Ingimundur Friðriksson: The banking crisis in Iceland in 2008

Paper by Mr Ingimundur Friðriksson, Governor of the Central Bank of Iceland, prepared for a seminar which was scheduled to be held at the Bank of Finland, 6 February 2009. The author was unable to attend.

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Iceland has been hit extraordinarily hard by the financial crisis that has swept across the globe. The rapid growth of the country's financial system in the past few years rendered it much more vulnerable to global developments than it would otherwise have been. In my talk today, I would like to trace in broad terms various aspects of the runup to the Icelandic banking crisis, particularly from the point of view of the Central Bank. It will not be a complete picture.

After Iceland's banks were fully privatised early this century, they began expanding at a rapid pace, with the primary focus of that growth outside Iceland. They acquired financial companies in other countries, opened branches, and expanded their international business from their headquarters in Reykjavík. This rapid growth was facilitated by Iceland's membership in the European Economic Area (EEA) through which the country had created for its financial system a regulatory framework that was rooted in the directives adopted by the European Union. Among other things, this meant that operating licences granted to Icelandic financial companies extended not only to Iceland but to all other EEA states. For example, they were permitted to operate branches anywhere in the EEA. The European regulatory framework gave the Icelandic banks the same operational flexibility all over the EEA as they enjoyed in Iceland. They had the same rights and responsibilities as banks in all of the other EEA states. The Icelandic Financial Supervisory Authority based its operations on European law, regulations, and procedures, and was given good marks by rating agencies and the International Monetary Fund.

But the regulatory environment was by no means the sole factor allowing the banks to expand to the degree that they did. During the early years of the 21st century, the situation on the global financial markets was highly unusual. The supply of credit was virtually inexhaustible and interest rates lower than they had been in a hundred years. Financial markets were hungry for bonds, including those issued by Iceland's banks, which were a welcome addition to many of the structured securities that became so popular. The banks were thoroughly scrutinised by international rating agencies and their favourable credit ratings greatly facilitated the banks' foray into the bond market. The banks became a vital link in the national economy, their expansion and that of other Icelandic companies garnered widespread support, they offered handsome salaries, and they paid the Treasury sizeable tax revenues, directly and indirectly.

The banks attracted international attention late in 2005 and early in 2006. The market became more wary of them, their CDS spreads began rising toward the end of 2005, and they received more probing and critical coverage by the media and others than they were accustomed to. The criticism was wide ranging, targeting the banks' growth pace, risk appetite, low deposit ratios and high dependence on borrowed funds, as well as cross ownership, lack of transparency, and so on. Until that time, the banks had increasingly been active in the global bond market, with ever larger debt issues.

In February 2006, Iceland's Prime Ministry, Ministry of Finance, Ministry of Business Affairs, Financial Supervisory Authority, and Central Bank concluded a collaboration agreement centring on financial stability and contingency measures. The government then established an advisory group on the basis of this agreement.

The Icelandic banks sought to respond in various ways to the criticism levelled at them. They greatly enhanced their information disclosure to the global marketplace, thus improving transparency in their operations. They sought to reduce cross-ownership, improve their liquidity position and capital ratios, and took the first steps toward increasing the share of deposits on the liabilities side of their balance sheets. They were strongly encouraged to do so by rating agencies and numerous foreign financial analysts, among others. Landsbanki launched its Icesave deposit accounts in the United Kingdom toward the end of 2006. The banks also sought out new credit markets for example in the US which was wide open at the time for issuers with favourable credit ratings.

Because they took this action, the Icelandic banks were perhaps better prepared than they would otherwise have been for the sudden changes that took place in the global financial markets in mid-2007. In this context, I wish to cite the Central Bank's 2007 *Financial Stability* report, which appeared in April that year. It contained the following statement: "The Central Bank underlines that global market conditions can take a sudden turn for the worse and it is important to be on the alert and prepared for such a contingency." The report goes on to say: "The current episode of ample liquidity and lower interest rates which has been ideal for risk-seeking investors may change unexpectedly. Short-term interest rates have been rising in most markets recently and capital costs are no longer so favourable." With this warning, the Central Bank was merely stating what should have been obvious, at least to those engaged in banking. The time had come to prepare for a change in the economic and financial climate. In the global arena, it had been stressed time and time again that risk premia were far too low, risk was not correctly priced, and that change would come.

One of the side effects of the dramatic developments in the global financial markets starting in mid-2007 was the sharp rise in risk aversion among investors and the rapidly shrinking supply of credit. CDS spreads began rising, including those of Icelandic banks. Around mid-August 2007, Kaupthing Bank announced its intention to acquire the Dutch bank NIBC, which was roughly two thirds its size. Kaupthing's CDS spreads widened as a result, as the proposed acquisition would have increased its need for re-financing in the years to follow.

Global market conditions continued to deteriorate throughout 2007: share prices plummeted, access to credit became much more limited, and interbank business transactions more complicated at best. CDS spreads widened, including those of all the Icelandic banks. Many clung to the hope that conditions would improve in early 2008. That hope proved fruitless. Market conditions continued to deteriorate, and the supply of credit became tighter than ever. The Icelandic banks' CDS spreads rose to very high levels.

As I have mentioned, the banks began to increase their deposit business after the experience of early 2006 by offering favourable premiums. Retail deposits in branches and subsidiaries abroad grew quickly and soon became an important source of funding for two of the banks, particularly in 2007 and early 2008. But the bond markets remained virtually closed to them as the year 2008 progressed.

At the beginning of May 2008, the Central Bank published its annual *Financial Stability* report, which included a detailed analysis of the state of and prospects for the financial system. The report pointed out vulnerabilities but also identified elements that tended to strengthen the system. The title of the Central Bank's analysis was: "Current conditions test the banks' resilience." The report stated that the system was considered broadly sound but that contingency measures were needed. The chief risk factors were a vulnerable foreign exchange market and limited access to capital, which represented a short-term risk. For the longer term, vulnerabilities centred rather on the effects of higher cost of capital and the risk of erosion of asset quality. The report included a detailed analysis of the quality of the banks' loan portfolios. Although the conclusion was that the banks were well prepared to face rising defaults and loan losses at that time, particular attention was drawn to the fact that the previous year had seen increases in the ratio of large exposures to capital and in the proportion of holding companies among borrowers. The report emphasised that there was good reason to scrutinise this development closely. The Central Bank had actually noted this in earlier publications as well. For the near term, the banks' most critical task was to guarantee access to foreign credit and reduce their borrowing requirement. Furthermore, confidence among investors and depositors was of vital importance. It was deemed unlikely that conditions in the international markets would improve to any dramatic extent in the near future, and when they did, investors would undoubtedly demonstrate more caution and conservatism than they had previously. In addition to this, the report shed light on the banks' very large re-financing needs in the next few years: They would need to re-finance 35 billion euros in foreign bonds through 2012, including 17 billion in 2009 and 2010.

Some critics have maintained that, in the May 2008 issue of *Financial Stability*, the Central Bank contradicted its own knowledge of the state of the banks – or even that it did not know any better. This is untrue. The report examined in a transparent manner the financial system's weaknesses, as well as its strengths. The developments in the global arena since the spring of 2008 rendered the risks mentioned in *Financial Stability* far more serious than was foreseen.

In its monetary policy statement in July 2008, the Board of Governors said *inter alia* that "Iceland's commercial banks play an important role in maintaining confidence in the financial system. Under the current global financial market conditions, they must protect their liquidity and capital position, seek all possible ways to reduce their need for foreign credit, and adapt the scope of their operations to dramatically changed circumstances."

Throughout 2008, the Central Bank of Iceland focused increasing attention on the developments and operational outlook at the nation's financial institutions – particularly its large banks. Among other things, it monitored their liquidity much more closely and frequently than is stipulated in the Bank's rules on liquidity requirements, and considerably more than had been customary. The Central Bank met with leaders from the large commercial banks and reviewed various aspects of their operations, requesting information on and explanations of the developments in certain areas, such as liquidity, funding, changes in lending and deposits, asset sales, etc. The banks were urged to show restraint and downsize, and to follow that up, the Central Bank specifically collected information from them on their downsizing efforts. They realised, of course, that they were in a tight position, and they responded by selling assets and discontinuing selected activities in a number of countries, among other things. Kaupthing Bank's decision to abandon its plans to acquire NIBC in the Netherlands was very important in this regard, not just for Kaupthing itself but for all of the banks. The Central Bank supported all of these actions wholeheartedly; however, it did not have the statutory authority power to force the banks to change their conduct.

It is known that the Central Bank expressed its growing concern over the position of the banks during meetings with governmental authorities. Early last year, the Central Bank's concern centred not least on the banks' large near-term refinancing requirement for the coming years, which I have already mentioned, and the opinion, expressed by leaders of a number of international banks, that the global credit crunch was unlikely to ease in the foreseeable future. The Central Bank feared that credit markets could remain closed to Icelandic banks for some time to come. Although various explanations have been given for the swift rise in the Icelandic banks' CDS spreads, first in early 2008 and again that summer, it is perhaps possible to claim that the most important explanation lay in growing scepticism about the banks' ability to obtain the medium-term funding they needed for refinancing purposes.

In late 2006, the Central Bank had doubled its foreign exchange reserves through an international Treasury bond issue the proceeds of which were deposited with the Central Bank. Early in 2008 it began preparing to fortify its reserves still further, as is explained in a memorandum published on the Central Bank's website in October 2008.2[1] Raising the foreign reserves was deemed important in order to bolster confidence in the Icelandic financial system and thus to facilitate its adjustment to a new reality. Currency swap agreements with three Nordic central banks were announced in May 2008 and renewed towards the end of the year. No other central banks apart from the Nordic ones were prepared to lend their support in 2008, in spite of the Central Bank's requests and in spite of the public declarations from the international community, including the Financial Stability Forum, about the necessity for consultation and co-operation, not least among central banks, including the establishment of swap lines.

As mentioned, the Icelandic banks significantly increased their presence in the retail deposit market abroad, beginning in late 2006. Actually, they were so confident about their success that, at meetings held over the course of 2008, some of their leaders voiced the expectation that it should be easy for them to fund all of their outstanding bonds and other debt for the coming years through deposit business in Europe. However, through discussions with governors and other representatives from central banks abroad, the Board of Governors of the Central Bank of Iceland had become aware of growing opposition to the Icelandic banks' accumulation of deposits. No doubt this opposition stemmed from many factors, among them the fact that banks in those same parts of Europe felt the pressure of the sudden competition and communicated their concerns to their authorities. Another cause was the fact that the accumulation of deposits in foreign subsidiaries increased the potential obligations of the deposit insurance schemes in the countries of operation. A third factor may have been concerns that the relatively high interest rates offered by the Icelandic banks might reflect underlying weakness. A fourth consideration was the concern about the Icelandic deposit insurance scheme with respect to deposits in foreign bank branches. It was clear, however, that the Icelandic system fulfilled the requirements set forth in European directives, which stipulate that the government must ensure that such a deposit insurance scheme is established but do not address the issue of government responsibility for the scheme's commitments, and certainly not in the event of a system-wide shock. Official European documents corroborate this.

Some declared outright that the Icelandic banks would be prevented from receiving deposits or that they would be forbidden to receive further deposits in the countries where they were already established. There were examples of demands that the banks reduce their deposits, in spite of the provisions in EU directives on financial companies' equal right to conduct business anywhere within the European Economic Area. In this case national interests outweighed pan- European commitments. As a result, it appeared as though the banks' plans to meet their funding needs through retail deposits would be, at best, difficult to carry out. The Board of Governors of the Central Bank explained the foreign authorities' attitudes towards this deposit accumulation to the leaders of the Icelandic banks and informed them that they would be faced with strong and swiftly mounting opposition.

The Central Bank of Iceland was unequivocally of the opinion that the banks' foreign deposits should be held in subsidiaries rather than branches and that Landsbanki's deposit business in London should be transferred to a subsidiary of the bank. The preparation for this transfer began early in 2008, and the Central Bank was informed soon thereafter of what was needed to make the change and how long it would take. Judging from discussions with senior executives at Landsbanki, the Central Bank assumed that the process had begun that spring. In July, it was revealed that this was not the case. Although the Central Bank's position on the matter was clear, it did not have the power to force changes or make demands. Moreover, other Icelandic authorities also had limited legal power in this respect under the legislation then in force which was and is based on EU Directives.

[1] See the memorandum dated October 9, 2008: Currency swap agreements and attempts to reinforce the foreign exchange reserves.

As I have mentioned, the Central Bank of Iceland kept close watch on the liquidity of the Icelandic banks throughout 2008, both by compiling data regularly and by meeting with senior executives in the banks. Among other things, the Central Bank tracked the banks' liquidity virtually on a daily basis and kept abreast of their refinancing efforts and asset sales. It was common knowledge that one of the banks, Glitnir, had a large foreign loan payment coming up in mid-October. Unlike the other banks, Glitnir had not been active in creating a presence in the retail deposit market abroad, having chosen instead to bolster liquidity by selling assets. In mid-September, the Board of Governors of the Central Bank met with the Glitnir management and reviewed the bank's liquidity outlook once again. At that time, the prospects for funding the October payment were good, and according to information presented to the Central Bank, Glitnir would be able to cover that payment with an asset sale that was virtually complete. It was then that American investment bank Lehman Brothers collapsed, starting a tremor that would shake financial markets all over the globe.

In its Quarterly Review in December 2008, the Bank for International Settlements went so far as to say that, after the failure of Lehman Brothers, the global financial markets "seized up and entered a new and deeper state of crisis.(…) With credit and money markets essentially frozen and equity prices plummeting, banks and other financial firms saw their access to funding eroded and their capital shrink owing to accumulating mark to market losses." The Lehman bankruptcy had triggered a widespread crisis of confidence.

Among other repercussions of the Lehman Brothers collapse, the above-mentioned virtually completed sale of Glitnir assets did not materialise. This kicked off the well-known chain of events. Glitnir turned to the Central Bank for assistance. Not only was the bank unsuccessful in its attempt to sell assets, it was unable to renew a bank loan that it had expected to extend without any difficulty. Ultimately, the Government decided that the Treasury should acquire a majority holding in Glitnir, but before that could be finalised, the bank collapsed.

In early October, there was substantial pressure on Landsbanki's deposit accounts in London, and the British Financial Services Authority (FSA) steadily tightened the demands it made on the bank. Landsbanki's liquidity difficulties became insurmountable, and it was clear that rescuing the bank would not represent prudent use of the Central Bank's foreign exchange reserves. The amounts involved were simply too large. By this time, only Kaupthing remained of the three large banks. In view of the prospects for Kaupthing's liquidity, the bank was deemed likely to survive the storm. On the basis of that assumption, the Central Bank, after consulting the Government, granted Kaupthing a collateralized four-day loan that should have sufficed – as things stood then. Subsequent events in London changed that, however, including the FSA´s action against the Kaupthing subsidiary.

The three leading commercial banks, representing about 85% of total banking assets, all collapsed. The Icelandic Financial Supervisory Authority took over their operations on the basis of newly adopted legislation, and they were divided into two entities, the new banks and the old. I will not expound on that process here, except to say that top priority was given to the maintenance of smooth payment intermediation and uninterrupted banking operations, and that efforts in that regard were successful in spite of measures such as the "freezing order" imposed on Landsbanki by the British authorities under the Anti-Terrorism, Crime and Security Act – a freezing order that originally extended as well to the Icelandic government, Central Bank, and Financial Supervisory Authority, among others. In fact, in the circumstances, the relative ease with which banking operations and payment intermediation continued to function bordered on the miraculous.

The International Monetary Fund conducted an FSAP appraisal of the Icelandic financial system during the summer of 2008. The resulting staff report can be found on the Fund's website. Another report, which was submitted to the Fund's Executive Board in connection with the Icelandic government's November 2008 request for a Stand-By Arrangement, includes the following statement:

> "Iceland's overstretched, over-leveraged banking system was ill-positioned to cope with the global financial turmoil. The Icelandic banking sector experienced a dramatic expansion in just a few years, funded by cheap foreign financing, which allowed it to boost its assets from 100 to almost 900 percent of GDP between 2004 and end-2007. This expansion made the Icelandic banking system one of the largest in the world in relation to GDP. As global conditions deteriorated in early 2008, banks' CDS spreads rose to unprecedented levels. In response, banks slowed lending growth, enhanced liquidity buffers, reduced costs, and started a process of downsizing non-core operations and laying off staff. But their ability to deleverage was limited by the global risk aversion. A recent FSAP update and Article IV Consultation conducted in June 2008 pointed to several risks that were mounting throughout 2008: (i) liquidity and funding risks, associated with the banks' reliance on market funding and their large funding needs over the short run; (ii) credit and market risks, resulting from foreign currency, equity exposures, and high indebtedness of domestic borrowers, as well as collateralized lending, connected lending, and large exposures; (iii) operational risks, associated with the banks' rapid expansion in recent years; and (iv) quality of capital risks, related to complex ownership structures. In this light, the Staff Report concluded that "if risks were to materialize in full, Iceland could face severe financial strains."
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> Despite the authorities' attempts to prepare for contingencies earlier in the year, the crisis brought down the three main banks within a week. In May 2008, the central bank entered into swap agreements with other Nordic central banks, in an effort to secure liquid foreign exchange should the need arise. In September, the government borrowed 300 million Euro to further boost reserves. At the same time, the central bank had been increasing liquidity provision, easing rules on eligible collateral (including by accepting uncovered bonds from banks) and reducing reserve requirements. But renewed global pressures in late September led to a swift loss of investor confidence in the Icelandic economy and financial system, and a massive depreciation of the króna. The three main banks could not secure payments for their due obligations, and the government decided to promptly intervene rather than to continue what was considered to be an eventually unsustainable process of supporting the three banks."

As I have already mentioned, the Central Bank responded to developments and prospects in 2008 by monitoring the banks' liquidity even more frequently and maintaining close contact with them. In addition, the Bank's contingency committee had been mobilised and worked continuously from the fall of 2007 onward. The advisory committee from the Prime Minister's Office, Ministry of Finance, Ministry of Business Affairs, Financial Supervisory Authority, and Central Bank met frequently and exchanged information. The committee prepared contingency plans and had a legislative bill drafted – the bill that later became the emergency legislation passed in early October.

It is obvious that the banks had become too large in relation to the Icelandic economy. They took advantage of a liberal regulatory environment, good credit ratings, and the unusually advantageous conditions on the global markets and expanded their operations at a rapid pace. The European regulatory framework made this possible. In many ways their activities resembled those of banks in other countries. Under normal market conditions, this posed no immediate problem. The banks could have funded their operations even under sub-optimal market conditions. Many were of the opinion that the Central Bank should build up very large foreign exchange reserves, even up to a multiple of GDP, in order to back up the financial system. Given the current account deficit on the balance of payments, this would only have been possible with massive foreign borrowing. It would never have transpired, for the simple reason that the Icelandic government would have been unable to borrow such a large amount. Its credit ratings would not have tolerated it, and lenders would have been difficult to find.

As I have touched on, the banks responded to mounting difficulties in various ways. Kaupthing, for example, abandoned its plans to acquire the Dutch bank NIBC. All of the banks sold assets and discontinued various non-core operations; however, as the IMF mentioned in the previously cited Staff Report, it was not a seller's market. In addition, the banks all reduced their lending and laid off staff. Meetings held last summer with the banks' leaders revealed, among other things, that some of them were making vigorous attempts to attract foreign investors, those with retail deposit collection in foreign branches were aiming to transfer the deposits held in those branches to subsidiaries within a few months, and some were even considering moving their headquarters out of Iceland which the Central Bank did not object to.

As pressures in the global liquidity markets intensified, much like banks in other parts of the world, the Icelandic banks turned to the Central Bank for funding, as many banks abroad have done. The Central Bank of Iceland expanded its liquidity facilities, as did its foreign counterparts. Iceland's banks obtained funding both from their own Central Bank and, through their foreign subsidiaries, from the European Central Bank (ECB), from which they sought liquidity in euros. As other banks, they became heavily dependent on ready access to liquidity facilities. However, the Central Bank of Iceland could not provide liquidity in currencies other than the Icelandic króna, and until recently most other central banks only provided loans in their own currency. All over the globe, central banks and other authorities fought to rescue banks and other financial companies, resorting to increasingly unconventional measures in the process. In spite of these attempts, financial companies of all sizes have gone bankrupt, while others have been rescued – at least temporarily – through massive government assistance or guarantees. At this point, banks are almost entirely dependent on central bank liquidity facilities, and the interbank markets are more or less non-functional because of the utter lack of confidence. The balance sheets of the world's largest central banks have grown significantly since the end of last summer, with some expanding many times over.

For several years, the Central Bank of Iceland's rules on liquidity facilities have been largely modelled on those of the ECB. I say *largely* because for quite a while the Icelandic rules were rather more stringent than those in Europe – that is, the Central Bank of Iceland set stricter requirements concerning eligibility of collateral. Facilities in the Central Bank of Iceland resembled those in the ECB's jurisdiction; the collateral accepted was similar, and so on. This applied, among other things, to bonds issued by banks. Last year, steps were taken to align the Icelandic rules more closely with those in Europe in order to increase access to liquidity.

In 2008, the European Central Bank responded sharply to what it considered excessive borrowing from the ECB by Icelandic banks through subsidiaries in EMU countries. The loans concerned had been taken in compliance with the ECB's rules on liquidity facilities for financial undertakings in EMU countries, but the ECB demanded that the Icelandic banks repay, quite quickly, a large share of the facilities of which they had availed themselves in good faith. Those repayments were funded at least partially with deposit accumulation in foreign branches. Early in October, two Icelandic banks received sizeable margin calls from the ECB. The ECB demanded that they be met immediately, which would have driven the banks to collapse. The news of these margin calls spread widely. For reasons that were not explained, the ECB withdrew the margin calls at the last moment, in spite of the fact that the Central Bank of Iceland had been informed that such decisions by the ECB were irrevocable.

In retrospect, perhaps the safest way to prevent the collapse of the Icelandic banks would have been, at the outset, to place more stringent limits on their operations than were placed on financial institutions in other EEA states; in other words, to deny them the rights conferred by the EEA Agreement. Had this been done, Iceland would not have been a full participant in the internal market of the European Union. I will leave it to others to answer the question of whether political support would have been forthcoming for the imposition of such restrictions on the banks at that time. On the other hand, in view of recent developments, it is obvious that the banks took advantage of extremely favourable conditions to expand more rapidly than was sustainable for the long term as things developed. Because of their relative size, the Icelandic banks were more vulnerable than many other businesses even to moderately adverse developments, not to mention the catastrophic events that have shaken the global financial environment in the past year. The question of when it would have been right to intervene – and how – is extremely difficult to answer, however. No one has perfect foresight. Many lessons will doubtless be learned from the experience of the past few years, including lessons about capital and liquidity requirements, concentration of financial company ownership, financial links between owners and financial companies, and financial companies' ownership of other businesses, to name a few. But those lessons are outside the scope of my talk today.

Conditions in the global financial system are at their worst since the Great Depression, particularly after the collapse of Lehman Brothers. It is virtually an unprecedented crisis. Perhaps it is possible to say after the fact that the fall of Lehman sealed the fate of Iceland's banks. Once Lehman had failed, nothing could have saved them. Assets had become almost impossible to sell due to the crisis of confidence and the global credit squeeze the Icelandic banks faced a much harsher operating environment and could expect that strict limitations would be placed on their foreign deposit business – if it were not stopped entirely. Government authorities in other countries consulted with one another more and more frequently on these issues.

Early in October, the Icelandic Parliament passed emergency legislation authorising the Financial Supervisory Authority to take over the banks' operations. The authorities had no choice but to act on that authorisation immediately, take over the three large banks, and divide their operations into two parts, the old banks and the new. The new banks, which are owned by the government, took over domestic banking activities, while foreign operations remained within the old banks, which have been granted a moratorium on payment. The government's response in October was guided by the overriding aim of guaranteeing continued domestic banking operations and domestic and cross-border payment intermediation under extraordinarily difficult circumstances.

Following the collapse of the banks, the Icelandic government negotiated a Stand-By Facility from the International Monetary Fund on the basis of an economic programme focusing on three main objectives: first, to stabilise the foreign exchange market and provide support for the appreciation of the króna from its recent exceptionally low levels; second, to formulate a fiscal policy for 2009 and beyond aimed at establishing a sustainable level of debt; and third, to restructure the banking system in a transparent manner consistent with internationally recognised practice. That process is underway. The Treasury was virtually debt-free on a net basis when the crisis struck but will now have to take on large debt, the exact amount of which cannot yet be estimated with any certainty because the government's total deposit insurance liability is still undetermined. The economic adjustment ahead will be sharp, but if the global economy makes a gradual recovery, Iceland should be well equipped to return to sound economic growth at the end of that adjustment. The assumption concerning global economic recovery is of vital importance, however, and remains shrouded in uncertainty.