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## The Icelandic credit system

*Domestic lending and securities of the credit system have grown much faster in recent years than over the period 1992-1998. The main reason is a surge in lending by the banking system and in foreign borrowing. Corporate borrowing has grown substantially in recent years.*

### Introduction

The credit system comprises lenders and borrowers in the domestic credit market. Lenders consist of the banking system, miscellaneous credit undertakings, pension funds, mutual funds and investment funds, insurance companies, state lending funds and abroad.

Within the banking system are the Central Bank of Iceland, commercial banks, savings banks, Postgiro and credit cooperatives.

Several types of corporations/institutions constitute miscellaneous credit undertakings, of which the Housing Financing Fund (HFF) is by far the largest. Other undertakings are investment banks, investment credit funds, two leasing companies and two payment card companies.

State lending funds consist of a number of funds/institutions responsible for lending by the state, i.e. the Student Loan Fund, Energy Fund, Harbour Improvement Fund, Unemployment Insurance Fund, Fisheries Development Fund – Employment Insurance Division, the guarantee and on-lending divisions of the National Debt Management Agency and the relevant divisions of State Accounts. Treasury foreign borrowing is also channelled through the state lending funds.

Borrowers are classified into four groups: central government, local government, corporate and household. They are confined to domestic entities, since

the accounts cover only the domestic credit market, but borrowing by foreign entities and Icelandic claims on abroad are deducted from foreign borrowing to yield a net figure, as discussed later.

Domestic entities are permanent residents in Iceland in accordance with the Act on Legal Domicile, irrespective of nationality, as defined under the Currency Act no. 87/1992. Foreign entities are all those not classified as domestic.

### Domestic credit and securities

Domestic credit and securities of the credit system, after eliminating inter-institutional transactions, amounted to 2,439.4 b.kr. at the end of June 2004, as shown in Table 1. Shares of individual lenders in total domestic credit and securities within the system have changed considerably since December 1992. The banking system has increased its share, as has foreign borrowing. Total lending by miscellaneous credit undertakings, including the HFF, and the pension funds has decreased correspondingly.

The most striking change is the massive increase in inter-institution transactions, i.e. lending by credit system entities to each other, which at the end of June 2004 exceeded 2,000 b.kr. – 45% of total lending. Including these transactions would give a different picture of relative shares. For example, the share of foreign borrowing would contract, since the largest item in inter-institutional transactions is foreign borrowing by deposit money banks (DMBs), at 925 b.kr. Also, the pension funds would gain share if inter-

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Table 1 Assets and liabilities of the credit system December 1992 and June 2004

	<i>Position at end of period (b.kr.)</i>		<i>% of total</i>	
	<i>Dec. 1992</i>	<i>June 2004</i>	<i>Dec. 1992</i>	<i>June 2004</i>
<i>Assets:</i>				
Banking system .....	210.4	1,183.2	22.6	26.5
Miscellaneous credit undertakings .....	209.0	620.9	22.4	13.9
Of which HFF .....	132.1	482.9	14.2	10.8
Pension funds .....	165.1	681.2	17.7	15.3
Insurance companies .....	17.0	68.4	1.8	1.5
Mutual and investment funds .....	8.0	221.1	0.9	5.0
Foreign lending .....	256.3	1,348.2	27.5	30.2
State lending funds .....	65.7	340.5	7.1	7.6
Total .....	931.5	4,463.6	.	.
Less inter-institutional transactions .....	-254.6	-2,024.2	27.3	45.3
Assets = liabilities .....	676.9	2,439.4	.	.
<i>Liabilities:</i>				
Domestic liabilities .....	457.0	1,760.4	.	.
Foreign liabilities, net .....	220.0	679.0	.	.

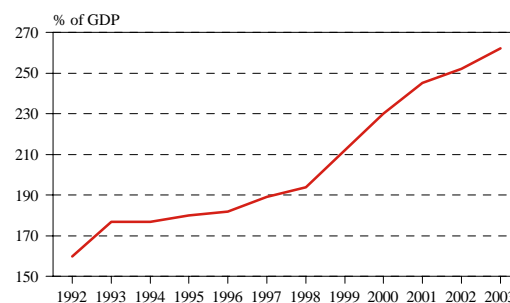
institutional transactions were included, even though their lending to other credit system entities amounts to 366 b.kr., comprising purchases of securities issued by credit institutions.

As a proportion of GDP, the development of domestic credit and securities in the credit system shows clearly accelerating growth in recent years compared with the earlier part of the period. Chart 1 presents the average loan stock position over the year relative to GDP for the period 1992-2003. It shows that the ratio was in the range 177-194% for almost all of the 1990s, but has since grown much faster to reach 262% in 2003.

More rapid growth may be traced in particular to the banking system, whose net lending soared over the period 1998-2003. In 1998 this was equivalent to 56% of GDP but had risen to 103% in 2003. Foreign borrowing and pension funds also grew relative to GDP over the same period, although not at a comparable pace.

Chart 1

### Domestic lending and securities of the credit system at year-end 1992-2003



Source: Central Bank of Iceland.

This period, 1992-2003, witnessed great volatility in twelve-month movements of lending in the credit system.<sup>2</sup> The sharpest spike was in mid-1999 at just over 35%, followed by a steep drop until the end of 2002 when growth was very subdued. Since then it has been steadily increasing. Foreign loan movements closely match those in the banking system, which is by far the largest foreign borrower.

### Lending classifications

As pointed out above, there are four main types of borrower in the Icelandic credit system: central government, local government, corporate and household. Transactions between credit system agents have been netted, i.e. credit institutions' borrowing from each other is included in the inter-institutional transactions in Table 1. At the end of June 2004, lending to corporations amounted to 1,333 b.kr. and to households 813 b.kr., while public sector entities had outstanding loans totalling almost 300 b.kr.

Since September 2003, credit institutions' lending has been automatically classified according to Statistics Iceland's ÍSAT standard, instead of manually. The new methodology resulted in shifts between categories of borrowers. Lending to households decreased with a corresponding rise in lending to both the corporate and local government sectors. The main reason for the reduction in lending to households was that some HFF debt was reclassified to local authorities and businesses which had previous-

2. Adjusted for transfers between miscellaneous credit undertakings and the banking sector.

ly been attributed to households as the ultimate borrower. There was also a sizeable decrease in household borrowing within the banking system, due to reclassification to the corporate sector. In statistical comparisons, earlier data have been adjusted to incorporate the changes made in September 2003.

### Lending to households

As mentioned above, total lending to households by the credit system stood at 813 b.kr. at end-June 2004. Chart 3 shows a breakdown by lender at that time.

Some 55.7% of total household debt, amounting to 453 b.kr., was with miscellaneous credit under-

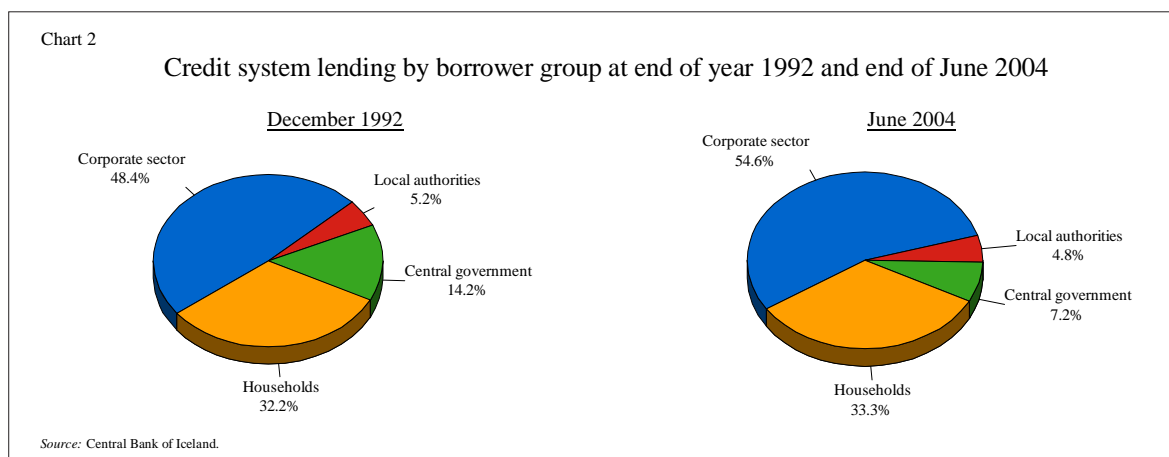


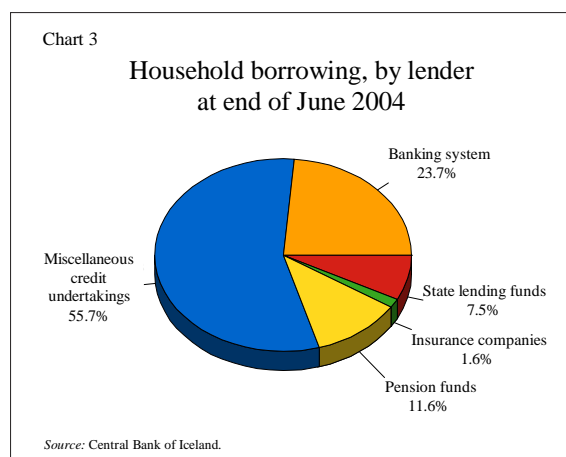
Chart 2 shows the change in borrowers' shares in total lending by the credit system since 1992. The greatest increase was in the corporate sector, which accounted for 48.4% of total lending at the end of 1992 but 54.6% at end-June 2004. The shares of local authorities and households remained broadly unchanged, while the central government's share contracted by 7 percentage points. An important explanation lies in foreign borrowing, with central government accounting for more than one-third of the total at the end of 1992 but less than 13% at end-June 2004.

### Lending to corporations

The largest lender to corporations is the banking system, which in June 2004 accounted for 57% of total corporate debt. A large share of this debt – more than 400 b.kr. – is exchange rate-indexed in addition to direct foreign borrowing by corporations amounting to almost 200 b.kr. Thus some 600 b.kr., or 45% of total corporate liabilities, were of foreign origin at the end of June 2004.

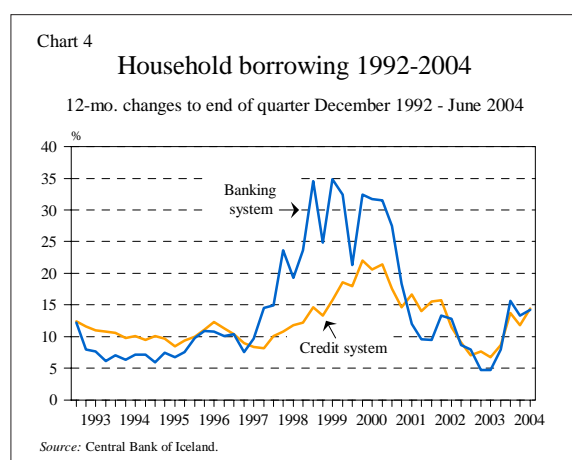
takings at end-June 2004. By far the largest individual agent in this segment is the HFF, which accounts for more than half the figure. The HFF's share in total household debt lay in the range 48-58% over the period from December 1991 to June 2004, reaching a peak in the mid-1990s and a low at the end of 2000.

At the end of June 2004, banking system lending accounted for just under one-quarter of total household debt, or 193 b.kr. The twelve-month rate of growth was around 10% over the period December

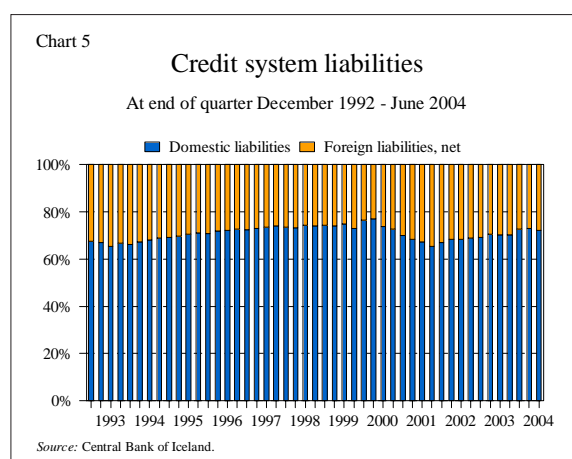


1992 until June 1997, when it soared as shown in Chart 4. Growth reached a peak in mid-2000.

Chart 4 shows that banking system lending to households has been more volatile than lending to them by the credit system as a whole. This is natural, since loans from the HFF, pension funds and Student Loan Fund are long-term and therefore stable over time. Short-term lending by DMBs, such as overdrafts, can fluctuate sharply in pace with conditions at any given time.



Pension funds' loans to members amounted to 94 b.kr. at the end of June 2004. Their twelve-month rate of growth surged in mid-2001 to beyond 30%. This has subsequently slowed down and since mid-2003 has been in the region of 9%.



State lending funds include the Student Loan Fund, which accounted for 7% of household debt at end-June 2004.

#### Financing of the credit system

Chart 5 shows a breakdown of the liability side of the credit system into domestic and foreign liabilities for the period December 1992 to June 2004. More than 2/3 of liabilities are with domestic entities for almost the whole period.

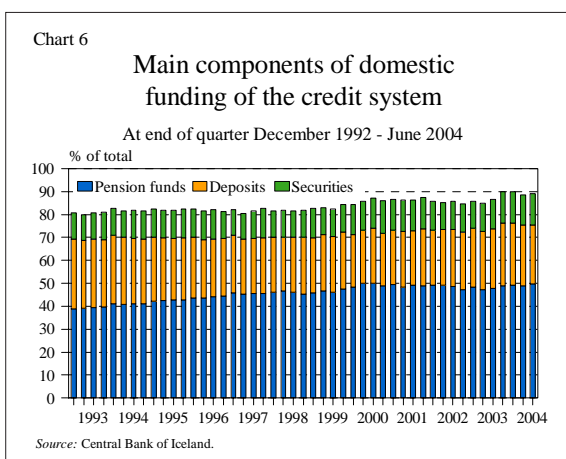
#### Borrowing from domestic entities

The lion's share of domestic borrowing by the credit system is the disposable (net) assets available to pension funds for lending or securities purchases. Pension funds' disposable assets accounted for almost 40% of the credit system's domestic liabilities at the end of 1992. The pension funds' share grew steadily until the beginning of 2000 when it stood at exactly half, and it has hovered around that level since.

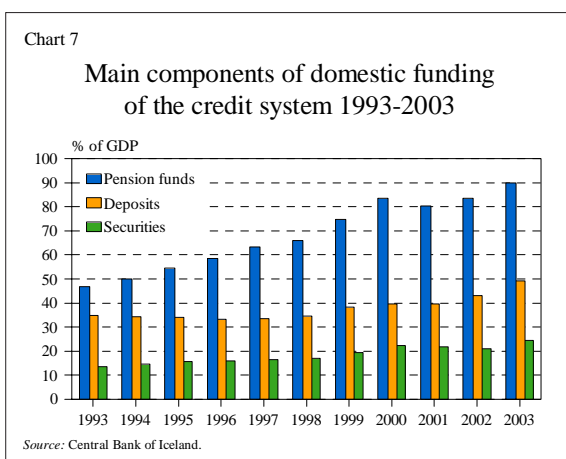
There are two main reasons for the pension funds' increased share. First, premia paid to pension funds mushroomed in the second half of the 1990s and until 2002. In 1996 they were equivalent to 4.1% of GDP, but had grown to 8.5% by 2002. Second, in 1994 the pension funds began investing in foreign variable-income securities when foreign investment rules were liberalised. At the same time the pension funds increased their positions in comparable domestic securities, having invested until then almost entirely in domestic fixed-income instruments. Investments in variable-income securities increased annually and in 2000 they accounted for almost 70% of total pension fund securities purchases. Returns were strong and the pension funds grew rapidly with a net real rate of return over the period 1995-1999 in the range 6.6%-12%.

Chart 6 shows the development of the three largest components of domestic financing over the period December 1992 to June 2004. Pension funds account for the largest share, as described above, followed by deposits with DMBs and securities portfolios of others than credit institutions. It reveals that deposits with DMBs have contracted over the period, from 30.5% in 1992 to 25.6% in June 2004. They hit a low of 23% at the end of 1999 and in September 2000. Shrinking deposits might have been expected

to produce a corresponding increase in the share of securities assets, but this was not the case. This item's share was 11.5% at the end of 1992 and 13.9% in June 2004, and lay somewhere in this range for the whole period.



These three largest components of domestic funding of the credit system can also be examined in terms of GDP. Measured by this criterion, pension saving-based financing spiralled over the period 1993-2003, from 47% of GDP to 90%, apart from a slight dip in 2001. Deposits have not grown as sharply, since their average position as a proportion of GDP was 35% in 1993 but had risen to 49% in 2003. For almost all the 1990s this ratio remained virtually unchanged in the range 33-35% of GDP.



### Foreign borrowing

Net foreign borrowing amounted to roughly one-third of total capital in the credit system in December 1992, then its share fell steadily until the end of March 2000 when it was only 23%. In September 2001 the share rose to 35% but more recently it has been trending slowly downwards and was 28% in mid-2004. Part of the explanation for the sharp increase from spring 2000 to autumn 2001 is the weakening of the króna over that period, when the exchange rate index rose (i.e. the króna depreciated) from 107 to 151.

Given the continuous reports of mounting foreign borrowing and securities issues in international markets, the recent declining share of foreign borrowing may come as some surprise. But the explanation can be seen in Chart 8. The foreign share of credit system funding is a net figure, i.e. foreign debt less claims on foreign entities, shown by the line "Foreign liabilities, net".

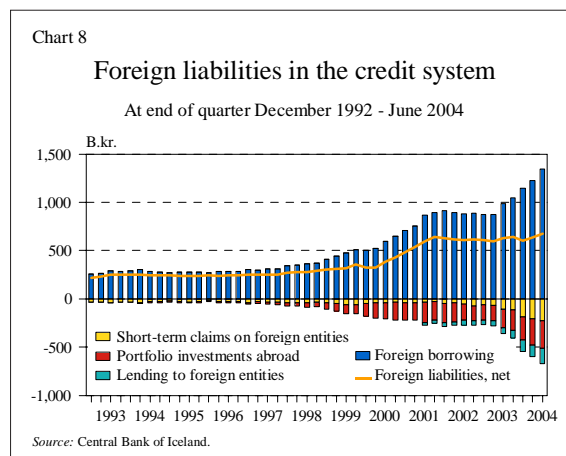


Chart 8 shows that foreign borrowing, including securities issues in international markets, soared in 2000-2001 and again in 2003 and the first half of 2004. For example, the stock was 1,348 b.kr. in mid-2004, compared with 872 b.kr. in March 2003.

However, the chart also shows that domestic claims on foreign entities have increased at the same time, especially in the more recent period. Short-term claims on foreign entities, residents' portfolio investments abroad and lending to foreign entities measured almost 670 b.kr. in the middle of this year, as against 277 b.kr. only 15 months before in March

2003. DMBs began lending to foreign entities on a significant scale in the first half of 2001 and the figure had exceeded 60 b.kr. in June 2003 (stated at July 2004 prices). Over the following twelve months their foreign lending soared by almost 100 b.kr. to reach almost 160 b.kr. at the end of June 2004.

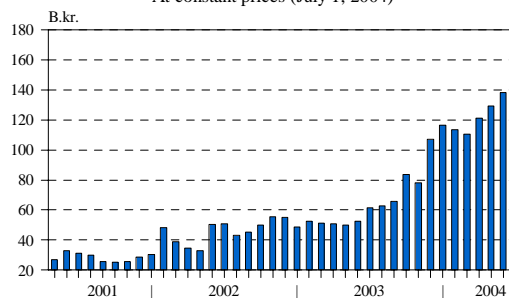
Residents' portfolio investments abroad have also surged in recent years. The stock measured 17 b.kr. at the end of 1996 but had risen to 282 b.kr. in June 2004, at respective price levels. Of the end-June 2004 figure, the pension funds held almost 193 b.kr.

Claims on foreign entities have therefore grown much more rapidly than foreign borrowing in the recent term, which explains why the foreign share in total financing of the credit system has remained relatively stable recently.

Chart 9

**DMB lending to foreign entities**  
**April 2001 - June 2004**

At constant prices (July 1, 2004)



Source: Central Bank of Iceland.