

Iceland

A practical overview for credit insurance

This document is intended to provide practical information about the economic situation in Iceland, the reorganization of the banking sector and the currency situation (ISK). The document also contains an overview of methods for obtaining up-to-date information about the standing of Icelandic companies, intended for use by credit insurance organizations.

The document will be modified as needed to reflect any changes relevant for credit insurance.

The contents are:

1. General Overview
2. Reorganization of the banking system
3. The foreign exchange situation – ISK
4. Information on status of Icelandic businesses – Credit Info

Last updated on November 28, 2008.

1. General Overview

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 has recently reached an agreement with the International Monetary Fund (IMF) on measures toward stabilization of the Icelandic economy.

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 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). The chart below illustrates this process.

The Icelandic Banks

The dilemma

- It was **not possible to rescue** the banks from bankruptcy
- At the same time, it was **unacceptable** to let the entire three banks **go bankrupt**

The solution

- The banks were **split** in "old" and "new" on basis of emergency legislation of October 6
- **Domestic liabilities** with priority (primarily deposits) and some **domestic assets** were moved to the new banks, and at the same time **bonds** with corresponding value were **issued from the new to the old bank**
- The **ownership** of the new bank (with 0 net asset value) was taken over by the Icelandic state
- The new bank was **recapitalized** by the Icelandic state after the split
- Creditors to the old bank will get exactly the same recovery as they would if the entire bank had gone bankrupt
- The Icelandic state has not gained from the takeover since the net asset value of the new banks when taken over was 0
- All assets transferred to the new banks have been paid for at fair value
- The Icelandic government was forced to take this action and has not defaulted on state obligations



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 limitations on currency outflows with the Icelandic krona. These restrictions have inevitably resulted in problems with payments and settlements of international transfers between Iceland and other countries.

IMF-supported stabilization program

Recently, 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 2.1 billion dollar loan from the IMF. The deal has now been approved by the IMF's executive board. There are three main objectives of the IMF-supported program: To contain the negative impact of the crisis on the economy by restoring confidence and stabilizing the exchange rate in the near-term; to promote a viable domestic banking sector and safeguard international financial relations by implementing a sound banking system strategy that is nondiscriminatory and collaborative; and to safeguard medium-term fiscal viability by limiting the socialization of losses in the collapsed banks and implementing an ambitious multi-year fiscal consolidation program.

According to the IMF's economic forecast for Iceland, the Icelandic economy is expected to adjust sharply in the near term under the program. Given the high leverage in the economy and significant dependence of the private sector on foreign currency and inflation-indexed debt, the economy is expected to enter into a serious recession in 2009-10. The anticipated large import compression will, however, lead to a rapid swing of the current account into surplus, providing significant support to the exchange rate going forward.

Once confidence is restored and balance sheets readjusted, domestic demand—both investment and consumption—is projected to rebound strongly in 2011.

Long-term growth prospects are favorable. 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.

Further information

Information on the IMF-program and IMF's economic forecast for Iceland can be found [here](#) and here <http://www.imf.org/external/pubs/ft/scr/2008/cr08362.pdf>.

The Central Bank's *Monetary Bulletin*, which contains the CB's economic forecast, may be accessed [here](#).

OECD Economic Outlook, November 2008 (<http://www.oecd.org/dataoecd/6/16/20212577.pdf>)

2. Reorganization of the banking system

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.

Elements of the reorganization effort

Regarding the reorganization of the Icelandic banking system, the following points are most important:

- Three new banks have been constituted in full Government ownership.
- The new banks have overtaken the domestic deposit liabilities of the three old banks that are in receivership.
- The new banks have acquired the current domestic assets of the old banks at fair value.
- A special external auditing process (due diligence) is underway, to be finalized in early January, to reassess the fair value of the transferred asset.

- The new banks will issue a bond to the old bank to cover the full amount of the difference between the deposit liabilities assumed and the assets acquired.
- The Government will inject new equity into all the three new banks.
- The provisional balance sheet of the new banks is shown in the following table.
- All other assets and liabilities of the old banks remain on their balance sheet and are presently in care of a special administration appointed by the financial regulator, FME.
- Administrations of the old banks have opened a dialog with stakeholders. Initial meetings were held last week.

Opening balance sheet of new banks

Provisional amounts per. 14 November 2008, ISK million	<i>New Kaupping</i>	<i>New Glitnir</i>	<i>NBI hf.</i>
	21 October	15 October	8 October
Cash and balances with central bank	77.187	146.461	238.133
Loans to credit institutions	27.144	18.999	87.574
Loans to customers	455.532	631.369	739.405
Financial assets held for trading	16.617	0	0
Financial assets designated at fair value	49.637	51.692	151.997
Investment in subsidiaries and associates	15.13	16.131	52.657
Intangible assets	5.867	0	1.002
Property and equipment	8.792	1.446	8.185
Non-current assets and disposals group classified as held for sale	449	456	2782
Other assets	43.571	19.347	18.414
Total assets	699.925	885.901	1.300.149
Deposits from credit institutions	78.348	14.923	63.783
Other deposits	339.043	338.556	478.275
Bond issued to old bank	172.337	422.423	558.091
Other liabilities	35.197	0	0
Total liabilities	624.925	775.901	1.100.149
Share capital	75,000	110,000	200,000

3. The foreign exchange situation - ISK

On November 28th, the Icelandic Parliament approved an amendment of Act no. 87/1992 on Foreign Exchange. The amended Act makes it clear that **all transactions connected to import and export of goods and services are now - and will continue to be - be unrestricted**. It includes a temporary clause which will be in effect for two years and authorises the Central Bank to impose rules that prohibit foreign exchange related to capital account transactions. The purpose is to prevent excessive short term volatility in the ISK and is in line with the conditions of the IMF Stand-by Arrangement.

The practical implications of this new act are:

- There should no longer be artificial thresholds for payments for imports, as all restrictions regarding payments for goods and services have been abandoned
- The Icelandic currency, krona, will stabilize and is more likely to strengthen than weaken in the immediate future

For further information about the actions of the Central Bank of Iceland is to be found here (<http://www.sedlabanki.is/?pageid=194>), specifically about the new act and the termination of current account restrictions (<http://www.sedlabanki.is/?PageID=287&NewsID=1980>, <http://www.sedlabanki.is/?PageID=287&NewsID=1980>).

4. Information on status of Icelandic businesses – Credit Info

For enabling the credit insurance companies to evaluate each company individually, Creditinfo Iceland will, in cooperation with Icelandic banks and the market's main players, endeavor to gather more information on Icelandic businesses and their status. This will be accomplished by preparing a new Credit Report for the credit insurance companies, to which various detailed information on the Icelandic companies, their current status and comparison to other companies in their industry will be added. The new and updated Credit Report will be ready in January 2009 and the additions will thus include:

- In addition to the general company data (name, domicile, telephone, the names of the executive director and the financial director, e-mail addresses of top executives, board members), information on the executives authorised to sign on behalf of the company as well as the name of Creditinfo Iceland's source. In this way foreign credit insurance companies can contact the source directly if they have any questions.
- In addition to the name of the commercial banks and domicile, we will add the banks' telephone numbers and e-mail addresses to the Credit Reports. This information should provide fast access for the credit insurance companies to further information or to send queries about companies they have for risk evaluation.
- Creditinfo Iceland will obtain a written authorization from Icelandic companies to produce an overview of loans for the credit insurance companies. This authorization will be so arranged as to be in force until revoked in writing. This means that the credit insurance companies can obtain information on the debt status of each individual company and review the evaluation by calling for the information as often as needed.
- Creditinfo Iceland will apply for a license change, permitting foreign credit insurance companies to obtain the information by themselves on the debt status of companies in Creditinfo Iceland's system. This means that the credit insurance companies can electronically obtain the debt status information on companies and without a repeated Credit Reports purchase every time.
- Creditinfo Iceland's debt status system displays loan overviews from the New Landsbanki and savings banks. The information reveals the status of loans and overdrafts, defaults if any, debt burden and whether the loan in question is Icelandic króna or foreign currency denominated. This means that the loan status relative to policy rates, the currency exchange and indexation related increase is displayed.
- For information on loans from New Kaupthing and New Glitnir, the credit insurance companies have to contact the e-mail addresses supplied by the relevant branches. It will soon be examined if the credit insurance companies' access to this information can be facilitated, e.g. through Creditinfo's debt status system, enabling them to access this information firsthand and without extra efforts for the credit insurance companies.

- In addition to the information obtained from the past five years' financial statements, information on other companies of the same industry will be added for comparison purposes, e.g. working capital ratio, cash ratio etc. This will enable the credit insurance companies to more easily evaluate the company's strengths/weaknesses in comparison to its activities and industry.
- To the Credit Reports will be added information on the relevant company's payment behaviour, which has not been included in the reports before. Its payment behaviour in comparison to the payment behaviour of other companies of the same industry will also be displayed.
- The Credit Reports will include information on the company's score category, relative to its CIP Score, i.e. the Creditinfo Predictor. To the reports there will also be added information on the company's score development for the past weeks and months.
- Information on the average score of companies within the same industry as well as the average score of similarly sized companies will also be added to the reports.
- If the Icelandic companies request certain information to be forwarded to the credit insurance companies, a comments field is added to the Credit Reports where the company's source can enter additional information if he sees it fit or believes it to be of importance for the evaluation of the company's operation.
- The credit insurance companies can get a default monitoring and a CIP Score monitoring from Creditinfo Iceland concerning the companies they credit insure. They have not had access to such services before in an online form.
- The credit insurance companies can also get a claims portfolio analysis, showing the extent of their own measured venture capital compared to the Icelandic companies they credit insure.
- The credit insurance companies can request from Icelandic companies to forward information on their claims portfolio and a risk assessment of their claims portfolio (claims portfolio analysis), if they request further information for an evaluation of their credit insurance.

In addition to above the workgroup that has followed up on the issues of the Icelandic companies and credit insurance companies in the past weeks has already initiated a joint annual reports'filing effort. The measures have included a repeated calling to its members for a filing of these reports by parties such as the Iceland Chamber of Commerce. At the same time, the government has for the first time applied fines against companies that file they're reports after the deadline. This move took place in November 2008 so filing the annual reports has not only redoubled during the past weeks but it also expected to be excellent next year.