Iceland’s Financial Crisis

A Global Crisis

- The current economic turmoil in Iceland is part of a complex global financial crisis and is by no means an isolated event.
- Governments around the world have introduced emergency measures to protect their financial system and rescue their banks, as they suffer from a severe liquidity shortage.
- Thus far, Iceland has been hit particularly hard by this unprecedented financial storm due to the large size of the banking sector in comparison to the overall economy.
- The Icelandic Government has taken measures and is working hard to resolve the situation, both independently and in cooperation with other parties.
- Iceland is cooperating with its Nordic and European partners and is currently consulting with the IMF on measures toward further stabilization of the Icelandic economy.
Bank Liquidity Tightens

- The liquidity position of Icelandic banks tightened significantly in late September and early October as interbank markets froze following the collapse of Lehman Brothers.
- The nationalization of Glitnir, one of Iceland’s three major banks, on Sept. 29th, led to a credit rating downgrade on sovereign debt and that of all the major banks.
- This led to further deterioration of liquidity.
- Early October, all three banks were suffering from a severe liquidity shortage and in dire need for Central Bank emergency funding. Negative coverage on the Icelandic economy, particularly in the U.K, did not help either.
- By mid-October, all three banks, Glitnir, Landsbanki and Kaupthing, had been taken over by the government on the basis of a new emergency law.
- The banks had become too large to rescue.

Too Big to Rescue

- In early October, the Icelandic government came to the conclusion that the Icelandic banks were too big to rescue.
  - Pre-crisis total balance sheet of the three Icelandic banks was €110bn.
  - Icelandic GDP in 2007 was €14.7 bn.
  - Government could not guarantee the whole balance sheet of the banks; nationalization was therefore no longer an option.
- Emergency law was passed on October 6th.
  - Allowed the Icelandic Financial Regulatory Authority (FSA) to take over operations of illiquid banks.
  - Powers to suspend payments in order to safeguard value and protect depositors.
  - Powers to establish new banks to overtake domestic deposit obligations and assets from failing banks.
Restructuring of the Banking System

- On the basis of the new legislature law, the Icelandic Financial Regulatory Authority (FSA) has assumed control of all three banks.
- Three new state-owned banks were created from the old banks: New Landsbanki (now NBI), New Glitnir and New Kaupthing.
- These new banks assume domestic deposit liabilities and the Icelandic government has guaranteed all domestic deposits.
- The new state-owned banks will overtake sufficient assets from the old banks to cover deposit liabilities and equity requirements. Further information here: http://fme.is/?PageID=867
- Foreign operations of the old banks will likely be sold to other parties, such as foreign financial institutions. Others may be shut down and their assets used to reimburse deposits and other outstanding liabilities – with the backup of the guarantee funds in the respective country according to EU/EEA regulations.

Deposits of Foreign Customers

- As previously mentioned, the Icelandic government has guaranteed all domestic deposits.
- The deposits of foreign customers in Icelandic banks are generally guaranteed according to EU/EEA rules.
- Depending on whether the bank is operated as a subsidiary or a branch, different deposit-guarantee schemes may come into play if assets do not cover commitments.
- Any foreign subsidiary of an Icelandic bank is fully covered by the deposit-guarantee scheme in the country it operates (i.e. Kaupthing Edge in the UK).
- All branches of Icelandic banks that have been nationalized (taken over by the FSA) are covered by the Icelandic Depositor’s and Investor’s Guarantee Fund, which operates according to the EU-directive relating to these issues (i.e. Icesave in the UK).
- According to the directive, the amount covered is €20,887 for each depositor in each financial institution.
The Landsbanki Predicament

- The assets of Old Landsbanki in the UK were frozen via provisions in the Anti Terrorism, Crime and Security Act from 2001.
- This has been forcefully opposed through diplomatic channels with UK authorities, as this clearly has a very damaging effect on the Icelandic banking sector and puts Icelandic companies in the UK in a difficult situation.
- Iceland has also taken the issue up for discussion within NATO and Icelandic authorities have considered legal action.
- This is also one of the main factors leading to disruptions in Iceland’s international payments and settlements system.

Deposit Insurance: Impact on Government Debt

- Net Government debt was close to none before the crisis.
- Potential impact on Government debt from deposit insurance:
  - Cost of insurance of international deposits of Icelandic banks likely to amount to EUR 4 bn.
  - Assets of international branches amount to > EUR 4 bn.
  - Sale of assets likely to cover 50%–60% deposit insurance costs
  - Overall impact on the Government debt level likely to be lower than 20%
  - Negotiation with UK and the Netherlands on deposit insurance resulted in an outline of an agreement
    - UK and The Netherlands will disburse deposit insurance claims
    - Dispute will thus not hamper IMF assistance
Impact on Government Debt from Other Factors

- Government debt is set to rise due to other factors as well:
  - Capitalization of the three new banks.
  - Recapitalization of the Central Bank.
  - Rising deficit due to economic slowdown.

Going Forward

- Going forward the debt level should nevertheless continue to be manageable.
- IMF to lend Iceland $2.1 bn:
  - Other sources with up to $4 bn over the next two years.
  - $830 million will be allocated when the IMF’s Executive Board approves agreement, on Friday.
  - Quarterly reviews of certain criteria followed by disbursement of additional funds.
  - Economic stabilisation plan to deal with impact of financial crash.
  - Banking sector regulatory framework to be reviewed.
Despite the fact that the recent financial crisis has hit Iceland hard, the economy is still strong and resilient. This can be attributed to strong economic fundamentals.

- High income
- Good education system
- Sophisticated health system
- Abundant natural resources
- Favourable demographics
- Fully funded pension system
- Flexible labour market
- Diverse exports and industries
- Competitive tax system
- Strong fiscal position
- Strong infrastructure
- Political stability and International co-operation

Appendix 1: Timeline of the Icelandic Financial Crisis

September 29
Government announces takeover of 75% share in Glitnir and EUR 600 m equity injection
S&P downgrades Glitnir to BBB; Sovereign to A-

September 30
Fitch downgrades sovereign to A-; Landsbanki to BBB; Kaupthing to BBB; Moody’s downgrades sovereign to A-; Landsbanki to BBB; Kaupthing to BBB
S&P downgrades Glitnir to CCC

October 4-5
Emergency law is introduced and passed by parliament; government guarantees all domestic deposits
Central Bank announces exchange rate peg and starts by selling EUR 6 m. at ISK/€131
Fitch downgrades sovereign to BBB; Landsbanki to B; Glitnir to B
S&P downgrades Glitnir to CCC

October 6
Emergency law is introduced and passed by parliament; government guarantees all domestic deposits
Central Bank announces exchange rate peg and starts by selling EUR 6 m. at ISK/€131
Fitch downgrades sovereign to BBB; Landsbanki to B; Glitnir to B
S&P downgrades Glitnir to CCC

October 7
Government announces exchange rate peg and starts by selling EUR 6 m. at ISK/€131
Fitch downgrades sovereign to BBB; Landsbanki to B; Glitnir to B
S&P downgrades Glitnir to CCC

October 8
Central Bank announces intention to maintain currency peg; later announces that peg is not sustainable and has been abandoned
Swedish Central Bank extends SEK 5 bn loan to Kaupthing Sweden
British authorities put Kaupthing Edge and Kaupthing Singer & Friedlander into administration
British PM threatens to sue Icelandic government in claim for Icesave deposits
Icelandic PM states that sale of Landsbanki assets will be used to refund Icesave deposits
Fitch downgrades sovereign to BBB; Landsbanki to D; Glitnir to D
Moody's downgrades sovereign to A- and puts on review for further downgrade; Kaupthing to Caa2
Board of Kaupthing requests FSA to assume control of bank

October 9
New Landsbanki starts operations with Dutch finance minister threatens to sue Icelandic government in claim for Icesave deposits
Fitch downgrades Kaupthing to Caa2
Moody's downgrades Kaupthing to Caa2
S&P downgrades Glitnir to D

October 10
Dutch delegation arrives in Reykjavik; initiates talks with treasury department about Icesave
Central Bank announces limits on currency outflow; low amounts for travel and import restricted to necessities; companies must apply for currency to the CB

October 11
Dutch delegation initiates talks with treasury department about Icesave
Accomiadated with Dutch government on loan to guarantee a refund of Icesave deposits
Outline of an accord with British government on loan to guarantee refund of Icesave deposits
October 14
Central Bank delegation starts talks in Moscow with Russian Finance Ministry on loan to Iceland
Central Bank draws on swap facility arrangements with Denmark and Norway, each by EUR 200 m.
Moody’s confirms sovereign credit rating issued on October 6 (A1)

October 15
Central Bank lowers policy rate by 350 bp to 12%
Central Bank introduces auction system to meet demand for foreign currency, resulting in an allocation of EUR 25m. at an SSEK rate of 150.

October 16
Central Bank announces that it guarantees that all payments will reach ultimate beneficiaries’ accounts with local banks in an attempt to revitalize payment system.

October 15
New Glitnir starts operations with ISK 110 bn in capital

October 16
New Kaupthing starts operations with capital of ISK 75 bn
Norwegian delegation arrives in Iceland to gather information about the situation.

October 17
Government announces an agreement at referendum with an IMF mission of USD 2 bn stand-by facility programme.
Government formally requests assistance from the Nordic countries, the ECB and the FED.
Delegation from the US Treasury Department arrives in Reykjavik.

October 22
Government formally requests assistance from the Nordic countries, the ECB and the FED.

October 24
High-level Nordic committee established to present proposals for Nordic assistance to Iceland in cooperation with the IMF.

October 28
Central Bank raises policy rate by 600 bp to 18%
Faroe Islands pledge DKK 300 million loan for Iceland.

Appendix 2: Iceland’s Economy

General government fiscal balance, % of GDP

General government net debt, % of GDP

Central government fiscal balance, % of GDP

Central government net debt, % of GDP

Source: Ministry of Finance
GDP Growth 1945-2007, YoY

Private Consumption 1945-2007, real growth YoY

Investment, real growth YoY

Balance of Goods and Services 1945-2007, % of GDP

Source: Statistics Iceland