The Kreppa that Almost Melted Iceland

By Jenna Gottlieb *Wed, May 22, 2013*

Iceland's economy and pension system has come back from the "kreppa" or banking crisis that struck five years ago. This country of the aurora borealis and matronymic last-names is full of surprises (Photo by Bjorn Ludviksson).

REYKJAVIK, ICELAND—Until the autumn of 2008, Iceland was best known for its Northern lights, geothermal springs and volcanoes with hard-to-pronounce names. Then this tiny Nordic country suddenly became the poster child of the Global Financial Crisis.

Roughly the size of Maine with a fourth as many people, Iceland became mired in the deepest recession Europe had seen in decades. The tiny but sturdy Icelandic economy, with a GDP of less than $15 billion, suddenly stopped. The value of the currency plunged. Interest rates soared.

The country's public pension assets weren't immune to the financial storm. At the onset of the "Kreppa," as Icelanders call the crisis, Hrafn Magnusson, the managing director of the National Association of Pension Funds (NAPF), predicted that the country's pension funds might shrink by up to 20%. The eventual drawdown was worse.

"The bank crisis affected most of Icelandic pensions funds and on average they lost about 20-30% of assets in the year 2008," Gunnar Baldvinsson, the chairman of the Icelandic Pension Funds Association (IPFA), told *RIJ*. The IPFA, whose office overlooks vast mountains and a glacier, is the umbrella organization for all 31 Icelandic pension funds.

Iceland has made a solid comeback since then, however. It helped a lot when the country's Supreme Court ruled in 2010 that bank loans indexed to foreign currencies were illegal. Icelanders who had taken out the loans in Icelandic kronur could repay them in (depreciated) kronur. With their personal debt load lightened, Icelanders began to spend again, buoying the economy.

The nation's pension assets have similarly rebounded, and pensions mean a lot here. Whether it's the diet of dried fish or the singular purity of its gene pool, Iceland has the world's longest male life expectancy at birth—80 years. For Icelandic women, it's a hearty 84 years. (Average life expectancy at birth for Americans is 78.7 years, according to 2010 data from the Centers for Disease Control.) Studies show that most Icelanders believe in elves; they also believe in saving carefully for retirement.

Icelandic pensions

Iceland's pension system, which differs somewhat from other pension structures in Europe, has three tiers: a tax-financed old-age pension, a system of mandatory occupational pension schemes that are co-funded by employers and employees, and a voluntary defined contribution saving plan.

"Public pensions are fully financed by taxes," said a director at the Central Bank of Iceland, who spoke on condition of anonymity. "In most cases, the old-age pension is paid from the age of 67. It is divided into a basic pension and a supplementary pension. Both are means-tested, but income from other pensions is treated differently from [non-pension] income; the level at which it begins to reduce the supplementary pension is higher."

The minimum basic pension in Iceland equals about 14% of the average earnings of unskilled workers. The combination of income from the basic pension and the supplemental pension amounts to about 71% of the average pre-retirement unskilled wage.

The second-tier pension, which is more complicated, is paid from a public pension fund and general funds. According to a spokesperson for Prime Minister Jóhanna Sigurðardóttir, public pensions are for individuals who work for the state. The actuarial position of public funds is currently negative by roughly ISK 440 billion ($3.64 billion) or about 30% of GDP. Roughly 85% of the Icelandic labor force is unionized and participates in the public pension, whose benefits are guaranteed by the government.

The general funds aren't guaranteed. If they underperform, benefits are cut. The general funds, however, have a positive actuarial position of about ISK 200 billion ($1.65 billion). The three largest general pension funds in Iceland are: Lsj. Starfsmanna Ríkisins (Pension Fund for State Employees), which has ISK379.5 million (US $2.9 million); Lsj. Verzlunarmanna (Pension Fund of Commerce), which holds ISK345.5 million (US $2.7 million); and Gildi Lífeyrissjóður (Gildi Pension Fund), which has ISK265.3 million (US $2 million). Each fund has its own asset management team and chief investment officer.

The final tier is financed by voluntary, tax-favored defined contributions. "Employees are allowed to deduct from their taxable income a contribution to authorized individual pension schemes of up to 2% of wages," said the Central Bank director. "Employers must match the supplementary contribution up to a limit of 2%. The pension savings are not redeemable until the age of 60 and must be paid in equal installments over a period of at least seven years." In other words, the DC savings can serve as an income bridge until the basic and supplementary pension benefits begin.

In 2008-2009, these funds, not unlike retirement accounts in the U.S., lost up to 30% of their value, then rebounded. Before the crash, at year-end 2007, total assets of the pension funds within the IPFA amounted to ISK1.7 trillion (US $13 billion). By the end of 2011, according to the most recent data, IPFA assets totaled ISK2.1 trillion (US $16 billion). Iceland's GDP in 2011 was ISK1.6 trillion ($13.9 billion).

Baldvinsson at the IPFA, said, "The pension funds had performed very well for a long period before the crisis and have done quite well since 2009. On average the real return from 1980 to 2012 is 4.4%."

Frozen assets

In hindsight, Iceland lacked the appropriate regulatory framework to support its ambitious banking endeavors during the1990s. Applying what it called "New Modern Vikings" economics, Iceland privatized its banks in the early 1990s. Deposits poured in from overseas, and banks lent money out even faster than it came in. The assets of Iceland's three largest banks eventually grew to 10 times the Icelandic GDP.

When the global meltdown came and deposits were withdrawn, Iceland fell hard. Along with soaring inflation, a depreciated currency, and unmanageable foreign-denominated debt, Iceland's credit rating got slammed for several quarters. But Iceland's economy has largely stabilized and recovered from the crisis. Without embracing extreme austerity, the government reduced public spending and raised taxes on high-income residents. A deficit that reached nearly 14% of GDP in 2009 fell to 2.3% in 2012.

Credit rating agencies have taken notice. In February 2013, Moody's Investors Services changed the outlook on Iceland's Baa3 rating from negative to stable. The "decision to revise the outlook to stable is based on the reduced event risk following the European Free Trade Association's court decision in January, which adds to a series of positive developments in Iceland over the past 12 months," Moody's said.

"The Icelandic economy has clearly emerged from the crisis-induced recession and is now expanding at a reasonable pace. Moody's expects real GDP growth at around 2.5% this year, following growth of 2.6% in 2011 and an estimated 2.2% in 2012," wrote analysts at the credit rating agency. "While the economic slowdown in the EU continues to negatively affects Iceland's exports, private consumption and investment have been strong and are expected to continue to support Iceland's growth in 2013."

"We survive"

As for Icelanders themselves, the Kreppa was certainly unsettling. "I worked my [whole] life and did the right things, and I didn't know what was going to happen," said Steinunn Pétursdóttir, a retired nurse. "There was a lot of fear and we didn't know if [benefits] would be cut."

Einar Magnusson, a worker in one of Iceland's bank, lost his job at the height of the crisis in early 2009. As the nation's unemployment rate quadrupled, Magnusson considered leaving the country. "I thought about packing up my home, my family, and moving to Norway," he told *RIJ*.

"But, with my children so young and in school, and the rest of our family here in Iceland, it was a last resort option." Then his Icelandic ingenuity came into play. "I decided to launch a consulting business, and that became something great," he said. "That's how it works here. We're tough, we survive."