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## Iceland's Solvency and Liquidity are Not at Risk

### Summary

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Moody's rates Iceland Aaa with a stable outlook. While displaying more volatile economic and financial patterns than most – but not all – Aaa economies, Iceland is a very wealthy country engaged in a major process of economic diversification.

In recent weeks concerns have been ignited about systemic risk in the banking system because of the sizable accumulation of banking system external debt and large short-term payments falling due. While Moody's has warned of the risks that may accompany increased leverage in Iceland's economy — including a magnification of an already volatile business and financial cycle, — we believe these concerns have been exaggerated.

Iceland possesses ample sources of alternative external liquidity above and beyond the banks' own liquidity that should enable the government and banking system to weather a period of market turbulence even if it were to become protracted. Strong government finances with general government debt equivalent to about 30% of GDP and 60% of revenues are about half the size of these ratios for Germany and France, for example. Iceland is well positioned to deal with any potential claims on government resources that might emanate from a systemic problem in any sector of the economy. Moody's Aaa rating for Iceland is therefore compatible with such an extreme scenario.

### Source of Recent External Debt Buildup

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Iceland has a long history of a large external debt, but the composition of this debt has changed over recent years as the government has reduced its own obligations because of its strengthening finances. The country has also experienced sizable foreign investment inflows into the country's power-intensive industries that help diversify the economy, thus making it even more resilient. Just as happened with an earlier round of such projects in the late 1990s, the investment boom sparked an overheating of the economy. Structural changes in the domestic mortgage finance system exacerbated the recent boom, however. Although the central bank hiked interest rates aggressively in response, Icelandic banks' access to foreign funding meant that monetary policy was increasingly ineffective in restraining abundant liquidity. Arguably insufficiently tight fiscal policy, including generous personal income tax cuts, and an overvalued exchange rate contributed further to the overheating.

Iceland's external debt stands at around 300% of GDP. The country's net international investment position at -86% of GDP at the end of December 2005, has deteriorated more slowly because of the buildup in external assets abroad by banks and corporations. However, Iceland is not an emerging market economy, for which such ratios might raise concerns. Iceland is an advanced economy, with per capita income of over \$50,000, one of the highest in the world. As is true for the other advanced economies, such ratios are sustainable for long periods of time. Economic adjustments in advanced economies take place through changes in the country's growth rate and through the exchange rate.

The sizable capital inflows triggered by foreign direct investment and portfolio inflows and other short-term inflows triggered by higher domestic interest rates (a tool to try to slow economic activity) caused the real effective exchange rate to appreciate. This has been exacerbated by sizeable bond issuance by nonresidents in Icelandic krona (ISK) over the past year. Given these developments, an adjustment of the exchange rate was inevitable. The only question was when, and by how much. At the latest, such an adjustment would have begun to occur as the project investment flows decelerated, toward the latter part of 2006. However, rising world interest rates, coupled with heightened market concerns about the sustainability of Iceland's macro disequilibria hastened the inevitable -- and probably healthy -- correction.

## **Banking Solvency and Liquidity Not in Peril**

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Recent market turbulence and the exchange rate depreciation of 14% since mid-February have given rise to some questions about the solvency and liquidity of the banking system. We believe these concerns are widely exaggerated.

### ***I. On Solvency...***

The banks are well-capitalized, well-supervised and follow sensible lending practices – all factors which make a systemic crisis highly unlikely. On-lending in foreign currency, while large and expanding rapidly, has financed reputable borrowers with natural hedges in foreign exchange. History offers some lessons: the deterioration of loan asset quality was contained in the aftermath of the floatation and large-scale depreciation of the ISK in 2001, as naturally hedged borrowers experienced a boost to profitability from the more competitive exchange rate. A large amount of the on-lending has financed Icelandic corporate acquisitions abroad, diversifying the risk experienced by Icelandic borrowers. Some banks have large equity portfolios that are less resilient to weakness in the operating environment.

Banks are permitted to maintain open foreign exchange positions of up to 30% of equity, but in practice they are considerably more cautious. In fact, their net foreign exchange exposure was positive at the end of 2005. What's more, the growing internationalization of the banks, whereby about half of the system's assets are derived from operations abroad, significantly insulates them from Icelandic-specific risks. Indeed, a good-sized portion of the external borrowings of the parent banks have been onlent to offshore customers, equivalent to about 20% of the total and over 50% of GDP.

### ***II: On Liquidity...***

On the liquidity front, the fundamentals are also solid. The recent cancellation of a government ISK auction, and news that certain money market managers were terminating extendable 13-month lines to the three banks (because the increased interest charges demanded were unacceptable to the banks) has increased concerns about liquidity of the government and the banks. Regarding the former, this is not the first time the government has opted to cancel an auction. It is fortunate to have the flexibility to do so until market conditions improve. Nor were the bids fully misaligned given the inflationary pressures that are ignited by the depreciation of the ISK. The government faces no material liquidity risk.

The banking system's external obligations due are large with about \$5 billion in market funds maturing in 2006. In addition, at year-end 2005 the system reported significant interbank borrowings, although some of this is long-term or internal. The banks have significant sources of liquidity with which to meet these obligations, including cash and cash flows, liquid securities, and pledgeable assets. In addition, there is no anecdotal evidence of a run on deposits. Nor have the markets been "closed" to Iceland, as is evident by recent transactions. Beyond this, the banks have access to committed credit lines, back-up lines and other sources of external liquidity.

The government's sources of alternative external liquidity are also more than sufficient to provide emergency funds to the banking system. It has total committed lines of \$325 million, open uncommitted lines of \$200 million, and an undrawn multi-bank credit facility of \$200 million. Above this, it also has a \$1 billion commercial paper program (P-1) with no outstandings. One-quarter of this is backed by bank commitments, where the commitment documents contain no clauses on material adverse circumstances. On top of this, there is close to \$1 billion of foreign

exchange reserves (at end-February 2006). These emergency sources are much larger than the net obligations of the banks (see table below and analysis that follows). The government's own debt due is a modest \$306 million in 2006.

The Central Bank of Iceland has also signed a memorandum of understanding (MoU) with the four other Nordic central banks on financial crisis management in 2003. While the MoU does not specifically dimension support levels, Moody's believes the funds available would be significant.

2006 Bank Refinancing Coverage	
	(Mils.)
<b>Banks' Net External Liabilities due to BIS Banks w/in 1 year (Sept. 2005)*</b>	<b>\$1,033</b>
<b>Government Sources of Liquidity</b>	<b>\$1,945</b>
Committed Lines	\$325
o/w BIS	\$75
Uncommitted Lines	\$200
Multi-bank Credit Facility	\$200
Backed-up CP program	\$250
Official FX Reserves	\$970
* Liabilities due in one year minus total assets in BIS banks.	

A final point to mention is that Iceland is an EFTA/EEA member, i.e. a member of the European Free Trade Association and the European Economic Area agreement with the European Union. It has a banking sector that is increasingly integrated regionally. The combination of a decline in the exchange rate, a fall in asset prices, and potential balance sheet difficulties, however unlikely, would probably lead to cross border acquisitions in the other way – with Icelandic banks being the prey – rather than a meltdown.

External financial assets are also an important variable. At the end of September 2005, according to the Bank for International Settlements, *BIS Quarterly Review, March 2006*, Iceland's external assets amounted to \$4.8 billion. External liabilities due within one year at that time were \$5.8 billion. The gap was at that point in time just \$1 billion – a small amount considering available alternative sources of finance and the banks' own on-hand liquidity.

## Related Research

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### **Banking System Outlook:**

[Iceland, December 2005 \(95656\)](#)

### **Banking Statistical Supplement:**

[Iceland, July 2005 \(93721\)](#)

### **Analysis:**

[Iceland, July 2005 \(93514\)](#)

### **Credit Opinion**

[Iceland, February 1, 2006](#)

### **Special Comment:**

[Moody's Sovereign Ratings: A Ratings Guide, March 1999 \(43788\)](#)

### **Rating Methodology:**

[Revised Country Ceiling Policy, June 2001 \(67679\)](#)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

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