



# INTERIM REPORT

JANUARY 1 TO JUNE 30, 2003

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ICE BANK  
SPARISJÓÐABANKI ÍSLANDS HF.

## *Financial Performance*

Icebank's mid-year results in 2003 show a strong improvement from the results in 2002. The net profit for the period amounted to ISK 64 million, as compared to a net loss of ISK 95 million one year ago. This strong turnaround has been achieved despite a slowdown in net credit demand from the savings banks, Icebank's principal customers, and fierce competition in the domestic credit market due to an extremely good liquidity position in the banking sector. The balance sheet of the Bank has continued to decline, amounting to ISK 39 billion at mid-year 2003, as compared to ISK 44 billion at year-end 2002 and ISK 50 billion one year ago. However, it is the policy of the Bank to turn this trend around gradually, with the focus on asset quality rather than aggressive growth. There are signs that the turning point was reached early in the second quarter of 2003. Also, the Bank has continued to adapt its operations to changes in market conditions, as witnessed by the reduced payroll and operating expenses from the same period last year.

The capital adequacy ratio of the Bank remains robust, standing at 15.6% at end-June, slightly below the year-end ratio of 2002. This puts the Bank in a very good position to expand its balance sheet as profitable opportunities arise.

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## *Economic Environment*

Economic developments in Iceland in the first half of 2003 confirm that the imbalances of recent years have disappeared. The speed at which economic balances were restored, clearly reflects the inherent flexibility in the goods, labour and capital markets and the sensible economic policies of the government and the independent Central Bank:

- Economic growth is expected to be around 2.75% in 2003 and 3.5% in 2004, as compared to a slight recession in 2002. For the six-year period of 1996-2001 the average growth rate was 4.7%.
- The twelve-month inflation rate is currently below 2%, as compared to almost 5% one year ago.
- The current account shows a slight deficit, as compared to a slight surplus in 2002, a deficit of almost 4% of GDP in 2001 and 10% in 2000.
- The Central Bank's repo rate stands at 5.3%, down from 8.5% one year ago. The nominal yield on 3-month T-bills is just over 5%, as compared to 8.6% one year ago. The real yield on 15 year T-bonds is down to 4.2%, as compared to 5.4% one year ago.
- The exchange rate of the króna stands at just about the same level as at the turn of the year, but has shown some fluctuation during the period. However, the exchange rate is currently about 5% higher than the 2002 average.
- The slowdown in economic activity in 2002 has resulted in a 3.4% unemployment rate, as compared to 2.3% one year ago. The unemployment rate is expected to take a turn for the better later in the year as the economy gradually picks up steam.

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## *Operating Results*

Icebank's operations during the first six months of 2003 were characterised by the easing demand for credit from savings banks and corporate customers together with growing deposits from savings banks. This is in line with expectations and will gradually change as the economy revives later this year and in the next year. Total outstanding loans to credit institutions and corporate customers fell slightly, from ISK 31 billion at year-end 2002 to ISK 29 billion at the end of June 2003. However, this change in the total masks the Bank's continued drive to gradually increase the weight of corporate lending, which increased by ISK 1 billion in the period, and thereby raise the overall interest rate margin in its lending portfolio. Net interest income in the first half of 2003 amounted to ISK 288 million, as compared to ISK 265 million in the first half of 2002. The interest rate margin was 1.5%, as compared to 1% in 2002. The interest rate margin bottomed out at 0.6% in 2000, but has gradually improved since then.

Other operating income and net results from financial transactions

show a strong improvement, from ISK 50 million in the first half of 2002 to ISK 181 million in the first half of 2003. There are several factors that explain this turnaround: improvements in the equities markets in Iceland and abroad, the activities of the Bank in the domestic bond market, where the yield continued to fall, the improved performance of the Bank as a market maker in Treasury instruments and instruments issued by the publicly owned Housing Financing Fund, and the continued drive by the Bank to generate more fees from its services to the savings banks and their customers.

In total, net operating income amounted to ISK 469 million in the first half of 2003, as compared to ISK 314 million in the corresponding period in 2002.

Icebank has gradually adapted its operations to the changes in market conditions. This has been achieved mainly by means of staff reductions, but also by cutbacks in various other operating expenses. The average number of full-time equivalent positions was 54 during the first half of 2003, as compared to 59 during the first half of 2002. All in all, salaries and other operating expenses amounted to ISK 301 million, as compared to ISK 310 million during the first half of 2002, and further savings are envisaged for the year as a whole.

Provisions for losses continued their downward trend, amounting to ISK 90 million in the first half of 2003, as compared to ISK 120 million during the corresponding period of 2002, and ISK 205 million for 2002 as a whole. The slowdown in the Icelandic economy and the negative impact of the falling prices of foreign securities have resulted in difficulties for many borrowers in Iceland, including the Bank's corporate customers. The net accumulated provisions for losses amounted to 3.5% of total outstanding loans at mid-year 2003, as compared to 3.6% at year-end 2002.

The capital adequacy ratio of Icebank remains solid. The ratio was 12.2% at mid-year 2002 and 15.7% at year-end 2002, slightly higher than the current 15.6%, of which 10.1% constitutes Tier 1 capital.

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## *Outlook for the Remainder of the Year*

The decision by the US aluminium producer Alcoa to build a 322,000 tpy aluminium smelter in Iceland and the associated investments by various local companies and communities in power plants and infrastructure have already contributed to growing optimism in Iceland. This has led to a pick-up in private consumption, which is driving economic growth at the moment. Various infrastructure projects by central and local governments to combat growing unemployment will also contribute to growth in 2003 and 2004. Economic growth is expected to remain above its long-term rate until 2006/2007. As a result, both the central government and the Central Bank will have to tighten their economic policies gradually in order to prevent overheating.

The slowdown in economic activity and surge in total deposits have resulted in a considerable improvement in the overall liquidity position in the banking sector, causing increased competition and declining margins. There are already some signs of an increased credit demand, and a change is expected in the current situation as the economy picks up steam in the second half of 2003 and beyond.

Icebank expects the second half of 2003 to be roughly in line with the first half of the year. Accordingly, the net profit for the year as a whole is expected to reach a level similar to that of 2002. However, the expectation is that the net profit for 2003 will be based on a much stronger performance of the core operations of the Bank than in 2002, when a large part of the net profit derived from the sale of holdings in companies within the savings banks group.

|  | §<br>ICEBANK              |                           |                           |                           | SAVINGS<br>BANKS          |
|--|---------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| <b>Profit &amp; Loss Account (ISK '000)</b>    | <b>Jan.-Jun.<br/>2003</b> | <b>Jan.-Jun.<br/>2002</b> | <b>Change<br/>%</b>       | <b>Full year<br/>2002</b> | <b>Full year<br/>2002</b> |
| Financial income                               | 1,010,746                 | 1,771,144                 | -42.9%                    | 3,068,000                 | 17,913,221                |
| Financial expenses                             | -723,005                  | -1,506,621                | -52.0%                    | -2,576,406                | -10,826,518               |
| <b>Net interest income</b>                     | <b>287,741</b>            | <b>264,523</b>            | <b>8.8%</b>               | <b>491,594</b>            | <b>7,086,703</b>          |
| Other operating income                         | 85,690                    | 123,941                   | -30.8%                    | 331,162                   | 739,081                   |
| Value adjustment of other financial operations | 95,257                    | -74,347                   | -                         | 163,211                   | 3,110,275                 |
| <b>Net operating income</b>                    | <b>468,688</b>            | <b>314,117</b>            | <b>49.2%</b>              | <b>985,967</b>            | <b>10,936,059</b>         |
| Salaries and salary-related expenses           | -139,142                  | -150,242                  | -7.4%                     | -289,548                  | -3,383,750                |
| Operating expenses incl. depreciation          | -161,537                  | -159,468                  | 1.3%                      | -335,648                  | -3,724,966                |
| Provision for losses                           | -90,000                   | -120,000                  | -25.0%                    | -205,000                  | -2,228,194                |
| <b>Profit before taxes</b>                     | <b>78,009</b>             | <b>-115,593</b>           | <b>-</b>                  | <b>155,771</b>            | <b>1,599,149</b>          |
| <b>Profit for the period</b>                   | <b>63,932</b>             | <b>-94,793</b>            | <b>-</b>                  | <b>125,328</b>            | <b>2,064,056</b>          |
| <b>Balance Sheet (ISK '000)</b>                | <b>Jun. 30<br/>2003</b>   | <b>Dec. 31<br/>2002</b>   | <b>Change<br/>%</b>       |                           | <b>Dec. 31<br/>2002</b>   |
| <i>Assets</i>                                  |                           |                           |                           |                           |                           |
| Cash and Treasury bills                        | 3,037,106                 | 1,736,974                 | 74.8%                     |                           | 1,180,429                 |
| Amounts due from Credit institutions           | 18,851,609                | 21,598,705                | -12.7%                    |                           | 16,132,182                |
| Loans  | 10,095,519                | 9,185,625                 | 9.9%                      |                           | 129,016,440               |
| Bonds and shares in other companies            | 6,974,513                 | 11,168,042                | -37.5%                    |                           | 32,287,868                |
| Other assets                                   | 513,142                   | 554,680                   | -7.5%                     |                           | 5,806,577                 |
|  | <b>39,471,889</b>         | <b>44,244,026</b>         | <b>-10.8%</b>             |                           | <b>184,423,496</b>        |
| <i>Liabilities and Equity</i>                  |                           |                           |                           |                           |                           |
| Amounts due to Credit institutions             | 27,447,545                | 33,229,823                | -17.4%                    |                           | 22,386,367                |
| Customer accounts, on demand                   | 2,000,047                 | 1,735,597                 | 15.2%                     |                           | 96,573,376                |
| Borrowings                                     | 6,410,489                 | 5,731,663                 | 11.8%                     |                           | 36,380,626                |
| Other liabilities                              | 242,760                   | 218,233                   | 11.2%                     |                           | 4,924,940                 |
| Subordinated loans                             | 1,040,435                 | 1,062,029                 | -2.0%                     |                           | 5,232,221                 |
| Total equity                                   | 2,330,613                 | 2,266,681                 | 2.8%                      |                           | 18,925,966                |
|  | <b>39,471,889</b>         | <b>44,244,026</b>         | <b>-10.8%</b>             |                           | <b>184,423,496</b>        |
| <i>Guarantees and documentary credits</i>      | 4,211,451                 | 2,372,811                 | 77.5%                     |                           | 4,670,969                 |
| <b>Key Indicators (%)</b>                      | <b>Jan.-Jun.<br/>2003</b> | <b>Jan.-Jun.<br/>2002</b> | <b>Full year<br/>2002</b> |                           | <b>Full year<br/>2002</b> |
| Cost-income ratio                              | 64.2%                     | 98.6%                     | 63.4%                     |                           | 60.2%                     |
| Return on equity before taxes                  | 6.8%                      | -11.0%                    | 7.1%                      |                           | 8.8%                      |
| Return on equity after taxes                   | 5.6%                      | -9.1%                     | 5.7%                      |                           | 11.4%                     |
| Capital adequacy ratio (CAD)                   | 15.6%                     | 12.2%                     | 15.7%                     |                           | 13.9%                     |
| Net accumulated provisions ratio               | 3.5%                      | 6.0%                      | 3.6%                      |                           | 4.0%                      |
| Interest rate margin                           | 1.5%                      | 1.0%                      | 1.0%                      |                           | 4.1%                      |

## The Icelandic Savings Banks

There are 24 savings banks in Iceland operating a branch network of 61 offices throughout the country and jointly representing nearly a quarter of the Icelandic banking market in terms of deposits. Some of the savings banks have been operating for over a century, while others are among the youngest banking institutions in Iceland.

Each of the savings banks is an independent entity, with its own board of directors and firmly rooted in its local community. The respective municipal authorities often appoint two out of five board members, with the remaining three elected at the annual general meeting of the respective bank. In many instances, the savings banks are the only financial institutions in their area of operation and render services to corporate entities and local authorities as well as to individuals.

The Icelandic Savings Banks' Association was established in 1967 and represented, albeit on a modest scale, the start of co-operation between the savings banks, which until then had been working independently of one another. The co-operation, initially mainly in administrative and legislative matters, has increased year by year and branched into other fields, such as product development and branding/marketing.

The establishment of Icebank and the Savings Banks' Guarantee Fund (mutual guarantee of deposits) in 1986 marked the start of close financial co-operation. This co-operation

has resulted in an increased market share for the savings banks, from some 15% in 1986 to a current market share of approximately 25% in terms of total deposits. The savings banks and Icebank are also covered by a sector-wide deposit guarantee and investor protection scheme under the auspices of the central government.

The role of Icebank is to serve as the central banking institution for the Icelandic savings banks and their subsidiaries with all the related tasks that this involves, such as liquidity administration, interbank lending and international service and representation.

Jointly, the saving banks operate the Computer Center of the Icelandic Savings Banks and in co-operation with the Icelandic commercial banks, they operate a joint clearing house and data processing centre, the Icelandic Banks' Data Centre. The savings banks also hold a quarter share of VISA Iceland and Mastercard Iceland, and Icebank is a member of the Banks' and Securities Dealers' Association of Iceland.

The close co-operation of the savings banks has made them into a significant and solid group of interrelated and modern financial institutions representing a large section of the Icelandic banking market.



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