Box 2 Credit ratings agencies' reports on the Icelandic financial system in 2003[1]

Standard & Poor's, December 16,2003 (A+/A-1+)[2]

- "Levels of net external debt are very high throughout the economy at an overall 272% of current account receipts in 2003. Capital outflows from Icelandic pension funds diversifying abroad put additional structural pressure on the balance of payments. Despite the rapid reduction of the current account deficit and a very strong increase in foreign exchange reserves, external liquidity has improved only slightly and will remain one of the weakest among rated sovereigns for the foreseeable future."
- "The off-budget and contingent liabilities of the government are subsiding. Imbalances in the financial sector had been significant as a result of the credit boom, and downside risks remain due to the large external leverage of the sector and a volatile exchange rate. However, tighter regulation and supervision, improved prudential indicators and increased profitability leave the sector in a better position than at the beginning of the decade."
- "A potential upgrade of Iceland's foreign currency ratings hinges on further strengthening of the financial sector, as well as a prudential macroeconomic policy stance over the period ahead. Conversely, any significant increase in external leverage or a recurrence of macroeconomic imbalances on the back of the country's large investment projects could lead to a downward revision of the outlook."

(Standard & Poor's, Press release, December 16, 2003)

Moody's, June 5, 2003 (Aaa/P-1)[2]

- "Improvements in banking system supervision … should help banks better administer their loan books. The adoption of more aggressive provisioning policies, more conservative standards for recognizing problem loans, and banks' increased capital reserves are important factors in containing the risk to the financial system, although short-term external exposure remains high. Continued consolidation of the industry, such as the recent merger of the savings bank Kaupthing and Bunadarbanki, will improve competition. Growing household debt service requirements should also restrain loan demand." (p. 3)
- "Another concern is the substantial external debt of the banking system. Icelandic banks are permitted to keep open positions in foreign currency of up to 30% of their capital, a significant level of exposure. Still, … supervision and regulation has improved, and the primary clients to which they onlend in foreign currency tend to have exporters' natural hedge. Throughout the episodes of krona devaluation and appreciation, the banks' asset quality has suffered only marginally." (p. 5)

(Moody's Analysis, May 5, 2003)

Fitch Ratings, March 2003 (AA-/F1+)[2]

- "Of more immediate concern has been the extent to which the banks have financed the surge in domestic lending with foreign borrowing. Banks' open foreign exchange positions are limited to 30% of capital, but exchange risk may still be a problem where domestic borrowers without foreign exchange revenues have contracted loans in foreign currency." (pp. 9-10)
- While expressing concerns about Iceland's high net external debt, Fitch points out that it "makes good sense that a country with good demographics and able to offer good investment returns should build up a negative investment position, though in relation to the size of its economy Iceland has gone even further in this direction than Australia and New Zealand. And unlike those two countries, Iceland has added further to its net external debt by, in national terms, building up debt to finance equity assets." (p. 1)
- Fitch identifies net external debt as "the main constraint on the rating. Net external debt ratios should fall – and the ratings could improve – more quickly if Icelandic pension funds curbed their appetite for foreign equities." (p. 1)

(Fitch Ratings, Sovereign Report Iceland, March 31, 2003)

1. Included in their sovereign reports.
2. Sovereign foreign currency rating.