Financial stability: Developments during the year

Several aspects of financial stability are addressed in this article in light of economic developments during the year and the first-half results announced by commercial banks and savings banks.

I. Introduction

A separate article in *Monetary Bulletin* 2000/1 (February) discussed the strengths and weaknesses of the Icelandic financial system with respect to the risk of financial instability. What this involves is the risk of disturbances to the activities of financial institutions which would be so decisive as to cause setbacks to the economy as a whole. The article in February concluded that, on the whole, the financial system was in a secure position and the macroeconomic climate favourable, especially since considerable economic and real income growth was still taking place and businesses were showing good profitability. It foresaw little probability of a financial crisis in Iceland in the near future, unless the economy were to suffer shocks. However, various weaknesses were identified which could prove critical in the course of time, not least if the foundations on which economic growth and rising real incomes are based were to become shaky. Main factors at work here were the large current account deficit, monetary and credit expansion, the low capital ratios of many credit institutions and the sensitive position of short-term national debt.

This article looks at whether and to what extent the position has changed since February. It discusses the development of the relevant economic factors during the year and summarises various aspects of the commercial banks and savings banks' operations according to their interim financial statements at the end of June.

The Central Bank of Iceland recently began organising its work in this field and is now engaged in further studies of main indicators from the economy and financial system which can be used to make financial stability assessments. The Bank will make regular announcements of its assessments, while a comprehensive survey of financial system stability will be published in the *Monetary Bulletin* in May next year.

II. Macroeconomic environment

Economic growth this year will be higher than was forecast in February. Offsetting this are new forecasts for a much wider current account deficit and higher rate of inflation this year. There has been no easing of credit expansion and real estate prices have gone on rising, albeit more slowly than last winter. Pressure in the labour market has also continued to mount. However, turnover growth has slowed down compared with last year. Overall company profits have deteriorated and share prices have been falling in recent months. The prospects for economic growth and increased national income have worsened, for reasons including the cutback in catch quotas during the current fishing year.

Economic growth prospects are now considered poorer than they have been for quite some time, partly because of the foreseeable contraction in next year's marine production. The National Economic Institute is forecasting a growth figure of only 1.6% next year and its projections show GDP growth of 2-2.5% during the years after that. This scenario could be altered by the probable strengthening of the cod stock, conceivable new power-intensive industrial projects and productivity gains due to advances in IT and telecommunication, although none of these can be taken for granted. Lower growth is highly desirable at the moment, since such a development would contribute to a cooling of the economy and help to reduce inflation. On the other hand, slackening growth undoubtedly increases the probability that businesses and households will face more difficulty in sustaining the liabilities they have accumulated in recent months and years through heavy consumption and investment.

In spite of rises in oil prices and depressed prices for fish meal and fish oil, the terms of trade are expected to deteriorate by only just over 1% this year after remaining stable in 1999 and showing a sharp improvement in 1997-1998. In a historical context the terms of trade are favourable, more than 3% above the average over the period 1990-1999. An improvement of 1.5% is forecast in the terms of trade next year, especially because oil prices are likely to come back down in the near future. Thus there is no prospect for a change in the terms of trade which would be likely to threaten exporters' ability to meet their obligations.

Greater economic growth in Europe and conceivably mounting fears of inflation in the USA make an even further rise in interest rates possible in the near future, over and above the 1% increase in nominal T-bond rates in main currencies over the past twelve months. Iceland's large current account deficit has seen a buildup in net foreign interest-bearing liabilities which now amount to 75% of GDP. This means that for each percentage point that interest rates on Iceland's foreign borrowing go up, a further 0.75% of GDP is added to the current account deficit in the form of debt service.[1]

If the real exchange rate of the króna appreciates on such a scale that it severely hampers the competitive position of export and competing industries, they could experience difficulties in meeting their obligations. At the same time this exacerbates the risk of a sudden depreciation which could handicap borrowers with no export revenues in servicing their foreign-denominated liabilities. The real exchange rate of the króna appreciated somewhat during the first part of this year in step with the rising nominal exchange rate and higher domestic inflation. It has slipped back in recent months as the króna has weakened. The real exchange rate during Q4 is now estimated at just over 5% lower in terms of unit wage cost than during Q2, assuming that the average exchange rate in October remains unchanged until the end of the year. If so, it will be lower than the 20-year average, but almost 4% above the average over the past 10 years. In fact, the real exchange rate has appreciated less during the current economic upswing than it has generally done in the past. All things being equal, a rise in the real exchange rate weakens Iceland's competitive position. However, it is by no means far from the equilibrium exchange rate at present, so it can hardly be the chief cause of the current account deficit, nor a likely catalyst of financial instability.

Other aspects of the macroeconomic climate for the financial system are described in the article on Economic and monetary developments and prospects in this issue of *Monetary Bulletin*.

III. Capital movements and the external position

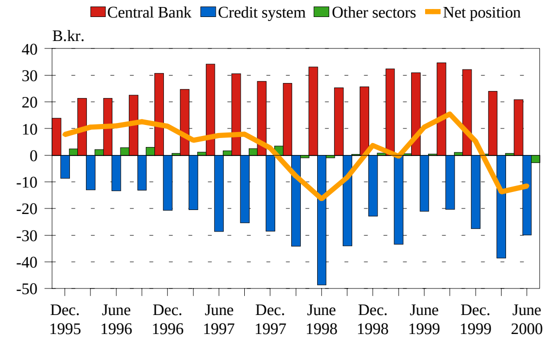
Capital outflows intensified during the first half of this year, driven in particular by foreign equity purchases. The net outflow of direct and portfolio equity investments amounted to 37 b.kr., while there was a 7.4 b.kr. inflow of short-term capital, mainly due to Central Bank funding of its foreign reserves, and a 55 b.kr. inflow of long-term capital. Over this period the current account deficit measured 33.5 b.kr. but figures showed a net capital inflow of 25 b.kr., leaving 8 b.kr. of deficit funding unaccounted for. Last year the current account was in deficit by 43 b.kr. while borrowing from abroad exceeded the deficit, as is the case this year. Last year, the outflow on direct investment and equity purchases was 20 b.kr. There is a possibility that the outflow was underestimated last year and correspondingly overestimated this year, with the discrepancy showing in "errors and omissions" terms of opposite signs in Table 1 for 1999 vs. the first six months of 2000. Growth in foreign assets is higher this year than the capital outflow figures would suggest, and was much higher last year. In part the explanation lies in changes in foreign asset prices. Last year, simple average share prices in

1. Part of the external debt carries fixed interest, so that Iceland's interest payments would rise by less than this amount in the short term when interest rates abroad go up.

Table 1 Financing of current account and capital exports, b.kr. at current prices

Net inflow of capital, b.kr.	*1997*	*1998*	*1999*	*First half of year 1998*	*1999*	*2000*
Short-term debt	1.8	-6.1	7.3	14.5	1.8	7.4
Long-term debt	21.3	63.5	76.0	11.7	29.2	54.6
Direct investment and equities	-6.2	-11.9	-20.3	-5.5	-7.3	-36.9
Balance on capital account.......................	16.9	45.5	63.1	20.7	23.6	25.1
Curr. account balance	-8.9	-40.1	-43.2	-24.5	-22.6	-33.5
Errors and omissions (overfinancing)	8.0	5.4	19.9	-3.7	1.1	-8.4

Chart 1 Net short-term foreign asset position



neighbouring countries rose by 35%, and the corresponding increase from the beginning of this year until August was just under 6%.

Pension funds and other investors are currently building up assets abroad, especially in the form of equities. On a long-term view this is a positive trend, since it improves yields and risk-spreading for pension fund assets. With borrowing exceeding the deficit and a net outflow on equity purchases, foreign borrowing is indirectly being used to finance equity purchases abroad. Unconditional claims are thereby being made on the Icelandic economy, in return for the prospect of gains when business performance overseas is good. This involves some risk for the national economy, especially from fluctuations in interest rates and asset prices. Rising interest rates not only push up debt service, they also tend to produce a corresponding drop in asset prices. Moreover, a large proportion of Iceland's foreign equity stock is in the hands of the pension funds. The age distribution of pension fund members makes it unlikely that these foreign investments will be liquidated in the near future in order to pay pensions. Icelandic owners of foreign equities and borrowers from abroad therefore form two distinct groups, so the assets of one are unlikely to be of much use if the other runs into difficulties. This therefore represents a certain risk for the national economy.

Credit institutions have been borrowing heavily abroad to fund their lending expansion over the past few years. The pattern was similar for the first seven months of this year, since the treasury has repaid even more of its domestic liabilities than last year, but privatised less. Not only has the position of major credit institutions worsened, but the maturity of outstanding loans has been shortening at the same time. This can be seen in Table 2 which shows foreign assets and liabilities that fall due within one year at the six largest credit institutions. The net position was negative by 95 b.kr. at the end of June, after a considerable deterioration since the beginning of the year. It was equivalent to almost three times the Central Bank's foreign reserve, which is much weaker than it was at the beginning of the year or at the same time in 1999. The net external position for less than three months is even worse. This was negative by the equivalent of 133% of the Central Bank reserve at the end of June, compared with 36% negative at the same time last year. Recent foreign long-term loans taken by two commercial banks can be expected to improve the banks' short-term position when they are disbursed.

Table 2 Net foreign position of six largest lending institutions. Maturity 12 months or less

	June 30 1998	*Dec.31 1998*	*June 30 1999*	*Dec. 30 1999*	*June 30 2000*
Net position, b.kr........	-39.8	-37.8	-35.0	-50.6	-94.6
% of balance sheet total............................	-8.2	-6.4	-5.4	-6.7	-10.7
% of gross foreign currency reserves	-120	-128	-113	-141	-285

Source: Financial Supervisory Authority.

Chart 2

12-month % increase in bank lending in real terms 1997-2000

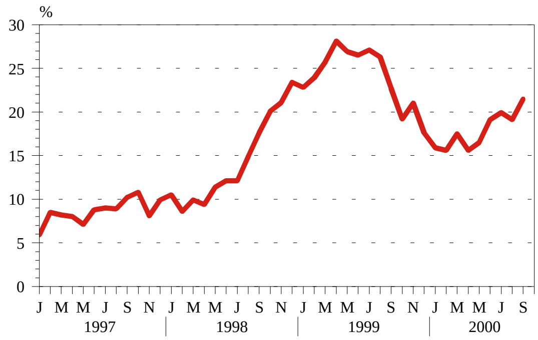
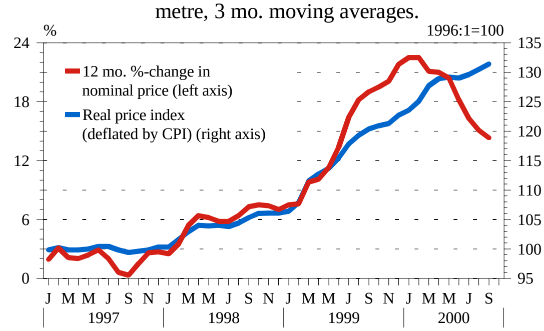


Chart 3

Residential housing prices

In Greater Reykjavík area. Price per square metre, 3 mo. moving averages.



IV. Lending developments

Credit expansion has not eased off. After adjustment for the merger of Íslandsbanki and FBA, twelve-month credit growth at DMBs until the end of September amounted to just over 27%, which is rather more than during the first months when it lay in the range 22-24% until the summer. During the first seven months of this year, corporate lending by investment credit funds and DMBs grew by 38 b.kr., or 10% more than inflation, a similar pattern to the same period in 1999. The same institutions saw their lending to individuals grow by 36 b.kr, or almost 9% more than inflation, compared with just under 6% over the same period last year. It is certainly safe to say that credit is still expanding at full force. DMB figures for the past three months show the same pattern, with lending up 3.9% to corporations in real terms and 6.4% to individuals. Part of the explanation for the speed-up in the DMBs' lending growth lies in the impact of the weaker exchange rate on the foreign relending stock. Credit institutions have also been lending directly to foreign borrowers to some extent, but this does not have an expansionary effect in Iceland and can even contribute to better risk-spreading by domestic banks. Sources within the banking system and payment card companies do not report an increase in defaults.

V. Asset prices

The recent asset inflation has apparently reversed or is on the wane. Share prices on the ICEX main index peaked during the first four months and have dropped by just over 20% since then. In itself this is not a serious development, since the index still shows share prices 15% above the 1999 average.

Residential property prices began climbing noticeably in 1998 after a long period of stagnation. They have continued to rise until very recently. Rises were most rapid in mid-1999 and in the Greater Reykjavík Area they totalled 22.5% from January 1999 to the same time in 2000 according to the Property Valuation Office index. In recent months the pace of growth has been equivalent to 10% a year. There are definite indications of a further slackening, given that individuals' incomes have by no means kept pace with rising property prices and interest costs. Based on rises in the wage index, residential property prices and housing bond interest rates – but excluding mortgage interest rebates – rise in the payments burden faced by the buyer of a typical apartment in the Greater Reykjavík Area has outstripped the rise in wages by more than 40% from January 1999 to September 2000.

Higher interest rates have had even more impact on the commercial property market. Prices there still appear to be climbing, by 10-15% during the first quarter of this year after increasing by up to a third in 1999. The Central Bank's rises in its interest rates at the beginning of the year appear to have dampened business premises price rises and sales very sharply.

The price of permanent quotas for cod peaked at the end of last year at 950 kr. per kilo, then fell suddenly and rallied again, partly depending on the progress of court action involving quota rights and distribution of extra quotas to regional communities with participation by local fishing companies in these purchases. Recently, estimated cod quota prices have dropped by 5-10% and are now in the range 850-900 kr. per kilo for permanent quotas with unused catch rights within the year. It should be borne in mind that the cutback in the total allowable catch of cod from 250 to 220 thousand tonnes for the present fishing year represents a 15-20% reduction in the TAC share in real terms.

VI. Corporate and household finances

Interim financial statements from companies listed on the Iceland Stock Exchange show that first-half profits are down somewhat from the same time in 1999. Financial sector profitability is discussed separately later in this article. For other companies, first-half profit after tax as a ratio of turnover decreased from 2.8% in 1999 to 1.3% in 2000. Consequently, return on equity dropped sharply from 8.2% during the first half of 1999 to 3.2% this year. Operating profit, i.e. before depreciation and financial items, remained reasonably good although it slipped from 7.4% to 6.8% of turnover between the two periods. More important factors at work here were higher depreciation and interest expenses on investments made with borrowed funds, exchange rate losses following the weakening of the króna, and higher tax reflecting their good results in 1999. The ratio of equity to total assets has slipped from 33% in mid-1999 to 30% in mid-2000. Long-term liabilities increased by 18% but assets by 15%. Mergers and takeovers have some effect on there figures, but it is clear that ongoing credit-driven expansion in balance sheet items since the beginning of the year has tended to weaken these companies. It should be pointed out that listed companies within certain sectors have preformed far better than the overall figures show, especially in the IT sector.

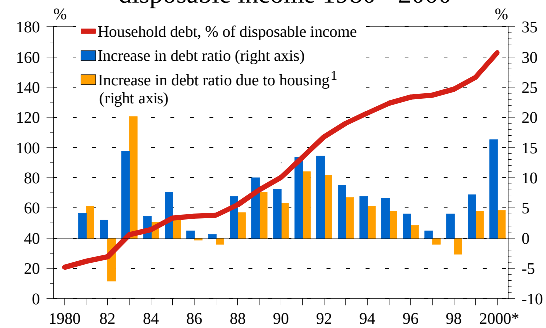
Table 3 Companies' equity ratios and debt ratios

	Net financial accounts			*Firms on ISE*		
Equity ratios (%)	*1986*	*1989*	*1997*	*1997*	*1999*	*2000*[1]
Fishing sector	12.6	8.1	26.3	36.0	32.7	32.4
Industrial sector	36.6	30.7	38.7	52.2	43.4	39.7
All sectors	36.6	28.1	26.5	...	33.0	30.2
Long-term debt/total assets						
Fishing sector	0.48	0.54	0.52	0.47	0.45	0.44
Industrial sector	0.26	0.27	0.29	0.21	0.32	0.32
All sectors	0.19	0.22	0.23	...	0.34	0.33
Long-term debt/equity						
Fishing sector	3.84	6.62	1.90	1.3	1.38	1.37
Industrial sector	0.70	0.88	0.75	0.4	0.73	0.82
All sectors	0.52	0.79	0.87	...	1.02	1.10

1. January-June 2000.

Chart 4

Household debt as a ratio of disposable income 1980 - 2000



1. Housing debt is estimated based on data on housing debt from DMBs and investment banks adding 80% of the lending by pension funds to its members.

According to Central Bank estimates, the ratio of household debt to disposable income will increase from 147% at the end of last year to 163% at the end of 2000. Households are therefore still accumulating debt. From the beginning of the year until July, household debt to banks and investment credit funds (including the Housing Financing Fund) outstripped inflation by 36 b.kr. The pace of growth in mortgages slowed down from last year to 4.5% in real terms, while other debt increased much faster, by 21% or 9 b.kr. Over the past three months a further 9 b.kr. has been added to household debts to DMBs, equivalent to 6% above inflation. Thus the risk of payments problems, if there is a shock to household incomes, is still increasing.

VII. Commercial banks and savings banks

Various indicators from credit institutions' operational figures can give some idea of financial system stability. The following is an analysis of four such factors based on the commercial banks' and savings banks' first-half figures and an external assessment of their deposit and financial strength ratings. These indicators are profitability, cost ratios, capital position and credit rating.

Profitability

On the whole, profitability of commercial banks and savings banks[2] was slack during the first half of the year. Measured as net profit as a proportion of average capital position, their profitability was 9.0%.[3] This is a much lower figure than the 16.8% achieved during the first half of 1999 and 17.8% for the whole year (see Chart 27 on p. 84). Broadly speaking, there are three explanations for this downturn. The value of banks' bond stock fell, other operating income shrank, and tax payments increased because by the end of last year the largest banks had used up their tax deferrals on account of projected losses and dividend payments in prior years.

Profitability was marginally better at the three commercial banks (9.2%) than at the largest savings banks (7.8%) as shown in Table 4. Qualifications need to be made when comparing financial institutions' profit figures, to identify whether profit derives from own operations or shares in the profits of subsidiaries or associates. Different methods of accounting for investments in marketable securities also need to be borne in mind.

On the former point, it is clear that without their share in the 529 b.kr. profit generated by Kaupthing Investment Bank, the savings banks would not have been able to report profits on the scale shown in their first-half statements. Regarding the value of marketable securities, this loss was incorporated in full into the figures of Íslandsbanki-FBA. Had Landsbanki and Búnadarbanki done the same, their pre-tax profits would have been lower. This is partly offset by the fact that the value of Landsbanki's equity in its investment portfolio is underestimated, which in fact is true of Íslandsbanki-FBA as well.

Table 4 From commercial banks' and savings banks' half-year reports 2000

M.kr.	*Íslands-banki-FBA*	*Lands-banki*	*Bún-adar-banki*	*Savings banks*	*Total*
Net interest income ..	3,549	2,919	1,921	1,630	10,019
Other operating income	2,552	1,576	1,012	987	6,127
Net operating income	6,101	4,495	2,933	2,617	16,146
Operating expenses .	3,358	3,287	2,244	1,945	10,834
Provisions for bad and doubtful debts	545	526	255	262	1,588
Value adjustments	1,164	0	0	0	1,164
Taxes	285	178	95	124	682
Profit	750	503	339	286	1,878
On June 30					
Total assets..............	269,370	216,477	128,449	96,397	710,693
Stockholders' equity	16,811	11,603	7,408	7,909	43,731
In %					
Return on equity	9.0	9.1	9.8	7.8	9.0
Cost ratio.................	55.0	73.1	76.5	74.3	67.1
Capital ratio.............	9.40	8.72	9.79	10.48	9.41
Capital ratio, excluding subordinated loans ...	7.22	5.69	6.54	7.09	6.63

Cost ratio

Cost ratio, i.e. operating expenses as a proportion of net operating revenues, offers a clear indicator of operational efficiency. It is important for any financial institution to keep costs down relative to revenues in order to maintain an acceptable competitive position, but this is vital in highly price-sensitive segments such as traditional banking services. Likewise, domestic financial institutions as a whole need to bear in mind their competitiveness against foreign rivals.

The cost ratio at commercial banks and savings banks has shown little change over the past five years, apart from last year, as shown in Table 5. It stood at 67.1% during the first half of this year, compared with 68.4% over the same period in 1996.

2. FBA is included with Íslandsbanki from 1998 onwards, and the Fisheries Investment Fund and Industrial Loan Fund are included before then. Icebank is not included with the savings banks. Figures for the six major savings banks refer to Reykjavík and Environs, Hafnarfjördur, Sparisjódur vélstjóra, Keflavík, Kópavogur and Mýrarsýsla.

3. Based on the simple ratio of net profit to the average between capital at the start and end of the period, less profit for the period. The figure is annualised. Different figures from those used here have appeared in press reports and discussions of the commercial banks and savings banks' profitability ratios. Those figures are calculated on a different basis, for example by adjusting profit to allow for the impact of inflation accounting, using only capital at the start of the period as a denominator, and making adjustments for dividend payments during the period.

Table 5 Cost ratios 1995-2000[1]

%	*Dec. 1995*	*June 1996*	*Dec. 1996*	*June 1997*	*Dec. 1997*	*June 1998*	*Dec. 1998*	*June 1999*	*Dec. 1999*	*June 2000*
Commercial banks and the largest savings banks	68.1	68.4	67.8	67.1	66.2	69.3	68.1	63.8	62.3	67.1
Íslandsbanki-FBA	63.3	61.3	59.0	57.7	55.1	59.6	59.4	55.3	55.2	55.0
Landsbanki	68.9	70.8	71.9	70.8	72.2	74.6	75.0	69.5	70.9	73.1
Búnadarbanki	74.7	74.1	74.2	73.6	71.4	73.7	68.5	63.6	61.5	76.5
The largest savings banks..........	68.1	70.9	70.1	71.3	71.8	73.3	72.6	71.9	62.1	74.3

1. Operating expenses as a ratio of net operating income.

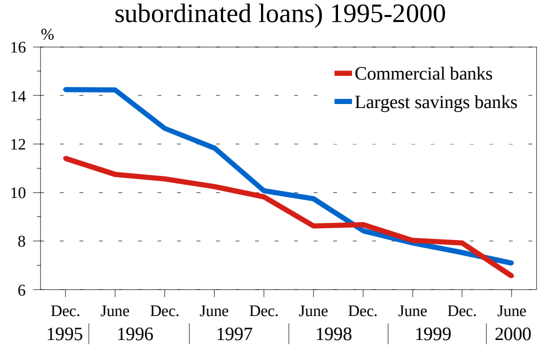
Source: Financial Supervisory Authority.

Unfortunately, the drop in the cost ratio which took place in 1999 appears to have been temporary and more the result of increases in other revenues than of cost restraint.

Other interesting points are revealed by looking at the position and development of individual banks underlying the averages. The cost ratio has fallen considerably at Íslandsbanki-FBA but risen among the other commercial banks and major savings banks. During the first half of this year, the ratio was 55% at Íslandsbanki-FBA, 73.1% at Landsbanki, 76.5% at Búnadarbanki and 74.3% at the major savings banks. It seems inevitable that the poorer performers in this cost comparison will respond with efforts to boost their operational efficiency and competitiveness.

Chart 5

Capital ratios (excluding subordinated loans) 1995-2000



Source: Financial Supervisory Authority.

Capital ratio

Among the balance sheet items, there are grounds for highlighting in particular the deteriorating capital position of the commercial banks and savings banks as a whole. Their capital position has been continually weakening in recent years and the time has surely

Table 6 Commercial banks' and savings banks' subordinated loans 1998- 2000

M.kr.	*Dec. 31 1998*	*Dec. 31 1999*	*June 30 2000*
Landsbanki	2,567	4,661	5,077
Íslandsbanki-FBA	1,959	2,586	4,780
Búnadarbanki	767	2,119	3,155
Kaupthing	607	642	1,257
Savings banks:			
Sparisjódur Reykjavíkur og nágrennis (Reykjavík and Environs).......	462	834	843
Sparisjódur Hafnarfjardar	308	640	749
Sparisjódur vélstjóra	0	200	400
Sparisjódur Keflavíkur	278	298	311
Sparisjódur Kópavogs	153	206	217
Sparisjódur Nordlendinga	0	102	196
Sparisjódur Ólafsfjardar	50	53	53
Sparisjódur Ólafsvíkur	0	46	46
Eyrarsparisjódur	0	38	43
Sparisjódur Hornafjardar	19	30	30
Sparisjódur S-Thingeyinga	25	26	26
Sparisjódur Súdavíkur	0	11	11
Total	7,195	12,492	17,194

come for them to reverse this trend by boosting capital and holding back the expansion in their balance sheets.

Five years ago, overall capital ratio as defined in capital adequacy requirements measured just under 12%, but by the end of June 2000 it had come down to 9.4% (see Chart 28 on p. 84). The savings banks had a much stronger capital position than the commercial banks, although the gap has been narrowing significantly. At the end of June Landsbanki had an capital ratio of 8.7%, Íslandsbanki-FBA 9.4%, Búnadarbanki 9.8% and the major savings banks 10.5%. Although the minimum requirement by law is 8%, the commercial banks have aimed to maintain their capital ratios at 10% and above, and it would seem natural for smaller financial institutions to set themselves higher targets than that.

All the commercial banks took subordinated loans during the first half of the year, bringing the total subordinated loan stock of credit institutions to 17.2 b.kr. at the end of June, as shown in Table 6. Around half the subordinated loans taken by Íslandsbanki-FBA and Landsbanki have been obtained abroad, the rest are domestic in origin.

The decline in capital ratios excluding subordinated loans gives even more justification for reversing the recent trend (Chart 5). Excluding subordinated loans, the capital ratio at the commercial banks and major savings banks has dropped from 11.1% at the end of June 1996 to 6.6% at the end of June this year. This figure stood at 8.0% at the end of June 1999, and has therefore dropped by 1.4 percentage points in the space of a single year. The ratio was 5.7% at Landsbanki, 7.2% at Íslandsbanki-FBA, 6.5% at Búnadarbanki and 7.1% at major savings banks.

Above all it is the rapid balance sheet expansion without a corresponding growth in profitability which has caused this drop in capital ratios at the commercial banks and savings banks. Credit growth remained high during the first half of this year, as pointed out elsewhere.

Obviously, access to equity and credit is a crucial factor in assessing the financial institutions' position. An important indicator in this respect is the risk premium that financial institutions need to pay to investors over and above prime credit terms. Since subordinated loans rank junior to other liabilities in the event of a bankruptcy and thereby entail a higher risk, the terms on them provide a very important indication of the market's assessment of financial institutions. The Financial Supervisory Authority intends to compile information on subordinated loan terms on a regular basis, which the Central Bank will be using in its analyses.

Credit rating

Another important assessment of the financial institutions' position is given by the ratings which international rating agencies assign to their obligations. Although some of these companies' findings may be disputed, it is a fact that investors and financial institutions worldwide use their ratings in deciding their lending and investments. Ratings are a crucial factor for financial institutions' credit lines and financing costs, especially for international bond issues. Moody's Investors Service has announced Bank Deposit Ratings and Financial Strength Ratings for the Icelandic commercial banks. The main categories of Moody's ratings are explained in Table 7.

At the beginning of June Moody's raised its rating for Íslandsbanki-FBA following a review launched in April when the banks announced their

Table 7 Moody's ratings[1]

Long-term bank deposit ratings[2]		*Short-term bank deposit ratings*		*Bank financial strength ratings*[3]	
Aaa	Exceptional	Prime-1	Superior	A	Exceptional
Aa	Excellent	Prime-2	Strong	B	Strong
A	Good	Prime-3	Acceptable	C	Good
Baa	Adequate	Not Prime	Questionable to poor	D	Adequate
				E	Very weak

1. The table shows the main Bank Deposit Ratings and Bank Financial Strength Ratings of Moody's Investors Service.

2. Ratings shown are investment grade. Lower ratings (Ba, B, Caa, Ca and C) are speculative grade. The numerical modifiers 1,2 and 3 indicate that the bank is in the higher, mid-range or lower range of its letter-rating category.

3. Financial Strength Ratings represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements. They do not address the probability of timely payment. They can be understood as a measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions. The symbol + indicates gradation.

pending merger. Icelandic finance companies can be ranked into three levels in terms of their credit ratings. After the merger, Íslandsbanki-FBA has a rating of A2 for long-term obligations, P-1 for short-term obligations and C for financial strength. One level down come Landsbanki with A3, P-2 and D+, and Búnadarbanki with A3, P-2 and D. Other finance companies are not rated. By way of comparison, the Republic of Iceland has a rating of Aa3 for long-term foreign obligations and P-1 for short-term foreign obligations.

VIII. Conclusion

On the whole, macroeconomic imbalances have intensified since the first special coverage of financial system strengths and weaknesses was published in the *Monetary Bulletin* for February 2000. This takes the form of a larger current account deficit, stronger pressure in most markets and higher inflation than was expected. In the event of a revenue shock, this trend could provide conditions for financial instability. However, there is no financial crisis looming, since the base forecast for macroeconomic developments indicates that the economy will cool down in the next few months, while still leaving sufficient growth to avoid a direct deterioration in real wages and disposable income. That said, the events in the foreign exchange market in June and July suggest that the large current account deficit entails some exchange rate risk. A sudden weakening of the króna could have negative consequences for financial system stability, for reasons including heavy foreign-denominated indebtedness of credit institutions and their clients.

Noticeable features of the interim figures for commercial banks and savings banks are lower profitability, high cost ratios and falling capital ratios, especially when subordinated loans are excluded. Hopefully the forecasts for more favourable developments during the second half of the year will hold, but on a longer-term view it would be desirable to see even more success from measures to boost the financial institutions' operations and positions. Acting with other factors, such a development would consolidate the foundations of the financial system. The raised credit rating of Iceland's largest commercial bank is gratifying. This facilitates its access to capital and reduces borrowing costs. If the merger between Landsbanki and Búnadarbanki is realised, management action can be expected which could boost the new bank's credit rating too.