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Iceland: Arion Bank, Islandsbanki, and Landsbankinn Capital Injections, 2008[1]

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Abstract

Iceland's three largest banks—Glitnir, Kaupthing, and Landsbanki—grew rapidly in the 2000s and failed amid depositor runs when they lost access to foreign funding markets at the onset of the Global Financial Crisis (GFC). On October 6, 2008, the Icelandic Parliament passed the Emergency Act, and authorities quickly used their new powers to nationalize the three banks. The Ministry of Finance created and capitalized Arion Bank (for Kaupthing), Islandsbanki (for Glitnir), and Landsbankinn (for Landsbanki), to hold the old banks' performing domestic assets and all insured domestic deposits, and the prime minister assured all domestic depositors that they would be protected. On December 15, 2009, the state injected EUR 1 billion (USD 1.4 billion) in capital into the new banks. Because fiscal resources were limited, the capital injection was in the form of a new type of government bond. It also gave the old banks contingent bonds and equity stakes in the new banks. The size of the equity stake was based on provisional valuations of the assets in the new and old banks, with consulting firms commissioned in November and December 2008 to provide more definitive valuations. Based on these valuations, the government capitalized the new banks and provided the creditors of the old banks with equity stakes as compensation. The total state financing in the three new banks was EUR 1 billion. The creditors of Kaupthing received an 87% stake in Arion Bank, and the creditors of Glitnir received a 95% stake in Islandsbanki. The creditors of Landsbanki received a contingent bond as well as a briefly held 18% stake in Landsbankinn. The government holds stakes in Landsbankinn and Islandsbanki as of the writing of this case study, while Arion Bank has been fully privatized.

Keywords: capital injection, Global Financial Crisis, Iceland, Landsbanki

[1] This case study is part of a Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering ad hoc capital injections. A survey of all the cases in this series (Rhee, Hoffner, et al. 2024) and the individual cases underlying it are available from the *Journal of Financial Crises* at https://elischolar.library.yale.edu/journal-of-financial-crises/vol6/iss3/. Rhee, Oguri, et al. (2022) surveys broad-based capital injection programs.

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Overview

This case study describes the capital injections provided to Arion Bank, Islandsbanki, and Landsbankinn, the three Icelandic banks created by the Ministry of Finance and Economic Affairs during the Global Financial Crisis of 2007–2009 (GFC). The restructuring of the Icelandic banking sector is detailed in the corresponding resolution and restructuring case study, George (2024).

Iceland's three largest banks—Glitnir, Kaupthing, and Landsbanki—grew rapidly following privatization in the early 2000s. Iceland had joined the European Single Market in 1994, which facilitated Icelandic banks' expansion into other European countries. By 2007, the assets of the three largest banks made up 85% of the Icelandic banking sector and several times Iceland's GDP. Their growth was driven largely by aggressive lending expansion funded by international financial markets. Critically, this became a major source of vulnerability as global credit tightened in 2007. Icelandic banks were increasingly transacting in foreign currencies such as the euro without a reliable foreign currency lender of last resort. From the onset of the GFC in summer 2007, funding for the banks became increasingly difficult, as international bond markets closed and foreign deposits started to flow out. Amid the panicked environment that followed the failure of Lehman Brothers in mid-September 2008, Landsbanki and the two other banks faced intensified runs from domestic and more importantly foreign depositors. Of the three, Landsbanki was the oldest; literally "the national bank," it had historically been Iceland's central bank before the Central Bank of Iceland (CBI) was established in 1961 and was privatized only in 2003 (Baudino, Sturluson, and Svoronos

Key Terms

Purpose: To preserve the functioning of the domestic banking system and protect the interests of domestic depositors	
Announcement Date	December 11, 2008
Operational Date	October 15, 2009
Date of Final Capital Injection	December 15, 2009
End Date	Government still holds stakes in two of the three major banks
Source of Funding	Icelandic Treasury issued government debt as payment for the equity stakes in the new banks
Administrator	Ministry of Finance and Icelandic State Banking Agency (ISBA)
Size	EUR 1 billion across the three new banks
Capital Characteristics	Ordinary shares and Tier 2 subordinated loans
Bail-in Terms	Shareholders and subordinated creditors in the old banks received nothing while senior creditors received partial compensation with contingent bonds and/or equity stakes in the new banks
Outcomes	The government holds stakes in two of the three major banks with a book value of EUR 2.6 billion
	(continued)

2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; CBI n.d.; Centonze 2011).

Notable Features	The government purchased capital using variable rate bonds that were eligible to be pledged at central bank liquidity facilities; Creditors received some of their post-resolution compensation in the form of a contingent bond; The government incentivized bank resolution committees to provide stability contributions from old bank estates

The crisis led Icelandic authorities to consider urgent measures the weekend of October 3–5, 2008. On Monday, October 6, the Icelandic Parliament hurriedly passed the Emergency Act, which reordered the hierarchy of claims in failing banks and granted sweeping new resolution powers to the Icelandic Supervisory Authority (Fjármálaeftirlitið, or FME) (Baudino, Sturluson, and Svoronos 2020; Braithwaite and Anderson 2008; Icelandic Parliament 2008).

Using its new powers, the FME placed Landsbanki into receivership on October 7, removing the board of directors and appointing a resolution committee to run the bank. On October 9, the FME announced that it was transferring the insured domestic deposits and most domestic assets of Landsbanki to a newly created bank called Landsbankinn (NBI). The state planned to provide Landsbankinn with initial capital of up to EUR 1.24 billion (USD 1.4 billion),[3] based on 10% of the estimated risk-weighted assets. At the end of 2008, Landsbankinn reported EUR 864 million in new capital from the state. However, the state provided just EUR 5 million of that in cash in 2008; the rest was in the form of a government IOU, which it replaced with a government bond the following year. The government left foreign assets and all other liabilities in the old bank, Old Landsbanki. Authorities left foreign deposits (IceSave accounts), in the old bank, causing extended disputes with foreign governments, particularly those of the United Kingdom and the Netherlands. Regarding the new bank, the FME published provisional balance sheets on November 14, 2008 (FME 2008f). Authorities emphasized that these were preliminary figures that could change and hired Deloitte to provide an independent valuation on December 24, 2008. At the end of 2008, the assets in the new bank were estimated to have been transferred at a 60% discount (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; CBI 2015; ESA 2014; FME 2008b; FME 2008e; FME 2008f; NBI 2010; Mayer Brown 2009; Settle 2008).

Regarding the old banks, authorities announced on December 11, 2008, that Oliver Wyman would provide a valuation on a similar basis to that of the new banks. The first complete financial statement did not become available until 2010, when it indicated that the assets had lost 50% of their pre-crisis value (Benediktsdóttir, Eggertsson, and Þórarinsson 2017; FME 2008a).

On December 15, 2009, Icelandic authorities announced that Old Landsbanki, which was owned entirely by senior creditors of the old bank, would receive contingent bonds and

[3] According to the Bank for International Settlements, USD 1 = EUR 0.70 on December 18, 2009.

equity stakes[4] in the new bank as part of a full capitalization of Landsbankinn based on provisional valuations available to authorities. Preexisting shareholders and subordinated debt holders were wiped out (Baudino, Sturluson, and Svoronos 2020; ESA 2014).

The government followed a similar process for the other two banks. It retained equity positions in all three banks, but it held the largest stake in Landsbanki, which therefore ended up immediately under government control. On December 18, 2009, Icelandic authorities issued a press release announcing that the restructuring of the three banks had concluded (MoF 2009f). The Treasury equity contributions across all three banks totaled EUR 1.17 billion (USD 1.67 billion) (ESA 2014; MoF 2009b; MoF 2009c). The timeline of capital injection events is shown in Figure 1.

Figure 1: Timeline of Events Related to the Resolution of Icelandic Banking Sector

Date	Event
Oct. 3–5, 2008	Icelandic authorities deliberate over the weekend on options for the three banks.
Oct. 6, 2008	Icelandic Parliament passes the Emergency Act.
Oct. 7, 2008	The FME puts Landsbanki into receivership, removing the board of directors and appointing a resolution committee for each bank.
Oct. 8, 2008	The FME puts Glitnir into receivership.
Oct. 9, 2008	The FME announces the transfer of insured domestic deposits and performing domestic assets of Landsbanki to a new bank, Landsbankinn (NBI), created by the Ministry of Finance and Economic Affairs. FME places Kaupthing into receivership.
Oct. 15, 2008	FME transfers Glitnir's insured domestic deposits and performing domestic assets to New Glitnir.
Oct. 22, 2008	FME transfers Kaupthing's insured domestic deposits and performing assets to New Kaupthing.
Nov.–Dec. 2008	Government commissions outside firms to conduct valuations of the assets in the new and old banks, which results in a wide range of potential values.
Dec. 11, 2008	The FME outlines the measures being taken to restructure the Icelandic banking sector, including the capitalization of the three new banks and plans for compensating creditors in the old banks.
July 20, 2009	Ministry of Finance announces agreements with resolution committees of the three major banks. For New Kaupthing and New Glitnir, government authorities and the resolution committees reach full compensation agreements. Regarding New Landsbanki, the result of the agreement is a further period of due diligence.
Sep. 4, 2009	Government and Old Kaupthing resolution committee reach an agreement regarding compensation for creditors.
Sep. 13, 2009	Government and Old Glitnir resolution committee reach an agreement regarding compensation for creditors.
Oct. 12, 2009	Government and Old Landsbanki resolution committee reach an initial agreement regarding the compensation for the creditors of the old bank.

[4] Old Landsbanki's equity stake in Landsbankinn was very short-lived as creditors benefited from higher-than-expected recoveries through a contingent bond.

Dec. 15, 2009	Authorities inject EUR 1.4 billion of capital into the new banks.
Dec. 18, 2009	Icelandic authorities announce completion of restructuring for all three major banks.
April 2013	NBI's contingent commitment to the old bank is priced and paid with a bond issue to Old Landsbanki. Simultaneously, the government receives the old bank's equity stake in NBI, increasing its ownership from 81% to 98%, where it remains to date.
Dec. 15, 2014	The five-year restructuring period dictated in European Free Trade Association (EFTA) Surveillance Authority (ESA) agreement ends.
Nov. 2015	Composition agreement between creditors and old bank estates are finalized.

Sources: Baudino, Sturluson, and Svoronos 2020; Braithwaite and Anderson 2008; ESA 2014; FME 2008a; FME 2008b; FME 2008c; FME 2008d; Halldórsson 2013; Jónsson and Sigurgeirsson 2016.

Summary Evaluation

The Icelandic government commissioned a three-person committee of experts called the Special Investigation Committee (SIC) to report the reasons behind the collapse of the three largest banks and assess the government's response. Chapter 2 of the SIC report criticizes government actions and inactions for being overly concerned with the image crisis facing financial institutions and failing to pay enough attention to the larger question of size and the associated systemic risk of the financial system relative to the economy. The report finds that it would have been impossible to save the banks from collapse, but that more thorough preparations by the government might have lessened the damage to the real economy (SIC 2010a; SIC 2010c).

Similarly, Benediktsdóttir, Eggertsson, and Þórarinsson (2017) states that the creation of the new banks worked well in the important sense that it preserved the Icelandic public's access to domestic banking services during the crisis without overextending government finances. The paper also praises the role of bank estates' fulfillment of stability conditions, which contributed to the state's relatively smooth exit from capital controls. The authors do suggest, however, that the controls could have been lifted more rapidly, which might have further sped up Iceland's economic recovery.

Context: Iceland, Arion Bank, 2008–2009	
Assets	**EUR 3.8 billion** as of Dec. 31, 2008 **EUR 4.2 billion** as of Dec. 31, 2009
Liabilities	**EUR 3.4 billion** as of Dec. 31, 2008 **EUR 3.7 billion** as of Dec. 31, 2009
Deposits	**EUR 2.5 billion** as of Dec. 31, 2008 **EUR 2.8 billion** as of Dec. 31, 2009
Capital Ratio (Tier 1)	**10.6%** as of Dec. 31, 2008 **13.7%** as of Dec. 31, 2009
Nonperforming Loans	**EUR 113 million** as of Dec. 31, 2008 **EUR 160 million** as of Dec. 31, 2009
Market Share	**Data not available** as of Dec. 31, 2008 **Data not available** as of Dec. 31, 2009
Banking System, % of GDP	**198.4%** as of Dec. 31, 2008 **190.6%** as of Dec. 31, 2009
Sources: Arion Bank 2010; Bloomberg; World Bank Deposit Insurance Dataset; World Bank Global Financial Development Database.	

Context: Iceland, Islandsbanki, 2008–2009	
Assets	**EUR 3.9 billion** as of Dec. 31, 2008 **EUR 3.9 billion** as of Dec. 31, 2009
Liabilities	**EUR 3.5 billion** as of Dec. 31, 2008 **EUR 3.5 billion** as of Dec. 31, 2009
Deposits	**EUR 3 billion** as of Dec. 31, 2008 **EUR 2.6 billion** as of Dec. 31, 2009
Capital Ratio (Tier 1)	**13.1%** as of Dec. 31, 2008 **15.6%** as of Dec. 31, 2009
Nonperforming Loans	**EUR 1.1 billion** as of Dec. 31, 2008 **EUR 1.4 billion** as of Dec. 31, 2009
Market Share	**Data not available** as of Dec. 31, 2008 **Data not available** as of Dec. 31, 2009
Banking System, % of GDP	**198.4%** as of Dec. 31, 2008 **190.6%** as of Dec. 31, 2009
Sources: Bloomberg; Islandsbanki 2010; World Bank Deposit Insurance Dataset; World Bank Global Financial Development Database.	

Context: Iceland, Landsbankinn, 2008–2009	
Assets	**EUR 6 billion** as of Dec. 31, 2008 **EUR 6.3 billion** as of Dec. 31, 2009
Liabilities	**EUR 5.3 billion** as of Dec. 31, 2008 **EUR 5.1 billion** as of Dec. 31, 2009
Deposits	**EUR 2.6 billion** as of Dec. 31, 2008 **EUR 2.6 billion** as of Dec. 31, 2009
Capital Ratio (Tier 1)	**13.1%** as of Dec. 31, 2008 **15.2%** as of Dec. 31, 2009
Nonperforming Loans	**EUR 5.5 million** as of Dec. 31, 2008 **EUR 14.4 million** as of Dec. 31, 2009
Market Share	**Data not available** as of Dec. 31, 2008 **Data not available** as of Dec. 31, 2009
Banking System, % of GDP	**198.4%** as of Dec. 31, 2008 **190.6%** as of Dec. 31, 2009
Sources: Bloomberg; NBI 2009; NBI 2010; World Bank Deposit Insurance Dataset; World Bank Global Financial Development Database.	

Key Design Decisions

1. Purpose: Icelandic authorities created new banks with government capital to ensure continued banking services; they later provided creditors of the old banks with capital stakes in the new ones to partially compensate them for their losses.

At the onset of the GFC, the Icelandic banking system was particularly vulnerable because of the disproportionate size of the banks relative to the size of the economy, and the dependence of the banks on foreign funding sources denominated in foreign currencies. The sources of foreign funding for the three largest banks included medium-term notes, foreign deposits, and central bank collateralized borrowing. The foreign currency deposits in Iceland's banks were eight times larger than the central bank's foreign exchange reserves. Funding stress in international markets cut off Icelandic banks' access to wholesale funding markets in the summer of 2007 (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; Centonze 2011; SIC 2010a).

The Geyser Crisis of 2006 had revealed the first signs of financial crisis risk in Iceland when fears of overheating made it more difficult for Icelandic banks to access funding through the sale of medium-term notes. Throughout 2007, confidence dwindled in the three largest Icelandic banks, a problem that became acute in the panicked macroeconomic environment of fall 2008. Icelandic banks had lent extensively to investors to fund purchases of their own shares. At the time, this preserved capital ratios that were slightly above regulatory minimums, but ultimately resulted in EUR 4 billion of loans that became worthless following the failure of the banks (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; Centonze 2011; SIC 2010a).

Icelandic banks were particularly vulnerable to the deterioration of international short-term funding markets, which became virtually inoperable beginning in the summer of 2007. With the major banks unable to unwind the risks that had developed on bank balance sheets and the central bank increasingly unable to access foreign currency through swap lines, the Icelandic financial system became isolated from the international community. This left few options by in the fall of 2008 when bank funding issues became catastrophic (SIC 2010a).

On September 26, 2008, the Icelandic Supervisory Authority met with the CEOs of the three large banks to encourage them to consider a merger. Such scenarios had been discussed in March 2008, but the option was dismissed owing to the expense to taxpayers and the high level of uncertainty regarding its effectiveness in restoring confidence. Two of Iceland's three major banks (Kaupthing and Glitnir) applied for emergency liquidity assistance (ELA) from the Central Bank of Iceland, which provided a small amount of foreign currency liquidity. CBI rejected Glitnir's request because of insufficient collateral, electing to resolve the bank and inject capital into a new bridge bank instead. Authorities granted Kaupthing's request, but the EUR 500 million loan was nowhere near enough to prevent the bank from defaulting (Baudino, Sturluson, and Svoronos 2020).

By October 3, 2008, there was a widespread run[5] on the Icelandic banking sector, which was on the brink of collapse (Baudino, Sturluson, and Svoronos 2020, 11). Amidst the deposit runs, the European Central Bank (ECB) issued a margin call of EUR 640 million (USD 864 million)[6] to Landsbanki that Friday, October 3 (Baudino, Sturluson, and Svoronos 2020; SIC 2010b).

Per the Emergency Act, Landsbanki handed over power to the government on October 7, followed by Glitnir on October 8 and Kaupthing on October 9. The Ministry of Finance and Economic Affairs then established three corresponding new banks: Arion Bank (for Kaupthing), Islandsbanki (for Glitnir), and Landsbankinn (for Landsbanki) (ESA 2014; FME 2008b; FME 2008c; FME 2008d).

The Ministry of Finance also commissioned independent firms to value the assets left in the old banks. Authorities announced this valuation plan on December 11, 2008, but a definitive financial statement for the old banks became available only in 2010. The ensuing report found that the value of assets in the old banks was EUR 19.1 billion, down from a pre-failure face value of EUR 40 billion. Landsbankinn originally agreed to issue a fixed income financial instrument to Old Landsbanki, corresponding to the excess value of assets transferred to Landsbankinn on October 9, 2008. This note would have compensated the creditors in the old bank for any excess value of transferred assets discovered by the sale of assets (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; ESA 2014; FME 2008a).

However, the FME decided to change this strategy because of disagreements about the legitimacy of the valuations by creditors of the old banks combined with the very low actual recovery rates. So low were the recovery rates for assets from the banks that the institutions were deemed to have been functionally insolvent at the time of split.[7] Authorities developed a new plan involving the negotiation of compensation in the form of shares in the new bank alongside Tier 2 subordinated loans and/or contingent bond instruments. The government and the creditors of Landsbanki reached an agreement on October 12, 2009. The agreement stipulated that the principal amount would not be determined until on or after March 31, 2013. The resolution committees for Kaupthing and Glitnir reached agreements with the Ministry of Finance in July 2009 which they finalized in September 2009. Authorities stated that the capitalization of the new banks was a major step forward for the reestablishment of a strong banking system. The government gave creditors of both banks the option to acquire controlling ownership stakes in their respective new banks. Creditors exercised this right in December 2009 (ESA 2014; Flannery 2009; MoF 2009a; MoF 2009b; MoF 2009c; MoF 2009e; MoF 2009f).

[5] The bulk of this run occurred in foreign deposit accounts denominated in foreign currencies.

[6] In October 2008, EUR 1 was equal to USD 1.35 (per FRED)

[7] This claim was made under the assumption that overseas assets were not worth substantially more than their book values (Flannery 2009).

2. **Part of a Package: The capitalizations occurred as part of a significant restructuring of the three major Icelandic banks, alongside an International Monetary Fund aid package and capital controls.**

Before the capitalizations, CBI looked to respond to the growing crisis by providing emergency liquidity assistance in foreign currency for Kaupthing. CBI authorities granted Kaupthing ELA because they considered it to be the strongest of the three major banks at the time. The foreign currency loan from the CBI did not prevent a default, forcing authorities to introduce new legislation in order to pursue a different approach (Baudino, Sturluson, and Svoronos 2020).

Iceland's central bank incurred tremendous losses during the crisis, eventually requiring a recapitalization that had an estimated net cost of 6.8% of Iceland's GDP.[8] The main driver of these losses was the "love letter" transactions, referring to unsecured bonds issued by the three major banks to serve as collateral for CBI repurchase agreement (repo) transactions. In the spring of 2008, the large banks issued "love letter" bonds to each other and smaller Icelandic banks, which posted them as collateral for repo transactions with the CBI. This allowed the large banks to access freshly printed Icelandic króna (ISK) liquidity at unprecedented levels, and the collateral became claims on the default estates following the collapse of the banks in October 2008. The balance of CBI loans backed by love letters totaled EUR 2.3 billion on October 6, 2008. The claims were transferred from CBI to the Icelandic Treasury at the end of 2008 with a write-off of EUR 500 million. The claims were written down a further EUR 1.2 billion in 2009. In total, the losses on loans collateralized by love letters totaled EUR 1.7 billion, or 20% of Iceland's GDP (Jónsson and Sigurgeirsson 2016).

The capitalizations occurred as part of a significant restructuring of the three major Icelandic banks. The resolution of the old banks and creation of the new banks is detailed in the corresponding resolution and restructuring case study George (2024). At the same time, Icelandic authorities also introduced an expanded deposit guarantee scheme intended to restore public confidence in the safety of their deposits (ESA 2014). A detailed account of this deposit guarantee scheme, called the "Depositors' and Investors' Guarantee Fund" can be found in the corresponding case study Kulam (2022).

Throughout the restructuring, Icelandic authorities also reckoned with significant balance-of-payments issues. As part of the plan to address these issues and stabilize the economy, Iceland sought International Monetary Fund (IMF) support to strengthen the central bank's foreign currency reserves. Icelandic authorities submitted a letter of intent for a two-year stand-by arrangement on November 15, 2008, which the IMF approved on November 19, 2008. The agreement included a USD 2.1 billion loan, of which USD 827 million became immediately available. The remaining USD 1.3 billion was disbursed in eight equal instalments. Additional loans worth USD 3 billion were secured from trading partners, including Denmark, Finland, Norway, Sweden, Russia, Poland, and the Faroe Islands. The key objectives of the IMF program were to: (a) stabilize and restore confidence in the króna; (b)

[8] Estimates of the gross cost to Iceland's central bank hover at approximately 18% (Benediktsdóttir, Eggertsson, and Þórarinsson 2017; Jónsson and Sigurgeirsson 2016).

restructure the banking system in order to restore its viability; and (c) ensure sustainable public finances by mitigating the socialization of losses (Baudino, Sturluson, and Svoronos 2020; CBI & MoF 2008; ESA 2014; Ibison and Barker 2008).

Alongside the IMF program, authorities introduced capital controls on November 28, 2008, to stem capital outflows, stabilize the exchange rate, and avert a balance-of-payments crisis. Among the flight concerns that the controls addressed was the liquidation of krónur-denominated domestic assets into foreign currencies, with distribution to foreign creditors. The capital controls restricted both capital movement and repatriated foreign currency export revenues. For the first months after the bank failures, Iceland's central bank served as the intermediary for all payments to and from Iceland (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017).

3. Legal Authority: The Icelandic Parliament passed the Emergency Act, which granted new powers to the FME.

At the time of the crisis, authorities did not have resolution plans in place for the three banks, and they had only draft paragraphs for potential emergency legislation (Benediktsdóttir, Eggertsson, and Þórarinsson 2017).

Facing the collapse of the three largest banks, the government passed the Emergency Act on October 6, 2008. Most significantly, the act restructured the hierarchy of claims in failed institutions. The Emergency Act accomplished this by amending Icelandic bankruptcy procedures and the "Deposit Guarantees and Investor-Compensation Scheme." Icelandic bankruptcy procedures were amended such that depositors receive priority during the process of dividing the estate of a bankrupt financial undertaking. The act includes the priority of claims of the deposit insurance fund on insolvent estates in Chapter IV, which contributed to the expansion of Iceland's deposit guarantee (Icelandic Parliament 2008).

The Emergency Act also gives the government the power to establish new financial institutions and to assume full shareholder and decision-making powers in old ones. The law authorizes the Ministry of Finance to establish and capitalize new banks and restructure old ones that face the probability of being unable to service customers and/or creditors. The FME also gained new powers, granting the supervisory authority the right to assume full shareholder powers and take necessary decisions in troubled financial institutions. Finally, the Emergency Act also restructured the hierarchy of claims such that customer deposits receive priority over all other claimants in resolution proceedings. The Emergency Act had to move through all levels of the Icelandic court system, with a Supreme Court ruling on October 28, 2011, removing all legal uncertainty (Icelandic Parliament 2008; Prime Minister's Office 2011).

Existing Icelandic law on financial undertakings gave the estates of the legacy banks three winding-up options: (a) return the estate to the shareholders, an option that would be available only if all creditors could be paid in full; (b) reach a composition agreement with creditors, in which they would agree to reduce or waive some of their claims; and (c) liquidate through bankruptcy. The three estates pursued the second option, taking the view

it would create more value for creditors, but didn't complete their composition agreements until 2015. Under bankruptcy laws, those agreements had to be approved by a proportion of creditors equal to the proportion of claims waived. So, for example, when general creditors' recoveries were estimated to be just 15% in the Landsbanki winding-up, the composition agreement needed approval from 85% of general creditors (Jónsson and Sigurgeirsson 2016).

Upon taking over the operations of the three old banks in October 2008, the FME and each bank's resolution committee identified several legal deficiencies regarding suspension of payments and liquidation. These deficiencies required several amendments to the law governing financial companies in Iceland, the Financial Companies Act no. 161/2002. The Icelandic Parliament drafted several amendments that overhauled the liquidation of financial companies, extending the amount of time allowed for the winding-up of a bank's estate, and calling for the creation of winding-up boards to oversee wind-up proceedings for banks in liquidation. The amendments also allow for financial companies in liquidation to resume operations with permission of the FME or establish a new company for parts of its operations. Finally, the amendments allow for liquidations to end with forced contracts or the sale of the financial company's estate (MoF 2011).

The European Free Trade Association (EFTA) Surveillance Authority (ESA) received seven complaints regarding the legality of the Emergency Act. The complaints, largely brought by foreign banks, considered the prioritization of depositors over creditors to be in violation of Article 40 of the EEA agreement on the free movement of capital. The president of the ESA requested that Icelandic authorities notify the EFTA of all aid measures taken under the Emergency Act. The ESA's December 15, 2010, decision ruled that the Emergency Act was justified and creditors were not illegally discriminated against (ESA 2014; MoF 2011).

4. Administration: The Ministry of Finance created the new banks, and the Icelandic Treasury injected capital.

The Ministry of Finance established the new banks and appointed the members of their respective leadership bodies. The FME contracted Deloitte and Oliver Wyman to value the assets in both the old and new banks in order to establish the basis for compensation for preexisting creditors and depositors of the banks (FME 2008a).

5. Governance: Authorities created the Icelandic State Banking Agency (ISBA) and several oversight committees.

The government created the Icelandic State Banking Agency in 2009 to handle the shareholding responsibilities of the state's holdings in financial undertakings. A three-person board of directors consisting of economists and lawyers administered the ISBA, with a fourth director serving as an alternate (MoF 2009d).

The Icelandic government also commissioned several oversight committees to investigate the origins of the banking crisis in Iceland and evaluate the handling of it (see Summary Evaluation). The FME completed its investigation of the origins of the crisis on February 14, 2013 (FME 2013).

6. Communication and Disclosure: Authorities ensured continued access to domestic banking services in the new banks and communicated progress on the compensation of creditors in the old banks.

Following the deliberations over the weekend of October 3–5, the prime minister delivered a speech on October 6, 2008. The speech sought to reassure domestic depositors and businesses, stating that authorities intended to ensure continued access to banking services to the maximum extent possible. The address also included an admission that a national failure of the banking system and/or default on sovereign debt was a possibility, this being the reason that the government created new resolution powers for the FME. Icelandic authorities continued to announce measures throughout the week, and the prime minister insisted that the state was not bankrupt (Baudino, Sturluson, and Svoronos 2020; Braithwaite and Anderson 2008; Haarde 2008; Icelandic Parliament 2008; Irish Times 2008).

Following the acute phase of the crisis, the Ministry of Finance issued regular press releases announcing progress toward reconnecting the old banks with the new banks. Icelandic authorities announced the agreements with the resolution committees of the old banks throughout the summer of 2009. The Ministry of Finance issued a press release on December 18, 2009, announcing that the three new banks were fully capitalized and that the bank reconstruction period was complete. The annual reports of the new banks communicated the importance of the agreements as expressions of confidence in the future viability of the banks (Arion Bank 2010; Islandsbanki 2010; MoF 2009a).

7. Treatment of Creditors and Equity Holders: Capital in the new banks served as compensation for creditors remaining in the old banks, though it did not make them whole.

The Emergency Act changed existing Icelandic law to place creditors and equity holders behind depositors in the hierarchy of claims. All foreign assets, liabilities, and derivatives were left in the old bank at the time of the creation of Landsbankinn. Following the decision, the old bank entered a resolution process, during which it received a waiver on compliance with bank regulatory requirements. The FME instructed the resolution committee to pursue the goal of maximizing the value of assets for the benefit of creditors in Old Landsbanki. The asset valuation, conducted in November 2008, concluded that the post-collapse conservative value was 40% of the previous book value across the three largest banks (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; FME 2008a; Icelandic Parliament 2008).

The compensation agreement resulted in Old Landsbanki, which was owned by its creditors, taking a 18% equity stake in the new bank. The new bank issued three contingent bonds denominated in euros, pounds sterling, and US dollars, with a combined principal value of EUR 1.4 billion. These contingent bonds were linked to the valuation and performance of specific assets in NBI. If the assets at year-end 2012 were to rise in value compared to the estimate given at the time of the agreement, the contingent bond would be reissued according to the new valuation, and Old Landsbanki would surrender some or all of its equity

stake in return for the greater value of bonds. In April 2013, Landsbankinn issued additional bonds to Old Landsbanki, worth EUR 581 million. Accordingly, Old Landsbanki surrendered its shareholding, resulting in the state holding a 98% equity stake and New Landsbanki holding 2% of its own shares, of which it distributed 0.5% to employees (ESA 2014; NBI 2014).

The extent of the losses to the banking sector meant that creditors and equity holders in the old banks faced significant losses to their claims. Senior creditors in the old banks received partial compensation in the form of equity in the new banks while subordinated creditors and equity holders received no compensation (Benediktsdóttir, Eggertsson, and Þórarinsson 2017).[9] The recovery rates for the three large, failed banks are listed in Figure 2.

Figure 2: Ex Post Recovery Rates for Glitnir, Kaupthing, and Landsbanki Liabilities, According to Their Priority

Assets and liabilities	*Value before failure (billions of euros)*	*Recovery rate (percent)*
Deposits from customers in parent company	18.8	100
Deposits from customers in foreign subsidiaries	14.5	100
Asset-backed securities	> 0	$29 < x < 100$
Borrowings and wholesale deposits in parent company	> 52.8	29
Borrowings and wholesale deposits in foreign subsidiaries	$10 < x < 20$	≈ 100
Other liabilities	8	29
Subordinated loans	5	0
Equity	6.7	0
Total	115.8	

Source: Benediktsdóttir, Eggertsson, and Þórarinsson 2017, 242.

The write-off for general creditors totaled EUR 28.1 billion, a figure that was twice Iceland's 2007 GDP. All domestic and foreign depositors recovered 100%. Equity and subordinated debt holders were wiped out while other general creditors of the three banks recovered 29%, on average—14.4% for Landsbanki creditors, 30% for Kaupthing creditors, and 30.2% for Glitnir creditors. Recovery of senior claims in foreign subsidiaries was much higher, at close to 100% (Baudino, Sturluson, and Svoronos 2020; Benediktsdóttir, Eggertsson, and Þórarinsson 2017; Centonze 2011; LBI 2015a).

[9] A full discussion of the recovery of claims in the old banks can be found in the corresponding resolution and restructuring case study, George (2024).

The 29% average recovery for general creditors was the result of the composition agreements that authorities negotiated with creditors in fall 2015. The composition agreements imposed stability contributions on the creditors of the old banks in lieu of a stability tax of 39% on the book value of assets. The purpose of the proposed stability tax was to ease the impact on the balance of payments of creditors' domestic asset sales if capital controls were lifted. The stability contribution haircuts varied for each bank but were always substantially lower than the proposed stability tax. For example, the government offered Old Landsbanki creditors a choice between a stability contribution of ISK 16 billion and a stability levy of ISK 163 billion to ISK 182 billion. Creditors who accepted composition agreements committed to refrain from litigation against the Icelandic state while also receiving exemptions from capital controls. The stability contributions were payable in domestic assets, amounting to approximately 20% of GDP, and concluded in 2015. While Landsbanki general creditors received 14.4% of face value, every creditor was entitled to a de minimis payment of ISK 1.7 million; creditors owed less than that amount were paid in full (Baudino, Sturluson, and Svoronos 2020; BIS 2016; LBI 2015a).

8. Capital Characteristics: The state purchased ordinary shares and provided subordinated loans, while the resolution committees of the old banks acquired ordinary shares as well.

The government purchased common equity in Islandsbanki and Arion Bank, the corresponding new banks for Glitnir and Kaupthing, respectively, in exchange for government bonds. Ordinary shares in both banks held voting rights, although only shareholders in Arion Bank had written rights to dividends. All three new banks did not pay dividends in 2009 or 2010. Following the acquisition of shares by Old Kaupthing and Old Glitnir, the government agreed to take on a minority shareholding and provide further Tier 2 capital, in the form of subordinated loans. These loans had no maturity date and contributed to the calculation of the solvency ratio (Arion Bank 2010; Islandsbanki 2010; NBI 2010; NBI 2011; MoF 2009a; MoF 2009b; MoF 2009c).

The solvency ratio allowed for subordinated Tier 2 debt, which the government provided to Arion Bank and Islandsbanki as part of the agreements with their respective resolution committees. Regarding Landsbankinn, the terms differed, with the government taking a majority stake and eventually holding 98% of Landsbankinn's share capital (Islandsbanki 2010; NBI 2014; MoF 2009f).

9. Size and Source of Funding: The Icelandic Treasury provided EUR 1 billion across the three new banks.

The Icelandic government committed to provide the initial capitalization for the new banks upon their creation in October 2008. Authorities published provisional balance sheets for the three new banks on November 14, 2008.

The resolution committees and government authorities negotiated a capitalization agreement publicized on December 15, 2009. Per the agreement on that day, the FME stipulated that Landsbankinn hold 12% core Tier 1 capital (CT1) in addition to 4% Tier 2

capital as a ratio of risk-weighted assets. In the case of Landsbanki, its CT1 ratio was approximately 15% as of January 20, 2010 (ESA 2014).

The government purchased its equity stakes using government bonds, which were eligible to be pledged at the central bank to access liquidity facilities. Historically, such bonds would have carried a fixed interest rate. However, authorities realized that this would expose the banks' balance sheets to interest rate risk. Furthermore, in the event of a reduction of interest rates by the central bank, variable interest rate bonds would benefit the government while fixed rate bonds would benefit the banks. Therefore, government authorities decided to create a new class of variable interest rate bonds. These bonds, issued on October 9, 2008, had a duration of 10 years,[10] and the average interest was 13.3% in the first year and 7.8% in the second year (MoF 2011).

The total capital injection by the Treasury ultimately came to EUR 1 billion across all three banks. The resolution committees of the three old banks and the Icelandic Treasury jointly capitalized the three new banks, with the equity breakdown differing between each. Regarding New Kaupthing, the government agreed to a EUR 396 million capitalization. After continued negotiations, the resolution committee of Old Kaupthing acquired an 87% stake on August 14, 2009, with the government owning the remaining 13% (see Key Design Decision No. 15, Exit Strategy). The state's 13% holding amounted to EUR 49 million, alongside a Tier 2 capital contribution in the form of subordinated loans amounting to EUR 132 million (Arion Bank 2010; ESA 2014; MoF 2009f).

Regarding New Glitnir, the government agreed to a EUR 357 million capitalization, of which Old Glitnir acquired a 95% stake. The government held a 5% stake amounting to EUR 17 million and contributed EUR 137 million in Tier 2 capital for a total of EUR 28 billion in state funding (MoF 2009c; MoF 2009f).

In the case of Glitnir, upon granting the creditors of Old Glitnir their compensatory stake in New Glitnir, the government received back the bond that it had used to purchase share capital in New Glitnir. New Glitnir had been using this bond to access central bank liquidity facilities, so the bond's return signaled a liquidity risk. To account for this, the government agreed to provide funding against New Glitnir's "solid assets," up to ISK 25 billion. The agreement was made until September 30, 2012 (MoF 2011).

The government formed a similar agreement with Arion Bank upon the transfer of its equity stake to the creditors of Kaupthing. In March 2009, Arion Bank had agreed to take on the deposits of a small Reykjavík-based savings bank (SPRON) in exchange for a bond issued by an asset management company that succeeded SPRON (Drómi). After Arion Bank returned its government bond during the granting of an equity stake to Kaupthing creditors, the central bank agreed to lend up to ISK 75 billion against the "SPRON bond" to preserve liquidity access (MoF 2011).

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[10] The government based this duration on the planned 10-year term of the subordinated loans being negotiated as Tier 2 capital for Arion Bank and Islandsbanki. However, the subordinated bonds were ultimately not issued until 2009, meaning they became due a year after the maturity date of the government bonds (MoF 2011).

The government agreed to a EUR 840 million capitalization of Landsbankinn, of which the government controlled a majority stake of 81%. After the issuance of further contingent bonds[11] to Old Landsbanki in April 2013, the government's stake increased to 98% (NBI 2014; MoF 2009f).

10. Timing: The capitalization occurred as part of the restructuring of the Icelandic banking sector following the acute phase in October 2008.

Following the passage of the Emergency Act on October 6, 2008, the Ministry of Finance created three new banks, Arion Bank, Islandsbanki, Landsbankinn. The government entered negotiations with the resolution committees of the old banks regarding stakes in the capital of the new banks (FME 2008a; FME 2008f; MoF 2009a).

On July 17, 2009, Icelandic authorities and the resolution committee of Kaupthing reached agreement on the valuation of assets transferred to Arion Bank. The creditors were compensated with an 87% capital stake in Arion Bank, and the resolution committee announced its purchase of the equity stake on December 1, 2009. The capital injection took place on January 8, 2010 (Arion Bank 2010).

Islandsbanki followed a similar trajectory, with Icelandic authorities reaching agreement with Old Glitnir's resolution committee in July 2009. On October 15, 2009, Glitnir acquired a 95% stake in Islandsbanki (Islandsbanki 2010).

Landsbanki required further time to negotiate the contingent bond instrument, and Icelandic authorities and the resolution committee reached an agreement on October 12, 2009 (MoF 2009e).

11. Restructuring: Icelandic authorities split the three major Icelandic banks into new banks for domestic claims and old banks for foreign liabilities.

The collapse of Iceland's three main banks led the Ministry of Finance, the Treasury, and the FME to use their newly granted crisis powers to secure the continuation of domestic banking services and downsize the banking sector to a level consistent with the size of Iceland's economy. The Ministry of Finance immediately established three new banks, which consisted of the performing domestic assets and insured domestic deposits of the failed banks. These new institutions were capitalized with new equity provided by the state (ESA 2014; FME 2008a).

The government wrote down the existing equity investors to zero. The government then left the assets and liabilities of foreign branches and subsidiaries in the old banks, as well as other low-recovery domestic liabilities and all derivatives (Baudino, Sturluson, and Svoronos 2020; ESA 2014).

[11] A full account of the contingent bond instruments used to compensate creditors in Old Landsbanki can be found in the corresponding resolution and restructuring case study, George (2024).

The FME granted temporary relief to Landsbankinn from the (overall) 16% capital requirement, conditional upon the submission of a plan for how the ratio would be achieved in the future (ESA 2014).

After provisional valuations of assets in the new and old banks, the FME said that it intended to create financial instruments to adequately compensate senior creditors in the old banks when possible (FME 2008a). A full account of the restructuring of the three major Icelandic banks is provided in the corresponding resolution and restructuring case study George (2024).

12. Treatment of Board and Management: The shareholders in each of the banks elected their board of directors following capitalization agreements with Icelandic authorities.

Upon nationalization, the FME removed the existing management and board of directors and appointed a resolution committee to manage the old banks during the resolution process, with the goal of achieving the best possible outcome for the old banks' creditors. The resolution committees consisted of three lawyers and two certified public accountants. The Ministry of Finance established the new banks and appointed the members of their respective leadership bodies (Baudino, Sturluson, and Svoronos 2020; FME 2008b; FME 2008a; MoF 2009a).

Following the January 8, 2010, capital injection, the shareholders of Arion Bank elected a new board of directors at a meeting on March 18, 2010, one of whom had been a member of the Kaupthing resolution committee. The board of directors then sought a new CEO, and they announced their new appointment on April 23, 2010 (Arion Bank 2010).

The shareholders of Islandsbanki also selected a new board of directors following Glitnir's October 2009 capital acquisition. ISB Holding, a subsidiary Glitnir, selected six of the board members, while the ISBA selected one board member. Of the seven board members, one had been chairman of the Glitnir resolution committee (Islandsbanki 2010).

The Icelandic state owned a controlling stake in Landsbankinn following the capital injection. The bank was run by an interim board of directors and interim CEO. A shareholder meeting in February 2010 elected a new board of directors and CEO. Based on the equity stake breakdown, Old Landsbanki creditors selected one of the five board members while the state selected the remaining four (NBI 2009; NBI 2011; MoF 2009f).

The Icelandic government called for the appointment of a special prosecutor in December 2008 to investigate potential criminal conduct related to the financial crisis. The office of the special prosecutor commenced operations on February 1, 2009. The CEOs of all three major banks received prison sentences. Both the Kaupthing CEO and chairman were charged with market manipulation, receiving a five-and-a-half-year sentence and a five-year sentence, respectively. The Landsbanki CEO received a one-year sentence for misconduct, and the Glitnir CEO received a nine-month sentence for fraud (Bray 2014; Jónsson and Sigurgeirsson 2016).

13. Other Conditions: The FME imposed restrictions on the new banks as part of measures to prevent balance-of-payments issues.

The FME required banks to maintain a minimum CT1 ratio of 12% and a solvency ratio of 16% for at least three years following their receiving an operating license (Islandsbanki 2010).

An FME stress test revealed potential strains on the capital bases of the new banks, particularly given that they were heavily reliant on unsecured funding from depositors. As a result, the FME required that the new banks hold cash and liquid assets such that they would be able to withstand a 20% outflow of deposits. Of this 20%, authorities required that at least 5% be held in cash (MoF 2011).

The FME also restricted the payment of dividends in the first three years after the transfer of ownership, and executive compensation plans required approval from the FME. The FME also monitored the disclosure of information related to internal operations, assessed the qualifications of management, and reserved the right to place further obligations on owners. This was done to ensure short-term interests during the banks' restructuring did not outweigh the long-term outlook on the banks' lasting operations (MoF 2011).

14. Regulatory Relief: The FME granted interim relief from capital requirements during the negotiation process.

Of the three new banks, Landsbankinn was the only one to not receive Tier 2 capital as part of the compensation agreement for creditors of the old bank. The FME granted temporary relief for Landsbankinn on the 16% capital requirement, conditional upon the submission of a plan illustrating how this capital ratio would be achieved (ESA 2014; MoF 2009f).

15. Exit Strategy: Icelandic authorities negotiated share capital stakes as partial compensation for creditors left in the old banks.

In its letter of intent to the International Monetary Fund, Icelandic authorities stated their intention to sell the government's equity stakes when market conditions stabilized. The government sold its stake in Arion Bank in 2018. The bank IPO'd on Nasdaq Iceland and Nasdaq Stockholm on June 15, 2018 (Arion Bank 2019; CBI & MoF 2008).

In 2016, the government received Old Glitnir's 95% stake in Islandsbanki as part of the Glitnir creditors' stability contribution.[12] This resulted in the government owning 100% of Islandsbanki's shares. The government has progressively sold parts of its stake and holds a 42.9% stake as of 2022 with a book value of EUR 641 million (Islandsbanki 2017; Islandsbanki 2023; Islandsbanki 2024).

Landsbankinn issued further foreign currency–denominated bonds to the creditors of Old Landsbanki in April 2013 to complete the compensation of Old Landsbanki creditors.

[12] The Icelandic government created a stability contribution system to avoid balance-of-payments issues. The stability contribution is detailed in the corresponding resolution and restructuring case study, George (2024).

Simultaneously, creditors of the old bank surrendered their equity stake, increasing the state's ownership in New Landsbanki to 98%. Landsbankinn finished paying off the contingent bond in June 2017. The state's equity holding remains at 98% with a book value of EUR 2 billion as of the writing of this case study (CBI 2017; NBI 2014; NBI 2023; NBI 2024; Halldórsson 2013).

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