December 11, 2008

Restructuring of the Icelandic banking sector

Overview

The work on restructuring the banking sector after the bank collapse in the beginning of October comprises five processes running in parallel:

1. A valuation of the net assets of the new banks at the point of their establishment. The methods used in this valuation aim at fair value measurement based on orderly transactions between market participants on the measurement date, not the price that would be achieved in a forced liquidation or distress sale
2. A valuation on a similar basis of the net assets of the old banks to serve as a frame of reference for the Resolution Committees in their work with the creditors.
3. The preparation of IFRS compliant primary financial statements for each of the new banks at the beginning of their operations.
4. A process that will lead to the creation of financial instruments linking the new and old banks which will be supported by the valuation process and the opening financial statements of the new banks.
5. A review of the bank regulatory framework and supervisory practices to strengthen safeguards against potential new crises.

1. Background to the current situation

1.1. In the spring and summer of this year there was still some hope that the worst of the international financial crisis, that began with the sub-prime mortgage loan problems originating in the USA a year earlier, was over. Unfortunately the financial crisis on the contrary deepened in the autumn. The whole of the international financial system is presently engulfed in the worst financial and banking crisis since 1930.
The crisis led to a loss of confidence in interbank relations, an international wholesale liquidity shortage of unprecedented proportions, escalating cost of capital and in effect the closing of international financial markets for the Icelandic banks.

1.2 This turn of events had disastrous consequences for Iceland's financial sector and its economy. Because of their high leverage and dependence on foreign financing, the global credit crunch led in the beginning of October to the collapse of Iceland's three main banks, despite their adequate capital ratios, liquidity provisions and profitability of their operations, as measured by traditional yardsticks.
These three banks accounted for around 85 percent of country's banking system, so in effect the global crisis and the turmoil in international financial relations had incapacitated most of the banking sector and the nation's network for international payments.

1.3. Following the collapse of the three banks, the immediate challenges facing the Icelandic authorities were to restore a functioning and viable banking system and to stabilise the currency, the króna. These are the objectives of the Government's comprehensive economic stabilisation programme which was prepared in consultation with the IMF as the basis for a loan agreement with the Fund which was approved on

November 19, 2008. The restructuring of the banking sector is an integral part of this programme.

1.4 The bank restructuring process is co-ordinated by a committee, comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority (FME), the Central Bank of Iceland, the Ministry of Foreign Affairs, the Ministry of Finance, and the Ministry of Business Affairs. The chairman of this committee is appointed by the Prime Minister.

2. Actions taken to date

2.1. As an emergency measure the Parliament of Iceland on October 6, 2008 enacted a law, Act no.125/2008, authorising the Treasury to provide capital for establishing new banks or to acquire ailing banks, partly or wholly, given the extraordinary situation in the banking sector because of the international financial crisis. The emergency legislation also gave far-reaching powers to the Icelandic Financial Supervisory Authority (FME) to intervene in the affairs of ailing banks under the prevailing extraordinary circumstances.

2.2 The provisions of the new law were quickly put to use. The Ministry of Finance established in October three new banks, wholly owned by the Treasury. After the Boards of the three main banks, Landsbanki, Glitnir Bank and Kaupthing Bank, had decided that they were not able to continue in business and had requested the FME to intervene on the basis of Act no.125/2008, FME decided to do so in order to secure the continuation of vitally important domestic banking services and to safeguard the public's bank deposits. It was also seen as important to down-size the banking sector to a level more in line with the size of the economy.

2.3. Each of the three banks was split into a "new bank" and an "old bank". The new banks consist of the domestic operations funded by local deposits. The three new banks were immediately handed over to the simultaneously established banking corporations owned by the Treasury referred to above. The old banks consist of what was left in the previously privately owned banking companies after the new banks had been split from them. They consequently comprise the activities, assets and liabilities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. All derivatives were left in the old banks.

2.4 For each of the three new banks, the government – the new owner – elected a new board of directors, who in turn recruited a new management team. In each of the three old banks, the FME replaced the board with a resolution committee with a mandate to protect the value of the assets left in the old banks.

2.5 The FME with the assistance of staff seconded from the three international accounting firms -Deloitte, KPMG, and PricewaterhouseCoopers - has established a preliminary statement of net assets for each of the new banks at the date of their establishment. In this provisional evaluation, which had to be made quickly, loan provisions were made to bring loan values in line with expected market values.

2.6 The FME has commissioned independent valuations of the net assets of the new banks, to be completed by the end of January 2009 and has appointed Oliver Wyman to co-ordinate the valuation process. Oliver Wyman will provide an independent valuation of the net assets of each of the three new banks and formally opine on the value of the net assets of the new banks. The methods used in this valuation will aim at fair value measurement based on orderly transactions between market participants on the measurement date, not the price that would be achieved in a forced liquidation or distress sale. The valuation approach will be transparent for all stakeholders in the restructuring of the banks. The creditors of the banks will be given an opportunity to meet with Oliver Wyman to comment on the valuation methodolgy while it is at a formative stage. The valuation methodology will be finalised in December 2008. Any currently released information on balance sheet numbers for the old and the new bank should be regarded as preliminary and may change based on this process.

2.7. The FME has also asked Oliver Wyman to provide a valuation of the net assets of the old banks on a similar basis. The purpose of this valuation is only to establish a frame of reference for the Resolution Committees in their work with the creditors. The Resolution Committees of the old banks have hired international advisors to assist in organising relations with the creditors.

2.8. The Icelandic National Audit Office will engage international auditing firms to assist the Board and management of the three new banks in their preparation and presentation of IFRS compliant primary financial statements for each of them, including the determination of the total amounts of the financial instruments referred to in 2.9 below. These IFRS compliant financial statements will establish the foundation for the continuing operations of the new banks.

2.9. Financial instruments will be defined to transfer payment from the new to the old banks to compensate fair value for the net transfer of assets in the other direction when the new banks were established. It is recognised that this is a complex exercise requiring dialogue with the creditors of the old banks and that different solutions may be found for each bank.

2.10. After the establishment of audited new opening financial statements for the new banks, the Government is committed to capitalising them up to a capital adequacy ratio of at least 10%. The total new equity to be injected is estimated at 385 billion ISK on the basis of the preliminary opening balance sheets. The injection, which will be made using tradeable financial instruments issued on market terms, will be completed not later than end-February 2009.

2.11. The government will review the bank regulatory framework and supervisory practice to strengthen safeguards against potential new crises. It has engaged an experienced foreign bank supervisor (Mr Kaarlo Jännäri, former Director General of the Finnish Financial Supervisory Authority) with extensive national and international experience to assess the regulatory framework and supervisory practices and to propose necessary changes. In particular, Mr Jännäri will assess the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the “fit and proper” status of owners and managers. The assessment, which is planned to be completed by end-March 2009, will be made public.