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Lessons learned from the financial crisis
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Building a sound financial system

Chairman, Director General and honoured guests.

I would like to congratulate the FME with its Annual Meeting and thank the Icelandic Financial Supervisory Authority for hosting this Conference, providing the Icelandic Financial Services Association with the opportunity of addressing the important issue of building a sound financial system. The SFF started its operations in the beginning of 2007 and is the representative body of Icelandic universal banks, savings banks, investment banks, life & non-life insurance companies, leasing companies, card acquiring companies, liability companies and securities companies. The association has a similar structure and mandate as Financial Services Associations in neighbouring countries and represents its members nationally and internationally. SFF aims to assist its members in building a sound and trustworthy financial market in Iceland, securing a competitive operating environment for financial companies operating in the country. By the end of this speech I will revisit this topic.

I am now going to turn my attention to the questions: Where have we been? Where are we now? and Where we are going?, as well as using some time to address the topic of regulation and supervision.

WHERE HAVE WE BEEN?

Icelandic banks began to expand into foreign markets in 2003 and their balance sheets saw rapid growth from 2003-2008 in line with the expansion of their foreign operations. Their expansion into foreign markets was on the basis of EU legislation (the European „passport“) that opened their access to European markets providing services to Icelandic parties seeking to expand their operations abroad and foreign parties independent of the Icelandic economy. Favourable external market conditions and high credit ratings eased their access to foreign credit, assisting the growth of their foreign operations. The banks even received a triple-A rating from Moody´s for a short period in 2007.

Investment banking became an increasingly important component of their domestic and foreign operations and by the end of 2007 the three largest foreign banks had become international banks with cross-border operations mainly focused on the European financial markets with the bulk of their activities concentrated in the United Kingdom and Scandinavian countries.

The bank´s relatively high credit default swaps compared to their favourable credit ratings made the bank´s bonds good inputs for structured bond products such as CDOs. As market conditions and sentiments deteriorated in late 2007 following the onset of the credit crunch, the rapid sell-off of structured bond products had a negative effect on the bank´s CDS spreads causing them to rise to unprecedented levels, practically sealing off their access to international wholesale credit markets.

The Icelandic economy was already in the grip of a currency crisis in early 2008 when capital inflows suddenly halted and the banks experienced problems refinancing their foreign currency liabilities. The currency crisis soon became a twin crisis as the banking system began to feel the full weight of the credit crunch.

Extremely negative market conditions in 2008 prevented the sale of assets necessary for the downsizing of the bank´s balance sheets and as the bank´s short term liabilities began to mature in 2008 the banks could no longer rely on market financing as the credit crunch tightened its grip on financial markets. In the absence of a credible lender of last resort, trust in the Icelandic banking system continued to deteriorate as its liquidity problems worsened. With the global tsunami which swept across financial markets following the collapse of Lehman Brothers in September 2008, liquidity problems became solvency problems. When approximately nine tenths of the Icelandic banking system collapsed in October 2008 its assets were over 10 times Iceland´s GDP.

The collapse in October further exacerbated the depreciation of the Icelandic króna fuelling a spike in inflation which peaked at 18% in January 2009. Although household debt is predominately inflation indexed 20% of household debt was in foreign currency compared to 70% of company debt and 40% of municipalities. Since January 2008 the króna lost over 70% of its value against the euro. As a result the crisis severely hurt the balance sheets of households, companies and public entities with falling assets values and rising debt, severely undermining their ability to service their debt.

The Icelandic Government entered into a two-year Stand-by-Arrangement with the IMF in November 2008 with three major policy goals: (i) to stabilize the exchange rate, (ii) adopt fiscal austerity measures to restore sustainability to government finances, and (iii) to rebuild a financial sector that is able to serve the needs of the Icelandic economy. Capital controls were deemed an important part of the IMF Program to reverse the downward spiral of the exchange rate depreciation and reign in its negative effects on inflation and inflation expectations and the balance sheets of households and companies, especially those with foreign currency liabilities. Access to USD 5bn in emergency funding was also deemed necessary to bolster Iceland´s foreign currency reserves and restore confidence in the króna. Fiscal reconciliation was vital to restore confidence in the Icelandic economy and its ability to meet its domestic and international obligations. The program entails strict austerity measures with the fiscal gap which opened as a result of the crash, about 10-15% of GDP, being closed in 2010-2013. Last but not least the restoration of the Icelandic financial system was imperative for the debt restructuring of homes and companies and its ability to support the eventual recovery of the Icelandic economy.

Monetary policy has since the crisis placed first priority on exchange rate stability instead of the usual primary focus on inflation targeting. While Iceland´s neighbouring countries were lowering interest rates to bolster domestic demand and investments the exact opposite happened in Iceland. The policy rate was raised to 18% at the end of October 2008 and monetary easing did not commence until March 2009 in line with falling inflation.

WHERE ARE WE NOW?

Several milestones have been reached to help the financial system and economy counter the effects of the crisis.

- Since the enactment of the emergency legislation in October 2008, months of negotiations ensued to reach a settlement with the foreign creditors of the old banks on suitable compensation for the domestic assets over liabilities that were transferred from the old banks to the new banks. Creditors lost an estimated $64 bn in the third largest bankruptcy in world history behind Lehman Brothers and Washington Mutual, larger than the Enron collapse. Agreement was finally reached at the end of 2009 and in January 2010 the Financial Supervisory Authority authorised the resolution committees of Kaupthing and Glitnir, on behalf of the creditors, to acquire a qualifying holding in Arion Bank hf. and Íslandsbanki hf. respectfully. As a result government ownership has been significantly reduced with the acquisition of the resolution committees and currently stands at 13% for Arion Bank, 5% for Íslandsbanki and 81% for Landsbanki.

- Largest part of the banking sector has been recapitalised and the new commercial banks have strong capital ratios of over 16% allowing them to meet Basel III requirements more than three times over.

- Interest rates have come down from 18% to 5,5% and inflation is expected to be below the Central Bank´s 2.5% by the end of 2010.

- Iceland has enjoyed a record trade surplus since the beginning of the crisis which has supported the gradual appreciation of the Icelandic króna under the protection of stringent capital controls.

- Fiscal consolidation is underway and great progress was made by the Government in reducing the budget deficit in 2010.

But what we are dealing with?

- Lack of trust in Government bodies and financial sector.
- Currency controls still in place.
- Rising debt of businesses and homes versus fall in asset prices.
- Economic contraction of households and corporate.
- Debt restructuring of homes and businesses being led by the banks, but there is still a long way to go. Measures are being implemented to speed up the process.

REGULATION AND CRISIS PREVENTION

Questions have been raised whether the Icelandic financial market was under-regulated before the collapse ?

The answer is no, Iceland had taken up all the EU financial acquis, supervised by a regulator following the European model.

Just after the collapse the Icelandic government recruited an experienced ex head regulator from Finland, Mr. Kaarlo Jännäri, to carve out a report on the big question; „Why Iceland?" He concluded that **bad banking, bad politics and bad luck** ran down the Icelandic financial system. He specifically stated that it was not lack of regulation, but rather the lack of respect for the spirit of the financial regulation that made the system so vulnerable in the end. Also important was some sort of power vacuum or uncertainty on who was to take the lead in addressing the systemic risks in the bank's business model and the threat imposed by the post financial crisis. This was clearly demonstrated in the Parliamentary Special Investigation Committees report.

But. lets go back to the regulation issue. If we rephrase the question and ask ourselves; Was the regulation perfect ? The answer is obviously No. We are in the midst of regulatory overhaul for the world financial markets, both international and at national level. In Europe the EU institutions in co-operation with stakeholders have spent night and day the past two years in spotting the loopholes that made such a world financial crisis possible. New measures and those in the making involve far stricter rules on capital and liquidity requirements, measures to make banking more risk averse and a new supervisory structure with the European Systemic Risk Board and the European Supervisory Agencies starting in 2011. The insurance business also felt the heat of the financial crisis, leading to a review of current insurance legislation in the so called Solvency II process. This is however a delicate task, since the uncertainty over the future regulatory environment for financial operators is creating new risk for the financial markets.

We can ask ourselves: „will those new rules prevent future crisis?" No, they won´t. Perhaps their most important factor will be bringing increased element of trust into the international financial system. We shall not forget the key role that a sound financial system plays in relation to a healthy functioning of enterprises and an economy as a whole. Thus, regulation and its enforcement has to strike the balance between regulating a market and allowing it to function effectively. Let me underline that of course regulation is important. It is immensely important, but what will be crucial to build on is sound financial business and proper business ethics. Fortune or misfortune will hereafter as hereto in the end depend on human behaviour.

The Icelandic financial sector is well aware that the business model of the fallen banks was unsound. I am not going to dwell on what led to things going so terribly wrong. We have already two years from the collapse reports and studies on that, and the causes and effects will continue to be studied by many in the years to come. What we do have to focus on is learning from mistakes in the past and use that knowledge to build a new sound financial system for the benefit of the Icelandic economy as a whole. In that respect, important regulatory changes have already been made and others are in the making.

WHERE ARE WE GOING?

The Icelandic banking system today is roughly the same size as it was in 2003-2004, only one fifth of what it was in 2008. It is today a domestically focused banking system. We do not have and are not on the road to have in the coming years aggressive expansion of Icelandic banks on foreign soil. This has nothing to do with regulation, it has to do with the lessons we have learned both at home as well as the lessons of the foreign counterparts. However, at the same time we must make sure that the operational environment for Icelandic banks will not hamper normal growth in the future and stand in the way of our own banks being able to serve their clients small and large. Otherwise we could end up with a cottage driven financial sector at home, losing its customers to stronger foreign banks. This will particularly be a risk factor in relation to corporate banking when the currency control curtain has been lifted.

Dear guests. At the same time the Icelandic banking system has shrunk five times, the levies on the system are similar to what they were before the collapse. According to figures that SFF calculated in September our members will be paying around 17 billion ISK in 2010 in various public taxes and fees. The most recent example of such fee pending by the Government is a special banking levy that has recently been introduced in a Parliamentary bill. True, many neighbouring countries have this year been introducing what they call financial responsibility fees, aiming at increasing risk awareness of banks. Not all though, particularly not the smaller countries. In a speech in June this year the CEO of the Malta FSA, said that such taxes were counterproductive since they ended up being paid by the public via bank charges reducing their disposable income and therefore their capacity to spur growth, that being the same public already coping with higher taxes and reduced purchasing power.

SUPERVISION AND ENFORCEMENT

I will now move the focus of this talk to the important issue of supervision and regulatory enforcement. Iceland in line with most European countries has a single regulator for both banking and insurance. The FME was heavily criticized in the aftermath of the crisis, for not having been able to prevent a catastrophe to happen. The FME was said to have been understaffed, to bureaucratic stuck in the details, blamed for not having prevented deposit expansion of Icelandic banks in other countries etc. There was also some accusation of the FME and the Central Bank not having co-operated in the way they should have. The Central Bank was said to have fuelled the currency crisis by keeping interest rates high 2006 through 2008 and thus having triggered the collapse of the króna. In addition, the handling of liquidity support request of one of the banks at the end of September 2008, in wake of the Lehman crisis is alleged to have led to a chain reaction. It is not for me to be a judge in what is right or wrong in such statements, I will simply advice those interested to read both accusations and replies being found in the report of the Parliamentary Special Investigation Committee and its annexes.

Talking on behalf of the SFF I however want to say this:

- We need a strong supervisor being able to guard the interests of the system as a whole vis-à-vis the economy as well as its individual players.
- We need a supervisor that strikes the right balance between guidance and enforcement.
- We need a supervisor that is professional and efficient.
- We need a forward looking supervisor, helping in building a sound financial system for the future. It is too late now for the FME to prevent the crisis two years ago.

I believe we have a supervisor that is focused on being all of this. It is no different for the FME than for the banks, it will take time to regain respect. However, I believe the FME is on the right track and so are the regulated entities.

One issue that has been raised is whether the FME and the Central Bank should be merged. The present arrangement is along the lines practised internationally. And certainly many countries avoided systemic collapse with the same model as applied here. A merger of the two surveillance authorities is of course something that should be studied carefully, particularly in a small country like Iceland with limited resources. However, if we would come to the conclusion that such a merger was beneficial for all, the timing would be important and an open question whether the present turmoil is optimal. Furthermore, questions on how supervision of insurance, pension and securities should be handled, if the FME an Central Bank would merge, are unresolved.

CRITISISM

The Icelandic banks have been under constant criticism since the collapse. We should not be surprised, taking into account the severeness of what happened.

The media has been criticized for being too much a follower of the financial system in Iceland before the collapse. Since then however, the pendulum has swung in the opposite direction with the media most of the time aggressive in criticising the current banks. Hopefully, a balance will be struck sooner than later, since it will be difficult for the sector to perform soundly if it does not receive a balanced treatment in the media. We must not forget that the driving force for the banks raison d'être is their ongoing business relationship with their customers which makes banks responsive to customer needs and problems.

The Icelandic banking system today employs over 3.500 people , 4100 adding the insurance sector. Most of those persons with years of experience. We all know the saying, once bitten _ twice shy." Without doubt the trauma those employees had to go through watching their companies collapse and dealing with the chaotic situation that followed has made them stronger and better prepared to carry out their tasks for the years to come, and to carry that experience forward. One thing is for sure, no-one wants to re-live anything similar again within their lifetime.

There has been discussion on whether commercial banking and investment banking should be separated. In that regard it is important to keep in mind that investment banking activities were not the cause of the financial crisis, it was lending activities, especially sub-prime lending and insufficient attention to liquidity. These issues are of course under review and I feel it is important that Iceland follows international developments in these matters. The recent experience from the global financial crisis obviously warrants a new look on whether conflicts of interest between financial institution and their customers was a contributing factor to the crises. This is something each financial operator should look into, at the same time it is being reviewed at an international level.

ISSUES REMAINING

Now I would like to turn my attention to four major issues that remain to be addressed before the Icelandic financial system can become fully functional again: Let us examine each point in question.

Capital controls

Although the currency controls may have been necessary and important at the time it is very important that we restore the free flow of capital as soon as possible as they have the effect of deferring foreign investments and reducing confidence in the Icelandic currency and economy. Currency controls tend to lose their grip with time and the longer they are in place the harder it will be to remove them, both politically and economically. It is also clear that the currency controls are in violation of the EEA agreement and can only be justified while the economy is going through its recovery process.

What has complicated monetary policy and delayed the eventual easement of capital controls are the locked-in foreign investors of króna-denominated assets which could rush out at first opportunity.

It is extremely important that the free flow of capital be restored as soon as possible as the economic damage of lower investments and reduced economic activity is already taking its toll.

Emergency legislation

As we all know the emergency legislation involved a priority status of bank deposits in relation to bankruptcy law. While we have those provisions in law bank financing will almost solely depend on deposits. Thus, as much as this was needed in October 2008 it is now time to gradually go back to normal and have domestic legislation on par with international legislation. This will however have to take into account the perceived strength of the financial system. These changes should perhaps be introduced in tandem with the revised framework for deposit guarantees.

Deposit guarantee scheme review

European nations are restructuring their deposit guarantee scheme in line with regulatory changes in the EU acquis. This includes a maximum guarantee of 100.000 Euros, faster payout etc. Iceland will have to follow suit and at the same time, step by step, lift the general state guarantee on deposits that we have today. At the present all deposits are covered by the blanket state guarantee on deposits. Obviously this will have to be harmonized with the EEA legislation. In order to smooth the transition from full to limited guarantee the change will have to be made in discreet steps.

Debt restructuring of homes and individuals

Successful debt restructuring of households and companies is a vital component for eventual economic recovery. In this regard the banks have guided the way here in Iceland. Throughout the crisis they have offered numerous debt relief options to its customers including payment smoothing, lengthening and freezing loans, reduction of principal, specific debt relief, in addition to the legal relief programs that have been set up. Although we have gone far there is still a long way to go, and measures are being implemented to speed up the process, both in relation to households and corporate.

We shall bear in mind that the debt restructuring process has seen numerous delays that have slowed down economic recovery. Many debtors have been under the impression that new and better debt relief remedies were imminent and therefore preferred to wait for better options instead of accepting the current solutions offered by the banks, even if benefits of any possible upgrade decreed by the legislator, the supreme court or contractual agreements, were always guranteed. The politicians have certaintly not helped in this regard, often adding to the uncertainty. Uncertainties regarding the fate of foreign currency demoninated loans of individuals have also served to delay the debt restructuring process.

The rebuilding of Icelandic financial system holds hand in hand with successful debt restructuring of homes and companies as it is important to get non-performing loans performing again. Without a sound customer base it is not possible to build a sound financial system.

SFF

Let us again turn our attention to the Financial Services Association, SFF. From October 2008 we have been heavily involved in the post crisis management in relation to regulatory changes, debt restructuring programs, joint rules for corporate restructuring, co-operation with government and other stakeholders on various issues. It all boils down to the same conclusion, we must join hands in building a sound financial system in Iceland for the future, both by solving the problems today as well as building for the future.

The SFF Board has in 2010 carried out an extensive strategic planning for the association and how we can further help our members on the way forward.

To take an example of important teamwork the FME and SFF joined forces this summer in a working group on how to simplify and increase transparency in the reporting process between our members and the supervisor. We have also agreed upon a co-operation in streamlining notes in the financial accounts of our members, to make them more understandable and comparable.

Dear guests.

Regaining trust is of fundamental importance for the financial system. Together we have to join hands and fully commit to this important mission.

Thank you.