23 July 2010
SI-65005

Parliamentary Ombudsman
Álftamýri 7
108 Reykjavík

Re: Response to the Parliamentary Ombudsman's query regarding the guidelines issued jointly by the Central Bank of Iceland and the Financial Supervisory Authority on 30 June 2010, due to non-binding exchange rate linkage clauses

Reference is made to the Ombudsman's query of 7 July 2010, regarding the guidelines issued jointly by the Central Bank of Iceland and the Financial Supervisory Authority on 30 June 2010, due to the Supreme Court decisions on non-binding exchange rate linkage clauses in loan agreements.

In Section III of the query, it is requested, with reference to Articles 7 and 9 of the Act on the Parliamentary Ombudsman, no. 85/1997, that the Central Bank of Iceland explain its position on the complaint that occasioned the query and to provide the Ombudsman with copies of any documents that may have been compiled or obtained during the preparation for the issuance of the guidelines, including numerical data. It was requested in particular that the Central Bank provide the Ombudsman with information and explain its position on six points, which are discussed and clarified below. Because the matter did not involve an administrative decision, as is further detailed in this letter, there are no identified case documents pertaining specifically to this case. On the other hand, the Central Bank and the Financial Supervisory Authority based their position on a variety of documents and data to which the two institutions have access. The most important of them are enclosed with this letter; however, they must be treated as confidential.

The Central Bank wishes to preface its response to the Ombudsman's query with a discussion of the occasion for and background to this matter.

I.
General introduction

The Supreme Court decisions in Cases no. 92/2010 and 153/2010 generated considerable uncertainty about the stability of the Icelandic financial system. That uncertainty takes two main forms. In the first place, it cannot be determined conclusively from the Supreme Court judgments how large a proportion of the Icelandic financial undertakings' asset portfolios contains non-binding exchange rate linkage clauses. The most extreme interpretations of the judgments assume that they could extend to nearly all exchange rate-linked loan agreements concluded by the financial undertakings. Among these is a large share of export companies' exchange rate-linked loans. These companies are usually fully protected against the detrimental effects of exchange rate movements, and their loan payments are by and large up to date and, in many instances, were purchased from the old banks at no discount. Credit institutions' outstanding foreign-denominated loans amounted to 911 b.kr., or just under one-third of their assets, as of year-end 2009. In the second place, the Supreme Court judgments do not address the issue of how the unlawful loans shall be settled, or what interest rates shall apply in the future, as the pleadings of the parties to the cases concerned did not touch upon these points; cf. the Conclusion of Judgment in Case no. 92/2010. How the latter uncertainty is resolved is a major determinant of how heavy a blow the former uncertainty represents for the financial system.

Stakeholders have maintained that the Supreme Court judgments imply that the original contractual interest rates on the foreign currencies shall apply, even though the link between the portion of principal bearing such interest rates and the exchange rate of the underlying currency has been severed. The Central Bank and the Financial Supervisory Authority (FME) consider such an interpretation illogical, and they deem it unlikely that the Supreme Court will come to such a conclusion in cases decided in the near future. On the other hand, it could cause considerable instability and prove detrimental to the public interest if the parties concerned were to yield to pressure from special interest groups to settle, using the original foreign contractual interest rates, the debt of all borrowers that consider themselves entitled to such settlement.

In order to shed light on the scope of the public interest at stake, it is useful to examine the effect on the financial system if the majority of exchange rate-linked loan agreements were deemed unlawful and the foreign interest rates remained unchanged. According to information available at the time the guidelines were issued, it was clear that all of the large financial undertakings would sustain such a massive blow to their capital that the Treasury would unavoidably have to contribute new capital to them. Some of the smaller financial undertakings would become bankrupt. More detailed information compiled after the

guidelines were issued confirms, in the main, the assessment made before their issuance. The Financial Stability Committee has estimated that, in order to restore the financial undertakings' capital ratios to acceptable levels, the Treasury would have to contribute new capital in the amount of 80 b.kr., provided that other shareholders contributed capital as well. If the other shareholders do not participate, that amount could rise to 160 b.kr. In order to put this amount into perspective, it is worth noting that it equals more than one-third of the Treasury's revenues for 2009.

In this connection, it is important to caution against the misconception that the banks' creditors will be willing to absorb this shock without repercussions for the Icelandic people. First of all, the Treasury owns about 45% of the large banks' capital. Second, it is not a given that the banks' creditors are willing to contribute new capital. On the contrary: the possibility cannot be excluded that, should foreign interest rates prevail for the majority of the banks' loan portfolios, their foreign creditors will demand a review of the capitalisation agreements for the new banks. It is important to bear in mind that, if foreign parties are convinced that this matter has been handled in an inappropriate way, there is the danger that they may change their attitudes towards investing in Iceland for a much longer period than they currently do. This would result in less foreign investment and poorer terms on Icelanders' foreign borrowings, ultimately reducing Iceland's national income.

The financial crisis that struck so forcefully in the fall of 2008 has caused the Treasury such difficulties that its credit ratings have suffered greatly. For example, CDS spreads have fluctuated between 300 and 1000 bp since the collapse, and the Republic of Iceland's sovereign credit rating is on the verge of dropping below investment grade. One rating agency has placed Iceland in speculative grade (below investment grade, or so-called junk). This is because foreign credit markets and rating agencies lack confidence in the Treasury's ability to service the debt that it has taken on. In order to prevent sovereign default, the Icelandic authorities have had to seek assistance from the International Monetary Fund. That assistance is granted on the condition that the authorities present a realistic macroeconomic programme aimed at restoring confidence in the sustainability of Government debt. A great deal of progress has been made on this front in the recent term, although a number of complex tasks remain. However, if the Treasury sustains a blow as large as that described above, it could set the economic programme back several years. Equilibrium in public sector finances will be much harder to achieve, and access to foreign credit markets would be delayed, as would

export-driven growth, which is a precondition for a lasting improvement in living conditions.

From the above, it should be clear that if the Supreme Court judgments jeopardise financial stability to the extent that the Treasury must contribute substantial new capital to financial undertakings, the matter is one of pressing public interest, which the Central Bank and the FME are obliged to protect, even if it runs counter to the interests of a specific group of debtors. A conclusion in accordance with the most extreme interpretation of the Supreme Court judgments would also lead to a substantial transfer of disposable income between individual groups of households. It is not possible to meet all the demands of one group of households without restricting the possibilities of other groups, including future generations.

If the interest rates that the Central Bank and the FME have recommended as a temporary solution are applied, the blow to the financial undertakings' capital would still be considerable: the capital adequacy ratios of those undertakings would drop below the current required minimum. But the resulting shock would probably not require a massive capital injection from the Treasury.

It is certainly not the role of supervisory bodies to take a position on the distribution of disposable income, but the potential impact of the Supreme Court judgments on income distribution is mentioned because of recent discussion to the effect that, with the guidelines, the Central Bank and the FME have in some way acted against the interests of consumers and households. The interests of various groups of households and businesses vary greatly in this matter. The stability of the financial system, however, is a clear example of public interest. And it is the public interest that supervisory bodies are required by law to protect.

The guidelines issued by the Central Bank and the FME cannot prevent a severe blow should the Supreme Court rule that nearly all exchange rate-linked loans granted by financial undertakings are unlawful (that they contain non-binding exchange rate linkage clauses) and that the original foreign contractual interest rate shall nonetheless remain unchanged. Although the Central Bank and the FME cannot rule out such a decision, they consider it highly unlikely. While uncertainty persists, it is important that the actions taken be as consistent as possible with the likeliest scenario.

While financial undertakings bridge the gap until the Court hands down judgments that clarify how large a share of the banks' loan portfolios contain non-binding exchange rate linkage clauses, and

which methods will be considered acceptable in the settlement of loans containing such provisions, they must assess the probability of given conclusions. The Central Bank/FME guidelines do not contain any instructions on which loan agreements, in the opinion of the two institutions, contain non-binding exchange rate linkage clauses, as the contractual agreements concerned are so numerous and so diverse that such an assessment is impractical. That assessment must be made by the financial undertakings themselves.

On the other hand, the supervisory institutions are of the opinion that there are strong grounds for believing that the courts will consider the lowest interest rates published by the Central Bank, or comparable interest rates (e.g., REIBOR, the domestic interbank rate), when rendering judgments on the settlement of unlawful loan agreements. The guidelines therefore provide for a certain predictability in contract settlement and financial system stability while the courts are ruling on the legal uncertainties. If the supervisory bodies' assessment proves correct and the guidelines are followed in all major respects, it is unlikely that large unpaid debt will accumulate on either side. Such accumulation would be detrimental to the interests of borrowers and lenders alike. An attempt is made to channel debtors' expectations onto a realistic path, one that is likelier to stand the test of time than the most extreme demands and to enhance debtors' willingness to pay.

Financial undertakings' existence depends on confidence. If confidence vanishes, even a strong financial undertaking can fail; e.g., if a large number of depositors decide to withdraw their money. The judgments handed down by the Supreme Court triggered widespread public discussion. Among other things, certain organisations encouraged debtors to stop paying their loans if the debtors themselves considered them to be exchange rate-linked. Some even encouraged mass withdrawals from the banks. If a large group of borrowers had responded to the call of these self-styled representatives, there could have been a run on the banks. Furthermore, the Consumer Spokesman sent a letter to the Minister of Economic Affairs and proposed the passage of temporary legislation, among other actions, stating that otherwise he would publicly recommend general, unilateral actions against the financial undertakings. This is just a small part of the public discussion that has taken place in the wake of the Supreme Court judgments, and it shows that the expectations of a certain group of borrowers with regard to the interpretation of the judgments could have led to severe instability. Among the objectives of the guidelines is to reduce the risk that a widespread disregard among borrowers of their duty to pay will undermine confidence in the financial system.

At the time the guidelines were in preparation, both financial undertakings and their customers were quite uncertain about how

collections and general treatment of exchange rate-linked loans conceivably covered by the Supreme Court judgments would be handled. There appeared to be no consensus among the financial undertakings about the ideas that had been presented at the time. The guidelines provided for a certain fixity and consistency in their response.

The guidelines are based on the Act on Interest and Price Indexation, no. 38/2001. Although the legislature obviously could not have foreseen subsequent developments at the time the Act was passed, the Act on Interest and Price Indexation was clearly intended to resolve uncertainties under comparable circumstances. Consequently, it is perfectly appropriate to refer to that Act when taking a position on how to settle contractual agreements containing non-binding exchange rate linkage clauses.

It should be emphasised that the Central Bank/FME guidelines are a temporary measure designed to prevail until a decision has been made on the scope of the contractual agreements falling under the Supreme Court judgments, and until the interest rate to be used for settlement has been determined. The guidelines also state that "If, for technical reasons, a financial institution cannot comply with these guidelines immediately, it shall ensure that payment amounts are aligned with the above guidelines as closely as possible, and that they are fully in compliance with the guidelines no later than 1 September 2010." Consideration was given to the fact that it would be technically impossible for the financial undertakings to carry out settlement according to the guidelines immediately. It was assumed that the problem would be addressed temporarily with fixed-amount payments. It is therefore incorrect to state that collecting fixed payments instead of calculating payment using the lowest advertised Central Bank interest rates is in contravention of the guidelines. Furthermore, the press release announcing the guidelines emphasised that the guidelines did not deprive financial undertakings and their customers of their right to negotiate.

A nation's financial system is delicate by its very nature. It is not always possible to foresee how a country's financial stability can be compromised at short notice. As a result, it is important that the law contain provisions that both require supervisory bodies to respond to such signs of instability and enable those supervisory bodies to wield the authority they have in order to reduce the risk. As emerges clearly in the report of the Parliamentary Special Investigation Commission (SIC), one of the lessons of the financial crisis is that Iceland's financial supervisors have sometimes been too hesitant to take the actions that were within their power and have limited their responses to the letter of individual statutory provisions to an excessive degree instead of concentrating on the logical context and purpose of those

provisions. The Central Bank and the Financial Supervisory Authority are determined to learn from the mistakes of the past several years.

It is our conclusion that the actions of the Central Bank and the Financial Supervisory Authority in this matter have been fully consistent with the mandate and purpose of the two institutions. By taking the initiative, within sensible limits, on the temporary settlement of loan agreements, the guidelines contributed to a given predictability in financial market transactions under extremely difficult circumstances.

Section II of this letter contains responses to individual questions in the Ombudsman's letter. Before proceeding further, the Central Bank wishes, however, to comment on the statements in that letter to the effect that the Ombudsman does not consider it necessary to discuss Items 3 and 4 in the guidelines. In the Central Bank's estimation, these items cannot be severed from Items 1 and 2 in the guidelines. The guidelines must be examined in their entirety. It is inappropriate to separate the latter items from the earlier because reporting and assessment of capital according to Items 3 and 4 are based on the existence of a coordinated and reliable valuation of assets and liabilities. In order for it to be possible to assess how heavy a blow the financial system can sustain as a result of the Supreme Court judgments, it is necessary that interest rate premises be consistent. Emphasis is placed on assessing two types of interest rate premises: the most likely scenario, which can be determined by using the Central Bank of Iceland's lowest published interest rates, as the guidelines assume; and the worst-case scenario for the financial system, which would involve the use of foreign contractual interest rates.

Such coordinated data compilation procedures are well known. An example of this approach can be found in the financial institutions' information disclosure on foreign exchange balance and liquidity ratio, pursuant to Rules no. 707/2009 and 317/2006. It would be extremely difficult for the Central Bank to enforce its rules if financial undertakings' information disclosure were not carried out according to coordinated criteria. Similarly, it is very difficult for the Central Bank and the Financial Supervisory Authority to assess the status of the financial system following the Supreme Court decisions without consistent premises for such an assessment. Such information disclosure, which is based on an assessment of the expense attached to various scenarios and the likelihood that those scenarios will develop, is also a precondition for the Government and the legislature's decision on whether to take further action in order to ensure financial stability.

II.

Response to question(s) in Item 1

In Item 1 of Section III of the query, the Ombudsman asks on what statutory grounds the Central Bank of Iceland considers itself authorised to direct guidelines to financial undertakings on how they handle treatment and settlement (including interest rate terms) of previously concluded civil contractual agreements with their customers (borrowers/debtors) if the guidelines deviate substantively from the provisions of the loan agreements.

In short, the Central Bank of Iceland's answer is that it considers itself authorised to issue such guidelines on the basis of Article 4 of the Act on the Central Bank of Iceland, no. 36/2001, with reference to the role defined for it in that Article, which is to promote an efficient and sound financial system; that is, to maintain financial stability. In the instance under discussion, there was a clear risk of financial instability. Furthermore, reference is made to the cooperation agreement between the Central Bank and the Financial Supervisory Authority. Finally, it should be noted that the guidelines are not binding.

Article 4 of the Act on the Central Bank of Iceland, no. 36/2001, states as follows:

> "The Central Bank of Iceland shall undertake such tasks as are consistent with its role as a central bank, such as to maintain external reserves and promote an efficient and sound financial system, including payment systems domestically and with foreign countries."

The wording of the Article is broad and does not constitute an exhaustive or detailed listing of the tasks entrusted to the Central Bank. The comments on Article 4 of the bill of legislation that became the current Act on the Central Bank of Iceland state that it was considered necessary to specify that the Bank should promote an efficient and sound financial system; that is, to safeguard *financial stability*. It was the legislature's considered opinion that this should be specified in the Act. With the wording "efficient and sound financial system," the Central Bank is entrusted with the task of safeguarding financial stability, and it is implied that the Bank's attention in this regard should be focused on the macroeconomic environment of the financial system and on the system as a whole, its strengths and weaknesses. It is therefore clear that one of the main tasks of the Central Bank is to ensure financial stability, which implies that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to distribute risk appropriately. If financial stability is threatened, the Central Bank is obliged to respond with the measures at its disposal at the time.

The situation that resulted from the Supreme Court judgments and the uncertainty about how to respond to it have already been described. There is no doubt that the Central Bank and the FME were faced with significant risk of financial instability. With reference to this, and on the basis of its statutory mandate, the Central Bank considered it necessary to draft and issue the guidelines.

As is stated above, the statutory role of the Central Bank of Iceland, as provided for in Article 4 of Act no. 36/2001, is to promote an efficient and sound financial system. The guidelines under scrutiny were issued in cooperation with the Financial Supervisory Authority. The Financial Supervisory Authority has a special statutory authorisation to issue guidelines such as these; cf. Article 8, Paragraph 2 of the Act on Official Supervision of Financial Activities, no. 87/1998. The Ombudsman's letter makes mention of the rule of legality. It should be borne in mind, however, that the guidelines in question do not represent an administrative decision taken by a governmental authority. They were merely guidelines that, in the Central Bank's estimation, fall clearly within the Bank's mandate and objectives. No decision has been taken with these guidelines, nor have any instructions been issued concerning the rights or responsibilities of individuals or legal entities, nor have any burdens or other onerous rules been imposed, as is shown below.

It can hardly be the aim of the rule of legality to constrict the working environment of the authorities to the extent that, when faced with a pressing and potentially dangerous situation, they cannot function in accordance with their statutory mandate by taking action that in no way curtails the rights of citizens or makes onerous demands on them, without explicit statutory provision permitting the authorities to take the action in question in each and every case. The legislature can never be prescient enough to foresee each and every instance to which the authorities may need to respond. Consequently, the Central Bank of Iceland cannot see how the rule of legality could prevent the issuance of the guidelines. In this context, it is interesting to consider the contents of Chapter 16.9.2, "Rule of Legality: General" in Volume 5 of the SIC report on the background to and causes of the collapse of Iceland's banks in 2008. That part of the report discusses the relative nature of the rule of legality:

> "The rule of legality is relative in the sense that the demands it makes are variable and are determined in part by the substance of the decision in question. The authorities themselves must begin by taking a stand on whether they have sufficient statutory authority to take a decision on a given matter, although that decision may subsequently be reviewed by other parties. The question of whether the statutory provisions in question confer sufficient decision-making authority is a matter of interpretation. In carrying out

> such interpretation, it is necessary to consider, among other things, the wording of the provision, its aims, the interpretive documents, the international obligations of the Icelandic Government, precedent, and customary administrative practice. Furthermore, the general rule is that the more severe or onerous an administrative decision is, the more stringent must be the requirement that the underlying statutory authority be explicit and unequivocal. The demands made of statutory authorisation are therefore variable depending on the substance of the decision under consideration. In assessing whether a decision is deemed onerous, consideration is given to the rights that are abridged and nature of the abridgement."

As this excerpt shows, the discussion concerns the requirements made with respect to the rule of legality when a *decision* is taken; however, this instance involves guidelines that do not have such legal effect. Consequently, it is instructive to ask whether such stringent requirements should be made in this instance, although it is always appropriate to operate in the spirit of the rule of legality and to maintain sound administrative practice generally. In the Central Bank's opinion, the issuance of the guidelines does not violate the rule of legality enshrined in administrative law, as the document concerned contains not a *decision* but guidelines that are not onerous for citizens in any way. Actually, the data available make it clear that not responding to the current situation, were such inaction to lead to financial instability, could prove most onerous to Icelanders.

Currently in effect is a cooperation agreement between the Central Bank of Iceland and the Financial Supervisory Authority, dated 3 October 2006. This agreement is based on Article 35, Paragraph 4 of the Act on the Central Bank of Iceland, no. 36/2001, and Article 15, Paragraph 4 of the Act on Official Supervision of Financial Activities, no. 87/1998. A provision on the conclusion of the cooperation agreement was added to Central Bank legislation with Act no. 88/1998, which amended the then-current Central Bank Act. Simultaneously, a bill of legislation on official supervision of financial activities was passed, establishing the Financial Supervisory Authority, whose role was to carry out the operations that the Central Bank of Iceland's banking supervision department and the Insurance Supervision agency had previously undertaken. In the exposition accompanying the bill of legislation passed as Act no. 88/1998, the comments on Article 7 of the bill state that the aims of the cooperation agreement were, on the one hand, to ensure that each of the two institutions, the Central Bank and the Financial Supervisory Authority, would be supported by the other, and on the other hand, to prevent duplication of effort in information gathering. The relationship

between the two institutions is also mentioned in the legislative bill later passed as the Act on Official Supervision of Financial Activities:

> "The bill places strong emphasis on good collaboration between the Financial Supervisory Authority and the Central Bank of Iceland. It is important that the Central Bank continue to benefit from the knowledge and compiled data already in existence in the banking supervision section so as to obviate the need for duplication of effort. Similarly, it is vital that the Financial Supervisory Authority maintain an effective relationship with the Central Bank. This is necessary to both institutions in order that they may carry out their tasks as successfully as possible."

It should therefore be clear that the separation of the tasks now in the hands of the Financial Supervisory Authority should not compromise the work of both institutions; for example, in maintaining financial stability.

The cooperation agreement between the Bank and the FME sets forth the main guiding principles that the two institutions must follow in their work. Article 7.2 of the cooperation agreement states as follows:

> "When significant difficulties arise in the operation of a company that is important to the financial system – for example, when an undertaking in the financial market faces liquidity issues or bankruptcy – the parties to the agreement shall consult on the actions to be taken. The same applies when difficulties involve several undertakings in the financial market, or the financial market as a whole."

Furthermore, Article 7.3 states as follows:

> "If systemic risk exists or is imminent, the experts referred to in Article 4 [insertion: those within the institutions who handle indications of systemic risk in the financial market] shall collaborate on proposals for joint actions by the Financial Supervisory Authority and the Central Bank of Iceland, as well as other responses."

On the basis of the cooperation agreement between the institutions and the Financial Supervisory Authority's authorisation to issue guidelines, the guidelines in question were issued by the Central Bank of Iceland and the Financial Supervisory Authority jointly, as the involvement of both institutions was both credible and necessary.

In this context, it is appropriate to consider the statement in Chapter 16.15.3.1, "Background to the banking collapse and flaws in supervision arrangements," in Volume 5 of the SIC report. Naturally, the Central Bank of Iceland has given consideration to the statements in the report, which include the following:

> "Examination of the background to the collapse of Iceland's banks reveals a lack of overview and of coordinated supervisory action in the financial market. The interplay of macroeconomic and operational stability monitoring (the interaction of the Central Bank and the Financial Supervisory Authority) was inadequate. […] Nonetheless, there was a lack of coordinated action. The reason for this must be that no one party was responsible for having an overview of the situation, or for coordinating responses to systemic risk and initiating action. Without doubt, a shortage of information flow between the institutions was part of the problem as well. This lack of overview and accompanying responsibility to take action, which can also be called a problem of coordination between parties responsible for different aspects of financial supervision, is a problem that is not limited to Iceland. This problem is discussed in the de Larosière report on financial supervision in Europe, which states that the current financial supervision setup in the European Union places too much emphasis on supervision of individual financial undertakings (microprudential supervision) and too little on macroprudential supervision."

The Central Bank of Iceland and Financial Supervisory Authority's collaboration on the issuance of the guidelines is fully consistent with these statements.

In the conclusion to Item 1 in the guidelines, reference is made to the fact that contractual agreements between financial undertakings and their customers are binding, as before, and that the guidelines were not intended to change this, "unless the parties agree otherwise." As such, the guidelines were not intended to interfere with civil contractual agreements unless another agreement were made, but given the situation at hand, it can be assumed that this will prove necessary. The guidelines are directed to financial undertakings in order to create some predictability in an extremely difficult situation by suggesting a specific temporary solution to be applied until a ruling has been rendered on the scope and terms of the loan agreements falling under the precedent set by the Supreme Court judgments.

It is also appropriate to refer to a recent opinion by the Parliamentary Ombudsman in Case no. 5815/2009, pertaining to the Financial Supervisory Authority's issuance of guidelines concerning the working relationship between various named employees and the Icelandic banks taken over by the Icelandic Government after the banks failed in the fall of 2008. The opinion states as follows on the value of such guidelines:

> " … the authority is conferred upon the Financial Supervisory Authority to issue and publish 'general guidelines on the

> activities of regulated entities, provided that their substance concerns a group of regulated entities'. Accordingly, it is clear that, if the FME issues guidelines based on this statutory provision, by law those guidelines may only be for purposes of 'guidance', provided that they pertain to the affairs of a group of regulated entities."

In the case under scrutiny here, it can be said that the situation is comparable, in that guidelines were issued which pertain to civil contractual agreements between regulated financial undertakings and civil parties. The difference, however, is that the guidelines of 30 June 2010 do not interfere with the parties' freedom to negotiate.

Response to question(s) in Item 2

In Item 2 of Section III in the query, the Ombudsman requests that the Central Bank of Iceland explain on what statutory grounds it considers itself authorised to issue guidelines stating that settlement should be carried out "fully in compliance with the guidelines" as of a specified date. In the Central Bank of Iceland's opinion, there is little substantive difference between the questions in Items 1 and 2; therefore, the Bank makes general reference to the response to Item 1.

However, Item 2 refers in particular to *recalculation and payment by the customer*. It also refers to the *debtor's legal position* and the fact that the guidelines recommend that the arrangement outlined therein be implemented *as soon as possible*.

The Central Bank issued guidelines in collaboration with the Financial Supervisory Authority on the basis of Article 4 of the Act on the Central Bank of Iceland, in view of the Central Bank's mandated task of ensuring and preserving financial stability.

It is also appropriate to mention that the guidelines were not binding; therefore, the action thus taken does not negatively affect debtors vis-à-vis their creditors. As a result, the points specifically mentioned in the question were not considered. Moreover, the guidelines were directed towards financial undertakings, not individuals. In other respects, reference is made to the response to Item 1.

Response to question(s) in Item 3

In Item 3 of Section III of the query, the Ombudsman's requests that the Central Bank of Iceland explain the basis for its assessment that "uncertainty" prevails concerning the terms of the loan agreements covered by the guidelines as a result of the Supreme Court judgments, with particular emphasis on interest rates, and that it explain why Articles 4 and 18 of Act no. 38/2001 apply.

As is stated in the introduction to this letter, it should be clear that there was great uncertainty about the treatment of loans falling under the precedent set by the Supreme Court judgments. As is stated there, the conclusion concerning interest on the loans concerned could deal the financial undertakings' capital such a heavy blow that the Treasury would be forced to provide them with substantial new capital. Also described is the significant underlying unrest concerning the treatment of these loans until a final ruling is made on the interest rate factor. The Central Bank of Iceland and the Financial Supervisory Authority decided to recommend a temporary solution to the problem, based on statutory provisions.

It must be considered beyond dispute that interest rates on loans unlawfully linked to currency exchange rates were determined with reference to interbank market rates in the currency areas to which the exchange rate linkage applied. Furthermore, it is generally agreed that no borrower would at any time have been offered a loan in Icelandic krónur bearing interest rates on foreign currency. Nor are there any known instances where interest rates are determined with reference to anything other than interest in the currency in which the loan is issued, unless complex and costly derivatives are involved. This is based, first of all, on the simple business principle that it is unlikely, if not impossible, that any party would offer another party a loan or other service without generating some income from it, at least enough to cover expenses and commission. Second of all, such would be utterly at odds with the basic nature and role of banks, which is to act as a channel for the intermediation and long-term custody of capital, as financial markets are based primarily on individuals' and companies' savings, which then earn interest via lending. If the returns on banks' lending operations are zero or negative – that is, if interest on loans granted does not cover the interest on the banks' domestic and foreign funding – the owners of the banks (or the taxpayers, if the loss is substantial) must make up the difference. It must therefore be considered unlikely, or even out of the question, that a financial undertaking would lend money at interest rates that generate no returns, or perhaps even negative returns.

In general, interest is composed of two parts: remuneration to the owner of capital for the use of the funds; and compensation for the erosion of the purchasing power of the loan principal during the term of the loan, either vis-à-vis goods and services that may rise in price or vis-à-vis foreign currencies. Indexation or exchange rate linkage entails protecting loan principal from erosion of purchasing power, with nominal interest rates primarily reflecting the former of these. The nominal interest rate on indexed or exchange rate-linked debt is generally lower than an interest rate without such insurance. This difference is therefore greater as the inflation history of a given

currency becomes more negative and the historical erosion of the value of that currency becomes greater, whether measured against a basket of goods and services (as with a consumer price index) or against foreign currencies. In Iceland's case, the difference between interest on indexed or exchange rate-linked obligations, on the one hand, and the interest on obligations without such indexation, on the other, has been significant, as inflation has been persistent and the purchasing power of each króna has declined steadily vis-à-vis both foreign currencies and goods and services. Indexation can be viewed as a portion of interest that is not paid but is added to the principal with each payment. In essence, if indexation (exchange rate linkage) is abandoned and nominal interest rates remain unchanged, the portion of the nominal interest rate on uninsured loans that compensates for erosion of the purchasing power of loan principal is simply cancelled. The interest rate specified in a loan agreement and the exchange rate linkage of the principal are therefore as connected to one another as a beard is connected to the chin from which it grows. The two cannot be separated.

For the above reasons, the Central Bank considers it impossible to interpret the Supreme Court to mean that the Court intends that foreign contractual interest rates should apply to loan principal in Icelandic krónur. This would mean, for example, that a currency basket loan consisting of specific percentages of Icelandic krónur (bearing REIBOR interest plus premium) and Japanese yen and Swiss francs (bearing LIBOR interest on the currency concerned) must now be calculated with three different interest rates (determined on the interbank markets of three different currency areas), even though the entire principal was in Icelandic krónur. The judgments state clearly that the Court did not address the issue of how loans containing non-binding exchange rate linkage clauses should be settled, for the simple reason that no reserve claim to this effect was lodged in the cases concerned. As a result, the Supreme Court lacked the grounds to rule on the matter. If the Supreme Court had considered it clear that the contractual interest rates should retain their validity, it would have been unnecessary to express such a reservation. Consequently, in interim settlement, predicting the likely court decisions pertaining to loans considered to contain non-binding exchange rate linkage clauses is inescapable.

The law does not stipulate what should be done under the precise circumstances that currently exist; however, it certainly provides for a course of action when contractual agreements are not thorough in all respects as regards interest rate provisions. It was this situation that the guidelines were intended to address, so as to create predictability and stability. The guidelines suggest that consideration be given to Articles 4 and 18 of the Act on Interest and Price Indexation, no. 38/2001, so

that the lowest indexed or nominal interest rates on loans granted by credit institutions will be used as a reference.

Article 4 of the Act on Interest and Price Indexation reads as follows:

> "Where interest is to be paid as provided for in Article 3, but the percentage rate or reference to be used for such interest is not otherwise specified, the interest rate shall be equal to the current interest rate set by the Central Bank of Iceland, having regard to the lowest rate of interest on new, general, non-indexed loans from credit institutions, and published as provided for in Article 10. In those instances involving an indexed claim, the interest rate shall be equal to the rate set by the Central Bank, having regard to the lowest rate of interest on new, general, indexed loans from credit institutions, and published as provided for in Article 10."

The provision focuses on conditions when the obligation to pay interest exists but the percentage *or interest rate reference* is not otherwise specified. In that instance, consideration shall be given to the lowest interest rate published by the Central Bank of Iceland, depending on whether the claim is indexed or not. According to the letter of the law, this provision covers instances where the interest rate percentage itself is not specified, as well as instances where interest rate premium is stated but without any mention of what it is added to or on what it is based; that is, the interest rate reference.

In any case, the discussed legal provisions must be interpreted as providing the foundation for some minimum interest rate if, for any reason, it is not possible to use the rates specified in a contractual agreement. The question is then whether the provision can be interpreted to include other factors that the legislature did not have in mind when the Act was passed, as well as situations in which interest rate provisions have been derogated or amended because the contractual premises do not apply. The Central Bank of Iceland is of the opinion that all logic indicates that the premises for the interest rate provisions of the contracts containing unlawful exchange rate linkage clauses cease to apply because the exchange rate linkage was a determinant of the interest rates on the contracts concerned.

Both of the Supreme Court judgments handed down on 16 June 2010, which were the reason for the issuance of the guidelines, state *verbatim* that it is "unequivocally the case that the agreement between the parties pertained to an obligation in Icelandic krónur." Assuming this, it is clear that the parties negotiated a loan in Icelandic krónur, bearing interest applied to agreements in foreign currency, which is generally much lower than that applied to agreements in Icelandic krónur. As a result, it is obvious that the premise for this was the unlawful exchange rate linkage. If exchange rate linkage had not been used as a basis for interest rate calculation, it would have been entirely

illogical to negotiate interest rates based on foreign currencies. The interest rates would have been the much higher rates that are imposed on loans in Icelandic krónur.

With all of this in mind, it must be assumed that the interest rate provisions of the contractual agreements containing unlawful exchange rate linkage clauses should be amended or derogated, as it must be considered doubtful that a lender that had loaned funds at specified interest rates should suddenly be considered to have loaned those funds at rates that prevented him from recouping his expenses or earning a commission on the loan. The Central Bank of Iceland is of the opinion that were this the case, the courts would seek support in Article 4 of the Act on Interest and Price Indexation, with reference to the foregoing statements on the interpretation of that Article, either by analogy or by so-called "fulfilment" in interpreting contractual agreements. Opinions like this have been expressed by scholars such as Eyvindur G. Gunnarsson (*On exchange rate-linked loans and indexation*, Úlfljótur, 2009).

Another option is to use REIBOR interest rates to settle the unlawful loan agreements. It is not unlikely that financial undertakings will demand this, citing the existence of loan agreements bearing such interest, which can be used as a reference. Some agreements that may contain non-binding exchange rate linkage clauses also bear REIBOR rates. The guidelines did not suggest the use of such interest because no mention is made of REIBOR interest in the statutory provisions mentioned above. However, the lowest Central Bank rates will probably be more beneficial to debtors in all instances and will therefore conform to consumer protection principles.

It is stated above that the Supreme Court judgments specify that the obligation between the parties to the disputed contracts were in Icelandic krónur. That being the case, it can be assumed that they were in Icelandic krónur from the outset and not only from the date the judgments were rendered.

Article 18 of the Act on Interest and Price Indexation reads as follows:

"If an agreement, on interest or other remuneration for the provision of a loan or deferral of payment or penalty interest, is deemed invalid and if remuneration has been paid, the creditor shall repay the debtor the amount which he has wrongly received from him. In determining repayment, regard shall be had for interest rates as provided for in Article 4, as applicable." The Article describes the handling of claims that a debtor may have against a creditor due to overpayment of debt, and it states that interest according to Article 4 of the Act shall be charged, *as applicable*. It is clear that those who have paid exchange rate-linked loans in Icelandic krónur have overpaid because of the exchange rate linkage; cf. the statements in Article 18 on remuneration. With reference to previous statements on the basic

premises for making reference to Article 4 of the Act on Interest and Price Indexation in the guidelines, *mutatis mutandis*, and to the statements in the Supreme Court judgments that the obligations were in Icelandic krónur, the Central Bank was of the opinion that the reverse claim and therefore the balance of the loan should be calculated with interest according to Article 4 from the date the loan was granted, on the basis of Article 18. Reference was therefore made to that Article.

In view of all of the foregoing, it should be noted that the three commercial banks have now, as a temporary solution for debtors with exchange rate-linked mortgages, offered borrowers the option of paying 5,000 kr. per month, per million krónur originally borrowed. It appears that the non-governmental organisations most concerned about this matter have welcomed this solution. Closer examination reveals also that this solution is in line with the guidelines and the basic views underlying them.

Response to question(s) in Item 4

In Item 4 of Section III of the query, the Ombudsman requests that the Central Bank of Iceland explain whether the statement in Item 1 of the guidelines, to the effect that, "instead of linking the loan agreements to foreign exchange rates and interest rates," the interest rates specified in the guidelines shall be used, pertains solely to the "recalculation" of the discussed loan agreements until the Supreme Court judgment was handed down, or whether it pertains both to payments already collected and those to be collected in the future. As regards the former point, the Ombudsman requested that the Central Bank of Iceland state whether, in issuing the guidelines, it had taken a position on how such calculation should be handled and on the financial undertakings' obligation to pay penalty interest, because borrowers/debtors may have overpaid their loans due to the non-binding exchange rate linkage clauses.

The Bank's reasons for making reference to Article 18 of the Act on Interest and Price Indexation in the guidelines have already been explained. With that reference, the Bank decided that Item 1 of the guidelines applied both to amounts already collected and those to be collected in the future, as this conclusion can be drawn from the precedent set by the Supreme Court, which has stated that the obligations were in Icelandic krónur. It can hardly be considered to apply only from the date the judgments were handed down. The interest rates recommended in the guidelines therefore apply to the calculation of both past and future payments.

However, the guidelines do not take a specific position on the calculation of penalty interest, as the guidelines were intended to be used as guidance for financial undertakings and to facilitate reporting,

but not to take a position with either party to a contract containing unlawful exchange rate linkage provisions. It is appropriate to reiterate that the Central Bank/FME guidelines were a temporary measure designed to prevail until a decision had been made on the scope of the contractual agreements falling under the Supreme Court judgments, and until the interest rate to be used for settlement had been determined. The guidelines also made reference to the fact that, in spite of technical difficulties, the financial undertakings should attempt to invoice the loans in accordance with the guidelines by 1 September 2010. This does not represent a statement or implication that this arrangement is a permanent one, for this would be inconsistent with the temporary nature of the guidelines. It is not certain, or even probable, that the situation necessitating the guidelines will be resolved by the beginning of September. The guidelines merely recommend that, by that time, the financial undertakings have implemented the arrangement specified therein.

Response to request for information in Item 5

In Item 5 of Section III of the query, the Ombudsman requests that the Central Bank of Iceland provide information and copies of documents showing to what extent the Bank, prior to the issuance of the guidelines on 30 June, acquainted itself with and compiled data on the claims in current Court cases – that is, cases as yet undecided – with reference to whether it could be expected that those documents might indicate the "scope and loan terms of the agreements" falling under the Supreme Court judgments of 16 June.

First of all, it should be noted that the Central Bank did not compile or maintain specific documentation on the claims pertaining to cases that are or were being considered by the judicial system. In part, this was because there was no intention to take an administrative decision; therefore, there was no need to fulfil the obligation to investigate or to compile data for subsequent submittal. Furthermore, the status of these cases has been a matter of public knowledge.

For example, it has been stated publicly and discussed in public that the District Court judgments would be appealed to the Supreme Court; cf. the Court's decisions in Cases no. 92/2010 and 153/2010. The scope of the loans at stake in those particular cases could be determined from the claims presented therein. Furthermore, on 1 July 2010, the day after the guidelines were issued, the District Court of Reykjavík registered a case that centres on what interest rate should be charged on unlawfully exchange rate-linked loans in Icelandic krónur. However, it was clear that the recess usually taken by Icelandic courts during the summer months was approaching; therefore, there was no expectation that the courts would hear cases pertaining to exchange rate linkage until after that time, irrespective of the particular matter of

dispute in those cases. The cases concerned would not have been decided at the District Court level before the fall, and a Supreme Court judgment would not be forthcoming until much later.

Furthermore, Parliamentary sessions were suspended as of 24 June 2010, without treatment of a bill of legislation providing for expedited handling of cases of the type described here, in accordance with Chapter XIX of the Act on Civil Procedure, no. 91/1991. As a result, the legislature could not be expected to intervene and facilitate matters.

Consequently, a District Court decision on whether contractual interest rates on unlawfully exchange rate-linked loans in Icelandic krónur should remain unchanged could not be expected before the autumn, at the earliest. It does not matter whether the case registered on 1 July 2010 was in preparation while the guidelines were being drawn up, as it is usually very difficult to foresee how cases will develop from the time the summons is prepared until a judge has made a decision. At all events, even though a case pertaining to the situation addressed by the guidelines may be in the court system, a Supreme Court ruling cannot be expected before several months have passed. As a result, information gathering of this type would not have solved the serious problem that had developed.

Response to Item 6

In Item 6 of Section III of the query, the Ombudsman requests that the Central Bank state whether, in issuing the guidelines, it had considered the effect that Article 17 of Act no. 38/2001 could have in the event that financial undertakings continue to collect payment on the basis of loan agreement provisions linking the underlying obligations to exchange rates.

In publishing the guidelines, the Central Bank did not give particular consideration to Article 17 of the Act on Interest and Price Indexation, as the Bank expected that the financial undertakings would stop collecting payment of exchange rate-linked claims in Icelandic krónur because of the existence of Supreme Court precedent on the legality of such claims.

III.

In this letter, the Central Bank of Iceland has explained its view that it acted in accordance with its mandate and purpose when it issued the guidelines on 30 June 2010, and, in so doing, proposed a means of handling the severe disruption that could have jeopardised the financial stability of the nation. The Bank has explained that the guidelines were not binding and were designed as a temporary

measure to be employed until Supreme Court judgments clarifying the scope of the matter should be handed down.

The complaint that resulted in the Ombudsman's letter pertains to an individual's position. The individual concerned has an exchange rate-linked loan and "therefore has interests at stake in the authorities' not setting policy for the financial undertakings," as is stated in the complaint. Although the Central Bank of Iceland understands that each individual wishes to advance his *own* interests to the maximum extent possible, this is a viewpoint that the Bank cannot allow itself to consider. Uncertainty about interest rates on previously exchange rate-linked loans in Icelandic krónur, which the Supreme Court has declared unlawful, could prove beneficial to certain companies and individuals, but it could have disastrous consequences for the vast majority of people if it causes financial undertakings to fail or puts them in such a precarious position that the Government must provide them with substantial new capital. The Central Bank is required to consider overarching interests. It was the joint assessment of the Central Bank and the Financial Supervisory Authority that the stability of the financial system was at stake and that it was necessary to present some collective point of departure until a court ruling should eliminate legal uncertainty.

In this context, it is appropriate to state that in no way did the Central Bank of Iceland intend to tie the hands of the Supreme Court of Iceland, although this opinion has been voiced. It is not the role of the Central Bank of Iceland to judge or adjudicate in cases involving civil claims. However, the Central Bank of Iceland does have the mandate of safeguarding and preserving financial stability, and it must fulfil that mandate successfully, with the public interest as a guiding principle, and to take the actions available to it in doing so. The Central Bank is convinced that the issuance of the guidelines was well in line with this mandate.

Respectfully yours,
CENTRAL BANK OF ICELAND

Már Guðmundsson
Governor

Arnór Sighvatsson
Deputy Governor