GlobalResearch
Center for Research on Globalization

“Vulture Capitalism”: Iceland’s New Bank Disaster

A Dress Rehearsal for Greece and Italy?

By Olafur Arnarson, Prof Michael Hudson, and Gunnar Tomasson
Global Research, November 15, 2011
15 November 2011

Region: Europe
Theme: Global Economy

The problem of bank loans gone bad, especially those with government-guarantees such as U.S. student loans and Fannie Mae mortgages, has thrown into question just what should be a “fair value” for these debt obligations. Should “fair value” reflect what debtors can pay – that is, pay without going bankrupt? Or is it fair for banks and even vulture funds to get whatever they can squeeze out of debtors?

The answer will depend largely on the degree to which governments back the claims of creditors. The legal definition of how much can be squeezed out is becoming a political issue pulling national governments, the IMF, ECB and other financial agencies into a conflict pitting banks, vulture funds and debt-strapped populations against each other.

This polarizing issue has now broken out especially in Iceland. The country is now suffering a second round of economic and financial distress stemming from the collapse of its banking system in October 2008. That crisis caused a huge loss of savings not only for domestic citizens but also for international creditors such as Deutsche Bank, Barclay’s and their institutional clients.

Stuck with bad loans and bonds from bankrupt issuers, foreign investors in the old banks sold their bonds and other claims for pennies on the dollar to buyers whose web sites described themselves as “specializing in distressed assets,” commonly known as vulture funds. (Persistent rumors suggest that some of these are working with the previous owners of the failed Icelandic banks, operating out of offshore banking and tax havens and currently under investigation by a Special Prosecutor.)

At the time when those bonds were sold in the market, Iceland’s government owned 100% of all three new banks. Representing the national interest, it intended for the banks to pass on to the debtors the write-downs at which they discounted the assets they bought from the old banks. This was supposed to be what “fair value” meant: the low market valuation at that time. It was supposed to take account of the reasonable ability of households and businesses to pay back loans that had become unpayable as the currency had collapsed and import prices had risen accordingly.

The IMF entered the picture in November 2008, advising the government to reconstruct the banking system in a way that “includes measures to ensure fair valuation of assets [and] maximize asset recovery.” The government created three “good” new banks from the ruins of its failed banks, transferring loans from the old to the new banks at a discount of up to 70 percent to reflect their fair value, based on independent third party valuation.

The vultures became owners of two out of three new Icelandic banks. On IMF advice the government negotiated an agreement so loose as to give them a hunting license on Icelandic households and businesses. The new banks acted much as U.S. collection agencies do when they buy bad credit-card debts, bank loans or unpaid bills from retailers at 30% of face value and then hound the debtors to squeeze out as much as they can, by hook or by crook.

These scavengers of the financial system are the bane of many states. But there is now a danger of their rising to the top of the international legal pyramid, to a point where they are in a position to oppress entire national economies.

Iceland's case has a special twist. By law Icelandic mortgages and many other consumer loans are linked to the country's soaring consumer price index. Owners of these loans not only can demand 100% of face value, but also can add on the increase in debt principal from the indexing. Thousands of households face poverty and loss of property because of loans that, in some cases, have more than doubled as a result of the currency crash and subsequent price inflation. But the IMF and Iceland's Government and Supreme Court have affirmed the price-indexation of loan principal and usurious interest rates, lest the restructured banking system come to grief.

This is not what was expected. In 2009 the incoming "leftist" government negotiated an agreement with creditors to relate loan payments to the discounted transfer value. On IMF advice, the government handed over controlling interest in the new banks to creditors of the old banks. The aim was to minimize the cost of refinancing the banking system – but not to destroy the economy. Loans that were transferred from the old banks to the new after the 2008 crash at a discount of up to 70% to reflect their depreciated market value. This discount was to be passed on to borrowers (households and small businesses) faced with ballooning principal and payments due to CPI indexing of loans.

But the economy's survival is not of paramount interest to the aggressive hedge funds that have replaced the established banks that originally lent to the Icelandic banks. Instead of passing on the debt write-downs to households and other debtors, the new banks are revaluing these loan principals upward. Their demands are keeping the economy in a straight jacket. Instead of debt restructuring taking place as originally hoped for, the scene is being set for a new banking crisis.

Something has to give. But so far it is Iceland's economy, not the vulture funds. With the IMF insisting that the government abstain from intervention, the government's approval rating has plunged to just 10% of Icelanders for floundering so badly while the new owners call the shots.

The New Banks have written off claims on major corporate debtors, whose continued operations have ensured their role as cash cows for the banks' new vulture owners. But household debts acquired at 30 to 50 percent of face value have been re-valued at up to 100 percent. The value of owners' share equity has soared. The Government has not intervened, accepting the banks' assertion that they lack the resources to grant meaningful debt relief to households. So unpayably high debts are kept on the books, at transfer prices that afford a windfall to financial predators, dooming debtors to a decade or more of negative equity.

With the preparatory work done, the time has come for the Vultures to cash in through re-sale of New Bank equity shares by yearend. The New Banks have kept their corporate cash cows afloat while window-dressing owners' equity with unrealistic valuations of consumer debts that cannot be paid, except at the cost of bankrupting the economy.

There is a feeling that Iceland's government has been disabled from acting as an honest broker, as bank lobbyists have worked with Althing insiders – now backed by the IMF – to provide a windfall for creditors.

The problem becoming a global one. Many European countries and the United States face collapsed banks and derailed banking systems. How are the IMF and ECB to respond? Will they prescribe the Icelandic-type model of collaboration between Government and hedge funds? Or should the government be given power to resist drive by vulture funds to profiteer on an international scale, backed by international sanctions against their prey?

The policy danger now facing Europe

An economic crisis is the financial equivalent of military conquest. It is an opportunity for financial elites to make their property grab as Foreclosure Time arrives. It also becomes a political grab to make real the financial claims that had become uncollectible and hence largely fictitious "mark-to-model" accounting. Populist rhetoric is crafted to mobilize the widespread financial distress and general discontent as an opportunity to turn losers against each other rather than at the creditors.

This is the point at which all the years of financial propaganda pay off. Neoliberals have persuaded the public to believe that banks are needed to "oil the wheels of commerce" – that is, provide the credit bloodstream that brings nourishment to the economy's moving parts. Only under such crisis conditions can banks collect what has become a fictitious buildup of debt claims. The overgrowth of mortgage debt, corporate debt, student loans, credit-card debt and other debts are fictitious because under normal circumstances there is no way for them to be paid.

Foreclosure Time is not sufficient, because much property has fallen into negative equity – about a quarter of U.S. real estate. And for Ireland, market value of real estate covers only about 30% of the face value of mortgages. So Bailout Time becomes necessary. The banks turn over their bad loans to the government in exchange for government debt. The Federal Reserve has arranged over $2 trillion of such bank-friendly swaps. Banks receive government bonds or central bank deposits in exchange for their bad debts, accepted at face value rather than at "mark-to-market" prices.

At least in the United States and Britain, the central bank can print as much domestic currency as is necessary to pay interest and keep these government bonds liquid. Public agencies then take on the position of creditor vis-à-vis debtors that can't pay.

These public agencies then have a choice. They may seek to collect the full amount (or at least, as much as they can get), as in the case of Fannie Mae and Freddie Mac in the United States. Or, the government may sell the bad debts to vulture funds, for a fraction of their face value.

After the September 2008 crash, Iceland's government took over the old, collapsed, banks and created new ones in their place. Original bondholders of the old banks off-loaded the

Icelandic bank bonds in the market for pennies on the dollar. The buyers were vulture funds. These bondholders became the owners of the old banks, as all shareholders were wiped out. In October, the government's monetary authority appointed new boards to control the banks. Three new banks were set up, and all the deposits, mortgages and other bank loans were transferred to these new, healthier banks – at a steep discount. These new banks received 80 percent of the assets, the old banks 20 percent.

Then, owners of the old banks were given control over two of the new banks (87% and 95% respectively). The owners of these new banks were called vultures not only because of the steep discount at which the financial assets and claims of the old banks were transferred, but mainly because they already had bought control of the old banks at pennies on the dollar.

The result is that instead of the government keeping the banks and simply wiping them out in bankruptcy, the government kept aside and let vulture investors reap a giant windfall – that now threatens to plunge Iceland's economy into chronic financial austerity. In retrospect, none of this was necessary. The question is, what can the government do to clean up the mess that it has created by so gullibly taking bad IMF advice?

In the United States, banks receiving TARP bailout money were supposed to negotiate with mortgage debtors to write down the debts to market prices and/or the ability to pay. This was not done. Likewise in Iceland, the vulture funds that bought the bad "old bank" loans were supposed to pass on the debt write-downs to the debtors. This was not done either. In fact, the loan principals continued to be revalued upward in keeping with Iceland's unique indexing designed to save banks from taking a loss – that is, to make sure that the economy as a whole suffers, even suffering a fatal austerity attack, so that bankers will be "made whole." This means making a windfall fortune for the vultures who buy bad loans on the cheap.

Is this the future of Europe as well? If so, the present financial crisis will become the great windfall for vulture banks, and for banks in general. Whereas the past few centuries have seen financial crashes wipe out the savings and creditor claims (bonds, bank loans, etc.) that are the counterpart to bad debts, today we are seeing the bad debts kept on the books, but the banks and bondholders that provided the bad loans being made whole at taxpayer expense.

This is not how economic democracy was expected to work during the 19th-century drive for Parliamentary reform. And by the early 20th century, social democratic and labor parties were supposed to take the lead in moving banking and credit along with other basic infrastructure into the public domain. But today, from Greece to Iceland, governments are acting as enforcers or even as collection agents on behalf of the financial sector – as the Occupy Wall Street movement expresses it, the top "1%," not the bottom 99%.

Iceland stands as a dress rehearsal for this power grab. The IMF and Iceland's government held a conference in Reykjavik on October 27 to celebrate the ostensible success in their reconstruction of Iceland's economy and banking system.

In the United States, the crisis that Obama Chief of Staff Rahm Emanuel celebrated as "too good to let go to waste" will be capped by scaling back Social Security and Medicare as soon as the autumn Doomsday Clock runs down and the Congressional Super-Committee of 12 (with President Obama holding the 13th vote in case of a tie) gets to agree to make the

working population pay Wall Street for its bad loans. The Greek austerity plan thus serves as a dress rehearsal for the U.S. – with the Democratic Party playing the role as counterparts to Greece's Socialist Party that is sponsoring austerity, and expelling labor union leaders from its ranks if they object to the grand double-cross.

*Olafur Arnarson is an author and columnist at Pressan.is. Michael Hudson is Prof. of Economics at UMKC. Gunnar Tomasson is a retired IMF advisor. 2,255 words

The original source of this article is Global Research
Copyright © Olafur Arnarson, Prof Michael Hudson, and Gunnar Tomasson, Global Research, 2011

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: **Olafur Arnarson**,
Prof Michael Hudson,
and **Gunnar Tomasson**

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca