Icelandic Economic Update

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Arion banki

The financial results of the three new banks

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Agreement reached with the Central Bank of Luxembourg

- Bonds which had been tied up at the Central Bank of Luxembourg (BCL) have now been released for what some people consider a fair "ransom." In other words, the Central Bank of Iceland and the Icelandic Treasury have reached an agreement with the Central Bank of Luxembourg over the bonds which the latter acquired following the failure of Landsbanki in 2008. This in effect solves, or at least delays, some of the problems looming over the ISK since the capital controls were imposed in 2008.

Calendar

Date	Title	Period
2 June 2010	Central Bank of Iceland Financial Stability Report	
4 June 2010	Auction Treasury Bonds	
11 June 2010	Unemployment Figures	May 2010
11 June 2010	Auction Treasury Bills	
23 June 2010	MPC's Interest Rate Decision	
25 June 2010	Auction Treasury Bonds	
29 June 2010	Consumer Price Index	June 2010

The financial results of the three main banks

The three main Icelandic banks, Arion Bank, Íslandsbanki and Landsbanki, have recently published their financial results for 2009, the first full year of operations. Íslandsbanki delivered the strongest results, with net earnings of EUR 151 million and return on equity of 30%. Arion Bank is the largest deposit bank in Iceland with deposits of EUR 3.7 billion. In comparison deposits from customers total EUR 2.9 billion at Landsbanki and EUR 2 billion at Íslandsbanki Landsbanki has the largest balance sheet with assets of EUR 6.7 billion and the most extensive branch network.

	Arion bank	**Íslandsbanki**	**Landsbanki**
Net interest income	76	201	92
Net fee and commission income	37	44	26
Operating income	312	283	193
Net earnings	81	151	90
Return on equity	15.4%	30.0%	9.5%
Total assets	4,763	4,512	6,667

* Amounts are in EUR million

Inflation balance. Inflation in Iceland had a positive impact on the results of Íslandsbanki and Landsbanki whose inflation-indexed assets exceeded inflation-indexed liabilities. Inflation had a negative effect on Arion Bank as its inflation-indexed liabilities exceeded inflation-indexed assets. This might explain Arion Bank’s lower interest-rate differential compared with the other two. The situation has changed, however, since the beginning of the year after the mortgage loans of the old Kaupthing were incorporated into Arion Bank’s accounts. Inflation was more than 7.5% in 2009 but is expected to be considerably lower in 2010.

Net interest income at Íslandsbanki was EUR 201 million, EUR 92 million at Landsbanki and EUR 76 million at Arion Bank. Excluding net adjustments and fair value change at Landsbanki, net interest income is almost halved, dropping from EUR 176 million to EUR 92 million.

Arion Bank generated the highest operating income, which might seem surprising considering the three banks' net interest and commission income. However, this is easily explained by the fact that Arion Bank has acquired several companies on a temporary basis which are classified as subsidiaries in the financial results (does not apply to Hagar and ÍAV). This isn’t to say that these companies contributed much to Arion Bank’s results. These subsidiaries generated income of EUR 112 million but operating expenses came to EUR 113 million, netting approximately EUR 1 million loss.

	Arion bank	**Íslandsbanki**	**Landsbanki**
Loan-to-deposit	65%	121%	136%
Deposits from customers/Assets	65%	47%	43%
Total deposits/Assets	80%	67%	52%

Loans to customers exceeded deposits by EUR 616 million at Íslandsbanki (or 15% of the bank's assets) and by EUR 1.3 billion at Landsbanki (or 20% of the bank's assets). At Arion Bank deposits exceed loans to customers by EUR 1.3 billion. Arion Bank is the largest deposit bank in Iceland with deposits of EUR 3.7 billion of which EUR 3 billion are from customers. In comparison deposits from customers total EUR 2.9 billion at Landsbanki and EUR 2 billion at Íslandsbanki.

In terms of deposits from customers as a ratio of assets, Arion Bank has the highest funding ratio from deposits at 65%. If liabilities to financial companies and the Central Bank are included as deposits, the ratio is 80% at Arion Bank.

	Arion bank	**Íslandsbanki**	**Landsbanki**
Net interest income/Assets	1.7%	4.7%	1.4%
Net interest income/Loans	3.1%	5.9%	2.0%
Net interest income/Fixed cost	72%	198%	92%
Net fee and commission income/Fixed cost	107%	242%	119%
Equity ratio (CAD)	16.4%	19.8%	15.0%
Number of employees end of year	1,096	981	1,161
Number of branches	26	21	37

Íslandsbanki's interest-rate differential was much higher than the other banks. Its interest-rate differential as a ratio of total assets was 4.7% and 5.9% as a ratio of total loans.

Net interest income was not enough to meet fixed costs at Arion Bank and Landsbanki, but was twice as high as fixed costs at Íslandsbanki. However, net interest and commission income covered fixed costs at all the banks in 2009.

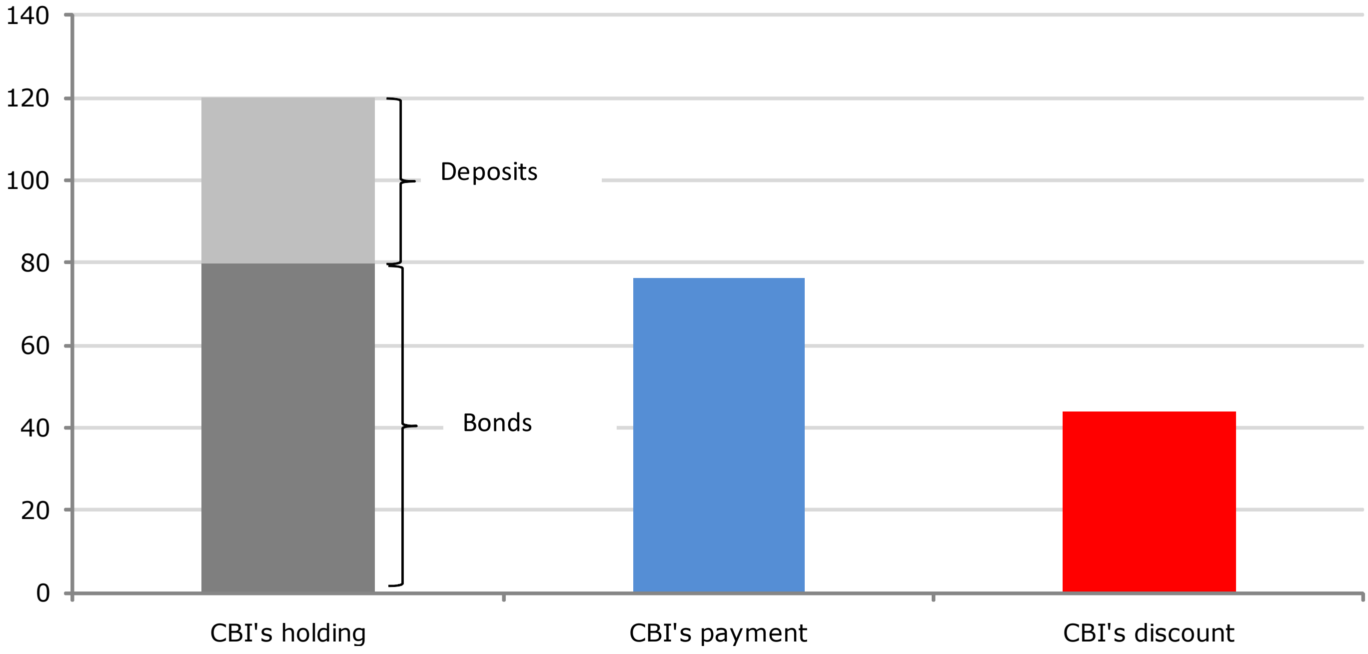
Landsbanki had the lowest capital ratio of the three banks at 15%, below the FME's minimum requirement of 16%. A higher capital ratio means lower profitability and a higher capital adequacy requirement means that reducing costs is more important than ever.

Agreement reached with the Central Bank of Luxembourg

Bonds which had been tied up at the Central Bank of Luxembourg (BCL) have now been released for what some people consider a fair "ransom." In other words, the Central Bank of Iceland and the Icelandic Treasury have reached an agreement with the Central Bank of Luxembourg over the bonds which the latter acquired following the failure of Landsbanki in 2008. This in effect solves, or at least delays, some of the problems looming over the ISK since the capital controls were imposed in 2008 - this reduces the impending short-term outflow of capital when the capital controls are relaxed.

In effect it is as if the Central Bank of Iceland had managed to secure a foreign loan at favourable terms in order to boost the currency reserve and had immediately spent it on buying up domestic assets at a sizeable discount.

CBI's purchase
- in ISK billion



Source: Central Bank of Iceland

Sizeable discount

Under this agreement, the Central Bank of Iceland will pay the BCL EUR 402 million (ISK 64 billion) with a 15-year bond denominated in euros and a cash payment of approximately ISK 12 billion in euros and ISK, making a total of approximately ISK 76 billion. In return the Central Bank of Iceland (or its asset holding company ESÍ ehf.) will receive bonds and deposits worth ISK 120 billion. Approximately 2/3 of the assets are government-backed bonds and 1/3 is deposits denominated in ISK. This represents a discount on the nominal value of the assets of 36% or the equivalent of the transaction having been done at an exchange rate of EUR/ISK 253. In comparison the offshore exchange rate is EUR/ISK 267.

At first glance this seems like a pretty good deal for the Central Bank of Iceland. The bond bears similar interest to loans obtained from Scandinavia and the IMF, i.e. EURIBOR plus a 275 bp premium. It is difficult to say however what foreign owners of ISK who cannot get rid of their assets would be willing to pay for euros if the Central Bank of Iceland were to auction bills in euros. This is one of the options proposed by the Central Bank of Iceland during the latter stages of the relaxation of the capital controls.

Presumably there are other factors involved and it is not unlikely that it will help free up other assets from Landsbanki's insolvency estate in Luxembourg. Naturally it would have a positive effect on paying off the Icesave debt and reducing the national debt.

Where does this leave foreign investors in ISK?

Following the failure of the Icelandic banks, BCL became the largest single owner of ISK-denominated assets in Iceland. At the time foreign investments in ISK-denominated assets were estimated at almost ISK 700 billion. This figure has been decreasing and recently the Central Bank of Iceland has estimated it at around ISK 500 billion. This change is probably due to the fact that some Icelandic investors were previously categorised as foreign investors.

Following this deal between the two central banks approximately ISK 350-400 billion of assets owned by foreign investors remain tied up in the Icelandic economy.

Bonds sold to pension funds

The bonds (or the indexed bonds which constituted 90% of the total bonds) have now been sold to 26 domestic pension funds in a closed auction. That solution must be considered quite positive for the Central Bank of Iceland since the pension funds pay with euros for the bonds. Hence CBI's foreign currency reserves are bolstered considerably or by EUR 512 million (17%) and at the same time CBI's net foreign debt is reduced. In an effect this transaction is as if the CBI was the middleman between the domestic pension funds and the BCL while securing a loan in euros to strengthen its foreign currency reserves.

However on the negative side foreign assets of Icelandic pensioners are lower after this transaction, since the pension funds are selling foreign assets and buying domestic assets instead. All in all these transactions, between BCL and the CBI and further between the CBI and domestic pension funds make the way for a faster relaxation of the capital controls.

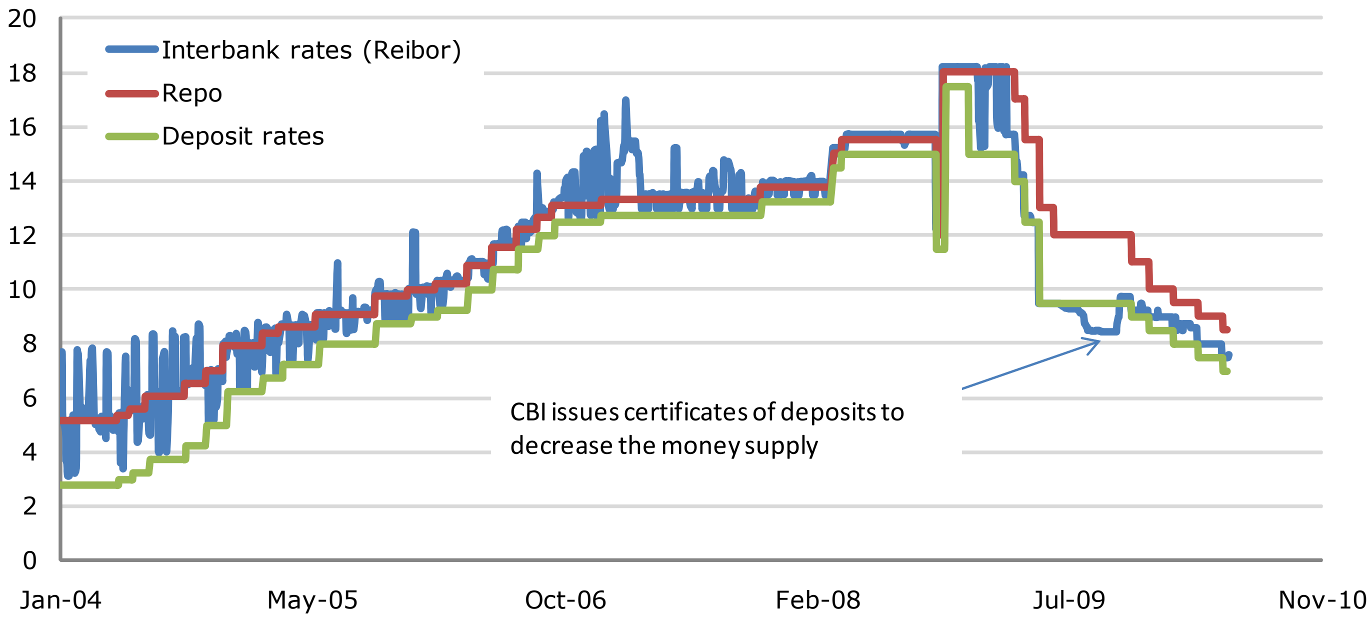
Impact on money supply

One factor which may affect money supply is the ISK 40 billion in deposits which the Central Bank of Iceland will acquire as a result of this deal.

If these deposits have been at the Central Bank of Iceland the whole time then there is no need to worry about the effect on the money supply. If however, we assume that these funds are already in circulation, it simply means that the Central Bank of Iceland can call on these funds and withdraw them from circulation. This would make collateral loan rates more important, as interbank rates (REIBOR) are currently 90 points below repo rates.

The Central Bank might have no plans to take such radical action as it would risk causing a shortage of liquidity and thus lead to the excessive tightening of monetary policy. The Central Bank's concerns that there is too much money in circulation have diminished recently as the issuing of certificates of deposits to reduce the money supply has been effective, leading to the narrowing of the spread between repo rates and interbank rates. It is nevertheless conceivable that the Central Bank will continue to bring interbank rates closer to repo rates and the money provided by the BCL yesterday might just be one of the tools used to this end.

CBI's interest rates and interbank rates (%)



Source: Central Bank of Iceland

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