

Appendix The foreign debt position of commercial and savings banks and systemic reforms

Net foreign position of commercial banks and savings banks has deteriorated considerably in recent years

A striking feature in recent coverage of the commercial banks' and savings banks' foreign debt has been its rapid rate of growth along with the short-term nature of the borrowing. Foreign assets have also increased, so the net debt position has grown by less than the gross position. From the viewpoint of financial stability it is important to distinguish between net and gross debt, and it is not enough merely to monitor the position of debt net of assets. Assets and debts are intrinsically different, with different risk levels. Foreign debt of commercial banks and savings banks comprises issued bonds and borrowing from banks, while their assets are in the form of lending to foreign borrowers, deposits abroad, and equities and other securities.

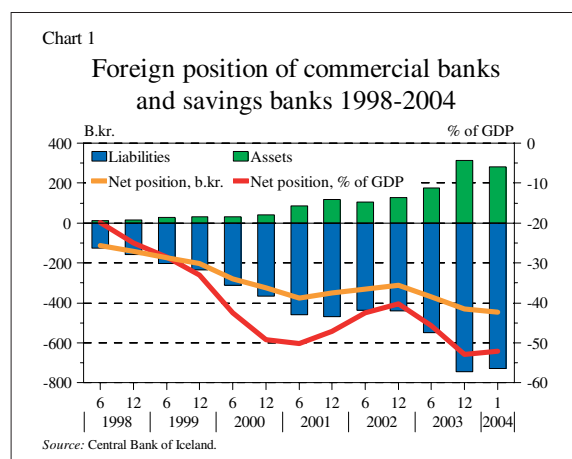


Chart 1 shows that total liabilities amounted to 742 b.kr. at the end of 2003, and that the net debt position had grown from 201 b.kr. at the end of 1999 to 430 b.kr. in December last year. As a proportion of GDP, net debt increased from 33% to 53% over the same period. This large inflow of foreign capital has been channelled into foreign currency-denominated lending to domestic businesses and on a small scale to households (4.1% of their total outstanding debt at the end of 2003). The more that exchange-rate indexation is used, the more common it becomes for

borrowers to be domestic entities with no foreign currency income. The Central Bank's rules on foreign exchange balance ensure that the commercial banks' and savings' banks total foreign currency-denominated assets and liabilities are in broad balance. While these rules limit the banks' own direct foreign exchange risk, the same does not apply to their customers.

Detailed analysis of the foreign position of the three largest commercial banks

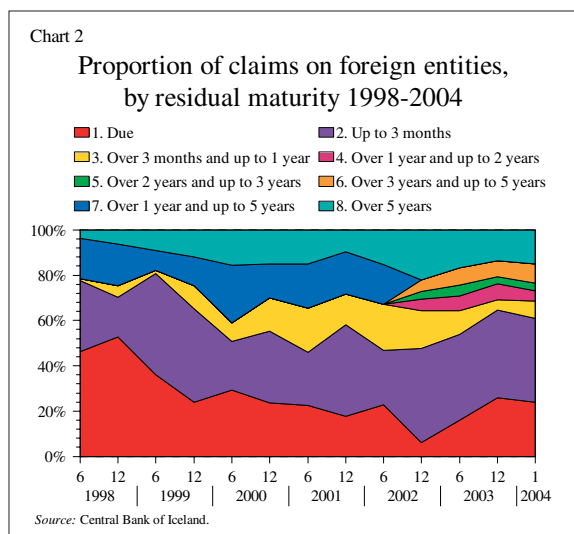
Over the whole of 2003, claims by foreign entities on commercial banks and savings banks surged by 69%. These banks' claims on foreign entities grew by proportionally even more over the same period, swelling by 148%. Nonetheless, the net position deteriorated in 2003 (see Chart 1).

To identify which accounting items changed most during the year, a comparison was made using data from reports on residual maturity, monetary indicators and liquidity for the three largest commercial banks. Data for the respective foreign positions of Kaupping banki and Búnaðarbanki Íslands at end-2002 were combined and compared with those of the merged KB banki on December 31, 2003. Glitnir asset leasing company merged into Íslandsbanki last year and a number of smaller domestic financial companies changed hands which could affect this comparison, while KB banki acquired several others in other countries. No attempt was made to adjust the figures to accommodate these factors, and the reports on which the survey was based are not comparable in all cases. However, the overall picture ought to be fairly clear.

Sizeable growth in claims on foreign entities in 2003 ...

The commercial banks' and savings banks' claims on foreign entities increased by 186 b.kr. from the end of 2002 to end-2003. For the three commercial banks alone, the increase was broadly the same. The time to maturity of the commercial banks' and savings banks' claims shortened slightly in 2003 – a breakdown of their residual maturity is shown in Chart 2. As regards changes in individual asset

categories for the three commercial banks, lending to foreign entities accounted for 36% (67 b.kr.) of the increase and deposits in foreign currency 34% (64 b.kr.). Another major asset category that swelled during the year was deposits in Icelandic currency in foreign banks, which accounted for 16% (30 b.kr.) of the rise in claims on foreign entities.¹

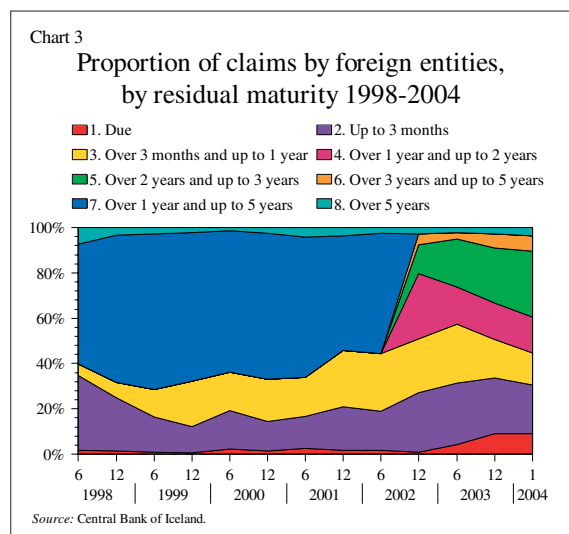


... but foreign entities' claims on the commercial banks grew by even more

Foreign entities' claims on commercial banks and savings banks increased by 303 b.kr. from the end of 2002 to end-2003. Claims on the three largest commercial banks rose by 305 b.kr. over the same period. Residual maturity of foreign entities' claims lengthened marginally, as Chart 3 shows. One category overshadows all other foreign liabilities of the three commercial banks: foreign currency-denominated securities issues with a maturity of more than one year. These soared by 207 b.kr. last year, accounting for 68% of total growth in claims by foreign entities. However, this increase needs to be seen in the context of a drop in long-term borrowing for relending amounting to 83 b.kr. As pointed out before, the increase in securities issues may be explained by the growth in the banks' MTN programmes, which appear to be replacing direct foreign borrowing by the banks to a substantial

1. It should be noted that in some cases the entity involved might be a foreign subsidiary of the respective bank.

degree. A sizeable increase also took place in issues of foreign currency-denominated securities with a maturity of less than one year, which grew by 78 b.kr. last year.



What are MTN programmes?

A common format for securities issuance in the European market is through European Medium-Term Note (EMTN) programmes. In order to qualify to issue under an MTN programme, the issuer must undertake to fulfil specific conditions and the market generally requires the issue to be awarded a credit rating from a recognised agency. MTN agreements include stipulations on maximum amount of the total issue and a panel of appointed dealers, as well as general provisions on the liabilities that the notes confirm. In this way the programme aims to minimise paperwork in corporate and sovereign instrument issuance and trading. Issues made under these programmes enable more flexibility in credit procurement, reduce issuance costs and give access to a broader investor group. Greater access to institutional investors is particularly important.

The three commercial banks, the Republic of Iceland and Landsvirkjun (the National Power Company) have all set MTN programmes in recent years. Landsvirkjun was first in spring 1998, FBA hf. (investment bank, later merged into Íslandsbanki) followed a year later, the three commercial banks launched programmes over the period 2000 to 2002

Table 1 Icelandic MTN programmes¹

	<i>Treasury</i>	<i>Landsvirkjun</i>	<i>Íslandsbanki hf.</i>	<i>FBA hf.</i>	<i>Landsbanki Íslands hf.</i>	<i>Búnaðarbanki Íslands hf.</i>	<i>KB banki hf.</i>
Ceiling	1,500 USD	1,000 USD	2,500 EUR	1,500 EUR	2,500 EUR	1,000 EUR	2,000 EUR
Outstanding	1,027 USD	912 USD	2,262 EUR	71 EUR	1,602 EUR	145,3 EUR	1,369 EUR
First deal (dd.mm.yy)	22.03.01	19.05.98	23.03.00	24.02.99	28.04.00	09.07.02	24.06.03
Latest review (dd.mm.yy)	28.05.03	12.08.03	22.07.02	01.03.00	19.02.04	...	...
First issue (dd.mm.yy)	06.03.01	10.07.98	12.04.00	30.03.99	May 2002	Oct. 2002	July 2003
Latest issue (dd.mm.yy)	12.05.03	22.03.04	11.03.04	31.01.00	10.03.04	20.02.03	17.02.04
Largest issue	250 EUR	150 EUR	350 EUR	60 USD	400 EUR	75 EUR	500 EUR
Longest tenor (years)	10	30	20	5,16	30	10	10
Shortest tenor (days)	913	730	362	1.827	183	540	183
No. of issues	7	27	59	3	31	5	16

Amount and no. of issues, by currency

EUR	977 (6)	550 (14)	1,786 (33)	.	1,559 (21)	135 (4)	1,165 (12)
USD	100 (1)	310 (11)	328 (7)	60 (1)	.	.	101,05 (2)
JPY	.	1,700 (1)	17,000 (8)	3,000 (2)	19,200 (6)	.	5,000 (1)
GBP	.	.	183 (4)	.	25 (1)	.	30 (1)
CAD	.	.	48 (3)	.	7 (1)	.	.
HKD	.	.	200 (1)	.	50 (1)	100 (1)	.
CZK	.	.	500 (1)	.	.	.	500 (1)
ISK	.	670 (1)	550 (2)	.	.	.	6,000 (3)
SEK	.	.	.	.	.	.	300 (1)
NOK	.	.	.	.	100 (1)	.	.

1. All amounts in millions. Data from Reuters, March 3, 2004. Includes agreed issues not due for payment until later in March.

and the Treasury negotiated a programme in March 2001. In general, Icelandic MTN issues have gone very smoothly and have been growing annually. Between them, the three commercial banks are authorised to issue €5.7 billion of debt, and Íslandsbanki has the highest ceiling at €2.5 billion. The Treasury and Landsvirkjun together have a ceiling of €2 billion. Table 1 presents details of the MTN programmes in which the banks, the Treasury and Landsvirkjun are involved.² It shows that notes are still outstanding under MTN programmes made by FBA hf. and Búnaðarbanki Íslands hf. These programmes have been closed, i.e. no further issues can be made under them, and the outstanding amount is €215 m. The single largest issue made by an Icelandic entity is a €500 m. issue by KB banki hf. in

July last year, and next-largest a €400 m. issue made by Landsbanki Íslands hf. in March the same year. Landsbanki Íslands hf. and Landsvirkjun have made the longest Icelandic issues currently in the system, with a tenor of 30 years. Landsbanki Íslands hf. also

Table 2 Issuing currencies

%	<i>Commercial banks</i>	<i>Treasury and Landsvirkjun</i>
EUR.....	78.3	81.4
USD.....	6.6	17.5
JPY.....	5.5	0.7
GBP.....	6.0	.
CAD.....	0.6	.
HKD.....	0.6	.
CZK.....	0.5	.
ISK.....	1.3	0.4
SEK.....	0.5	.
NOK.....	0.2	0.0

2. Based on data from Reuters (MTNINDEX). Some discrepancies are possible between data recorded there and the real position, but should not alter the overall picture.

shares the shortest tenor with KB banki hf., both at 183 days.

Íslandsbanki hf. has the most diverse currency composition in its MTN programme with outstanding issues in eight currencies, including 550 m.kr. in Icelandic currency. KB banki hf. comes just behind with seven currencies. Íslandsbanki also has the largest number of single issues, namely 59 as of March 3.

Around 80% of MTN issues are denominated in euros. Some 17.5% of issues by the Treasury and Landsvirkjun are in US dollars, but only 6.6% by the commercial banks. Also, 6% of commercial bank issues are in sterling and 5.5% in yen. These figures do not necessarily reflect the final currency composition of liabilities, because the liabilities can be altered with derivatives.

Table 2 shows remaining facilities under the MTN programme. The programme sets a ceiling at a fixed amount in either euros or US dollars. For example, the Treasury has a US dollar-denominated facility and if it issues a euro series the amount is converted to USD at the dollar-equivalent exchange rate on the date of issuance. This is done for all issues in other denominations than US dollars. The remaining facility is calculated as the ceiling less cumulative issues at the dollar-equivalent exchange rate at any time. On the basis of these calculations, all the Icelandic issuers had room for issuance under their facilities in March.

One driver of debt is interest-rate differential, although this has been narrowing in the recent term ...

The interest-rate differential between Icelandic and international financial markets, with higher domestic than foreign long-term rates, has given impetus to foreign debt accumulation, which has been the case for a long time and presumably will remain so. Icelandic commercial banks and savings banks have easy access to foreign credit markets, and this has never been easier than over the past two years. Ample access to foreign financing has prompted commercial banks and savings banks to offer foreign currency-denominated loans for a wider range of purposes and to more groups of borrowers than before. For example, leasing companies' contracts for vehicle and machinery purchases are largely denominated in foreign currencies. Partial or full currency-linked mortgages are now available as well. It should be borne in mind that financial services in the form of basket loans and exchange-rate hedging derivatives can simplify and soften the risks entailed by foreign borrowing, if customers chose to take advantage of them.

Over the period 1997-2001 the interest-rate differential with abroad widened, but since the end of 2001 it has narrowed again and is currently broadly the same as at the beginning of the period. The development of the interest-rate differential with abroad can hardly be the sole explanation for

Table 3 Room for issuance under Icelandic entities' MTN programmes¹

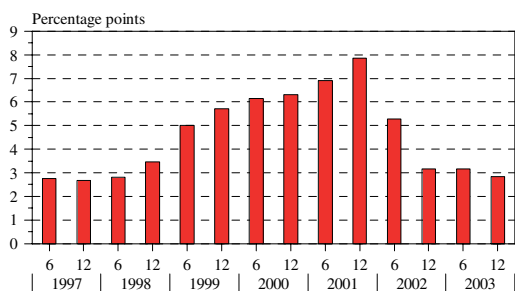
<i>Outstanding as per Reuters</i>	<i>Treasury</i>	<i>Landsvirkjun</i>	<i>Íslandsbanki hf.</i>	<i>FBA hf.</i>	<i>Landsbanki Íslands hf.</i>	<i>Búnaðarbanki Íslands hf.</i>	<i>KB banki hf.</i>	<i>Total</i>
EUR	822	730	2,262	71	1,758	145	1,369	7,156
USD	1,027	912	2,826	88	2,001	181	1,710	8,745
<i>Ceiling</i>								
EUR	1,201	801	2,500	1,500	2,500	1,000	2,000	11,501
USD	1,500	1,000	3,123	1,874	3,123	1,249	2,498	14,367
<i>Room for issuance</i>								
EUR	379	70	238	Closed	742	Closed	631	2,061
USD	473	88	297	Closed	1,122	Closed	789	2,770
<i>Outstanding as per Central Bank calculations²</i>								
EUR	1,057	819	2,518	70	1,758	145	1,444	7,810
USD	1,320	1,23	3,145	88	2,196	181	1,804	9,757

1. All amounts in millions. Data from Reuters, March 3, 2004 and Central Bank calculations.

2. Based on the exchange rate on March 3, 2004 (www.oanda.com).

Chart 4

Interest-rate differential¹ at the end of June and December 1997-2003



1. Interest-rate differential between 3-month Icelandic T-notes and 3-month T-notes among main trading partner countries, using the same weighting as the exchange rate basket. Sources: Reuters and Central Bank of Iceland.

mounting foreign debt in recent years. However, businesses have probably become more sensitive to interest rates and the interest-rate differential alongside the ever-increasing opening of the economy, liberalisation of markets and competition.

...and various systemic reforms

Many landmarks have been reached in the financial markets in recent years. Systemic reforms and innovations in services have tended to increase the foreign debt position and change the nature of the risks faced by credit institutions and the Icelandic economy. Credit institutions, businesses and households have directly and indirectly been replacing Icelandic krónur with foreign currency in their balance sheets.

It is important to bear in mind a number of changes that have taken place over the past five years relating to commercial banks and savings banks:

1. Lending to foreign entities.
2. Investment in foreign market securities.
3. Overseas expansion of Icelandic banks with the establishment of foreign branches and subsidiaries.

4. Overseas expansion of Icelandic businesses with acquisitions of foreign companies, financed by Icelandic commercial banks.
5. Participation by Icelandic banks in foreign banks' syndicated loans.
6. Emergence of real estate management companies and other asset management companies, partly financed with foreign capital.
7. Leasing agreements are now largely foreign-financed.
8. Mortgages available denominated in foreign currencies.
9. Credit ratings for the largest commercial banks.
10. Icelandic banks have access to a deep market for debt instrument issues (MTN, ECP) by virtue of their credit ratings.

Various consequences

This development has already had wide-reaching consequences. Ample liquidity is available for foreign currency-denominated lending and borrowers face heightened exchange rate risk. As far as monetary policy and financial stability are concerned, the impact of changes in the Central Bank's policy interest rate has diminished accordingly – in particular in the corporate sector. This makes it more difficult to apply monetary policy measures to bring about cyclical adjustments. However, monetary policy still has undiminished potential for determining the long-term rate of inflation in domestic currency. It should also be borne in mind that the Central Bank's scope for providing liquidity facilities is becoming correspondingly narrower. While the Bank has virtually unlimited scope for providing domestic liquidity facilities to a credit institution with adequate capital, this is substantially restricted if the liquidity problem occurs in a foreign currency.