Municipality Credit Iceland

Financial statements
for the year ended December 31, 2004

Index

Municipality Credit Iceland
Identity number 710169-4979
Borgartún 30, Post-box 8100, 128 Reykjavik

Board of directors' report

During the year one of the main tasks of the board of directors was to formulate a new long term strategy for Municipality Credit Iceland (MCI).

The premises at Haaleitisbraut were sold during the year and new premises bought at Borgartun 30. The budget for the investment and refurbishment of the new premises totaled 177.8 million ISK, but the final investment amounted to 170.8 million ISK or 96% of the budget. MCI owns 35% of the property.

During the year MCI issued bonds amounting to 1,700 million ISK in the domestic bond market, listed on the Iceland Stock Exchange. The Board approved loans amounting to 3,442.6 million ISK, whereof 1,349 million ISK were investment loans and 370.6 million ISK refinancing loans financed with equity. Re-lending of borrowed money amounted additionally to 1,723 million ISK. In all 52 municipalities borrowed money from MCI during the year.

The loans financed with equity funds are lent in ISK carrying an index linked floating interest rate. On 1 October the interest rate was lowered from 4.5% to 4.0%. Loans financed with borrowed money are re-lent on the same terms with a margin and 1% up-front fee. The margin was lowered from 0.15% to 0.05% on 1 December.

Total defaults at year end amounted to 4.0 million ISK as compared to 9.4 million ISK the previous year. Only one municipality was in default at year end.

MCI carries a pension obligation for those staff members that participate or have participated in the B-department of the State Employees' Pension Fund. MCI's portion amounted to 31.6 million ISK at year end. The increase in the obligation during the year amounted to 3.3 million ISK.

Operating results were good in 2004. According to the profit and loss account the net profit was 810.9 million ISK as compared to 654.7 million ISK the previous year. The financial position of MCI is strong. At year end the equity position was 9,912.5 million ISK as compared to 9,101.5 million ISK a year ago and has therefore increased by 8.9%. Equity was 65.75% of total assets against 71.13% the previous year and the CAD-ratio was 340.4% compared to the minimum requirement of 8%.

In December 2003 the Board hired a consultant to assist the Board in formulating a new long term strategy for MCI. Work has continued on this during 2004 in co-operation with the Ministry of Social Affairs. On 10 December Parliament passed a new act no. 136/2004 regarding MCI effective from 1 January 2005. According to the law MCI will in the future operate as a loan company pursuant to the law on financial undertakings. The supreme power of MCI is transferred to the municipalities and now rests within owners´ meetings, which are attended by representatives elected by the municipalities to attend the national congress of the Association of Local Authorities.

The Board of Municipality Credit Iceland and the Managing Director hereby confirm the annual accounts for 2004 with their signatures.

Reykjavík, 2 March 2005

Magnus B Jonsson
Chairman

Einar Njalsson

Kristinn Jonasson

Magnus Gunnarsson

Reinhard Reynisson

Thorsteinn Thorsteinsson
Managing Director

Auditor's report

To the Board of Directors' of Municipality Credit Iceland

We have audited the financial statements of Municipality Credit Iceland (MCI) for the year 2004. The financial statements consist of the Board of Directors' report, income statement, balance sheet as of December 31, cash flow statement, summary of accounting principles and notes 1 - 21. These financial statements are the responsibility of the MCI's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The audit is based on our assessment of materiality and risk, and includes an analytical review and examination, on a test basis, of evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements present fairly, the financial position of the MCI as of December 31, 2004 and the results of its operations and its cash flows for the year then ended are in accordance with law and generally accepted accounting principles in Iceland.

Reykjavík, 2 March 2005

Sveinn Saemundsson
State authorized accountant

Jonmundur Gudmarsson
examiner

Income statement

	Notes	Year ended 31 December 2004	2003
			Amounts in thousands of ISK
Interest income			
Interest on amounts due from credit institutions		21,642,072	14,759
Interest and indexation on loans		1,110,836,897	852,047
Other interest income		143,979	1
Total interest income		1,132,622,948	866.807
Interest expenses			
Interest and indexation on borrowings	1	376,728,246	218,895
Other interest expenses		278,214	3,339
Total interest expenses		377,006,460	222,234
Net interest income		755,616,488	644,573
Other operating income			
Dividend income		60,125	0
Contribution of Local Authorities' Equalisation Fund		78,124,845	38,430
Foreign exchange rate difference		(1,017,945)	(2,274)
Gain from sale of fixed assets		11,241,569	82
Total operating income		88,408,594	36,238
Other operating expenses			
Share in joint costs	2,4	18,658,263	15,942
Separate costs	3	13,319,436	8,964
Depreciation		1,129,049	1,212
Total operating expenses		33,106,748	26,118
Net profit		810,918,334	654,693

Balance sheet

Assets	Notes	At 31 December 2004	2003
			Amounts in thousands of ISK
Cash and amounts due from credit institutions			
Cash		10,000	10
Current bank accounts		459,274,870	119,058
		459,284,870	119,068
Loans			
Bonds and other fixed-income securities	5,6	14,557,572,614	12,645,802
		14,557,572,614	12,645,802
Investments in other companies			
Shares	7	390,561	376
		390,561	376
Other assets			
Debtors		955,912	526
Property and equipment	8	58,652,322	29,469
		59,608,234	29,995
Total assets		15,076,856,279	12,795,241

Balance sheet

Equity and liabilities	Notes	At 31 December 2004	2003
			Amounts in thousands of ISK
Equity	12		
Retained earnings		9,912,507,280	9,101,589
		9,912,507,280	9,101,589
Borrowings			
Issued bonds	10	2,698,870,003	979,442
Amounts owed to credit institutions		2,344,772,944	2,639,319
		5,043,642,947	3,618,761
Other liabilities			
Creditors		3,151,785	2,411
Accrued expenses		85,871,267	42,809
		89,023,052	45,220
Deferred liabilities			
Pension obligations	11	31,683,000	29,671
		31,683,000	29,671
Total liabilities		5,164,348,999	3,693,652
Total equity and liabilities		15,076,856,279	12,795,241

Cash flow statement

	Notes	Year ended 31 December 2004	2003
			Amounts in thousands of ISK
Cash flows from operating activities			
Net profit		810,918,334	654,693
Items not affecting cash:			
Depreciation		1,129,049	1,212
Indexation of loans		(480,138,452)	(283,536)
Indexation of borrowings		148,020,529	56,076
Exchange rate difference of loans		104,190,322	53,705
Exchange rate difference of borrowings		(103,548,174)	(51,611)
Change in share valuations		(14,707)	0
Pension obligations, changes		2,012,000	2,161
Gain from sale of fixed assets		(11,241,569)	(82)
Cash generated from operations		471,327,332	432,618
Decrease (Increase) in operating assets:			
Other assets		(430,191)	6,813
Increase (decrease) in operating liabilities:			
Other liabilities		43,802,559	631
		43,372,368	7,444
Net cash from operating activities		514,699,700	440,062
Cash flows from investing activities			
Loans, changes		(1,535,822,137)	(1,216,916)
Proceeds from sale of fixed assets		(19,070,334)	232
		(1,554,892,471)	(1,216,684)
Cash flows from finance activities			
Borrowings, changes		1,380,409,787	743,089
		1,380,409,787	743,089
Increase in cash and cash equivalents		340,217,016	(33,533)
Cash and cash equivalents at beginning of year		119,067,854	152,601
Cash and cash equivalents at end of year		459,284,870	119,068

Accounting policies

The financial statements are prepared in accordance with the Financial statements act and rules on the financial statements of credit institutions. The financial statements are based on historical cost accounting.

The principal accounting policies adopted in the preparation of these financial statements are described in this chapter and are mainly the same as last year except where stated below.

Changes in accounting policies and presentation

Exchange rate difference is now recorded in operating income, but was classified as interest income or interest expense before. Previous year's comparison amounts have been changed in conformity.

Income statement

Interest income and and exchange rate difference

Interest income and interest expense are recorded in the income statement when earned/incurred. Interest income is calculated on loans to credit insitutions and other loans. Interest expense is calculated on debt owed to credit institutions and borrowings.

Accrued foreign exchange rate differences and indexation are recorded in the income statement. Index linked assets and liabilities are stated using indexes that were effective at the beginning of the year 2005. Assets and liabilities in foreign currency are converted into Icelandic kronur at the year-end exchange rates.

Balance sheet

Loans

Loans are capitalized with accrued interest, indexation and exchange rate difference at year-end. Indexed loans are entered based on indices effective at the beginning of 2005 and loans in foreign currency based on the exchange rate of the relevant currencies at year-end 2004.

Contributions from the Local Authorities' Equalisation Fund to muncipalities have been pledged as collateral to secure MCI's loans to the borrowers, in accordance with article 13 of act no. 35/1966 regarding MCI, as well as the muncipalities' revenues, in accordance with the third paragraph of article 73 of local government act no. 45/1998. In light of the above, bad debt provisions have been deemed unnecessary and there have been no loan losses.

Accounting policies

Property and equipment

Property and equipment are capitalized at cost price less depreciation. Depreciation is calculated as a fixed annual percentage based on the estimated useful life of the property and equipment until scrap value is reached.

Pension obligations

According to the calculations of an actuary, the pension obligation of the collaborative institutions, with respect to employees that participate in the B-department of The State Employee's Pension Fund, amounts to 95 million ISK. MCI's portion of the obligation, to 31.6 million ISK, is recorded under long term liabilities in the balance sheet and the annual increase of the obligation is expensed under the MCI's separate costs. In calculating the pension obligation an interest rate of 2% over and above salary increase is used.

Cash and cash equivalents

Cash and cash equivalents in the statement of cash flows consist of cash and demand deposits with credit institutions.

Notes

	2004	2003
		Amounts in thousands of ISK

1. Interest expenses

Interests on borrowings are specified as follows:

Interests on issued bonds	206,629,042	57,134
Interests on borrowings	170,099,204	161,761
	376,728,246	218,895

2. Salaries and related expenses

MCI's share in salaries and related expenses are specified as follows:

Salaries	10,474,055	9,804
Salary-related expenses	2,268,125	1,884
	12,742,180	11,688

3. Auditor's Fee

Remuneration to the MCI's auditor are specified as follows:

Audit and preparation of the financial statements and other services	991,300	929
	991,300	929

4. Joint costs

MCI operates an office in association with the Emergency Relief Fund and the Association of Local Authorities. Total joint costs for the year 2004 amounted to 69.1 million ISK, of which the Association payed 33.5 million ISK, MCI payed 18.6 million ISK and the Emergency Relief Fund payed 17 million ISK. Joint costs the year before amounted to 55.1 million ISK.

During the year 2004, a total of 8 employees were employed in the joint offices of MCI, the Emergency Relief Fund and the Association of Local Authorities, occupying 7.5 full-time positions, which remains unchanged from the previous year. MCI carries 1/3 of the joint salary and salary related expenses.

5. Loans

Loans are specified as follows:

Foreign currency bonds	850,090,624	1,104,627
Indexed bonds	13,707,481,990	11,541,175
	14,557,572,614	12,645,802

Loans are specified as follows by maturity:

On demand	4,006,654	9,432
After one year	2,183,638,825	1,850,615
After two years	1,765,922,246	1,661,112
After three years	1,623,699,210	1,498,764
After four years	1,496,058,117	1,357,190
Over five years	7,484,247,562	6,268,689
	14,557,572,614	12,645,802

Notes

	2004	2003
		Amounts in thousands of ISK

6. Default

Loan defaults on loans provided by MCI amounted to 4 million ISK at year-end 2004, but at year-end 2003 loan defaults amounted to 9.4 million ISK.

	2004	2003
Overdue, installments	2,584,465	6,721
Overdue, interest	1,364,598	1,938
Overdue, late payment finance charge	57,591	773
	4,006,654	9,432

7. Investments in other companies

Shares in other companies are specified as follows:

	Nominal value	Book value
Straumur fjarfestingabanki hf	171,789	390,561

8. Other assets

Property is specified as follows:

	Real estate (building and land)	
	2004	2003
		Amounts in thousands of ISK
Total value 01.01.2004	55,700,370	55,700
Additions during the year	59,781,371	0
Disposals during the year	(55,700,370)	0
Total value 31.12.2004	59,781,371	55,700
Previously depreciated	26,230,902	25,018
Depreciated during the year	1,129,049	1,213
Disposals during the year	(26,230,902)	0
Total depreciation 31.12.2004	1,129,049	26,231
Book value 31.12.2004	58,652,322	29,469
Depreciation ratios	2%	

The official real estate value at 31.12.2004 is ISK 33.3 million. The fire insurance value of the real estate is ISK 44.1 million at 31.12.2004.

Notes

9. Assets and liabilities inflation-indexed or subject to currency-rate fluctuations

The total indexed linked assets amounted to ISK 13,707 million at year-end, and the total amount of indexed liabilities amounted to ISK 4,205 million.

The total amount of assets in foreign currencies amounted to ISK 853.3 million at year-end and the total foreign currency liabilities amounted to ISK 838.7 million at that time.

10. Borrowings

	2004	2003
		Amounts in thousands of ISK
The borrowings are specified as follows:		
Issued bonds	2,698,870,003	979,442
Loans from credit institutions	2,344,772,944	2,639,319
	5,043,642,947	3,618,761
Borrowings are specified as follows by maturity:		
On demand	0	0
After one year	558,608,074	318,273
After two years	478,543,089	459,747
After three years	455,096,896	367,120
After four years	422,811,457	340,688
Over five years	3,128,583,431	2,132,933
	5,043,642,947	3,618,761

11. Deferred liabilities

Pension obligations are specified as follows:

Balance 01.01.2004	29,671,000	27,510
Payments	(1,318,531)	(1,418)
Increase in obligations	3,330,531	3,579
	31,683,000	29,671

Notes

	2004	2003
		Amounts in thousands of ISK

12. Equity

	2004	2003
Balance 01.01.2004	9,101,588,946	8,446,791
Changes in share valuation	0	105
Net profit of the year	810,918,334	654,693
	9,912,507,280	9,101,589

Equity at year-end amounted to 9,912.5 million ISK or 65.75% of total assets against 71.13% the previous year.

	Book value	Weighted value 2004	2003
			Amounts in thousands of ISK
Risk base:			
Assets recorded in the financial statements	15,076,856,279	2,911,905,084	2,529,536
Capital:			
Recorded equity		9,912,507,280	9,101,589
Capital adequacy ratio		340.4%	359.8%

13. Taxes

According to act no. 90/2003 regarding income and property tax, MCI is exempt from paying these taxes.

According to act no. 94/1996 regarding finance tax, MCI is exempt from paying this tax.

According to act no. 35/1966 regarding MCI and a new act on MCI no. 136/2004, which took effect on 1 January 2005, bonds issued and grants are exempt from stamp duty.