

## **Már Guðmundsson: To what extent do international and EU reform proposals address the fault lines in cross-border banking?**

Keynote address by Mr Már Guðmundsson, Governor of the Central Bank of Iceland, at the Eighth High-Level Meeting for the Middle East & North Africa Region “Recent policy developments for strengthening the resilience of the financial sector”, Abu Dhabi, 28 November 2012.

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Governor, chairmen and participants,

Let me begin by thanking the organisers for inviting me to address this impressive gathering and thus enabling me to visit this fascinating place.

In my speech I will discuss the risks in cross-border banking that manifested themselves in the crisis and what has been done since to address them. The bottom line is that, at the global level, we had developed significant cross-border banking operations that were only very partly covered by the safety net of lender of last resort (LOLR), deposit insurance and adequate resolution powers, and the associated regulation and supervision. I use the metaphor of a fault line to describe this.

But first I want to tell you a little more about the origin of my perspective on these issues. It comes first from my tenure at the Bank for International Settlements (BIS) from 2004–2009, where I was involved in work on these issues, with the BIS International Banking Statistics providing a constant point of reference. But more importantly, it comes from my current position as a policymaker from a small, open economy where the collapse of three cross-border banks was the most noticeable event in the unfolding of the financial crisis that hit the country in 2008. The combined balance sheets of these banks was 10 times Iceland’s GDP, 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. I will use the case of these banks to illustrate current problems with cross-border banking more generally and as a yardstick against which to measure current reform proposals.

Cross-border banking expanded significantly in the years prior to the financial crisis, as is witnessed, for instance, by the growth in cross-border banking claims measured by the BIS International Banking Statistics. Attending this growth was a steady build-up of cross-currency liquidity risk. Such risk can take two forms: currency mismatches and maturity mismatches between foreign currency assets and liabilities. To take an example, the euro area as a whole had a more or less balanced current account position. A fact that drew less attention before the crisis, however, was that European banks had built up huge USD-denominated balance sheets that had mismatches, especially in terms of maturity. This became a major problem when there was a run on dollar-denominated bank liabilities of non-US international banks post-Lehman. Many big European banking names might not still be with us had it not been for the USD swap lines granted to the European Central Bank (ECB), the Bank of England (BoE), and the Swiss National Bank (SNB).

So the financial crisis revealed a major fault line in cross-border banking in the form of large foreign currency balance sheets featuring significant maturity mismatches, but with limited LOLR facilities in terms of foreign currency. Maturity mismatches are, of course, the bread and butter of banking, and we know how to deal with the risk in a domestic setting: with central bank LOLR operations and deposit insurance complemented by regulation and supervision, partly to deal with the moral hazard issues created by this safety net. This process is facilitated by two factors. First, and abstracting from leakages through the FX market, the funds withdrawn from banks during a domestic run flow in one form or

another to the central bank, which can then redirect them back to the banks. Second, central banks have a very large short-run capacity to expand their balance sheets.

In the current setting, it is far from guaranteed that this process can be replicated at the international level. In normal times, of course, managing liquidity across currencies from countries with free movement of capital and relatively developed capital markets is not much of an issue. In these conditions, foreign exchange swap markets can speedily be used to convert liquidity from one currency to another at spreads that closely reflect the differences in domestic money market rates in the two countries concerned. But as we saw so clearly in 2008, this mechanism has a tendency to break down in a time of a financial crisis – precisely when it is most needed.

Central banks can lend out their foreign exchange reserves, of course, but there is a well-known limit to that process. Some form of global liquidity provision is therefore needed. The swap lines granted during this crisis were precisely that, and most studies seem to support the conclusion that they made the crucial difference in relieving strains in banks' foreign exchange funding. To a significant degree, this was the domestic LOLR process replicated at the international level.

We have a solution, then, at least at the conceptual level. But it is not clear that it is a robust solution in practise. The swap lines are not at present a permanent and a reliable feature of the international monetary system; for instance, they have been strongly challenged in political discussion in the US. Furthermore, there are important unresolved governance issues, such as who should decide which countries get a swap line and which do not. It is thus an important item on the reform agenda to clarify the extent to which standing foreign currency LOLR facilities for solvent cross-border banks can be set up without going through national governments.

Let me now turn to the case of the Icelandic banks, which highlights these issues in an extreme form and at the same time throws light on the flaws in the EU setup for cross-border banking.

When its three cross-border banks failed in the first week of October 2008, Iceland was already on its way into a recession partly related to macroeconomic imbalances that accumulated during 2005–2007. The banking collapse and the associated wealth loss and further depreciation of the currency significantly deepened the ensuing recession.

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) to almost 10 times GDP (in mid-2008). Most of this expansion was cross-border, and a significant part of it was really off-border, having very little to do with Iceland, as both financing and investment took place abroad.

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 balance sheets involved (10 times GDP overall, nearly three-fourths of it in foreign currency), it was impossible for the Icelandic authorities to provide such assistance on their own and could have been catastrophic for the credit of the sovereign if they had made a full-scale attempt to do so.

The Icelandic authorities were assuming, however, that the banks were solvent. Their published CAD ratios were well above the 8% threshold, and as late as August 2008, the Icelandic Financial Supervisory Authority had deemed them able to withstand severe capital shocks. Now, however, we know that this was probably not truly the case, as there were hidden vulnerabilities in their capital positions. Be that as it may, with the solvency assumption in mind, 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.

There was also a failed attempt to nationalise one of the banks in late September. It was fortunate that it failed, as nationalising the bank would have turned a bank foreign currency refining problem into a sovereign problem, with the serious risk that the sovereign might have defaulted on such foreign currency payments. In this light, and given the lack of international co-operation, the Icelandic authorities were forced to consider radical solutions. Although they were not necessarily articulated fully at the time, these solutions entailed several goals: to preserve a functioning domestic payment system, ring-fence the state in the case of bank failures, limit the socialisation of private sector losses, and create the conditions for rebuilding a domestic banking system.

The adopted solution included a declaration that all deposits in Iceland were safe and all deposits in Icelandic-headquartered banks were given priority over other unsecured claims. The Financial Supervisory Authority was granted broad-based powers to intervene in failing institutions, and the Government was authorised to inject capital into new domestic banks.

This so-called Emergency Act thus allowed new domestic banks to be created when the old cross-border banks failed and were placed in special resolution regimes followed by winding-up proceedings. The new banking system amounted to around 1.7 times GDP, compared to 10 for the old banking system. As a result of these measures, the domestic payment system functioned more or less seamlessly throughout, and customers had continuous access to their deposits.

I have expanded at some length on the measures taken when the banks failed, as there are still a number of misconceptions about the process in international discussions. There have been claims that Iceland allowed its banking system to collapse, with what now seem reasonable results, and that others should consider doing the same. The fact is that Iceland kept the domestic part of the banking system running throughout; otherwise, the consequences would have been dire. Some have claimed that the banks were nationalised. They were not. The old banks are private companies. They are in winding-up proceedings governed by law; they are not under the control of the Government. The Government has a majority stake in only one of the new banks. Others have claimed that Iceland defaulted and got away with it. The opposite is true. The credit of the sovereign was preserved, and all debt obligations have been paid on time. This is why the sovereign has been able to tap international capital markets twice so far since the crisis struck, and why its five-year CDS spread is currently below 180 points.

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. This case also highlights the link that must exist between the LOLR function and deposit insurance, which, in the absence of clear prior arrangements for currency swaps or another such mechanism, must be mostly in the same currency in order to work. The EU framework for this was therefore deeply flawed, as is currently being recognised in the plans for a banking union.

Why were these huge risks in the Icelandic banking system 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. These are Iceland's membership in the European Economic Area (EEA) in 1994, 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.

Let me expand a bit on the EEA part, as it is highly relevant to my topic. The EEA Agreement is basically a mechanism through which EFTA countries like Iceland and Norway were allowed to participate in the EU single market, which includes free movement of capital and provision of financial services. The underlying principles are those of home licensing for operation anywhere in the area and of a level playing field for competition, where size and location are not supposed to matter. It therefore goes against the underlying principles of this framework to consider the size of banks relative to GDP as a metric for concern, as is now so rightly in fashion. This so-called European "Passport" enabled the Icelandic banks to operate throughout the EEA, including through branches in other EEA countries.

We now know that there are deep flaws in this framework and that these flaws are important elements in the current euro area crisis. A key issue here is the contradiction between the European Passport rights, on the one hand, and national supervision, national deposit insurance, and national crisis management and resolution regimes, on the other. This is what recent proposals of a banking union are supposed to address. All of these problems are much aggravated when different currencies come into play, and for EEA countries and EU countries outside the euro area, this framework also has embedded in it a potentially huge foreign currency liquidity risk in the banking system that is not covered by a LOLR.

I have now described the fault lines in cross-border banking, both at the global and the EU/EEA level, and how they burst open in a particularly violent form in the case of Iceland. But what is and what should be done about this? The problem with giving a precise answer to this question is that what needs to be done at the national level will depend on what is ultimately done at the global level, and for countries that are part of the EU single market it also depends on what is done at that level. In turn, necessary reforms at the EU or global level are put in place partly to avoid national responses that would unduly fragment the international financial system or, in the case of the EU, undermine the single market and the eurozone.

Bearing in mind that circularity, let me start at the national level. The key issue here is that, as long as global risks and EU flaws are not dealt with, individual countries are forced to take action to protect themselves: action that might contribute further to the retreat of cross-border banking and financial globalisation more generally. Such action might take the form of restricting international activities of home banks, placing much stricter prudential limits on foreign currency maturity mismatches, limiting FX lending to unhedged parties, and deciding that deposit insurance shall be paid only in the local currency. The Central Bank of Iceland has recently issued a report called *Prudential rules following capital controls*, which includes all of the above. These rules are foreseen to be in place as long as Iceland is not a part of banking union and the eurozone. The problem is that it is not clear at this point whether these rules are compatible with the EU single market, of which Iceland is a member. They would certainly not be so if pre-crisis interpretations still prevailed. But times are changing.

Let me then move to the EU level. As a response to the crisis on the eurozone, the EU is currently considering banking union that will include common supervision and deposit insurance and a common resolution mechanism to deal with failing banks. This makes very good sense and will, with time, take care of the flaws for eurozone countries. However, it will

only solve part of the problem for EU countries outside the eurozone, as it will leave the currency problem – or, in other words, the LOLR problem. The same applies to single market participants that are not members of the EU, such as Iceland and Norway, and even more so if they cannot opt into the banking union. This raises the crucial question of how the banking union will affect the single market more generally, and here the UK seems to be an important case.

What should happen at the global level is somewhat less clear to me. Some temporary retrenchment is probably not undesirable at this point, as cross-border banking – and perhaps financial globalisation more generally – far outpaced developments in public frameworks. The issue of global liquidity provision to banks needs further exploration. And finally, if countries are increasingly taking unilateral action to protect themselves, someone – probably the IMF – must monitor the process. Going forward, some ground rules might have to be considered so that we are not faced with too serious unintended consequences for the global system.

Thank you very much.