Seðlabanki Íslands

Lessons from Icelandic households' risky ride on the credit carousel

Conference on Consumption, Credit, Health and Welfare
Session: Financialisation and Welfare – A Nordic perspective
Lund, 22 May 2015

Thorvardur Tjörvi Ólafsson
Senior Economist, Central Bank of Iceland

The opinions expressed herein are those of the author and do not necessarily reflect the opinions or policy of the Central Bank of Iceland.

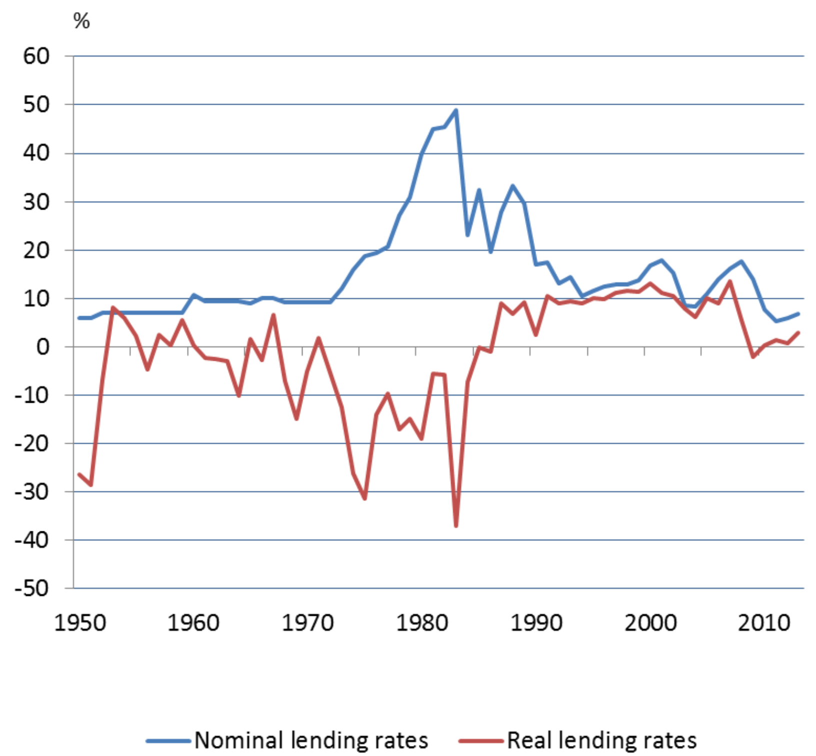
Introduction

- Financialisation is the focus of this conference
- It can be claimed that Iceland is a poster child of too rapid and extensive financialisation of a welfare state gone bad
  - – I will discuss the household sector but this was of course far more extreme in the case of other sectors within the economy
- The presentation is partly based on a working paper co-written by my colleague Karen Áslaug Vignisdóttir – paper available at the Central Bank website

Historical background

- During most of the 20th century, Icelandic households' access to credit was limited as the country's credit system was characterised by substantive state control, real interest rates were negative for years (decades even) and credit was channelled to specific sectors at discount rates
- If access was granted, households had strong incentives to make use of the opportunity

Domestic bank interest rates

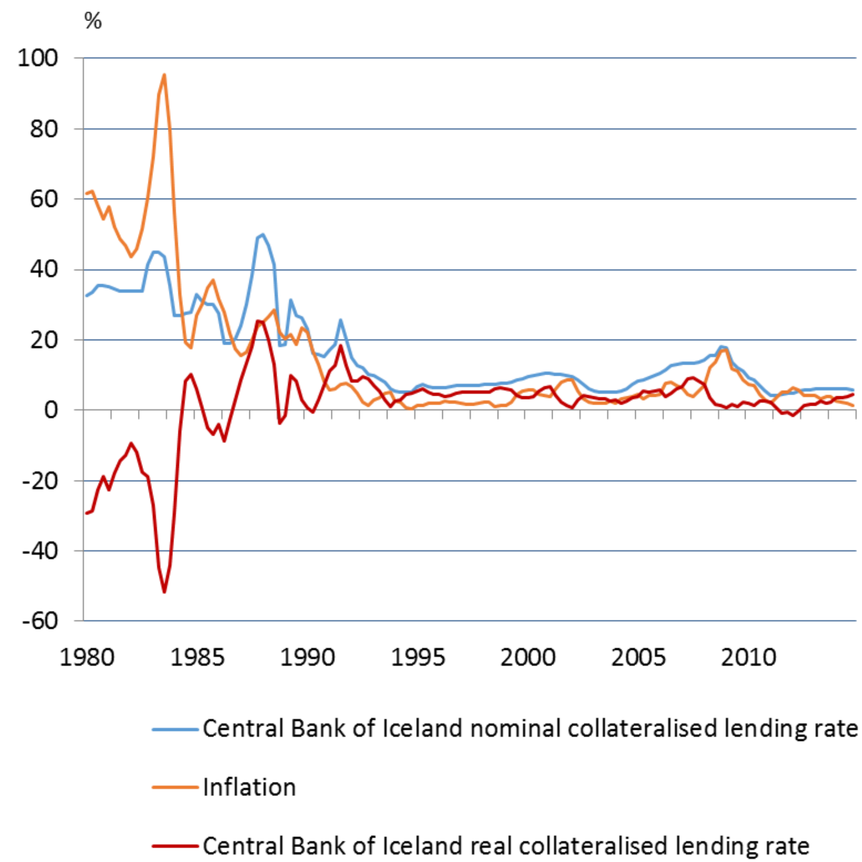


Sources: Icelandic Historical Statistics, Statistics Iceland, author's own calculations.

Historical background

- CPI indexation of loans introduced in late 1970s as savings was decreasing rapidly, market interest rates introduced in mid-1980s, and the chronic high inflation reigned in during the late 1980s and early 1990s
- Some financial distress among households during this period

Central Bank of Iceland key lending rate and inflation 1980-2014



Sources: Central Bank of Iceland, Statistics Iceland, author's own calculations.

Lesson #1: Design of policy measures

Liberalisation of domestic financial markets

- Liberalisation of financial markets and institutions took place later in Iceland than in most other advanced economies …
- … and in line with other countries’ experience such liberalisation led to expansion of banks’ balance sheet and increased domestic credit extension

Global liquidity abundance

- In Iceland’s case, the domestic liberalisation coincided with exceptional circumstances on international financial markets and the newly privatized Icelandic banks rode the wave of global liquidity abundance

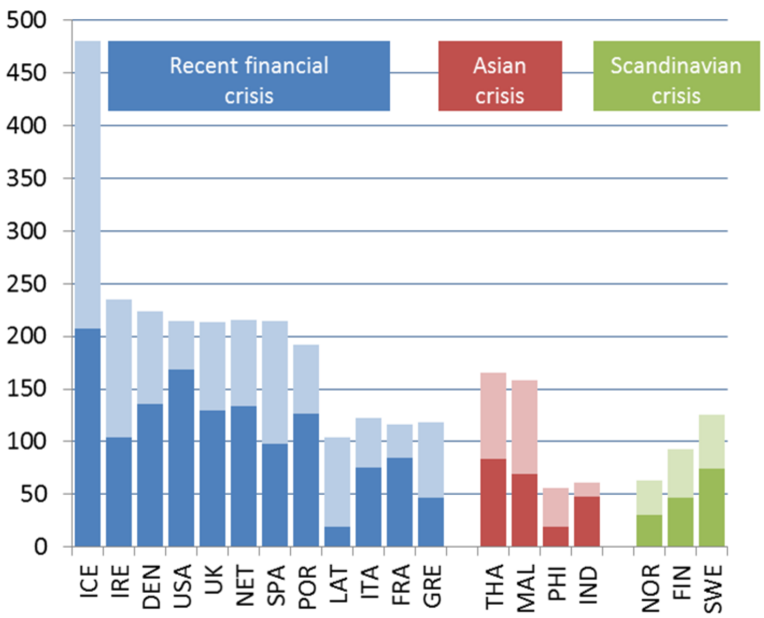
Changes to the mortgage financing system

- In addition, the Icelandic government concurrently introduced important changes to the Housing Finance Fund (the most important mortgage lender within Iceland), substantially increasing households’ access to credit despite warnings from the Central Bank

Credit and asset price boom-bust

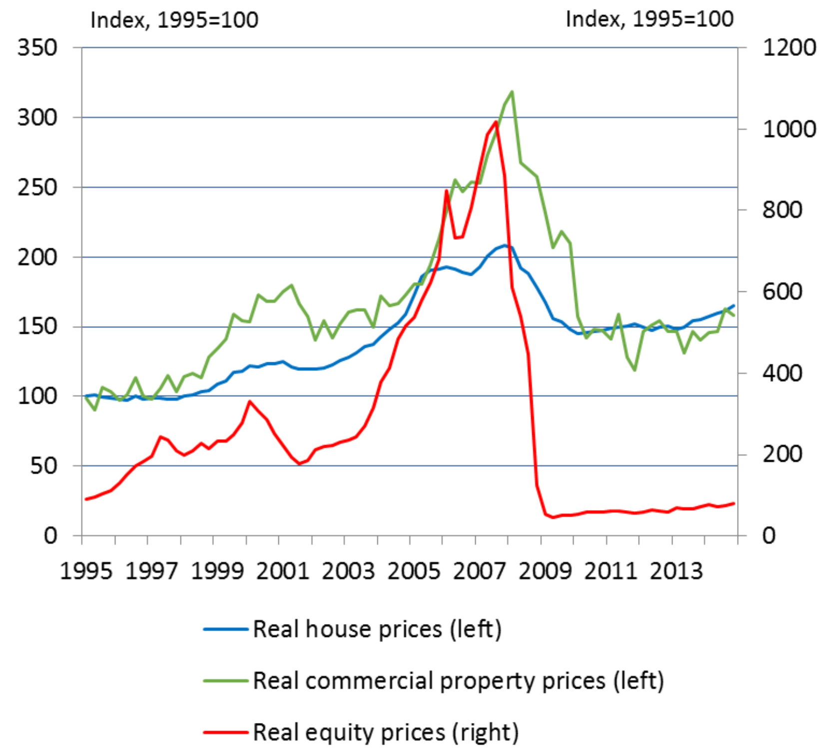
- These changes fuelled a strong boom in credit and assets prices, which turned into bust as the large cross-border banks in Iceland collapsed within a week in early October 2008
- What followed was extensive analyses on households' position, a lengthy process of debt restructuring, and a sequence of government-led household relief measures

Figure 1.4
Domestic credit to the private sector in the run-up to three financial crises[1]



1. Darker-shaded bars show the debt level of the non-financial private sector in 2000 in the current crisis, 1990 in the Asian crisis, and 1980 in the Scandinavian crisis. Lighter-shaded bars show the increase in debt to the peak level during the crisis.
Sources: Macrobond, Central Bank of Iceland.

Figure 1.5
Asset prices in the run-up to the financial crisis[1]



1. Quarterly data.
Sources: Central Bank of Iceland.

Lesson #2: Importance of reliable data

In the run-up to the crisis

- The Central Bank of Iceland had mainly access to aggregate data
- Incomplete samples of household-level data were only available with a 2-year lag and firm-level data was limited to a few listed companies
- The balance sheet expansion was clear from the available data, but the build-up of vulnerabilities and increased risk were only partly observable

When the crisis hit

- Serious lack of data to assess the effects of the crisis on borrowers' financial position and advice policy makers
- Shocks to private sector balance sheets described as "the perfect storm"

Post-crisis

- Nationwide household-level database and an extensive firm-level database built in 2009 by the Central Bank in response to the crisis but the analysis only extends to end of 2010
- Ongoing efforts to structure data gathering for households

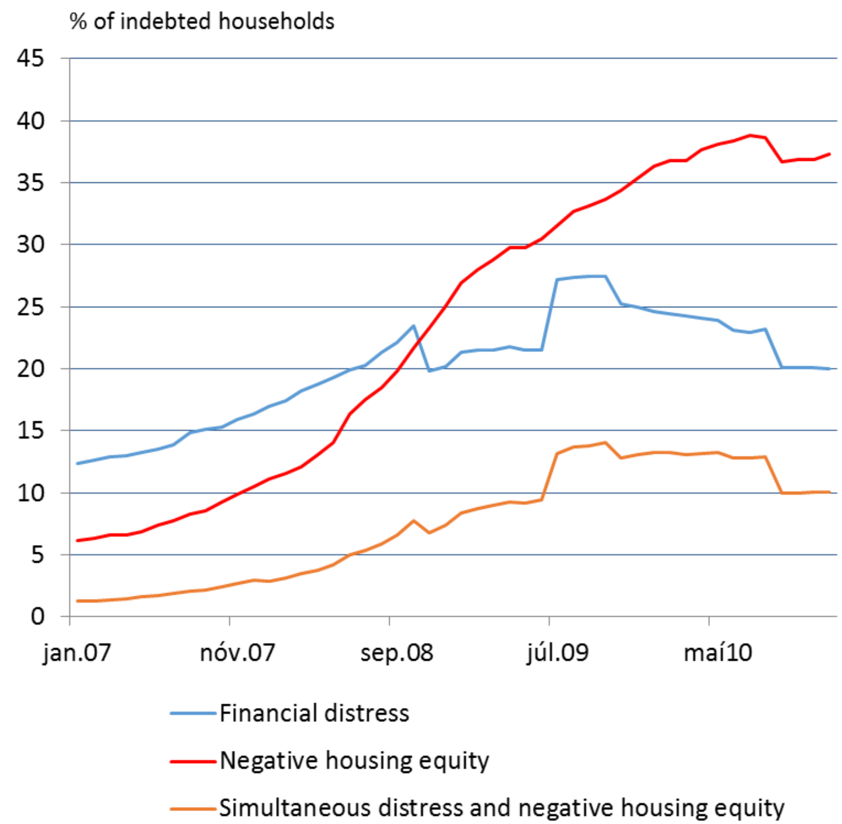
Lesson #3: Type of problem, characteristics, and design of solutions

- Financial distress
- Over-indebtedness
- Distress and over-indebtedness

Financial distress and over-indebtedness

- Financial distress more likely to lead to bankruptcies than negative housing equity
- Households in both distress and negative housing equity are most likely to default
- Focus of relief measures

Financial distress and negative housing equity among Icelandic households 2007-2010

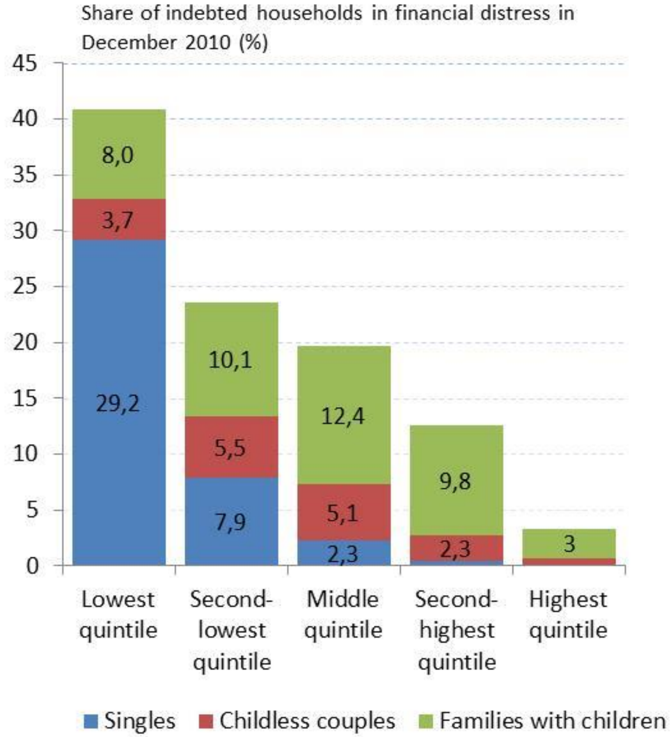


Source: T.T Ólafsson and K.Á. Vignisdóttir (2012). Households' position in the financial crisis in Iceland. *Central Bank of Iceland Working Paper* no. 59.

Characteristics of vulnerable households

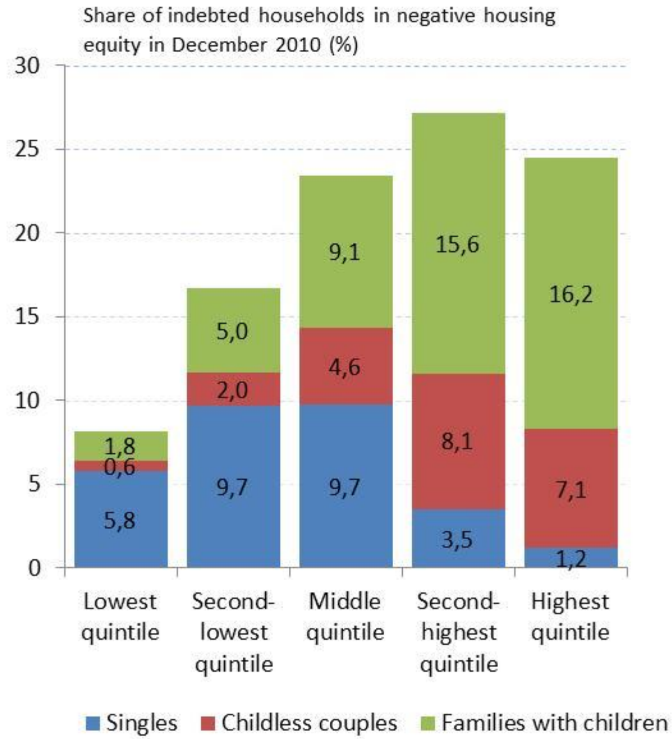
- Roughly a third of households in distress at year-end 2010 were middle-income families with children, while 37% were low-income singles
- Almost half of households in negative housing equity were high-income families while one-in-six were low-income singles

Figure 5.3a
Composition of households in financial distress in December 2010 by income and family type[1]



Source: Central Bank of Iceland Household Sector Database.

Figure 5.3b
Composition of homeowners in negative housing equity in December 2010 by income and family type[1]



Source: Central Bank of Iceland Household Sector Database.

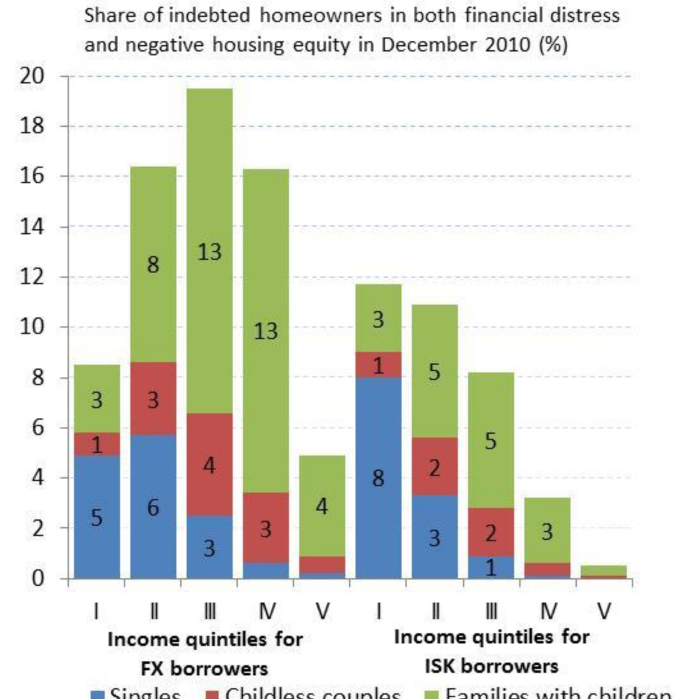
Characteristics of vulnerable households

- Just shy of 47% of households in simultaneous payment and debt problems were middle-income families with children, of which 2/3 were FX borrowers
- Roughly 22% of households in this highly vulnerable position were low-income singles, split evenly between being FX and ISK borrowers

Figure 5.3c
Composition of homeowners in financial distress and negative housing equity by income and family type[1]

Source: Central Bank of Iceland Household Sector Database.

Figure 5.3d
Composition of homeowners in financial distress and negative housing equity by currency-denomination of debt, income and family type[1]

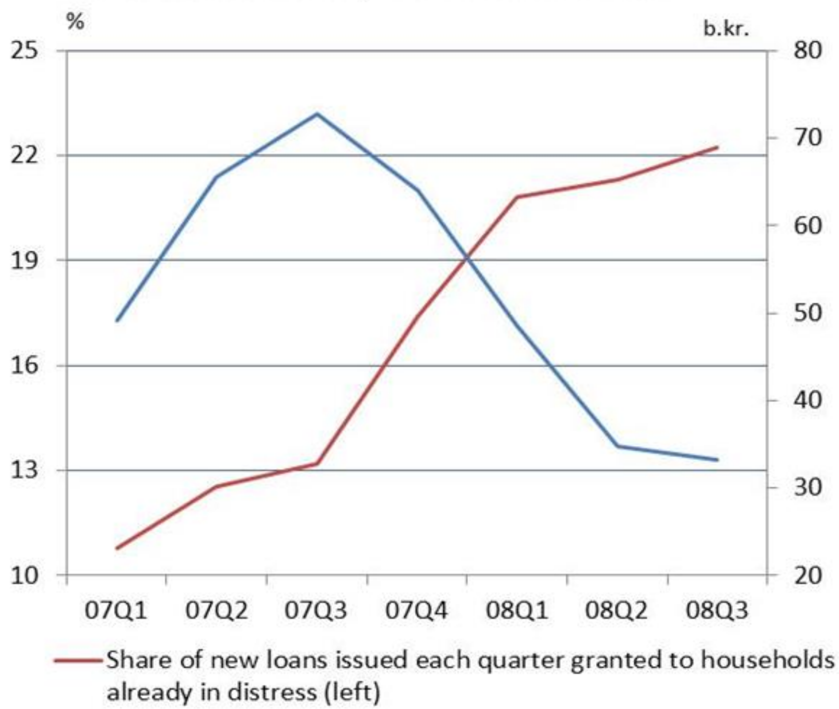


1. I-V represents the income quintiles within each borrower group, from the lowest (I) to the highest (V).
Source: Central Bank of Iceland Household Sector Database.

Lesson #4: Credit policies can change fast

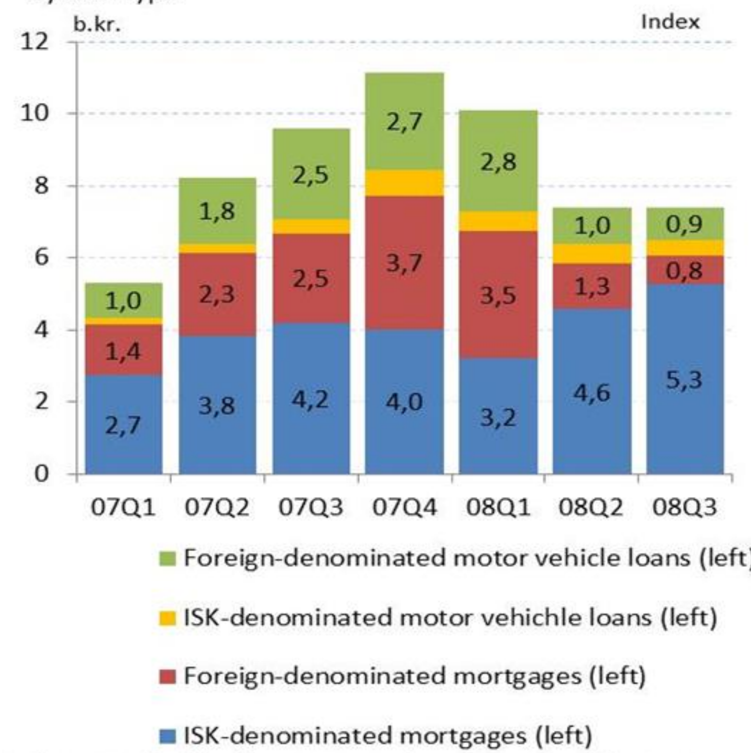
- Our analysis indicates that 16% of the total sum of new loans in January 2007 – September 2008 was granted to already distressed households, mainly reflecting increased risky FX lending to already distressed low- and middle-income households
- A third of household in distress in 2010 were in that group

Figure 5.5a
Share of the sum of new loans in the run-up to the banking collapse granted to households already in financial distress[1]



Source: Central Bank of Iceland Household Sector Database.

Figure 5.5b
Loans granted to households already in financial distress at the time of issuance[1]
By loan type



1. The sum of original loan amount in each quarter of loans to households already in distress in the last 6 months prior to issuance.
Source: Central Bank of Iceland Household Sector Database.

Lesson #5: Debt restructuring framework

- Debt restructuring involves deciding how to distribute the burden from a systemic crisis
- This is a daunting task and the tendency is often to wait and hope that it will self-correct
- Experience shows that there are some key factors important for the success of debt restructuring involving direct collaboration between borrowers and lenders:

Capital position of banks

- The most common mistake is to inject too little capital into the banking system during recapitalisation, resulting in cosmetic restructuring

Incentives provided by the institutional framework

- Bankruptcy laws, accounting rules and out-of-court schemes

Relationship between creditor and debtor

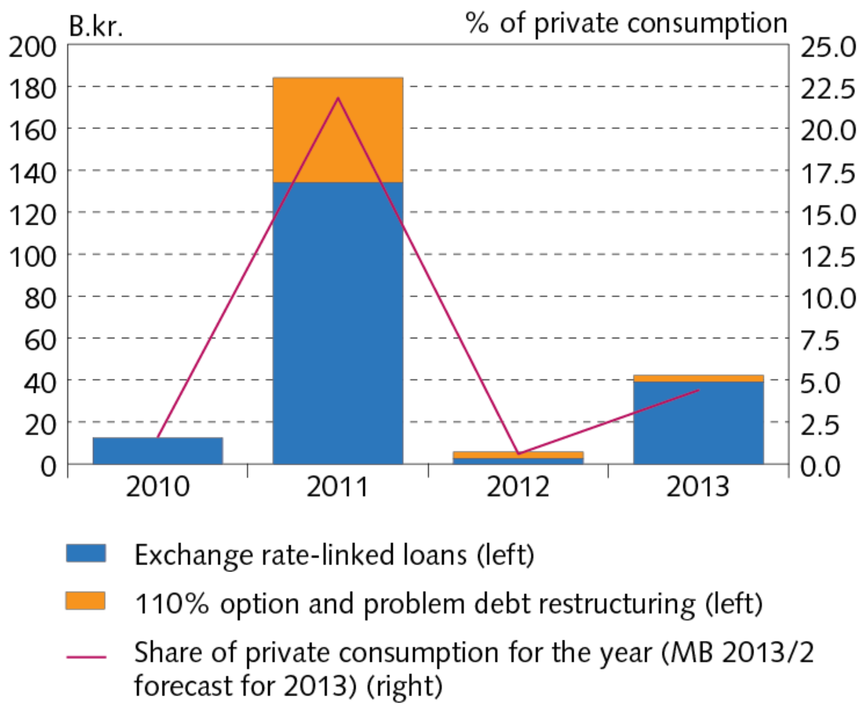
- It is important to ensure that links between the borrower and the lender – whether these are business connections, ownership ties, or family or friendship ties – do not have a detrimental effect on debt restructuring

Lesson #6: Management of expectations in relation to relief measures

Extent of measures

- After various efforts to introduce relief measures, household debt continued to be a highly political issue and new measures were introduced after the last general elections in 2013

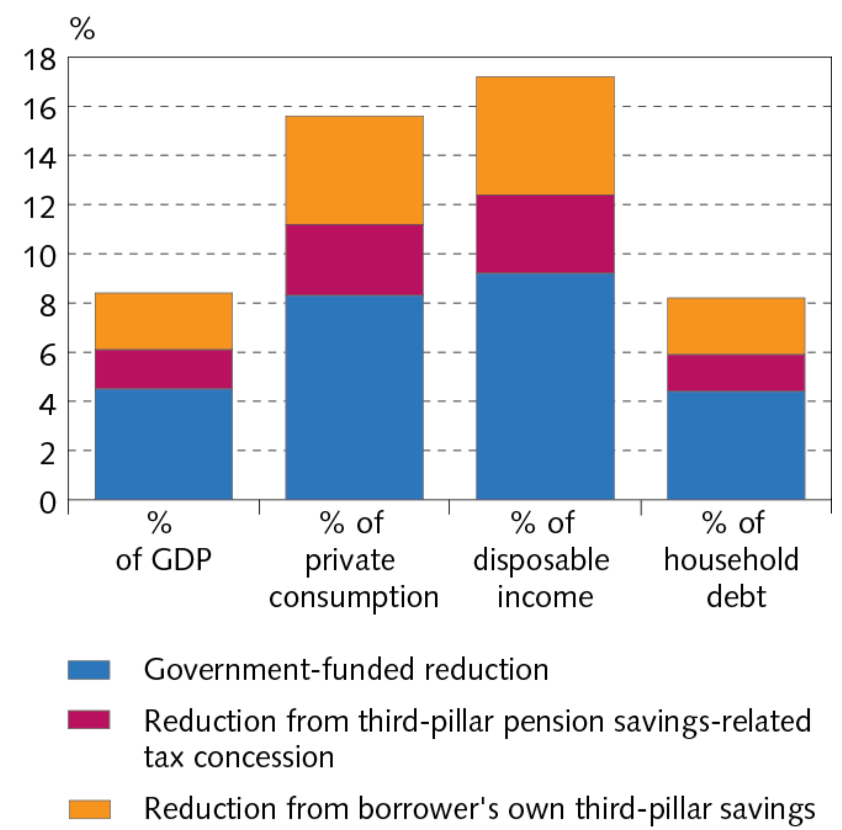
Post-crisis write-downs of household debt



Sources: Icelandic Financial Services Association, Statistics Iceland, Central Bank of Iceland.

Scope of debt relief measures

Percentage of estimated economic variables 2013



Sources: Prime Minister's Office (2013), Central Bank of Iceland.

Conclusions – overview of some lessons

- Design of liberalisation and credit enhancing measures
- Access to reliable and detailed enough data
- Identification of type of problems and characteristics of vulnerable households
- Credit policies and lending practices can change fast
- Design and implementation of debt restructuring and debt relief measures
- Regulatory framework, tax incentives, and policy implementation