

# The Icelandic Economic Situation: Status Report

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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. 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.

## What happened?

A modern globalized economy, and an active participant in the EU's common market, Iceland is among the first nations to be seriously hit by the global financial crisis. The situation has hit Icelandic households hard and many have lost a sizeable portion of their savings. Inflation is in double-digit numbers, unemployment is on the rise and the currency, the Icelandic Krona, has fallen to historical lows.

The large size of the banking sector in comparison to Iceland's overall economy is doubtless a driving factor behind the current economic turmoil. However, it should be underlined that the Icelandic banks operated in full compliance with European banking laws and the strictest of international regulatory standards. Nevertheless, as the liquidity crisis deepened, Iceland's three largest banks, Glitnir, Landsbanki and Kaupthing, whose balance sheets are several times larger than the total output of the Icelandic economy, were no longer able to re-finance their operations. As a response to these circumstances, the Icelandic parliament passed a new law, allowing the Financial Supervisory Authority (FSA) to take over the operations of the banks. On the basis of this new law, all three banks are now being restructured and the domestic operations are being separated, re-capitalized and will be governmentally owned (at least for some period of time). More information on the new bank act is provided in appendix 2.

## What is being done?

Progress has been achieved in ensuring continued functioning of the Icelandic financial system. The Icelandic government has prioritized the tasks facing the economy based on their importance for the general public. The first task was to secure the functioning of the domestic banking, payment and settlement systems. The stock market has been re-opened even though the operations are obviously limited considering that the financial companies were the majority share of the total market



capitalization of the stock exchange. The next priority is to stabilize and secure the functioning of international payments and settlement system as well as the foreign exchange market.

Furthermore, Iceland is working closely and constructively with other countries to address problems that have arisen in connection with the government takeover of Iceland's three largest commercial banks. The government of Iceland has clearly stated that it intends to honor its legal commitments and seeks close cooperation with other countries' authorities.

In order to prevent a potential shortage of foreign currency, the Central Bank of Iceland has implemented temporary restrictions on foreign exchange transactions with the Icelandic krona. These restrictions have inevitably resulted in problems with payments and settlements of international transfers between Iceland and other countries. In an effort to restore balance in the currency market, the Central Bank has drawn on its swap facility arrangements with the Central Banks of Norway and Denmark, a total of €400 million.

On October 24<sup>th</sup>, Iceland's prime minister announced that the government had reached an agreement with the International Monetary Fund (IMF) on a comprehensive stabilization program, which will include a two billion dollar loan from the IMF. The deal still needs to be approved by the IMF's executive board, but it is nonetheless a positive step toward restoring economic stability in Iceland. The deal is expected to be approved on October 10<sup>th</sup>.

Recently, the Icelandic government also formally requested loans from the other Nordic countries, the ECB and the FED in the United States. The Faroe Islands have already pledged a DKK 300 million loan for Iceland and on October 6<sup>th</sup>, the UK government announced that it would lend Iceland GBP 800 million to cover Landsbanki's Icesave deposits.

## **What will happen to Icelandic banks abroad?**

The Icelandic banks' operations abroad are inevitably affected by the restructuring of the Icelandic banking system. Some of the banks may continue to operate abroad as before, but more likely they will 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.

The deposits of foreign customers in Icelandic banks are generally guaranteed according to EU 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. 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. According to the directive, the amount covered is €20,887 for each depositor in each



financial institution. These are the basic rules that apply throughout the EU and the EEA, of which Iceland is a part.

One of the provisions approved in the new Emergency Bank Act, is that deposits are to be considered a priority claim on the bank's estates. This was done in order to secure the interests of depositors in the foreign branches. Ideally, a bank's assets will be worth enough to cover all or most outstanding deposits.

In several countries, the government has stepped in and offered support to their banks, including Icelandic owned subsidiaries. In Sweden and Norway, for example, measures have been taken by the government to ensure the ongoing operation of banks. This is the best way to safeguard assets and investments, which might otherwise be sold prematurely or liquidated at a price well below true value.

However, the assets of 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 British authorities, as this clearly has a very damaging effect on the Icelandic banking sector and puts Icelandic companies in Britain 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.

## **Temporary currency restrictions**

As previously explained, there are problems with payments and settlements of international transactions between Iceland and other countries as the Central bank imposed temporary restrictions on currency outflows.

There is, however, no reason for foreign stakeholders to be concerned. Firstly, as it is expected that the currency restrictions are a temporary remedy to the current situation. Secondly, because all commercial terms recognized within the EU are also recognized in Iceland, both Incoterms and other terms. The Icelandic customs Authority is a member of the World Custom Control (WCC), and the Icelandic Customs control is fully in line with customs control in other countries. Furthermore, it should be noted that trading partners of Iceland have numerous remedies at their disposal for a potential breach of contract. The Icelandic legal framework is in line with that of other countries as Iceland is a member of the WTO and the EEA-agreement, which provides Iceland with access to the EU's market.

These circumstances have created many and convoluted problems for Icelandic businesses involved in international trade. Unfortunately, because of the complexity of the situation, the government has not been able to publish reliable information on the restructuring timeframe. Therefore, it has been hard for Icelandic businesses to give detailed information to their business counterparties about the progress. However, these circumstances are temporary and on behalf of our members, the Iceland Chamber of Commerce kindly asks foreign counterparties and stakeholders to show patience and flexibility while these issues are being resolved.

## Iceland's future is bright

Despite the current economic setbacks, Iceland's future is bright. Iceland is a dynamic, technology-driven society with a young and well educated workforce. The country is endowed with abundant natural resources, which include rich fishing grounds, vast renewable energy sources (of which only a third has been harnessed), a plentiful supply of clean water and a natural environment and culture that draw an increasing number of tourists to the country each year. Other major strengths of the economy include diverse export industries, a flexible labor market, a strong fiscal position, an efficient pension system and an excellent education system. Armed with these strengths, it is expected that Iceland will emerge from the current turmoil as an economy with a prosperous future.

## Appendix 1: Timeline of the Icelandic Financial Crisis

<b>September 29</b>	Government announces takeover of 75% share in Glitnir and EUR 600 m equity injection  S&P downgrades Glitnir to BBB; Sovereign to A-
<b>September 30</b>	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
<b>October 4-5</b>	Government evaluates crisis in an attempt to save banking sector.
<b>October 6</b>	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
<b>October 7</b>	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
<b>October 8</b>	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

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	<p>British authorities put Kaupthing Edge and Kaupthing Singer &amp; Friedlander into administration</p> <p>British PM threatens to sue Icelandic government to claim guarantee for Icesave deposits</p> <p>Icelandic PM states that sale of Landsbanki assets will be used to refund Icesave depositors</p> <p>Fitch downgrades sovereign to BBB-; Landsbanki to D; Kaupthing to CCC; Glitnir to D</p> <p>Moody's downgrades sovereign to A1 and puts on review for further downgrade; Kaupthing to Baa3; Glitnir to Caa2</p> <p>Board of Kaupthing requests FSA to assume control of bank</p>
<b>October 9</b>	<p>New Landsbanki starts operations with</p> <p>Dutch finance minister threatens to sue Icelandic government over Icesave deposit guarantee; British PM reiterates threats</p> <p>Fitch downgrades Kaupthing to CC</p> <p>Moody's downgrades Kaupthing to Caa2</p> <p>S&amp;P downgrades Glitnir to D</p>
<b>October 10</b>	<p>Dutch delegation arrives in Reykjavik; initiates talks with treasury department about Icesave</p> <p>Central Bank announces limits on currency outflow; low amounts for travel and import restricted to necessities, companies must apply for currency to the CB</p>
<b>October 11</b>	<p>British delegation initiates talks with treasury department about Icesave deposits</p> <p>Accord signed with Dutch government on loan to guarantee a refund of Icesave deposits</p> <p>Outlines of an accord with British government on loan to guarantee refund of Icesave deposits</p>
<b>October 14</b>	<p>Central Bank delegation starts talks in Moscow with Russian Finance Ministry on loan to Iceland</p> <p>Central Bank draws on swap facility arrangements with Denmark and Norway, each by EUR 200 m.</p> <p>Moody's confirms sovereign credit rating issued on October 8 (A1)</p>
<b>October 15</b>	<p>Central Bank lowers policy rate by 350 bp to 12%</p> <p>Central Bank introduces auction system to meet demand for foreign currency, resulting in an allocation of EUR 25m. at a ISKEUR rate of 150.</p> <p>Fitch issues credit update for sovereign debt holding rating steady at BBB- on negative watch.</p> <p>Iceland and Russia agree to continue discussions on a possible loan.</p> <p>New Glitnir starts operations with ISK 110 bn in capital</p>
<b>October 16</b>	<p>Central Bank announces that it guarantees that all payments will reach ultimate beneficiaries' accounts with local banks in an attempt to revitalize payment system.</p>

<b>October 22</b>	New Kaupthing starts operations with capital of ISK 75 bn  Norwegian delegation arrives in Iceland to gather information about the the situation.
<b>October 24</b>	Government announces an agreement ad referendum 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.
<b>October 27</b>	High-level Nordic committee established to present proposals for Nordic assistance to Iceland in cooperation with the IMF.
<b>October 28</b>	Central Bank raises policy rate by 600 bp to 18%.  Faroe Islands pledge DKK 300 million loan for Iceland.

## Appendix 2: More on the New Bank Act

As previously mentioned the Icelandic parliament passed on October 6<sup>th</sup> a [new law](#), allowing the Financial Supervisory Authority (FSA) to take over the operations of the banks in unusual and extraordinary circumstances in order to limit damage or the risk of damage in the financial markets.

These unusual and extraordinary circumstances are stipulated further in art. 1 ph. 2. This list of circumstances is however not exhaustive; the FSA can thus, in other circumstances, apply its authority given by the law as long as the board of the FSA approves. The Central bank, which monitors liquidity status of financial institutions, appoints one member to the FSA board. The Central bank therefore has first hand information about the status of financial institutions and probable FSA actions in that regard.

The FSA has, on basis of this new law, taken over Iceland's three biggest banks and the procedure has been as follows:

1. The boards are dismissed
2. Special Resolution Committees are appointed to take over board activities and management
3. New companies are founded
4. The FSA decides on disposal of assets and liabilities of the old banks to the new companies