



# **Iceland's international financial sector: Puzzles in the market**

**Richard Portes**

**Professor of Economics, London Business School  
and**

**President, Centre for Economic Policy Research  
*Copenhagen, 11 March 2008***

# La calunnia

(Aria of Don Basilio)

Gioachino Rossini, *Il barbiere di Siviglia*, act I

## Rumours start...

La calunnia è un venticello  
un'auretta assai gentile  
che insensibile, sottile,  
leggermente, dolcemente,  
incomincia a sussurrar.

Slander is a little breeze,  
a gentle little zephyr,  
which, insensibly and subtly,  
lightly and softly,  
begins to murmur.

Piano piano, terra terra,  
sotto voce, sibillando,  
va scorrendo, va ronzando;  
nelle orecchie della gente  
s'introduce destramente,  
e le teste ed i cervelli  
fa stordire e fa gonfiar.

Very softly, quite prosaically,  
under one's breath, with a hiss,  
it flows, it buzzes;  
into the ears of the public  
it deftly introduces itself,  
and it stupefies heads and brains  
and makes them swell up.

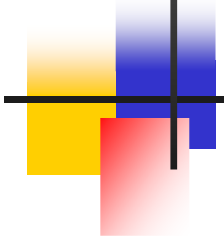
## ...and lead to crisis – with an unpleasant dénouement...

Alla fin trabocca e scoppia,  
si propaga si raddoppia  
e produce un'esplosione  
come un colpo di cannone,  
un terremoto, un temporale,  
un tumulto generale  
che fa l'aria rimbombare.

E il meschino calunniato,  
avvilito, calpestato,  
sotto il pubblico flagello  
per gran sorte va a crepar.

Finally it issues forth and bursts,  
it spreads and redoubles  
and produces an explosion  
like a cannon shot,  
an earthquake, a thunderstorm,  
a general uproar  
that makes the air echo.

And the miserable victim of slander,  
humiliated, downtrodden,  
under the scourge of the public,  
by good luck, drops dead.



# Road map

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- The rumours
- The data – don't fit the rumours – hence the puzzle
- Two dysfunctional elements in today's capital markets
  - the CDS market
  - the ratings agencies
- Puzzle solved – but how to get out of the vicious circle?



# The rumours – an example from the British press

**Telegraph**.co.uk

## **Is Iceland facing meltdown?**

*18 March 2006*

*'Déjà vu all over again...'*

## **Is Iceland headed for meltdown?**

***A Northern Rock style crisis is threatening Iceland's entire banking system***

*5 February 2008*

At least they added a sentence at the end: "Results published by the key players in Iceland's financial sector last week helped alleviate fears that the country is on the cusp of a Northern Rock-style bank funding crisis." Indeed...



## How to react?

# Economists look at the data

- *Growth* has decelerated to 2.9% in 2007, zero in 2008 (forecast)
- But *current account* deficit fell from 26% of GDP in 2006 to 16% in 2007, with exports up 20% (data controversial – a better estimate of income component would probably cut 2007 deficit to 10%) – projected to fall to levels long sustained by Australia and NZ
- 5<sup>th</sup> highest *GDP per capita* in OECD on new PPP estimates (behind only L, N, US, EI)
- *Fully funded pension system*
- *Fiscal surplus*, central government *net debt* 6% of GDP, *gross debt* 24%
- End-2006 external assets 395% of GDP, liabilities 517%
- Total banking sector assets 800% of GDP at end-2006, probably around 10 times GDP now

# Multiple comparisons of Icelandic with other Nordic banks look pretty good

Company	Price (loc.curr)	% YTD (loc.curr)	Mcap (EUR bn)	P/E 2007E	P/E 2008E	P/B 2007E	P/B 2008E	ROE 2007E	ROE 2008E	EPS growth (%) 2007E	EPS growth (%) 2008E
Kaupthing*	750.0	-14.8%	5,647	7.9	9.5	1.51	1.43	19.0%	15.0%	12.9%	-16.5%
Glitnir**	18.0	-17.8%	2,731	9.8	9.1	1.54	1.38	19.3%	16.1%	-30.7%	7.6%
Landsbanki**	28.8	-19.0%	3,272	8.4	8.8	1.82	1.54	23.9%	19.0%	-1.2%	-4.4%
Nordea Bank	89.7	-16.9%	24,997	8.3	8.8	1.46	1.34	17.5%	15.2%	-0.6%	-5.1%
Danske Bank	175.8	-12.0%	16,473	7.7	7.7	1.16	1.08	15.1%	14.1%	5.4%	0.6%
SEB	147.5	-10.9%	10,848	7.9	8.2	1.34	1.19	16.9%	14.5%	-1.4%	-3.9%
Handelsbanke n	178.5	-13.8%	12,032	9.9	9.3	1.52	1.40	15.4%	15.0%	-10.8%	5.8%
DnB Nor	76.0	-8.4%	12,799	8.8	8.7	1.39	1.29	15.8%	14.8%	5.6%	1.1%
Sydbank	179.0	-18.4%	1,621	7.2	7.6	1.71	1.45	23.9%	18.9%	24.2%	-6.5%
Okobank	11.4	-12.8%	1,819	11.0	10.6	1.24	1.19	11.3%	11.3%	10.6%	3.8%
Carnegie	91.8	-26.9%	763	10.1	8.6	2.56	2.37	25.3%	27.4%	-39.8%	17.4%
Swedbank	168.5	-7.9%	9,318	7.4	7.5	1.30	1.17	17.7%	15.7%	4.5%	-1.1%
<b>Average</b>		<b>-14.2%</b>	<b>10,074</b>	<b>8.7</b>	<b>8.6</b>	<b>1.52</b>	<b>1.39</b>	<b>17.6%</b>	<b>16.3%</b>	<b>-0.2%</b>	<b>1.3%</b>
<b>Median</b>		<b>-12.8%</b>	<b>10,848</b>	<b>8.3</b>	<b>8.6</b>	<b>1.39</b>	<b>1.29</b>	<b>16.9%</b>	<b>15.0%</b>	<b>4.5%</b>	<b>0.6%</b>

\* From JCF database \*\* Kaupthing Research, latest estimates



## Banks perform well in comparison with Nordic peers

- *Deposit ratios much improved, market funding maturities relatively long, overall and core profitability high*
- This is despite *high capital adequacy ratios* with which they counterbalance high equity exposure
- *Negligible exposure to US subprime market, structured finance products, related financial vehicles*
- FSA stress tests indicate they could withstand quite extreme movements in market variables specific to Iceland



# Nothing unusual about the financial structures

<b>ISKbn</b>	<b>Glitnir</b>	<b>Kaupthing</b>	<b>Landsbanki</b>
<b>Credit institutions and central banks</b>	<b>55.177</b>	<b>339.088</b>	<b>337.915</b>
<b>Deposits</b>	<b>725.349</b>	<b>1381.457</b>	<b>1421.41</b>
<b>Borrowings</b>	<b>1746.199</b>	<b>2615.96</b>	<b>774.754</b>
<b>Subordinated loans</b>	<b>101.669</b>	<b>267.289</b>	<b>111.89</b>
<b>Other liabilities</b>	<b>150.547</b>	<b>387.12</b>	<b>227.572</b>
<b>Shareholders equity</b>	<b>169.201</b>	<b>345.608</b>	<b>180.008</b>
<b>Minority interest</b>	<b>0.768</b>	<b>10.823</b>	<b>3.996</b>
<b>Total liabilities and equity</b>	<b>2948.91</b>	<b>5347.345</b>	<b>3057.545</b>

## Funding: a good deposit base now

Deposit ratios						
	Glitnir	Kaupthing	Landsbanki	DnB Nor	Swedbank	SHB
End of 2007	36,7%	41,8%	70,3%	55,5%	40,4%	39,7%
End of 2006	24,9%	29,6%	47,5%	57,3%	42,3%	48,5%
End of 2005	25,9%	31,5%	33,9%	58,9%	41,2%	41,4%

# Funding maturities look good too

Maturity profile (EURm)	Glitnir	Kaupthing	Landsbanki
2008	3,276	3,323	749
2009	2,786	5,484	2,443
2010	2,889	4,118	1,543
2011	2,501	2,222	1,715
2012	2,874	1,845	751
>2013	942	5,331	1,584

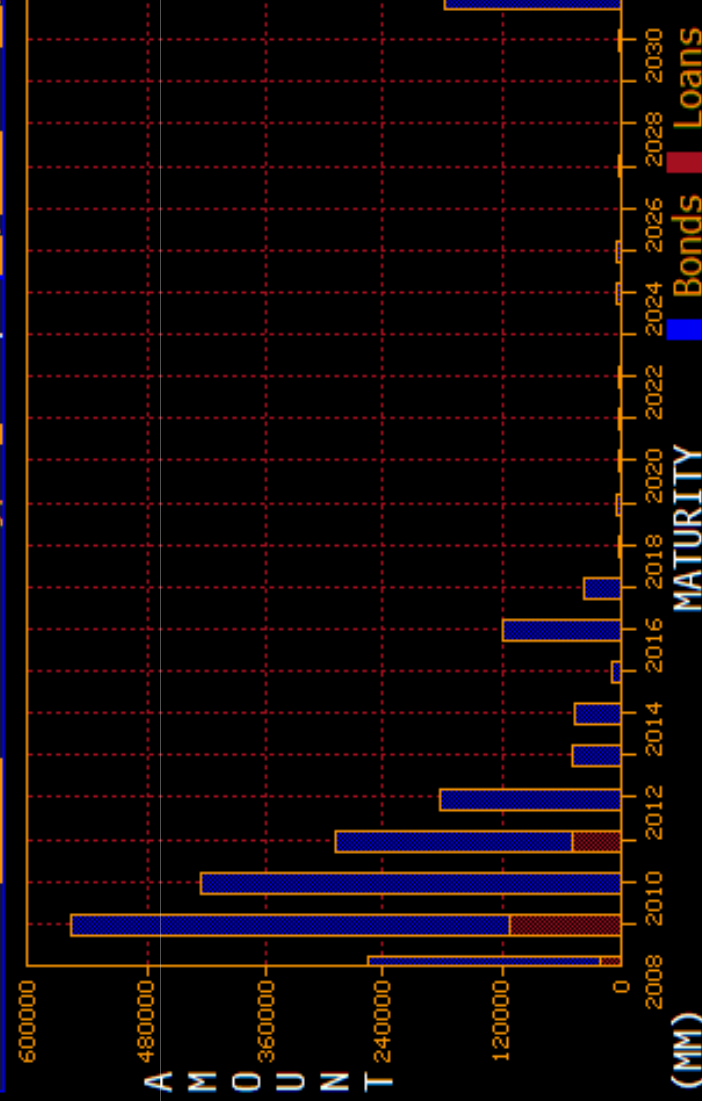
# Kaupthing maturity profile

KAUP IR Equity DDIS  
 25 <GO> to view breakdown of bond types  
**SYNDICATED BANK LOAN & DEBT DISTRIBUTION**

EquityDDIS

Search by:  
 Debt Type **3**Bonds & Loans  
 Issuer **Kaupthing Bank Hf**  
 Include **2**Current issuer and subs  
 Or Ticker **1** Ticker Type **1** Corp

Filter by:  
 Curr of issue **█** Maturity **A** All  
 Country of issue **█** Coupon **A** All  
 Date Range **2/2008** to **12/2058** Sec Type **A** All  
 Loan Type **A** All



Displays issued amounts of all bank loans disclosed to Bloomberg  
 Australia 61 2 9777 8600 Brazil 5511 3048 4500 Germany 44 20 7330 7500  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
 Copyright 2008 Bloomberg Finance L.P.  
 6609-512-0 29-Feb-2008 15:02:40

# Swedbank maturity profile

SWEDA SS Equity DDIS

25 <GO> to view breakdown of bond types

## SYNDICATED BANK LOAN & DEBT DISTRIBUTION

Equity DDIS

Search by:  
 Debt Type **3** Bonds & Loans  
 Issuer **Swedbank AB**  
 Include **2** Current issuer and subs  
 Or Ticker **1** Ticker Type **1** Corp

Filter by:

Curr of issue **■** Maturity **A** All  
 Country of issue **■** Coupon **A** All  
 Date Range **2/2008 to 12/2058** Sec Type **A** All  
 Loan Type **A** All



(MM)

MATURITY **■** Bonds **■** Loans

Total # of Issues: 266

Displays issued amounts of all bank loans disclosed to Bloomberg

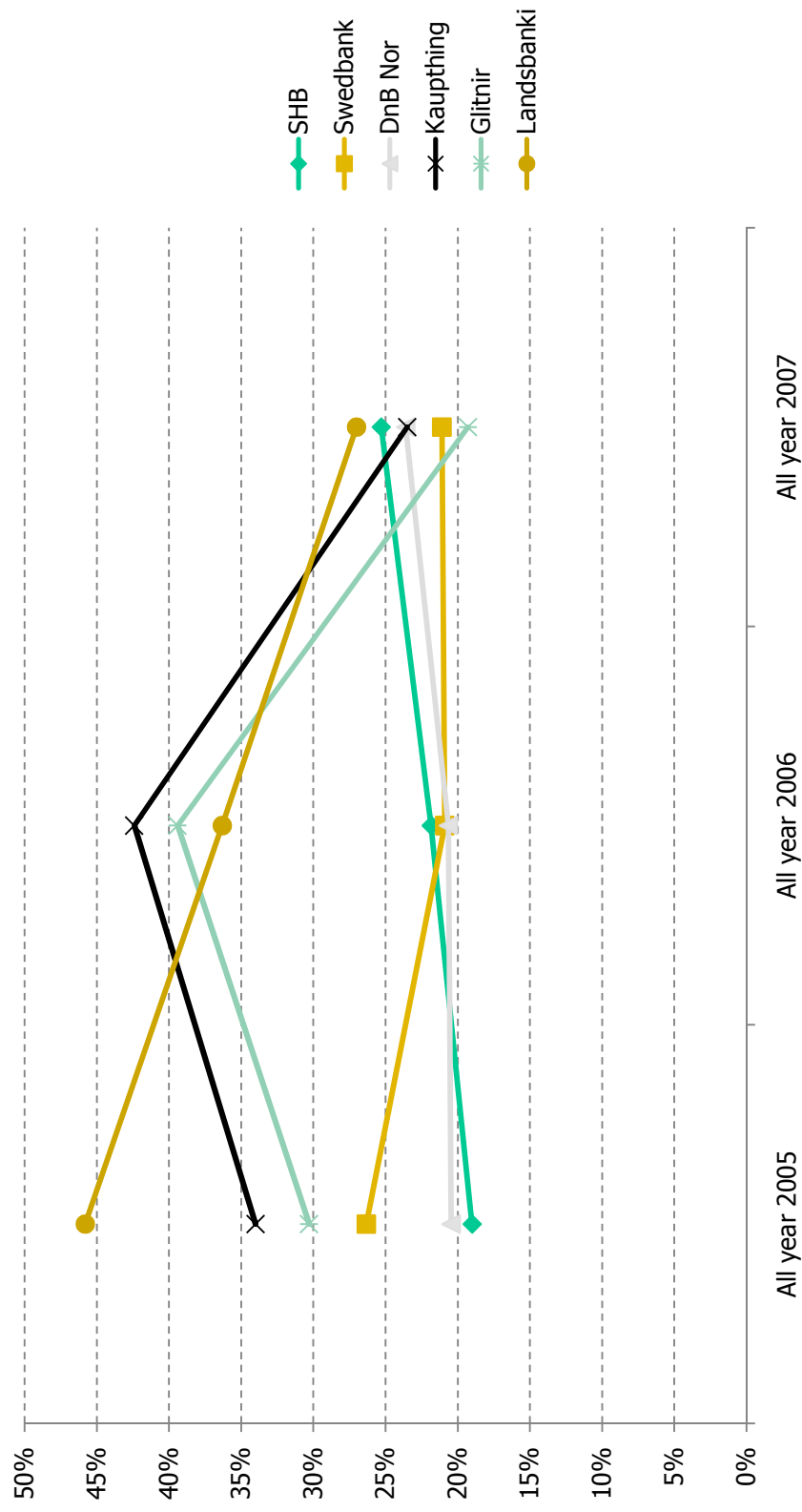
<PGFWD> to see issues

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000  
 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000  
 Copyright 2008 Bloomberg Finance L.P.  
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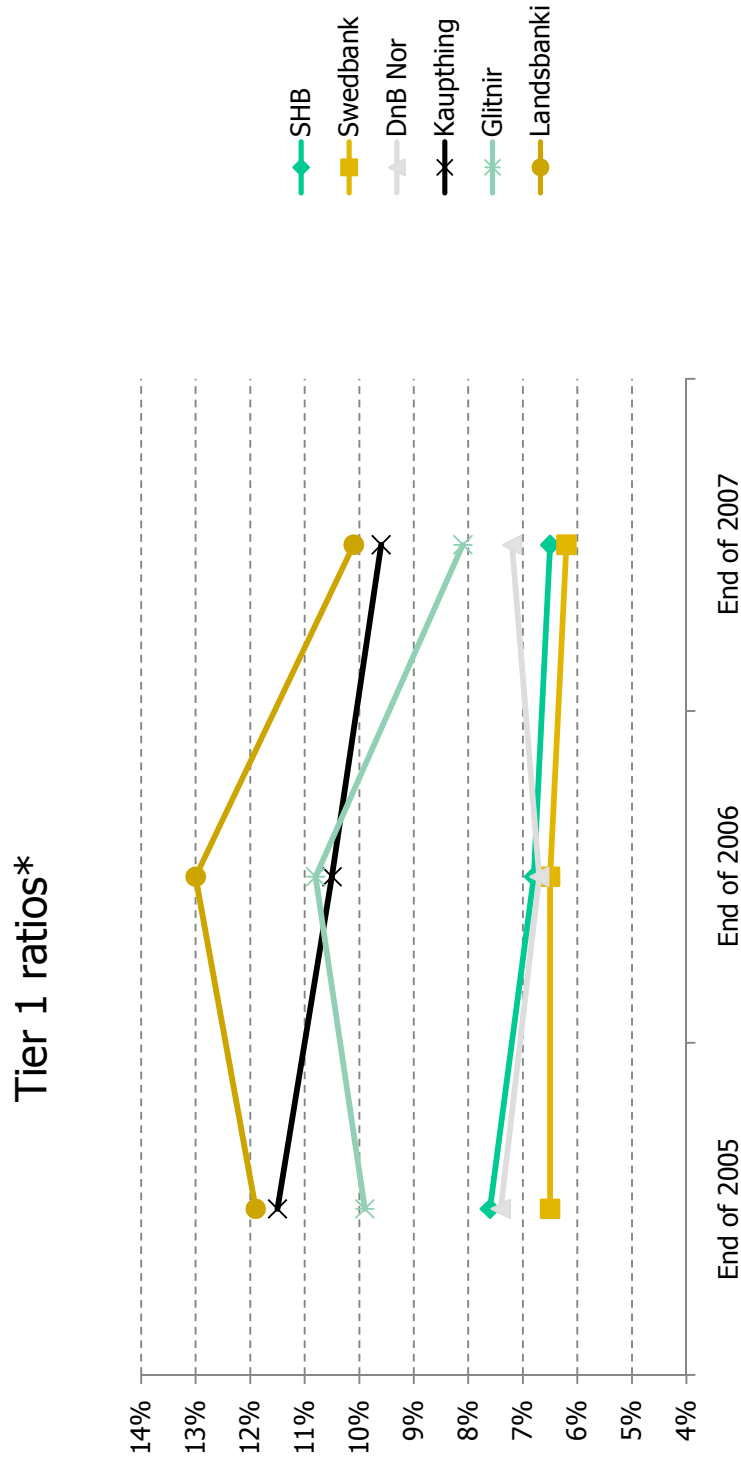
# Capital adequacy ratios are strong

	Glitnir	Kaupthing	Landsbanki
<b>CAD ratio</b>	<b>11.2%</b>	<b>11.8%</b>	<b>11.7%</b>
<b>Tier I</b>	<b>8.1%</b>	<b>9.6%</b>	<b>10.1%</b>

# Icelandic banks and their peers: return on equity



# Icelandic banks and their peers: Tier 1 capital ratios



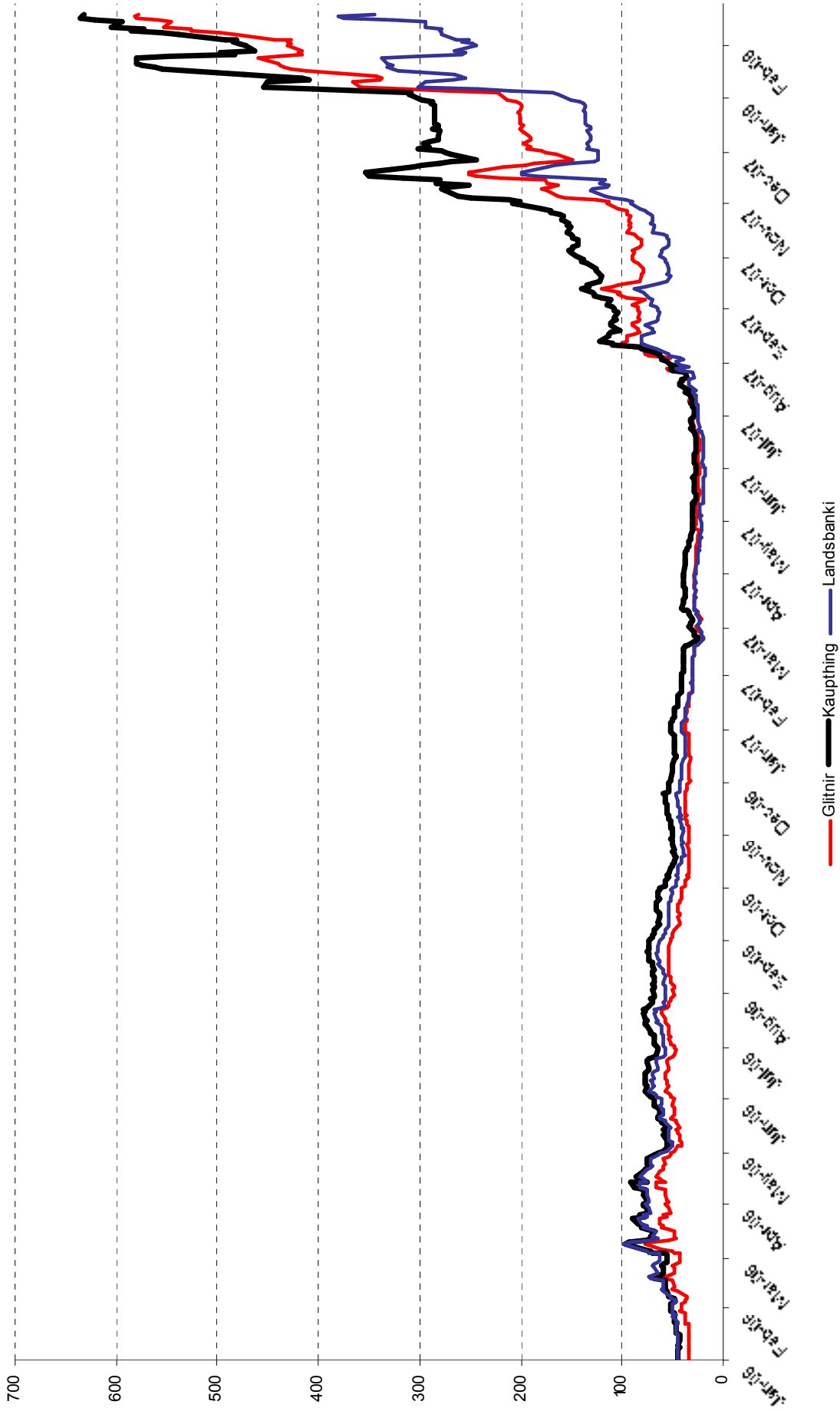
\*According to transitional rules 2007



# But the ratings (even before recent changes) put Icelandic banks below Nordic peers

	Kaupthing	Landsbanki	Glitnir	SHB	Swedbank	DnB Nor
Moody's	Long term	A2	A2	Aa1	Aa1	Aa1
	Short term	P1	P1	P1	P1	P1
S & P	Individual	C-	C-	B	B	B-
	Long term	n/a	A-	AA-	A+	A+
Fitch	Short term	n/a	A-2	A-1+	A-1	A-1
	Long term	A	A	AA-	A+	n/a
	Short term	F1	F1	F1+	F1	n/a

# And despite the data, Icelandic banks' CDS spreads have risen dramatically





## **CDS spreads: disaster looms? But what do they mean?**

- If the current level of CDS spreads were an accurate estimate of probability of default, then the Icelandic banks would be pronounced dead
- But the CDS market is highly distorted
  - it started as credit protection, then became also a vehicle for speculation, one reason why volume is so much higher than the underlying
  - now everyone wants to hedge Icelandic banks, but no one wants to write protection – with very limited supply and rumours fuelling demand, price has gone way up



## **CDS market stress is a general phenomenon – iTraxx is out of sight**

*'The risk of European banks defaulting rose higher than their clients for the first time in four months as credit-market losses spread, according to credit- default swaps traders. Contracts on the Markit iTraxx Financial index of banks and insurers jumped to as high as 153 basis points today, surpassing the Markit iTraxx Europe index by 3.5 basis points, according to JPMorgan Chase & Co.'* Bloomberg, 7 March 2008



## A dysfunctional market creates a vicious circle

*'This year banks began to unwind complex structured products through the CDS markets by bulk-buying insurance. This sent CDS spreads to record highs, totally divorced from the underlying riskiness of the companies.'* Financial Times, 7 March 2008

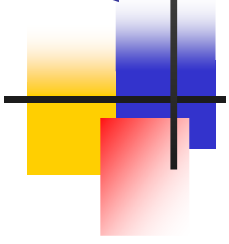
*'Liquidating structured credit instruments requires buying large amounts of protection using credit default swaps. This... drives the cost of protection higher, potentially triggering a chain reaction... The markets are so illiquid that a few trades can lead to sharp movements, producing violent price swings and knock-on effects.'* Financial Times, 10 March 2008

*'Many CDS sellers were highly leveraged. They're now being forced to close positions, and prices are rising fast.'* Breaking Views, 10 March 2008

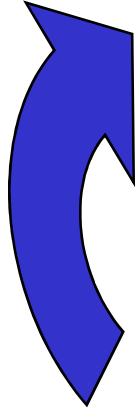


## The abnormally high CDS spreads are a major problem for the banks...

- ...because new issues have been priced by reference to (so above) CDS spreads
- At such prices, the markets are effectively closed
- The only way around this is to find investors who are willing to ignore the CDS spreads – e.g., Kaupthing issued privately last week at an (undisclosed) level well below its CDS spread, and it is not alone
- Hedge funds may be ‘playing rough’ – if you buy CDS at 200 bp (say), you would want to make things look worse and drive spreads up further
- How will HFs eventually close their CDS positions? – by writing them – so it may be just a matter of time before the market self-corrects – meanwhile, however...

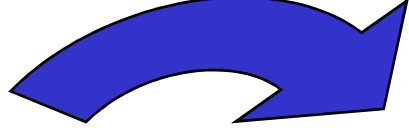


# A second CDS vicious circle

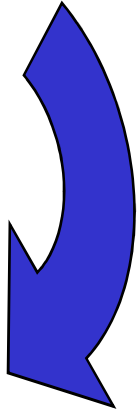


**CDS spreads  
widen**

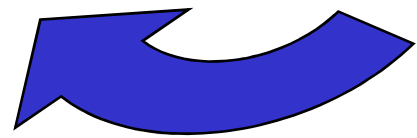
**Investors demand higher yields**



**Cost of capital goes up**



**Balance sheet deteriorates**



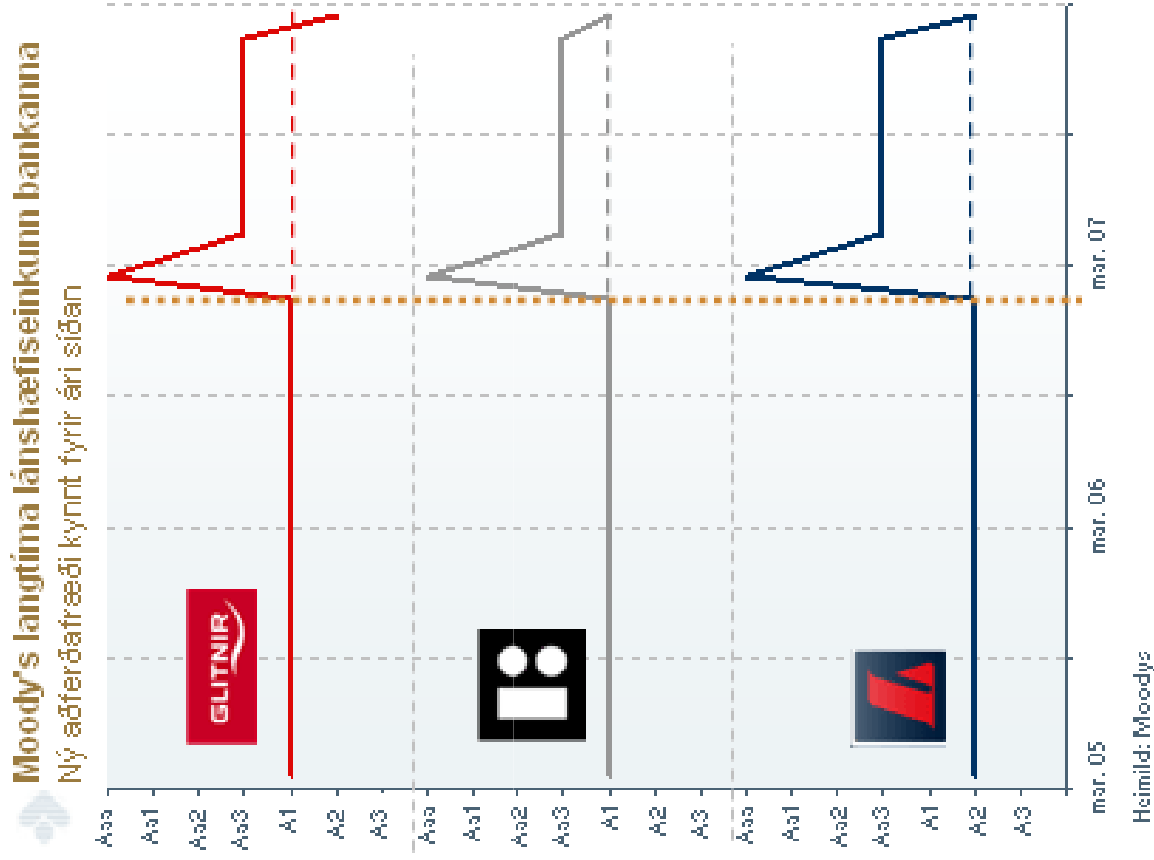


## **And a second dysfunctionality: the (dis)credit(ed) ratings agencies**

- The agencies have been erratic and misleading on Iceland...
- ...but this is just one aspect of a C-rated performance
- Consider Moody's, which has just downgraded the banks and put Iceland's sovereign rating on negative watch



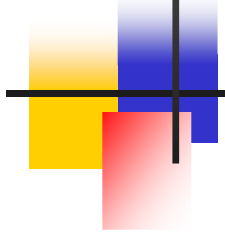
# Moody's ratings rollercoaster





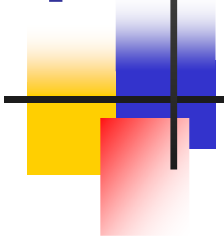
# Why this reversal? – according to Moody's

- For the banks:
  - a possible 'hard landing' for the Icelandic economy, leading to deterioration of bank loan quality
  - related lending and cross-shareholding
  - they may be 'too big to rescue' for the central bank and government
- For the sovereign: Moody's have downgraded the banks, which are contingent liabilities for the government
- But this is obviously circular! Supposed bank weakness → government financial weakness → bank weakness...



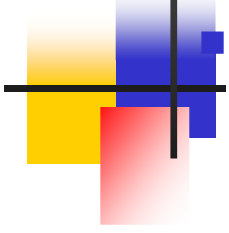
# The 'opinion' doesn't fit the facts

- *The CBI has the resources to act as LLR* – the banks' total external liabilities exceed CBI foreign exchange reserves, but
  - the banks' market funding is assured for the coming year
  - the maturity profiles are favourable – a relatively small part of the foreign currency liabilities are liquid short-term
  - banks' net foreign exchange assets are positive by € 6 bn, and they are well hedged against ISK fluctuations
  - deposits in foreign branches and subsidiaries are insured by host countries on same terms as domestic institutions
- *The potential deterioration of domestic loan quality is overstated* – only Landsbanki has over one-third of its loans to domestic borrowers (and it is the one with least reliance on market funding)



## Then there is Fitch...

- ...an example of sheer irresponsibility
- Financial Times 24 November quoted Paul Rawlings (Senior Director) as saying, 'If you look at their [Icelandic banks'] loan to deposit ratio, it is still 300%, which shows their dependence on the wholesale markets'
- Brian Coulton (Head of Global Economics) admitted that the data cited were from *end-2006*, although the banks' 2007Q3 results appeared at end-October
- The correct number at end 2007Q3 was 200% - similar to Nordea (177%) and Danske Bank (208%)



# The agencies should now be ignored

Not an original thought! 'By now no one should care what the ratings agencies think.' WSJ 26 February 2008

- They were notoriously behind the curve in Asia in 1997
- Their disastrous performance in rating structured finance instruments is a major source of the current capital market turmoil
- And now they are (characteristically) reacting with indiscriminate downgrades, again behind the curve, again *exacerbating market instability*
- They are understandably running scared, trying to convince policy-makers not to break them up, change their revenue model, or eliminate the barriers to entry that have made them so profitable



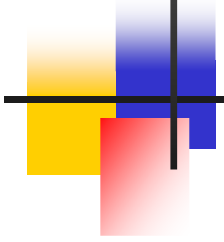
## And the sovereign is in exceptionally good fiscal health

- Fiscal surplus (overall, not just primary surplus)
- Very low debt/GDP ratio
- But what about the 'contingent liabilities'? Aside from the banks, they are the Housing Finance Fund and the National Power Company – both backed by very substantial collateral!
- Even Moody's have to streeeeeeetch to find any significant vulnerability, even if there were a full-scale run on the banks



# Bottom line: market risk premium on Icelandic banks is excessive

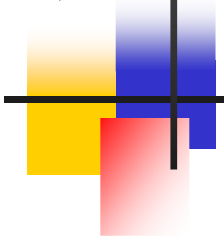
- These banks exploit *strong competitive advantages*:
  - highly entrepreneurial management
  - careful risk control
  - flat management structures
  - unusual and strong business models
- *Economy and financial sector are flexible and highly resilient* – effective response to mini-crisis of early 2006, stability in current turmoil
- Yet current market premium (e.g., CDS spreads) is very high (and ratings low) relative to risk exposure and Nordic peers
- *Whether that premium is for the banks or is a country risk premium, it is not justified by the data*



## But 'la calunnia' continues...

- Recall the Guardian saying in October 2006, 'Viking invaders return undefeated to Britain's financial territory.'
- Now the Vikings are in trouble, so the British should worry – 'British savers have billions in Icelandic accounts, but its banking system is looking shaky.'  
Sunday Times 10 February 2008
- And they are pretty suspicious characters: 'The origins of Iceland's wealth are still something of a mystery.'  
Telegraph 5 February 2008





## Why? Again, a British perspective

- A natural suspicion, even hostility towards 'upstarts'
- Worse when they come from a tiny island (to whom we lost the last of the 'cod wars' in 1976), buy up our firms (including West Ham United FC!), and then compete aggressively – and successfully
- Schadenfreude provoked by the Northern Rock disaster
- And of course, bad journalism – scare stories always sell papers, so suggest 'Your money really isn't safe in IceSave'...
- ...a rumour that just might be spread by competitors, too



## How to get out of the vicious circle?

- Analogy: Brazil 2002 – sovereign spreads rose, fiscal position deteriorated, so spreads rose further...until IMF stepped in
  - But the LLR usually prefers ‘constructive ambiguity’
  - That’s dangerous now - both the CBI and the government should overcome their reticence
  - They must state explicitly and often that the banks could not be allowed to fail, and the authorities have the resources to ensure both the liquidity and the solvency of the banks, so that any speculation to the contrary will be unprofitable
  - Meanwhile, the banks will have to retrench somewhat for the time being and focus on ensuring that the assets they have acquired are good assets

# Then the rumours will turn around!

JUST A NORMAL DAY AT THE NATION'S MOST IMPORTANT FINANCIAL INSTITUTION...



International Herald Tribune, October 27, 1989. Kal, Cartoonists and Writers Syndicate, 1989.