

**Coordination Committee**

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# **STRATEGY NOTE**

No. 1

## **Table of contents**

Introduction.....	3
1. Role and responsibility of the Coordination Committee .....	5
2. State owned banks.....	6
3. Savings banks and other financial companies .....	7
4. Corporate sector .....	8
5. Resolution of old banks .....	9
6. Ownership issues .....	10
7. Regulation and supervision.....	11
8. Communication - Public Information .....	12
Appendix 1 .....	13

## **Introduction**

This report describes actions that the Coordination Committee (Committee) has recommended to the government to address problems in the banking sector and the intention is to update the report on a regular basis, at least every quarter.

The problems that materialized in the banking sector in early October have affected every sector of the economy and the problems will continue to affect the economy throughout this year. Since the impact on both households and the corporate sector will be severe, it is important that the government as soon as possible announce policies on how to support the economy and thereby minimizing the negative effects, particularly on banks, the corporate sector and households.

Banks have many important roles to play in an economy. That is why it is so important to restructure their businesses in the instances they have failed. Banks are, for example, trusted to invest people's money and to act as intermediaries between depositors and borrowers, transforming short-term deposits into long-term investments. Banks also play an important role in providing payment services and it is through banks that central banks carry out their monetary and foreign exchange operations. Moreover, it is widely recognized throughout the world that it is hard to achieve economic growth unless the economy is supported by a sound and solvent banking system.

Bank restructuring, however, is a tricky and complicated exercise. The main purpose is to limit the negative effects on the economy and particularly on households and corporate customers, while shareholders and bank managers should not be protected. Bank restructuring is also normally a costly exercise and if the shareholders lack the resources, public funds have to be used causing an extra burden on taxpayers.

Without a strong and profitable corporate sector there will be no economic growth and the government should consider which strategy to adopt in supporting the corporate sector. It is the view of the Committee, that the establishment of an Asset Management Company could be an essential part in such a strategy. Moreover, it is important that the state banks recognize the new environment and that it is no longer business as usual. As state banks, it is important that banks contribute and support the government in implementing a policy for economic recovery.

Households are facing serious problems because of the banking crisis and the downturn in the economy but it goes beyond the mandate of the Committee to recommend actions to support households. The Committee wishes, however, to underline the importance of a centralized policy ensuring a fair and consistent treatment of households throughout the banking system.

Actions to address problems in the banking sector are mostly recommended by the Committee, which consists of representatives from all relevant parties involved in dealing

with banking issues. The role and responsibility of the Committee is described in **section 1**.

**Sections 2 and 3** describe what the future banking system in Iceland might look like and what actions are considered in order to get a sound and viable banking system. Section 4 deals with the need to support the corporate sector while **section 5** deals with the downsizing of the old banks and how to do it in an orderly way. **Section 6** addresses ownership issues given that most banks in Iceland have been nationalized. The legal framework and how supervisory procedures can be improved are addressed in **section 7**.

Finally, the importance of keeping the public informed about the banking problems are being recognized and addressed in **section 8**.

## Section 1

### Role and responsibility of the Coordination Committee

In the Letter of Intent that the government has signed with the IMF it is stated:

*“A well-reputed expert in banking was appointed to be in charge of managing the bank restructuring process. The expert reports to the prime minister and has the overall responsibility of developing, implementing and communicating a comprehensive strategy for bank restructuring. A committee comprising representatives from FME, the central bank, the Ministry of Finance, and the Ministry of Commerce has been established to coordinate policy input and dialogue with the expert”.*

This clause led to the establishment of a Coordination Committee, chaired by an impartial banking expert and with six representatives<sup>1</sup> from various ministries, the FME and the Central Bank.

The motive behind the set up of the Committee was to ensure that all parties that necessarily would be involved in dealing with issues related to the restructuring of banks would be fully informed about problems in the banking sector, how they should be addressed and by whom.

It is very important to note that the Committee in no way is a decision-making body. It will analyze and discuss problems (issues) in the banking sector and then make a formal recommendation to the relevant party on how a specific problem could be addressed. That party is not obliged to follow the recommendation made by the Committee.

Recommendations made by the Committee are documented in Minutes, which are circulated to all parties involved ensuring that the views of the Committee are known. Recommendations do not need to be unanimously adopted. Dissenting view will be recorded in the minutes.

For the Committee to be able to fulfill its mandate, all parties involved must recognize its role and responsibilities. The Committee, however, should not be involved in the day to day work on banking issues such as the FME’s ongoing responsibility of supervising banks.

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<sup>1</sup> One representative each from the Prime Minister’s Office (has also the right to appoint an observer), the Ministry of Commerce, the Ministry of Finance, the Ministry of Foreign Affairs, the Central Bank and the Financial Supervisory Agency (FME). The Central Bank also provides managerial assistance to the Committee.

## **Section 2**

### **State owned banks**

#### **Goal:**

Ensure the offering of banking services in Iceland by sound, solvent and efficient banks.

#### **Key issues and priorities:**

- Provide credits to keep viable businesses operating throughout the financial crisis.
- The banks should be forward looking and not occupied dealing with past mistakes and they should focus on providing their customers with banking services and rebuilding for the future.
- It is of vital importance to revive key financial markets such as the foreign exchange market, the bond market, interbank money market and the stock market.
- The state banks (new banks), savings banks and other financial companies are encouraged to compete actively.
- The new banks have to reduce costs significantly. Mergers of banks and financial companies will be considered in order to make the system efficient.
- The state banks will be adequately capitalized by the government and it is of vital importance that the banks support the government's policy for economic recovery.
- The payment flows for NBI's (i.e. the new Landsbanki) customers is affected by the UK freezing order on Landsbanki Íslands. It should be lifted.

#### **General:**

Maintaining domestic banking services for companies and individuals was the fundamental reason for the split of the banks into new/old, domestic/foreign, after the three main Icelandic banking groups collapsed. Domestic payment services were thus preserved.

Subsequent to the collapse of the major banks, banking services have been provided by the new banks and the remaining smaller financial companies but the level of service has deteriorated. In addition, significant problems had to be solved in order to minimize the detrimental effects of the financial crisis on corporate customers and individuals.

Operations of the banks were hampered in the beginning. The banks do not have a clear picture of their assets, liabilities, capital ratios, interest rate margins and risk exposures. The conditions will be clarified in April, at the latest, when the valuations of the banks are completed, their debt to the old banks has been determined and they have been properly capitalized by the State.

## Section 3

### Savings banks and other financial companies<sup>2</sup>

#### Goal:

Maintain sound, solvent and efficient financial institutions.

#### Key issues and priorities:

- **Support viable financial undertakings in temporary difficulties:** The savings banks, comprising around 15% of the domestic market, have an important role in providing credits to households and small retail companies and a role in receiving deposits from the public. Other financial institutions have an important role in providing credits to specific sectors of the economy. Both savings banks and other financial institutions have an important role to play as competitors to the larger banks.
- **Encourage mergers and rationalization within the financial system:** The financial crisis has already resulted in considerable setbacks in income and equity of the savings banks and other financial institutions. There is an urgent need to strengthen the equity position and profitability of these institutions. Hence, measures have to be taken to rationalize and reduce costs. In some cases there is a need for capital support as a part of a financial restructuring of a financial institution. To that end rules have been formulated that define if and under which terms and conditions the State will assist savings banks. To consolidate the sector, mergers of small institutions might be a prerequisite for capital support from the government.
- **Permit the AMC to acquire “bad” assets from savings banks as a support to rationalization measures:** An Asset Management Company (AMC) permitted to acquire “bad” assets from savings banks could be a useful tool to help the savings banks to focus on their main function as a provider of financial services to households and small retail companies.

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<sup>2</sup> Other financial companies comprise investment banks, leasing companies, insurance companies etc. Their situation and possible actions will be addressed in the next version of the Strategy Note.

## **Section 4**

### **Corporate sector**

#### **Goal:**

To contribute to economic recovery and to minimize the negative effects on companies of strategic importance to the economy, the government should consider developing a policy on how to support the corporate sector.

#### **Key issues and priorities:**

- Identify measures to support companies experiencing problems related to the financial crisis. The government to define the role of the government in corporate restructuring.
- The government to consider the establishment of a centralized Asset Management Company (AMC) in charge of the restructuring of larger companies of strategic importance to the Icelandic economy.

#### **General:**

A failure to address the corporate restructuring challenge adequately will have a very significant negative impact on the overall economy and the people of Iceland. When businesses fail their supply chains are also adversely affected and a central failure leads to a “ripple effect” causing more damage across the wider economy. Which businesses to support and which to leave to fail is a decision that needs to take into account such factors and one that should be managed centrally and consistently across the whole process. Furthermore, there are some businesses that are so critical to the Icelandic economy or supply chain that all measures should be deployed to secure their future.

Furthermore, the banking system remains under intense operational pressure. The State Banks (new banks) need to focus on moving forward and supporting the economy as it recovers. The restructuring process will be a drain and a distraction on operational management. Moreover, Iceland has only limited financial resources to direct towards the restructuring. A successful restructuring process therefore needs to first assess the overall size of the requirement from corporate Iceland before deploying these scarce resources. The government should consider making the creation of an Asset Management Company an essential part of the Icelandic bank restructuring programmed.

## **Section 5**

### **Resolution of old banks**

#### **Goal:**

Set up the legal and procedural framework for the resolution of the old banks in order to maximize asset recoveries and to distribute the proceeds to the creditors in a fair, equitable and transparent manner in line with best international practice.

#### **Key issues and priorities:**

The Resolution committees are in charge of the resolution of the old banks.

- It is the responsibility of the authorities to provide a legal framework for the resolutions in line with best international practice.
- The work of the Resolution Committees should be transparent with an ongoing flow of information to the public about activities being carried out.
- The Resolution Committees should emphasize the relationship with the creditor.
- The compensation to the creditors for the assets transferred to the state banks should be determined in a fair and transparent manner.
- Work in a positive way for the settlement of outstanding issues regarding minimum deposit guarantee obligations in some foreign countries.

#### **General:**

After the collapse of the Icelandic banking system Glitnir, Landsbanki and Kaupthing were split into state (new) banks and old banks. The state banks will make up the future new banking system while the old banks will be dissolved and wound down in an orderly manner. The proceeds from the asset sales will be distributed among the creditors in a fair and transparent manner.

The resolution of the old banks may take several years. The old banks are now in moratorium, which means the Resolution Committees are in charge of their operations and the Court appointed assistants. It is the responsibility of the government to provide a legal framework acceptable to creditors and in line with best practice, allowing the Resolution Committees to maximize asset recoveries and thereby minimizing the losses creditors will have to absorb. It is very important for the reputation of Iceland that the winding down of the old banks is done in line with best international practice. If not, there is a risk that much needed foreign capital contributing to the recovery of the economy will be delayed.

## **Section 6**

### **Ownership issues**

#### **Goal:**

The government to consider the set up of an independent holding company to ensure professional and transparent management of shares held by the State in financial institutions. It is necessary for the government to also consider future ownership and the possible divestment of the shares as soon as possible.

#### **Key issues and priorities:**

- The government to consider the establishment of an independent holding company at arm's-length distance from political power, that will manage the government's stake in the banks.
- The government to define in advance decisions that need political approval, including to form a policy on foreign ownership.
- The government should consider making the holding company responsible for discussions with creditors of the old banks on the design of the financial instrument, ensuring a fair compensation for the net assets transferred to the new banks.

#### **General:**

The three banks nationalized in October 2008 will be capitalized after the completion of their valuation. The banks will be capitalized by injecting government bonds, which will be issued on market terms and tradable. Following best practice in many countries, the government should consider the establishment of a holding company to manage the shares held by the government at arm-length distance from political power. The ownership by the government will at first be limited to the transitional period during which the banks are restructured. Thus, a policy should be developed upfront covering future ownership, including the role of foreign investors.

## **Section 7**

### **Regulation and supervision**

**Goal:** Have a regulatory and supervisory framework in line with best international practice.

**Key issues and priorities:**

- The bank regulatory framework and supervisory practice are being reviewed by an international expert with the aim of strengthening safeguards against potential new crisis.
- The review focuses on rules on liquidity management, connected lending, large exposures, cross-ownership, and the “fit and proper” status of owners and managers. The review and proposed changes will be completed by the end of March

**Refer to the Appendix on Planned Bills of Law**

## **Section 8**

### **Communication - Public Information**

#### **Goal:**

Keep the public informed on an on-going basis on progress being made in the restructuring of the banking system.

#### **Key issues and priorities:**

- The Strategy Note will be updated on an ongoing basis and at least every quarter.
- Media seminars will be held every time the Strategy Note is updated.
- Representatives in the Coordination Committee will keep the public informed on progress being made in implementing recommendations related to their areas of responsibility.
- The Coordination Committee will actively work with representatives from the media to keep the public informed.

#### **General:**

There is strong and growing demand for more transparency in the work of the authorities in relation to the financial crisis. The Coordination Committee will meet this demand by increasing the flow of information to the general public.

## Appendix 1

Planned bills of law prepared by the Ministry of Business Affairs are as follows:

1. Review of the bank regulatory framework and supervisory practice.  
The bank regulatory framework and supervisory practice are being reviewed with the aim of strengthening safeguards against potential new crisis. A Finnish bank supervisor, Mr. Kaarlo Jännäri, is currently assessing 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 and a proposal for necessary changes will be completed by the end of March. Also, the Minister of Business Affairs has appointed a committee comprised of representatives from the Ministry of Business Affairs, FME, SFF and SF that shall prepare a bill of law on amendments on the Act on Financial Undertakings in the light of the banking crises. The committee and Mr. Jännäri will exchange information. The work of the committee shall be completed by 15 April.
2. Chapter XII of the Act on Financial Undertakings.  
The Ministry of Business Affairs started reviewing Chapter XII of the Act on Financial Undertakings on winding-up of Financial Undertakings in December 2008 with the aim of having more detailed rules and a better structure for the winding-up of financial undertakings. The proposal will be ready in February.
3. UCITS  
The Ministry is currently working on the implementation of Directive 2007/16/EB on undertakings for collective investment in transferable securities (UCITS). Also, it will be assessed whether the act on UCITS should be amended in light of the financial crisis.
4. Public and Private Limited Companies.  
The Ministry has asked the Institute of Law at the University of Iceland to undertake a research on the Acts on Public Limited Companies and Private Limited Companies in light of the crises.