The banking crisis in Iceland[1]

Executive summary

Financial crises offer important insights into banking sector vulnerabilities and policy responses. Over the past few decades, banks have been at the heart of several financial crises that affected both developed and developing economies. Although each crisis tends to have specific features, bank crises help to shed light on structural weaknesses, on shortcomings in bank regulation and oversight by financial authorities, and on the adequacy of policy responses. The latter can be of interest beyond the individual crisis episode itself. In this light, and more than 10 years after the start of the great financial crisis, several crisis episodes are likely to be of interest to policymakers.

This paper covers the banking crisis in Iceland that started in 2008, and was unprecedented in certain respects. The scope of the crisis – the three banks made up over 80% of the financial system and had experienced break-neck growth – and its speed – the banks collapsing within a few days of each other – was unmatched elsewhere. The root cause was the banks' excessive balance sheet growth, to an aggregate size of 10 times Iceland's GDP, and an outsized share of both foreign assets and liabilities. The Central Bank of Iceland (CBI) could not act as the lender of last resort in foreign currency as its FX reserves and foreign credit lines were no match for the banks' needs. A government bailout was also excluded as the state's resources were dwarfed by the size of the problem and it would have risked a sovereign default. Resolution options were therefore limited from the outset.

The main focus of this paper, the first of a series, is on the authorities' response to the banking crisis in Iceland. As the response evolved over time, the paper tracks and discusses the major measures taken in the immediate aftermath of the bank failures, as well as in the following months, when additional measures were introduced. The focus of this paper therefore differs from that of most of the existing literature on the Icelandic crisis, which tends to address its causes and consequences. Moreover, this paper does not seek to address the overall effectiveness of the policy response.

Emergency Liquidity Assistance (ELA) was part of the initial response, but it turned out to be inadequate. Although ELA in foreign currency was provided to one bank, this did not prevent it from defaulting. In practice, the banks were already insolvent but the financial authorities were unaware of their true financial position and unable to correctly assess the quality of their assets. In addition to uncertain asset valuations that arises in any crisis, the information initially provided to the government was neither sufficient nor reliable enough to allow it to determine whether the banks were merely illiquid or insolvent.

Emergency legislation conferred new resolution powers that allowed Iceland's authorities to create new, viable banks, and to establish depositor preference. Voted into effect overnight, the Emergency Act and its three main measures provided the legal basis of the resolution process. The first measure empowered the Ministry of Finance to provide funds and capital to establish new banks or to restructure an existing bank. The second measure authorised the supervisory authority to take control of failing banks. The third measure changed the hierarchy of claims by giving customer deposits priority of

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payment over general unsecured claims in a financial institution's bankruptcy proceeding ("depositor preference"). Without these measures, the Icelandic authorities would not have had the tools to resolve the banks and maintain at least some activities in the banking sector. Depositor preference, together with the government's blanket guarantee for domestic deposits, also put an end to bank runs by restoring retail customers' confidence.

Each of the banks was resolved by carving domestic activities out of the "old" bank and transferring them to a "new" bank. The objective was to maintain basic banking services for the domestic economy by separating domestic operations from the larger foreign operations of each bank. Other options, such as splitting each bank into a "good" and a "bad" bank, were not feasible in the absence of potential buyers. Accordingly, assets transferred to the new banks were principally loans and other claims related to the banks' domestic operations, while liabilities transferred were mostly domestic retail and corporate deposits.

Other measures involved the economic and financial assistance of an IMF programme, the introduction of capital controls and the restructuring of private debt. Such far-reaching measures were necessitated by the depth of the crisis, which required a multi-pronged response. In particular, the IMF programme, which lasted until 2011, gave credibility to Iceland's crisis response and stabilised markets. Authorities also introduced measures to keep payment systems operational.

In addition, regulation and supervision were overhauled. Among these reforms, higher capital levels are now required for all banks, especially larger ones. In addition, new liquidity requirements limit maturity and foreign currency mismatches.

The Icelandic crisis yields lessons for other countries and authorities. In some way, the Icelandic crisis was unique. At the same time, general lessons about crisis management can be drawn. The complex policy response also illustrates the trade-offs and challenges that may come into play when seeking to address a crisis of this intensity.

Significant operational challenges need to be addressed when creating new and viable banks. The major challenge relates to the uncertainties surrounding depressed asset values during a crisis, which may not necessarily reflect the potential for a recovery. When assets are transferred to a new bank, a priority is to put in place a mechanism that gives creditors of the failed entity a share in any increase in the value of the transferred assets. In Iceland, the risk of legal challenges arising from the allocation of the creditors' general claims to the old banks was mitigated by providing them with shares in the new banks, which could increase in value with the economic recovery. Bail-in was a necessary complement to the creation of new banks, and was challenged in court. Parity of treatment between creditors of the new and the old banks, which generally corresponded to domestic and foreign claims, was also debated and contested. Restructuring of domestic debt, both of households and corporates, was also an issue, because many of the transferred loans were inflation-indexed or linked to foreign currency.

Some form of public sector support was unavoidable during some phases of the crisis. The Icelandic banking sector was so large in comparison with the economy and public sector resources that a fully-fledged bailout was out of the question. Nonetheless, public funds were needed to set up new banks.

While capital controls helped to stem capital outflows, a carefully designed exit strategy was needed. Capital controls were a novel feature of the IMF programme, but they were kept in place for much longer than originally planned because their removal proved to be more difficult than initially envisaged. This was because their removal depended on solving balance of payments issues, so that they could only be lifted when the central bank could ensure that the release of króna-denominated claims held by foreigners would not result in a new currency crisis. However, they probably also imposed opportunity costs on the Icelandic economy by increasing transaction costs and reducing inward investment.