Annual General Meeting 2017

Chairman's statement

Íslandsbanki Annual General Meeting, 23 March 2017
Friðrik Sophusson, Chairman of the Board

Honoured guests:

Íslandsbanki had a strong and eventful 2016. At the end of the year, the Bank moved to new headquarters in Nordurturn in Kópavogur, after 20 years at Kirkjusandur. The Bank still owns the lot at Kirkjusandur, however, and has some interesting development projects in the pipeline, at least for the moment.

The Bank's after-tax profit totalled ISK 20.2bn, and its return on equity was 10.2%. Its profit from regular operations amounted to ISK 15.1bn, and the return on equity from regular operations was 10.7%. Commission and fee income rose during the year, but cost ratios rose as well, due to pay increases and one-off expenses relating to the depreciation of the old headquarters. At the end of the year, the Bank paid out an extraordinary dividend in the amount of ISK 27bn, in addition to the ISK 10bn approved by the AGM. The Government therefore received ISK 37bn in dividend payments from the Bank during the year.

Bank tax

Íslandsbanki paid ISK 10.2bn in taxes in 2016, including income tax in the amount of ISK 5.2bn. The bank tax, introduced as a temporary measure to finance the Government's mortgage loan adjustments, totalled ISK 2.8bn. The mortgage adjustment measures are estimated to have cost about ISK 80bn; therefore, the special tax on the financial sector plus the stability contributions from the old banks' estates have delivered this amount and more besides.

It was reported recently by the Icelandic Financial Services Association that taxes such as the bank tax erode the State's holding in the financial system by at least ISK 150bn. The bank tax reduces the Bank's returns by about 3 percentage points. This means that if the target is to achieve a 10% return, the bank tax will reduce it to 7%. Until now, the tax has not been passed on to customers, but it is clear that the Bank must review this policy if the bank tax is not eliminated or substantially reduced.

In comparison with neighbouring countries, our tax burden — excluding the bank tax — is among the highest, and including the bank tax it is heavier by a factor of four.

There is no longer any justification for this tax. The authorities must therefore eliminate it or reduce it significantly. It is extremely important to give investors some assurance about developments in tax rates. Otherwise, the bank tax will have severely affect both the possibility of listing the Bank on the exchange and the price the State could receive upon selling it. In addition, the tax situation erodes the competitive position of Iceland's banks.

Competition and the regulatory framework

It is sometimes said that there is a shortage of competition in the Icelandic financial markets. In this context, it is worth noting that Icelandic banks have only a 50% share in the corporate lending and household mortgage lending market. Foreign lenders in lower-tax jurisdictions with lower capital requirements are dominant players in the corporate market, although their lending activity focuses on large companies and specific sectors. In addition, the pension funds have entered the mortgage lending market, thereby adding a strong competitor. Other things being equal, increased competition is a good thing. But that cannot be said in this case because not all of the competitors in the market pay the same taxes, nor are they all subject to equally costly regulatory frameworks. This explains the growth of the so-called shadow banking system.

Banking system size and investment banking activities

Now that Iceland's three main banks are majority-owned by the State, various ideas about restructuring come to the fore. This is an interesting topic, particularly in view of how rapidly the banking services industry is developing. Some of the discussion centres on how to improve the Icelandic banking system and minimise the risk associated with it. However, it is a misunderstanding to maintain that streamlining and changes in the banking system are inextricably linked to changes in the banks' ownership structure. The State can introduce regulatory provisions on banking activities irrespective of ownership.

Although the commercial banks are considered large in domestic context, they are small by international criteria and are actually uneconomical. With increased competition from foreign financial and tech companies, it is essential that we run efficient and economical firms in Iceland. If we compare ourselves to neighbouring countries, the Icelandic banking system has shrunk from more than eight times GDP in 2008 to less than twice GDP at the end of 2014. By that measure, it has shrunk by roughly 80% and is now modest in size compared with the banking systems in other Nordic countries.

Discussions of the separation of commercial and investment banking activities have been prominent in recent years. This is a topic that should be addressed carefully, by means of informed discussion. Íslandsbanki has offered comprehensive banking services, and investment banking is a part of that. In public discourse, risks in banking activities appear to be linked to investment banking operations. In Íslandsbanki's case, however, investment banking accounts for only 3% of the balance sheet. Most companies make use of some sort of investment banking services, such as foreign exchange transactions and bond funding.

The Director General of the Financial Supervisory Authority said recently that there was the hope of some change in this next year with the introduction of a bill of legislation based on an EU directive. She noted that it is possible to segregate investment banking within a financial institution but that it is first necessary to define exactly what activities fall into that category. Then it is possible to minimise risk so as to prevent investment banking losses from spilling over onto depositors and taxpayers. It is shareholders and those who have granted subordinated loans who absorb the loss. Furthermore, in all of this discussion, it must not be forgotten that during financial crisis a decade ago, banks engaged solely in commercial banking activities failed just as investment banks did. The main point is that the regulatory framework should be similar to that in the EEA so that Icelandic banks are work under comparable operating conditions.

Ownership

It is well known that the Icelandic Government owns a much larger share of the country's banks than is customary elsewhere. 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 utterly incorrect, of course. The Icelandic Government had to contribute capital to one State-owned bank in the 1990s, and in other countries state banks were privatised because public ownership had been one of the principal causes of financial crises in those countries.

Íslandsbanki has a long history as a private bank. It was formed with the merger of three private banks and Útvegsbankinn (the Fisheries' Bank of Iceland) in 1990, a decade before the privatisation of Landsbankinn and Búnadarbankinn The name was taken from Útvegsbankinn's predecessor, Íslandsbanki, a private bank was founded in 1904.

It is my hope that Íslandsbanki will once again be a strong privately owned bank. In this context, there is every reason to welcome the Government's ownership policy for financial institutions, which states the authorities' intention to sell the Government's entire holding in Íslandsbanki. And I agree with the Minister of Finance: it is simply undesirable and unnecessary for the Government to own banks that compete with their privately run counterparts, both for competition reasons and in view of regulatory provisions on state aid. Íslandsbanki has been preparing itself for reprivatisation in recent years and will be ready when the time comes.

Favourable economic situation

The economic situation is unusually favourable at present. Year-2016 GDP growth turned out very strong – one of the best outcomes ever measured – and the current growth episode is long in historical context. Real wages are higher than ever before. Unemployment is low, and labour participation is high. Furthermore, households' asset position has improved substantially.

Rapid GDP growth and a long upward cycle have begun to test the resilience of the economy, as can be seen in both the labour market and asset markets. There is a shortage of labour in many segments of the economy, wages have risen swiftly, and the need for labour is now met increasingly with imported workers. House prices have soared in the recent past, and the average time-to-sale is one of the shortest ever recorded. These are clear indications of overheating in the market, and the causes are numerous and interrelated.

In spite of its buoyancy, the Icelandic economy is well balanced externally and inflation has remained low. In fact, inflation has been at target for three years, a historical milestone for domestic monetary policy. It is also noteworthy that even now, in the seventh year of the upswing, we are still running a strong trade surplus. The causes are numerous: the burgeoning tourism sector, favourable terms of trade, and a positive external debt position.

This favourable position has laid the groundwork for capital account liberalisation, which is vital for the resurrection of the domestic economy. Lifting the capital controls moves the domestic financial market closer to what we see in comparison countries. It has already prompted foreign long-term investors to participate in building up the Icelandic economy. In addition, rating agency Standard & Poor's has unexpectedly upgraded the sovereign, and presumably others will follow later in the year.

Fluctuations in the ISK exchange rate have been a source of economic volatility in Iceland. The rapid appreciation of the currency in the recent past has eroded the competitive position of firms that compete internationally and has stimulated demand for imported goods and services, which are now seeing strong growth. It is a noble task to try to mitigate these fluctuations. Statements concerning Government measures, a review of monetary policy, and the recent mention of a stability fund are all interesting in this light.

Forecasts indicate that the economic outlook for Iceland is bright. We expect GDP growth to be solid this year, and stronger than in most other countries, albeit less than Iceland experienced in 2016. Inflation is projected to remain within reasonable boundaries, job creation robust, and the tourism season the biggest yet.

There is an old saying that one needs strong bones to tolerate good times. Those words of wisdom are highly appropriate at the moment, when the economic boom puts our resilience to the test. We must be aware that we are probably at the top of the business cycle, when the need for prudent economic policy is greatest. Under these circumstances, it is important not to increase public spending without countervailing cutbacks or new revenue sources. It has never been more important for the Government to hold the reins tight and reduce debt so that we will be on solid ground when the downward cycle begins.

Proposals for the Annual General Meeting

In accordance with the Act on Public Limited Companies and the Act on Financial Undertakings, proposals have been presented for consideration by this meeting. First of all, the Board recommends that a dividend in the amount of ISK 10bn, or just under 50% of the profit for 2016, be paid to the Bank's owners. Furthermore, it is recommended that the Board be authorised to call a special shareholders' meeting later this year, as a proposal for an extraordinary dividend payment may be forthcoming.

Second, Icelandic State Financial Investments, which administers the State's holding in the Bank, proposes that the current Board members and alternates be re-elected. Third, it is recommended that Ernst & Young be kept on as auditors of the Bank's accounts.

Fourth, there is a proposal concerning Board members' remuneration. It is proposed that Board members' basic remuneration be unchanged at ISK 400,000, that the Chairman receive an additional ISK 300,000, or 75%, and that the Deputy Chairman receive an additional ISK 100,000, or 25%. For committee work, it is recommended that Board members receive ISK 200,000 instead of the previous ISK 100,000, and that committee chairmen receive an additional ISK 25,000 instead of the previous ISK 50,000. It is proposed that payments to alternates be set at ISK 200,000 per meeting, subject to a minimum of ISK 400,000 per year and a maximum of ISK 400,000 per month.

Fifth, a proposal for an employment terms policy has been presented. The proposal contains minor changes, most of them centring on the discontinuation of performance-based incentive payments to key employees. According to the policy, the employment terms of the CEO, managing directors, and Board members are to be laid down at the Annual General Meeting. In this context, I would like to refer you to Note 86 in the Bank's annual accounts.

Íslandsbanki leads in innovation

In coming years, we can expect major changes in financial institutions' operations, not least in response to rapid technological advances, steadily changing customer expectations, and changes in the regulatory framework. Íslandsbanki is stepping up its use of electronic solutions and will naturally adopt the innovations needed to conduct modern banking activities, in line with its determination to be at the forefront in this and other aspects of its work.

Thanks and concluding remarks

I would like to take this opportunity to thank all of those who have collaborated with Íslandsbanki this year. In particular, I wish to thank the Board and staff of Icelandic State Financial Investments, which administers the State's holding in the Bank. Thanks are due as well to the Financial Supervisory Authority and the Central Bank. I would also like to thank Íslandsbanki's customers for their confidence and loyalty. And on behalf of the Board, I want to extend my warmest thanks to the Bank's management and staff for their ambitious and successful efforts during the year. Special thanks go to CEO Birna Einarsdóttir for an outstanding collaborative relationship and for her strong leadership as she directs the Bank's day-to-day activities. In coming years, we will continue to work together as we strengthen our Bank and improve even further the service we provide our customers.