SM/99/94
Correction 1

CONTAINS CONFIDENTIAL
INFORMATION

June 17, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Selected Issues**

The following corrections have been made in SM/99/94 (4/21/99):

Page 70, para. 97, line 5: for "though 1990,"
read "through 1990,"

para. 98, lines 5–7: for "their subsidiaries and does...banking market. It"
read "their subsidiaries. It"

Page 83, para. 120, line 1: for "A Central Depository"
read "A Central Securities Depository"

Page 123, para. 178, lines 4 and 5: delete last sentence

Page 124, para. 179, lines 5 and 6: for "of dividend payments."
read "of the face value of shares outstanding."

Page 128, para. 196, line 4: for "rate. Personal"
read "rate. The partial...abolished. Personal"

Page 132, para. 209, line 2: for "capital institution, an insurance company,..."
read "capital institution, a fish processing company,..."

Corrected pages are attached.

Att: (6)

Other Distribution:
Department Heads

V. FINANCIAL SECTOR STRUCTURE AND REFORMS[1]

A. Introduction and Overview

93. Financial markets in Iceland have developed rapidly over the past decade. Some nonbank financial institutions have grown, and a recent effort to privatize public credit institutions has gathered momentum. The regulatory environment has been aligned more closely with that of the EEA. At the same time, the capital account has been liberalized and measures have been taken to develop financial markets. This chapter will examine changes that have occurred in each of these areas, including how reforms were intended to improve economic performance. This chapter also discusses whether there are signs that these changes have increased financial vulnerability along the lines of other, notably Nordic, countries following financial liberalization.

94. Following a brief overview, Section B discusses the evolving structure of the financial sector, focusing on the main institutional players. The framework for supervision and regulation of the financial sector is presented in Section C and some indicators of recent prudential performance of banks are examined. The development of financial markets and reforms are outlined in Section D. Finally, Section E assesses macroeconomic performance in Iceland following financial and capital account liberalization.

95. A process of liberalization and legislative reform has created conditions in which market forces play an increasing role in Iceland. The current Central Bank Act was adopted in 1986 and at the same time deregulation of interest rates was completed. In the mid-eighties the Iceland Stock Exchange was established, securities companies emerged and the first mutual funds were established. Towards the end of the decade a process of rationalization in the banking sector took place through mergers. The Basle standard for rules on capital adequacy of commercial and savings banks was implemented at the beginning of 1993. In connection with the European Economic Area (EEA) Agreement,[2] new legislation was enacted in 1993, including acts governing the operations of commercial and savings banks, other credit institutions, securities transactions, mutual funds and the Iceland Stock Exchange. The legislation was aimed at imposing stricter rules on the minimum capital ratio and exposure to risk to ensure the economic health of banks and other financial institutions, and to strengthen banking supervision. A new Foreign Exchange Act became effective in November 1992, implementing a policy of a phased elimination of foreign exchange restrictions by the beginning of 1995. Changes in monetary policy instruments and increasing independence of the Central Bank of Iceland, discussed in Chapter IV, have also helped develop financial

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[1]Prepared by Valerie Cerra.

[2]An agreement between the member countries of the EU and European Free Trade Association (excluding Switzerland) on the free movement of goods, services, capital and labor.

markets. With the deregulation of markets, there has been a rapid increase in the issuance of new bonds and other financial instruments. The Government, banks and other financial institutions have become active in this market. Financial institutions have also started to offer financial services not previously available in Iceland.

B. Financial Institutions

96. This section describes the main institutions in the financial market. An overview of the structure of the financial system as of 1996 is presented in Table 14.

Commercial banks and savings banks

97. **Iceland's banking sector is dominated by the four commercial banks.** *Íslandsbanki hf.*, the only fully private limited liability commercial bank was established on January 1, 1990 with a merger of four banks. The merger was a major step in the restructuring of the banking industry in Iceland, which had been completely state-owned from the 1930s through 1990, and had been incurring large losses at the end of the 1980s. The four merging banks were the Union Bank, Ltd., established in 1970, the Industrial Bank of Iceland, Ltd. (1953), The Fisheries Bank of Iceland, Ltd. (1930), and Iceland Bank of Commerce, Ltd. (1961). The *National Bank of Iceland* (Landsbanki Íslands), the largest commercial bank, and the *Agricultural Bank Ltd.* (Búnaðarbanki Íslands) had been fully state-owned banks until 1998. They were turned into limited liability companies at the beginning of 1998, and a public offering of 15 percent new equity for each bank came to market in autumn 1998. The Minister of Commerce is authorized to sell new equity up to 35 percent of the former equity position. The Government has announced its intention to seek parliamentary approval for a full privatisation of the bank in 1999. The main objectives of this privatization program are to increase competition and improve financial services in all sectors and regions, and to increase private domestic and foreign ownership. These three commercial banks perform all the traditional banking operations. The two partly privatized state banks will not incur state guarantees on new obligations.

98. The fourth commercial bank, *Icebank Ltd.* (Sparisjódabanki Íslands hf.), is owned by the 26 savings banks in Iceland. As the central bank of the Icelandic savings banks, its operations are fundamentally different from those of other commercial banks, although still governed by commercial banking legislation. It functions as a service bank for the savings banks and their subsidiaries. It handles foreign exchange transactions and other overseas activities for the savings banks, acts as their clearing bank and fulfills the required reserve deposits with the Central Bank on their behalf. The operations of Icebank allow the savings banks to take on larger lending operations which would, due to size or extent of borrowing requirement, otherwise be beyond their individual capacity, by sharing risk and by syndicating loans within the savings banks group and to other financial institutions.

Payment and clearing systems

119. The banks, together with the central bank, operate a clearing system through the Banks' Data Centre.[3] The Centre facilitates the clearing of checks and the flow of payments, including giro payments. The same clearing system functions both as an interbank circuit and as a retail clearing system. The net results from the daily clearing are settled on the participants' current accounts with the central bank the same day. Cross-border payments are carried out almost exclusively via the SWIFT network and correspondent banking relations. The banks, including the central bank, are all SWIFT members connected via the Banks' Data Centre. In 1998, a working group was appointed to consider the present structure of the payments system and recommend changes. In December 1998, the working group delivered proposals for reforms to the payments system including the establishment of a clearer distinction between wholesale and retail payments systems. Some proposals are being debated, such as those that would affect the operations of the Icelandic Banks' Data Centre.

120. A Central Securities Depository (CSD) for dematerialized securities, which will also handle clearing and settlement, is due to begin operations in 1999. In accordance with the Act on Electronic Registration of Securities, which became effective on January 1, 1998, the CSD will use a book-entry only system and initially operate the central registry for all securities listed on the Iceland Stock Exchange. Securities will be held in separate accounts, as nominee accounts are not allowed. Ownership will be recorded through account institutions (banks, brokerage firms) which will be remotely linked to the CSD.

Indicators of financial sector vulnerability

121. Evidence on financial sector vulnerability is mixed, but recent trends point to an increase in some types of risks (Tables 19 and 20). **Credit** by deposit-taking banks surged by over 30 percent year-on-year at end-1998, compared to around 12 percent at end-1997.[4] [5] Loans to the real estate sector do not appear to represent a large share of total loans—this

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[3]For more information, see the report on Payment Systems in Iceland, BIS, Basle, May 1995, prepared by the Central Bank of Iceland and the Committee on Payment and Settlement Systems of the central banks of the Group of Ten countries.

[4]Lending by deposit money banks increased by around 28 percent in 1998 after adjusting for the merger of an investment fund with one of the commercial banks during the year.

[5]Hardy and Pazarbasioglu (1998) find a persistent tendency for credit to the private sector to follow a boom and bust pattern in advance of banking crises, with a further decline in credit growth during the crisis. Sachs, Tornell, and Velasco (1996), Radelet and Sachs (1998b) and Corsetti, Pesenti, and Roubini (1998b) argue that the quality of bank loans is likely to deteriorate significantly when bank lending grows at a rapid pace in a relatively short period of time.

Table 19: Selected Financial Institution Indicators

	1995	1996	1997	1998 1/
Number of banks:	33	33	31	30
Majority state-owned (as a % of total assets)	56.8	54.2	53.2	52.6
Number of banks accounting for:				
25% of total assets	1	1	1	1
75% of total assets	3	3	3	3
Number of investment banks:	1	1	2	3
Majority state-owned (as a % of total assets)	-	-	-	72.5
Number of investment banks accounting for:				
25% of total assets	1	1	1	1
75% of total assets	1	1	2	2
Number of investment funds:	9	9	9	5
Majority state-owned (as a % of total assets)	87.4	87.5	88.6	100.0
Number of investment funds accounting for:				
25% of total assets	1	1	1	1
75% of total assets	4	4	3	2
Total assets (as a % of GDP)				
banks	58.5	62.2	68.0	77.1
investment banks	0.6	0.9	2.7	16.7
investment funds	16.0	15.5	15.3	3.6
Credit to private sector (as a % of GDP)				
banks	35.2	36.0	44.1	50.5
investment banks	0.4	0.7	1.2	10.2
investment funds	14.1	13.6	13.5	3.2
Total loans of banks (as a % of GDP)	45.9	47.1	48.0	53.7
Real estate loans (as a % of total loans)	8.2	8.3	7.9	7.5
Loans to fisheries (as a % of total loans)	20.4	22.8	23.9	22.4
Loans to households (as a % of total loans)	22.9	22.9	24.1	25.3
Foreign currency-denom. assets (as a % of total bank assets)	22.5	27.7	33.1	36.3
Foreign currency-denom. liabilities (as a % of total bank assets)	20.9	27.2	31.6	36.3
Contingent and off-balance sheet accounts (as a % of total bank assets)	12.4	12.5	13.3	9.1
Central bank credit to banks (as a % of GDP)	1.19	0.39	1.23	2.32
Average lending spread	6.9	6.4	6.1	5.8
Nonperforming loans, substandard or lower quality (as a % of total bank loans)	5.89	5.37	4.64	4.05
Total bank provisions for loan losses (specific plus general):				
as a % of nonperforming loans	76.7	75.3	67.8	68.2
of which, specific	58.7	58.1	47.7	48.0
of which, general	18.0	17.3	20.1	20.2
as a % of total loans	4.5	4.0	3.1	2.8
Risk-weighted capital/asset ratio				
banks	11.1	10.7	9.9	9.8
investment banks	14.5	14.1	16.3	14.9
investment funds	22.3	21.2	21.4	19.4
Bank stock price index	1.39	1.83	3.39	3.85

Source: Financial Supervisory Authority

1/ Some data for 1998 is at end-June or end-November.

175. presented on an accruals basis, creating a break in the series of government finances.[3] On an accrual basis, the treasury balance for 1998 is expected to be in deficit by ½ percent of GDP compared with a balanced 1998 Budget.

176. On a cash basis, Treasury finances are significantly stronger. Accrued payments, such as for future pension liabilities, exceed cash outlays by some 2¼ percent of GDP. Combining this adjustment with financial transactions such as the revenue from the sale of government assets, the **net financial balance** (public sector borrowing requirement) of the treasury is estimated to show a surplus of 15 billion kronur (2½ percent of GDP), sharply higher than the budgeted financial surplus of around 1 percent. Of this amount, 10 billion was used to repay foreign debt; 2-3 billion was used to repay domestic debt; and the remainder augmented the Treasury's cash position at the central bank. Gross Treasury debt declined by 10 percentage points of GDP from 1996 to 1998.

Revenue

177. **Treasury revenue** is expected to improve by ¼ percent of GDP compared to the 1998 budget assumption, mainly due to higher revenue indirect taxes, such as the VAT, and from personal income tax receipts (individual income taxes and social security taxes). This improvement reflects the strong cyclical position of the economy in 1998. Although the 1998 revenue estimate is subject to greater uncertainty as a result of the change in accounting standards, preliminary cash flow data for the 1998 outturn is consistent with the projections presented in the Budget proposal in October 1998.

178. The increase in receipts from **taxes on goods and services** is attributed mainly to higher VAT collections. As in the past, domestic VAT collections were slightly lower than expected in the budget, although they appear to be more in line with budgetary expectations than in previous years.

179. The boost in revenue from **personal income taxes** stems from the effects of higher domestic demand on incomes. Indeed, tax returns have thus far confirmed the higher estimate relative to previous projections. The cyclical effect on income tax revenue thus more than compensated for the lower income tax rate in 1998. This revenue item is particularly buoyant owing to the structure of income taxes—a high income threshold combined with high marginal tax rates. Indexation of tax brackets to inflation had been abolished a few years ago, although the budget assumed that the tax credit for 1998 would increase by 2½ percent based on the expectation for inflation. The cut in the personal income tax rate by 1.9 percent in 1998

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[3]The Treasury presentation differs from the NEI presentation of central government finances, which is also on an accruals basis, in three respects. Capital gains from the sale of public assets are treated as revenue by the Treasury, but the NEI presentation shows the entire amount below the line. Accrued pension liabilities are fully accounted for as expenditures in 1998, but the NEI spreads the amount over several years. The depreciation of taxes (taxes levied but not collected or writeoffs) is not accounted for in the NEI presentation.

was the second in a three year program of income tax rate reductions. The revenue loss from this change is estimated at 3 billion kronur. Revenue from **corporate taxes** is estimated at 7 billion kronur. Companies had previously been permitted to subtract 7 percent of the face value of shares outstanding. Effective 1999, this allowance was abolished, but was offset by a reduction of the corporate tax rate to 30 percent from 33 percent.

180. Revenue from the **sale of public assets** is below earlier forecasts since the sale of Iceland Prime Contractors has been postponed until 1999. Revenue for 1998 mainly reflects profits from the sale of 49 percent of government owned shares in the new investment bank—roughly one third is included as revenue and the other two thirds is shown below the line. Assets in a number of other companies have also been sold on the market.

Expenditure

181. Total expenditure was ¾ percent of GDP higher than budgeted in 1998. The expenditure overrun mainly reflects higher-than-expected future pension liabilities following a restructuring of public sector wages, which affect the budget on an accruals basis. This source accounted for 9 billion krónur of the 12 billion krónur overrun. The remainder of excess expenditure owes mainly to a higher wage bill and higher operating costs in hospitals. However, with strong economic activity, transfer payments were lower than budgeted due to the decline in unemployment relative to the rate that had been projected in the budget. The reduction in total public debt reduced interest expenditures.

182. Agricultural **subsidies** represent a transfer from the government to farmers for production quotas, and are intended to provide income support as agricultural wages have not kept pace with wage growth in other sectors. Other subsidies and transfers include an electricity subsidy intended to equalize electricity prices across regions. The Municipal Equalization Fund is part of regional management policy, in which funds are directed to municipalities to assist small communities with the provision of services, including primary education, the responsibility for which was transferred to the local government. Interest rebates are provided as a subsidy to home ownership and is income-and wealth-tested with a limit related to the debt on the property. This rebate on interest paid for residential mortgages has an individual maximum of 140,000 krónur per year, covering about 50,000 (mainly young) individuals.

General government

183. General government finances continued to improve in 1998, reflecting mainly the revenue impact of the economic upswing. The general government balance is expected to be in surplus by ½ percent of GDP in 1998, compared with a balanced position in 1997. The improvement in recent years can be attributed primarily to a steady decline in the expenditure to GDP ratio from 1992, mainly on account of lower interest payments, operating subsidies, and public investment expenditure. The local government financial balance for 1998 is estimated to be in deficit by ¼ percent of GDP. The share of local government in general

1-3 percent. Agreements for hospital staff salaries have been in place since the end of 1997, but a series of strikes in 1998 has resulted in pay rises.

191. **Transfer payments** are budgeted to decline as the projected fall in the unemployment rate from buoyant economic activity in 1999 leads to lower unemployment insurance payments.

192. **Tax write-offs** are expected to amount to 4 billion krónur. These items represent unrealistic levies on companies that have either gone bankrupt or have not earned income as high as estimated. High estimated levies are also used as a measure to improve tax administration by encouraging quick tax filing.

General government

193. The general government balance is expected to be in surplus by ¾ percent of GDP, representing an improvement by ¼ percent of GDP relative to the 1998 projected outturn. The weaker improvement in the general government balance compared to the central government balance stems from the smaller cyclical benefits accruing to local governments. The improved public finances will be used to reduce gross general government debt to 40¾ percent of GDP from a peak of 59¼ percent of GDP in 1995.

C. Recent modifications of the tax system

194. Over the past decade, **the tax system** has undergone comprehensive reforms aimed at achieving several objectives:

- To foster international cooperation and strengthen the competitiveness of Icelandic firms by aligning the tax system with other OECD countries.

- To improve incentives to work and save by reducing distortions in taxes on capital income, personal income, and means-tested benefits.

- To enhance the role of automatic stabilizers by shifting to direct from indirect taxation, which earlier accounted for three-fourths of central government revenue.

195. The **corporate income tax** system has been made more flexible and integrated with that of other European countries. The corporate tax rate has been lowered from 51 percent in 1989 to 30 percent in 1999, while various exemptions have been abolished, and the tax base widened. In addition, the period for which trading losses can be carried forward has been extended from 5 to 8 years, and depreciation rules made more flexible. A four step plan to harmonize the two-tier **social security tax** across industries will be completed in the year 2000. Finally, various changes to the system of **excise duties**, including a reduction in the

196. Tax distortions on **capital income** have been reduced by applying a uniform 10 percent tax rate on all forms of capital income (interest, dividends, capital gains and rent) in place of the previous system which exempted some forms while taxing other forms at the 42-47 percent personal income tax rate. The partial tax deductibility of dividends at the corporate level has been abolished. **Personal income tax** rates have been reduced by 4 percent over a period of three years and numerous exemptions and deductions have been abolished. These measures helped reduce distortions in the system which featured high marginal tax rates, but low average tax rates. For equity considerations, the child benefit system was fully means tested.

The social security tax

197. The social security tax has been levied at two different rates. At the end of 1996, the lower rate was 3.55 percent on agriculture, fisheries, manufacturing, hotels and restaurants, rental of cars and computer services, and 6.85 percent on other sectors, for an average rate of around 5½ percent. On January 1, 1997, the first of four steps to harmonize the two-tier system of the social security tax became effective. The unified rate will be 5½ percent for all industries when fully implemented in the year 2000, and the change will be revenue-neutral. Revenue from the social security tax is received by the Unemployment Insurance Fund (1.3 percent of the tax base), and the Occupational Safety and Health Administration (0.08 percent of the tax base), and the remainder is channeled to the social security system, for financing pension and insurance payments.

The personal income tax

198. By 1997, the two main features of the personal income tax system were a low average tax rate, but a fairly high marginal tax rate at low levels of income reflecting extensive tax credits and means-tested benefits. In 1988, an old system of personal income taxes levied and collected on the basis of the previous year's income was replaced by a Pay-As-You-Earn (PAYE) system. Furthermore, the tax system was simplified by abolishing numerous exemptions and deductions and thus broadening the tax base. However, changes in the tax structure over the years heightened the disincentives to work. The basic personal income tax rate had crept up to almost 42 percent by the beginning of 1997 (constituting a central government tax rate of 30½ percent and a local government rate of 11½ percent), and a 5 percent surtax on higher incomes raised the effective marginal tax rate to 47 percent for higher income individuals. Moreover, a basic tax credit amounting to 24,544 krónur per month, which was transferable between couples up to a maximum of 80 percent, was deductible from the taxes levied. In effect, a one-earner couple with monthly earnings below 105,000 krónur (about $1,500) paid no personal income tax, but all income above this threshold was taxed at 42 percent. This tax structure created significant work disincentives. In addition, there were two kinds of means-tested benefits related to the personal income tax system, child benefits

205. The **new pension fund** has a very different structure. Premiums are paid on total pay (base pay, overtime and all other emoluments). Employees and the government contribute 4 percent, and 11.5 percent, respectively. The government guarantees the solvency of the fund and pays annually any shortfall that may arise, based on actuarial evaluations. For the first three years, the government's contribution is 11.5 percent and thereafter it will be determined annually, based on actuarial calculations. Pension payments at retirement are linked to the employee's prior contributions. Pensions are also tied to the consumer price index and not based on the public employee pay index, as in the old pension fund.

206. Government pension costs associated with the old pension fund have risen as a result of salary agreements that were concluded with public employees early in 1997. One of the most important provisions of the agreement is related to the restructuring of the salary system for government employees. The supplementary component of the government salary system has become progressively larger over time, particularly for higher pay grades. The salary agreement stipulated that the supplementary portion would gradually be transferred into basic pay. This meant that actual take-home pay of active employees would not change, but the calculation base of the pension contribution would rise. Both employees and the government would pay higher premiums. Since the pension payments to government pensioners of the old fund were tied to the basic salary of the post which they occupied at the time of their retirement (the successor rule), government costs for their pensions increased in line with the transfer of supplemental pay into basic pay.

207. The wage agreements stipulated that the additional agreements involving the transfer of supplemental pay into basic pay was to be finalized by the end of 1997 and hence that the consequent increase in pension liabilities would be accounted for in that year. Therefore, the 1998 budget only allowed for an increase in pension liabilities in line with general wage increases. As it turned out, however, the additional agreements were concluded in 1998. This explains the bulk of the upward revision of pension liabilities for 1998.

Privatization

208. Public enterprises in Iceland account for over 30 percent of GDP. The state owns two of the three major commercial banks, various other financial institutions and funds as well as several manufacturing and service industries. Hospitals, schools, the energy industry, and the Post and Telecommunications monopoly are also public property. Recent governments have emphasized a policy of privatization of enterprises owned by the state. The main objectives of privatization are: to increase economic efficiency by eliminating the distortions inherent in state-ownership; To widen share ownership and encourage development of the Icelandic stock market; to raise capital for the Treasury and support industrial development. Revenues from

the privatization program are an important element of the strategy to reduce the budget deficit and repay public debt. However, the government has decided to use on fifth of revenues from sales of privatized companies to support R&D in Iceland and thereby promote industrial development.

209. Several state enterprises have already been sold to the private sector. The privatized enterprises include a venture capital institution, a fish processing company, a fish meal company, a coastal shipping line, and a machinery and heavy equipment plant. The state-owned and operated Vehicle Inspectorate, was incorporated and privatized. In 1997 the government and the City of Reykjavik privatized a joint computer data center. In 1997 the government agreed to sell part of the ferrosilicon plant at Grundartangi to one of its co-owners, a Norwegian firm. In addition, the state-owned Post and Telecom Iceland was incorporated and divided into two entities in the beginning of 1998, a postal company and a telecom company.

210. The government's plan for privatization in 1999 includes sale of the remaining shares of Icelandic Investment Bank Ltd. and Icelandic Prime Contractors Ltd., and sale of 25 percent of the shares of a cement manufacturer. In addition, it plans to privatize several other companies, including a fertilizer manufacturing firm, a recycling company, and internet company, and two fish breeding plants.