

Iceland's Financial Crisis



A Global Crisis

- The current economic turmoil in Iceland is part of a complex global financial crisis and is by no means an isolated event.
- Governments around the world have introduced emergency measures to protect their financial system and rescue their banks, as they suffer from a severe liquidity shortage.
- Thus far, Iceland has been hit particularly hard by this unprecedented financial storm due to the large size of the banking sector in comparison to the overall economy.
- The Icelandic Government has taken measures and is working hard to resolve the situation, both independently and in cooperation with other parties.
- Iceland is cooperating with its Nordic and European partners and is currently consulting with the IMF on measures toward further stabilization of the Icelandic economy.

Bank Liquidity Tightens

- The liquidity position of Icelandic banks tightened significantly in late September and early October as interbank markets froze following the collapse of Lehman Brothers.
- The nationalization of Glitnir, one of Iceland's three major banks, on Sept. 29th, led to a credit rating downgrade on sovereign debt and that of all the major banks.
- This led to further deterioration of liquidity.
- Early October, all three banks were suffering from a severe liquidity shortage and in dire need for Central Bank emergency funding. Negative coverage on the Icelandic economy, particularly in the U.K, did not help either.
- By mid-October, all three banks, Glitnir, Landsbanki and Kaupthing, had been taken over by the government on the basis of a new emergency law.
- The banks had become too large to rescue.

Too Big to Rescue

- In early October, the Icelandic government came to the conclusion that the Icelandic banks were too big to rescue.
 - Pre-crisis total balance sheet of the three Icelandic banks was €110bn.
 - Icelandic GDP in 2007 was €14.7 bn.
 - Government could not guarantee the whole balance sheet of the banks; nationalization was therefore no longer an option.
- Emergency law was passed on October 6th.
 - Allowed the Icelandic Financial Regulatory Authority (FSA) to take over operations of illiquid banks.
 - Powers to suspend payments in order to safeguard value and protect depositors.
 - Powers to establish new banks to overtake domestic deposit obligations and assets from failing banks.

Restructuring of the Banking System

- On the basis of the new legislature law, the Icelandic Financial Regulatory Authority (FSA) has assumed control of all three banks.
- Three new state-owned banks were created from the old banks: New Landsbanki (now NBI), New Glitnir and New Kaupthing.
- These new banks assume domestic deposit liabilities and the Icelandic government has guaranteed all domestic deposits.
- The new state-owned banks will overtake sufficient assets from the old banks to cover deposit liabilities and equity requirements. Further information here: <http://fme.is/?PageID=867>
- Foreign operations of the old banks will likely be sold to other parties, such as foreign financial institutions. Others may be shut down and their assets used to reimburse deposits and other outstanding liabilities – with the backup of the guarantee funds in the respective country according to EU/EEA regulations.

Deposits of Foreign Customers

- As previously mentioned, the Icelandic government has guaranteed all domestic deposits.
- The deposits of foreign customers in Icelandic banks are generally guaranteed according to EU/EEA rules.
- Depending on whether the bank is operated as a subsidiary or a branch, different deposit-guarantee schemes may come into play if assets do not cover commitments.
- Any foreign subsidiary of an Icelandic bank is fully covered by the deposit-guarantee scheme in the country it operates (i.e. Kaupthing Edge in the UK).
- All branches of Icelandic banks that have been nationalized (taken over by the FSA) are covered by the [Icelandic Depositor's and Investor's Guarantee Fund](#), which operates according to the EU-directive relating to these issues (i.e. Icesave in the UK).
- According to the directive, the amount covered is €20,887 for each depositor in each financial institution.

The Landsbanki Predicament

- The assets of Old Landsbanki in the UK were frozen via provisions in the Anti Terrorism, Crime and Security Act from 2001.
- This has been forcefully opposed through diplomatic channels with UK authorities, as this clearly has a very damaging effect on the Icelandic banking sector and puts Icelandic companies in the UK in a difficult situation.
- Iceland has also taken the issue up for discussion within NATO and Icelandic authorities have considered legal action.
- This is also one of the main factors leading to disruptions in Iceland's international payments and settlements system.

Deposit Insurance: Impact on Government Debt

- Net Government debt was close to none before the crisis.
- Potential impact on Government debt from deposit insurance:
 - Cost of insurance of international deposits of Icelandic banks likely to amount to EUR 4 bn.
 - Assets of international branches amount to > EUR 4 bn.
 - Sale of assets likely to cover 50%–60% deposit insurance costs
 - Overall impact on the Government debt level likely to be lower than 20%
 - Negotiation with UK and the Netherlands on deposit insurance resulted in an outline of an agreement
 - UK and The Netherlands will disburse deposit insurance claims
 - Dispute will thus not hamper IMF assistance

Impact on Government Debt from Other Factors

- Government debt is set to rise due to other factors as well:
 - Capitalization of the three new banks.
 - Recapitalization of the Central Bank.
 - Rising deficit due to economic slowdown.

Going Forward

- Going forward the debt level should nevertheless continue to be manageable.
- IMF to lend Iceland \$2.1 bn:
 - Other sources with up to \$4 bn over the next two years.
 - \$830 million will be allocated when the IMF's Executive Board approves agreement, on Friday.
 - Quarterly reviews of certain criteria followed by disbursement of additional funds.
 - Economic stabilisation plan to deal with impact of financial crash.
 - Banking sector regulatory framework to be reviewed.
 - Tight monetary policy and tighter fiscal policy – especially after 2009.

Short-term difficulties... favourable long-term outlook

Despite the fact that the recent financial crisis has hit Iceland hard, the economy is still strong and resilient. This can be attributed to strong economic fundamentals.

- High income
- Good education system
- Sophisticated health system
- Abundant natural resources
- Favourable demographics
- Fully funded pension system
- Flexible labour market
- Diverse exports and industries
- Competitive tax system
- Strong fiscal position
- Strong Infrastructure
- Political stability and International co-operation

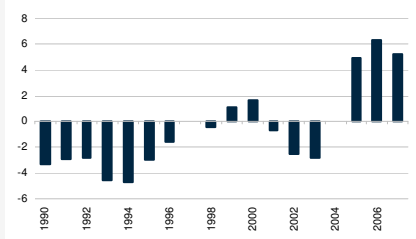
Appendix 1: Timeline of the Icelandic Financial Crisis

September 29	Government announces takeover of 75% share in Glitnir and EUR 600 m equity injection S&P downgrades Glitnir to BBB; Sovereign to A-
September 30	Fitch downgrades sovereign to A-; Landsbanki to BBB; Kaupthing to BBB; Glitnir to BBB- Moody's downgrades sovereign to Aa1; Landsbanki to A2; Kaupthing to A1; Glitnir to Baa2
October 4-5	Government evaluates crisis in an attempt to save banking sector.
October 6	Emergency law is introduced and passed by parliament; government guarantees all domestic deposits Icelandic FSA seizes control of Landsbanki under terms of emergency law S&P downgrades sovereign to BBB
October 7	Assets of Landsbanki seized by UK authorities; Landsbanki Luxembourg goes into administration FSA seizes control of Glitnir under terms of emergency law Central Bank extends EUR 500 m loan to Kaupthing; announces intentions to negotiate EUR 4 bn loan with Russian government Central Bank announces exchange rate peg and starts by selling EUR 6 m. at ISKEUR 131 Fitch downgrades sovereign to BBB-; Landsbanki to B; Glitnir to B S&P downgrades Glitnir to CCC
October 8	Central Bank announces intention to maintain currency peg; later announces that peg is not sustainable and has been abandoned. Swedish Central Bank extends SEK 5 bn loan to Kaupthing Sweden British authorities put Kaupthing Edge and Kaupthing Singer & Friedlander into administration British PM threatens to sue Icelandic government to claim guarantee for Icesave deposits Icelandic PM states that sale of Landsbanki assets will be used to refund Icesave depositors Fitch downgrades sovereign to BBB-; Landsbanki to D; Kaupthing to CCC; Glitnir to D Moody's downgrades sovereign to A1 and puts on review for further downgrade; Kaupthing to Baa3; Glitnir to Caa2 Board of Kaupthing requests FSA to assume control of bank
October 9	New Landsbanki starts operations with Dutch finance minister threatens to sue Icelandic government over Icesave deposit guarantee; British PM reiterates threats Fitch downgrades Kaupthing to CC Moody's downgrades Kaupthing to Caa2 S&P downgrades Glitnir to D
October 10	Dutch delegation arrives in Reykjavik; initiates talks with treasury department about Icesave Central Bank announces limits on currency outflow; low amounts for travel and import restricted to necessities, companies must apply for currency to the CB
October 11	British delegation initiates talks with treasury department about Icesave deposits Accord signed with Dutch government on loan to guarantee a refund of Icesave deposits Outlines of an accord with British government on loan to guarantee refund of Icesave deposits

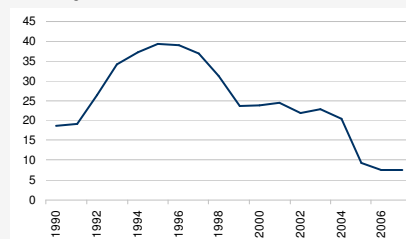
October 14	Central Bank delegation starts talks in Moscow with Russian Finance Ministry on loan to Iceland Central Bank draws on swap facility arrangements with Denmark and Norway, each by EUR 200 m. Moody's confirms sovereign credit rating issued on October 8 (A1)
October 15	Central Bank lowers policy rate by 350 bp to 12% Central Bank introduces auction system to meet demand for foreign currency, resulting in an allocation of EUR 25m. at a ISKEUR rate of 150. Fitch issues credit update for sovereign debt holding rating steady at BBB- on negative watch. Iceland and Russia agree to continue discussions on a possible loan. New Glitnir starts operations with ISK 110 bn in capital
October 16	Central Bank announces that it guarantees that all payments will reach ultimate beneficiaries' accounts with local banks in an attempt to revitalize payment system.
October 22	New Kaupthing starts operations with capital of ISK 75 bn Norwegian delegation arrives in Iceland to gather information about the the situation.
October 24	Government announces an agreement <i>ad referendum</i> with an IMF mission of USD 2 bn stand-by-facility programme. Government formally requests assistance from the Nordic countries, the ECB and the FED. Delegation from the US Treasury Department arrives in Reykjavik.
October 27	High-level Nordic committee established to present proposals for Nordic assistance to Iceland in cooperation with the IMF.
October 28	Central Bank raises policy rate by 600 bp to 18%. Faroe Islands pledge DKK 300 million loan for Iceland.

Appendix 2: Iceland's Economy

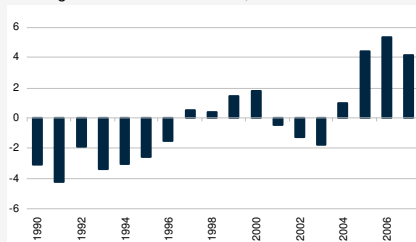
General government fiscal balance, % of GDP



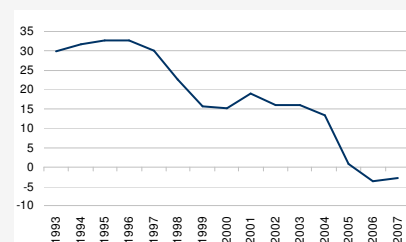
General government net debt, % of GDP



Central government fiscal balance, % of GDP

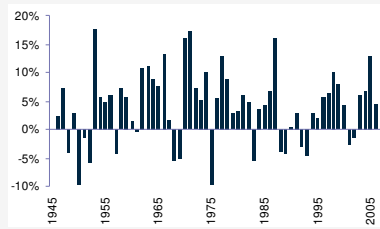


Central government net debt, % of GDP

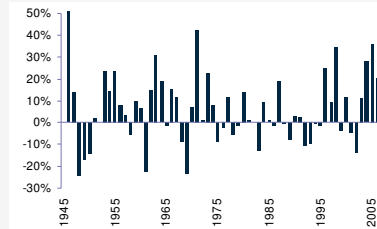


Source: Ministry of Finance

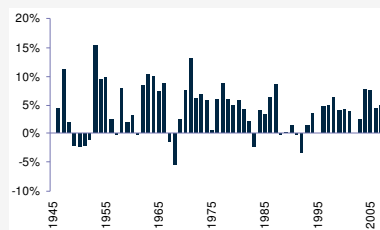
Private Consumption 1945-2007, real growth YoY



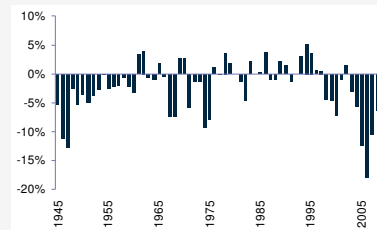
Investment, real growth YoY



GDP Growth 1945-2007, YoY



Balance of Goods and Services 1945-2007, % of GDP



Source: Statistics Iceland