Davíð Oddsson: The commercial banks are more resilient

Opening statement by Mr Davíð Oddsson, Chairman of the Board of Governors of the Central Bank of Iceland, on behalf of the Board of Governors at a Press Conference on the occasion of the publication of the Bank's *Financial Stability 2007*, 25 April 2007.

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In its analysis published in *Financial Stability* at the beginning of May 2006, the Central Bank of Iceland's finding was that the financial system was broadly sound, but more challenging waters lay ahead. Two main causes of concern were identified: macroeconomic imbalances and uncertainty about the commercial banks' refinancing of their foreign borrowing. Refinancing was successfully completed. However, macroeconomic imbalances increased. A year ago the focus was on short-term risks on the liabilities side of the financial companies' balance sheets, but now it has shifted more to the long-term asset quality.

The most pressing economic policy task is to restore stability. The conclusion of large investments in the aluminium and power sectors will automatically reduce imbalances, but other adjustment has been slower than expected. Increased foreign debt service has delayed the unwinding of the current account deficit, which will hardly be brought down to a sustainable level without a substantial contraction in demand. The latest forecast in *Monetary Bulletin* in March 2007 indicates that such a contraction lies ahead, as growth of investment and private consumption slows down. As discussed in this report, a depreciation of the króna coinciding with a fall in asset prices – possibly originating in tighter global financial conditions – could amplify the forecast contraction.

The necessary reduction of pressures in the economy will squeeze businesses and households, many of which are vulnerable due to heavy debt. They could withstand a short-lived reversal, but a lasting contraction would be difficult to weather.

In late autumn 2005, after a surge in borrowing by Icelandic banks in international bond markets, investors revised their risk assessments of the banks. CDS spreads and secondary market yields on their issues increased. The banks deferred further borrowing in the European bond markets, which had been their main source of funding. Foreign analysts and agencies published negative reports about the banks and the state of the Icelandic economy. The climate turned most adverse at the end of February 2006 after Fitch Ratings changed Iceland's sovereign outlook from stable to negative, claiming *inter alia* that the banks' tight financing could have implications for the Treasury.

This situation and its aftermath squeezed the banks for a while, forcing them to respond firmly to the uncomfortable position that had arisen. They made efforts to explain the structure and organisation of the Icelandic banks. The banks adjusted certain aspects of their operations and cross-ownership in response to relevant criticisms, and refuted what was less relevant with both communication and successful business performance. Temporarily they needed to look beyond their traditional markets for funding, with issuance in the US and Japan. The problem that loomed around this time a year ago is a thing of the past and terms in the secondary market are more favourable again.

The Central Bank underlines that global market conditions can take a sudden turn for the worse and it is important to be on the alert and prepared for such a contingency.

The current episode of ample liquidity and lower interest rates which has been ideal for risk-seeking investors may change unexpectedly. Short-term interest rates have been rising in most markets recently and capital costs are no longer so favourable. The Icelandic banks are better equipped for such a reversal than a year ago, because experience has taught them to extend and disperse their borrowing, and build up substantial liquid reserves in foreign currency. In 2006 the spotlight was on the banks' liquidity risk. Now that this risk has ebbed, the focus has shifted to credit risk and the potential impact of higher interest rates and a depreciation of the króna.

Amidst the turbulence of 2006, the banks slowed down their credit growth and expansion of their balance sheets. No major foreign financial companies were acquired and equity exposures were reduced. Nonetheless, it is natural to consider their credit risk and vulnerability towards a fall in asset prices.

Icelandic households' debts with credit institutions have soared in recent years, especially average-income and young households. Debt service has not risen by the same proportion, due to rising

incomes and easier credit terms, and arrears are at a low. However, some borrowers have stretched their capacity to the limit and the most indebted group has seen its debt grow substantially as a proportion of income and assets in recent years. Conditions will not need to change much to cause them serious difficulties. The bulk of household debt is in the form of CPI-indexed mortgage loans, making low inflation critical. Household debt in foreign currency was very low, but has been increasing. High levels of foreign currency-denominated debt could prove questionable for households with no income in foreign currency. Since house prices are currently buoyant, they are likely to rise by less than general inflation or even fall in nominal terms. Household equity could shrink under such conditions.

Business profitability appears to have been strong in 2006, in spite of a massive increase in financial expenses from exchange rate losses on foreign borrowing, higher interest expenses and a substantial increase in interest-bearing debt. Debt of listed companies grew as a ratio of equity and the same is probably true of other businesses. Higher debt levels leave them more vulnerable to a contraction in the economy.

Equity prices have soared in Iceland in recent years. One explanation for the increase may be that Icelandic companies were undervalued by the markets, for example by international comparison, and another that bold investment ventures have driven up their value. But risk and high yield often go hand in hand and it must be assumed that equity prices can fall just as easily as rise.

The Central Bank has assessed the banks' credit portfolio quality on the basis of geographical and sectoral distribution. It is no longer enough to focus solely on activities in Iceland, because three-quarters of the banks' total lending on a consolidated basis was to non-residents, especially in the other Nordic countries and the UK. The assessment indicates that the banks' loss provisioning is more than adequate to meet expected losses. However, this view must be tempered by hefty credit growth in recent years and the large increase in leveraged buyouts and forward contracts connected with them. House prices are at a historical peak in real terms and may unwind. Equity prices reflect expectations of ongoing rapid output growth, but such sentiment can quickly reverse, as recent experience has shown. Arrears and impairment are minimal, but both may be expected to increase in the coming years.

One major vulnerability of the Icelandic economy at present is the risk of a rapid and unforeseen rise in international interest rates and premia. Short-term rates have already risen widely and may go up further. Long-term rates have not changed much but could begin to climb. Premia are prone to change at short notice due to shifts in investors' risk assessments or risk-seeking.

The Icelandic economy has never been so sensitive to changes in global markets, which could significantly affect it. It is critical to achieve some redress of imbalances before external conditions tighten.

Strange as it may sound, the banks' efforts to hedge against the effect of a conceivable depreciation of the króna on their equity ratios has increased the market risk on their foreign exchange exposures. Credit institutions fulfil the Central Bank's rules on foreign exchange balance, but have been permitted to maintain separate additional currency balances. Thus the banks' capital positions are well hedged against a conceivable depreciation of the króna, but a short-term appreciation cannot be ruled out. The banks' customers, on the other hand, are less protected against shocks from a depreciation, although data from the banks show that most of their borrowers of foreign currency-denominated loans also have substantial currency earnings and thereby a natural hedge against exchange rate movements.

Financial Stability 2006 reported on a Central Bank stress test of the impact of a serious shock involving a simultaneous large rise in global interest rates, depreciation of the króna and fall in asset prices. This simulation has now been repeated using new data and assuming an even larger depreciation and decrease in house prices. Were all these shocks to coincide, estimates show that the contraction in national expenditure could prove considerably greater than in the Central Bank's most recent macroeconomic forecast in *Monetary Bulletin* in March 2007. The pressure on the financial sector will be determined to some extent by the pace of the adjustment and the banks' own responses to it. Although the adjustment would ultimately be greater if it occurred slowly, a very rapid contraction would deliver such a jolt to the finances of many households and businesses that loan losses would result.

It is likely that a range of risks will have to be faced, but efforts must be made to minimise the probability of a financial crisis that could harm potential output and living standards. In the final

analysis, the critical factor is how strong and well equipped the financial system is to withstand shocks, i.e. its resilience.

The crucial factor behind the Central Bank's assessment that the financial system is now more resilient to shocks is the banks' stronger liquidity and equity positions than a year ago. The major commercial banks have a diversified income base that extends to many countries. Another advantage is the somewhat different business models they have used in their expansion. Their diversified assets give less reason to fear the consequences of an unexpected strain on the financial system.

Iceland's strong fiscal position underpins the banks' international credit ratings. Other important factors have been the strengthening of Iceland's foreign reserves and the Central Bank's capital. Both measures represent natural responses to changes caused in the Central Bank's operating environment by the very rapid expansion of the commercial banks, especially abroad.

Although the main function of a financial stability report is to highlight risks, factors conducive to strengthening the long-term economic outlook should also be duly noted. Iceland's economy is advanced, transparent and dynamic. The population is relatively young, well educated and quick to adapt to technological and scientific innovations. A strong fully funded pension system has been built up and, unlike other countries, there is no reason to fear for its sustainability. GDP per capita ranks with the highest in the world, and the economic and social infrastructure is solid. The openness of the economy results in a smaller effect from a contraction in domestic demand on employment than might be expected.

The authorities shape the framework in which businesses and the financial system operate. Through its membership of the European Economic Area, Iceland enjoys similar operating conditions to those within the European Union. Nonetheless, it retains various features that influence economic advancement, such as a rather business-friendly tax environment, efficient public administration and flexible labour market. Extensive and rapid transformation of the financial sector puts supervisory agencies under pressure. The Financial Supervisory Authority (FME) has been granted an increasingly wide remit in recent years and its activities have been strengthened. One task is to monitor the banks' transactions with main shareholders and executives.

Payment and settlement systems are a key component of an efficient and sound financial system. Steps have recently been completed towards bringing their regulatory framework into line with international best practice. Although such work tends to go relatively unnoticed, it is crucial for enhancing security of settlements and reducing technical risks.

The main financial sector vulnerabilities are presented in the table below. The first three relate to macroeconomic imbalances that could cause a further widening of the current account deficit, higher external debt and a depreciation of the króna. Vulnerability on these counts is no less than a year ago, and higher global interest rates and premia could have widespread repercussions. On the other hand, much of the uncertainty about the banks' access to financing has been dispelled and they have built up ample liquid reserves. Under such conditions, the focus shifts to asset quality.

The second table highlights factors that contribute to financial system resilience. The most noteworthy development is the banks' stronger position in the form of ample liquidity and capital adequacy ratios which are very acceptable and historically high.

On the whole, the Central Bank's finding is that the financial system is broadly sound. It is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks appropriately. In other words, it is capable of performing its function in an orderly and efficient way. Iceland's banking system meets the demands made of it and performs well on stress tests conducted by the Central Bank and FME.

Table 1 Main vulnerabilities

Risk	*Explanation*
Exchange rate developments	Macroeconomic imbalances are pronounced. The current account deficit poses the risk of a depreciation of the króna. Shifts in carry trades and other exposures could catalyse a sudden turnaround. The FX market relies on three market makers and is still relatively thin. Some borrowers from the commercial banks have little or no hedge against exchange rate movements.
Global interest rates and premia	In recent years, interest rates and premia have been at a historical low. Interest rates have begun to climb and sooner or later premia will rise again, increasing corporate financing costs.
Terms of trade	Export prices could drop and oil prices rise. Unfavourable developments could widen the current account deficit and erode national income. Economic and social infrastructure is sound. The Central Bank's macroeconomic forecast assumes a deterioration in the terms of trade.
International market funding	High dependence on market funding and deposits on call makes credit ratings and global market conditions crucial for the commercial banks. Experience shows that credit assessment can shift suddenly.
Asset quality of commercial banks	Rapid credit growth often eventually leads to poorer loan quality. Loans with equities as collateral are substantial. Prices of equities and real estate are buoyant. Although arrears and impairment are at a low, they are unlikely to remain so over the next few years.

Table 2 Resilience

Resilience	*Explanation*
Economy	The economy is flexible and in the past has shown itself capable of tackling cyclical swings through adjustment of imports. Investment and output growth have been robust. The long-term economic outlook is favourable.
Strength of the commercial banks	The commercial banks' liquidity and capital ratios have never been higher. They have built up liquidity in foreign currency and secured refinancing into 2008. Profitability is strong from the bank's diverse operations and assets are diversified.
Institutional and supervisory framework	Iceland's framework is the EEA Agreement and its guidelines are international best practice and transparency. Economic and social infrastructure is sound. Financial supervision has been boosted and extensive cross-border cooperation is in place.
Payment and settlement systems	Payment system infrastructure is largely electronic and efficient. Steps have been taken to enhance security and contingency plans. Systems meet international standards.
Fiscal position	The Treasury's position is strong with consecutive fiscal surpluses. Net external Treasury debt, including foreign reserves, is virtually zero. No pension gap is foreseeable.