# AN OUTLINE OF A RESOLUTION

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# Prologus

This report is written at the request of the winding-up board of Glitnir to chart up the possibilities for the estate to pay out to creditors without adversely affecting the balance of payment situation of Iceland.

The authors first define the transfer problem Iceland currently faces, and subsequently the options available for a solution. They then look at the roots of the transfer problem, in connection with measures taken by the Icelandic authorities both before and after the financial crisis of October 2008.

As other sovereign states with their own currency, Iceland has two powers to deal with a banking crisis: printing power and taxing power. The printing power is vested in the Central Bank as a lender of last resort. The taxing power to re-capitalize banks is vested with the Treasury and the parliament. In the last two chapters of the report the authors examine how these powers were applied and the cost incurred for the Icelandic Treasury.

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# Summary and main results

Iceland faces a *transfer problem* in the aftermath of the banking collapse of 2008. The term was coined by Lord Keynes in his book entitled *The Economic Consequences of the Peace* published in 1919. It refers to the challenges associated with transferring large sums from one currency area to another through the capital account without causing a large deviation in the exchange rate from economic fundamentals. The chief cause of the Icelandic *transfer problem* was the quadrupling of the money supply (*M3*) from 2003–2008. Money is held almost solely as bank deposits and thus the financial system is currently awash with excess liquidity, which is waiting to exit through the currency market. Therefore, the risk that the ISK will suffer both sudden and large depreciation if the currency market is liberalized, leading to a large drop in household purchasing power and economic instability, is imminent.

There were two causes for the excessive increase in the money supply. First, in 2003, reserve requirements for depository institutions were lowered from 4% to 2% as a part of the Icelandic Central Bank's (ICB) efforts to adopt European banking standards. As a consequence, the money multiplier doubled, as did the money supply, in just three years from 2004–2007, in a rapidly expanding credit boom. Second, in 2008 the ICB began to implement extensive quantitative easing ("QE") policies, whereby banks used their own bond issues (now commonly referred to as "love letters") as collateral in repo transactions through proxies. At that time, financial markets were faltering and there was great demand for cash, as investors sought to exit the stock market and safely pocket the enormous capital gains enjoyed thanks to the asset bubble. The banks were able to meet this new demand for liquidity with ICB funding. In fact, the banks used the money, hot from the printing press, to finance extensive purchases of their own stock by on-lending the funds to holding companies at the value of their own shares, effectively exchanging stock for cash. Thus, the proceeds of the asset bubble were turned into bank deposits, which then received a blanket guarantee when the emergency legislation – passed on October 6$^{th}$ 2008 – was brought in to give depositors a priority claim to the assets of the failed banks.

The lending practices and QE measures of the Icelandic Central Bank were not qualitatively different from similar actions of other central banks at the time. However, since Iceland is an extremely small currency area – in fact the smallest currency area in the world – QE is bound to have a very strong impact on the currency market. Therefore, it could not have come as a surprise that the quadrupling of the money supply, and the increase in the *M3* to GDP ratio from 45% in 2003 to above 100% in 2008, had a very negative impact on the balance of payments, especially after the bubble burst and the Icelandic asset market ceased to deliver extraordinary returns.

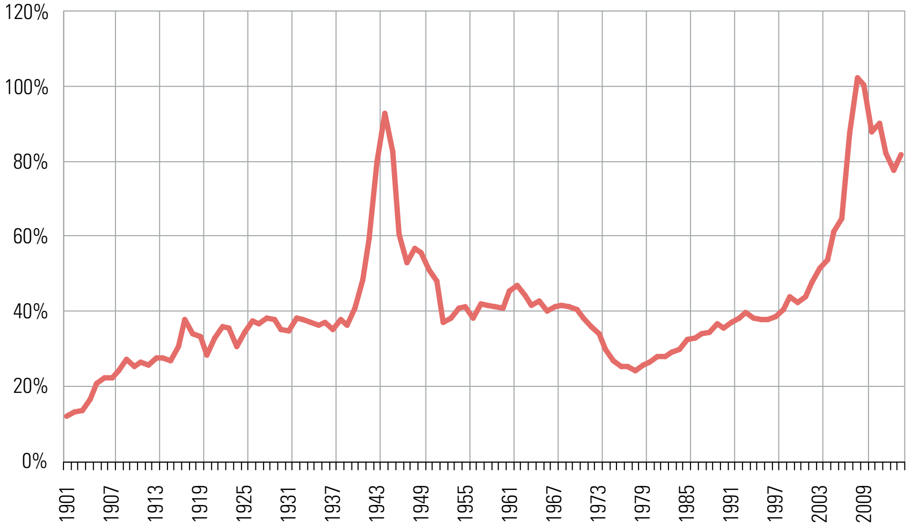


**Figure 1** **M3 as a ratio of GDP from 1901 to present**

## The transfer problem

The *transfer problem* arising from the extensive QE measures has become especially acute as money printed before the collapse has come into the possession of foreign parties. This is the case both for the off-shore ISK holdings of the former owners of Glacier bonds and other carry-traders – now commonly referred to as “the over-hang” – and for the estates of the failed banks. The nature of winding-up proceedings is that the insolvent estate aims to sell assets and accumulate cash, which in turn is paid out to creditors. Thus, the estates of the three fallen banks now have substantial ISK cash holdings, which are being held as deposits or excess capital in the new banks.

However, one must not forget that the *transfer problem* itself is not really contingent on foreign ownership. Domestic owners of ISK could run for the exit as fast as foreign owners and stir up the currency market in the process. The root of the problem is excess liquidity in the banking system. Thus, all solutions to the *transfer problem* must be built on taking money out of circulation as well as changing bank funding from short term deposits into longer term instruments. Even though capital controls will persist, and investors will be prevented from taking their funds out of the country, unless otherwise addressed this excess liquidity is bound to create both inflation and a new asset bubble.

## The principle of non-socialization of losses

In the midst of the crisis of October 2008, the Icelandic authorities resorted to definitive measures to prevent the socialization of losses stemming from the bankruptcy of the three banks, as exemplified by the emergency legislation. This policy was approved by the International Monetary Fund ("IMF") at the start of the joint economic plan with the Icelandic government in November of 2008. It is clear that one part of this policy involved dealing with the *transfer problem* in a way that did not adversely affect public welfare nor put sand in the wheels of foreign trade.

In the authors' opinion, a successful solution to the *transfer problem* following the payments from the estates to creditors must adhere to five necessary conditions. They are:

1. Payments from the estates must be capital account neutral.
2. The disposal or allocation of ISK assets from the estates must not endanger financial stability nor create future balance of payments disturbance.
3. Currency transactions following payments from the estates must take place separately from the official currency market.
4. There can be no hold-outs after payments have been made which could await their time until the capital controls have been lifted.
5. The fulfillment of the four conditions above must not entail legal risk for the Icelandic government in order to ensure that claims on the estates will not be converted into claims on Icelandic tax payers.

There are two possible ways of meeting these five conditions: composition with creditors or taxation. It is very clear that composition will automatically meet conditions 4 and 5, given that it meets the legal criteria of support and would be ratified by an Icelandic court. All creditors would be bound by the contract and there would be no legal implications involved for the Icelandic government. However, conditions 1–3 would have to be met through negotiation with creditors, the outcome of which would be uncertain. The main issue in such a negotiation would undoubtedly concern the allocation of the largest domestic assets of the estates, the new banks, and whether the estates would be given the opportunity to sell them for foreign currency. Taxation could meet conditions 1–3, but leaves conditions 4 and 5 in doubt since it would always entail legal risk. The only way to curtail such a risk would be to target the levy very specifically to solve the *transfer problem* with no other alternative goals in mind.

## On the government's efforts to abolish the capital controls

The government appointed the first committee to form proposals to liberalize the currency market in November of 2013, the second committee was appointed in July of 2014 and the third in January of 2015. None of these three committees has published proposals, or in fact disclosed any of their work publically, during the two year period that their work has been underway. It seems to be a deliberate government policy not to disclose any information on their plans or intentions. Nevertheless, despite the sworn secrecy, there has been a steady stream of leaks to the media, which appear to come straight from the source. Judging from newspaper reports, the government's advisors seem to have had their mind set on reaching two other alternative goals, in addition to solving the *transfer problem*. These two goals are:

6. The estates should be a source of substantial fiscal revenue, among other things to compensate for the damage done by the old banks through their reckless behaviour during both the boom and the crash.
7. Payouts from the estates should be capital account positive and bolster foreign reserves of the ICB in order to implement a general solution to Iceland's *transfer problem*, including the problem stemming from the overhang.

Government advisors initially seem to have considered bankruptcy as the best option to complete the winding-up proceedings. That stance seems to have been taken due to a specific interpretation of Icelandic bankruptcy law: that all claims from any bankrupt company in Iceland would have to be paid in ISK. Therefore, in line with that interpretation, the estates would have to hand over their foreign assets to the ICB in the event of bankruptcy at an on-shore exchange rate and buy ISK in order to settle with creditors. The creditors would then be required to take part in currency auctions along with other owners of off-shore ISK in order to exchange their ISK holdings for foreign currency.

This approach was termed *the bankruptcy-route* in the public discourse. However, this interpretation was not supported by Icelandic courts and on November 10$^{th}$ 2014, Iceland's Supreme Court struck it down in a ruling in the case of *Kaupthing v Aresbank S.A*. The ruling clearly stated that although all claims should be calculated in ISK – Iceland's legal tender – there is no obligation to settle the claims in ISK. Thus, the *bankruptcy-route* turned out to be a blind alley, which caused a year's delay in the government's efforts to reach a settlement with the estates and liberalize the currency market.

In the authors' view, fulfilling the above five conditions in order to solve the *transfer problem* in the event claims on the estates are to be settled will be a great challenge. Furthermore, it will be impossible to simultaneously reach the alternative goals (nos. 6 and 7). This also seems to be the current view of the government as its leaders have repeatedly stated in past weeks and months that they are just aiming to solve the *transfer problem* and have no other goals in mind.

## Iceland's bargaining power

When the controls were originally established in 2008, payments from the estates to creditors were exempt, whether they were in local or foreign currency. This exemption was revoked at a late night meeting in Althing on March 12th 2012. With regard to the two estates that have already settled with priority creditors in full, 63% of Glitnir's and 72% of Kaupthing's assets are foreign assets. These assets are domiciled outside of Iceland and could be paid out to foreign creditors without any effects on the local currency market. However, the government has not authorized such payments.

By repealing the estates' exemption from the capital controls, one could say that the government has created a bargaining position in respect of which the estates and creditors must reckon with Icelandic preferences when allocating domestic assets. Icelandic authorities are thus in a much better position to deal with the *transfer problem* stemming from domestic assets of the estates than, for example, the problem stemming from the overhang. Despite having a special exit route through the ICB´s currency auctions the overhang investors have not been rushing to exit so far.

In this context, the government's later emphasis on the *bankruptcy-route* can be viewed as a tool to reinforce their bargaining position. If this is the case then not trying to capitalize on this position and reach a deal with the estates before the Supreme Court ruling on November 10th last year must be considered a mistake. Perhaps the current ideas on exit taxes and a stability levy can also be seen as tools aimed at regaining bargaining power in order to being able to achieve composition with creditors that would address the government's concerns.

## The winding-up boards' proposals for composition

In November 2012, Glitnir's winding-up board applied to the Central Bank of Iceland for an exemption from the capital controls to complete a composition with creditors. A response from the ICB came almost a year later, in September 2013. In the response letter the ICB said that such an exemption would only be granted if it would not, in the Bank's own opinion, have an adverse effect on the currency market or present a financial stability risk. No direct guidance was however provided on how the composition proposal should actually be structured to meet those concerns. Glitnir's winding-up board has since put forward several proposals to the ICB but has yet to receive any answers. The same goes for Kaupthing's attempts; the

ICB has not responded to its proposals at all. At the same time the government has complained that the winding-up boards have not put forward any proposals to their liking, but without explaining what they would really like to see.

It should be self-evident that if the Icelandic authorities require the compositions to obey certain macroeconomic conditions, there must be an internal agreement as to what they should entail and that these condition must then be set forth in a clear manner for the winding-up boards and the creditors so they can respond appropriately. As at the day of writing, the authorities have not made any conditions public.

## Exit taxes

Historically, exit taxes have successfully been applied as part of programs to lift capital controls, a good example being Malaysia from 1998–2001. A conventional exit tax could also be useful as part of a plan to lift controls in Iceland, but the size of the overhang in relation to the ICB reserves rules it out as a stand-alone measure. Because of the small reserves, an exit tax would need to be very high, which would give little incentive for offshore ISK holders to exit. One must bear in mind that there are always two ways for foreign investors to liquidate their domestic assets: one is to exit through the local currency market, the other is to sell the assets off-shore to some other foreign investor and thereby transfer ownership.

Exit taxes can therefore hardly be considered a useful tool for currency liberalization until the overhang problem has been resolved and payments from the estates mostly completed. An exit tax is though just another form of capital control where transaction costs replace direct prohibitions, but taxation is nevertheless a more efficient and flexible tool as it can be reduced in an incremental manner, as was the case in Malaysia.

## Stability levy

There is a long standing tradition in economics to apply taxes to solve problems of pollution and other externalities. The Icelandic *transfer problem* can be categorized as an economic externality and thus taxation must be considered. However, in practical terms, it can be difficult to apply this methodology to produce any meaningful outcome. There are three main controversies:

1. Whether it is possible to apply taxation in such a specific manner. Taxation is a general tool, requiring equal treatment of equal circumstances, so applying it in a specific manner, such as taxing only assets of bank estates, needs a good justification.

2. If the current situation merits such specific treatment then care must be taken not to encroach further than the situation warrants. For example, it is debatable how large a share of the local assets of the estates needs to be taxed away, and whether the estates are given leeway to sell their local assets for hard currency.
3. Such taxation must always be a last resort action, taken when other less onerous measures have been exhausted, such as a composition that fulfills the five conditions set forth above. The principle of proportionality is often cited in this context.

The authors of this report are not legally-qualified and cannot rule on whether such a tax on the estates is legally justified nor quantify the legal risk that it could impose on the Treasury. It is indisputable however that such taxation is a journey into unexplored territory and such ventures always involve risks. In the worst case scenario it could expose the Treasury to a liability, or at least cause delays in collecting the tax. Such a tax could also potentially impose a significant burden on residents.

## Money printing as pollution

The "pollution" that a stability levy would be intended to counter is clearly the excess liquidity that has accumulated in Iceland´s financial system. If one attempts to quantify excess printing by assessing the loans the ICB made using Icelandic banking bonds as collateral, then the total amount outstanding was about 350 billion ISK at the time of collapse. The recovery from these bonds can be roughly estimated at 100 billion ISK, and thus the net loss outstanding would be around 250 billion ISK. This amount is now effectively a "helicopter-drop" of money as defined by Milton Friedman – a baseless increase in the money supply. In the authors' view the government should set a goal of retrieving these money drops as the winding-up proceedings are finalized, whether that takes place through composition with creditors or direct taxation.

The money retrieved would have to be taken back to the coffers of the ICB, with the settlement of the bonds issued by Treasury to recapitalize the ICB in the wake of the losses suffered through repo-lending, or by other means. Thus, reducing the money supply in this way would lead to lower government debts and an improved fiscal balance going forward, which would benefit future generations. However, if this money retrieval is treated as revenue that could be used to increase fiscal spending, then that is a totally different matter. In that scenario money would be re-injected into the economy, stimulating demand, reducing the current account surplus and thus endangering the balance of payment situation of the country. By doing that, the *transfer problem* would still linger on after the estates had ceased to exist and payments had been made to creditors, and all plans to lift the capital controls would be severely complicated.

## The capital structure of the banking system

The capital structure of the new banks, in particular their dependence on short term deposits, makes them vulnerable to the lifting of capital controls. It is therefore important to reduce the role of short term funding in the banking system to some degree before lifting the controls. There are a few possible means to that end.

The first means would be to extend the maturity profile of the banks and exchange deposits for long term bonds. This could possibly come at too high a cost to the banks.

The second would be transferring a larger part of the financial intermediation from banks to the capital markets. Through direct financial intermediation, companies and entrepreneurs acquire funds directly from savers or the capital markets without the intermediation of the balance sheet of a bank, where deposits are converted to loans. This results in a reduction of deposits and growth in investment banking activities.

The third measure would be scaling down the banking system by transferring its assets to other financial institutions that have longer term liabilities, such as pension funds or other investment funds.

The fourth would be to convert the domestic assets of the estates, which are mostly deposits and equity in the new banks, to long term bonds as a part of the estates' composition with creditors or as a part of the sale of the banks to new owners.

The fifth and final means to this end would be the imposition of a stability levy. The part of the levy that is not used to reduce the money supply directly would have to be converted to a long term bond issued by the banks to the Treasury, which could subsequently be sold in the market. This would possibly be the only way to carry out the large transfer to the Treasury that a stability levy could entail, without serious negative effects for the banks.

## Net fiscal cost of the crisis

In early 2012 the IMF assessed the Icelandic Treasury's net fiscal cost of bank support and restructuring for the years 2008–2011. Its results were that the net fiscal cost amounted to 18.3% of GDP. The result of the authors' re-valuation of the cost for the years 2008–2014 is that the net cost is significantly lower at about 13.4% of GDP. The main reason for our lower estimate is that the recapitalization of the new banks resulted in a net gain for the Treasury amounting to 4.6% of GDP for the period from 2008–2014. This estimate is based on the assumption that the new banks will be sold at price-to-book of 1.0 so a sale at a different multiplier will affect the estimate.

Since 2008 the Treasury has also collected significant tax revenues, both from the new banks and the estates. Tax revenues from direct taxes on the banks and the estates from 2008–2014 amount to a total of 9.3% of GDP for the period, of which 5.2% of GDP is due to new taxes on financial companies introduced since 2010 and of which 4.1% is from conventional income taxes. The Treasury has therefore recovered around 5.2% to 9.3% of GDP through taxation of the banks and the estates. The remaining net fiscal cost to the Treasury is in the range of 4.1 to 8.2% of GDP. Table 1 summarizes the main components of the Treasury's net fiscal cost and tax revenue from the estates and the new banks.

| | Billion ISK | Percent of GDP |
|---|---|---|
| **Cost:** | | |
| Treasury securities lending | 91.9 | 5.9 |
| Central Bank recapitalization | 100.8 | 6.5 |
| State Guarantee Fund | 27.6 | 1.7 |
| Savings banks recapitalization | 22.4 | 1.3 |
| Central Bank loan to Kaupthing | 38.6 | 2.6 |
| *Total cost* | 281.3 | 18.0 |
| Commercial bank recapitalization | -103.9 | -4.6 |
| **Net fiscal cost** | **177.4** | **13.4** |
| **Tax revenues:** | | |
| New taxes | 98.8 | 5.2 |
| Income tax | 70.9 | 4.1 |
| **Total tax revenues** | **169.7** | **9.3** |

Table 1 **Net financial cost of bank support and restructuring, and tax revenues from the new banks and the estates for the years 2008–2014, both in billion ISK and as a percentage of GDP.**

A final estimate of the cost will only be available when the winding-up proceedings have been concluded and the new banks have been sold. However, the above estimate underpins the conclusion that the objective of the emergency legislation of limiting the socialization of losses has been mostly reached. Instead the losses have been borne by unsecured creditors of the failed banks, both by giving depositors priority and by taxation of their assets.

## Conclusion

According to *public choice* theory, politicians have a commitment problem when it comes to large, and potentially risky, decisions. It is as put in the children's fable: everyone wants to eat the cake, but no one wants to go through the effort involved in making it nor take responsibility if the baking fails. Therefore, the need for a collective commitment, in which all responsible parties take a mutual share of the gain, pain and failed outcomes, cannot be overstated. Otherwise, the political arena could turn into an auction market in which politicians compete for votes by placing ever higher bids without consideration of the risks or potential costs involved. This is especially true when it comes to the estates of the fallen banks, to which the claimants are not only foreign but can very easily be demonized as vultures.

It is now about 3–4 years since conditions were put in place for a payout to creditors of the fallen banks and the Icelandic authorities were faced with the potential *transfer problem* arising from the finalization of the wind-up proceedings. The delay, and the almost total lack of visible action in facing this problem, can for the most part, be explained by the high level of disunity within Icelandic politics about future goals and the roads by which to reach them. The fact of the matter is that the Icelandic authorities have yet to put forth clear conditions to the estates as to how the *transfer problem* associated with their payments to creditors should be addressed, let alone devise a general plan as to how to open the capital account again.

It should be emphasized that even though the *transfer problem* associated with payments from the estates could be solved, that in itself will not automatically mean the capital controls can be safely abolished. The biggest obstacle for lifting controls will have been eliminated but a capital account liberalization is a much bigger and more complicated task that can only be achieved with a public, confidence inspiring plan that has bi-partisan support.