Íslandsbanki

Annual General Meeting 2016

Chairman's statement

Íslandsbanki Annual General Meeting 2016
Friðrik Sophusson, Chairman of the Board

Honoured guests:

2015 was an eventful year for Íslandsbanki. A number of changes took place: the old banks' composition agreements were finalised, and changes were made in the Bank's ownership structure. The Bank's after-tax profit totalled ISK 20.6bn, and its return on equity was 10.8%. Core operations continued to solidify, with the profit from regular operations totalling ISK 16.2bn and the return on equity from regular operations measuring 13.2%. Commission and fee income rose, and expense ratios declined.

Taxes, levies, and a challenging competitive environment

Íslandsbanki paid a combined total of ISK 8.6bn in income tax and bank tax in 2015. Since 2008, it has paid ISK 48bn in taxes to the Treasury. The Bank is large, active participant in the Icelandic economy and is proud to pay its taxes to the community at large. But it should be noted that taxes and levies on Icelandic financial institutions are among the highest in the world. In addition to income tax, payroll tax, and other conventional taxes and levies, Icelandic banks pay a 5.5% financial administration tax on wages and a 6% tax on profits in excess of a billion krónur. Furthermore, the banks pay to so-called bank tax, which currently totals just under 0.4% of liabilities in excess of ISK 50bn. The bank tax was increased significantly in 2013, as a temporary measure to pay for the Government's mortgage relief package. It is abundantly clear that paying nearly 0.4% of liabilities in tax severely erodes the competitive position of Icelandic banks. Those who invest in Icelandic banks in the future must be assured that these taxes will expire in 2017, as was assumed at the outset.

High taxes and levies and more stringent capital requirements have been extremely costly for financial institutions. Domestic financial institutions do not operate under the conditions as their foreign competitors. It is estimated that foreign banks' market share in corporate lending in Iceland is about 30%. In addition, shadow banking activities are on the rise – particularly mortgage lending by pension funds, which are not taxed as financial institutions are and are not subject to the same regulatory environment.

The State holds substantial assets in financial institutions

At the end of 2015, the Icelandic banks' equity totalled ISK 660bn, and the State's equity holding in Íslandsbanki and Landsbankinn amounted to ISK 467bn. These two banks are owned almost entirely by the Icelandic Government. In comparison, in 1997 the Government's holding in two State-owned banks totalled ISK 19.5bn, which has a present value of ISK 48.5bn. Yet at that time, many considered the State-owned banks too dominant. Now, the State's holding is ten times larger, at constant prices. The banks' total assets amount to ISK 3,800bn, slightly more than one-and-a-half times GDP. At the beginning of 2008, however, they totalled nearly ISK 10,000bn, or six-and-a-half times then-current GDP.

With the nationalisation of the banks, the Icelandic Government's holding in them has become much larger than is found in most other countries. The ratio of the State-owned banks' assets to total banking system assets is currently estimated at 71%, similar to that in Syria, Belarus, and India, but many times higher than in the countries we are accustomed to compare ourselves with. For the purposes of such a comparison, a bank is considered state-owned if the state owns a holding of more than 50%.

It is sometimes argued that if banks are state-owned, their operations are less risky and there is no need to fear shocks. This is not borne out by history, however. On the contrary, state ownership has been one of the most common causes of financial crises, and this is one of the reasons so many banks have been privatised. In Iceland and elsewhere, the authorities have had to rescue state-owned banks. In 1993, several years before Landsbankinn was privatised, the State made a substantial contribution to it so as to enable the bank to fulfil statutory capital adequacy requirements. The capital injection totalled ISK 4.25bn at 1993 prices, the equivalent of ISK 11bn today.

As has been said numerous times in this setting, Íslandsbanki has a long history and is deeply rooted in Icelandic financial life. In 1990, when three private banks merged with Útvegsbankinn, it was decided to emphasise the new bank's independence by giving it the name of Útvegsbankinn's predecessor. Íslandsbanki had therefore become privately owned a decade before the other large banks were sold. It is the express hope of the Bank's staff and management that Íslandsbanki will once again be a strong privately owned bank. I agree wholeheartedly with the opinion expressed by the IMF mission that visited Iceland last week, that "efforts [should be] focused on finding high-quality buyers—ideally, reputed foreign banks."

Limited risk from investment banking activities

As can be seen in recent public discourse, many observers envision the possibility that Government ownership will provide the opportunity to reform and restructure the financial system. It is a misunderstanding, of course, to assume that state ownership is needed in order to streamlining financial institutions' operations. It is possible for all banks to reduce costs through joint activities in areas where competition does not extend – the Icelandic Banks' Data Centre is a good example – and Íslandsbanki has taken great strides to cut costs in this way.

It is often said that systemic risk lies in having commercial banking and investment banking under the same roof, so to speak. This discussion has often gone astray, however. Íslandsbanki is a comprehensive bank with wide-ranging commercial and investment banking activities. Its investment banking activities take place mainly in the Markets division, a separate income-generating unit, and to a lesser extent in the Corporate Finance division. Many customers of other divisions also use services that are sometimes classified as investment banking services, such as the purchase and sale of foreign currency. This is why only a very small part of Íslandsbanki's credit risk stems from investment banking operations. Dividing up operations would compromise banking system efficiency, and systemic risk can be controlled without such separation. For example, Íslandsbanki sets rules providing for overall limits on market risk, equity securities risk, and underwriting. Furthermore, in all of this discussion, it must not be forgotten that during the last financial crisis, banks engaged solely in commercial banking activities failed just as investment banks did.

Good economic outlook

It is undisputed that Iceland's economic situation has improved markedly in the recent past. GDP per capita has now risen above its pre-crisis peak. Unemployment has more or less vanished, and inflation has remained below the Central Bank's inflation target for two years, in spite of large wage increases. Iceland's terms of trade have improved significantly, mainly because of falling oil and commodity prices. Export revenues have grown because of the booming tourism industry. These developments have been noticed abroad, and they are taking place at a time when neighbouring countries and trading partners are battling deflation and the problems it brings.

But even though this phenomenal economic recovery is cause for satisfaction, we must not forget that circumstances can change very quickly. Oil and commodity prices can be expected to rise in time, and the tourism sector is sensitive to a variety of forces. Consequently, we must remain cautious and prudent during this upswing, as it is during this phase that the risk of excessive ambition and mistakes is greatest, as we have seen in the past.

Liberalisation of capital controls

Settling the failed banks' estates has transformed the Icelandic debt landscape and created conditions for balanced external trade. Iceland's net debt is now about 14% of GDP, its lowest in half a century. There is every reason to praise the authorities for their success in drafting and implementing sensible measures.

The next big step towards liberalisation will be the auction of offshore krónur. The authorities have indicated that it could take place in coming weeks, as the conditions for it are extremely favourable at present. Afterwards, the authorities must amass the tools and instruments they need to ensure the stability of the financial system and the general economy. It is not simple for a small country to have an independent currency. If it is to be successful, everyone must pull in the same direction. The Government and the Central Bank bear the brunt of the responsibility, but the social partners and the financial system must do their part as well.

One of the biggest challenges ahead is to lift the capital controls while ensuring that non-resident investors' short-term interests are not allowed to gain control of the foreign exchange market and the Icelandic economy. At present, we consider lifting the controls an obvious move. This is most welcome, not least in view of the fact that it took us 63 years to lift the controls introduced as a temporary measure in 1931, during the Great Depression. Hopefully the liberalisation process will be smooth and successful, as it is a prerequisite for our being able to maintain relatively free trade with other countries.

Policy rate and reserve requirements

In recent years, the Central Bank has mainly used its policy interest rate to keep inflation within the defined reference limits. Unfortunately, however, the policy rate has been of limited use as a policy instrument, in part because fixed-rate non-indexed debt constitutes only a small portion of household debt. As a result, interest rate hikes have limited and sluggish impact on households, and firms generally try to pass rate increases on to prices, fuelling further rises in inflation. Reserve requirements, however, have a clear and quick impact on the banking system. They reduce the banks' measured liquidity, therefore prompting the banks to be more cautious in lending. We saw this in the fourth quarter of 2015. The problem with reserve requirements, however, is that they apply only to banks and do not affect shadow banking activities. At the same time that the Central Bank told the banks to slow down, we saw a surge in new lending by pension funds and newly established credit funds. And although increased competition is a welcome thing, it must be carried out on normal premises. As a result, it is important that the Central Bank ensure that its policy instruments extend to all players in the credit market; otherwise, they will not have the intended effect.

Proposals for the Annual General Meeting

In accordance with the Act on Public Limited Companies and rules on financial institutions, proposals have been presented for consideration by this meeting. First of all, the Board of Íslandsbanki proposes that owners be paid a dividend of up to 50% of last year's profit. Second, Icelandic State Financial Investments, which administers the State's holding in the Bank, has put forward a proposal for the Board of Directors for the upcoming operational year. Third, it is recommended that the Icelandic National Audit Office be entrusted with auditing the Bank's financial statements, as companies that are majority-owned by the State are required by law to make such a recommendation. At the last Annual General Meeting, Ernst and Young were engaged to act as the Bank's external auditors, and it is assumed that this arrangement will continue. Fourth, the Board recommends that its remuneration remain the same as during the last period of operation. And finally, in consultation with Icelandic State Financial Investments, proposed amendments to the Bank's employment terms policy will be presented, with the aim of reviewing performance-based remuneration to key employees.

As was reported last weekend, Íslandsbanki is planning to move its headquarters to Kópavogur later this year. An amendment to the Bank's Articles of Association is therefore proposed, in order to reflect this.

It is clear that there will be major changes in the Íslandsbanki Board of Directors at this Annual General Meeting. Only two of the seven members elected at the last meeting will remain. Three of those who are stepping down – Árni Tómasson, Marianne Økland, and Neil Brown – have sat on the Board for six-and-a-half years, ever since the Bank was resurrected in its current form. Eva Cederbalk has been a Board member since the last Annual General Meeting, and Gunnar Fjalar Helgason has been an alternate Board member since last autumn, when Þóranna Jónsdóttir resigned. I would like to thank all of these good people for their important work on behalf of Íslandsbanki and for their successful collaboration while on the Board. I would like to thank our foreign

Board members in particular for their contribution. With their outstanding experience and expertise, Marianne and Neil, who have been with us from the beginning, and Eva, who joined us a year ago, have made major contributions to the Bank's reconstruction and vision for the future.

Dear Marianne, Neil, and Eva. I take this opportunity to thank you for your very important contribution to Íslandsbanki. Your outstanding knowledge, skills, and experience have been invaluable for our work. We also appreciate and value your generosity – how you have inspired and assisted your fellow directors and the executives of the bank. We will certainly miss you all.

Please give them a big hand.

Confidence must be restored

During the operational year that is now coming to a close, the Íslandsbanki Board of Directors has held 19 meetings. Since the crash, the Board's work has centred primarily on strengthening the Bank's regulatory structure and internal procedures. The Board and the Bank's executives, together with its employees, have made genuine efforts to improve procedures and work habits in order to improve the service they provide to the Bank's customers. These efforts have been very successful.

Since the banks failed eight years ago, the level of confidence in Iceland's institutions and in the fundamental ideas on which society is based has been extremely low. Even though businesses create jobs, make a large contribution to GDP growth, foster innovation, participate in educating their employees, pay taxes, and pay dividends to their owners, less than half of participants surveyed by Gallup indicate that firms' impact on Icelandic society is positive. Over a quarter of respondents consider it negative. Naturally, the banks have not been excluded from this negative attitude, which worsened after the crash. For this reason, Íslandsbanki has defined regaining the trust and confidence lost during the crisis as a high-priority task. The Bank's owners and employees must continue to work on worthy goals such as this. It is a long-term project that demands that the Bank adhere to sound, recognised governance practices, demonstrate social responsibility, foster open discussion, and have transparency as a guiding principle in its activities. It is of vital importance that firms and the associations they belong to use news media and social media to explain the role and purpose of the economy in Iceland.

Conclusion

In closing, I would like to thank the Bank's departing owners, the Glitnir winding-up board, and the Board members of ISB Holding for their cooperation. I would also like to thank the Financial Supervisory Authority and the Central Bank. And furthermore, I wish to thank Icelandic State Financial Investments for their collaboration during the past year and express my hope for a successful relationship in the coming year. On behalf of the Board of Directors, I would like to extend my warmest thanks to the staff and management of Íslandsbanki for an exemplary job. And last but not least, thanks to CEO Birna Einarsdóttir, who has led the Bank and its staff through their daily challenges.

In the weeks and months to come, the Board, management, and staff of Íslandsbanki will participate in formulating the Bank's strategy, which is now at a crossroads in many senses of the word. All of our efforts will be focused on strengthening the Bank's operations, with the primary aim of protecting the interests of customers, staff members, and owners. In order to succeed, we must maintain and bolster the ambition and enthusiasm that Íslandsbanki employees have adopted. If we do this, all doors will be open to us.