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Preserving the credit of the sovereign through a financial sector meltdown – the case of Iceland

Már Guðmundsson, Governor of the Central Bank of Iceland, Speech at Banque de France, International Monetary Seminar 2013: Sovereign Risk, Bank Risk and Central Banking, Paris, 8 July 2013.

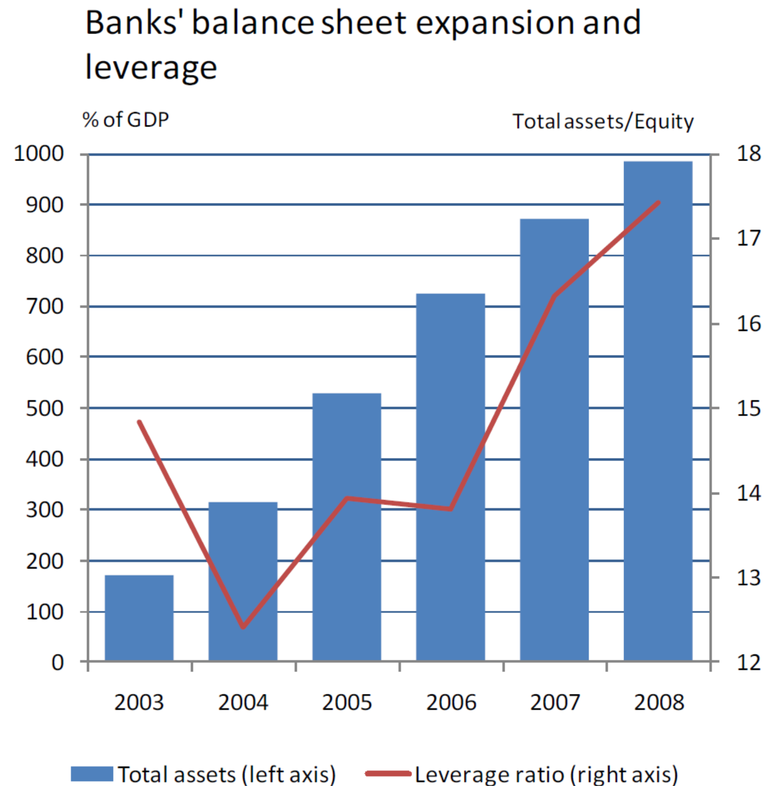
I would like to thank Banque de France for inviting me to speak at this interesting seminar.

This session is on resolving sovereign debt crises and the relative roles of the public and private sectors in that process. My comments will obviously be based on my own country's experience during the financial crisis, which is a case of a sovereign debt crisis being avoided in spite of the meltdown of a large part of the financial sector and the country's deepest recession since the interwar period. That result was achieved by relatively good fiscal position prior to the crisis, by a refusal – based on need rather than stubbornness – to rescue private cross-border banks with public money, and by on-going medium-term fiscal consolidation that was an important part of the economic programme developed in cooperation with the IMF. The bottom line is that all sovereign obligations have been honoured; the sovereign has maintained investment-grade credit ratings and market access.

In order to distinguish between the parts of this story that provide lessons that are applicable to the rest of the world and those that do not, we need to get some of the facts straight, because to this day there are still several misconceptions floating around about what was done in Iceland during the crisis.

The collapse of Iceland's three cross-border banks in early October 2008 was the most noticeable event in the unfolding of the financial crisis. The combined balance sheet of these banks was 10 times Iceland's GDP (see Figure 1), and their combined bankruptcy, measured in terms of balance sheets, ranks second in size in the international history of corporate failures, only after Lehman Brothers. And this happened in a country that ranks among the smallest in the world! We are still dealing with the complications that this entails, as can be seen in our overblown and unbalanced IIP and the controls on capital outflows.

Figure 1



Source: Central Bank of Iceland.

Before the collapse, the banking system had expanded very rapidly, growing in just five years from a combined balance sheet of less than 2 times GDP at the end of 2003 (see Figure 1). Most of this expansion was cross-border, and a significant part of it was actually off-border, having very little to do with Iceland, as both financing and investment took place abroad. Around two-thirds of the balance sheet of the three cross-border banks was denominated in foreign currency. As is typical for banks, the FX part of the balance sheet had a significant maturity mismatch. However, there was no safety-net of the type that we have at the national level to back it up. This turned out to be the fatal flaw in the whole setup.

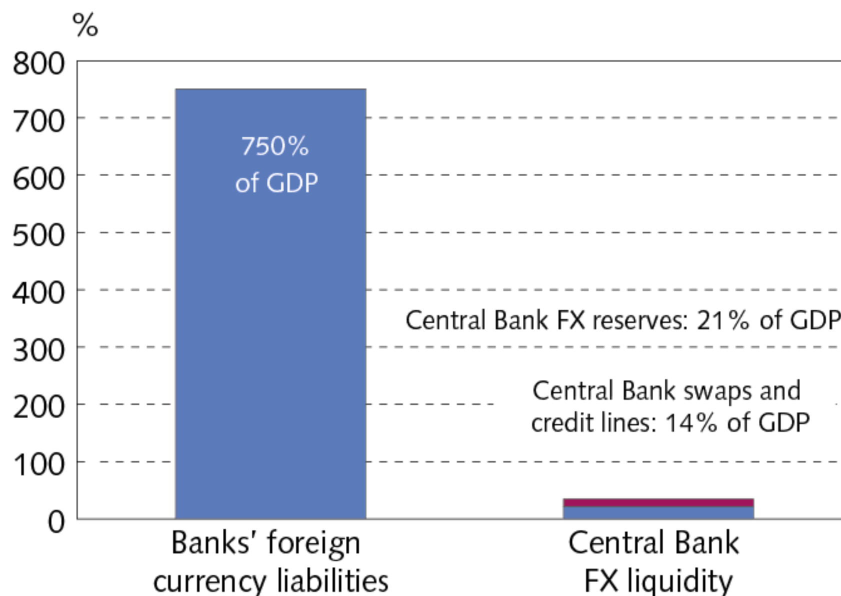
Why were these big risks allowed to build up? I do not think we yet have the research and the consensus to provide a reasonably undisputed list of the main causal factors in this process; however, I think four factors will rank highly on that list. The first of them is Iceland's membership in the European Economic Area (EEA) beginning in 1994, which made it possible for the banks to operate more or less freely throughout the area on the basis of home licencing but with

national supervision, safety net, and crisis management and resolution. The other three causes are the privatisation of the Icelandic banking system in the early 2000s in a manner that placed the major banks in the hands of risk-loving investment bankers, the global conditions of ample and cheap credit that prevailed in the years prior to the international financial crisis, and the tendency in Iceland both to adopt international and EU regulations without critical analysis of Iceland-specific risks and to base supervision to a significant degree on mechanical checks of adherence to those regulations.

In the panic that gripped global financial markets after the collapse of Lehman Brothers, these banks were faced with a wholesale run on their foreign currency liabilities and were therefore heading towards a default on those liabilities in the absence of LOLR assistance in foreign currency. However, given the size of the banks, it was impossible for the Icelandic authorities to provide such assistance on their own.

There was actually a plan to nationalise one of the banks in late September 2008. Fortunately it failed, as nationalising the bank would have turned a private bank's foreign currency refinancing problem into a sovereign problem, with the serious risk that the sovereign might have defaulted on such foreign currency payments, thus initiating a full-scale sovereign debt crisis. Figure 2 gives a sense of the potential scale involved in the case of the three banks, by comparing the foreign currency liabilities of the banks and the Central Bank's FX liquidity at the time.

Figure 2



Based on published financial accounts and the analysis of the supervisor, the Icelandic authorities assumed that the banks were solvent. On that premise, the authorities tried to build defences against potential foreign currency liquidity problems at the banks by negotiating swap lines and tapping foreign capital markets, in both cases with limited success. Now, however, we know that there were hidden vulnerabilities in the banks' capital positions.

However, given the lack of international cooperation, the Icelandic authorities were forced to consider radical solutions. Although they were not necessarily articulated fully at the time, these solutions entailed several goals: preserving a functioning domestic payment system, ring-fencing the sovereign in the case of bank failures, limiting the socialisation of private sector losses, and creating the conditions for rebuilding a domestic banking system.

In essence, the adopted solution saved the domestic operations of the banking system and let the international part to go into a resolution process. The new banks were created by carving the domestic assets and liabilities out of the old failing banks. The idea was then that the Government would recapitalise the banks and place compensation bonds in the estates of the failed banks. However, valuing the assets and liabilities proved a complicated process in the middle of an economic and financial crisis, and a solution emerged where the estates of the failed banks became majority owners of two of the banks and kept a small equity stake in the third, which was otherwise recapitalised by the Government. The new banking system amounted to 1.7 times GDP.
In order to stop an incipient run on domestic deposits, all deposits in Iceland were declared safe and all deposits in Icelandic-headquartered banks were given priority over other unsecured claims, including the deposits of the Icelandic banks in branches abroad.

As a result of these measures, the domestic payment system functioned more or less seamlessly throughout, and there was uninterrupted access to deposits in Iceland. The run on the domestic banks stopped, but at its peak, demand for cash tripled and the Central Bank almost ran out of banknotes. International payment flows were seriously affected, however, not least because of the freezing order imposed by the British authorities on Icelandic banks, but also because of a general distrust among foreign counterparties.

Why did the Government give a verbal blanket guarantee for domestic deposits only and not for deposits in the banks' foreign branches? After all, this distinction probably added fuel to the fire of the so-called Icesave dispute about the settlement of deposit guarantees in Landsbanki's Dutch and British branches. The short answer is that such a guarantee would never have been credible. As a result, it would not have stopped the run on these deposits and, if attempted, might have bankrupted the Government. At the time, the Central Bank of Iceland's FX reserves amounted to 2½ billion euros, while the foreign currency deposits in Landsbanki's Dutch and British branches totalled 11½ billion euros and payment of the EU minimum deposit insurance would have required 4½ billion euros. The sovereign was completely closed off from

foreign capital markets at that point. Furthermore, in economic terms, given that these deposits were used to a significant degree to finance illiquid assets in these same countries, such a payment, if possible, would have amounted to a net transfer of resources from Iceland to these countries at a time when Iceland was going through its deepest financial and economic crisis in the post-war period! That made no sense.

The only possibility of a speedy pay-out of deposit insurance in order to contain contagion was for the authorities in the host countries to pay it and leave the issue of settlement with Iceland for a later date. And this was what they did.

From the beginning, there were legal arguments about the merits of such claims. In spite of that legal uncertainty, the Icelandic Government took part in several good-faith attempts to reach a negotiated solution. However, it proved impossible to get ratification through the Icelandic political process, in two cases involving referenda. In retrospect, it is clear that the main reason for this was the Icelandic people's unwillingness to shoulder financial liabilities that had not been clearly signed by those mandated to do so on behalf of the nation or proven in a court of law to be sovereign obligations. Instead, these were seen as the debts of reckless private bankers.

Now the EFTA court has ruled that it was indeed not a sovereign liability. In any case, the recovery from the estate of Landsbanki will cover 100% of all deposits in foreign branches. Without the priority given to deposits in the Emergency Act of October 2008, the recovery to be paid to these depositors would be much lower. This case provides important lessons about the design of deposit insurance within the EU and the clarity of wording, or lack thereof, in EU directives.

This case also highlights the link that must exist between deposit insurance and the LOLR function. Part of the rationale is to prevent and stop runs. But at the end of the day, that only works if bank liabilities are flowing to a central bank that has the mandate, willingness, and capacity to recycle them against collateral and expand its balance sheet as needed. This means that, in the absence of arrangements for currency swaps, it must take place mostly in the same currency in order to work.

So the bottom line is that a sovereign default was avoided in spite of an almost unprecedented financial collapse and the worst economic recession since the interwar years. A key to that result was the attempt to ring-fence the sovereign from the collapse of these three cross-border private banks. However, the avoidance of default during such a severe crisis does require the willingness to use the means available to avoid that outcome and the ability to endure the temporary hardship that might come with it.

Even if the Icelandic authorities tried to avoid the socialisation of private sector losses in the case of the collapse of the three-cross border banks, the direct

fiscal costs of the financial crisis were enormous. In this case, it is difficult to distinguish between the cost of the banking crisis and the recession that would nevertheless have occurred in Iceland in 2009, as a result of the unavoidable macroeconomic adjustment following the serious overheating of the economy in 2005-2007. Be that as it may, the direct fiscal costs of capital injections into domestic banks, losses on government guarantees, the blanket guarantee of domestic deposits, and the refinancing of the Central Bank are estimated to have amounted to one-third of year-2010 GDP. The net might turn out to be somewhat lower, however; for instance, there will be some recovery on the collateral of CB lending to failed banks.

Gross government debt went from under a third of GDP before the crisis to a peak of one GDP, and net debt rose from around a tenth to two-thirds. As a result, there was no fiscal space to save banks 10 times GDP, and attempting to do so would have bankrupted the country. Indeed, Iceland had to embark on a medium-term fiscal consolidation programme even as output was still contracting, in order to stop government debt from reaching an unsustainable level and to rebuild the external confidence needed for the sovereign to regain market access. The overall fiscal effort (measured by changes in the cyclically adjusted primary balance as a percentage of potential GDP) amounted to 10 percentage points 2010-13, more than that of Ireland during the same period (although Ireland will overtake Iceland if the expected effort for 2014 and 15 is added). This effort has been sufficient to create a primary surplus and, along with growth in the economy from H2/2010 onwards, to put debt on a downward trajectory as a share of GDP, which is predicted to be 85% gross and below 60% net in 2015. But this has not come without significant pain, and again, would not have been possible if private bank liabilities had been guaranteed more than was needed to keep the domestic payment system and basic banking services up and running.

Let me conclude by summarising some of the potential lessons from this tale:

1. Iceland did not allow its entire banking system to collapse, it did not nationalise its banking system, and it did not default on sovereign debt. So, in spite of what one sometimes hears, the Icelandic case does not teach any lesson on the pros and cons of such measures.
2. Iceland avoided sovereign default through a good initial fiscal position, the ring-fencing of the sovereign as much as possible from collapsing cross-border banks, and a medium-term fiscal consolidation programme. The lesson is to practise fiscal prudence and avoid the socialisation of private sector losses.
3. Iceland protected its domestic payment system and deposits. The lesson might be bail-in, separability in resolution between the public utility element of banking from the rest, and deposit preference.
4. The EU system for cross-border banking is deeply flawed. Existing official reform proposals are a step in the right direction but do not fully address the problems revealed by the Icelandic experience.