SAMTÖKFJÁRMÁLAFYRIRTÆKJA

Icelandic Financial Services Association

Icelandic banks

Rebuilding a financial system

Yngvi Örn Kristinsson

A twin crises

- Iceland was hit by a twin crises
  - Financial crises caused by the failing of all the major banks and savings banks
    - Huge loss in assets due to the failure
      - Equity in largest listed companies lost
      - International assets seized or liquidated by regulator
  - Currency crises following the financial crises
    - ISK (krona) depreciated trade weighted by over 50% from pre-crises level
    - Leading to major balance sheet effect on both household and corporate sector
      - Overall equity ratio of the corporate sector fell from 30% to –8%

Impact on the economy

- Severe economic downturn followed
  - GDP contraction in 2009 – 2010 over 10%
  - Domestic demand contracted by 22% 2009 – 2010
    - Sharp correction of current account deficit
- Depreciation lead to an inflation spike
- Short term interest rates rose sharply in response to the crises
- Real wages declined by 11% between Jan. 2008 and end of 2010
  - Partly due to nominal reductions and partly due to inflation erosion

Timeline of financial crises

- Glitnir Bank sought official assistance on September 25, 2088
  - Treasury undertook to provide new equity for a 75% stake on September 29, 2008
- Iceland sovereign credit rating downgraded September 30, 2008, again on October 7, October 8, October 14, November 24,December 4
  - Final rating by S&P and Fitch BBB and Moodys Baa1
- Landsbanki and Glitnir bank failed on October 7, 2008
- Kaupþing Bank failed on October 9, 2008
- New entities form out domestic business of failed banks, New Landsbanki, New Kaupþing (Arionbanki) and New Glitnir (Islandsbanki)
- Straumur Burdaras, investment bank failed on March 9, 2009
- Reykjavik Savings bank and Icebank failed on March 21, 2009
- Government announced on March 21, measures to support the continuing operations of 11 other deposit taking institutions, including Byr bank and 10 other savings banks
- Myrarsysla Savings banks failed on July 3, 2009
  - Estate overtaken by Arionbanki
- Sjóvá-Almennra, insurer, restructured on July 9, 2009, insurance contracts moved to a new entity SA insurance. SA insurance fully authorised by FME on September 24, 2009
- VBS investment bank failed on march 3, 2010
- Byr bank and Keflavik Savings bank failed, on April 23, 2010
  - Business of Keflavik Savings bank overtaken by Landsbanki
  - Business of Byr overtaken by Islandsbanki
- Askar Capital and Avant, leasing company failed on July 13, 2010
- MP bank recapitalised by private investors on April 11, 2011
- Saga bank, relinguishes its banking licence, November 4, 2011

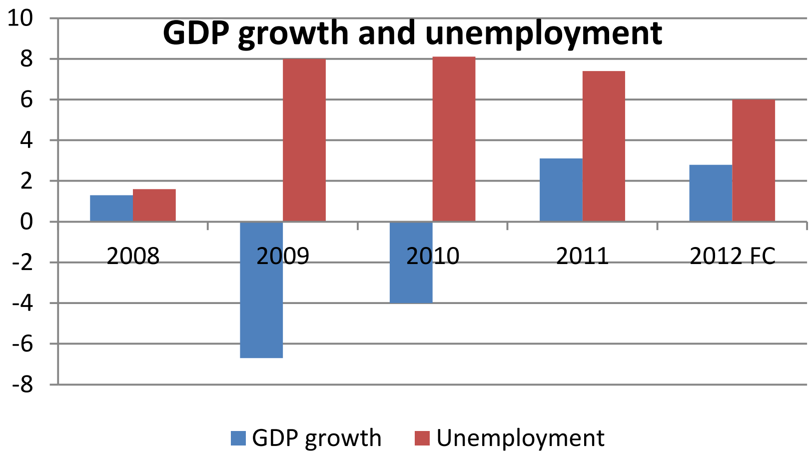
Response to the crises

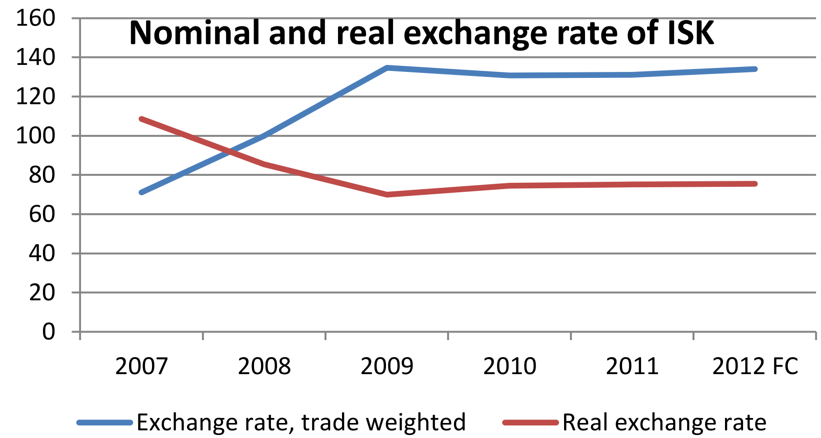
- Emergency legislation passed on October 6, 2008
  - Deposits given priority over other claims in default estates of deposit institutions
  - FME (regulator) given power to take control of failing financial institutions and dispose of assets and liabilities
  - FME authorised to set up new banks
  - Treasury authorised to equity finance new banks or banks overtaken by FME
  - Treasury authorised to inject up to 25% of new equity of failing savings banks
- Government issues a blanket guaranty for all domestic deposits on October 6, 2008
- Foreign exchange controls introduced on October 10, 2008
  - Initially as Central Bank recommendations to banks, from October 15 based on an agrement with market makers
  - By legislation on November 28, 2008
- Assistance formally sought from IMF on October 24, 2008 – informal contact since early October
- Agreement with IMF finalised on November 21, 2008
  - Total funding 5,1 billion USD, provided by IMF (2,1 b), Denmark, Finland, Norway, Sweden, Poland, Russia and Faroe Islands
  - Agreement spans period until March 2012

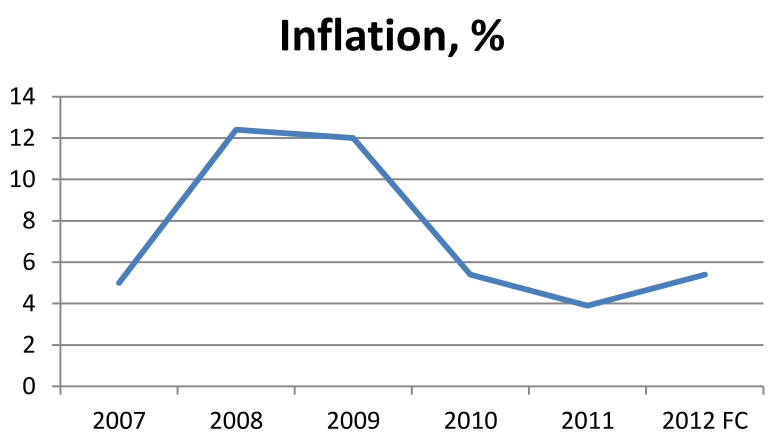
Economic policy

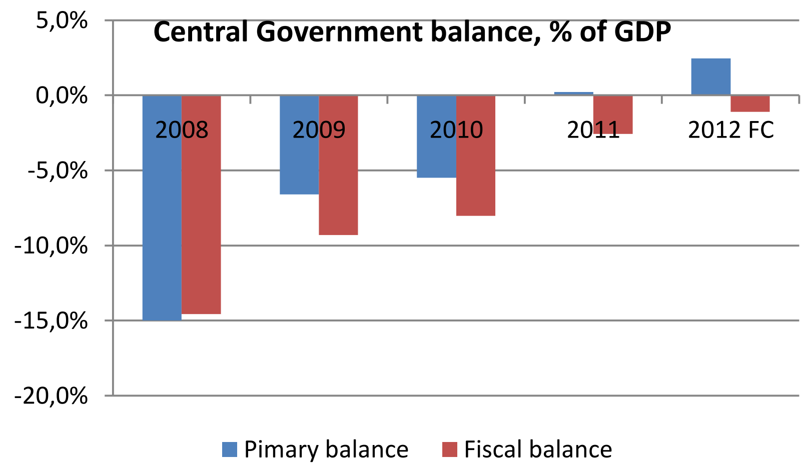
- Economic policy 2009 – 2012 based Letter of Intent associated with the IMF emergency funding.
- Main focus of the program:
  - Fiscal policy:
    - 2009 no effort - automatic stabiliser allowed to work
      - Overall fiscal balance -10% (-13% in 2008)
    - 2010 Primary balance improved by 4,5% of GDP
    - 2011 Primary balance improved by 2,75% of GDP
    - 2012 Primary balance improved by 2,0% of GDP
    - 2013 Primary balance improved by 0,9 % of GDP
    - Overall fiscal balance to improve from -14,4% of GDP in 2009 to a surplus in 2013
    - This plan is broadly on track in 2011
      - Primary balance is in balance in 2011
      - Primary balance in 2012 +2% of GDP according to Budget
      - Overall fiscal balance in 2011 -2,5% of GDP
      - Overal fiscal balance in 2012 -1% of GDP
  - Monetary policy targetted at stabilising the exchange rate
    - Foreign exchange controls applied
    - Relaxation of foreign exchange controls foreseen in future
  - Rebuilding a sound banking system
  - Restructuring balance sheets of households and corporates

Stability achieved – growth the main challenge









Restructuring of banks

- All three big banks failed between October 7 – 9.
- FME took over control and instated new management boards
- FME established 3 new banks October 9 – 13 using the powers of the emergency legislation
  - New Landsbanki (now Landsbankinn), New Glitnir (now Íslandsbanki) and New Kaupþing (now Arionbanki)
  - Most domestic assets and liabilties (including deposits) of old banks transferred to new banks
  - Other assets and liabilities remain in default banks estates (old banks)
  - New banks temporarily capital funded by Icelandic Treasury
- FME stipulates a valuation process to value transferred assets and liabilities in order to determine fair value
  - Deloitte in London and Oliver Wyman assigned to undertake valuation
  - Valuation determines net claim of old banks on new banks
  - Valuation also forms basis for size of balance sheet, risk weighted asset base and equity requirements (capital funding)

Valuation and capital funding

- Valuation process finalised on April 21, 2010
  - Assets transferred heavily impaired, valued at deep discount
- Negotations between stakeholders took place from May – December 2009 on:
  - Final valuation of transferred assets and liabilities
  - Terms of instrument for net claim between old and new bank
  - Capital funding
- Estates of old banks hold majority in two banks, Icelandic Treasury in one
- FME decreed that minimum CAR should be 16% for the new banks, minimum tier 1 is 12%
  - Due to uncertainty in recovering impaired assets, primarily in the loan book

Equity stakes in new banks

	Estates of old banks	Icelandic Treasury
Arionbanki	87%	13%
Íslandsbanki	95%	5%
Landsbankinn	18,70%	81,30%

Other failed deposit institutions

- Deposits of Reykjavik Savings banks were transferred to New Kaupþing (Arionbanki) in March 2009. Other liabilities and assets remain with the estate
- Myrarsysla Savings bank was merged with New Kaupþing (Arionbanki) in July 2009
- Deposits of Straumur-Burdaras were transferred to New Glitnir (Íslandsbanki) in March 2009
- Keflavik Savings banks was merged with Landsbankinn (New Landsbanki) in March 2011
- Byr bank was merged with Íslandsbanki (New Glitnir) in November 2011

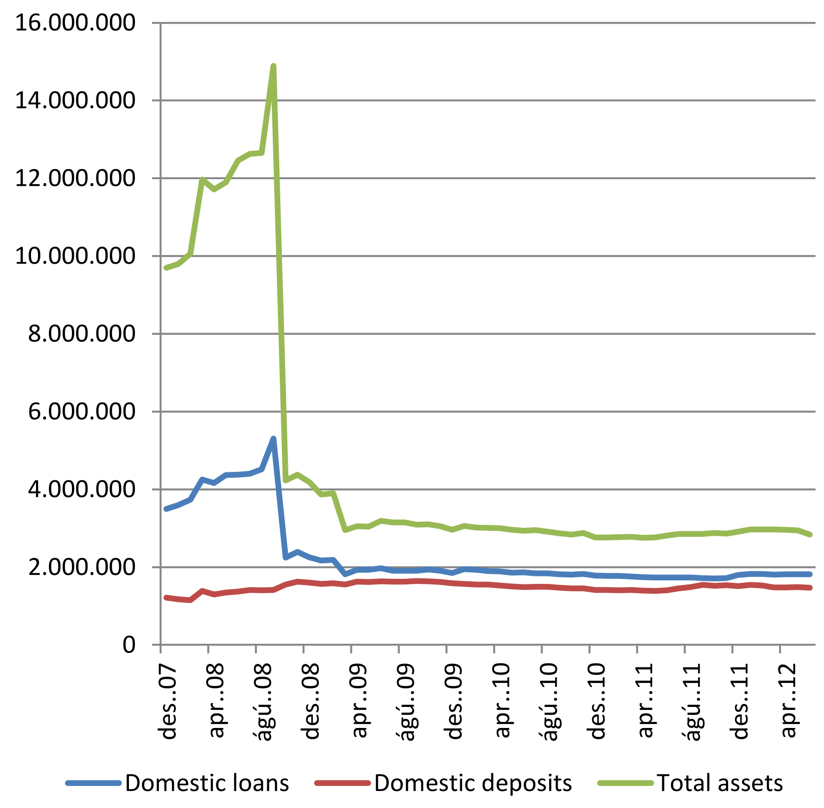
The present structure

- Three big universal banks, one smaller universal bank
  - The three big banks are continuations of the the three large failed banks
  - MP bank has survived the crises but needed restructuring and recapitalisation
- 10 Savings banks remain in operation, all outside the Capital Area
  - All extremely small units
- The estate of Straumur-Burðarás has restarted its operations with an investment bank licence
- Several new startups are operating with licences as securities brokers

Downsized balance sheets

- The restructuring of the banking system implies a huge balance sheet adjustment
- Total assets have shrunk from 14.900 billion ISK in Sept. 2008 to 2.876 billion ISK at end of Oct. 2011
  - From 10xGDP to 2xGDP
- Banks are now predominantly deposit funded (domestic)
- Deposits are 1.519 b.ISK or around 100% of GDP
- Total loans amount to 1.704 b.ISK
- Total book-value equity amounts to 476 b.ISK at the end of Oct. 2008
  - Book-value equity 16,5% of balance sheet

Total assets, deposits and loans of banks



Market structure

- The three big (new) banks dominate the banking sceene
- 3 banks market share in the deposit market is 85%.
  - This is prior to Islandsbanki merger with Byr banki (effective from November 2011)
- 9 savings banks remain

Position at end of March 2012

	Deposits	% share
Arionbanki	472	32%
Íslandsbanki	509	35%
Landsbankinn	455	31%
Other banks	34	2%
Total deposits	1470	100%

New banks financially strong

- All three banks been profitable since start of operation
- Interest rate margin has widened
  - Reflecting increased perceived risks since the crises in 2007 - 2008
- Capital adequacy ratios have risen well above the required minimum
- Irregular factors are contributing to the return on equity
  - Sale of assets
  - Revaluation of loanbook
  - Increased interest rate margins

Key figures for 3 big banks

Key figures for thre big banks

	------------ Operating year 2011 -------------		
	Arionbanki	**Íslandsbanki**	**Landsbankinn**
Interest rate margin	3,4%	4,5%	2,9%
Cost ratio	52,5%	56,0%	57,2%
Return on equity	10,5%	1,5%	8,8%
Tier 1 ration	16,4%	19,1%	21,9%
CAR	21,2%	22,6%	21,4%

	-------------- Result Q1 2012 ---------------		
	Arionbanki	**Íslandsbanki**	**Landsbankinn**
Return on equity	16,50%	17,70%	15,20%
CAR	20,20%	23,30%	22,10%

Valutation of Loan portofolio

- Loan portfolio severly impaired, bougth from estate of old banks at deep discount
- Valuation based on same principles for all three banks
  - Deloitte and Oliver Wyman responsible for all three valuations
  - Assessment of probability of default (PD) and loss given default (LGD) relatively early in the crises (Q1 2009)
  - Assessment of cost of carry of the loan book for the new banks at a time of exceptional circumstances
- Portfolios different leading to differing overall discounts
  - Discount ratios reflect on quality of portfolios in the ownership of estates of default banks
  - For the new banks all the portfolios should be of similar quality
- Overall discount 54% for all three banks
- The relative size of the discount implies that variation between actual value (as witnessed by final repayment) and valuation can have a significant impact on the operating results of banks going forward

Loans and receivables to credit institutions and customers				
Inititial valuation for Arionbanki, Íslandsbanki and Landsbankinn				
In billion ISK	Nominal value	Discount	Fair value	% discount
Arionbanki	1114	754	360	67,7%
Íslandsbanki	925	432	493	46,7%
Landsbanki	1247	586	661	47,0%
3 banks total	3286	1772	1514	53,9%
Information from Initital Financial Statement of the banks				

Household and Corporate debt restructuring

- Balance sheets of households and corporate severly impaired
  - The asset bubble has burst, both in the equity market and in the real estate market
    - Housing prices have fallen over 30% in real terms
  - Depreciation of the ISK (+50%) and and resulting surge in prices (30%) and interest rates has inflated debt
  - Income and production has fallen drastically in line with GDP contraction
- Corporate sector was overexposed in foreign currency, over 75% of corporate debt linked to foreign currency
- Significant part,15% of mortgages in foreign currency
- Autoloans primarily in foreign currency
- At outset over 70% of loan portfolio of the new was in default
- Main effort in debt restructuring and write-downs in 2011

Debt retructuring main focus

- Various forms of payment restructuring
  - Lengthening of loans, irregular payments, payment equalisation (repayment of indexed mortgages regulated with wage index)
- Household debt writedown
  - Joint initiative with the Government
    - Voluntary debt mitigation for household in distress
      - Debt above market value of collateral assets written off
      - Debt service brought down to minimum of 70% of asset value for three years, payment on other part of debt deferred
      - Deferred debt, revisited after three years time. Service resumed in line with debtor capacity after 3 years
    - Debt written down to 110% of asset value
      - Subject to fixed quantative ceiling
      - Subject to net wealth constraint
  - Foreign exchange linked mortgages and autoloans have been converted into ISK loans and recalculated backwards to issuance
    - Based on a High Court ruling
  - In addition individual institutions have developed their own solutions to household debt and payment difficulties
- Overall 173 billion ISK of mortgage debt and autoloans have been written off by banks, savings banks, leasing companies, HFF and estates of defaulted banks
  - Primarily in 2011
- Expectations are that restructuring of household debt will be largely completed by end of 2011

Corporate debt restructuring

- Work-outs based on:
  - Joint set of procedural rules, approved by the FME
  - An agreement on how to handle debt restructuring of small and medium sized companies (10 m.ISK<Debt<1000 m.ISK) in December 2010
  - Larger corporates restructured along the same principles
    - London Approach
- Foreign exhange loans converted to ISK and recalculated backwards or a general „haircut“ applied (25%)
  - Some loans have been ruled illegal by High Court
- Debt restructuring of corporates will largely be finalised by the end of 2011 or in Q1 2012
- Main effort in debt restructuring in 2011

Write-downs and default rates

- Default rates are coming down as the loan book is cleaned up
- Write-offs have so far been broadly in line with expected costs
- In the case of the three new banks the write-offs have been in line with the deep discount applied when the loans were bought from the estates of the default banks
  - Overall write-offs on household debt are sligthly higher than the deep discount
  - The reverse is the case sofar for corporate debt
- Two measures of default
  - Total amount of loans in default as ratio of total loans
  - All loans to client considered in default of one loan in default
- Default rate expected to come further down over the coming two quarters
  - Reflecting the close of debt restructuring
  - More than half of loans in default are in active restructuring