the 8 percent minimum. Liquidity ratios are likewise above minimum levels.

Notwithstanding the positive indicators, vulnerabilities are high and increasing, reflecting the deteriorating financial environment.[1] Global international liquidity has declined significantly in the past 12 months confronting the banks with unforeseen challenges. In particular:

- Liquidity ratios, while high, now depend more than before on access to central banks' liquidity facilities because of the turmoil in global markets and any reduction in such access would require changes in the banks liquidity management strategy.

- Capital levels, while above minimum levels, are below the average of the last five years and may not provide adequate buffers, in light of the deterioration in the global environment and market uncertainties about the strength of the banks.

- Foreign debt maturities of the financial sector are relatively short, concentrated in the period 2008–2010, and create funding risks as outstanding facilities mature in a context of limited market funding and perceived counterparty risk.

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[1] The mission took place in the context of increasing market turmoil and was narrowly focused on the financial conditions of the banks. For that reason, several issues, including the deposit insurance framework and the foreign exchange position of the economy were not examined.

- Asset quality concerns are increasing in the light of a likely slowdown in economic growth in Iceland and host countries, higher inflation, exchange rate pressure, together with a restricted supply of credit. While reported NPLs are low, they are rising and banks are exposed to market risk through their securities holdings and collateralized lending.

Banks are implementing measures to manage these risks and bolster market confidence. They have diversified their funding sources, increasing the proportion of retail deposits. The banks are paying down market debt by reducing their loan book, selling noncore assets, and withdrawing from marginal markets. As a result, banks estimate that they have sufficient liquidity to meet debt service requirements through early 2009 and expect to be able to meet obligations maturing over the medium term. Recently, the CBI has provided much of banks' domestic liquidity needs. Banks have been augmenting their liquidity ~~Banks plan to augment their liquidity~~ through issuance of covered bonds, sales of additional noncore assets, raising private capital, and the structuring of loans into securities eligible for repo operations with major central banks. Some borrowing is possible from foreign banks, albeit at a much higher cost.

It remains uncertain whether these adjustments will be sufficient in today's difficult financial environment. Funding and asset quality pressures are likely to remain at least until 2010 and the ability of the banks to mobilize sufficient funds will be tested, especially given lower profitability, declining asset quality, uncertainties about the quality of capital and the financial strength of shareholders, the complex ownership structure, and the perception of substantial related party lending. Moreover, the situation is delicate because a financial misstep in any one bank could lead the market to penalize all Icelandic banks.

The CBI has become the principal provider of market liquidity in the domestic market, exposing the CBI to potential risks. CBI collateralized lending to commercial banks increased steadily since 2006 and the institution now is the primarily provider of liquidity to the banks. As a result, CBI holdings of bank securities reached 370 percent of capital by early 2007. While the CBI was responding appropriately to the liquidity needs of the financial system, this policy may undermine other macroeconomic objectives and exposes the CBI to possible losses and may generate a need for future recapitalization.

The supervisory framework has been strengthened and the FME's capacity to supervise banks enhanced. All issues raised by the 2003 BCP assessment have been addressed. Prudential laws and regulations have been updated and the FME, in collaboration with the CBI, has increased its emphasis on liquidity management and contingency planning, extending its scope to cover the foreign activities of the banking groups. More consistent contact among supervisory authorities in host countries would enhance these efforts.

- A reported 6.5 percent of total lending is to related parties. While such lending has declined in recent years, it still poses a risk to some banks.

- Holding companies have proliferated during the last three years, with over 300 new companies created each year. Reportedly, these companies are established by small enterprises for tax purposes and pose no systemic risk; however, the opaque nature of their structure exacerbates uncertainties about loan concentration and related-party lending.

19. **Some indications of a slippage in credit quality have already appeared.** The flow of impaired assets has increased, almost doubling in some banks over a three-year period (Figure 5). Banks have increased loan loss provisioning and, recognizing the likelihood of future deterioration in asset quality; banks have provisioned prudently (Figure 5). In addition, forced collateral sales reflecting problem loans increased sharply in 2008. Given these developments, the FME could require banks to establish reserves for future losses.[6]

20. **The strong credit performance to date reflects, in part, collateral policies of the banks and Iceland may be exchanging credit risk for market risk.** A significant portion of credit is extended on the basis of collateral. A fall in loan collateral values or loan payment difficulties ~~triggers early prepayment~~triggers additional collateral calls or early prepayment (see Figure 5). While such instances occur with some frequency, they do not increase delinquency rates or NPLs. While this practice keeps reported NPLs low, it raises the potential for volatile equity price fluctuations forcing borrowers to sell securities, generating a vicious cycle of declining asset prices, margin calls and further equity price declines as borrowers liquidate their collateral. Thereby, banks' credit risk is shifted to market risk.

21. **The uncertain prospects for future credit quality point to the need for careful monitoring and, where warranted, rapid supervisory action.** Supervisors need to ensure that asset values are accurate, provisioning levels are adequate, and that collateral valuation is appropriate. In that context, the FME could encourage banks to adopt more forward-looking provisioning policies as protection against unforeseen risks.

Liquidity and funding risk

22. **Funding risk is a critical vulnerability for the Icelandic banks.** Debt repayments due for all three banks are large in 2009 and 2010 (Figure 6) and for one bank significant in the second half of 2008. While originally contracted amid abundant international liquidity, such rollovers are increasingly difficult. All three banks were able to access the market in the

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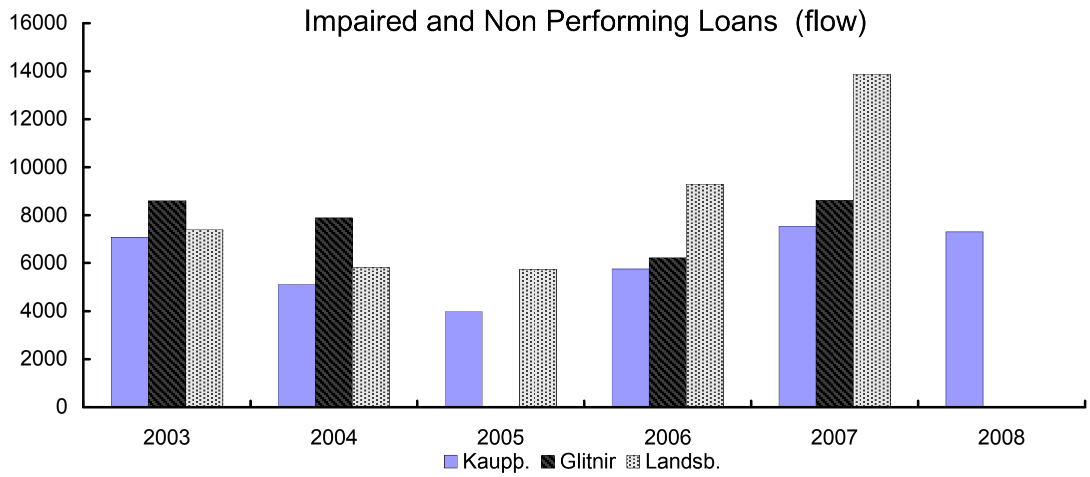
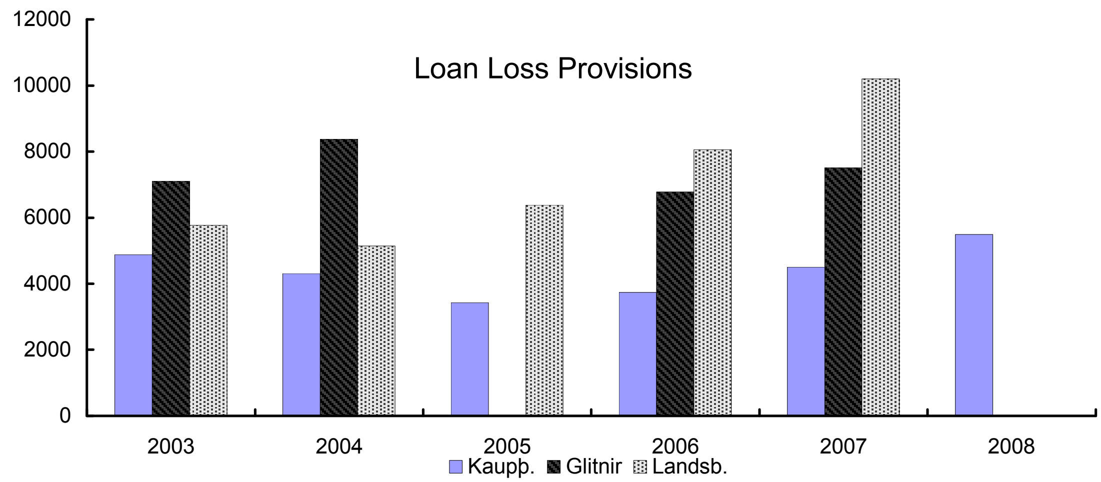
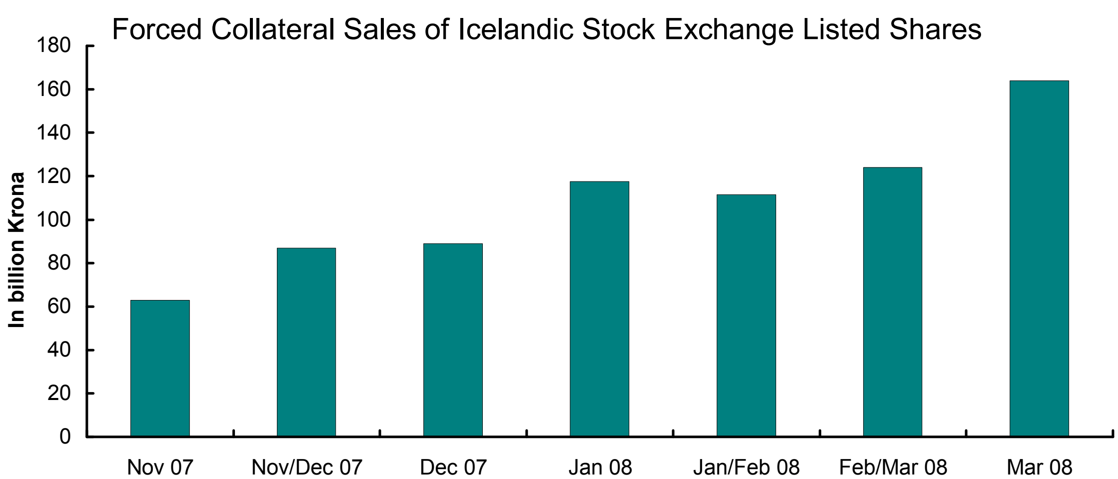
[6] For prudential purposes, such reserves would be deducted from regulatory capital.

Figure 5. Asset Quality







Source: CBI.

Market risk

28. **Icelandic banks are a hybrid between commercial and investment banks, with relatively large exposures to market risk.** The portion of equity securities in total assets (15 percent) is high by regional standards, which includes direct equity holdings (approximately 2–3 percent of total assets). In addition, a significant share of loans is collateralized with equities, increasing banks exposure to market risk.[7]

29. **The direct foreign exchange risk seems to be hedged but underlying risks may remain**. Approximately 70 percent of lending to Icelandic corporates is denominated in foreign currency. While much of that foreign exchange risk may be naturally hedged, the banks remain exposed to implicit credit risks, as about one-third of foreign-denominated lending to households has no natural hedge. The large banks have relatively small open foreign exchange positions. Moreover, the internationally active banks have designed their foreign exchange positions to protect their regulatory capital from changes in the exchange rate by establishing long foreign exchange positions. Such hedges can offset a reduction in the foreign exchange value of a bank’s equity attributable to a decline in the Icelandic króna.

B. Institutional Investors

30. **The main institutional investors in Iceland are the pension funds**. Their assets under management have grown to 122 percent of GDP at end-2007. Most of the increase is attributed to the growth of the pension system and to the increase in the stock exchange index of the past years.

Pension funds

31. **The pension fund industry in Iceland is very liquid**. The system includes the three basic pillars.[8] Today, with 32 fully operational occupational pension funds, the 10 largest hold 80 percent of the system assets. Their actuarial positions appear solid and returns were high in the past four years. However, the significant fall in market values of domestic and foreign equities in their portfolios resulted in slightly negative returns in 2007.

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[7] Some banks, instead of making loans on the balance sheet to customers for the purchase of securities and taking such securities as collateral, achieve the same objective, while requiring less regulatory capital, by buying the securities and selling them forward to their customers. Only the net of the two transactions requires capital.

[8] The three pillars of a pension system include a state-run pension system offering basic coverage, a funded system that recipients and employers pay into and voluntary private funded accounts.

32. **The pension funds use derivatives to acquire long positions in domestic real interest rates.** As a result, their portfolios are highly exposed to domestic inflation-linked securities. The long-term nature of the investment and the real return structure matches well their liability structure. Regulations allow net exposures to foreign securities to represent 60 percent of portfolios though actual exposures are significantly below the limits. About 10 percent of their assets is represented by mortgage lending to their contributing members, with, reportedly, low loan-to-value ratios and delinquencies.

Housing finance

33. **Historically, the main institution providing housing finance was the Iceland Housing Authority or Housing Finance Fund (HFF)**. The HFF is a government-owned entity with a government guarantee that can lend directly, subject to restrictions on loan amounts, funding itself through the issuance of bonds. The market share of HFF in mortgage lending declined since 2004, when favorable international funding conditions allowed domestic banks to enter the local mortgage market aggressively, lowering interest rates, increasing loan-to-value ratios, and allowing refinancing and takeout cash. As house prices soared, regulatory limits on HFF's admissible loan amounts became binding, limiting its activities. The loan quality of the HFF has remained strong as most loans are for owner-occupied homes with relatively low LTV ratios (60 percent).

34. **In June 2008, the government introduced new lending programs for the HFF to ease liquidity in the mortgage market.** New classes of loans allow the HFF to finance the banks' mortgage portfolios and origination activities, including rental housing, subject to the HFF mortgage lending requirements. Loan limits were increased to 80 percent of the purchase ~~price of the property~~ price of the property, subject to a loan limit of 20 ISK million. This framework will allow banks to obtain needed liquidity both from the publicly owned HFF and from the CBI. Credit risks therefore, become shared between the two public institutions.

C. Capital Markets

35. **The Iceland capital markets are composed of a money market in króna, an interbank foreign exchange market, a bond and equities market.** The money market consists of short-term interbank loans and a secondary market in government securities and other bank bonds (Figure 8). Spot and forward rates for euros and U.S. dollars and foreign currency swaps are traded in the foreign currency market. The domestic bond market is comprised mainly of issues by domestic public and private credit institutions and the government. The stock exchange (Nasdaq OMX Icelandic Exchange) is the only authorized stock market where public listings of equities and security trading are carried out. The exchange lists both bonds and equities. Pension funds are the largest investors in the domestic securities market.