

## Appendix 2 Securities portfolios of the commercial banks and six largest savings banks

As part of the analysis of the position of Icelandic banks, a comparison has been made of key figures for Nordic commercial banks over the period 1998-2002. The largest Nordic commercial banks have been chosen for the comparison and it is interesting to note that the Icelandic banks are fully on a par with them in terms of performance, despite the difference in their sizes.

Data from Moody's Investors Service are used to provide close comparability. The banks and their total assets at the end of 2002 are shown in the following table:

### *Most volatile return on equity<sup>1</sup> among Icelandic and Finnish banks*

The Icelandic banks have shown broadly the same return on equity as other Nordic banks over the period apart from their poor profitability in 2000. It should be noted that ROE is stated in real terms for the Icelandic banks until 2002 because of price indexation, but in nominal terms for the other banks. Nominal ROE of the Icelandic banks for the period 1998-2001 is therefore higher than shown in the chart. ROE is generally best among Swedish banks, while the Danish banks show little year-on-year change.

### *Net interest margin highest at Icelandic banks*

Icelandic banks are well ahead of the rest for net interest earnings as a percentage of risk-weighted assets. One explanation is the small share of narrow-margin housing loans in the Icelandic banks' lending portfolios, due to the activities of the Housing Financing Fund. Banks' interest margins have tended to move closer to each other over the period.

### *Cost-income ratio similar in Iceland*

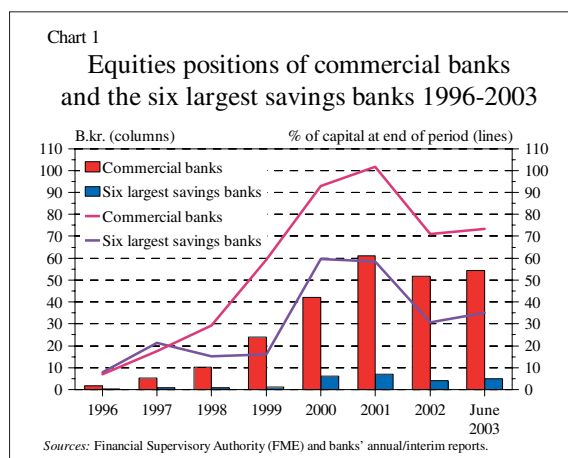
The cost-income ratio of Icelandic banks, i.e. operating expenses as a proportion of net operating revenue, decreased in 2002 to the lowest overall figure

ever, falling below 60% for the year.

As the Central Bank has pointed out in its financial stability reports, the drawback to using cost-income ratio as a measure is that operating income volatility may cause it to change sharply from one year to the next. Privatisation of Landsbanki Íslands hf. and Búnaðarbanki Íslands hf. was completed during the first half of 2003, along with the merger of Búnaðarbanki and Kaupþing banki. A merger between Íslandsbanki hf. and Sjóvá-Almennar tryggingar hf. is pending as well. These transformations can be expected to allow the cost-income ratio to be reduced even further.

### *Capital ratios also broadly the same*

The final criteria involve capital ratios. The first is the mandatory CAD ratio, which for the Icelandic banks contracted from 1998 until 2000, then rose. A comparable fluctuation apparently took place among the other Nordic banks. Average CAD does not



1. Kaupþing banki hf. (previously Kaupþing hf.) and FBA hf., which were originally investment banks but later merged with commercial banks, are included in figures for the commercial banks over the period 1996-2002.
2. For the period 2000-2002, Kaupþing banki hf. and Búnaðarbanki hf. are regarded as a single bank.

3. E.g. foreign subsidiaries of Icelandic banks such as Kaupþing Bank Sverige (a subsidiary of Kaupþing Búnaðarbanki), R. Raphael & Sons (Íslandsbanki) and Heritable Bank (Landsbanki), plus many others.
4. E.g. banks' shareholdings in the Icelandic Banks' Data Centre (RB) and other companies.
5. Exceptions include Glitnir (asset-based financing) and VÍB (asset management) which were previously subsidiaries of Íslandsbanki hf. but have been virtually or entirely merged into the parent company.

appear to be below 10% over the period examined; the mandatory minimum is defined as 8%.

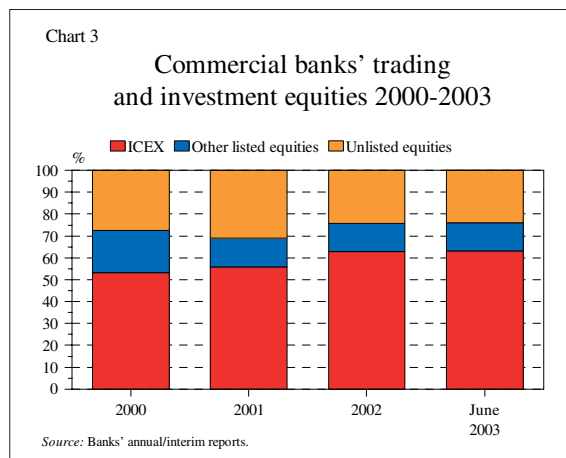
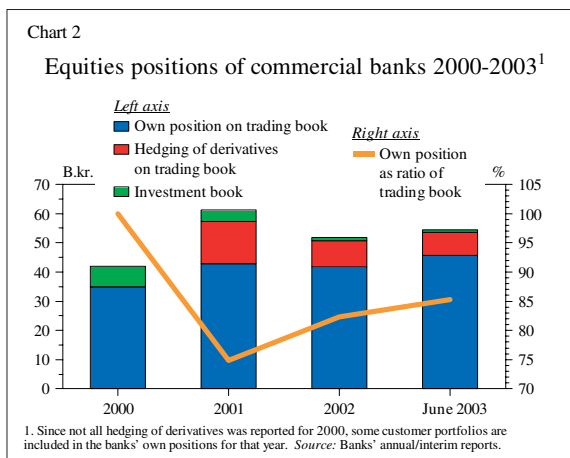
A similar picture is provided by Tier I capital (i.e. total capital excluding subordinated loans which are not classified as Tier I capital). It is interesting to note that the Norwegian banks' Tier I capital has been on a fairly steady upward trend apart from 2000, while the Finnish banks have had one of the weakest ratios in recent years.

Thus the Icelandic banks appear to be fully on a par with those in the other Nordic countries in terms of profitability, cost and capital ratio. Although their small size is obvious compared with the very largest Nordic banks, the recently merged Kaupþing Búnaðarbanki has now entered the top ten.

The development of the securities portfolios of the commercial banks<sup>1</sup> and six largest savings banks is analysed below for the period 1996-2003/Q2. A further breakdown of the portfolios between investment books and trading books is given for the three largest commercial banks, i.e. Íslandsbanki hf., Kaupþing Búnaðarbanki hf.<sup>2</sup> and Landsbanki Íslands hf., using year-end figures for 2000-2002 and the most recent position according to first-half statements for 2003. Equities positions and bond positions are discussed separately.

### Equities positions

The commercial banks' holdings in other companies have been very much in the spotlight recently. Equity portfolios of banks take various forms but on the basis of the Rules on Credit Institutions' Accounts No. 692/2001 (as amended) they can broadly be divided into four groups:



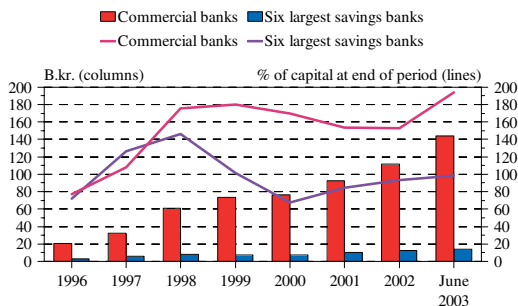
6. Including figures for Kaupþing hf. and FBA hf.  
 7. Some double counting would be involved for the years when the savings banks marked their holdings in Kaupþing to market and Kaupþing itself was included in the figures as well.

- *Related companies*, which are subsidiaries of the financial institution, its parent company or sister companies (i.e. when companies are owned by the same parent). The parent company and its subsidiaries are termed a group.
- *Associates* are not subsidiaries, but the relevant institution (and where appropriate, its subsidiaries) owns either separate or joint holdings in

8. Íslandsbanki's shareholding was 44.8% at that time but had increased beyond 90% at the time of writing.

Chart 4

### Bond positions of commercial banks and six largest savings banks 1996-2003



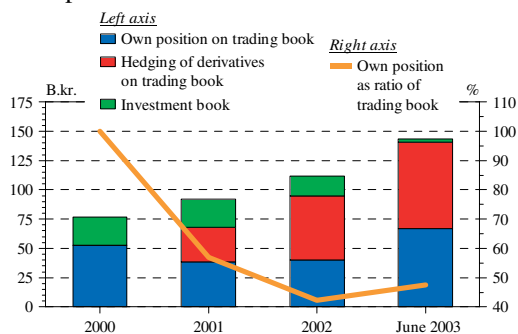
Sources: Financial Supervisory Authority (FME) and banks' annual/interim reports

them and exerts control on their boards. An institution (and where appropriate, its subsidiaries) holding at least 20% of the votes in a company is considered to exert control on its board.

- *Investment equities* are equities that an institution has made a formal decision to own for a longer period (at least one year). Shares in associates or related companies are not classified as investment equities.
- *Trading equities* are equities that are not acquired with the aim of owning them as long-term operating assets. The term embraces, among other things, short-term positions in other companies, assets in connection with the role of market making, and hedges against derivative contracts made with customers.

Chart 5

### Bond positions of commercial banks 2000-2003<sup>1</sup>



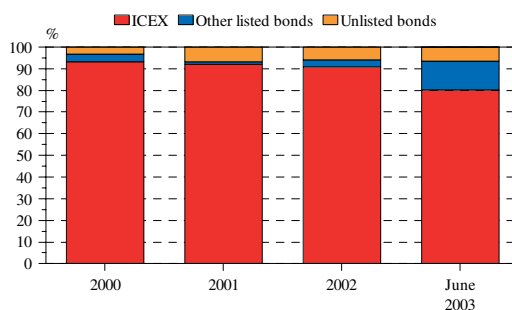
1. Since not all hedging of derivatives was reported for 2000, some customer portfolios are included in the banks' own positions for that year. Source: Banks' annual/interim reports.

This appendix does not discuss related companies<sup>3</sup> and associates<sup>4</sup> in particular; their number has increased considerably in recent years, mainly due to international expansion by commercial banks.<sup>5</sup> The commercial banks' and six largest savings banks' equities exposures have grown enormously in the past few years. In 1996 they held equities in the amount 2.3 b.kr., but in their half-year statements for 2003 total portfolios had reached 59.4 b.kr., having peaked at the end of 2001 at just over 68.2 b.kr. Chart 1 shows the development of equities positions in b.kr. and as a ratio of capital.

While broadly the same trend can be discerned for the commercial banks and six largest savings banks, in 1998 the commercial banks<sup>6</sup> ratio of equi-

Chart 6

### Commercial banks' trading and investment bonds 2000-2003

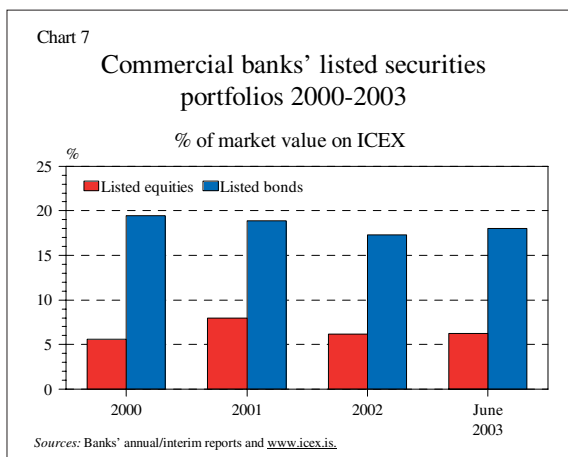


Source: Banks' annual/interim reports.

ties to capital overtook that of the savings banks and has been growing at a faster rate since then. The six largest savings banks' equity portfolios swelled in 2000 when they marked to market their shareholdings in Kaupping on their trading and investment books, as discussed in previous financial stability reports.<sup>7</sup> The commercial banks' ratio of equities to capital exceeded 100% at the end of 2001, dropped suddenly in 2002 and has been climbing again in 2003. It is clear that the banking system's market risk

9. I.e. the ratio of income from equities and investments, plus gains on other financial activities, to total net interest income, net service income, income from equities and investments and gains on other financial activities.

10. The figure fluctuated from one year to the next; for example, there was a loss on these items in 2001.



has been increasing in recent years, although with the qualification that some of these exposures are hedges in connection with the banks' derivatives books. In this light, it is worth examining how their equity portfolios are spread between trading books and investment books. Chart 2 shows this distribution for the commercial banks in 2000-2003/Q2.

Investment book exposures have decreased noticeably in recent years, with a corresponding increase in the trading book position. As a proportion of the total trading book position, the banks' own positions in equities have clearly been increasing in recent years. from 75% in 2001 to beyond 85% in mid-2003.

Chart 3 shows a breakdown of the commercial

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11. I.e. on investment and trading books, own positions and positions connected with customers' derivative contracts.

banks' equity portfolios into shares listed on Iceland Stock Exchange (ICEX), other listed shares and unlisted shares. On average, just over one-quarter of their equity exposures were in unlisted shares over the period 2000 to 2003/Q2. In the middle of the year the book value of unlisted shares amounted to 13 b.kr.

Only two of the four commercial banks, Íslandsbanki and Landsbanki, have announced their nine-month results. Their equities exposures have grown considerably since they published their half-year statements. Landsbanki's equities portfolio swelled by 5.8 b.kr. over the period, virtually all of it (5.5 b.kr.) in trading book equities listed on ICEX. Íslandsbanki reported much lower growth, at 1 b.kr., but in the nine-month statements its holding in Sjóvá-Almennar tryggingar hf. insurance company was booked as shares in related companies, with a book value of more than 8.4 b.kr.<sup>8</sup>

#### *Bond positions*

Chart 4 shows that the commercial banks' and six largest savings banks' bonds portfolios, i.e. on both their investment books and trading books, have been growing in recent years and amounted to just over 158 b.kr. in mid-2003.

As a ratio of capital, the six largest savings banks' bond positions peaked in 1998, then fell until 2000 but have been increasing since. The lower ratio after 1998 did not reflect a reduction in króna terms; the explanation was a sizeable increase in their capital at that time. The commercial banks' bonds positions have grown year-on-year, but the increase between 1999 and 2000 was only slight. However, their bond holdings mushroomed between the end of 2002 and their half-year statements. Some of this growth can be attributed to lower yields, and some to increased position-taking by their customers through derivative contracts. Part of the increase has also been traced to foreign investors.

The investment book position has been steadily dwindling and stood at 3 b.kr. in the banks' most recent half-year figures, while their own positions on trading books and hedges against customers' derivative contracts have spiralled over the past two years to total 141 b.kr. in the most recent six-month statements. It is interesting to note that since the commercial banks' own position-taking accounted for less than 50% of their bonds on the trading book in

mid-year, the derivatives market where bonds are the underlying asset has obviously multiplied in value in recent years. This prompts the question of when this trading will be made more visible by listing bond derivatives on ICEX. Such a move ought to deepen the Icelandic bond market even further and kindle even more interest among foreign investors.

The bulk of the bonds portfolios was listed on ICEX. However, this ratio has fallen from more than 93% in 2000 to just over 80% in mid-2003. The proportion of other listed bonds grew over the same period from 3.4% to 13.2%.

#### *Conclusion*

It is clear from the above that the risk faced by the commercial banks and the six largest savings banks has grown in recent years in pace with their securities market activity. This is clearly illustrated in the most recent half-year statements which show that 24% of their income<sup>9</sup> was derived from shares and investments, together with gains on other financial activities, compared with just over 9% in 1996.<sup>10</sup> The commercial banks' share of listed securities on ICEX is noteworthy, relative to total market value on the exchange. Total value was much higher for listed bonds<sup>11</sup> than for listed equities, as can be seen from Chart 7. Since a large proportion of the banks' securities exposures are in connection with customers' derivative contracts, it seems desirable that ICEX should make such transactions more visible by setting up a market for listing and trading derivatives.