Coping with a banking crisis

– Rise, fall and rebirth of the Icelandic banking system

Second International Workshop on
Managing Financial Instability in Capitalist Economies
Reykjavik, Iceland
September 23 - 25, 2010

Tryggvi Pálsson, Director Financial Stability

Central Bank of Iceland

SI-65698

Coping with a banking crisis

The Rise

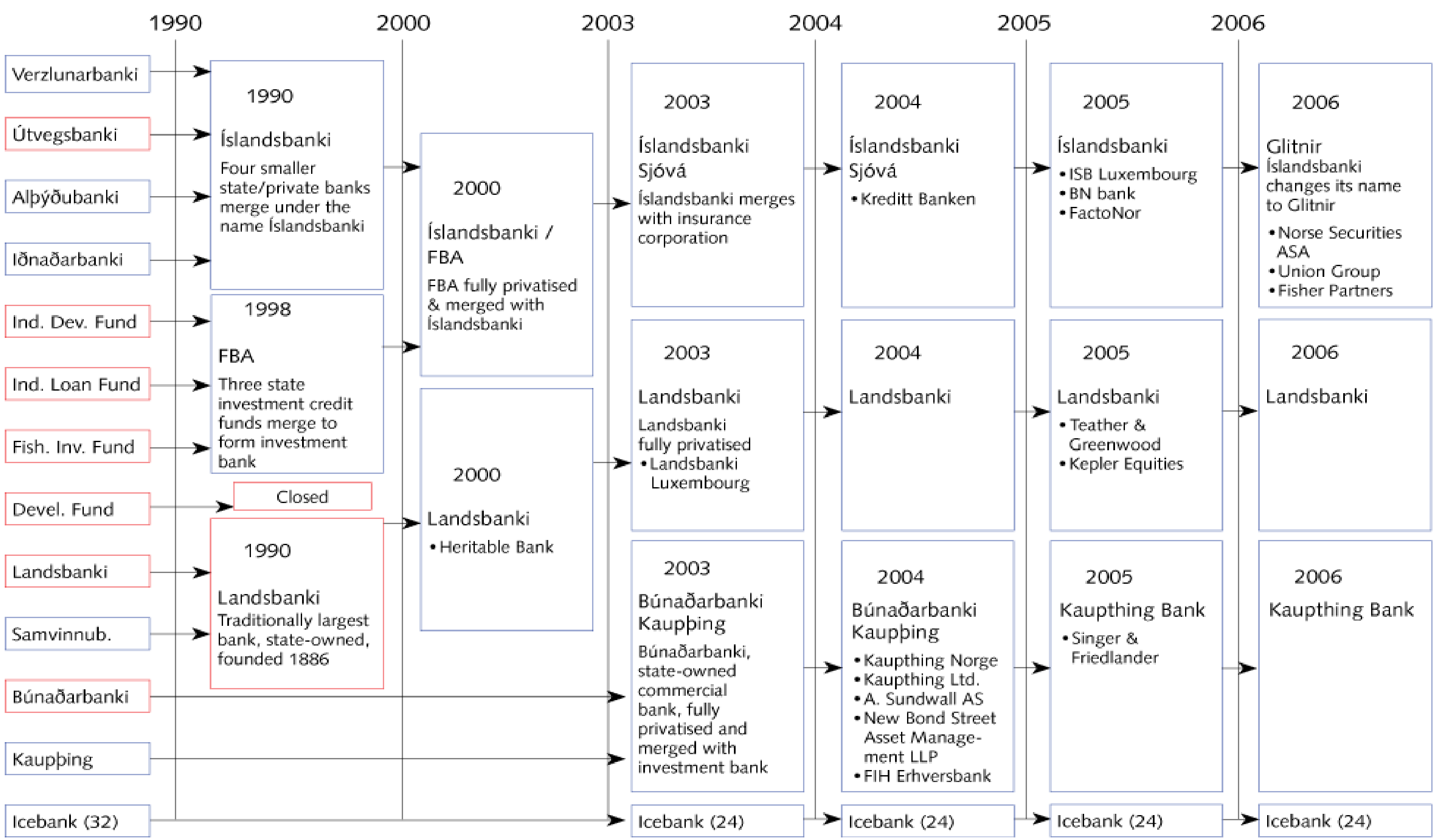
International Herald Tribune, October 27, 1989. Kal, Cartoonists and Writers Syndicate, 1989.

Iceland

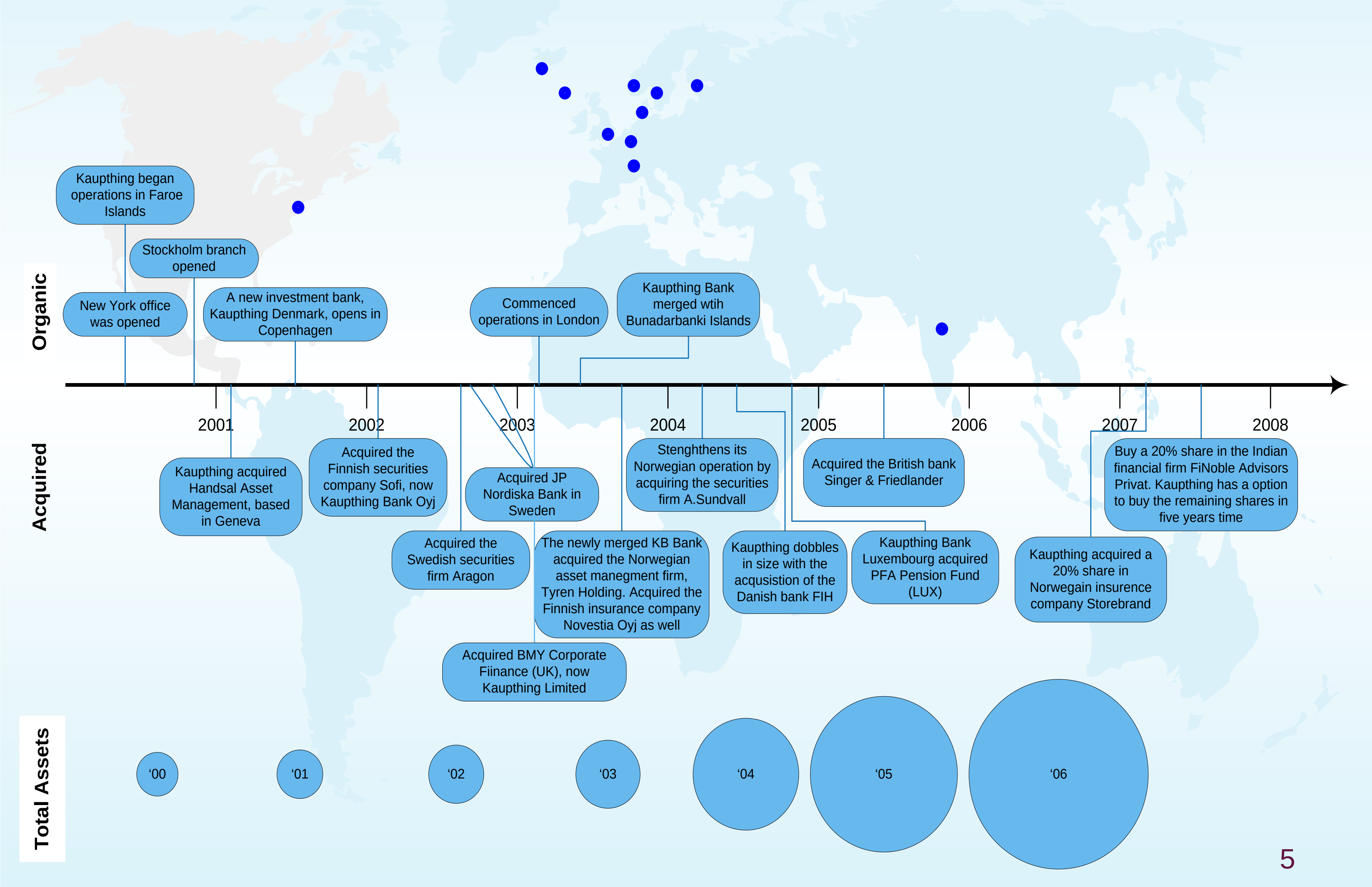
- In the 20th century Iceland went from being one of the poorest economies in Europe to a prosperous one
  - High but volatile growth, -mostly led by fisheries
  - From 2/3 of labour force in agriculture to 2/3 in services
- In past decades: liberalization, deregulation and privatization
- Member of the EEA in 1994
  - Free movement of capital
  - European “passport” for financial institutions headquartered in any country within the area
  - Common legal and regulatory framework …
  - … but the safety net, e.g. deposit insurance and LOLR, and crisis management and resolution remained largely national (*a poisonous coctail*)

Banking system:
- from sectoral and state owned to fully privatized (2003)
- major acquisitions abroad 2004-2005

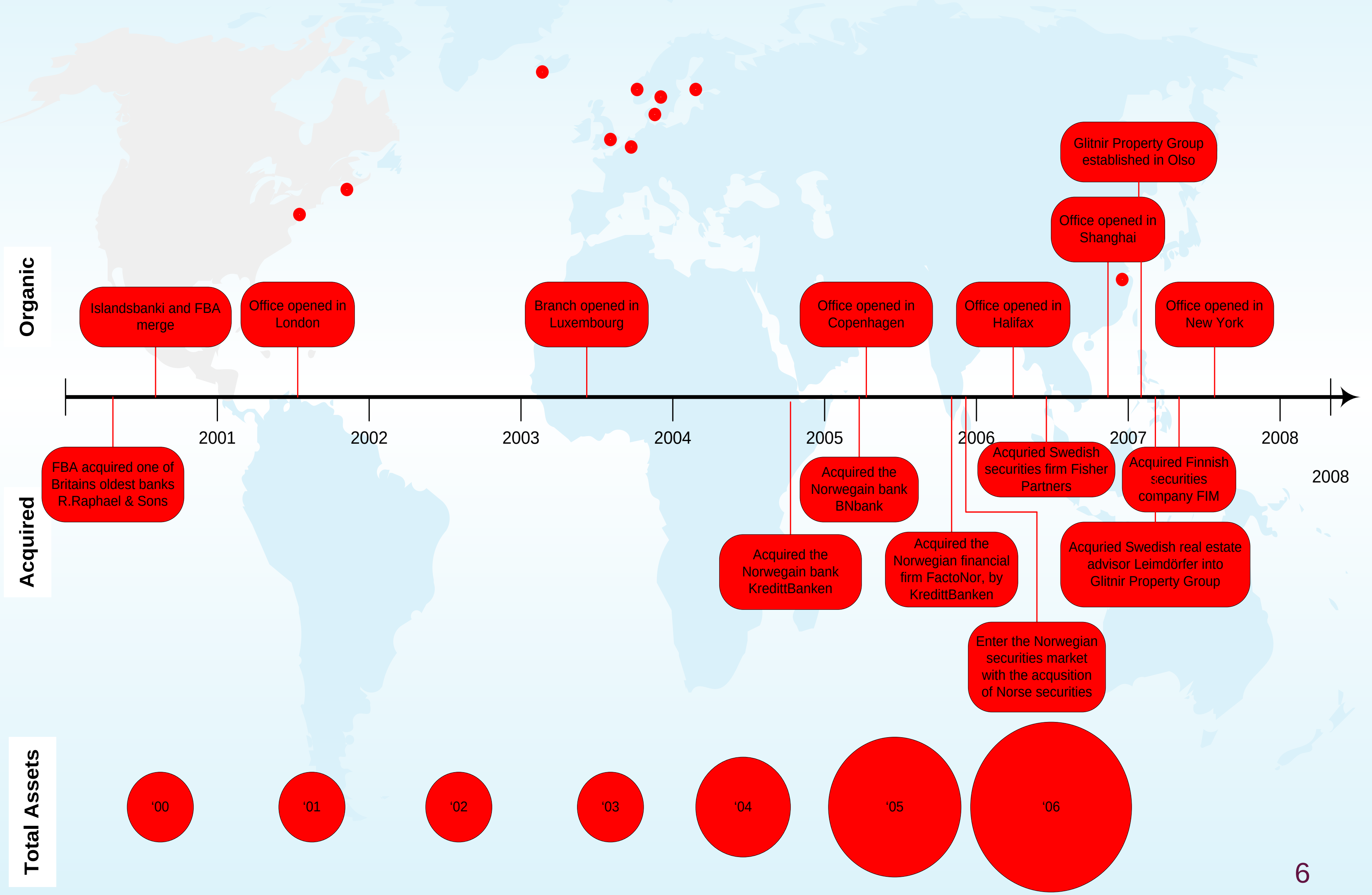
Consolidation of the banking system

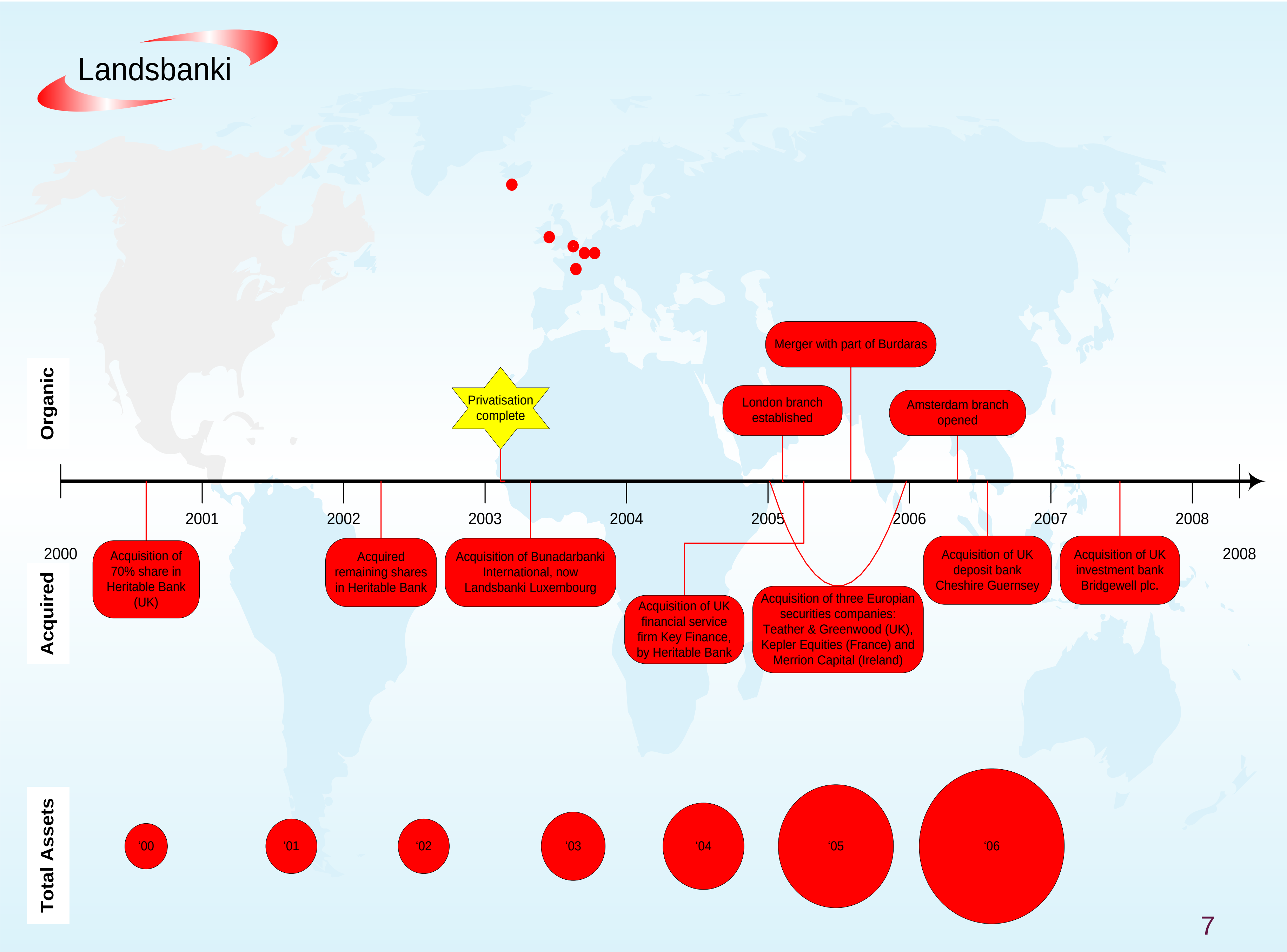


Kaupthing Bank



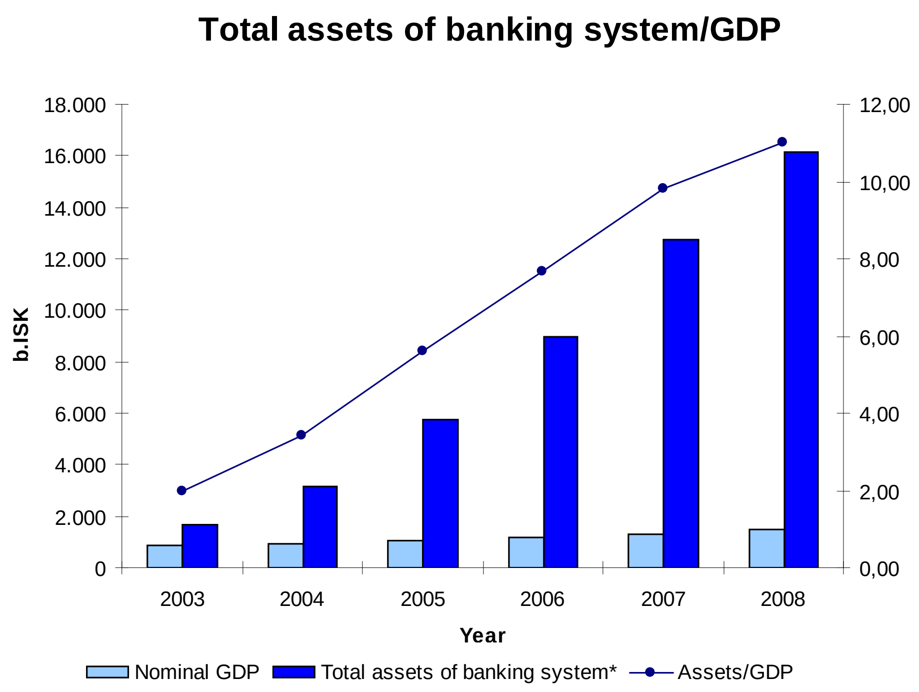
Glitnir Bank




Landsbanki
Organic
Acquired
Total Assets
Privatisation complete
London branch established
Merger with part of Burdaras
Amsterdam branch opened
2000
2001
2002
2003
2004
2005
2006
2007
2008
2008
Acquisition of 70% share in Heritable Bank (UK)
Acquired remaining shares in Heritable Bank
Acquisition of Bunadarbanki International, now Landsbanki Luxembourg
Acquisition of UK financial service firm Key Finance, by Heritable Bank
Acquisition of three Europian securities companies: Teather & Greenwood (UK), Kepler Equities (France) and Merrion Capital (Ireland)
Acquisition of UK deposit bank Cheshire Guernsey
Acquisition of UK investment bank Bridgewell plc.
'00
'01
'02
'03
'04
'05
'06

Rapid expansion of the banking system

- Assets 2 times GDP in 2003, roughly 11 times GDP in 2008
- Two thirds of the banks' activities were in other countries and more than half of their revenues
- No foreign banks were operating in Iceland



Rapid expansion of the banking system

- Macro imbalances domestically
  - Large aluminium investment projects
  - Housing loans by banks: initiated in 2004 and not properly funded
  - Decrease of direct and indirect taxes
  - Balance of payments showing increasing deficits
- Business opportunities were tempting
  - Easy access to market financing with low rates and risk premia
  - Appreciating currency partly due to carry trade (Glacier bonds)
  - Acquisitions of financial companies in other countries and establishment of branches easy due to EEA agreement
  - Icelandic banks were highly rated by credit rating agencies
    - For a while in 2007 the banks had the highest possible rating with one of the rating agencies

Mini crisis 2006

- Foreign investors & media expressed concern
  - Too rapid expansion and risk appertite
  - Reliance on market funding
  - Ownership structure and governance

“Iceland provides global warning to Wall Street” Wall Street Journal: Apr. 10, 2006

The crisis of confidence (in 2006) - as seen by investors*

Even though profitable, the growth was too dramatic!

Growing borrowings, with over-reliance on wholesale funding

It all appears unreal to the average investor!

Perceived vulnerability of banks with deteriorating macroeconomic environment

Small and little understood economy… with absolute and relative macroeconomic indicators out of sync with Western Europe

Limited understanding of the ownership structures with intricate cross-shareholdings

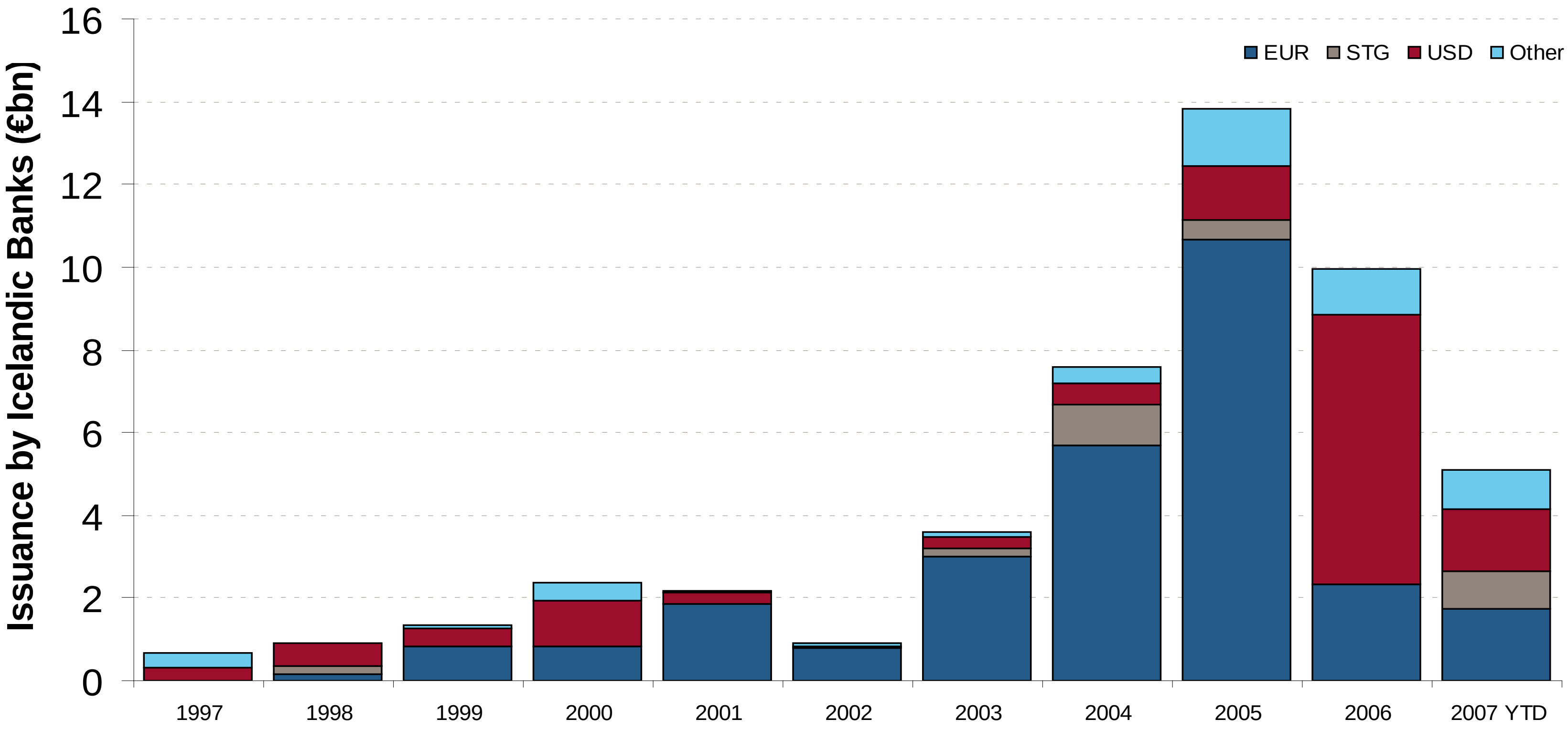
Frequent and transformational acquisitions, with young management teams

One-way bets by big money managers followed by negative analyst reports become a self-fulfilling prophecy to blow out spreads and shut market!

* Sandeep Agarwal, MD, Head of FIG Debt Capital Markets, Credit Suisse

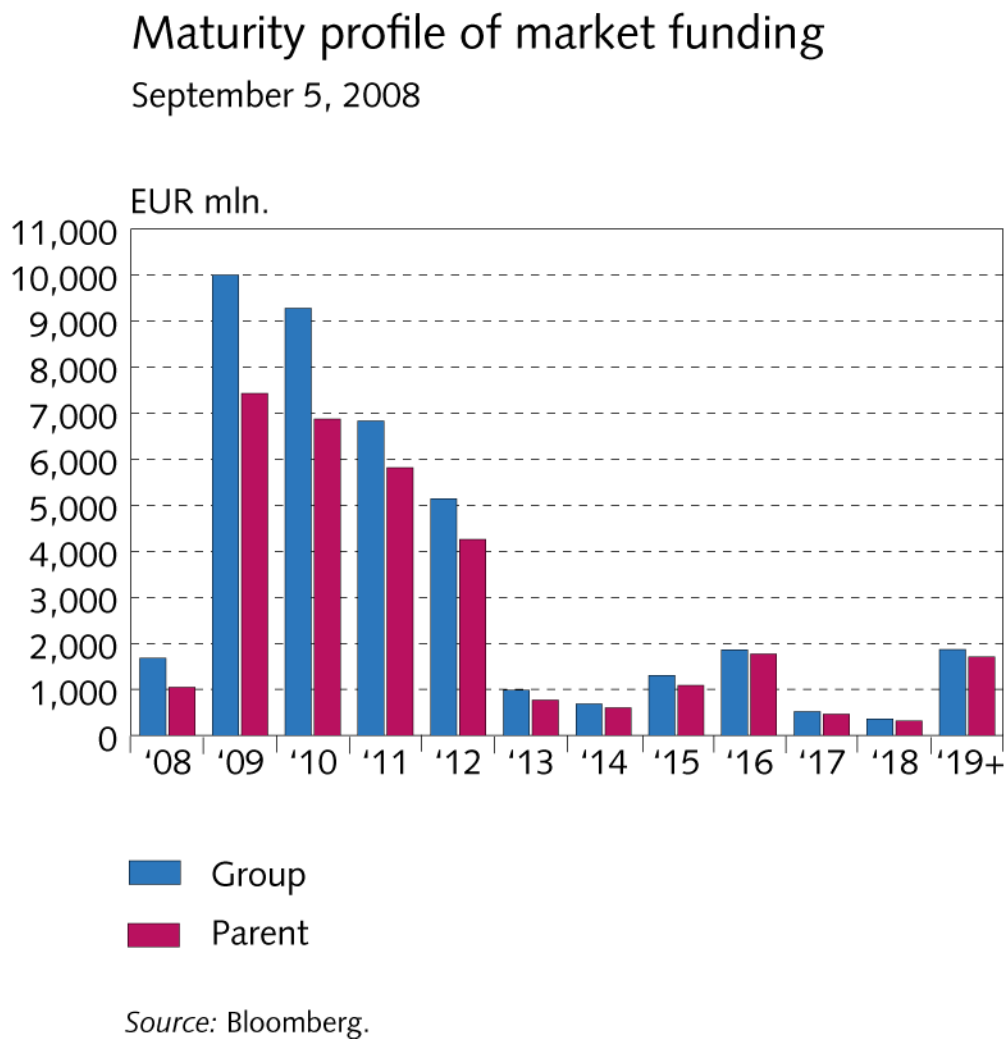
Market financing peaked in 2005

New Debt Issues from Icelandic Banks



European Medium Term Notes dominant until 2006 when US issues replaced EMTN

Maturity profile just before the downfall

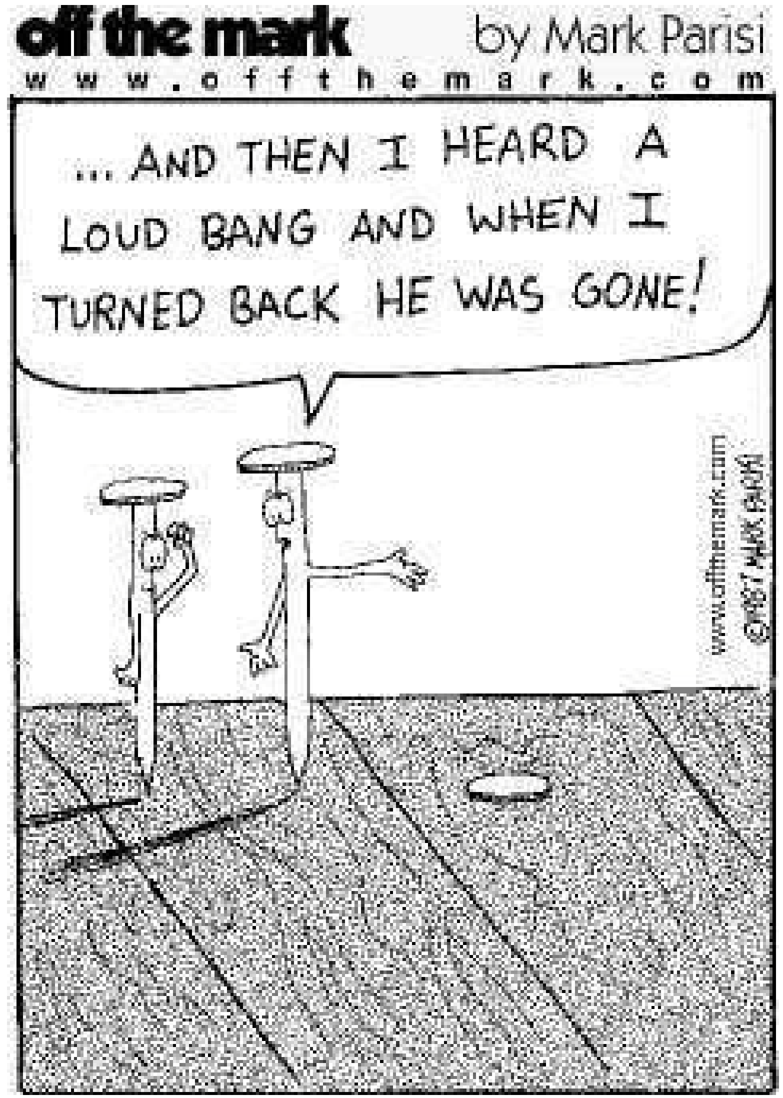


Contingency work in run-up to crisis

- Contingency working group established in 2006
  - Representatives from three ministries, the Central Bank and FME (the Icelandic FSA)
  - Ever increasing frequency of meetings as of late 2007
- Contingency exercises
  - Payment systems exercise in 2007
  - Nordic/Baltic crisis management exercise in September 2007
- Among Central Bank measures
  - Internal contingency group activated in Nov. 2007
  - Closer cooperation with FME
  - Intensified liquidity monitoring both in frequency and coverage
  - Advise sought from international experts
  - Relayed concerns to the government
  - Pressured banks to downsize and encouraged subsidiarisation of banks' operations abroad
  - Swap arrangements with three Nordic central banks

Coping with a banking crisis

The Downfall



Crisis Timeline

September 15th
- Collapse of Lehman

September 29th
- Icelandic State announces its plans to inject capital into Glitnir
- S&P downgrades Iceland

October 6th
- Trading in three largest Icelandic banks suspended
- CBI grants Kaupthing 500 m. EUR liquidity support
- Government guarantees all deposits
- Prime minister announces that the country is in danger of "national bankruptcy"

October 7th
- Emergency banking bill passed
- FME (Icelandic FSA) takes control of Landsbanki
- FME takes control of Glitnir
- Glitnir is downgraded
- Trading on the FX market is ground to a halt

October 8th
- Landsbanki assets frosen
- Moodys downgrades Iceland
- Riksbanken grants Kaupthing 520 m. EUR liquidity line

October 9th
- FME takes control of Kaupthing
- Trading of all stocks on the stock exchange is suspended
- Fitch downgrades Iceland

November 19th
- IMF programme signed

November 21st
- S&P downgrades Iceland to BBB-

November 28th
- The Central Bank activates capital controls

January 25th
- Minister of Business affairs resigns
- Director of the FME and the board suspended

February 1st
- Previous government replaced by a minority government

February 9th
- Governor IF resigns from the CBI

February 27th
- New laws passed on the Central Bank. New governor and deputy governor appointed

February 26th to March 13th
- IMF mission to Iceland

March 9th
- FME takes control of Straumur

March 21st
- FME takes control of SPRON and Sparisjóðabankinn (Icebank)

Collapse of 88% of the banking system

- In early October 2008 the major banks Glitnir, Landsbanki Íslands and Kaupthing, representing 88% of the banking system in asset terms, collapsed in a week. (In March 2009 a second wave increased it to 97%)
- Large defaults internationally; a devastating blow for a small economy

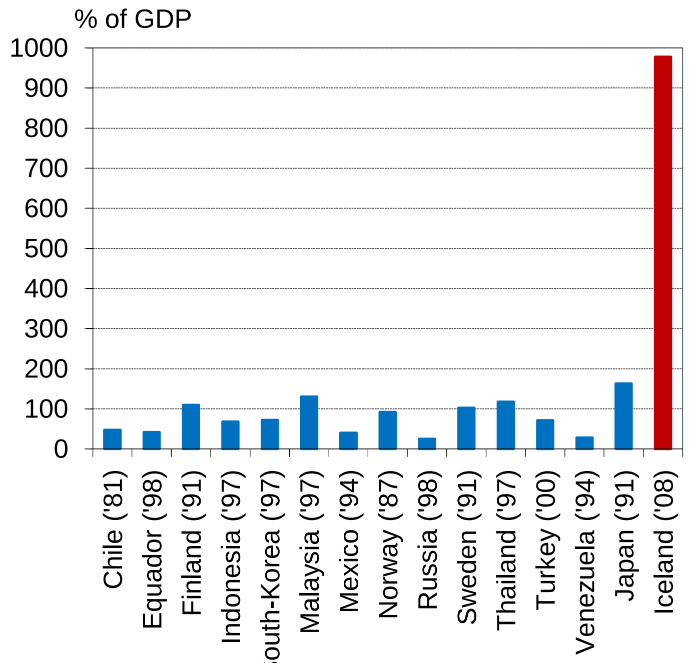
Largest Moody's-Rated Defaults, 1920-2008

Corporate Family	Default Volume (US$ Mil)	Default Year	Specific Industry	Domain
Lehman Brothers Holdings Inc.	$120,483	2008	FIRE: Finance	United States
Worldcom, Inc.	$33,608	2002	Telecommunications	United States
GMAC LLC	$29,821	2008	FIRE: Finance	United States
Kaupthing Bank Hf	$20,063	2008	Banking	Iceland
Washington Mutual, Inc.	$19,346	2008	Banking	United States
Glitnir Banki Hf	$18,773	2008	Banking	Iceland
NTL Communications Corp.	$16,429	2002	Media: Broadcasting & Subscription	United Kingdom
Adelphia Communications Corp.	$16,256	2002	Media: Broadcasting & Subscription	United States
Enron Corp.	$13,852	2001	Energy: Electricity	United States
Tribune Company	$12,674	2008	Media: Diversified & Production	United States

Comparison with previous crises

- Relatively largest banking system ever to have gone through a crisis and an unusually large share of it became insolvent

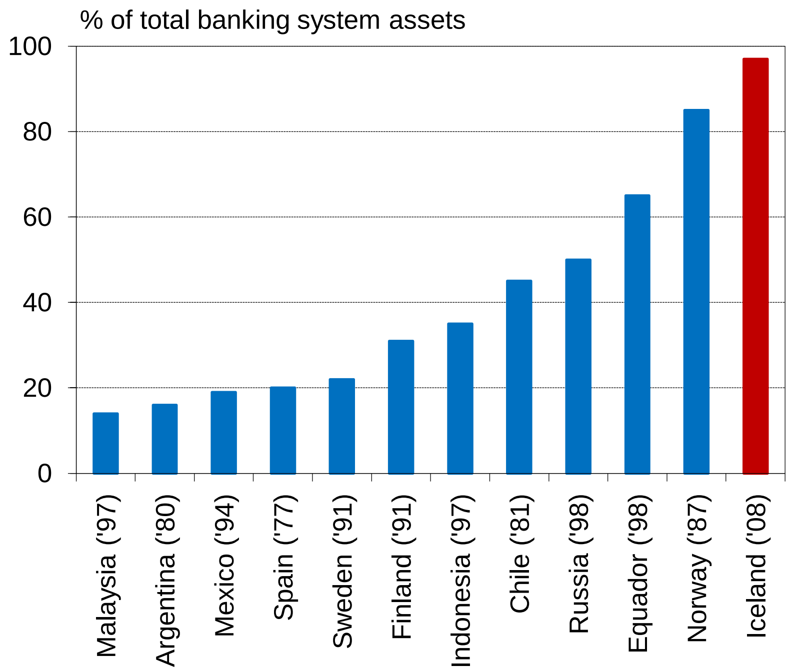
Commercial banks' assets in various previous financial crises



1. The year in parentheses represents the onset of the crisis in the country concerned.

Sources: Bank of England, Central Bank of Iceland.

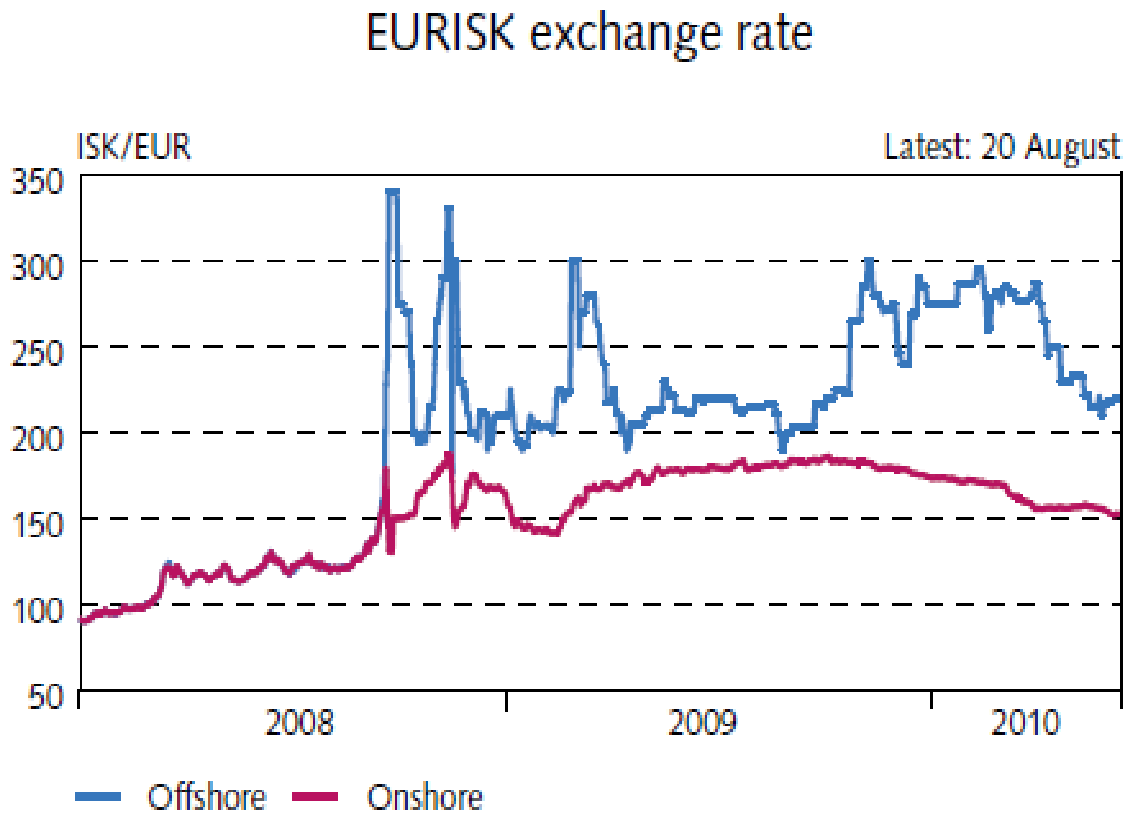
Share of banking system in insolvency in various previous crises



1. The year in parentheses represents the onset of the crisis in the country concerned.

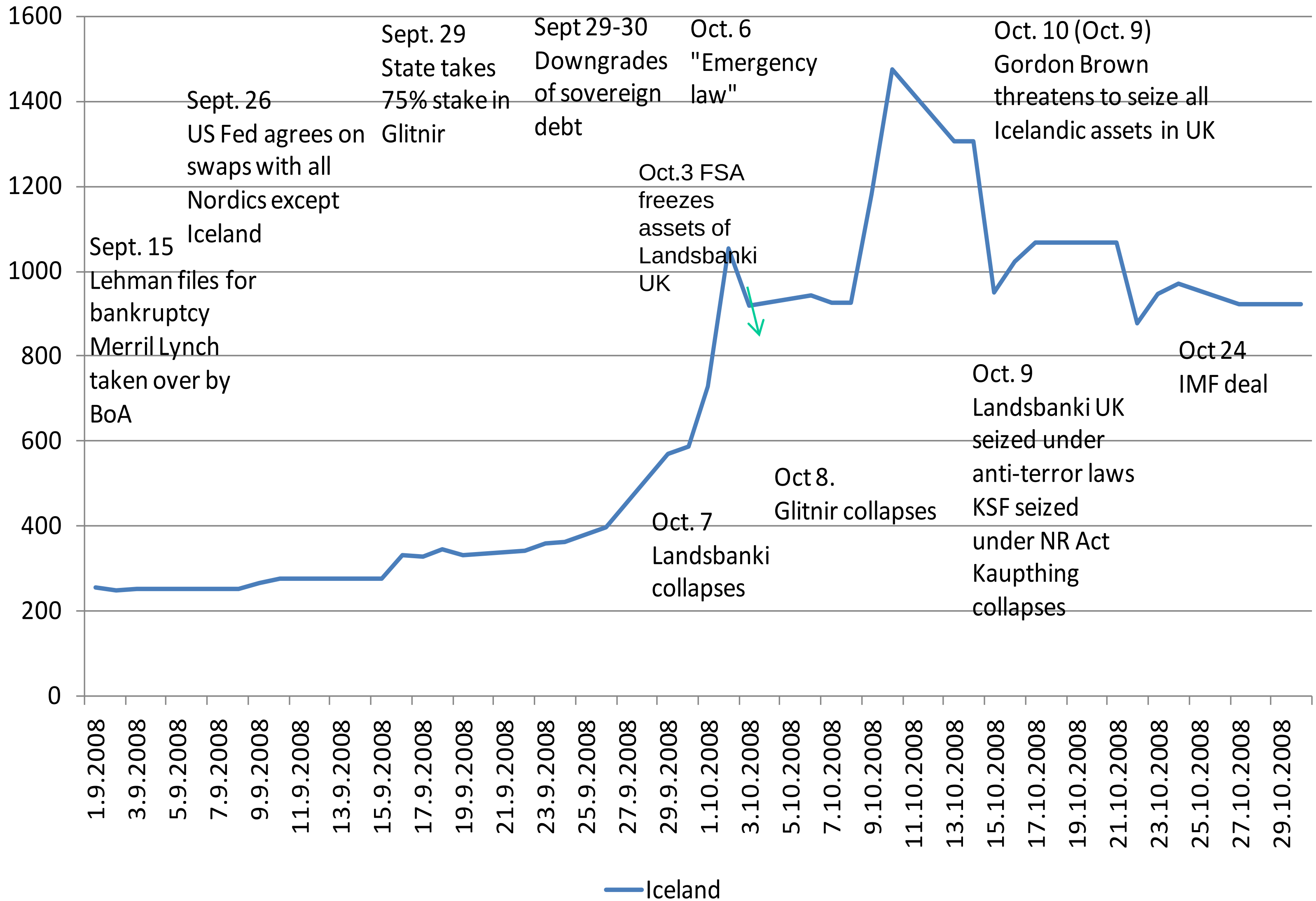
Sources: Caprio, Klingebiel, Laeven and Noguera (2005), Central Bank of Iceland.

A financial crisis and a currency crisis

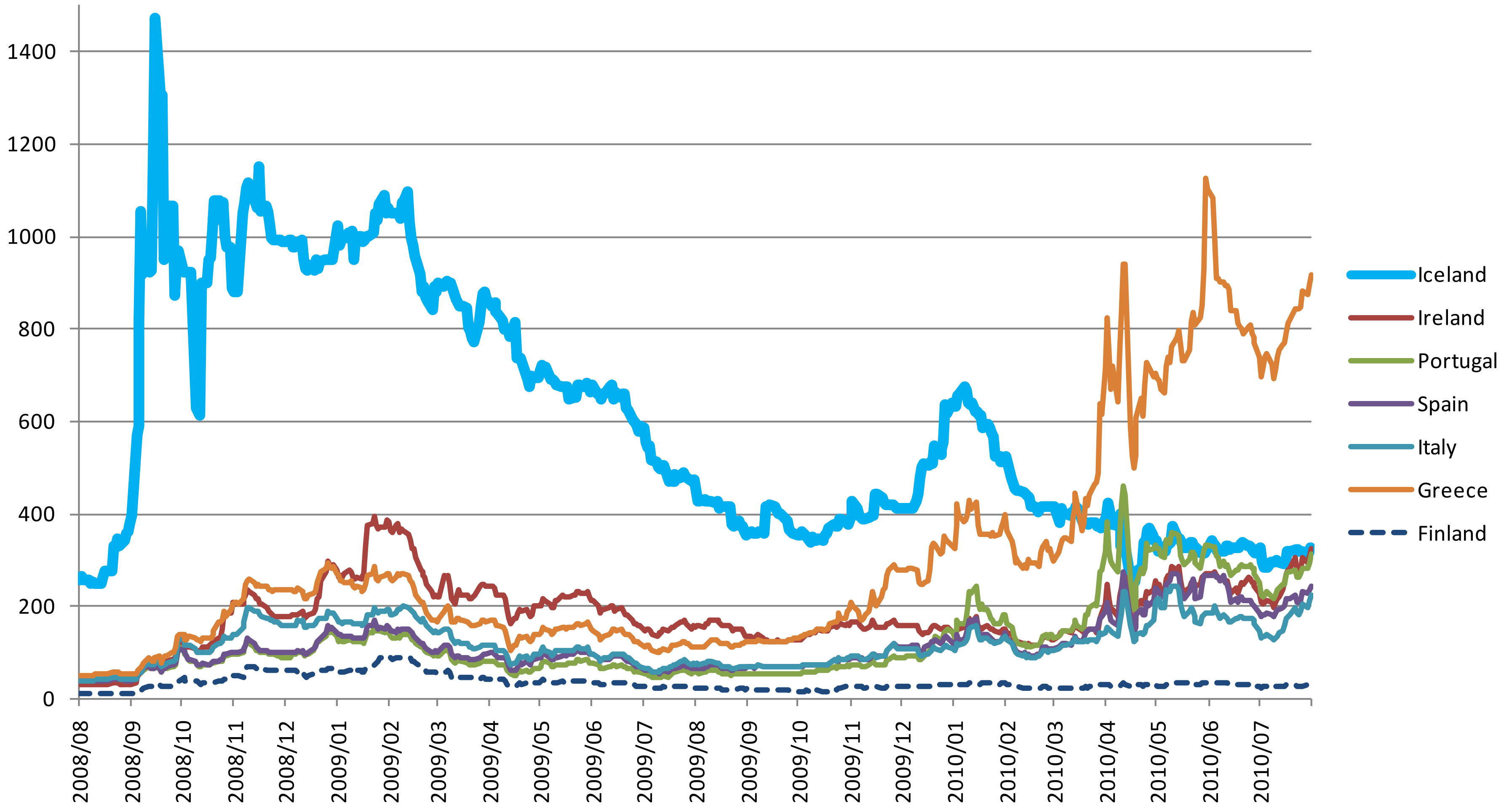


The onshore exchange rate is the end-of-day rate. Daily data.
Source: Central Bank of Iceland.

The CDS spread of Iceland tells the story



CDS: from financial crisis to sovereign crisis



Payment systems

- International
  - International payment flows affected
    - UK freezing order under the Anti-Terrorism, Crime and Security Act of 2001 initially included the authorities besides Landsbanki
    - Payments stopped at first but gradually restored with Central Bank involvement
    - UK lifted the freezing order on 15 June 2009
- Domestic
  - Domestic payment systems functioned well throughout
    - When the major banks failed in October 2008 all deposits were transferred overnight to the new banks
    - All payment cards up and running the whole time
      - The CBI issued statements guaranteeing the acquirers access to foreign exchange and access to ISK funds from the issuers

Emergency Act: main features

- Special Measures of the FSA (FME)
  - Powers of Shareholders’ Meetings
  - Taking over Operations
  - Disposing of/or Merging
  - Appointment of Resolution Committee

- Deposit Guarantee Scheme
  - Priority of Claims

Securing continued banking operations

- Fundamental need to ensure continued banking operations in the country
  – On the basis of an emergency law passed by the Parliament on 6 October 2008, the FME (Icelandic FSA) intervened in the three banks, at the requests of the banks' boards
  – Statement from the Government that all deposits in Iceland were guaranteed
- The banks were not split according to the "good/bad bank" methodology

Domestic operations put into new banks

- Each of the three major banks was split into a new bank and an old bank. The new banks consist of domestic operations, funded by local deposits

Old
(foreign)

New
(domestic)

- Holding companies of the old banks now hold a majority stake in two of the new banks

Crisis management – some lessons learned

- Excessive expansion had to be nipped in the bud
- Essential to have clear overall responsibility, coordination of authorities and will to act
- Contagion effects on financial institutions and corporate sector are cumulative, hard to predict and have varying time lags leading to bouts of instability
- Expect ringfencing by foreign authorities and forced asset sales of operations abroad when banks fail
- Cross- border crisis arrangements are feeble and cross-border banks better not fail
- Deposit Guarantee Schemes severely flawed and do not correspond with the single EEA passport

Deposit Guarantee Schemes

- “The crisis has demonstrated that the current organisation of DGSs in the Member States was a major weakness in the EU banking regulatory framework”

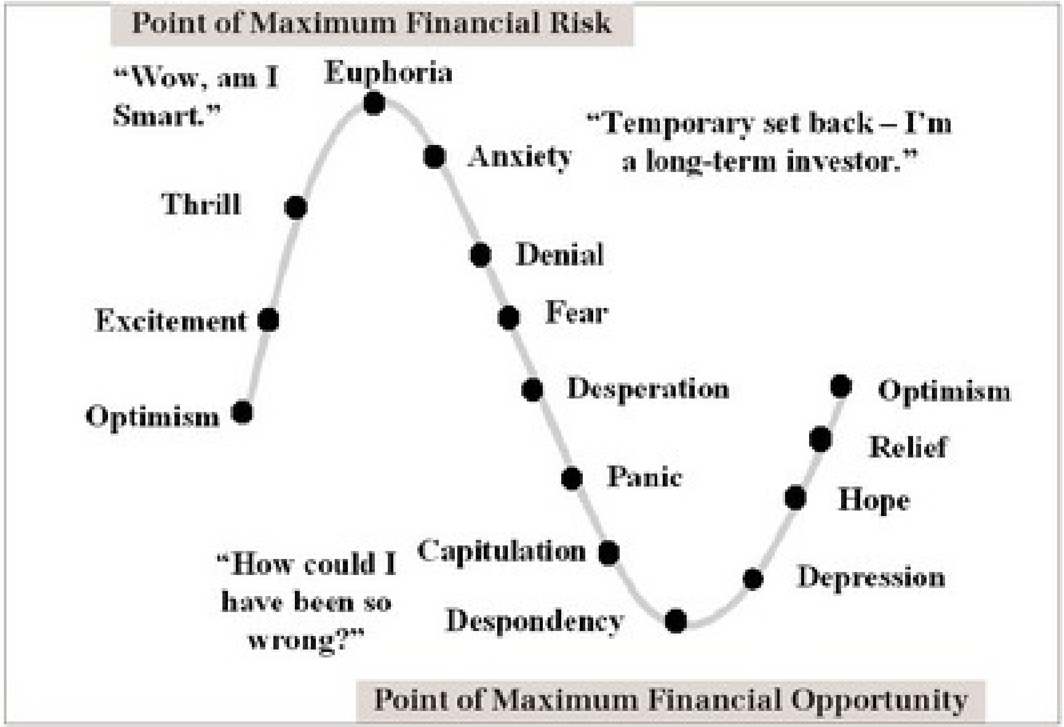
  De Larosière report, February 2009

- “The insolvency of Landsbanki therefore illustrates a weakness in the current European approach to a single market in retail banking.[...] The approach to bank branch passporting rights, at least as they apply to branches conducting retail business, therefore requires review. Options for change could include:
  - Increased home country power
  - Increased European coordination.”

  The Turner Review, March 2009

Coping with a banking crisis

The Revival



Political repercussions

- Former government replaced in February 2009 by a minority government. Elections held in April 2009 and a majority government formed.
- Change in Central Bank Act; Board of Governors replaced by a Governor, Deputy Governor and MPC
- Replacement of FSA Director and Board and principal Permanent Secretaries of Ministries
- Special prosecutor appointed, investigations ongoing in numerous cases
- Parliament appointed an Investigative Committee which in April 2010 delivered its report http://rna.althingi.is/

Strengthening of supervisory practices

- The government engaged Kaarlo Jännäri, the former Director General of the Finnish FSA, to assess the regulatory framework and supervisory practices and to propose necessary changes
  - Framework of liquidity management, connected lending, large exposures, cross-ownership and the “fit and proper” status of owners and managers
- The assessment was completed in March 2009 and was made public

Main recommendations by Kaarlo Jännäri

- Kaarlo Jännäri summarises his major recommendations in eight points as follows:
  - **Decrease the number of ministries** that have a hand in financial market legislation or are otherwise **involved in the financial markets**.
  - **Merge the CBI and the FME,** or at least bring them under the same administrative umbrella (as in Finland and Ireland).
  - **Give more discretionary powers to the FME** and encourage it to use its powers more forcefully.
  - **Create a National Credit Registry at the FME** to diminish credit risks in the system and to provide a better overview of large exposures at the national level.
  - **Lay down tougher rules and, subsequently, apply strict practice on large exposures, connected lending and quality of owners,** using discretionary best judgment when necessary.
  - **Conduct more on-site inspections** to verify off-site supervision and reports, particularly on credit risk, liquidity risk and foreign exchange risk.
  - **Review and improve the deposit guarantee system,** closely following the developments within the EU.
  - **Participate actively in international cooperation on financial regulation and supervision,** particularly within the EEA and EU.

IMF programme

- A 2 year Stand-By Arrangement (Nov.´08); extended for 6 months after first review (Oct.'09) was held up as settlement on the "Icesave" cross-border deposit insurance issue was a precondition for funding. Third review pending
- The focus of the programme was on three key challenges:
  1. Preventing a further sharp króna depreciation
     - Capital controls were established on 28 November 2008 and will be maintained for the time being
  2. Ensure medium-term fiscal sustainability
     - Taxes have been raised and expenditure cut
  3. Developing a comprehensive bank restructuring strategy
     - Includes measures to ensure fair valuation of assets, maximize asset recovery and strengthening of supervisory practices

Foreign Exchange: Capital Contols

Capital Contols

- Protect the Current account
- Limit the Capital account
  - Residents blocked
  - Non-residents limited to transactions with non-residents
- Limitations on cross-border transfer of krónur
- Oct 2009: the first phase of the liberalisation strategy was implemented, as controls were lifted on new investment

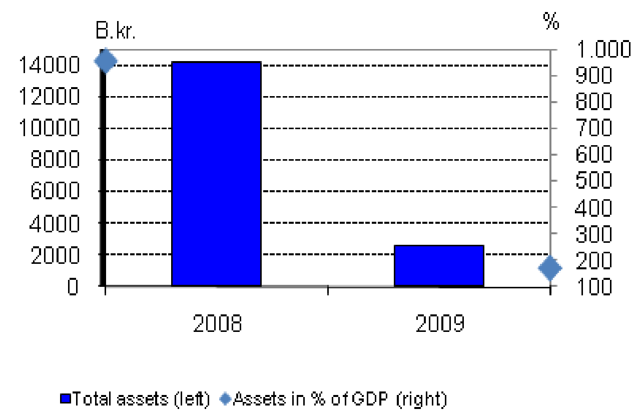
Liberalisation strategy

- Timing based on preconditions
  - A significant reduction in the perceived risk of investments in Icelandic assets is a precondition for removing the capital controls.
    - implementation of macroeconomic stabilisation package
    - Strong financial sector
    - Adequate reserves

The banking system in 2010

- The banking sector
  - The banking system is now much smaller than in 2008 (roughly 2 x GDP)
  - Four commercial banks with domestic operations
    - 87% of the banking system
  - Smaller savings banks
    - 10 savings banks operating
  - The majority of the banking system is now foreign owned

Picture V-1
Commercial banks total assets, % of GDP[1]



1. Commercial banks' parent companies, Sept. 2008 and Dec. 2009.
Source: Seðlabanki Íslands

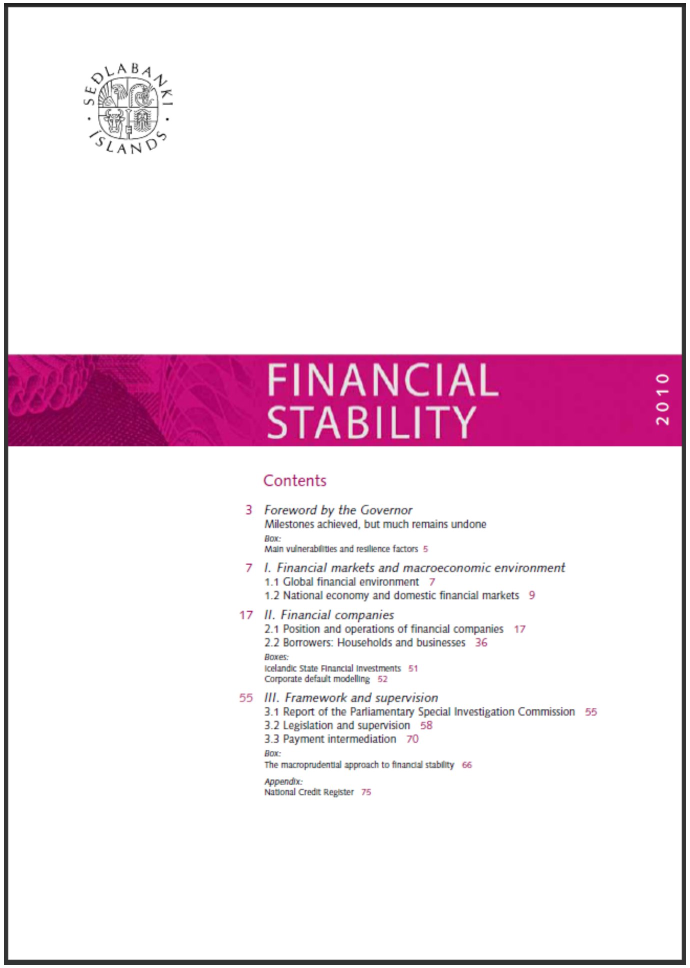
Icelandic State Financial Investments (ISFI)

- Icelandic State Financial Investments (ISFI)
  - Established in August 2009 with a sunset after 5 years
  - Started to operate in January 2010
  - Manages the state's holdings in financial undertakings
    - in accordance with the law, good governance and business practices and the state's ownership policy at any given time.
  - Allots funds to financial companies on the state's behalf
    - in accordance with Treasury budget allocations.

Assessment of the system

- Financial stability report published 2 June 2010
  - Assessment of main vulnerabilities and resilience factors of the financial system

http://sedlabanki.is/?PageID=1101


SEDLABANKI ÍSLANDS

FINANCIAL STABILITY

2010

Contents

Financial stability report 2010

- Main vulnerabilities
  - Uncertainty regarding banks' asset quality
    - Further write-offs
  - A part of the banks' deposits is likely to be transferred into other forms of investments when the opportunity arises
    - Capital controls
    - Markets have been weak with few investment opportunities
  - Regulatory framework and supervision
    - Reform takes time

Table 1 Main vulnerabilities

Risk	*Explanation*
DMBs' asset quality	The assessment of the banks' and savings banks' assets is still subject to considerable uncertainty. Assets are largely foreign-denominated and indexed, while liabilities are in Icelandic krónur and at variable interest rates. These imbalances must be addressed. Write-offs are certain to increase because of operational difficulties and reduced asset prices. The economy has contracted, and the position of businesses and households is weak. Restructuring of loans to businesses and households will become increasingly prominent in the months to come.
Financing	Deposits are foundation for banks' and savings banks' funding, and some of then could prove mercurial. Substantial transfers could ensue when the capital controls are lifted and new criteria for deposit insurance are implemented. The interbank, bond, and equity markets are weak. Foreign direct investment and access to foreign credit markets remain extremely limited.
Flaws in regulatory framework and supervision	The collapse revealed a number of flaws in regulatory framework and financial supervision. Correcting them will take time. A strategy to combat systemic risk has yet to be formulated, as has the institutional framework for such a strategy. A number of legal issues are awaiting resolution, creating uncertainty about matters such as the legality of linking financial instruments to the exchange rate.

Financial stability report 2010

- Resilience factors
  - Economic outlook
  - Smaller revitalised financial system
  - Tighter supervision and closer co-operation
    - Revision of regulatory framework

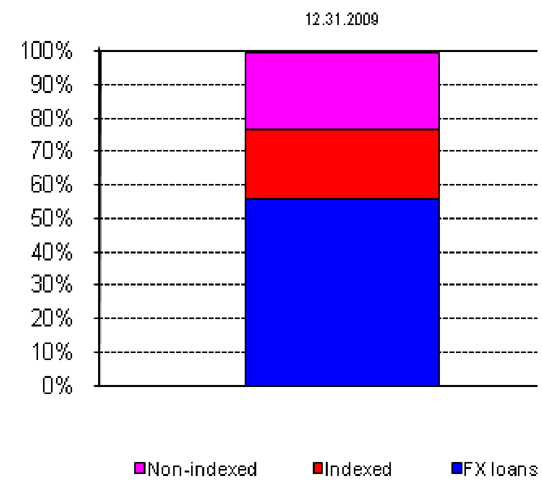
Table 2 Resilience

Resilience	*Explanation*
Economic outlook	The economic programme of the Government and the International Monetary Fund (IMF) has delivered exchange rate stability and fiscal consolidation. The Treasury is taking on an enormous burden due to the collapse, but the resulting debt will be manageable when growth returns. Adjustments in imports and exports have created a trade surplus.
Revitalised financial system	The reconstruction of the financial system is well advanced. The current banks' and savings banks' activities are small in scope compared to those of their predecessors, but there is still a need to stream-line by cutting costs and merging financial institu-tions. The banks' operations now centre on service to domestic firms, institutions, and households.
Institutional and supervisory framework and payment systems	Work is being done to improve the EU/EEA regulatory framework over the next few years. Corresponding improvements will be implemente in Iceland. However, regulatory framework and super-vision of systematic risk have yet to be developed fully. Financial supervision is being tightened, and co-operation between the Central Bank and the Financial Supervisory Authority must be re-examined. Payment systems have withstood the strain, and work to ensure their security and efficiency continues.

Supreme Court ruling on foreign currency denominated loans

- Illegal to index-link loans to exchange rates of foreign currency but straight foreign currency loans are legal(16 June ‘10)
- Lowest ISK interest rates published by the CB should be applied to these contracts (16 Sept ‘10)
- Financial companies face loss of equity but the financial system will be able to cope with that

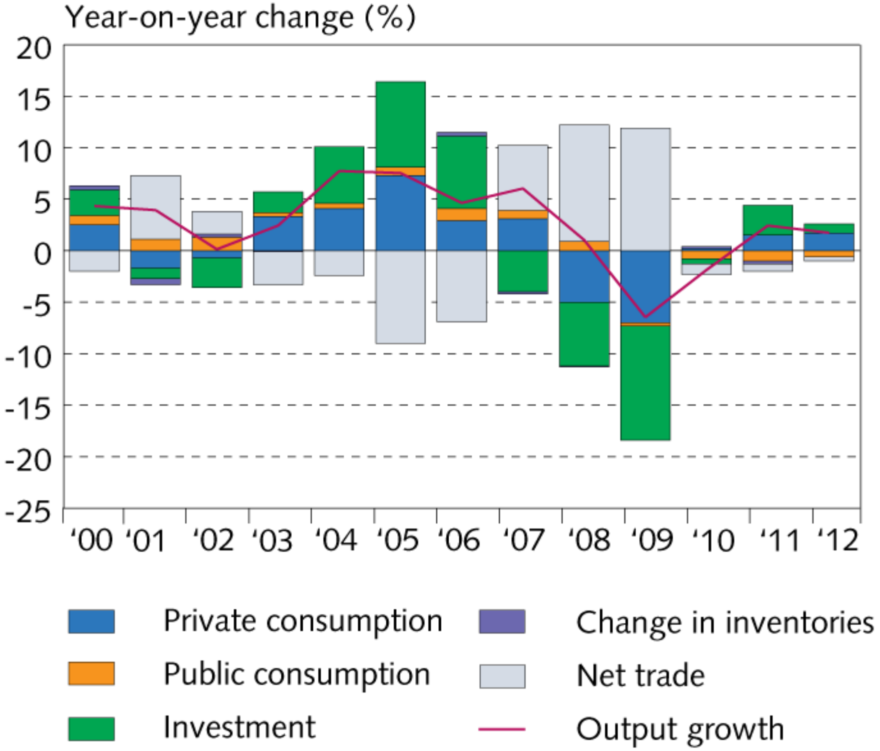
Picture V-3
Loan categories[1]



1. Commercial banks parent companies. 2009
Heimildir: Central bank of Iceland

Economic growth

Output growth and contribution of underlying components 2000-2012[1]



1. Central Bank baseline forecast 2010-2012.
Sources: Statistics Iceland, Central Bank of Iceland.

Iceland: Strengths and Weaknesses

- Weaknesses
  - Cyclicality/volatility
  - Inflation management remains a challenge
  - Relatively high public debt after financial crisis

- Strengths
  - Relatively fast growing
  - Efficient infrastructure
  - Rich energy resources
  - Strong pension funds
  - Young, educated and well motivated people

Iceland is on the road to recovery ...

- …but, many steps needs to be taken

No need to despair as:

"Success is the ability to go from one failure to another with no loss of enthusiasm".

Sir Winston Churchill