A presentation by Jón Sigurgeirsson at a World Bank Global Forum on Law, Justice and Development, Washington D.C., 10 December 2012.

Let me begin by thanking the organisers for inviting me to speak here today. I have been asked to speak on the case of Iceland and share some of our experiences from the resolution process.

Given the title of today's seminar – sovereign debt resolution – I would like to begin by setting the record straight. The Republic of Iceland did not default and has never defaulted on its sovereign obligations. Its ratings may have fallen from triple-A to triple-B, but the sovereign has maintained an investment-grade rating.

At bottom, Iceland's crisis was a private banking problem with fiscal consequences, combined with a severe currency crisis. The banking crisis in Iceland had been brewing for quite some time, but the symptoms were blurred by an abundance of global liquidity and mispricing of risk. It turned out to be a spectacular crisis: one that did away with 90% of Iceland's financial system virtually overnight, taking with it the credit that had taken years to build up. The impact on the economy was devastating and bought the country to the altar of the IMF in November 2008.

In my presentation I will focus on three areas: a brief history and a summary of the run-up to the crisis, crisis resolution, and the role of the IMF.

The free-state

As this is a conference of lawyers, I feel compelled to say a few words about early Icelandic history. The country was settled in the 9th century, and one of the settlers' first tasks was to establish a parliament. By the end of that first millennium, it was said that the Icelanders had no king, only law. Icelanders went on to do great things during this period. I regret to tell you that it didn't really work out so well, but in any case, the Golden Age lasted a good 300 years before the country fell under the Norwegian Crown in the 13th century. The reason for the demise of the so-called free-state has been a topic of popular debate for several centuries in Iceland, and theories are numerous.

Legal historian James Bryce wrote that medieval Iceland should be of interest to the student of politics and law because it produced a constitution unlike any other in recorded history, as well as engendering a body of law so elaborate and complex that it is hard to believe it existed among men whose chief occupation was to kill one another.

Recent history

By the time Iceland regained control of its own affairs at the turn of the 20th century, it was among the poorest and least developed countries in Europe, without any infrastructure. But before the 20th century was out, Iceland ranked among the most affluent nations in the world.

This remarkable transformation was based on abundant resources, globalisation, good neighbours, and good governance. The latter part of the 20th century brought on liberalisation, deregulation, and privatisation, and in 1994 Iceland joined the European Economic Area, thereby gaining access to single market of the European Union. This included the adoption of EU laws and regulations on financial market activities.

Free movement of capital enabled the Icelandic banks to dive headfirst into the globalisation of finance. Finance was seen as the new frontier. The Icelandic banks became truly international, acquiring subsidiaries and opening branches abroad.

The emperor's new banks

The newly privatised banks attracted the best and the brightest – lawyers, MBAs, and engineers – but they were young and inexperienced, and the explosive growth of the system meant that supervision and regulation had no chance to keep pace with them. At the same time, the world was swimming in liquidity, so that money poured into the Icelandic banks. And the banks had the Good Housekeeping seal of approval from the big four international audit firms and up to triple-A ratings from the rating agencies, under the tacit assumption that the sovereign would step in – even when their size mushroomed to 10 times GDP. And they took maximum advantage of this opportunity.

The banks appeared extremely successful, providing well-paid jobs for educated young people, providing tax receipts, and bringing affluence to the public. They were seen as national champions, and it became government policy to nurture them. Unfortunately, in this millennium, the Golden Age lasted only three years.

When the rush of global liquidity came to a halt, the Icelandic banks were left high and dry, with no real lender of last resort in foreign currency. In the face of this, the Icelandic government was faced with an awful choice: should they attempt to save the banks or be forced to let them go under?

An emperor's safety net

Much like the rest of the world, Iceland was in crisis mode more or less throughout 2008. The currency began to depreciate significantly. The banks' CDS levels began to show signs of distress early in the year, and the authorities sought to obtain liquidity support, both through swap agreements with central banks in the countries where the Icelandic banks had operations and through debt offerings. Their efforts yielded limited success.

Going to the IMF was not considered a feasible option because the problem wasn't seen as a sovereign debt issue. At the time, the authorities were operating under the assumption that the banks were solid and were merely facing liquidity problems.

The authorities invited the IMF for a "secret" mission in the spring, followed by an FSAP mission during the summer of 2008. While valid concerns were expressed, liquidity was seen as the main concern.

Following the collapse of Lehman in mid-September 2008, the distress in the market became so acute that the Icelandic banks came to the authorities for help. After exhausting all other possibilities, the authorities finally came to the conclusion that they could never do a credible job of rescuing the banks. It was an unusual decision, given the pressures involved and the fact that some of our neighbouring countries were providing blanket guarantees during those very days.

Resolution

Given the scale and complexities of the problem, it was impossible to rely on any manual for resolution. The authorities sought to protect the signature of the sovereign and maintain a banking and payment system. They enacted emergency legislation, giving the Financial Supervisory Authority the powers of a shareholder meeting, taking over the banks, splitting the commercial banks into domestic and foreign operations, and prioritising and providing a blanket guarantee for domestic deposits. None of these actions were considered traditional medicine, but they worked to a large extent. The domestic payment system stood the test, and the population retained access to their bank accounts.

As was to be expected, expanding the rule book did not come without consequences. First came a drove of very angry bankers, followed by concern and suspicion from neighbouring countries. There was a very scary period when the UK authorities served Iceland with a terrorist order, naming the Ministry of Finance, the Financial Supervisory Authority, and the Central Bank, and all international flows to the economy were blocked. The phones that had been ringing off the hook suddenly went silent. At that stage, the Central Bank resorted to rationing foreign currency. The authorities were unsure how to pay for food and medicine.

Lessons

In terms of lessons, Iceland is a rather unique case. The banks became so much larger than the economy itself that it was almost comical. The assets of the Icelandic banks were estimated at well over 100 bn euros in 2008. In the context of the firepower used in the global financial crisis, this figure does not stand out. However, in a sovereign context it is larger than Argentina and goes some way towards the size of the current Greek problem. Let's not forget that Iceland's population totals 320,000.

Cross-border banking resolution proved unnecessarily messy. On the one hand, it may have been a function of the severe strain on the system at that time, where it was every country for itself, but clearly Iceland and the creditors would have benefitted from greater international cooperation and clarity. Obviously, this is an area where work is underway for a banking mechanism, but unfortunately that work has proven difficult.

In the resolution process, Iceland benefitted from efforts to engage the creditors and provide an open dialogue. A tradition of guidance by the rule of law, which I have highlighted earlier, also played an important part.

While it was important to engage the creditors, it was also important to remind them on a regular basis that the balance sheet of the Republic was not part of the discussion.

As an overall guiding principle, a great deal can be said of the power of transparency and predictability. These are at the core of the Principles of the IIF.

The role of the IMF

The IMF arrived in Reykjavik in the wake of the crisis. They did an excellent job in designing a well-balanced and successful programme for Iceland, and our neighbouring countries provided valuable support. The design of the programme made it acceptable to the public. Iceland also benefitted greatly from the IMF legal department in taking on incredibly complex financial sector issues. Again, to put things in context, the Central Bank of Iceland's legal department had a staff of two at the time.

Should Iceland have gone to the IMF earlier? Iceland is not unique in its hesitation to call in the IMF. Recent examples are all around us. This is a problem that probably won't go away. Elected authorities do not want give up the reins to the IMF until every other possibility has been exhausted.

In retrospect, one wonders what would have happened in Iceland had the IMF been called in before the banks collapsed. What would have been the advice of the IMF staff? Would Fund staff have received a mandate from the Executive Board to let the banks go?

When the collapse took place, Iceland found itself in a dispute with some European countries over deposit insurance. I will not enter into that topic here; it is before the courts in Europe and awaits a ruling. This dispute resulted in individual countries holding up reviews of Iceland's programme in the IMF Executive Board. I shouldn't have to stress that the IMF is a multilateral institution and should not fall prey to bilateral disputes.

If the IMF is to be entrusted with an enhanced role in resolution mechanisms, such issues must be considered.

Epilogue

In a sense James Bryce's rather caustic comment on the Icelanders – still applies today, and much like the demise of the free-state, the collapse of the Icelandic banks will remain a topic of debate for years to come. My time is limited, and I have only touched on a few items in my presentation, that I found relevant to this forum, but let me close with a brief epilogue.

Following the collapse of Iceland's banks, it quickly became clear that their capital position was nowhere near what had been reported. This brings me to highlight the role of international accounting standards, which at the time seemed bereft of all common sense when it came to evaluating assets.

On a related subject, allegations of mismanagement began to emerge soon after the collapse. Some now await judicial attention.

The resulting bankruptcies rank among the largest in corporate history. According to Moody's, the collapse of the Icelandic banks combined ranks second, only after Lehman. The question in my mind is this: How much did the practises of the Icelandic banks differ from the practises of their counterparts in neighbouring countries?