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The EEA and the Global Financial Crisis: The Case of Iceland

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The EEA and the global financial crisis – the Case of Iceland

Executive Summary

The effects of the global financial crisis in Europe have exposed important shortcomings of the regulatory and supervisory framework of the European Union's single market. This view was recently supported by the so-called de Larosière report on Financial Supervision in the EU, which highlighted a number of shortcomings and made recommendations for wide ranging reforms to remedy flaws in the Union's patchwork of nationally based supervision.

This report will limit its scope to the consequences of the international financial crisis on the European Economic Area by looking at the Icelandic experience. The financial crisis that overcame Iceland – which enjoys full membership of the single market as a member of the European Economic Area outside of the European Union - and subsequent actions taken as a result have revealed the nature of some of these important shortcomings and the need to implement comprehensive measures that take into account the interests of all EEA member states.

The aim of this report is to highlight the importance of incorporating the interests and compatibility of EEA legislation into relevant reforms that affect the functioning of the single market.

Key points:

- The consequences of the global financial crisis in the EEA risk undermining the viability of the single market.

- The case of Iceland highlights some important risks to the single market, in particular the shortcoming of EU Directive 94/19/EEC on Deposit Guarantee Schemes and the difficulties of managing an independent monetary policy in an economic area with free financial flows.

- Urgent reform measures must reflect the interests of all 30 EEA states, which constitute the membership of the single market. Uniform and equal access to EU assistance measures is needed to maintain an open and well functioning single market.

The case of Iceland

The financial crisis now engulfing the world claimed Iceland as one of its early and hardest hit victims in the fall of 2008. Iceland became the first developed country in 30 years to request the assistance of the International Monetary Fund after its three largest banks collapsed and were taken into government administration in the same week in October 2008.

Iceland's current situation is not an isolated event, but needs to be understood in the larger European context. The roots of Iceland's financial expansion into Europe can be traced back to Iceland's accession to the Agreement on the European Economic Area in 1994. Indeed, the first article of the EEA Agreement states that the Agreement aims to promote a continuous and balanced strengthening of trade and economic relations between the Contracting Parties with equal conditions of competition, and the respect of the same rules, with a view to creating a homogeneous European Economic Area. In order to achieve those objectives, the four single market freedoms and rules on competition are applied among all the members of the EEA Agreement.

The financial crisis in Iceland came about as a result of many contributing elements.[1] The IMF attributes Iceland's oversized banking system as a key factor of the financial crisis, a sector which had combined assets and debts worth close to 10 times Iceland's GDP. The IMF reports that problems related to the banking crisis quickly spilled over into other sectors of the economy. Within a week, the three banks collapsed and the stock market lost more than 80% of its value. The krona, which had already weakened dramatically since the beginning of 2008, collapsed. The future outlook for the Icelandic economy is bleak, characterized by widespread bankruptcies, structural unemployment and emigration. Iceland's GDP is expected to contract by up to 10% in 2009. For a small economy that is very much dependent on imports, this is a crisis of huge proportions.

The relative size of the Icelandic banking system meant that the government was not in a position to fulfil its role as a lender of last resort, unlike in other European countries. This effect was further escalated by the inability of the Central Bank to extend its foreign currency reserves. In response, the government of Iceland requested assistance from the IMF and received a package totalling $2.1 billion under the Fund's fast track emergency financing mechanisms, as well as additional funding from partner states totalling $ 5.2 billion. The IMF program is focused on stabilizing the exchange rate by a combination of high interest rates and severe capital controls, which will be gradually dismantled; on fostering a banking system and protect relations with foreign financial institutions by adopting a strategy that is non-discriminatory and collaborative; and, finally, on organizing fiscal consolidation in light of the much greater anticipated level of public indebtedness.

The financial crisis in Iceland has received considerable attention in the international press, especially in Europe, as it reflects Iceland's status as one of the earliest and hardest hit victims. It is important to remember that although Iceland played the part of the metaphoric canary in the cave, the elements that caused the crisis in Iceland are similar to those of numerous countries in the rest of the EEA. For instance, the situation is comparable to some Eastern European States with respect to expensive debt servicing due to high rates of borrowing in foreign exchange. In Iceland's case, this entails higher interest rates and restrictions on the movement of capital until stability returns to the foreign exchange market.

The relevant EEA regulations and their shortcomings

Iceland's financial crisis has raised a number of concerns regarding the proper functioning of the single market and the EEA.

Bilateral disputes over the legal interpretation of Deposit Guarantee Schemes

[1] For a more detailed overview, see for example '*The Collapse of a Country'* by Jon Danielsson and Gylfi Zoega. http://www.riskresearch.org/

As a member of the EEA since 1994, the Icelandic Government is legally obligated to implement relevant EU directives, making Iceland an integral part of the European Single market for financial services. Indeed, Iceland has adopted all EU Directives relating to financial services and consumer protection, including EU Directive 94/19/EEC on Deposit Guarantee Schemes. The Directive provides for each Member State to ensure within its territory the introduction of and official recognition of one or more deposit guarantee schemes to which credit institutions are required to belong. The Directive ensures that the main elements of the deposit guarantee schemes are harmonised across the EEA, and thus fully harmonised between Iceland and other EEA member states.

The deposit insurance set out in the Directive is provided by insurance funds, which are funded by contributions from relevant banking institutions. It is however unclear what is supposed to happen if the national insurance fund does not suffice for payments following a banking crisis. In the first instance, the cost may be borne by other banks. If however the entire banking system of a country collapses, as happened in Iceland, such an option is not possible. This raises the question of whether the respective national government is obliged to cover the insurance.

The shortcomings of the Directive became apparent when the financial crisis hit Iceland and spilled over into the economies of other European countries in the EEA. The United Kingdom and the Netherlands in particular were concerned about their citizens' deposits in high interest savings accounts. These so-called Icesave accounts were operated by Landsbanki Bank under local branches of the Icelandic entity in the UK and the Netherlands, meaning they were primarily regulated and insured in Iceland but were also under the jurisdiction of local UK and Dutch authorities. Kaupthing Bank operated similar accounts under the name Kaupthing Edge, but these accounts were for the most part registered as subsidiaries, which meant they were regulated and supervised in the host country. In Germany, however, Kaupthing Edge was registered as a branch. The Dutch, UK and German governments sought to recover the losses to their savers from the Icelandic government and secure the same guarantees of deposits as was promised to Icelandic depositors. The Icesave accounts, for instance, had attracted £4.5 billion in the UK and close to £1 billion in the Netherlands. The amount in the Icelandic deposit insurance fund only covers a small fraction of these losses.

Under European law, a certain percentage (usually 0.5% to 1.5%) of deposits go into a deposit insurance fund, which is intended to provide each saver with a protection of approximately €21,000 in case of bank failure. Apparently, existing European law did not foresee the possibility of a whole banking system collapsing nor spell out the legal obligation of governments to top up deposit insurance funds. In Iceland's case, the Icelandic Deposit Guarantee Fund did not have sufficient funds to cover the costs associated with foreign deposits.

In light of the enormous implications to Iceland's economy and the legal uncertainty surrounding the issue of liability, the Icelandic Government considered seeking absolute clarity through binding arbitration or court proceedings. Other EEA states did not share this approach, as legal uncertainty could have destabilized the whole of the European banking system, and Iceland eventually reached a common understanding with the EU and several of its member states on resolving matters related to deposit holders in foreign branches. It must be kept in mind that throughout the process, the Government of Iceland maintained steadfastly that Iceland would honour all of its legal obligations.

In a disturbing turn of events, the UK government enacted anti-terrorism legislation against Icelandic entities, including Landsbanki, to freeze assets in order to secure deposits in the UK. This led to the extraordinary situation of listing Icelandic government entities on the same terrorist watchlist as Al Qaeda, North Korea and the Taliban. Furthermore, significant pressure seems to have been employed during discussions with the IMF to pressure Icelandic authorities to reach a common understanding on the interpretation of legal obligations with respect to deposit guarantees in the European Economic Area.

Regardless of the legal issues, the ability of the Icelandic Government to meet these claims is very limited and the long term effects of debt payments borne by the Icelandic taxpayer for foreign deposits in private banks is unprecedented. The crisis has demonstrated that the current organization of Deposit Guarantee Schemes in the Member States represents a major weakness in the EU banking regulatory framework. It failed to address systematic failures. Urgent reforms are needed, and they should take into account the needs and interests of all EEA member states.

The European Commission adopted on 15 October 2008 a proposal to improve key aspects of the Directive on Deposit Guarantee Schemes. The proposal would help by requiring Member States to increase the coverage level to at least € 50 000 and within a further year to at least € 100 000, by abandoning co-insurance i.e. ensuring that the totality of deposits are reimbursed up to the coverage level, and finally by reducing the payout delay to 3 days.

Capital restrictions and safeguard clauses

The severity of the global financial crisis has impacted all EEA member states to varying degrees. The European Union is now under immense pressure to address the situation and provide for more uniform and comprehensive reform measures, evidenced most recently by the conclusions of the de Larosière report. The consequences of inaction or misguided policies risk calling into question the continued viability of the full functioning of the single market.

EU action in this respect must take into account the economic situations of all member states of the EEA and of the single market. Members of the eurozone have thus far been shielded from the currency crisis and have received assurances from the Economic and Monetary Affairs Commissioner Joaquin Almunia that no eurozone member need look to the IMF for assistance. Other hard hit EU member states outside of the eurozone, in particular Latvia and Hungary, have had to look for multilateral assistance from the IMF, but have also received assurances from the EU and promises of tangible financial support in terms of emergency loans through the European Bank of Reconstruction and Development and the European Investment Bank.

On 28 November 2008, the Central Bank of Iceland issued new rules on foreign exchange based on the Foreign Exchange Act of 1992. The policy aims to stabilize the Icelandic krona by restricting the cross border capital flows. This measure accompanies the IMF loan package and additional loans by other European states. These capital restrictions raise a number of concerns regarding the full functioning of the single market. The new rule on foreign exchange can be enacted according to the legislation until the end of November 2010, which coincides with the timeframe of the IMF economic package.

As a member of the EEA with an independent floating currency, Iceland will be hard pressed to lift the currency restrictions and rejoin the single market without continued safeguards. The safeguard measures must be lifted in the future, but it is very likely that national control mechanisms with regard to foreign capital will need to be maintained, for instance to prevent currency speculation. The viability of maintaining small independent currencies in the single market has truly been called into question.

Conclusions

There is now an emerging consensus that keeping intact the present arrangements is not the best option in the context of the Single Market. The present regulatory framework in Europe lacks cohesiveness. This was highlighted in the European Parliament's report[2] on the Crisis at the Equitable Life society adopted in 2007 which among other things called for urgent revision of the Deposit Guarantees Directive, and considered that there could be "no mobility without liability" for undertakings wishing to provide financial services cross-border - this entailed the availability of collective redress mechanisms covering the entire single market with a view to achieving a fair, non-discriminatory and cost-effective result.

Relevant reforms should take into account the interests and compatibility of EEA legislation, in particular if they place greater onus and responsibility on the ECB for supervisory functions. The EEA members and legislative framework must adapt in parallel to the EU structures.

In light of the important shortcomings that have been discussed in this working paper, the co-rapporteurs draw the following three main conclusions and urge the EU institutions to:

- acknowledge the close relationship between a fully functioning single market and monetary union,
- stand ready to advocate for monetary stability through the quick implementation of the ERM should Iceland decide to apply for membership to the European Union, which would pave the way to adoption of the euro, and
- speed up the ongoing revision of EU Directive 94/19/EEC on Deposit Guarantee Schemes, in light of the experience from the collapse of the Icelandic banks.

[2] http://www.europarl.europa.eu/comparl/tempcom/equi/report_en.pdf