

Britain and Iceland in bitter conflict over banking collapse

Jordan Shilton**14 October 2008**

The seizure of £4 billion in banking assets by the British government is the most extraordinary move in the escalating hostilities that opened up following the collapse of Iceland's major banks last week.

With British investors faced with losses of up to £8 billion (€9.6 billion) in the failed institutions, including many local authorities and police services, the Brown government used anti-terror legislation to freeze the assets of Icelandic banks in Britain. The move was also in retaliation to the freezing of British investors' assets in Iceland's three main banks, Kaupthing, Landsbanki and Glitnir.

Prime Minister Gordon Brown appeared on television denouncing Iceland's actions as "unacceptable", following its move to freeze assets in all of the nationalised banks. He vowed to sue the state for any deposits lost by Britons in the failed banks and went on to declare, "I've been in touch with the Icelandic Prime Minister, and I've said that this is effectively illegal action that they've taken. They have failed not only the people of Iceland, they have failed people in Britain."

Iceland's Prime Minister Geir H. Haarde shot back, claiming that Britain had committed an "unfriendly act" and adding that it was "not very pleasant" to have legislation designed for terrorists employed against his administration.

On Monday he accused Britain of "bullying a small neighbour" over funds frozen in the online bank Icesave, and threatened to take legal action in response. He told the *Financial Times* that the British government's reaction to the collapse of the bank, including Brown's threat to sue, had worsened the banking crisis and that Iceland could counter-sue. The move to put part of Icelandic bank Kaupthing's British operations into administration "led to the collapse" of its parent bank and he would support Kaupthing's plans to sue the Brown government, Haarde said.

As the Icelandic government announced it was taking over Kaupthing, the last of the island's three big banks to be taken into state control, it was revealed that its British subsidiary Singer and Friedlander would be placed in administration. Roughly 160,000 savers have deposits that had been managed by Singer and Friedlander and these were transferred by the UK financial Services authority (FSA) to Dutch banking group ING.

Britain's central bank is lending Iceland's Landsbanki up to £100 million to help it to repay Britons with money deposited at the bank, Chancellor Alistair Darling said on Monday. But no agreement has been reached with regard to institutions.

A further 100,000 savers in the Netherlands find themselves in the same position having placed deposits worth €1.7 billion in Icesave accounts. The Dutch government, which has had to deal with its own financial troubles, announced on Friday that it would guarantee deposits in Icesave accounts up to €100,000. On the same day, the central bank of Holland made available €20 billion to provide extra liquidity for struggling financial institutions.

In negotiations over the weekend, it appears that a deal has been agreed to between the two countries to re-fund some deposits, with the Icelandic authorities pledging to re-fund up to €20,887 of Dutch savers' money. To facilitate this, the Dutch government will make available a loan to Iceland since the government in Reykjavik lacks funds of its own.

Back in Britain, the situation is serious for companies, particularly in the retail sector where Iceland's three big banks have been heavily involved. It is believed that British companies have at least £10 billion of funds in the failed institutions which they are unable to access at present. British banks also have assets tied up in Icelandic banks, with the Royal Bank of Scotland reportedly threatened with the loss of half a billion pounds.

Numerous local authorities, charities, police authorities and other organisations began to reveal last Thursday the extent to which they had invested in Icelandic banks. Kent County Council, with £50 million (€60 million) was one of the largest hit, but councils across England, Wales and Scotland all suffered. At least 108 councils in England and Wales had some form of involvement with Icelandic banks which have now collapsed. Added to this, the London Transport Authority, which manages public transport in the Capital, revealed that it had £40 million invested in the same banks.

While councils have maintained that such a loss of funds will not impact upon core service delivery, the danger that vital public services could be at risk is very real given the sums involved. A report in the *Independent* raised the possibility that some authorities may struggle to pay wages this month due to

the losses. Unlike the virtually unlimited funds provided by government to prop up the banks, Brown has refused to promise financial aid to the councils affected.

Various charities will also take a severe hit. One children's hospice in Hampshire faces ruin with the loss of £5 million.

Officials from the finance ministry, the Financial Services Authority and the Bank of England were among the team which held talks over the weekend in Reykjavik. A statement was issued claiming that "significant progress" had been made, but a deal has not yet been finalised. Iceland has agreed "in principle" to fund the first £16,000 of retail deposits in Icesave accounts and to ensure a "swift" pay out. No information has yet been released on a deal regarding the funds invested by councils and other organisations.

British Chancellor Alistair Darling was also due to meet with his Icelandic counterpart Arni Mathiesen at the meeting of the International Monetary Fund (IMF).

The possibility that the International Monetary Fund could come to Iceland's aid and provide a loan is now seriously being considered, although Haarde is still insisting they have other avenues to pursue. Earlier this year, the central banks of Sweden, Norway and Denmark provided the Icelandic central bank (Sedlabanki) with €1.5 billion to boost its currency reserves. Now this is barely a drop in the ocean as the country attempts to deal with banking assets up to 12 times greater than its GDP. To this end, negotiations with Russia over a €4 billion loan will commence today.

A team from the IMF has been in Reykjavik since last week.

Arsaell Valfells, a professor at the University of Iceland told the *New York Times*, "Iceland is bankrupt. The Icelandic Krona is history. The only sensible option is for the IMF to come and rescue us."

Such a "rescue" would entail vast cuts in government spending, in order to reduce inflation, at a time when people are already struggling to get by. The collapse of the krona is already hitting the tiny economy hard, since firms relying on imports are seeing their costs skyrocket. At the end of last week, it was acknowledged that trading in the krona had ceased altogether, the last quoted value being 340 per euro, down from around 140 per euro at the start of last week. Predictions by some economists suggest that inflation could jump to 50 percent before the end of the year and that the Icelandic economy could contract by 10 percent.

Such a situation would be devastating for ordinary Icelanders, many of whom will be out of a job. Immediately after being nationalised, Landsbanki announced it would lay off 500 staff. Many who took out loans to purchase their homes or cars are already suffering. Particularly for those who took out loans in foreign currency, attempting to avoid the high interest levels at home, the collapse in the value of the krona could spell financial ruin.

In an illustration of just how precarious the current situation is, Haarde appealed to Icelanders not to withdraw their money

from the banking system. "I want to emphasize ... that people remain calm and understand that the transaction system is fully functioning and deposits are safe," he told a press conference. "I also ask the public not to withdraw large sums of money from the banks. It will make things more difficult."

There is a real threat that other states could soon be in a similar position to Iceland as ever greater sums of money are directed towards failing financial institutions, leading to national bankruptcies. Even now, the reach of Iceland's problems continues to grow. On Friday, Austrian bank Erste Bank revealed that it had €300 million tied up in the failed institutions. Trading in Vienna was suspended on Friday morning while the exposure of Austrian banks and firms to the financial crisis was assessed. In Prague, the stock exchange was forced to halt trading in Austrian firms shares, with Erste Bank having fallen by over 20 percent.

There is also exposure to Iceland in the Nordic region, with the Finnish financial monitor declaring that the country's banks had at least €200 million invested in Iceland. The Finnish branch of Kaupthing asked the Finnish government for a loan on Friday in order to pay back depositors. On Thursday, regulators halted withdrawals from the bank, freezing more than 10,000 depositors' funds.

In Norway, the country will have to use its own deposit guarantee fund to reimburse savers. It will need to pay out 1 billion Norwegian kronor (NOK) of its reserves of 18 billion NOK.

The possibility that Russia may step in to provide Iceland with a €4 billion loan is also viewed with concern. Bronwen Maddox, writing in the *Times* noted, "Declining to offer Iceland a quick €4 billion loan is one of the worst decisions the US and European countries have made in the financial turmoil. It is a false economy that will prove diplomatically expensive."

Going on to claim that Russia may use the situation to attempt to gain geopolitical advantages in the Arctic in a bid to secure oil reserves, she concluded, "The US, European Union and NATO are in danger of taking its deep links to them (Iceland) for granted. They missed a trick in allowing in the Russian loan."

A comment in the *Telegraph* was entitled "Iceland should turn to IMF, not Russia". It hoped that Iceland would accept help from the IMF rather than negotiate a loan from Russia since the strings attached to such IMF assistance would be "sensible and financial rather than strategic and dangerous." It threatened Iceland that "Unless it wants to become a pawn in a geopolitical power play, Iceland should welcome the fund with open arms."



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