Iceland's Financial Crisis

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Summary

On March 6, 2010, Icelandic voters overwhelmingly rejected a proposition to pay back more than $5.3 billion to the British and Dutch governments incurred during the financial crisis. The British and Dutch governments had expended the funds to cover the losses of British and Dutch depositors, respectively, when Iceland's major banks failed and were nationalized in the fall of 2008. The issue has continued to strain relations between Iceland and Great Britain and the Netherlands and could complicate Iceland's remaining efforts to join the European Union and to replace the krona with the Euro.

Following the collapse of the banks, Iceland and the International Monetary Fund (IMF) finalized an agreement on November 19, 2008, on a $6 billion economic stabilization program supported by a $2.1 billion loan from the IMF. Following the IMF decision, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion. Iceland's banking system had collapsed as a result of a culmination of a series of decisions the banks made that left them highly exposed to disruptions in financial markets. The collapse of the banks raised questions for U.S. leaders and others about supervising banks that operate across national borders, especially as it has become increasingly difficult to distinguish the limits of domestic financial markets. Such supervision is important for banks that are headquartered in small economies, but operate across national borders. If such banks become so overexposed in foreign markets that a financial disruption threatens the solvency of the banks, the collapse of the banks can overwhelm domestic credit markets and outstrip the ability of the central bank to serve as the lender of last resort.

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Background

Iceland is the smallest economy within the Organization for Economic Cooperation and Development (OECD) with a gross domestic product (GDP) in 2008 of about $16.8 billion, as indicated in **Table 1**. Historically, Iceland's economy has been based on marine and energy resources. More recently, Iceland has developed a strong services sector, which accounts for two-thirds of the economic output. Since 2000, Iceland has experienced particularly strong growth in its financial services sector. Trade accounts for a large share of Iceland's GDP, with imports and exports of goods and services equivalent in value to 46% and 35%, respectively, of GDP. Fish and other marine products were Iceland's main export item until 2006, when Iceland began to capitalize on its abundant thermal energy resources to produce and export aluminum. As the data in **Table 1** indicate, Iceland experienced a severe slowdown in its rate of economic growth in 2009 and is projected by the OECD to post a negative rate of growth again in 2010 before showing positive growth in 2011. Iceland also has battled a high and rising rate of inflation, as measured by the consumer price index (CPI) and interest rates, as measured by the long-term government bond rates.

Table 1. Iceland: Main Economic Indicators and Projections

(in billions of dollars and in percent)

	2006	2007	2008	2009	2010	2011
	Actual				Projected	
GDP (in $billions)	$16.6	$20.3	$16.8	$11.8	$11.7	$11.8
Real GDP growth	4.3%	5.6%	1.3%	-7.0%	-2.1	2.6
CPI	6.7%	5.1%	12.7%	11.9%	5.8	2.5
Interest rates	9.3%	9.8%	11.1%	8.1%	7.7	7.3

Source: *World Economic Outlook*, October 2009, International Monetary Fund; and *Economic Outlook*, November 2009, Organization for Economic Cooperation and Development.

Recent Economic Activity

A combination of economic factors over the early to mid-2000s led to Iceland's current economic and banking distress. In particular, access to easy credit, a boom in domestic construction that fueled rapid economic growth, and a broad deregulation of Iceland's financial sector spurred the banks to expand rapidly abroad and eventually played a role in the financial collapse. Iceland benefitted from favorable global financial conditions that reduced the cost of credit and a sweeping liberalization of its domestic financial sector that fueled rapid growth and encouraged Iceland's banks to spread at a fast pace throughout Europe.

In 2004, Iceland's commercial banks increased their activity in the country's mortgage market by competing directly with the state-run Housing Financing Fund (HFF), which had been the major provider of mortgage loans. In contrast to the Housing Financing Fund, the commercial banks began offering loans with lower interest rates, longer maturities, and a higher loan to value ratio. Also, the banks did not require a real estate purchase as a precondition for a loan, which made it possible for homeowners to refinance existing mortgages and to access the equity in their homes for consumption or investment purposes. These measures spurred an expansion in credit and caused real estate prices to soar. In addition, the improving economic conditions led to an expansion in consumer spending which resulted in rising inflation and a larger trade deficit. As a further stimulus to the economy, the Icelandic government reduced both direct and indirect taxes, which provided further impetus to consumer spending.

By 2004, Iceland's central bank began tightening monetary policy by raising interest rates in an attempt to curtail inflationary pressures. Between 2004 and 2007, the Bank raised nominal short-term interest rates from 5% to 15%. The increase in interest rates, however, was not reflected in the interest rates the Housing Financing Fund charged for mortgages. As a result, the comparatively low interest rates charged by the HFF pushed up demand for housing which, in turn, further inflated the price of homes in Iceland. In addition, since the commercial banks were willing to make loans based on the equity in a home, the rising equity values in housing allowed consumers to finance a higher level of consumption, with the attendant pressure on inflation and interest rates. At the same time, the higher domestic interest rates made bond issues in krona attractive to foreign investors who could borrow abroad at low interest rates, which placed upward pressure on the value of the krona and worsened the trade deficit.

As Iceland deregulated its commercial banks, those banks expanded to the United Kingdom, the United States, Scandinavia, continental Europe, and elsewhere. Iceland has five commercial banks: Glitnir, Kaupthing, Nyi Landsbanki, Straumur Investment Bank, and Icebank, which serves as the clearing house for the 20 locally run savings banks. Prior to the financial crisis, the three largest banks, Kaupthing, Landsbanki, and Glitnir, had total assets of more than $168 billion, or 14 times Iceland's GDP. Iceland also has 20 savings banks, with assets at the end of 2007 valued at $9 billion.

After Iceland deregulated its commercial banks, the banks expanded their operations abroad by acquiring subsidiaries in commercial banking and in securities brokerages. They also engaged in a highly risky business strategy that depended on borrowing heavily in foreign capital markets in order to finance the international expansion of Icelandic investment companies that typically were controlled by the major shareholders of the banks. This strategy exposed the Icelandic banks to almost any deterioration in the international financial markets. At the end of 2007, almost half of the total assets of the largest commercial banking groups were accounted for by foreign subsidiaries, most of them located in Northern Europe, and in 2007 about 58% of their overall income was generated from their subsidiaries located abroad. By the end of 2007, Iceland's three largest banks relied on short-term financing for 75% of their funds, mostly through borrowing in the money markets and in the short-term interbank market. Iceland's banks are a hybrid between commercial and investment banks, with relatively large exposure to market risk. By March 2008, investors had become wary of Iceland's banks due to their large funding needs and high dependence on short-term funds in money markets. Even before the financial crisis erupted in the fall of 2008, the Central Bank of Iceland and other institutions forecasted a slowdown in Iceland's rate of economic growth in 2008 and 2009 and had begun taking steps to rein in the activities of Icelandic banks.

Banking Collapse

In October 2008, Iceland's Financial Supervisory Authority (FSA), an independent state authority with responsibilities to regulate and supervise Iceland's credit, insurance, securities, and pension markets, took control of Iceland's three largest banks: Landsbanki, Glitnir Banki, and Kaupthing

Bank. Subsequently, the FSA took over control of Iceland's last remaining large bank, Straumur Investment Bank, and it reorganized the country's saving banks. On November 19, 2008, Iceland and the International Monetary Fund (IMF) finalized an agreement on an economic stabilization program supported by a $2.1 billion two-year standby arrangement from the IMF.[1] Upon approval of the IMF's Executive Board, the IMF released $827 million immediately to Iceland with the remainder to be paid in eight equal installments, subject to quarterly reviews. Following the decision of IMF's Executive Board, Denmark, Finland, Norway, and Sweden agreed to provide an additional $2.5 billion in loans to Iceland. During this period, Iceland's central bank abandoned its attempt to maintain the value of the krona. With the takeover of the three major banks, the central bank effectively shut down the last clearing houses for trading krona.

As part of the IMF agreement, Iceland proposed a plan to restore confidence in its banking system, to stabilize the exchange rate, and to improve the nation's fiscal position. Also, as part of the plan, Iceland's central bank raised its key interest rate by six percentage points to 18% to attract foreign investors and to shore up its sagging currency.[2] The takeover of the banks was orchestrated in an attempt to quell a sharp depreciation in the exchange value of the Icelandic krona. The krona depreciated relative to the euro and the dollar between January 2008 and July 2008; the depreciation became more pronounced after July 2008. For Iceland, which relies heavily on trade, a sharp depreciation in its currency increases the costs of its imports and adds to domestic inflationary pressures.

On October 15, 2008, the Central Bank of Iceland set up a temporary system of daily currency auctions to facilitate international trade. Without a viable currency, Iceland could not provide support to its banks, which had done the bulk of their business in foreign markets. The financial crisis also created problems with Great Britain and the Netherlands, because hundreds of thousands of Britons and Dutch held accounts in the online branches of the Landsbanki, known as Icesave, and feared that those accounts would default. At the heart of the dispute was a difference of views between the British and Dutch governments and the Icelandic governments over how the assets of British and Dutch depositors would be covered by deposit insurance. Iceland argued that it would provide funds from its Depositor's and Investor's Guarantee Fund according to provisions of the European Economic Area (EEA), which includes the members of the European Union.

The British and Dutch governments, however, feared that this process would leave their citizens without access to their accounts for an unreasonably long period of time and without clear assurances that they would be fully reimbursed. Icelandic officials argued that the EEA process was not meant to provide depositors without full reimbursement in the case of systemic crisis and that the UK and Dutch governments acted prematurely without giving Iceland sufficient time to liquidate the assets of Landsbanki, which they argue should be sufficient to satisfy the British and Dutch account holders. The government of British Prime Minister Gordon Brown used powers granted under the Anti-terrorism, Crime, and Security Act of 2001 to freeze the British assets of Icesave, Landsbanki, the Central Bank of Iceland, and any Icelandic government assets related to Landsbanki. Iceland filed suit in Britain to unfreeze the assets, but eventually dropped the suit.

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[1] Anderson, Camilla, Iceland Gets Help to Recover From Historic Crisis, *IMF Survey Magazine*, November 19, 2008.

[2] Iceland Raises Key Rate by 6 Percentage Points, *The New York Times*, October 29, 2008.

The FSA moved to take over Iceland's major banks after Iceland's Parliament passed legislation that authorized the Treasury to disburse funds to the banks and that authorized the FSA to "take special measures" due to "special circumstances" in order to minimize harm or danger of harm to Iceland's financial markets.[3] The act authorized Iceland's Treasury to contribute an amount up to 20% of the book value of the equity of the bank in return for shares in the bank that are equal in value to the capital contribution of the Treasury and for voting rights that are in proportion to the shares purchased through the Treasury funds. The measure also authorized the FSA to assume the powers of a shareholder's meeting, to suspend the Board of Directors, and to appoint a resolution committee to take over the assets, rights, and obligations of the troubled banks and to decide on any measures regarding the future of the three banks. The Financial Services Authority can limit or prohibit the disposal of the banks' capital or assets and can take custody of those assets that are required to meet the banks' obligations and can require that the assets be valued and disposed of for payments for claims.

One of the first acts of the three resolution committees was to guarantee the deposits that had been placed with the three banks. Next, the resolution committees established three new banking entities (New Landsbanki Islands HF, New Glitnir Banki, and New Kaupthing Bank) into which they placed the assets and a large share of the liabilities of the three existing banks. The foreign subsidiaries and foreign branches of the banks, however, remained with the old banks, except in those instances where the principal banking activities of the foreign branches were carried out in Iceland. In addition, certain other liabilities were not transferred to the new banks, including securities issues and other borrowing; subordinated debt; income tax liabilities; and derivative contracts.

One issue that was difficult to resolve was determining the value of the assets and the liabilities that were transferred to the three new banks. According to the process established by the FSA, the value of the assets and liabilities of the three banks was determined by a group of appraisers that was appointed by each of the resolution committees shortly after the three banks were reorganized. According to the IMF, that appraisal process took longer than initially expected and was completed in early April 2009.[4] As part of the IMF's stand-by agreement, creditors agreed to delay the sale of any of the assets of the three banks, essentially placing a moratorium on payments to creditors. Creditors also disagreed with the auditors over the value of the assets, which delayed the time it took to restructure the old banks. Once that process was completed, a settlement was arranged that required the three new banks to pay the three old banks the "market value" of the assets and the liabilities at the time of the transfer of the assets and liabilities to the new banks. As a final stage in the process, the three new banks were required to issue bonds to the old banks as payment for the assets. This process was delayed further by creditors who asked for more time to evaluate the structure of the bonds they will receive in compensation for the assets that were transferred to the new banks.

In August 2009, the British, Dutch, and Icelandic governments agreed on a process to reimburse the British and Dutch governments for the funds they expended in deposit insurance to British

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[3] Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual financial Market Circumstances etc., Prime Minister's Office, October 8, 2008.

[4] *Iceland: Stand-By Arrangement – Interim Review Under the Emergency Financing Mechanism,* International Monetary fund, February 2009,

and Dutch account holders of Icesave and presented the agreement for approval to the Icelandic Althing, or Parliament. Instead of approving the agreement, the Parliament amended the agreement and altered the terms to place a ceiling on the amount of repayment based on the size of the British and Dutch gross domestic product (GDP). Up to 4% of Iceland's GDP was to be paid to Britain from 2017 to 2023 and the Netherlands was to receive up to 2% of Iceland's GDP. The British and Dutch governments rejected this measure and the Icelandic Parliament narrowly adopted in December 2009 a different measure that satisfied the demands of the British and Dutch governments. The measure would reimburse the governments over a 14-year period the full amount they had expended on depositor insurance. Widespread public opposition led Iceland's President Olafur Ragmar Grimsson, on January 5, 2010, to reject the measure and to call for a public referendum. The measure failed to pass the public referendum on March 6, 2010, with 98% of the people voting in opposition to the measure.[5] Following President Grimsson's actions, Icelandic government bonds were downgraded, which has made it increasingly difficult for the Icelandic government to obtain additional funds from international creditors.

The demise of Iceland's three largest banks is attributed to an array of events, but primarily stems from decisions by the banks themselves. Some observers argued that the collapse of Lehman Brothers set in motion the events that finally led to the collapse of the banks,[6] but this conclusion is controversial. Some have argued that at the heart of Iceland's banking crisis is a flawed banking model that is based on an internationally active banking sector that is large relative to the size of the home country's GDP and to the fiscal capacity of the central bank.[7] As a result, a disruption in liquidity threatens the viability of the banks and overwhelms the ability of the central bank to act as the lender of last resort, which undermines the solvency of the banking system.

By the time of the acknowledged start of the global financial crisis in mid-2007, Iceland's central bank and Iceland's banks themselves had begun to recognize the vulnerability of the banks. In particular, officials in Iceland as well as financial observers in Europe had begun to reassess the risks associated with various financial instruments, and to raise questions about the asset strength of the banks and the asset size of the banks relative to the size of Iceland's economy. In addition, by late 2007, various organizations had begun to recognize the imbalances that were becoming apparent in Iceland's economy and had forecast a slowdown in Iceland's torrid pace of economic growth for 2008 and 2009.[8]

When Lehman Brothers collapsed, the international financial markets had already begun to reassess the risks associated with a broad range of financial instruments. Eventually, this reassessment of risks undermined the remaining amount of trust that existed in the credit markets, which caused banks and other financial firms to grow unwilling to make loans to short-term money markets and to engage in interbank lending, which caused those activities to freeze up. For

[5] Faiola, Anthony, Fiery Icelanders Reject Bailout Payment, *The Washington Post*, March 8m 2010, p. A7.

[6] Portes, Richard, The Shocking Errors Behind Iceland's Meltdown, *Financial Times*, October 13, 2008, p. 15.

[7] Buiter, Willem H., and Anne Sibert, *The Icelandic Banking Crisis and What to Do About it: The Lender of Last Resort Theory of Optimal Currency Areas*. Policy Insight No. 26, Centre for Economic Policy Research, October 2008. p. 2.

[8] *The Economy of Iceland*, p. 9-11.

Iceland's three largest banks, this collapse in short-term borrowing meant that they found that it was increasingly difficult to finance debts in the interbank market.

In addition, Iceland's Landsbanki and Kaupthing Bank experienced a sharp rise in the cost of private deposit insurance. This withdrawal of credit eliminated a major source of the bank's funding and threatened their ability to finance the nation's trade deficits. Typically, this situation is remedied by the central bank, which stands as the bank of last resort. In Iceland's case, however, the debts of the commercial banks were so large that Iceland's central bank was unable to guarantee the banks' loans, which lead to the collapse of the banks. In turn, the krona experienced a serious depreciation in its value, which raised the cost of imports and threatened to fuel domestic inflation. The large foreign debts held by Iceland's banks proved to be unsupportable once they could not utilize the interbank market to refinance their substantial loans.

Conclusions

The failure of Iceland's banks raises questions about bank supervision and crisis management for governments in Europe and the United States. This incident raises questions about how national governments should address the issue of supervising foreign financial firms that are operating within their borders and how to protect their depositors when a foreign-owned firm may attempt to withdraw deposits from one market in order to offset losses in another. One approach focuses on broad levels of cooperation between national governments with each government addressing the crisis from its own perspective and in its own limited way. For a number of governments in Europe this approach is appealing, because their economies and their banks have felt little direct effect from the crisis.

An alternative approach argues in favor of a more integrated and coordinated response from national governments and central banks. Proponents of this approach argue that a coordinated systemic approach is necessary, because financial markets in the United States and Europe have become highly integrated as a result of cross-border investment by banks, securities brokers, and other financial firms. As a result of this integration, economic and financial developments that affect national economies are difficult to contain and are quickly transmitted across national borders, as attested to by the financial crisis of 2008. As financial firms react to a financial crisis in one area, their actions can spill over to other areas as they withdraw assets from foreign markets to shore up their domestic operations. For instance, as Icelandic banks began to default, Britain used an anti-terrorism law to seize the deposits of the banks to prevent the banks from shifting funds from Britain to Iceland.[9] Banks and financial firms in Europe have felt the repercussions of the U.S. financial crisis as bank balance sheets have deteriorated and as U.S. firms and European firms have adjusted their operations in response to the crisis.

The Icelandic case also raises questions about the cost and benefits of branch banking across national borders where banks can grow to be so large that disruptions in the financial market can cause defaults that outstrip the resources of national central banks to address. Such branch banking across national borders has significantly expanded financial opportunities for individual

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[9] Benoit, Bertrand, Tom Braithwaaite, Jimmy Burns, Jean Eaglesham, et al., Iceland and UK clash on Crisis, *Financial Times*, October 10, 2008, p. 1.

investors and firms alike and is unlikely to disappear as a result of the current financial crisis. Nevertheless, if some financial institutions are deemed to be too big to fail, financial regulators and national governments may be called on to address the issue of how such institutions should be supervised when their operations span national borders and they are engaged in a vast array of banking and investment operations.

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