Appendix 1 Requirements for the solvency ratios of credit institutions and scope for taking subordinated loans

Definition of solvency ratio and provenance of rules

The solvency ratio of credit institutions is defined as the ratio of own funds to risk liabilities (the risk-weighted base). Section VI of Act no. 113/1996 on Commercial Banks and Savings Banks and Art. 10 of Act no. 123/1993 on Credit Institutions other than Commercial Banks and Savings Banks, with subsequent amendments, and Rules no. 693/2001, state the requirements for credit institutions' solvency ratios.

Icelandic rules on solvency ratios are based on the harmonised minimum requirements in EEA law and the Basel rules of 1988. The rules combine requirements for own funds and solvency ratio of credit institutions with respect to lending risk, cf. Directive no. 2000/12/EC, and capital adequacy of credit institutions (and enterprises engaged in securities services) on account of market risks, i.e. foreign exchange risks, position risks, counterparty/settlement risks and specific risks of large exposures, cf. Directive no. 93/6/EEC.

Parts A, B and C (Tiers I, II and III)

Own funds of credit institutions are defined in Art. 54 of Act no. 113/1996, cf. Art. 10 of Act no. 123/1993, and classified into Tiers, i.e. Parts A, B and C. The rules specify what each part shall consist of, and their relative weightings.

Own Funds Part A consist of paid-up share capital, reserve funds, share premium account, retained earnings after deducting the loss for the year, and the revaluation account according to inflation accounting principles. From these are deducted own shares, goodwill and other intangible assets, and also any foreseeable off-balance sheet tax charges which reduce the ability of the institution to cover future losses. According to Regulation no. 852/2000, cf. Regulation no. 964/2000, subordinated loans may be included under Part A if they do not specify a due date and have limited interest payments which may first begin 10 years from the date of issue, provided that the Financial Supervisory Authority authorises such repayment. Own Funds Part A must constitute at least half of own funds prior to deduction (see below). At the same time, subordinated loans counted in Part A cannot exceed 15% of total Own Funds Part A.

Own Funds Part B consists of a subordinated loans and the revaluation account not included in Own Funds Part A. To qualify for Own Funds Part B, the repayment period of a subordinated loan must be at least five years and in the event of bankruptcy, repayment must be subordinate to all claims against the institution other than the repayment of share capital or guarantee capital. When five years of the loan period remain, the amount of the loan shall be scaled down by 20% for each of these remaining five years. The maximum total amount of Own Funds Part B may be no more than 50% of Own Funds Part A.

Own Funds Part C consists of subordinated loans with a repayment period of not less than two years on which payments may not be made if the solvency ratio of the institution in question falls below 8%. The maximum total amount of Own Funds Part C must not exceed 50% of Own Funds Part A. The maximum total amount of Own Funds Part C cannot exceed 4.8% of the institution's risk-weighted base due to items of the trading book subject to market risks and foreign-exchange risk.

Deduction

According to Art. 55 of Act no. 113/1996, the book value of shareholdings and subordinated loans held by the institution in any other companies which engage in financial activities must be deducted from own funds if (a) the shareholdings amounts to more than 10% of the share capital of the companies in question, or (b) the shareholding amounts to up to 10% of the share capital of the companies in question and also is in excess of 10% (i.e. the amount in excess of that limit) of the own funds of the institution. Shareholdings and subordinated loans made to subsidiaries which engage in insurance activities or comparable activities shall be deducted from own funds when calculating the solvency ratio. Furthermore, shareholdings in companies which are not engaged in banking activities must be deducted from

Table 1 Division of own funds and scope for taking new subordinated loans in the commercial banks, six largest savings banks and investment banks (based on annual accounts for 2001)

	Own funds							
	A							
B. kr .	*Other than subordinated*	*Subordinated*	*B*	*C*	*Deduction from own funds*	*Risk-weighted base*	*Solvency ratio (%)*	*Solvency ratio with advantage taken of scope (%)*[1]
Búnadarbanki Íslands	12,911	1,115	4,159	0	458	168,110	10.5	14.0
Íslandsbanki	19,840	3,500	9,286	0	869	259,966	12.2	13.4
Landsbanki Íslands	15,183	872	7,254	401	1,496	213,891	10.4	12.1
Icebank	2,141	0	1,041	0	590	22,473	11.5	15.2
Commercial banks total	50,076	5,487	21,740	401	3,413	664,439	11.2	13.2
SPRON	3,192	548	1,225	0	2,477	22,215	11.2	14.7
Hafnarfjördur Savings Bank	2,514	0	751	0	229	25,985	11.7	16.9
Sparisjódur vélstjóra	2,944	0	501	0	880	13,402	19.1	32.2
Keflavík Savings Bank	1,742	243	336	0	728	14,033	11.3	16.7
Kópavogur Savings Bank	672	0	174	0	76	7,721	10.0	14.8
Mýrasýsla Savings Bank	978	0	243	0	395	6,308	13.1	21.1
Six largest savings banks total	12,042	791	3,228	0	4,784	89,663	12.6	18.7
Kaupthing Bank	8,830	0	2,783	0	675	94,840	11.5	17.5
Frjálsi Investment Bank	2,237	0	0	0	0	10,249	21.8	38.6
Investment banks total	11,067	0	2,783	0	675	105,089	12.5	19.6
Total	73,185	6,278	27,751	401	8,873	859,192	11.5	14.6

1. Solvency ratio if the bank should take full advange of its scope to add to its own funds by taking new subordinated loans.
Sources: Financial Supervisory Authority and the banks' annual accounts.

own funds if they are in excess of 15% (i.e. the amount in excess of that limit) of the own funds of the institution in question.

Solvency ratio requirement

Paragraph 1 of Art. 54 of Act no. 113/1996 requires that the own funds of a credit institution shall not at any time be less than 8% of the risk-weighted base. Calculation of the risk-weighted base is specified in Rules no. 693/2001.

Calculation of risk-weighted base

Firstly, the risk-weighted base covers the credit risk of asset items and off-balance sheet items which are not considered part of the trading book. The term trading book refers to securities, other financial documents and commodities that the institution has acquired or retains for resale and/or arbitrage on short-term changes in their market value. In calculating credit risk, individual items are weighted with the appropriate risk weights on the basis of the estimated ability of the debtor to repay them.

Secondly, the risk-weighted base covers currency risk of all asset and liability items and off-balance sheet items denominated in foreign currencies, gold and Icelandic krónur with a currency reference, irrespective of whether they are on or off the trading book. The risk-weighted base for currency risk is the credit institution's net foreign exchange and gold position in excess of 2% of its own funds. In calculating the currency position, the open position in individual currencies is calculated first, then the institution's net currency position.

Thirdly, the risk-weighted base covers position risk connected with debt instruments, equities and commodities on the trading book. Position risk is connected to the position taken by the institution in a given financial document because of conceivable

changes in that document's value.[1]

Fourthly, the risk-weighted base covers counterparty risk, which is connected with trading with securities and commodities on the trading book. Counterparty risk generally involves the failure of a counterparty to a financial agreement to fulfil its terms. Counterparty risk can take the form of delivery risk, settlement risk or credit risk.

Fifthly, the risk-weighted base covers specific risks on large exposures.

Review of rules on solvency ratio

As reported in *Monetary Bulletin* 2001/4, a review of the international capital adequacy requirements of credit institutions is now in progress under the auspices of the Basel Committee and European Commission. At the end of last year the Basel Committee announced that the third edition of new requirements based on submitted comments on earlier drafts could be expected in October 2002. It is aimed for the revised rules to enter into effect in 2005.

Own funds of several financial institutions

Table 1 shows the division of own funds of the commercial banks, six largest savings banks and two investment banks into the three parts specified above (columns 2-5) based on year-end 2001. Column 6 shows the deduction from own funds and column 7 these companies' risk-weighted bases. Column 8 is the mandatory solvency ratio. The end column assesses how high the solvency ratio would be if the companies took full advantage of their scope for taking subordinated loans provided they fulfil the rules applying to them. However, it should be noted that it is assumed here that all such subordinated loans can be taken, which could prove difficult to achieve on acceptable terms.

All the commercial banks except Icebank have taken advantage of authorisation to take subordinated loans which qualify as Tier I (Part A) Capital, Íslandsbanki is approaching the permissible maximum and Búnadarbanki is not far behind. Two savings banks included in this survey have taken subordinated loans classified as Tier I Capital, Keflavík Savings Bank and SPRON, which is close to the maximum.

1. Position risk is divided into general risk and specific risk, cf. Rules no. 693/2001.

All the commercial banks have taken subordinated loans which qualify as Tier II (Part B) Capital and most are close to the ceiling. Furthermore, all the savings banks in the survey, apart from Mýrasýsla Savings Bank, have taken such loans, but still have considerable scope for taking more.

Landsbanki is the only financial institution which has taken a loan classified as Tier III (Part C) Capital.

As mentioned above, holdings in other companies in excess of a specified amount are deducted from own funds.[2] SPRON has the largest deduction in nominal terms, where its holding in Kaupthing Bank weighs heaviest. Landsbanki has the next-largest nominal deduction, which includes its holdings in the insurance companies Vátryggingafélag Íslands hf. and Líftryggingafélag Íslands hf. Landsbanki's sale of the leasing company Lýsing hf. lowered this item and served to strengthen the bank's solvency ratio.

Íslandsbanki has proportionally the least scope for adding to its own funds with the issue of new subordinated capital, and will have to rely on higher profits and the issue of new share capital stock to increase its mandatory own funds. Other commercial banks still have some scope left, although proportionally this is starting to diminish at Landsbanki. The six largest savings banks, Kaupthing Bank and Frjálsi Investment Bank still have considerable scope for increasing their subordinated borrowing.

If all these financial institutions were to take advantage of their scope for increased subordinated borrowing, their mandatory solvency ratio could rise from 11.5% to 14.6%.

However, it is undesirable to keep the solvency ratio up with an excessive level of subordinated loans. For example, the Financial Supervisory Authority has emphasised the desirability of a solvency ratio excluding subordinated loans which is not under 8%, while several financial institutions today are close to or below that reference point. In order to equip financial institutions better for withstanding external shocks, it is prudential to strengthen their solvency ratios even further, with profits, new share issues or restraint on the expansion of their balance sheets.

2. As the Financial Supervisory Authority interprets the rules on own funds, shareholdings in other financial institutions must be deducted from calculations of the solvency ratio, irrespective of whether they are on the trading book or the investment book.