The Financial Crisis
Mandatory Private Pension Systems

The Icelandic Perspective

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Background

- Iceland has been hit extraordinarily hard by the financial crisis that has swept across the globe
- Its three major banks, Kaupthing, Landsbanki and Glitnir, all collapsed in the same week in October 2008
- After the banks privatization early this century, they began expanding at a rapid pace, with the primary focus of that growth outside Iceland
- They acquired financial companies in other countries and opened branches
- This rapid growth was facilitated by Iceland’s membership in the European Economic Area (EEA)
- The financial system had a regulatory framework based on the directives adopted by the European Union
- The banks had the same rights and responsibilities as banks in all of the other EEA states
- The Icelandic Financial Supervisory Authority based its operations on European law, regulations and procedures

Temptations and then warnings

- The supply of credit was virtually inexhaustible
- Interest rates lower than they had been in a hundred years
- Financial markets were hungry for bonds, including those issued by Iceland's banks, which were a welcome addition to many of the structured securities that became so popular
- The banks were thoroughly scrutinized by international rating agencies and their favorable credit ratings greatly facilitated the banks' foray into the bond market
- The banks attracted international attention late in 2005 and early in 2006
- Their CDS spreads began rising toward the end of 2005 and they received more probing and critical coverage by the media and others
- The criticism was wide ranging, targeting the banks' growth pace, risk appetite, low deposit ratios and high dependence on borrowed funds, as well as cross ownership, lack of transparency, and so on
- Until then banks had increasingly been active in the global bond market, with ever larger debt issues

Responses

- The Icelandic banks greatly enhanced their information disclosure to the global marketplace, thus improving transparency in their operations.
- They sought to reduce cross-ownership, improve their liquidity position and capital ratios, and took the first steps toward increasing the share of deposits on the liabilities side of their balance sheets
- Landsbanki launched its Icesave deposit accounts in the United Kingdom toward the end of 2006
- The banks sought out new credit markets for example in the US which was wide open at the time for issuers with favorable credit ratings
- Because they took this action the Icelandic banks were better prepared than they would otherwise have been for the sudden changes that took place in the global financial markets in mid-2007
- In mid 2007 we saw the sharp rise in risk aversion among investors and the rapidly shrinking supply of credit. CDS spreads began rising, including those of Icelandic banks

And then Lehman Brothers

- Glitnir had a large foreign loan payment coming up in mid-October
- In mid-September, the prospects for funding the October payment were good, and that Glitnir would be able to cover that payment with an asset sale that was virtually complete
- Then the Lehman Brothers collapsed, starting a tremor that would shake financial markets all over the globe
- In its Quarterly Review in December 2008, the Bank for International Settlements went so far as to say that after the failure of Lehman Brothers, the global financial markets "seized up and entered a new and deeper state of crisis.(...) With credit and money markets essentially frozen and equity prices plummeting, banks and other financial firms saw their access to funding eroded and their capital shrink owing to accumulating mark to market losses." The Lehman bankruptcy had triggered a widespread crisis of confidence
- Substantial pressure was on Landsbanki's deposit accounts in London, and the British Financial Services Authority (FSA) steadily tightened the demands it made on the bank
- It was clear that rescuing the bank would not represent prudent use of the Central Bank's foreign exchange reserves. The amounts involved were simply too large
- Only Kaupthing remained of the three large bank and was deemed likely to survive the storm. Subsequent events in London changed that, however, including the FSA´s action against the Kaupthing subsidiary.

The collapse

- The three banks, representing about 85% of total banking assets, all collapsed
- The Icelandic Financial Supervisory Authority took over their operations on the basis of newly adopted legislation
- Efforts in that regard were successful in spite of measures such as the “freezing order” imposed on Landsbanki by the British authorities under the Anti-Terrorism, Crime and Security Act – a freezing order that originally extended as well to the Icelandic government, Central Bank, and Financial Supervisory Authority, among others.
- Iceland’s overstretched, over-leveraged banking system was ill-positioned to cope with the global financial turmoil
- The Icelandic banking sector experienced a dramatic expansion in just a few years, funded by cheap foreign financing, which allowed it to boost its assets from 100 to almost 900 percent of GDP between 2004 and end-2007
- This expansion made the Icelandic banking system one of the largest in the world in relation to GDP
- It is obvious that the banks had become too large in relation to the Icelandic economy
- The European regulatory framework made this possible

Could we have prevented the collapse?

- Perhaps the safest way to prevent the collapse of the Icelandic banks would have been to place more stringent limits on their operations than were placed on financial institutions in other EEA states to deny them the rights conferred by the EEA Agreement
- Had this been done, Iceland would not have been a full participant in the internal market of the European Union
- It is unlikely that political support would have been forthcoming for the imposition of such restrictions on the banks
- Conditions in the global financial system are at their worst since the Great Depression, particularly after the collapse of Lehman Brothers
- It is possible to say after the fact that the fall of Lehman sealed the fate of Iceland's banks
- Early in October, the Icelandic Parliament passed emergency legislation authorising the Financial Supervisory Authority to take over the banks' operations
- Following the collapse of the banks, the Icelandic government negotiated a Stand-By Facility from the International Monetary Fund on the basis of an economic programme. That process is underway

The history and structure of the Icelandic pension system

- The mandatory Icelandic system is based on a wage agreement from 1969 which was given a law status by the pension act of 1974
- The pension act from 1980 made it mandatory for all working people – all employees and employers or self-employed people – to become members and contribute to a pension fund.
- The Icelandic pension system is developed according to the three pillar principle proposed by the World Bank
  - The first pillar is a tax financed public pension like the Icelandic social security system
  - The second pillar is based on a mandatory membership in a fully funded occupational pension funds
  - The third pillar is constitutes a free individual pension savings with tax incentives
- Contributions to the pension funds are tax deductible both for employees and employers. Pension fund income is excemt from all taxes. Benefits in payment are taxed like salaries

Assets of the system before the crises

- Before the collapse of the banks the assets of the Icelandic pension system totaled 1.658 billion ISK
- The assets of the system amounted to 133% of GDP which was without comparable in the world
- Many factors had a positive impact on this favorable position;
  - The most important one is the mandatory contributions to the pension funds
  - Privatization of the Icelandic banks had proven favorable for the pension funds due to exceptionally good returns in the domestic stock market. Obviously a considerable part of the previous gains were wiped out in October 2008
  - The pension funds have also reaped benefits from high real interest rates in the domestic bond market for over twenty years
  - Other factors worth mentioning are that women´s fertility rate in Iceland is among the highest in the world, the nation is younger than most western nations and retirement age is relatively high at 67 compared to other nations

Effect of the collapse on assets and returns

- The collapse of the Icelandic stock market dealt a serious blow to the assets of the pension funds
- The pension funds also had to write off a considerable part of their domestic bond portfolio
- Because of the October disaster the Pension Fund of Commerce saw it´s assets decline by 14,4% in that month alone
- The year end result showed the Pension Fund of Commerce down 11,8%
- An important factor in this results which seems not so bad taken into account the disaster the country had just been through stems from the huge devaluation of the Icelandic krona which lost 45% of it´s value over the year 2008
- At the end of the year the Pension Fund of Commerce had 33% of the total assets in foreign securities
- The first two months of 2009 show negative returns for the pension funds, both due to the strenghtening of the Icelandic Krona but also because of continuing decline in the international equity markets.