Már Guðmundsson: Rebuilding after the financial crisis

Statement by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, for experts and journalists on the occasion of publishing of the Central Bank of Iceland's *Financial Stability Report*, Reykjavik, 30 October 2009.

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Early in October 2008, nearly nine-tenths of Iceland's banking system collapsed when its three large commercial banks – Glitnir, Landsbanki, and Kaupthing – were taken into special resolution regimes on the basis of the emergency legislation that had just been passed by Parliament. This collapse has caused the entire Icelandic nation economic hardships, which came on top of those caused by the difficult but inevitable adjustment already underway after the overheating and macroeconomic imbalances that characterised the period from 2005-2007. The crash amplified the contraction in production and employment and aggravated households' and businesses' debt problems.

The failed banks had their headquarters in Iceland and were majority-owned by Icelanders. But in order to better understand the chain of events, it is important to bear in mind that the banks were only partly Icelandic, in that a large share of their activities took place overseas. For example, about 60% of their lending was to non-residents and about 2/3 of their deposits denominated in foreign currency. It was these international operations and the size of the banks relative to Iceland's GDP that ultimately proved to be their Achilles heel.

It is not unlikely that the current investigation of the banks' failure will reveal weaknesses in areas such as asset quality and governance, in addition to the more obvious flaws in their business model and risk management. Moreover, the estimated recovery ratios from the banks' estates have given rise to questions about both the quality of their financial reporting and the reliability of their financial ratios as indicators of financial strength. But it was the banks' difficulties in refinancing their foreign assets that catalysed the crash. Then, because of their size, the Icelandic Government was unable to rescue them in their time of need.

Those working in the financial sector at the time will long remember the panic that ensued when US investment bank Lehman Brothers failed in mid-September 2008. All confidence and trust vanished. Financial undertakings tried to protect their equity and hoarded liquid assets as much as they possibly could. They resorted to measures that appeared sensible from the perspective of individual businesses but had devastating consequences for the system as a whole. When everyone is hoarding cash, a liquidity shortage will ensue. When no financial undertaking is willing to lend to any other, even the staunchest of them could end up in difficulties. This resulted in closure of credit lines and massive margin calls. Assets that were sold to raise liquidity, other than the very safest, were put on fire sales. Financial markets all over the world were close to freezing solid, and premia of all types rose to record heights. The situation was especially dire in the foreign exchange swap markets, and an acute global dollar shortage became a fact. Banks around the world had severe difficulties refinancing their foreign assets.

It was against this backdrop that the Icelandic banks faced illiquidity. A number of other banks would probably have met the same fate if governments all over the globe had not made broad-based rescue efforts. The future will probably reveal just how close the global financial system was to complete collapse during those weeks. But the scope of governmental measures is unprecedented. They involved a dramatic increase in domestic liquidity facilities from central banks; new currency swap agreements between the US Federal Reserve Bank and other central banks, and expansion of existing swap agreements; direct lending to banks from various countries' foreign exchange reserves; expanded deposit insurance schemes; government guarantees of deposits and wholesale financing; and capital injections.

Rescue efforts were also carried out in Iceland in connection with the banks' failure. They were somewhat different in nature, however, as the Icelandic authorities did not, on their own, have the resources to rescue the banks, and international support was not forthcoming, even though it could be argued that the three banks concerned were systemically important because of the possibility of a domino effect throughout Northern Europe in the event of their collapse. On the contrary: The response to Iceland's crisis was characterised by ring-fencing and hostility, yet it is well known that such an approach creates a worse outcome in the aggregate. Iceland's rescue efforts focused on keeping payment intermediation and domestic banking operations up and running to the extent possible, and then on rebuilding the financial system and the economy on new foundations. As is described in this report, attempts to keep domestic payment intermediation functioning were broadly successful under the circumstances. This is due in large part to attempts made over the past several years to improve the efficiency and security of payment intermediation, in line with international standards. Cross-border payment intermediation was disrupted when the banks fell, however, partly because of the actions taken by the British authorities. But a variety of measures described in some detail in this report restored the functioning of cross-border payment intermediation, which is largely back to normal as of this writing.

Rebuilding the domestic banking system is part of the economic programme prepared by the Government in collaboration with the International Monetary Fund (IMF). The restructuring of the three commercial banks is well advanced. The savings banks' restructuring is still incomplete, and it remains unclear how large a capital injection will be required from the Treasury. The cost of recapitalising the commercial banks will be much less than originally assumed, however.

Although the banks' restructuring is proceeding apace, there is still considerable work to be done before the long-term structure of the new Icelandic financial system is complete. The banks are still operating under capital controls, and they have limited access to foreign funding. At this point, when the First Review of the economic programme of the Government and the IMF appears imminent, it is timely to begin lifting the capital controls. As the economy and financial system are rebuilt and conditions improve on the global markets, we expect that the Republic of Iceland will have access to foreign credit markets once again, and that the banks will follow in its wake.

At that point, it will be more important than it is now to decide to what extent Icelandic financial institutions will be allowed to engage in international banking operations. In a sense, the financial crisis represented a run on such operations. The crisis revealed clearly the contradiction between the internationalisation of finance, on the one hand, and national supervision and safety nets, on the other. The problem was particularly prominent in the case of the EEA regulatory framework, which had gone farther in lifting restrictions on cross-border banking activities than was the case in many other parts of the world. In this context and others, it is important to bear in mind that international or pan-European regulatory provisions represent minimum requirements. Iceland and other nations may need to adapt those provisions to the specific risks that they face. In some areas, this may imply more stringent capital adequacy and liquidity requirements, or special restrictions on financial undertakings' activities. Work is currently being done, both in Europe and globally, towards reforming the regulatory framework for international banking operations. Until the framework for those operations is more secure, however, the wisest course for Icelanders may be to proceed with caution and adopt tighter rules on cross-border financial activities than are set forth in the minimum requirements. A clear example of this is a restriction on the accumulation of deposits in foreign bank branches. The long-term need for such more stringent rules will be determined to a degree by Iceland's future currency and exchange rate regime. Experience shows that maturity mismatches between banks' assets and liabilities that are not backed up by a lender of last resort represent a substantial risk.

The global financial crisis has revealed a variety of weaknesses in the regulatory framework and the supervision of the financial sector. On the whole, the quantity and quality of financial

institutions' capital was insufficient to provide the necessary shock absorption. In particular, there should have been more unpledged common equity. The risk assessment of assets and liabilities was distorted because it was based on historical data that did not assign sufficient weight to bad states of the world. Liquidity risk was vastly underestimated, and the procyclical tendencies within the financial system were not sufficiently offset by the regulatory and supervisory framework. On the contrary, it can be argued that the interplay of regulatory provisions and financial reporting rules based on mark-to-market exacerbated these tendencies. The remuneration schemes in financial undertakings and the decisions made by credit rating agencies added fuel to the fire. Financial supervisors tended to focus on risk attached to individual financial institutions more than on system-wide risk. There was also a tendency to practise somewhat lax supervision in order to stimulate the development of financial centres. As a result of all of the above factors, the financial system became far too leveraged.

At this writing, a variety of efforts are being made internationally towards correcting these flaws, as is described more fully in this report. The Central Bank of Iceland is following these developments closely, not least through its membership in the Bank for International Settlements in Basel, which is the venue for a number of the committees and institutions that assess risk in the global financial system and formulate the regulatory framework and standards that govern it.

The experience of this financial crisis – both in Iceland and abroad – calls for a reassessment of the most effective architecture for financial supervision, with particular emphasis on the nature of the relationship with the central bank. For some time, the trend was towards separating central banks from financial supervision, particularly in countries with developed financial systems. But as is discussed in this Financial Stability report, banking supervision has remained within the central banks of a majority of European countries, and the pendulum might be swinging in that direction once again in countries with developed financial systems. An example of this is Germany's decision to transfer its banking supervision into its central bank.

The relationship between the Central Bank and the Financial Supervisory Authority (FME) is among the issues that must be examined thoroughly in Iceland in the coming period. The arguments in favour of closer collaboration between the Central Bank and the FME touch on the previously mentioned shortcomings in the regulatory and supervisory framework. In order for a central bank to perform its role as lender of last resort, it must at all times have information that allows it to assess whether a financial institution in distress is faced illiquidity or insolvency. It must also have thorough knowledge of the available collateral. Moreover, it is important that the central bank have an overview of large exposures in the system as a whole and that it be able to assess the risk of contagion between financial institutions. This requires that the central bank have access to information similar to that possessed by financial supervisors. In the event that it is decided to let capital adequacy ratios vary with reference to credit and asset price cycles, it will be necessary to join the tools of financial supervisors with the macroeconomic overview of central banks. Furthermore, it is widely held that in small countries, where the external sector plays a key role, there is a stronger argument in favour of close co-operation or merger between these institutions than there is in larger economies. There are two reasons for this: First, exchange rate movements and foreign exchange market conditions can be of critical importance to domestic financial institutions; and second, the personnel and other service elements necessary to build up two effective institutions in this field are limited.

The Central Bank of Iceland published its last Financial Stability report in May 2008. The present report has been written without confirmed information on the banks' and savings banks' balance sheets, operations, and ownership structure. Consequently, it is not possible to assess the status of the banking system as a whole, as has been done in previous reports. Nonetheless, the Bank considered it important to issue a Financial Stability report at this time, both to document certain information on the financial crisis and the subsequent

recovery work, and to discuss anticipated projects related to the regulation and supervision of financial activities. It is important to note that this report does not attempt to present a comprehensive analysis of the causes of the banks' collapse, nor does it pass judgment on the actions taken by the Government and the supervisory authorities prior to the crash. In recent years, the Central Bank has engaged in broad-based contingency work in preparation for a possible financial crisis, in collaboration with domestic authorities and supervisory institutions, and with foreign central banks. That work is not discussed in the present report. One of the roles of the Parliamentary Special Investigative Commission is to compile information on these topics and present an analysis of them. The Central Bank neither has the capacity nor the will to front-run that analysis. The Bank will probably need to revise its operational practices in these areas in view of experience and the Commission's findings, as will other supervisory institutions. In addition, the Bank will soon review its precautionary rules, such as those pertaining to financial institutions' liquidity and foreign exchange balance, in light of recent events. Various elements of payment intermediation and settlement will also be reviewed in the near future, with the aim of promoting financial stability more effectively.

Because of the uncertainty still surrounding assets, capitalisation, and ownership of Icelandic financial undertakings, it is difficult to assess the main risks in Iceland's financial system at this time. However, those risks are clearly related to asset quality, on the one hand, and foreign exchange and indexation mismatches, on the other. For this reason, among others, it is important that financial institutions maintain capital adequacy ratios well above the statutory minimum in the near future. At present, deposits form the backbone of the banks' funding, as foreign investment in Iceland and access to global credit markets are limited. Lifting the capital controls entails a certain risk, partly because it involves liberalising capital flows while the ownership structure of the banks is still being clarified. It is also clear that restructuring and recapitalising the savings banks is in the offing, and this could also pose some risk. The risk that had accumulated in the Icelandic financial system prior to the crash has materialised, however, and it is unlikely such a situation will arise again in the near future. Broadly speaking, the risk in the system should abate over time, particularly if reforms of the regulation, supervision, and governance of the financial system are well and speedily implemented.