Luck O’the Icelanders?

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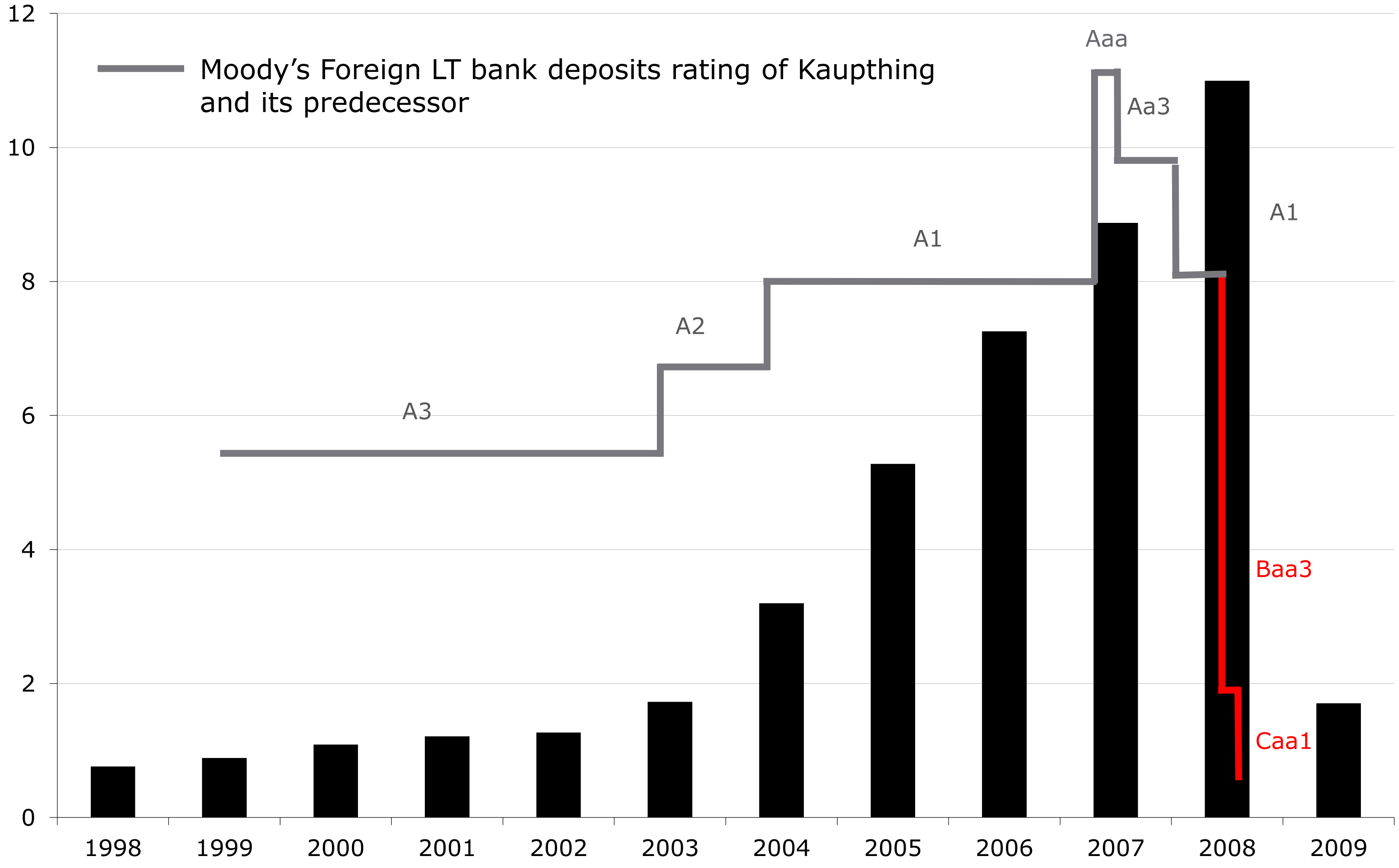
- “Iceland still has high unemployment and is a long way from a full recovery; but it’s no longer in crisis, it has regained access to international capital markets, and has done all that with its society intact.”
- “And it has done all that with very heterodox policies — debt repudiation, capital controls, and currency depreciation. It was as close as you can get to the polar opposite of the gold standard. And it has worked.”

  Paul Krugman
  New York Times, September 1, 2011

- What has Iceland done to earn such praise?

Growing out of Iceland seemed to be a virtuous cycle

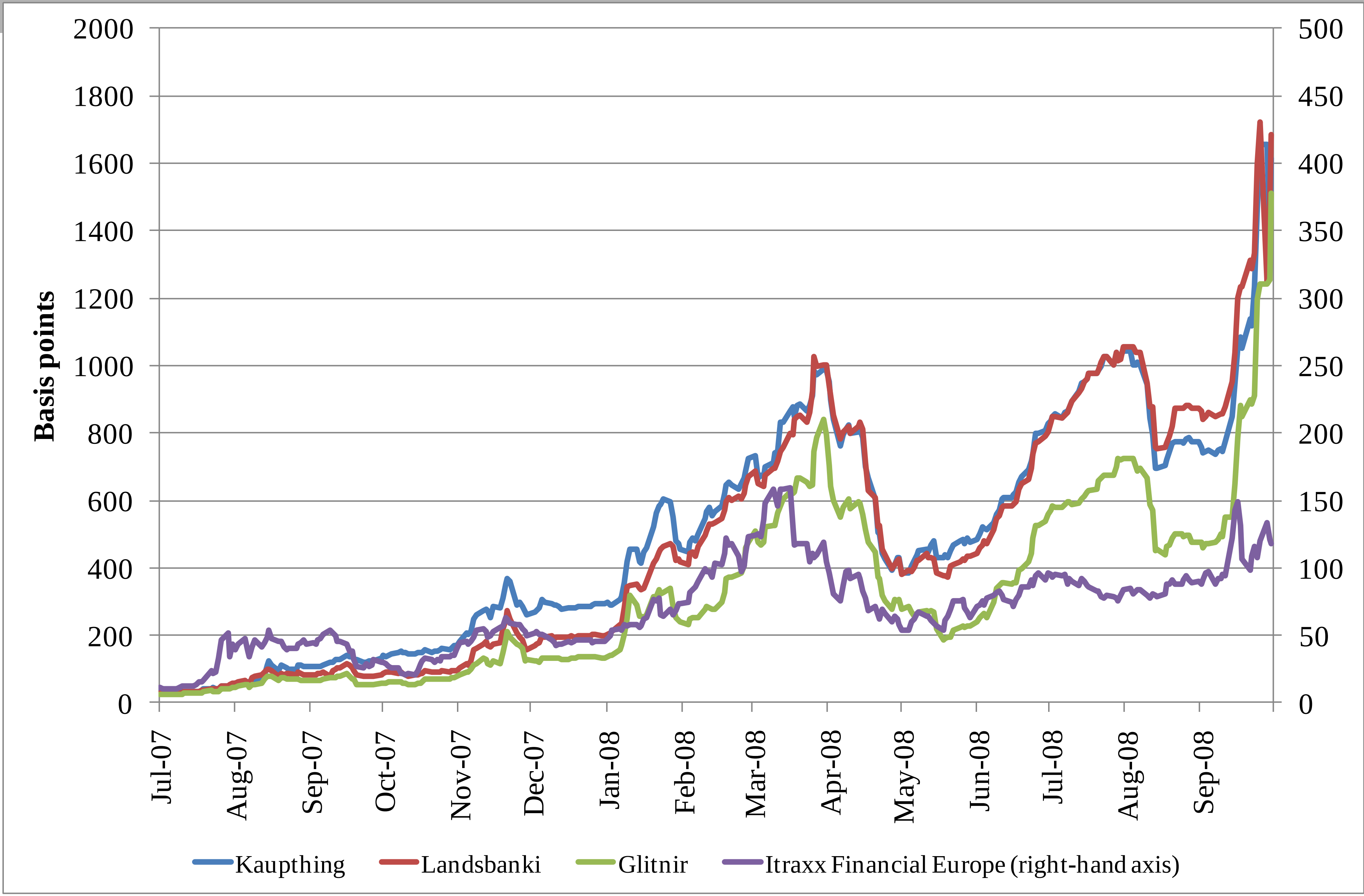
Bank assets - As a multiple of Iceland's GDP



When international banks get into trouble they become domestic

- When the Lehman crisis hit, the banks had largely been shut out of capital markets since onset of subprime crisis in August 2007
  - CDS spreads widened from 20-30 basis points in Spring 2007 to 700-1000 bp in the Bear Sterns debacle in March 2008
- Majority of lending (about 60%) and funding (80%) abroad
  - Loans to firms were 65% foreign currency; to households 25%
- No credible lender of last resort – declaration of Prime Minister in March 2008 notwithstanding
  - The Icelandic Central Bank had no open lines to the Central Banks of the main funding currencies of its banking system
- Refinancing needs on the order of €1 bn per month on average – about 1 GDP per year
  - The perception was that the banks were solvent but had liquidity problems, but banks claimed liquid reserves would last until mid-2009
- Exchange rate had depreciated by 25% since beginning of year and Carry trade inflows had subsided, but huge stock remained (60-70% of GDP)

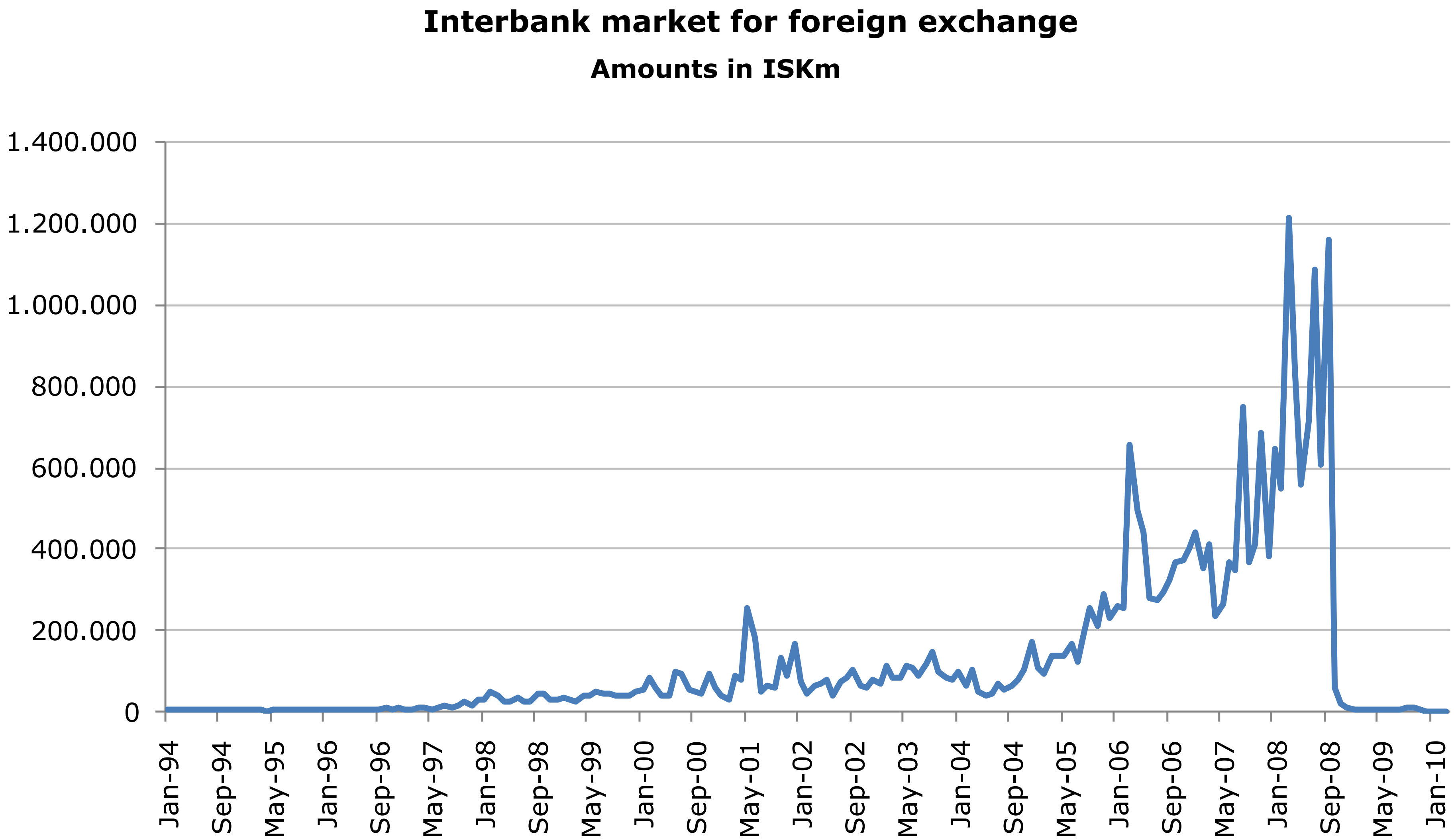
Icelandic and European banks' CDS Spread



Timeline of the crisis

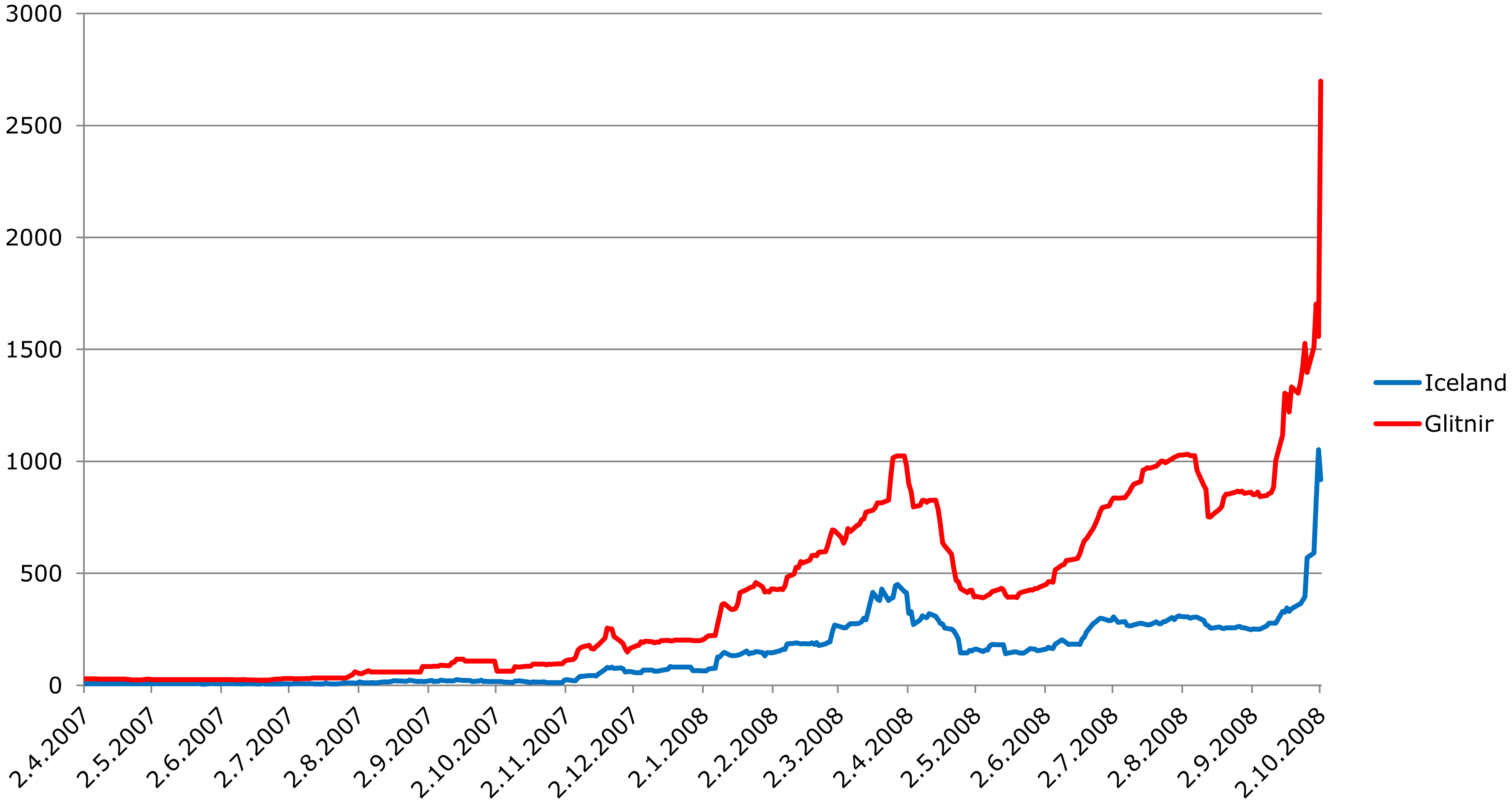
- **15 September**, Lehman Brothers default followed by money market meltdown on both sides of Atlantic
- **24 September**, the US Fed grants all Nordic countries, except Iceland, an overdraft facility. The Icelandic currency market collapses.
- **28 September**, the Icelandic government attempts to nationalize Glitnir.
- **29 September**, the Icelandic government and the banking system are downgraded. Run begins on Landsbanki’s Icesave internet accounts.
- **3 October**, Landsbanki is drained of liquidity. Run begins on Kaupthing Edge internet accounts.
- **6 October,** The Icelandic government passes emergency law and the Icelandic FSA takes control of Landsbanki.
- **7 October**, The FSA takes control of Glitnir.
- **8 October**, The UK government invokes a terrorist law against Iceland. Kaupthing Singer & Friedlander forced into bankruptcy.
- **9 October**, The Icelandic FSA takes control of Kaupthing.

September 24th - liquidity evaporates in the currency market



September 28th – A failed bailout attempt of Glitnir sparked a system wide bank run

The CDS of Glitnir Bank and the Icelandic Sovereign from 2007 to October 3rd 2008



The emergency measures

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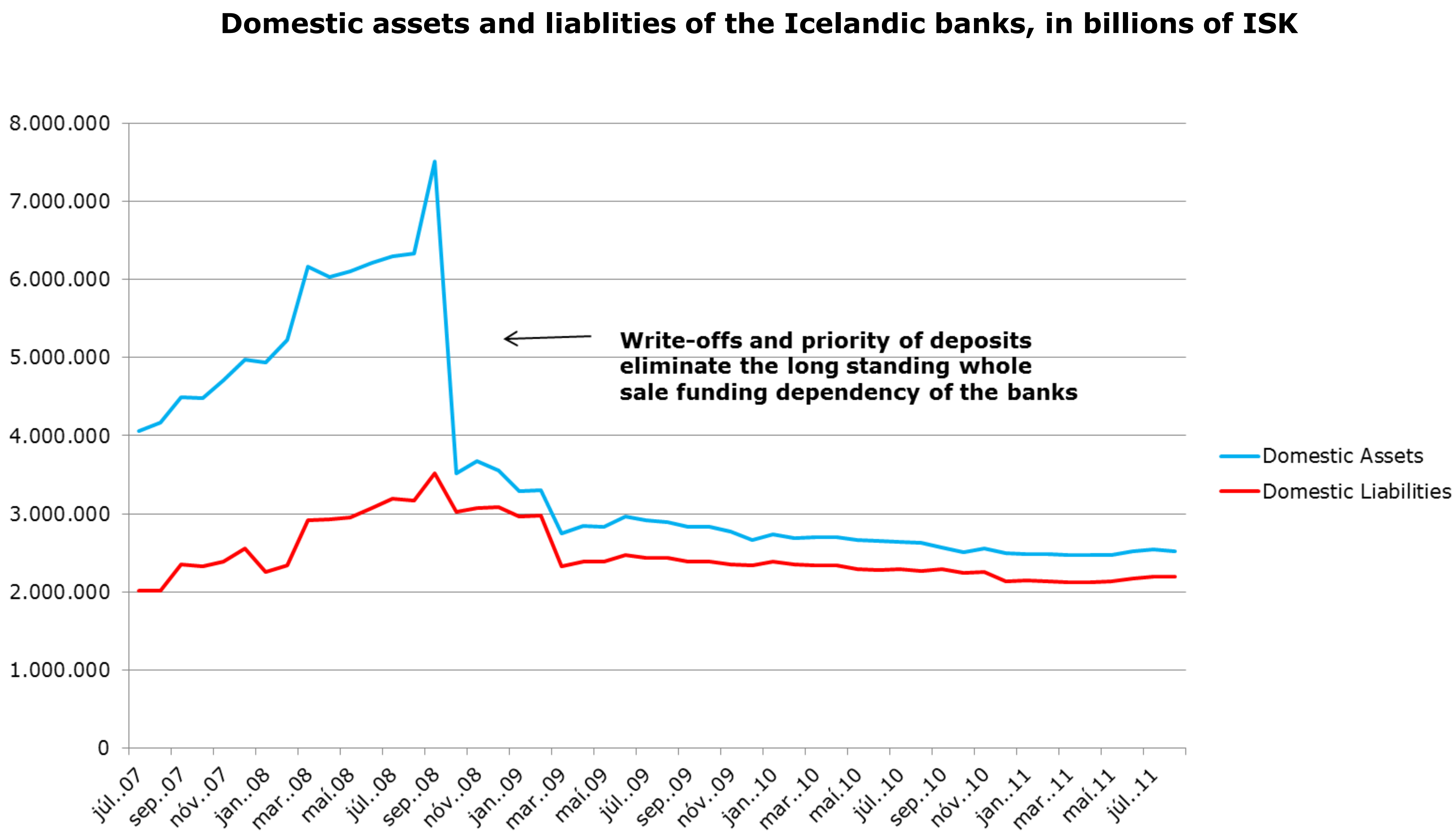
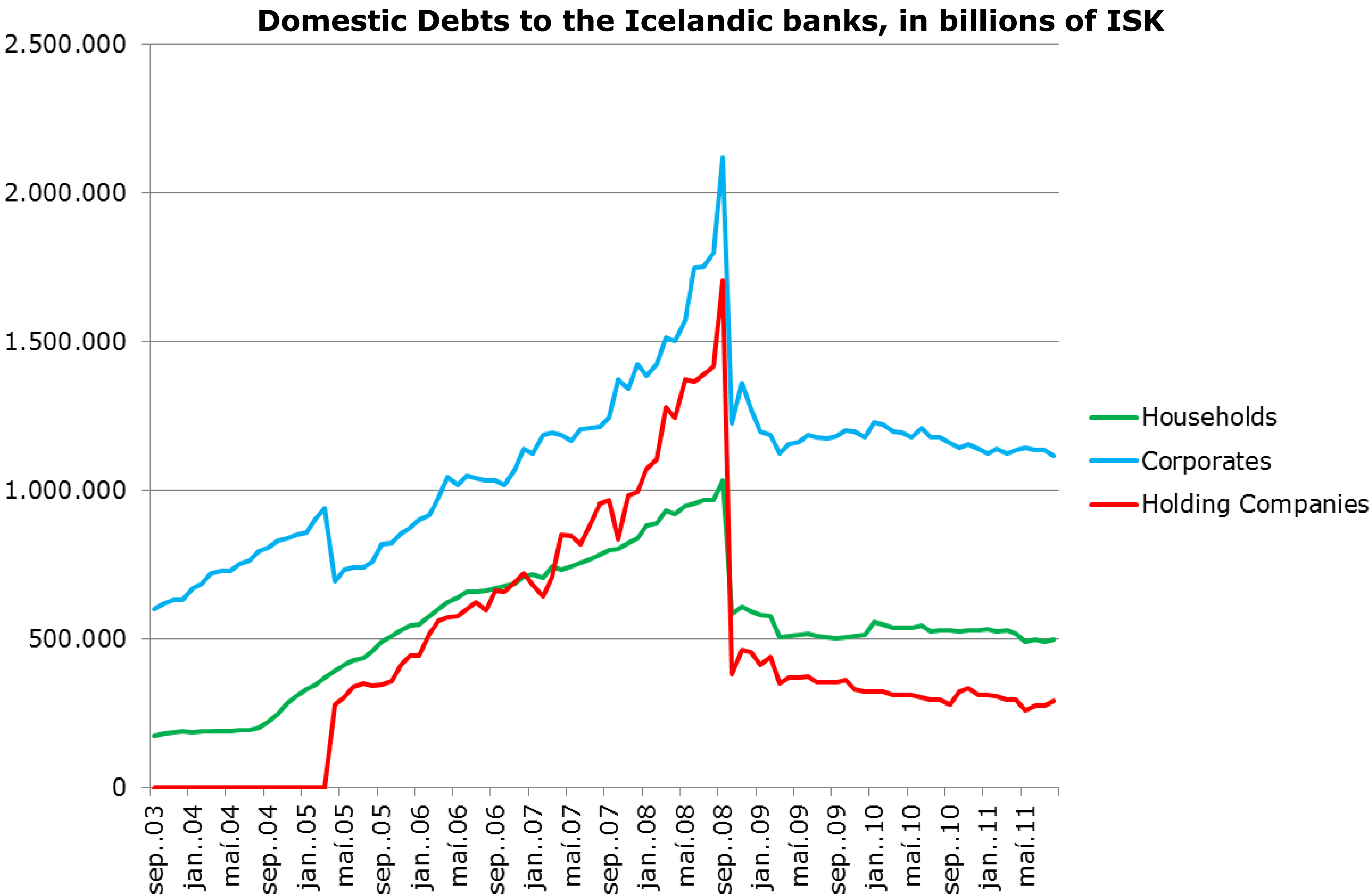
October 6th - Emergency legislation passed through parliament in an evening session

- Domestic part ring-fenced in new banks
  - Icelandic assets and liabilities (deposits) transferred
  - All deposits in Icelandic branches fully covered
  - Assets in excess of liabilities paid out to “old banks”
- Creditors (international and Icelandic) left with claims to “international” assets of old banks
- Recovery rate of creditors – after deposits – in two out of three banks (Kaupthing and Glitnir) on order of 30%
- Recovery rate of creditors in Landsbanki much lower, perhaps 10% or less
  - Deposit-loan ratio higher (63%) than at Glitnir (25%) and Kaupthing (45%) – Icesave
- Overall recovery rate perhaps around 60%

October 6th to 9th – New banks founded with deposits and domestic assets



Fault line: balance sheet adjustment following emergency law allowed for large write-offs to banks´ customers



The banking crisis has been resolved with the emergency legislation, the currency crisis is contained by capital controls

- **The new Icelandic banks are structured like old fashioned retail banks with 90% deposit financing and 15-20% equity ratios.**
- **Their asset quality is among the highest in Europe given the steep write-offs that were taken at their founding.**
- **The banks are still supported with a 100% government guarantee on deposits.**
- **However, their liquidity position is still contingent on the capital controls that prevent capital flight from Iceland and run on the currency.**
- **The creditors have taken majority equity stake in two of the banks – the Icesave issue prevents such solution for Landsbanki.**
- **Thus, the potential upside from an economic recovery in Iceland will be shared with the former creditors.**
- **Claims on the old banks were trading for 6% face value after the collapse but are now around 30% (Glitnir and Kaupthing) and rising.**

Luck O'the Icelanders?

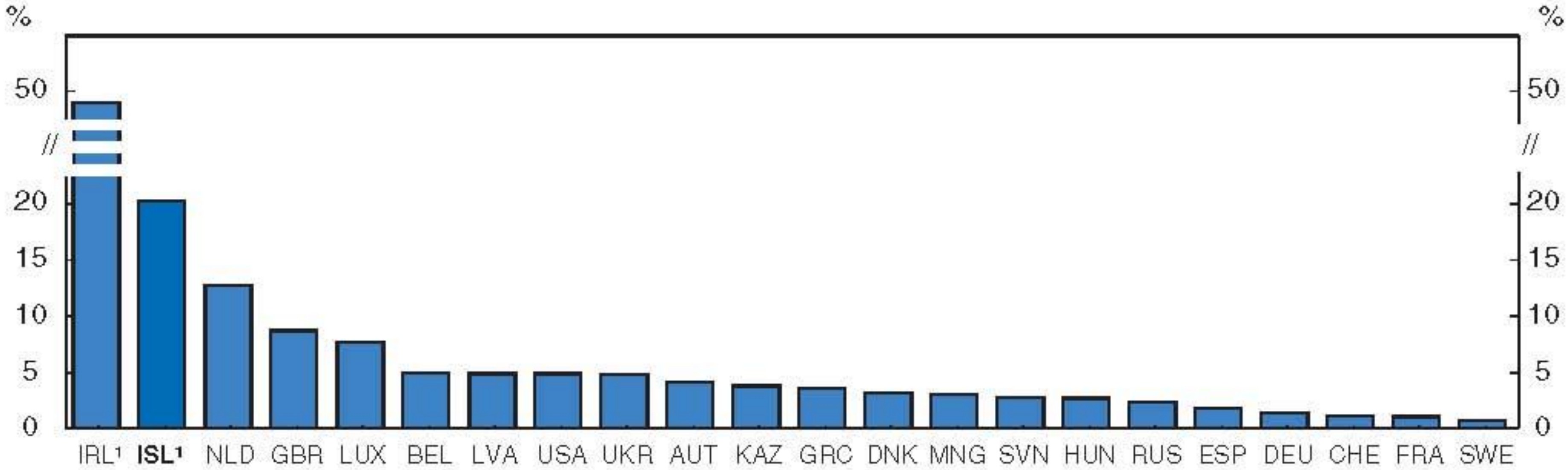
What options were available before the crisis?

- **The expert advice the Icelanders got from abroad before the crash was to:**
  - **…amass 10-11 billion EUR in foreign reserves by issuing bonds abroad and through lines to the main Central banks.**
  - **Buy back bank bonds at a discounted price**
  - **Take over the banks and then take them apart.**
- **This inevitably would have led to taxpayers assuming responsibility for bank liabilities.**
- **This is indeed what the government attempted by nationalizing Glitnir in September 2008, but too late, and without the proper liquidity support.**
- **The Icelandics were forced into painful restructuring as they came to terms not only with a banking bubble but also currency bubble.**
- **The Icelanders could not print their way of out the crisis in 2008!**

The costs are high, but they are capped since the worst scenario has already played out

Figure 1.2. **Direct fiscal costs of the financial crisis over 2007-09**

As per cent of 2009 nominal GDP



1. OECD estimates up to early 2011 as per cent of 2010 nominal GDP. For Iceland, fiscal costs comprise losses on loans to the failed banks (12.9% of GDP, of which 11.1 percentage points is attributable to losses on loans made by the CBI), the net costs of recapitalisation of failed banks (3.8% of GDP), the costs of recapitalising the HFF (2.1% of GDP) and the cost of called loan guarantees (1.5% of GDP). For Ireland, these are the estimated costs of bank recapitalisations.

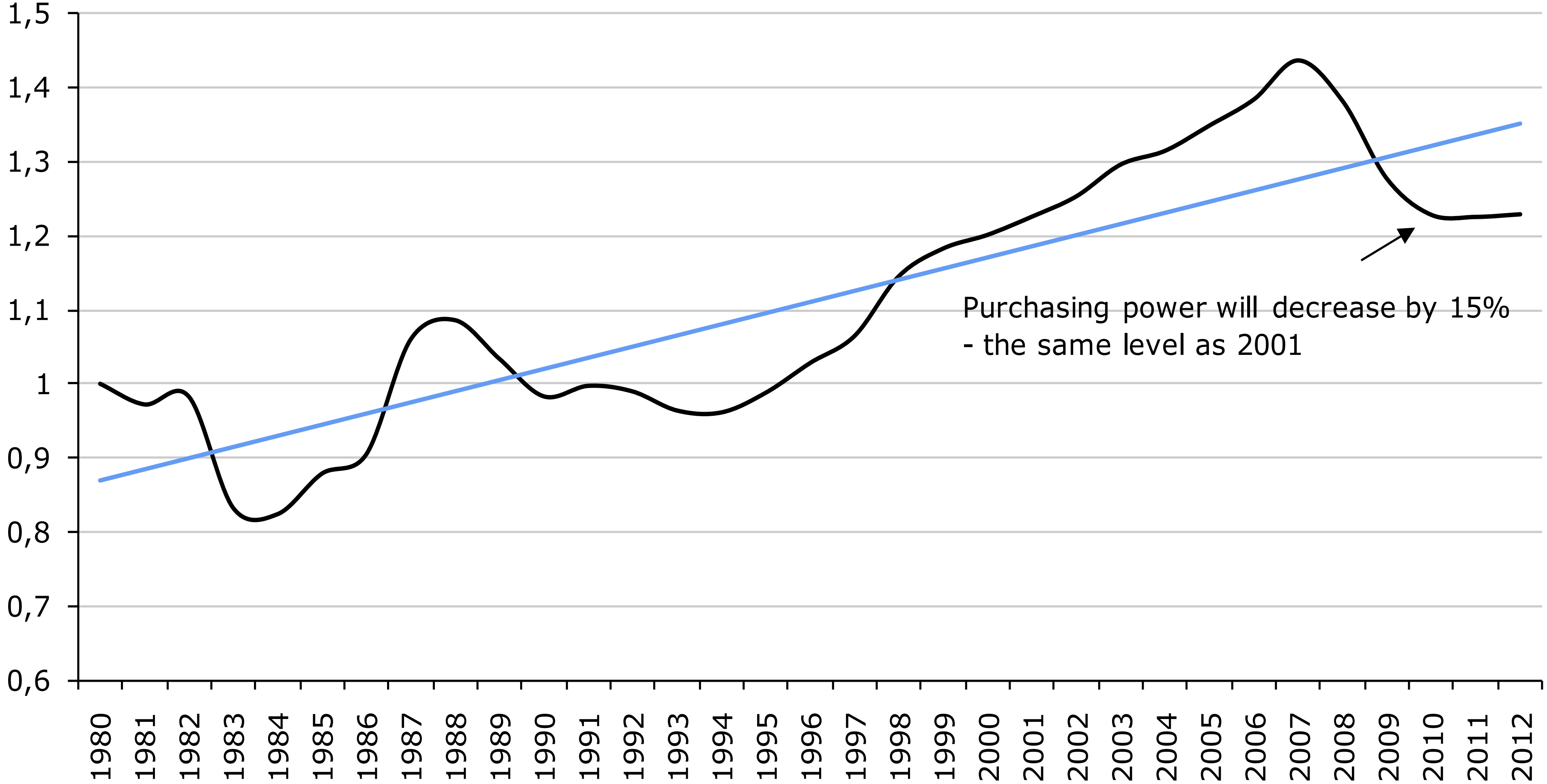
Source: Laeven and Valencia (2010), "Resolution of Banking Crises: The Good, the Bad, and the Ugly", *IMF Working Paper* WP/10/146; and OECD for Iceland and Ireland.

StatLink http://dx.doi.org/10.1787/888932445657

From OECD Economic Surveys: Iceland, June 2011

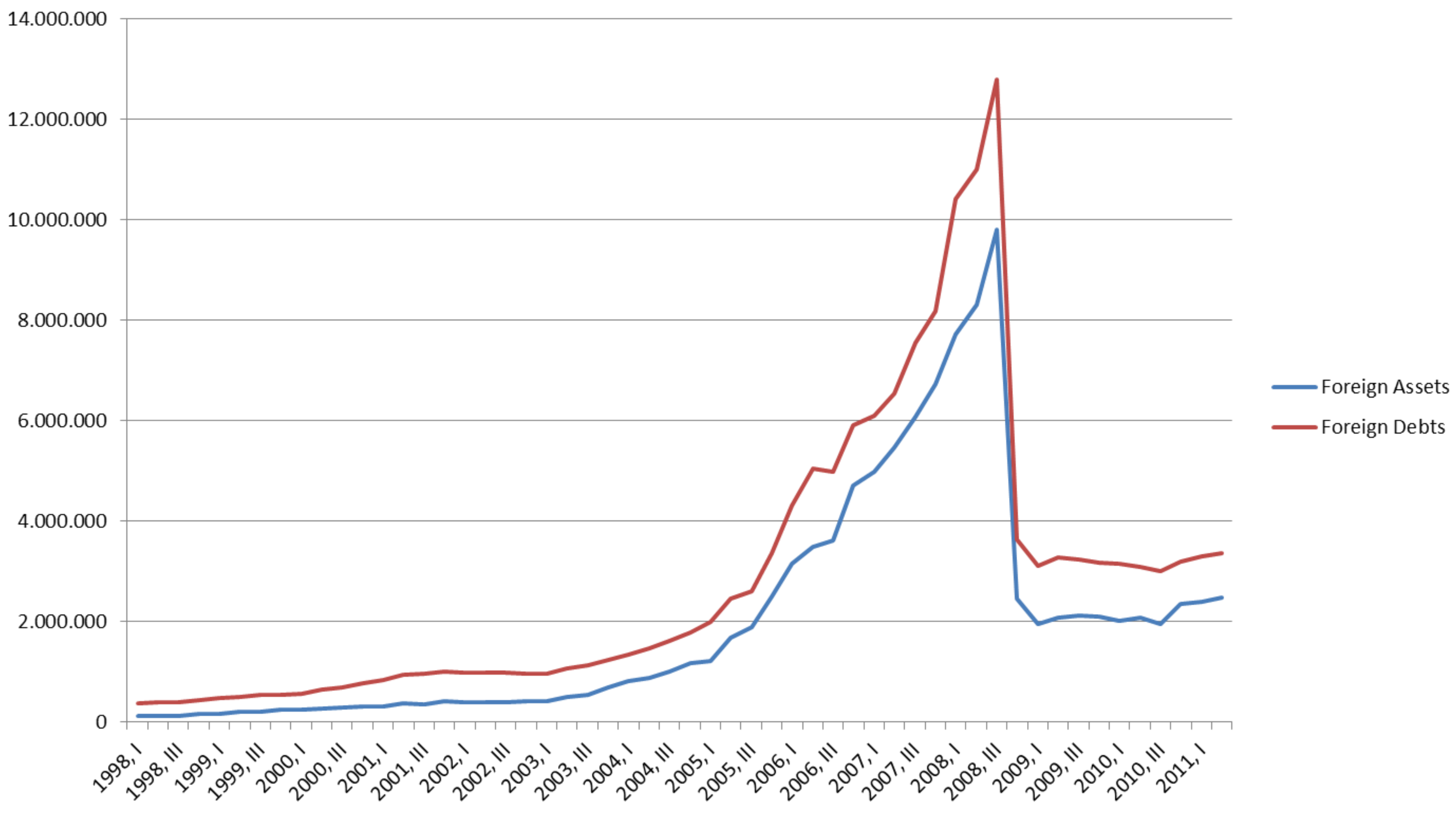
Pain in the wallet – back to 2001 purchasing level

Household Purchasing Power, index based on average wages and inflation



The main thing: A leaner and healthier balance sheet of Iceland after the collapse

Foreign debts and assets of Iceland, excluding failed financial institutions



The accidental entrepreneur in bank restructuring

- The total collapse occured not only because the Icelandic banks were **too-big-to-save** but Iceland itself was **too-small-to save**.
- Since Iceland was not part of the European Union and the failure of its banking system wasn't sparking any "contagion" fears, no other major central banks were willing to lend to a hypothetical Icelandic bank-bailout scheme.
- Iceland is probably the first triple-A rated country to so utterly lose confidence of international markets, and its collapsed banks now have the dubious distinction of being the first A-rated enterprises in history to default.
- What was seen as a disaster three years ago is, however, increasingly being seen as good fortune.
- Icelanders may have lost their financial system, but instead they were spared the burden of nationalizing private debts, and that makes all the difference.
- The economy contracted, general purchasing power declined by 30%, but, crucially, adjustment has taken place.

The country that got saved is the one in trouble

The CDS spread on Irish and Icelandic debt

Iceland’s luck was that it did not qualify for a bailout.

- **It is becoming clearer by the day that the current international financial crisis was initially misdiagnosed as a problem of liquidity rather than one of a solvency.**
- **Yet, European policy makers have stubbornly rejected any meaningful restructuring measures.**
- **Instead the stakes steadily get higher in a game of confidence against the markets, and the distinction between private and public debt becomes increasingly blurred.**
- **The Icelandic story provides a warning of how fast confidence can evaporate in financial markets, especially if debt issues are not tackled preemptively.**
- **However, it is also an example of how gain can follow pain if the business cycle is allowed to follow through a path of adjustment and creative destruction.**
- **Iceland's “luck” was that it did not qualify for a bailout.**