The collapse of Iceland’s banks: the predictable end of a non-viable business model

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In the first half of 2008, Buiter and Sibert were invited to study Iceland’s financial problems. They identified the “vulnerable quartet” of (1) a small country with (2) a large banking sector, (3) its own currency and (4) limited fiscal capacity – a quartet that meant Iceland’s banking model was not viable. How right they were. This column summarises the report, which is now available as CEPR Policy Insight No. 26 with an October 2008 update.

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Early in 2008 we were asked by the Icelandic bank Landsbanki (now in receivership) to write a paper on the causes of the financial problems faced by Iceland and its banks, and on the available policy options for the banks and the Icelandic authorities.

We sent the paper to the bank towards the end of April 2008; it was titled:

“The Icelandic banking crisis and what to do about it: the lender of last resort theory of optimal currency areas.”

On July 11, 2008, we presented a slightly updated version of the paper in Reykjavik before an audience of economists from the central bank, the ministry of finance, the private sector and the academic community.

It is this version of the paper that is now being made available as CEPR Policy Insight No 26 (http://cepr.org/sites/default/files/policy_insights/PolicyInsight26.pdf). In April and July 2008, our Icelandic interlocutors considered our paper to be too market-sensitive to be put in the public domain and we agreed to keep it confidential. Because the worst possible outcome has now materialised, both for the banks and for Iceland, there is no reason not to circulate the paper more widely, as some of its lessons have wider relevance.

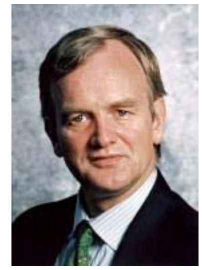
A banking business model that was not viable for Iceland

Our April/July paper noted that Iceland had, in a very short period of time, created an internationally active banking sector that was vast relative to the size of its very small economy. Iceland also has its own currency. Our central point was that this ‘business model’ for Iceland was not viable.

With most of the banking system’s assets and liabilities denominated in foreign currency, and with a large amount of short-maturity foreign-currency liabilities, Iceland needed a foreign currency lender of last resort and market maker of last resort to prevent funding illiquidity or market illiquidity from bringing down the banking system. Without an effective lender of last resort and market maker of last resort – one capable of providing sufficient liquidity in the currency in which it is needed, even fundamentally solvent banking systems can be brought down through either conventional bank runs by depositors and other creditors (funding liquidity crises) or through illiquidity in the markets for its assets (market liquidity crises).

Iceland’s two options

Iceland therefore had two options. First, it could join the EU and the EMU, making the Eurosystem the lender of last resort and market maker of last resort. In this case it can keep its international banking activities domiciled in Iceland. Second, it could keep its own currency. In that case it should relocate its foreign currency banking activities to the euro area.
The paper was written well before the latest intensification of the global financial crisis that started



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October 2008, in all three banks being put into receivership and the Icelandic authorities requesting a $2 bn loan from the IMF and a $4 bn loan from its four Nordic neighbours.

Policy mistakes Iceland made

During the final death throes of Iceland as an international banking nation, a number of policy mistakes were made by the Icelandic authorities, especially by the governor of the Central Bank of Iceland, David Oddsson. The decision of the government to take a 75 percent equity stake in Glitnir on September 29 risked turning a bank debt crisis into a sovereign debt crisis. Fortunately, Glitnir went into receivership before its shareholders had time to approve the government takeover. Then, on October 7, the Central Bank of Iceland announced a currency peg for the króna without having the reserves to support. It was one of the shortest-lived currency pegs in history. At the time of writing (28 October 2008) there is no functioning foreign exchange market for the Icelandic króna.

In addition, outrageous bullying behaviour by the UK authorities (who invoked the 2001 Anti-Terrorism, Crime and Security Act, passed after the September 11, 2001 terrorist attacks in the USA, to justify the freezing of the UK assets of the of Landsbanki and Kaupthing) probably precipitated the collapse of Kaupthing – the last Icelandic bank still standing at the time. The official excuse of the British government for its thuggish behaviour was that the Icelandic authorities had informed it that they would not honour Iceland's deposit guarantees for the UK subsidiaries of its banks. Transcripts of the key conversation on the issue between British and Icelandic authorities suggest that, if the story of Pinocchio is anything to go by, a lot of people in HM Treasury today have noses that are rather longer than they used to be.

The main message of our paper is, however, that it was not the drama and mismanagement of the last three months that brought down Iceland's banks. Instead it was absolutely obvious, as soon as we began, during January 2008, to study Iceland's problems, that its banking model was not viable. The fundamental reason was that Iceland was the most extreme example in the world of a very small country, with its own currency, and with an internationally active and internationally exposed financial sector that is very large relative to its GDP and relative to its fiscal capacity.

Even if the banks are fundamentally solvent (in the sense that their assets, if held to maturity, would be sufficient to cover their obligations), such a small country – small currency configuration makes it highly unlikely that the central bank can act as an effective foreign currency lender of last resort/market maker of last resort. Without a credit foreign currency lender of last resort and market maker of last resort, there is always an equilibrium in which a run brings down a solvent system through a funding liquidity and market liquidity crisis. The only way for a small country like Iceland to have a large internationally active banking sector that is immune to the risk of insolvency triggered by illiquidity caused by either traditional or modern bank runs, is for Iceland to join the EU and become a full member of the euro area. If Iceland had a global reserve currency as its national currency, and with the full liquidity facilities of the Eurosystem at its disposal, no Icelandic bank could be brought down by illiquidity alone. If Iceland was unwilling to take than step, it should not have grown a massive on-shore internationally exposed banking sector.

This was clear in July 2008, as it was in April 2008 and in January 2008 when we first considered these issues. We are pretty sure this ought to have been clear in 2006, 2004 or 2000. The Icelandic banks' business model and Iceland's global banking ambitions were incompatible with its tiny size and minor-league currency, even if the banks did not have any fundamental insolvency problems.

Were the banks solvent?

Because of lack of information, we have no strong views on how fundamentally sound the balance sheets of the three Icelandic banks were. It may be true, as argued by Richard Portes in his Financial Times Column of 13 October 2008, that "Like fellow Icelandic banks Landsbanki and Kaupthing, Glitnir was solvent. All posted good first-half results, all had healthy capital adequacy ratios, and their dependence on market funding was no greater than their peers'. None held any toxic securities."[1]

The only parties likely to have substantive knowledge of the quality of a bank's assets are its management, for whom truth telling may not be a dominant strategy and, possibly, the regulator/supervisor. In this recent crisis, however, regulators and supervisors have tended to be uninformed and out of their depth. We doubt Iceland is an exception to this rule. The quality of the balance sheet of the three Icelandic banks has to be viewed by outsiders as unknown.

If there is a bank solvency problem, even membership in the euro area would not help. Only the strength of the fiscal authority standing behind the national banks (and its willingness to put its fiscal capacity in the service of a rescue effort for the banks) determines the banks' chances of survival in

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The required combined internal transfer of resources (now and in the future, from tax payers and beneficiaries of public spending to the government) and external transfer of resources (from domestic residents to foreign residents, through present and future primary external surpluses) could easily overwhelm the economic and political capacities of the country. Shifting resources from the non-traded sectors into the traded sectors (exporting and import-competing) will require a depreciation of the real exchange rate and may well also require a worsening of the external terms of trade. Both are painful adjustments.

If the solvency gap of the banking system exceeds the unused fiscal capacity of the authorities, the only choice that remains is that between banking sector insolvency and sovereign insolvency. The Icelandic government has rightly decided that its tax payers and the beneficiaries of its public spending programmes (who will be hard hit in any case) deserve priority over the external and domestic creditors of the banks (except for the insured depositors).

Conclusions, lessons and others who might be vulnerable

Iceland's circumstances were extreme, but there are other countries suffering from milder versions of the same fundamental inconsistent – or at least vulnerable - quartet:
(1) A small country with (2) a large, internationally exposed banking sector, (3) its own currency and (4) limited fiscal spare capacity relative to the possible size of the banking sector solvency gap.

Countries that come to mind are:

- Switzerland,
- Denmark,
- Sweden

and even to some extent the UK, although it is significantly larger than the others and has a minor-league legacy reserve currency.

Ireland, Belgium, the Netherland and Luxembourg possess the advantage of having the euro, a global reserve currency, as their national currency. Illiquidity alone should therefore not become a fatal problem for their banking sectors. But with limited fiscal spare capacity, their ability to address serious fundamental banking sector insolvency issues may well be in doubt.

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1 Richard Portes, "The shocking errors behind Iceland's meltdown", *Financial Times*, 13 October 2008.

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