Settlement of the failed financial institutions on the basis of stability conditions: impact on balance of payments and financial stability

According to the current draft composition proposals from Glitnir hf., Kaupthing hf., and LBI hf.

Introduction and main conclusions

On 12 March 2012, restrictions were placed on authorisations for distributions in Icelandic krónur from domestic insolvency estates and for payments to non-residents on contractual claims according to composition agreements (cf. the Act on Bankruptcy, etc., no. 21/1991). At the same time, restrictions were imposed on the authorisation of the failed financial institutions' estates to conduct cross-border transfers of foreign currency, which had enabled them to pay their creditors in foreign currency. Since spring 2012, the failed banks' estates have needed exemptions from the Foreign Exchange Act, no. 87/1992, in order to conclude their winding-up proceedings, either with composition agreements entailing foreign exchange transactions and cross-border capital transfers and/or with distributions to foreign creditors.

According to Article 13(o) of the Foreign Exchange Act, no. 87/1992, cf. Article 7 of the same Act, it is the Central Bank of Iceland that grants such exemptions. If an exemption requested for a financial undertaking in winding-up proceedings entails an authorisation to carry out foreign exchange transactions and cross-border capital transfers in an amount exceeding 25 b.kr. in a single year, or if an exemption requested for a legal entity whose balance sheet is over 400 b.kr. in size could have a major impact on Iceland's debt position and could affect the ownership of the commercial banks, the Bank must consult with the Minister of Finance and Economic Affairs and the Minister must acquaint the Parliamentary Economic Affairs and Trade Committee with the economic impact of the exemption before it may be granted; cf. Article 13(o), Paragraph 2 of the Act.

The winding-up boards of the three largest failed commercial banks, Kaupthing hf., Glitnir hf., and LBI hf. (hereinafter referred to as the *estates*), have requested that the Central Bank of Iceland grant them exemptions from the Foreign Exchange Act in connection with the proposed composition agreements with their creditors and the conclusion of the winding-up proceedings for the companies; cf. Article 103(a) of the Act on Financial Undertakings, no. 161/2002. According to Article 7 of the Foreign Exchange Act, exemptions may only be granted from the restrictions provided for in the Act if it is ensured that monetary, exchange rate, and financial stability will not be jeopardised by the winding-up process. In order to ensure that the settlement of the estates does not cause instability, it is necessary to adopt countervailing measures in order to mitigate the adverse effects deriving from distributions of domestic assets to foreign creditors.

The report that follows contains the Central Bank of Iceland's assessment of the effect that winding up Kaupthing hf., Glitnir hf., and LBI hf. will have on monetary and exchange rate stability, on the one hand, and financial stability, on the other, on the basis of the estates' proposals for the conclusion of winding-up proceedings, with reference to stability conditions. The Bank has concluded that the drafts submitted satisfy the requirements set forth in the Foreign Exchange Act, in that the fulfilment of the composition agreements together with the proposed countervailing measures will not jeopardise monetary, exchange rate, or financial stability.

The estates' proposals include a number of mitigating measures that all but eliminate the likelihood of capital transfers that could cause instability. These measures entail the conversion of foreign currency deposits in operating financial institutions to medium-term loans, the prepayment of loans granted by the State and the Central Bank to Arion Bank hf. and Íslandsbanki hf. upon their establishment, and the payment of a stability contribution that, among other things, ensures that low-valued assets on the estates' balance sheets do not cause balance of payments problems if they prove more valuable than originally estimated. A portion of the estates' current króna-denominated assets will be allocated to taxes, expenses, and reserves; therefore, they will not have any adverse effects on the balance of payments. Furthermore, the Central Bank of Iceland Asset Management Company's (ESÍ) foreign-denominated recoveries in connection with the settlement of the estates would counteract the negative impact of settlement on the balance of payments. In addition, the transfer of Glitnir hf.'s holding in Íslandsbanki hf. to the State would dramatically reduce the balance of payments risk connected with the sale of Íslandsbanki. Together with domestic assets already backed with foreign assets, this creates a counterweight to potential outflows from the estates' domestic assets in the amount of 856 b.kr. Excluding domestic assets backed with foreign assets, there remain current and planned mitigating measures equivalent to 807 b.kr. The planned mitigating measures alone total nearly 660 b.kr., assuming that Arion Bank hf. is sold at book value (see Table 1). In addition, it should be noted that the difference between nominal value and book value of transferred assets equals 720 b.kr. If low-value assets prove more valuable than previously estimated, the stability contribution – and therefore the mitigating measures as a whole – will total a larger amount. If recoveries exceed 15% of that difference, the planned mitigating measures increase to about 770 b.kr., and current and planned mitigating measures combined will total 920 b.kr.

Settling the failed banks' estates on this basis does not jeopardise the stability of operating financial institutions. Their króna-denominated liquidity could deteriorate, but within manageable limits, and their foreign-denominated liquidity will improve. The banks' foreign funding will be improved because of conversion and lengthening of foreign-denominated loans.

As regards economic stability in Iceland, the principal benefits of winding up the failed financial institutions according to their proposals, with reference to the stability contributions, are as follows:

- Negative effects on the balance of payments and risks deriving from settlement of the estates are eliminated with the above-mentioned mitigating measures, both current and planned. The negative impact on the balance of payments due to low-value assets and the future sale of Arion Bank and Íslandsbanki is significantly reduced. Current and planned mitigating measures plus domestic assets backed by foreign assets amount to a total of 856 b.kr. Of that total, planned mitigating measures amount to approximately 660 b.kr. but could be much more, as is mentioned above. Including the mitigating measures that have already been implemented (such as the lengthening of the Landsbanki Íslands-LBI debt), the measures amount to 807 b.kr. This is the equivalent of the estates' domestic assets net of those domestic assets that are backed by foreign assets and therefore do not cause a balance of payments problem.

- Iceland's net debt position will improve significantly following settlement on the basis of the stability conditions. Net foreign debt will decline by 3,740 b.kr., and Iceland's underlying international investment position (IIP) will improve by 360 b.kr. as a direct result of the winding-up. After adjusting for other factors and growth in nominal GDP, the debt position is projected to improve from just under a third of GDP this year to less than 10% of GDP by the end of 2016.[1] This does not include the reduction in debt that will occur as a result of the planned auction of offshore krónur, as it is not possible to foresee how much that will be. Iceland's external debt position has not been this favourable in decades.
- The foreign exchange reserves will expand in coming years because of ESÍ's foreign-denominated recoveries and the estates' refinancing of the facilities granted by the Central Bank and the State to the new commercial banks. There will be some offsetting outflows due to króna-denominated assets converted to foreign currency. The overall impact of these factors on the foreign exchange reserves is estimated to be positive by just over 40 b.kr.
- Kaupthing hf., Glitnir hf., and LBI hf. will pay a total of 491 b.kr. to the authorities in the form of stability contributions, tax payments, and ESÍ's recoveries from the three estates. The recoveries will ultimately revert to the Treasury, in accordance with the rules governing financial interactions between the Central Bank of Iceland and the State.
- Because of the transfer of shares in Íslandsbanki hf. and related changes in deductions due to foreign currency inflows, the reserves will grow less next year than they would have under previous proposals. Offsetting this, the balance of payments risk due to the sale of Íslandsbanki hf. no longer exists, and Iceland's net external debt position will be better in coming years than it would otherwise have been because dividend payments from Íslandsbanki hf. to non-residents put less strain on the balance on income.
- Treasury debt will decline, as the stability contribution is to be allocated towards the reduction of Treasury debt, including debt to the Central Bank.[2] Reduced Treasury debt is also conducive to improved access to foreign credit and reduced refinancing risk for both the State and the banks. This will also reduce the risk of balance of payments problems. Credit rating agencies upgraded Iceland's sovereign ratings in July, following the announcement of the liberalisation strategy in June and the creditors' proposals submitted afterwards. The agencies' analysis implies that Iceland's sovereign ratings will improve even further once the composition agreements have been approved.
- The banking system's foreign funding will be lengthened, which also tends to reduce the refinancing risk of systemically important financial institutions, thereby contributing to the stability of the financial system and reducing the likelihood of the monetary and exchange rate instability that refinancing risk can entail.
- Scenarios showing developments in the balance of payments assuming settlement based on the above indicate that, in the absence of economic policy mistakes that derail the domestic economy in coming years, Iceland's IIP could turn positive by the beginning of the next decade; that is, its foreign assets will exceed its foreign liabilities.

[1] The underlying IIP is defined as the IIP excluding the estates and including the estimated external position due to the estates once all assets have been distributed to creditors.

[2] It should be noted that prepaying debt using liquid assets could cause instability unless it is done over a long period of time. Therefore, the Stability Tax Act contains provisions stating that the allocation of the stability contribution shall be subject to the opinion of the Central Bank.

- Granting exemptions on the basis of stability conditions reduces the risk of legal disputes, which could entail long-term balance of payments risks that would delay the removal of capital controls on residents. This risk is not easy to assess, however.
- It is certain that disputes concerning tax issues (bank levy, financial administration tax, etc.) do not entail further capital outflows, which would otherwise total just over 60 b.kr.
- The winding-up boards, on behalf of the failed banks' estates, creditors, and shareholders, submit statements where the companies in question and their estates and creditors irrevocably release the Icelandic authorities from any type of claim or liability to the extent permissible by law.

It is appropriate to emphasise that the amount of the stability contribution and the amount of the stability tax are not comparable. It is necessary to assess the measures entailed in the estates' proposals on the basis of the stability conditions in their entirety and the impact they have on economic stability, and not the amount of the stability contribution alone. The proposed mitigating measures total nearly 660 b.kr. but will probably be higher. In comparison, it should be noted that, based on the estates' most recent financial statement and accounting for exchange rate movements, the stability tax totals 770 b.kr. in all, and 620 b.kr. after adjusting for deductions. Concluding composition agreements on the basis of the stability conditions is much less risky than the stability tax option, as risk is contained with various measures and the risk of legal action will be much less. The amount of the imposed stability tax reflects this risk in part. It is possible that credit ratings would improve more slowly under the tax option, in spite of the positive outcome that has been shown. The domestic economy would therefore be denied those benefits. This would delay the removal of capital controls on Icelandic residents. The Central Bank is therefore of the opinion that both financial stability and the balance of payments are better served if creditors agree to composition agreements that fulfil the stability conditions on the basis of the proposals submitted than if they are taxed. In addition, sustainability considerations must recommend this option if it can ensure adequate stability in the long run. Presumably, views of this type must have been considered when Parliament decided that the stability tax legislation would provide taxable entities the possibility of deductions upon fulfilment of certain conditions. The assessment of the balance of payments scenarios based on less favourable assumptions than are used in the baseline scenario discussed later in this report does not change the fundamental aspects of this positive development (see Appendix I). It can be assumed that the uncertainty relating to the implementation of the composition agreements is relatively minor in comparison with various other uncertainties that could affect the results of the balance of payments estimate – such as changes in Iceland's terms of trade.

In view of the above, the Central Bank recommends that the Minister of Finance and Economic Affairs approve the exemptions that the Bank wishes to grant to the estates. The Bank's analysis and assessment are discussed in greater detail below.

This report is divided into two sections, followed by an appendix. Section I discusses the impact on the balance of payments of settling the estates with composition agreements on the basis of the stability conditions and assesses whether winding up the estates will jeopardise monetary and exchange rate stability. Section II focuses on the impact of winding-up on financial stability.