

**EXECUTIVE  
BOARD  
MEETING**

SM/17/130

Correction 2

June 22, 2017

To: Members of the Executive Board

From: The Secretary

Subject: **Iceland—Staff Report for the 2017 Article IV Consultation**

Board Action:

The attached corrections to SM/17/130 (5/30/17) have been provided by the staff:

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

**Pages 6, 7, 25**

Questions:

Mr. Bhatia, EUR (ext. 37626)  
Mr. Arena, EUR (ext. 36735)  
Mr. Bower, EUR (ext. 36099)



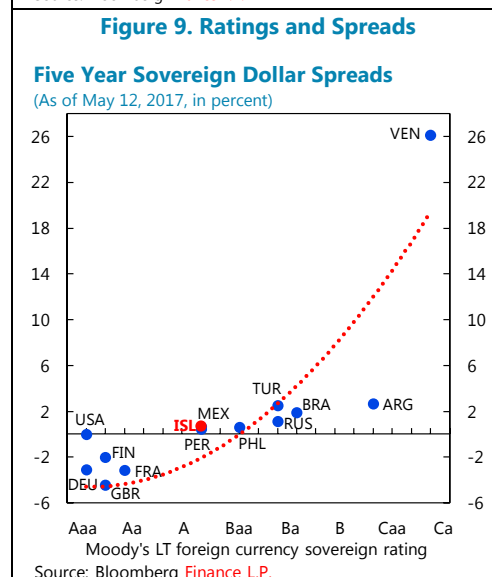
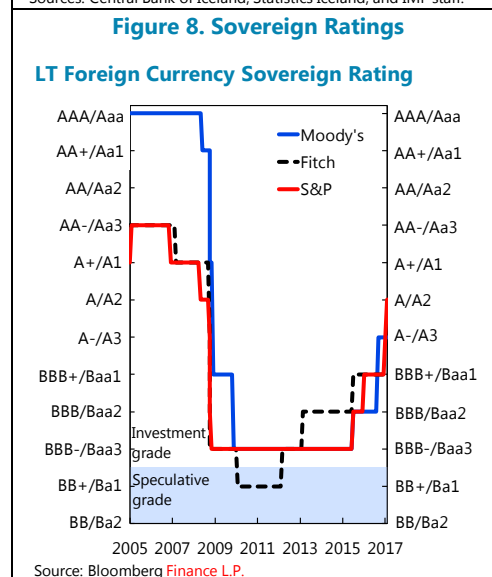
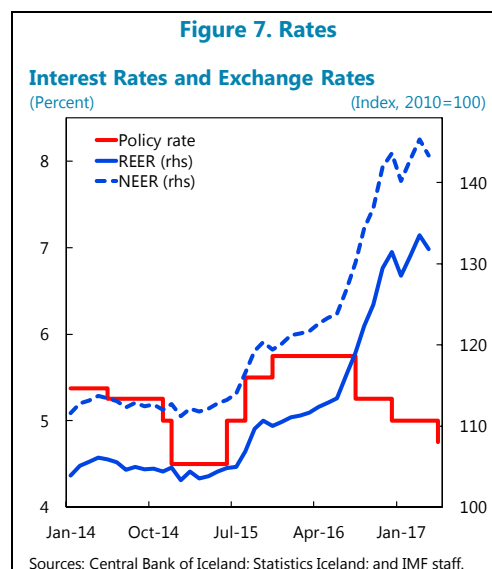
clear whether overall volumes were affected, with one view being that the equity flows would have come irrespective of the CFM.

### 10. Solid fiscal outturns have won rating upgrades.

The general government balance came in at a surplus of 12.4 percent of GDP in 2016, after accounting for about 16 percent of GDP in one off receipts from the estates and nearly 5 percent of GDP in one off spending on a pension reform package passed in December. The structural primary balance is estimated to have improved by 1.7 percent of potential GDP. Below the line, the government acquired Íslandsbanki in 2016 as a “stability contribution” from the Glitnir estate, and net debt fell by 7½ percentage points, to 42 percent of GDP.

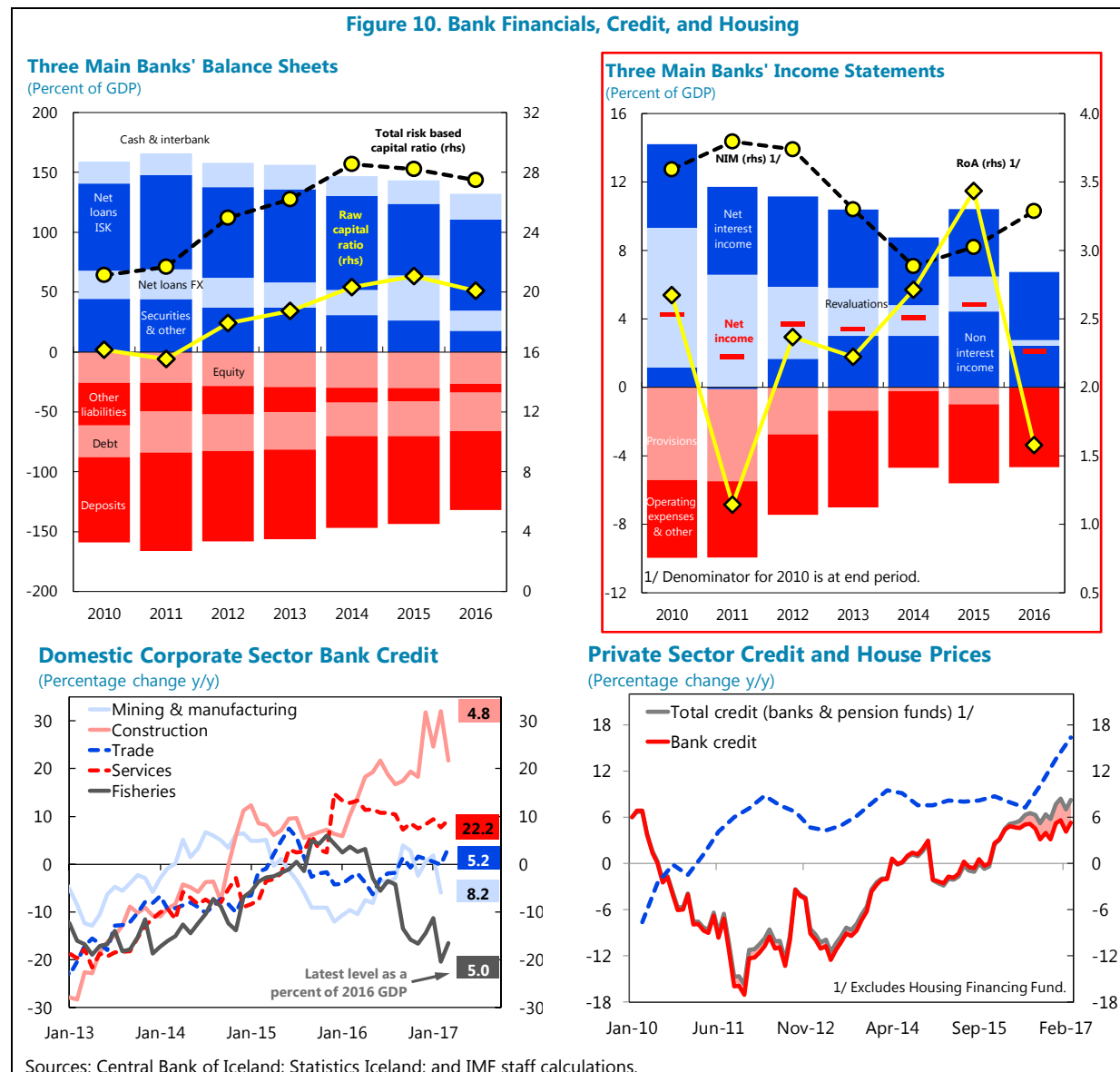
**11. The banks remain profitable.** The three main banks’ “raw” total capital to total (unweighted) assets ratios were 17–23 percent at end 2016, with returns on assets at 1.4–2.01.8 percent. Funding is still dominated by domestic deposits, and net interest margins are improving on the back of recovering credit growth. Revaluation gains have run their course. Asset quality at one bank took a hit in Q4 2017. In Q1 2017, three foreign funds and a U.S. investment bank acquired 29.1 percent of Arion Bank from the successor to the Kaupthing estate (in which they have a combined stake of about two thirds), with an option to take their stake in the bank to 51 percent ahead of an IPO this summer. The first leg of sales proceeds, amounting to just under 2 percent of GDP, flowed to the state as prepayment on a secured bond issued as part of Kaupthing’s wind up. Net public debt fell accordingly, and reserves rose.

**12. Housing prices have surged despite still moderate credit growth.** Total credit to the private sector, including loans from pension funds which now account for about half of new mortgages, has been growing at close to 8 percent y/y. Despite the recent pick up in (mostly inflation indexed) mortgage lending, the ratio of household debt to GDP has fallen from a peak of some 120 percent in 2010 to below 80 percent in 2016. Housing prices climbed almost 10 percent in 2016,



centered on Reykjavík where the crowding out of homebuilding by hotel construction, and of rentals to residents by rentals to tourists, is most acute. A supply response appears to be kicking in, however, with residential investment expanding by 34 percent in 2016. For now, investment financing has a large element of retained earnings.

Figure 10. Bank Financials, Credit, and Housing



**13. Staff sees a positive but still limited output gap.** Investment spurred by growing demand for tourism services boosts actual and potential output. Very strong growth, full employment, still brisk wage increases, the deteriorating merchandise trade balance, and firming house prices point to risks of overheating. But there are also mitigating factors: flexible labor supply, low inflation and falling inflation expectations, the large tourism driven current account surplus, and still moderate credit growth. Some bottlenecks, notably those linked to tourism infrastructure, may be more lasting. These are being buffered by the appreciation of the real exchange rate. Should wages accelerate again, however, that would point to greater cyclical pressures than currently estimated.

**Table 3. Iceland: Financial Soundness Indicators, 2014–16 1/**  
(Percent)

	2014Q1	2014Q2	2014Q3	2014Q4	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4
Regulatory capital to risk-weighted assets 2/	25.6	27.0	27.1	28.4	26.3	26.5	27.3	28.2	29.3	28.5	27.7	27.5
Regulatory tier 1 capital to risk-weighted assets 2/	23.3	24.9	25.0	26.1	24.6	25.3	26.1	27.4	28.5	27.6	27.5	27.0
Net interest margin 2/	3.0	3.1	3.0	2.6	2.8	3.4	3.3	2.9	3.0	3.5	3.2	3.3
Return on assets 2/	2.1	4.3	1.9	2.7	3.5	2.3	3.1	4.9	1.2	3.1	1.9	0.1
Return on equity 2/	11.4	23.1	10.0	14.2	18.5	11.9	16.2	24.9	6.1	15.3	9.4	0.5
Net interest income to total income 2/ 3/	55.0	40.3	57.0	38.5	37.3	56.7	46.4	32.2	65.0	48.6	56.8	73.0
Noninterest expense to total income 2/ 3/	105.4	124.4	123.5	128.6	120.7	57.4	78.1	117.4	86.9	109.5	92.5	70.3
Liquid assets to total assets 2/ 4/	27.9	27.9	28.3	24.7	27.0	26.4	26.3	25.0	24.2	23.6	24.7	24.0
High-quality liquid assets to total assets	19.1	18.7	19.7	16.5	16.8	18.1	19.2	19.0	18.6	18.0	19.3	17.3
Net open foreign exchange position to capital 2/	11.2	11.4	10.4	11.0	10.6	8.0	8.0	9.0	5.4	1.7	0.6	1.2
Total nonperforming loans (NPLs), facility level 5/	4.3	3.2	3.2	2.5	2.1	2.1	2.0	1.7	1.6	1.6	2.2	2.0
Household NPLs, cross default basis 6/	12.6	12.0	11.1	10.1	8.8	8.7	8.1	7.2	5.9	5.4	4.9	4.2
Corporate NPLs, cross default basis 6/	11.6	10.8	10.1	7.2	6.1	6.7	6.8	9.0	8.7	7.4	5.9	5.8
Household and corporate NPLs, cross default basis 6/	11.6	10.8	10.0	7.9	6.7	7.0	6.7	7.9	7.6	6.6	5.5	5.2
Allowances to household loans in default	50.2	49.3	49.7	48.9	52.1	51.4	52.7	50.4	49.6	50.1	50.0	39.4
Allowances to corporate loans in default	62.6	47.3	44.6	42.7	45.3	44.8	41.3	36.5	35.8	39.1	41.8	38.9
Allowances to total loans in default	58.5	48.1	46.8	45.7	48.6	47.8	46.3	41.8	40.9	43.2	45.1	39.2

Sources: Central Bank of Iceland, Fjármálaeftirlitid, IMF staff calculations.

1/ Three largest deposit money banks unless otherwise indicated.

2/ Data for 2014Q1 through 2016Q4 are IMF staff estimates.

3/ Total income is total comprehensive income.

4/ Liquid assets comprise cash and balances with the central bank, claims on credit institutions, and bonds and debt instruments.

~~5/ All banks.~~

~~6/ 5/~~ Over 90 days in default.

~~7/ Includes loans from the Housing Financing Fund.~~

~~8/ 6/~~ Over 90 days in default or deemed unlikely to be paid.