Small states and big banks – the case of Iceland

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Abstract

The Icelandic economy was hit hard by the global economic and financial crisis that started in the fall of 2008. During this crisis the three largest banks all collapsed and many other smaller banks and companies went bankrupt in the aftermath of the crisis with severe consequences for the economy and the people. Prior to the crisis, Iceland, a high income economy, had experienced strong growth rates and unprecedented expansion in overseas investment and activities, especially in the financial sector. This article focuses on action by top government officials during this expansion as well as during and after the collapse of the Icelandic banks. The findings of the study are that the government showed negligence and made mistakes by not taking credible action to manage risks following a rapid cross border expansion of the Icelandic banking system. This had severe consequences and resulted in the collapse of the Icelandic economy in October 2008. The discussion can have a wider relevance than that for Iceland only. This is especially true for small countries with a large banking sector, using their own currency, and with limited fiscal space to support their banks during a crisis.

Keywords: Economic and financial crisis, economic policy, international expansion of firms, risk management.

JEL Classification: F21, G32, H12

1. Introduction

The Icelandic economy was hit hard by the global economic and financial crisis that started in the fall of 2008. During this crisis the three largest banks (Glitnir, Kaupthing, and Landsbanki) all collapsed and many other smaller banks and companies went bankrupt in the aftermath of the crisis with severe consequences for the economy and the people. Prior to the crisis, Iceland, a high income OECD economy, had experienced strong growth rates and unprecedented expansion in overseas investment and activities, especially in the financial sector. This article will focus on action by top government officials during this expansion as well as during and after the collapse of the Icelandic banks. Did the government of Iceland fuel the international expansion of the Icelandic banking sector that eventually resulted in collapse? How did it react to the banks’ expansion and what action did it take, or not take, to protect the economy from collapse? How did it respond to international concerns about the banks’ overseas expansion? Can its behavior be classified as negligence?

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2 The three banks accounted for about 85% of Iceland’s financial system.
The government officials focused on are the President of Iceland, who has traditionally been a symbolic and ceremonial figure in the government, as well as the role of key cabinet ministers including the Prime Minister, the Minister of Finance, and the Minister of Business Affairs. After this brief introduction the article will be organized as follows: (i) the expansion of the banking sector in Iceland, (ii) what did experts say about the health of the Icelandic banks before and after the collapse in October 2008 (were the banks solvent after all?), (iii) how did the government react to concerns and criticism about the banking system prior to the crisis, (iv) the Special Investigation Commission and its report to the parliament, (v) the President of Iceland and the expansion of the Icelandic banks, (vi) the role of the Central Bank of Iceland (CIB) and the Icelandic Financial Supervisor (FME), (vii) some thoughts on how the crisis could have been prevented, and finally (viii) conclusions.

This article is based on a review of theoretical literature, reports, public speeches, local and international media news, and secondary data. This is a case study on Iceland. Some of the lessons, however, can have a wider relevance than for Iceland only. This is especially true for small countries with a large banking sector, using their own currency, and with limited fiscal space to support their banks during a crisis.

2. The expansion of the banking sector in Iceland

Prior to the global economic and financial crisis that started in October 2008 the Icelandic banks had grown extraordinarily. According to the IMF the consolidated assets of the three main Icelandic banks increased from 100 percent of GDP in 2004 to 923 percent at end 2007, reflecting expansion overseas. By end-2007, almost 50 percent of the three banks’ assets were held abroad (IMF, 2008, p. 11)

Access to global debt finance markets was a key driving force behind this growth. The big three banks also enjoyed high credit ratings inherited from Iceland’s sovereign debt rating at the time. According to the Special Investigation Commission (SIC)3 the three banks issued around 14 billion EUR in foreign debt securities markets during 2005, a little over the GDP of Iceland that year. Most of the funding matured in only 3 to 5 years. Refinancing risk was thus imminent (SIC, 2010a).

In early 2006, during the so called mini crisis, international debt funding dried up temporarily. Once a liquidity crisis started in 2007, foreign deposits and short-term securitized funding became the main source of funding for the three banks. This short-term funding was sensitive to market conditions and thus risky (SIC, 2010a).

According to the SIC other countries with relatively large financial systems managed to avoid disastrous banking outcomes, since, unlike Iceland, those nations have long experience and proven ability to supervise large, international banks. Their accumulated reputation for careful prudential supervision therefore offsets their inability to provide fully reliable lender

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3 The Special Investigation Commission (SIC) delivered its report to the Althingi (the Icelandic parliament) on April 12, 2010. The SIC was established by Act No. 142/2008 by the Althingi in December 2008, to investigate and analyze the processes leading to the collapse of the three main banks in Iceland. Members of the Commission were Supreme Court Judge Mr. Páll Hreinsson, the Parliamentary Ombudsman of Iceland Mr. Tryggvi Gunnarsson, and Mrs. Sigríður Benediktsdóttir Ph.D., lecturer and associate chair at Yale University, USA.
of last resort protection, at least to some extent. But in Iceland the Financial Supervisory
Authority (FME) was in general understaffed and lacked experience, the Central Bank of
Iceland’s (CBI) foreign currency reserve was low, and the deposit insurance fund was un-der-
funded (SIC, 2010a).

How could this happen in a high income developed country like Iceland? How could Iceland
move from privatization of state owned banks to an exploding banking sector and then to
collapse?

3. What did the experts say about the health of the Icelandic banks before
and after the collapse?

A number of experts, local and foreign, commented on the viability of the Icelandic banking
system as well as on the soundness of the government’s macroeconomic policies both prior to
the banks’ collapse (including after the so called mini-crisis in 2006) as well as after the col-
lapse in October 2008. It is especially interesting to recall remarks made prior to the collapse
as they may have influenced government action or inaction. It is also interesting to review
some comments made after the collapse to see what lessons may have been learned from this
catastrophic event.

3.1 Before the collapse of the banks in October 2008

Danske Bank issued a critical report in 2006 highlighting some of the macroeconomic im-
balances in Iceland. “Based on the macro data alone, we think the economy is heading for
a recession in 2006-7. GDP could probably dip 5-10% in the next 2 years, and inflation is
likely to spike above 10% as the ISK depreciates markedly” and “we see a substantial risk of
a financial crisis developing as an integral part of an Icelandic recession in 2006-7.” (Danske
Bank, 2006). Iceland is a former colony of Denmark and large investments had recently been
made there by Icelandic companies so that any negative comments from Copenhagen were
likely to be received with some suspicion in Reykjavik. Talking about a possible financial
crisis during a period that many people experienced as a boom was not likely to be taken
too seriously in Iceland. Nevertheless Icelandic business interests and cabinet ministers re-
sponded with assistance from individuals in academia. An international PR campaign was
launched to present a favorable view of the Icelandic banks and point to a strong government
that balanced its fiscal budget and carried only small debts on its books. The Iceland Cham-
ber of Commerce commissioned well known and respected Icelandic economists who joined
forces with distinguished and internationally known foreign colleagues who together painted
a favorable picture of Iceland’s banking system and its economy. In 2006 Herbertsson and
Mishkin issued a report entitled: “Financial stability in Iceland” (Herbertsson and Mishkin,
2006) and in 2007 Baldursson and Porters issued a report entitled: “The internationalization
of Iceland’s financial sector” (Baldursson and Porters, 2007). The title of the Herbertsson
and Mishkin report is especially ironic given what happened in 2008 and in fact Mishkin
was accused in the famous movie “Inside Job” of having changed the title of the paper on

4 The Financial Supervisory Authority in Iceland is a regulatory organisation charged with the task of supervising
financial enterprises, referred to as regulated entities (see further http://en.fme.is/about-the-fsa/).
5 In the movie “Inside job” Mishkin is said to have received US$124,000 for his contribution to the report http://www.
youtube.com/watch?v=5msVI3oZI4U .
his CV into Financial instability in Iceland, a label more in line with what subsequently happened. The Herbertsson and Mishkin report painted a picture of a strong, stable financial system in Iceland. According to the report Iceland was “an advanced country with excellent institutions (low corruption, rule of law, high education, and freedom of the press). In addition, its financial regulation and supervision is considered to be of high quality. Iceland also has a strong fiscal position that is far superior to what is seen in the United States, Japan and Europe.” (Herbertsson and Mishkin, 2006, p. 8). According to the report there are three traditional routes to financial instability that manifested themselves in the recent financial crises: 1) financial liberalization with weak prudential regulation and supervision, 2) severe fiscal imbalances, and 3) imprudent monetary policy. None of these routes were said to describe the current situation in Iceland (Herbertsson and Mishkin, 2006, p. 8). So politicians and business leaders in Iceland did not have much to worry about according to the report and the government could well use these results to justify inaction during a time when it should have taken drastic measures to insist on downsizing the banking sector and stabilize the economy, including a very large current account deficit. The Baldursson and Porters report came out in 2007 and again a nice picture is painted of the state of affairs in Iceland. According to the report “Icelandic banks come out well in a comparison with their Nordic peers – and their overall and core profitability is higher” (Porters and Baldursson, 2007, p. 3). Furthermore, according to the report “Overall, the internationalisation of the Icelandic financial sector is a remarkable success story that the markets should better acknowledge” (Porters and Baldursson, 2007, p. 3). Here Icelandic banks outperform other Nordic banks so Icelanders had every reason to be proud of a large banking system that was unlikely to turn into a violent monster and the markets should do a better job in appreciating this “remarkable success story.” This idea seemed at this time to occupy the minds of many politicians who seemed to think that foreign critiques were insufficiently informed about the Icelandic way and needed more education to understand the realities in Iceland. In fact, according to Porters and Baldursson “The ‘mini-crisis’ of 2006 was an informational crisis, arising from external criticisms of the banks’ reliance on market funding with short maturities, questions of earnings quality, cross ownership, and lack of transparency, as well as perceived macroeconomic imbalances in the Icelandic economy” (Porters and Baldursson, 2007, p. 1). Danske bank and other critiques were thus misinformed and unappreciative of Icelandic success.

Not every report was positive; indeed, well known economists pointed out weaknesses in the financial system and the Icelandic economy. Warnings thus came not only from Danske Bank in 2006. Among scholars who expressed concern was Robert Z. Aliber of the University of Chicago Business School who presented a paper at the University of Iceland in May 2008 (Aliber, 2008). Anne Sibert of Birkbeck College and Willem Buiter of the London School of Economics, who were commissioned by Landsbanki to write a report about the Icelandic banking system in early 2008 (Buiter and Sibert, 2008b), also expressed concern about the situation in Iceland.

Aliber was highly critical of the Bank’s expansion as well as the overall economic situation in Iceland. Icelandic bankers were still at the time of Aliber’s visit seen as national heroes in Iceland and often linked to the Vikings and their golden age. Aliber could not help joking in his lecture “And the Icelandic banks may have a compensating advantage in the form of the “Viking spirit”, although it is not clear how this plays out in Norway and Denmark and Sweden.” (Aliber, 2008, p. 22).
According to Aliber “The increase in asset prices and household wealth in Iceland between 2002 and 2007 was larger in percentage terms than the comparable increases in most other countries. The likelihood that Iceland is likely to remain immune from the market forces that are leading to declines in the price of real estate and increases in the costs of capital in the United States, Britain, and other countries seems low” (Aliber, 2008, p. 23). In a meeting with the current Prime Minister, Aliber urged the government to split each of the Icelandic banks into separate domestic retail banks and foreign investment banks (Rannsóknarnefnd Alþingis, 2010, p. 226). After the meeting the Prime Minister commented “He (Aliber) did not talk the whole thing down as he did in his lecture, he was just a nice, old man on a visit.”6 The PM did not take an international expert like Aliber seriously and preferred to chat about common friends at Brandeis University where Aliber had taught and the PM graduated from.

In early 2008 Buiter and Sibert were asked by one of the three big banks, Landsbanki, to write a paper on the causes of the financial problems faced by Iceland and its banks, and on the available policy options for the banks and the Icelandic authorities (Buiter and Sibert, 2008a). In April 2008 they submitted a paper entitled: “The Icelandic banking crisis and what to do about it: The lender of last resort theory of optimal currency areas.” In July 2008, they presented a slightly updated version of the paper in Reykjavík before an audience of economists from the central bank, the ministry of finance, the private sector and the academic community. In April and July 2008, their “Icelandic interlocutors considered our paper to be too market-sensitive to be put in the public domain and we agreed to keep it confidential” (Buiter and Sibert, 2008a, p. n.p). This paper was made public only after the collapse of the three large banks in Iceland (see, Buiter and Sibert, 2008b).

Buiter and Sibert’s 2008 analysis focused on the banks’ liquidity problems caused by the absence of a credible lender of last resort. According to them “The main message of our paper is, however, that it was not the drama and mismanagement of the last three months that brought down Iceland’s banks. Instead it was absolutely obvious, as soon as we began, during January 2008, to study Iceland’s problems, that its banking model was not viable. The fundamental reason was that Iceland was the most extreme example in the world of a very small country, with its own currency, and with an internationally active and internationally exposed financial sector that is very large relative to its GDP and relative to its fiscal capacity” (Buiter and Sibert, 2008a, p. n.p). Furthermore according to Buiter and Sibert “The only way for a small country like Iceland to have a large internationally active banking sector that is immune to the risk of insolvency triggered by illiquidity caused by either traditional or modern bank runs, is for Iceland to join the EU and become a full member of the euro area. If Iceland had a global reserve currency as its national currency, and with the full liquidity facilities of the Eurosystem at its disposal, no Icelandic bank could be brought down by illiquidity alone. If Iceland was unwilling to take that step, it should not have grown a massive on-shore internationally exposed banking sector.” (Buiter and Sibert, 2008a, p. n.p). And according to Buiter and Sibert it ought to have been clear to everyone (including presumably Icelandic politicians) that the banks’ business model was not viable long before the global economic and financial crisis hit in the fall of 2008. “This was clear in July 2008, as it was in April 2008 and

in January 2008 when we first considered these issues. We are pretty sure this ought to have been clear in 2006, 2004 or 2000. The Icelandic banks’ business model and Iceland’s global banking ambitions were incompatible with its tiny size and minor-league currency, even if the banks did not have any fundamental insolvency problems” (Buiter and Sibert, 2008a, p. n.p).

3.2 The collapse in October 2008 – Were the banks solvent after all?

The collapse of the Icelandic banks in October 2008 was a shock to the Icelandic nation as well as internationally. If fact, it can be said that this was the first time that financial events in a tiny country like Iceland sent shockwaves through the international financial markets. As before the collapse, experts continued to express their views including Porters who had painted a favorable picture of the situation in Iceland in a report in November 2007. In his Financial Times column of 13 October, 2008 Porters argued that “Like fellow Icelandic banks Landsbanki and Kaupthing, Glitnir was solvent. All posted good first-half results, all had healthy capital adequacy ratios, and their dependence on market funding was no greater than their peers”. None held any toxic securities. These banks had been managed well since their “mini-crisis” in early 2006” (Porters, 2008, p. n.p). Porters thus still maintained after the collapse that the banks were solvent; but how could he know the quality and value of the banks’ assets with any certainty? Buiter and Sibert pointed out that the “only parties likely to have substantive knowledge of the quality of a bank’s assets are its management, for whom truth telling may not be a dominant strategy and, possibly, the regulator/supervisor. In this recent crisis, however, regulators and supervisors have tended to be uninformed and out of their depth. We doubt Iceland is an exception to this rule. The quality of the balance sheet of the three Icelandic banks has to be viewed by outsiders as unknown” (Buiter and Sibert, 2008a, p. n.p). We now know that the Financial Supervisory Authority in Iceland in charge of the task of supervising financial enterprises was understaffed and lacked experience.

Kaarlo Jännäri, 7 a retired Director General of the Finnish Financial Supervision Authority, who prepared a report on banking regulation and supervision in Iceland after the collapse of the banks, concluded that: “There might – just might – have been a possibility for the Icelandic banks to survive if the almost total freezing of the international financial markets had not taken place and confidence in Iceland had not been lost. Even in that case, they probably would have needed government support to maintain their solvency, as credit losses would have risen due to the deterioration of their loan portfolios.” (Jännäri, 2009, p. 37).

Mark J. Flannery8 who prepared a report for the Icelandic Special Investigation Commission just after the banks’ collapse stated that “In the end, we cannot establish definitively whether one or all of the banks was in fact insolvent during that first week of October. However, their increasing loan delinquencies after March 2008 and the low recovery values implied by the

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7 In November 2008, as part of its Stand-By Arrangement with the International Monetary Fund, the Icelandic Government undertook to invite an experienced bank supervisor to assess the regulatory framework and supervisory practices in Iceland and to propose needed changes. Kaarlo Jännäri, retired Director General of the Finnish Financial Supervision Authority, was invited to carry out the assessment and prepared a report entitled: “Report on Banking Regulation and Supervision in Iceland: past, present and future.” http://eng.forsaetisraduneyti.is/media/frettir/Kaar-loJannari_2009.pdf
8 Mark J. Flannery, professor of finance at the University of Florida, prepared a report for the Icelandic Special Investigation Commission just after the banks’ collapse entitled; “Iceland’s Failed Banks: A Post-Mortem.” http://sic.althingi.is/pdf/RNAefVidauki3Enska.pdf
FME’s ultimate settlement with the Old (receivership) banks imply that insolvency was a good possibility even before the banks encountered their terminal funding crises. One is left with the strong suspicion that some or all of the banks were insolvent – and hence that the market’s unwillingness to lend was rational.” (Flannery, 2009, p. 106).

Weaknesses in EU banking regulations, insufficient supervision and inappropriate policy responses in Iceland, as well as the global financial crisis all contributed to the storm in October 2008. As risk aversion replaced financial mania in the international financial markets community, the Icelandic banks were doomed. Only a concerted international rescue effort could have saved the banks in October 2008. At this point the government of Iceland was isolated and could not assemble assistance. The outrageous bullying behavior of the British government also did not help.9 After the collapse of the three largest banks the only way forward seemed to be to try to regain some international credibility by entering into negotiations with the IMF and agree on a program to stabilize the troubled economy. In October 2008 the government of Iceland was left with no other choice.

4. How did the government react to concerns and criticism about the banking system prior to the crisis?

Prior to the crisis and the collapse of the Icelandic banks the government had great ambitions regarding the potential for growth of the banking sector and even proposed that Iceland should become an international financial centre (Invest in Iceland, 2006). In fact a report was published on the issue by a committee appointed by the Prime Minister (Nefnd forsætisráðherra um alþjóðlega fjármálastarfsemi, 2006). The chairman of the committee was Sigurður Einarsson, then the Chairman of the Board of Directors, Kaupthing Bank, one of the three big banks. According to the Invest in Iceland Agency “Iceland’s positive business environment, low tax rates and efficient infrastructure make the country an ideal candidate for an international finance center according to a new report compiled for the Prime Minister by a team of experts” (Invest in Iceland, 2006, p. n.p). Furthermore, “Iceland does not have a long history as a financial center and is much better known for competitively priced sustainable energy and quality seafood. But extensive reforms, including liberalisation and privatisation, has changed the business environment dramatically during the last decade and Iceland is now recognized as one of Europe’s most competitive economies” (Invest in Iceland, 2006, p. n.p). The government thus saw a great growth opportunity in the banks.

Liberalization of the financial markets and privatization of the state owned banks was good music internationally at this time and these efforts were supported globally by institutions such as the IMF and the World Bank. As it turned out, supervision of the banks in Iceland was weak and many people still question how the privatization of the state owned banks was implemented with few politically influential groups taking control and involving managers with little experience in international banking. As Jännäri pointed out “For the most part, the new owners and the people behind them were not traditional commercial bankers; instead, they had the rather innovative and somewhat adventurous mindset of investment bankers, which favoured a strategy of rapid growth and highly leveraged, aggressive deals.” (Jännäri, 2009, p. 14).

9 UK authorities invoked the 2001 Anti-Terrorism, Crime and Security Act, passed after the September 11, 2001 terrorist attacks in the USA, to justify freezing the UK assets of Landsbanki and Kaupthing.
How could this happen in a developed OECD country like Iceland? How could Iceland move from privatization of state owned banks to ideas for creating a financial centre and exploding banking sector and then to a collapse? As Eggertsson and Herbertsson point out in a paper entitled “System Failure in Iceland and the 2008 Global Financial Crisis”, “the prime minister talked about turning Iceland into a full-scale center of international finance. Scholars have documented how communities that are caught in extreme price bubbles become virtually manic and throw caution in the wind. Iceland is no exception, although, as always, there were early critics and skeptics” (Eggertsson and Herbertsson, 2009, p. 28 to 29). And further “Modern capitalism has had its fair share of financial manias, panics and crises, but the global financial exuberance and the subsequent crash in the first decade of the 21st century stands out as exceptional and has been compared to the events leading to Great Depression” (Eggertsson and Herbertsson, 2009, p. 11).

As discussed above, respected international experts issued warnings to the government about expansion of the Icelandic financial sector well before the collapse in 2008. This included for example the Danske Bank report in 2006 and Aliber’s lecture in 2008 as well as the Buiter and Sibert report in 2008. Lower credit ratings issued by rating agencies were still another warning signal. The refusal of the Bank of England, the ECB, and the Federal Reserve to increase the Icelandic Central Banks’ foreign exchange reserves should also have been a warning to the government and triggered an immediate response from key ministers involved.10 However, in Iceland, the response to negative reports and lower credit ratings was generally one of shock and anger over what was seen as unfair and unsubstantiated criticism. Business interests and cabinet ministers, aided by experts from some Icelandic universities, initiated a public relations campaign and painted a positive picture of the situation for example by emphasizing the excellent standing of the government, which was virtually debt free and balanced its budget.

Kaarlo Jännäri claims that foreign supervisors and central banks, with which he was in contact when he was preparing his report on banking regulation and supervision in Iceland, generally commented favorably on the cooperative and friendly attitude of the Icelandic authorities. However, he also comments that “Some disappointment has also been expressed about the willingness of the CBI and the FME to share the concerns they had about the Icelandic banks with their EU counterparts before the crisis exploded. There are feelings that the Icelandic authorities were protective of the banks and tried to tone down the worries expressed by their foreign counterparts. This has undermined the credibility of the FME and the CBI in the eyes of their colleagues. The FME and the CBI consider these criticisms to be unfair and unjustified.” (Jännäri, 2009, p. 12). Furthermore he comments that “The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments, but the overall national pride in the success of the banks would probably have made it futile even to try while the going was good and success followed success. By the time the tide turned, it was too late, and there was too little that could be done to avoid catastrophe.” (Jännäri, 2009, p. 37).

The same may have applied to the Icelandic cabinet of ministers. They may have lacked the courage to intervene and simply decided on a hands-off policy and to hope for the best

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10 The responsibility for money, banking and finance in Iceland is divided between three ministries, those of the Prime Minister, the Minister of Finance, and the Minister of Business Affairs.
and not to prepare for the worst. As Danelsson and Zoega say in a recent paper “By not addressing the pending failure of the banking system, perhaps in the hope that the instability would disappear, we cannot escape the feeling that the Icelandic authorities gambled for resurrection, and failed” (Zoega and Danielsson, 2009, p. 14). But could the banks have been saved even if the cabinet had intervened with full force? Eggertsson and Herbertsson have expressed their opinion as to whether it was still possible to restructure the banking system in 2006, following the early warning signs and criticisms from abroad. They “believe that even then, had they desired, the banks could have either downsized or split and moved their headquarters for foreign operations abroad” (Eggertsson and Herbertsson, 2009, p. 28). But in their view “only the prime minister and the cabinet could have made the critical political decision to reverse the spectacular growth of the country’s banking system or relocate most of it overseas” (Eggertsson and Herbertsson, 2009, p. 28). But the cabinet did not take action after the 2006 mini-crisis and decided to defend the banks instead of downsizing or moving their HQ overseas. The cabinet chose to be inactive during a critical time in Iceland’s history. Their hopes for resurrection did not materialize. The consequences were dire.

5. The Icelandic Special Investigation Commission (SIC) and its report to the parliament

A Special Investigation Commission (SIC) delivered its report to the Icelandic parliament, the Althingi, on April 12, 2010. The Commission was established by Act No. 142/2008 by the Althingi in December 2008, to investigate and analyze the processes leading to the collapse of the three main banks (Glitnir, Kaupthing and Landsbanki) in Iceland. The following section gives a flavor of the failure of leadership and coordination at top government level in Iceland before the crisis hit with disastrous consequences. In fact, the SIC named ministers and high level government officials in its report who were thought to have shown negligence. The report, which accounts for 9 volumes, is quite extensive and only a few key points can be highlighted in this section.

According to the SIC the balance sheets and lending portfolios of the Icelandic banks expanded beyond the capacity of their own infrastructure. Growth had been especially rapid during the latter part of 2007. The banks’ rapid lending growth had the effect, according to the SIC, that their asset portfolios became fraught with high risk. In the opinion of the SIC such large-scale and high-risk growth was not compatible with the long-term interests of solid banks (SIC, 2010b, p. 1). Access to international financial markets was, for the banks, the principal premise for their extensive growth. According to the SIC “there were mainly two reasons why international financial markets opened their doors to the banks, firstly, because of their good credit rating. This was to some extent inherited from the Treasury. Secondly, they had access to European markets, on the basis of the EEA Agreement” (SIC, 2010b, p. 1). Banks that had operated as state owned banks for decades before their privatization had earned a reputation for being rather conservative and reliable, and economic integration in Europe via the EEA agreement opened doors for the Icelandic banks to European financial markets.

The SIC made strong comments on the lack of government response during a critical time prior to the crisis “When the banking system had become far too big, relative to the size of the Icelandic economy, the governmental authorities needed to respond. No later than 2006
it would have been necessary to take action, if there was to be any chance of preventing the collapse of the banks, without severely impacting upon the value of their assets. Neither that year nor the next did the authorities try, in a decisive way, to have the banks reduce the size of their balance sheets” (SIC, 2010b, p. 2). In addition to this the policy of the government was that the banks’ headquarters remained in Iceland which meant that Iceland was responsible for their supervision.

The SIC was also highly critical of the government’s macroeconomic policies during the period when the banks expanded: “The authorities decided to lower taxes during an economic expansion period. This was done despite expert advice and even against the better judgement of policy makers who made the decision. This decision was highly reproachable. The changes made to the lending guidelines at the Housing Financing Fund in 2004 also fuelled expansion. The changes in the lending guidelines were one of the biggest mistakes in monetary and fiscal management made in the period leading up to the banks’ collapse. That mistake was made with full knowledge of the likely consequences. The repercussions were quick to emerge and the consequences were even greater under the global low interest rate environment at the time. These decisions in fiscal and monetary management and others named in the report exacerbated the imbalance in the economy. They were a factor in forcing an adjustment of the imbalances, which ended with a very hard landing.” (SIC, 2010b, p. 5) According to the SIC it was mostly left to the Central Bank of Iceland (CBI) to counteract the effects of expansion by raising interest rates.

According to the SIC “From November 2007 onwards the Board of Governors of the CBI became increasingly concerned about the situation that was developing in the operational environment of the banks. The Board of Governors described these concerns either directly to the Prime Minister and a small group of ministers, or within the platform of the government consultative group. In spite of these concerns there is no evidence that the Board of Governors of the CBI made available to the government formal propositions for necessary measures” (SIC, 2010b, p. 8).

And key cabinet ministers failed to report the problems to the others in the government as the SIC states “Nothing suggests, either from the government’s minutes or the accounts of those who reported to the SIC, that the ministers of the Icelandic government responsible for economic affairs (the Prime Minister), banking affairs (the Minister of Business Affairs) or the state’s finances (the Minister of Finance) submitted to the government a specific report on the problems of the banks or its possible impact on the state’s economy and finance when the banks started to face constraints in their operations and until the banking system collapsed in October 2008.” (SIC, 2010b, p. 10). Again this shows a failure of coordination and the cabinet as a whole seemed not to have been formally informed. Nor was the cabinet activated to share responsibility or discuss possible government action.

According to the SIC “In 2008 the Prime Minister had quite a few meetings with the Chairman of the CBI Board of Governors and the CEOs of the banks. During the period from February until May 2008 Board of Governors had at least five meetings with the Prime Minister, Minister of Finance and the Minister for Foreign Affairs. Banking affairs came under the domain of the ministry of Mr. Björgvin G. Sigurðsson, Minister for Business Affairs. He was not summoned to attend any of these meetings, in spite of the fact that the problems the
banks were facing and the liquidity crisis were being discussed there” (SIC, 2010b, p. 10). This shows a grave coordination failure within the government and as the SIC emphasizes “As the leader of the government, the Prime Minister had the responsibility to inform the Minister of Business Affairs of the aforementioned meetings so that he could attend to his duties” (SIC, 2010b, p. 10).

As stated earlier in this article the ministers considered the outside criticism of the banks unjustified, unfair and due to lack of information. Foreign critiques needed education and efforts were mostly spent on improving the image of the banks. As the SIC states “It is the assessment of the SIC that the government’s actions concerning matters relating to the banks were unfocused when the situation became more dire in the beginning of 2008. The ministers focused too much on the image crisis facing the financial institutions rather than the obvious problem, that the Icelandic financial system was far too large in relation to the Icelandic economy. When the ministers intended to improve the image of the banking system by partaking in public discussions, mainly abroad, it was done without any assessment of the financial capability of the state to come to the banks’ assistance and without information being available on the cost of a possible financial shock.” (SIC, 2010b, p. 10).

When one looks at the analysis presented by the SIC, the powerlessness of the government and the authorities, when it came to reducing the size of the financial system in time before a financial shock hit, becomes evident. As the SIC states: “It appears that both the parliament and the government lacked both the power and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going. It had grown so large, that it was impossible to risk that even one part of it would collapse” (SIC, 2010b, p. 17). Thus the government hoped for the best but did not prepare for the worst. Unfortunately the worst scenario materialized.

And in its conclusions the SIC names ministers and high level officials and accuses them of negligence. “The SIC’s assessment, pursuant to Article 1(1) of Act no. 142/2008, was mainly aimed at the activities of public bodies and those who might be responsible for mistakes or negligence within the meaning of those terms, as defined in the Act. Although the SIC was entrusted with investigating whether weaknesses in the operations of the banks and their policies had played a part in their collapse, the Commission was not expected to address possible criminal conduct of the directors of the banks in their operations. On the basis of events and viewpoints that are described in more detail in individual chapters of this report, the SIC is of the opinion that Mr. Geir H. Haarde, then Prime Minister, Mr. Árni M. Mathiesen, then Minister of Finance, and Mr. Björgvin G. Sigurðsson, then Minister of Business Affairs, showed negligence, within the meaning of Article 1(1) of Act No 142/2008, during the time leading up to the collapse of the Icelandic banks, by omitting to respond in an appropriate fashion to the impending danger for the Icelandic economy that was caused by the deteriorating situation of the banks. The SIC is also of the opinion that Mr. Jónas Fr. Jónsson, then Director General of the FME, and Mr. Davíð Oddsson, Mr. Eirikur Guðnason and Mr. Ingimundur Friðriksson, then Governors of the CBI, showed negligence, within the meaning of Article 1(1) of Act No 142/2008, in the course of particular work during the administration of laws and rules on financial activities, and monitoring thereof.” (SIC, 2010, p. 18).
In April 2012 the former Prime Minister, Geir H. Haarde, was found guilty before a special court, the Landsdómur, for not holding cabinet meetings when things turned critical in the period leading up to the crisis in 2008. His response to the media was “I always found that charge to be even more ridiculous than the others. I still hold that view. It is therefore my opinion that the Court has made a grave error in reaching this conclusion and I therefore plan to take this case to the European Court of Human Rights as soon as I can” (x-D, 2012).

6. The President of Iceland and the expansion of the Icelandic banks

In the Icelandic political system the president remains largely a ceremonial figure. However, he is influential both locally and internationally and has been very active in promoting Icelandic business interests abroad. As stated above, according to the Special Investigation Commission “No later that 2006 it would have been necessary to take action, if there was to be any chance of preventing the collapse of the banks, without severely impacting upon the value of their assets. Neither that year nor the next did the authorities try, in a decisive way, to have the banks reduce the size of their balance sheets” (SIC, 2010b, p. 2).

What did the president say about the Icelandic banking sector in 2006? In a speech at “The Kaupthing Seminar” in Helsinki in May 2006 the president said “Yes, the future does indeed offer fascinating opportunities – and the growing strength of the Icelandic banking sector will, as before, play a crucial role, both in itself and by providing valuable connections to the international banking community. The three leading Icelandic banks – Kaupthing, Landsbanki and Glitnir – are amongst the fastest growing banks in the world. And the largest of the three, Kaupthing, has already established a pivotal position in Northern European banking. It has been both a privilege and an education for me to follow the growth of their activities and witness the praise that the Icelandic banks have received from their foreign clients – to confirm how the Icelandic banks have become key players in international financing for prominent European and American companies” (Grimsson, 2006, p. 5).

Like the government, the president is concerned about the image of the banks. The outside world needs to be informed and educated about the Icelandic banking sector. At “the Kaupthing Seminar” the president makes his view on this very clear when he says: “We have, however, been reminded of valuable lessons. One is that if you are a player in the global financial system, it is of paramount importance to keep foreign confidence in your financial institutions – to confirm how the Icelandic banks have become key players in international financing for prominent European and American companies” (Grimsson, 2006, p. 5).

It is worth noting that in the avalanche of reporting and evaluation to which we have been submitted in recent weeks, there is a prevailing characteristic: - The greater the knowledge

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11 The trial and the verdict drew attention in the international media, see examples below:
Financial Times: http://www.ft.com/intl/cms/s/0/13c2552a-6eb3-11e1-acf0-00144feab49a.html#axzz1zrEtSUii
Bloomberg: http://www.businessweek.com/printer/articles/51940?view=bloomberg
The Guardian: http://www.guardian.co.uk/world/2012/mar/05/iceland-pm-charged-crisis
BBC: http://www.bbc.co.uk/news/world-europe-17817174
of Iceland and the longer the experts have followed the Icelandic voyage, the more positive, informed and optimistic the conclusions have been.

We have to admit, however, that we could be more active in explaining our case; but then you have to remember that we Icelanders make up the nation that discovered America 1000 years ago but did not tell anyone about it. We only wrote the story down in books for ourselves, in texts we alone could understand. Consequently, Christopher Columbus got all the glory when he stumbled upon America 500 years later.

Now we have to do better: to build on the tradition of storytelling, aimed currently not only at ourselves but also at others. It is important to further the extensive knowledge and detailed understanding of the Icelandic experience; to be both transparent and open – willing to engage in dialogue with others.” (Grimsson, 2006, p. 7). At the Walbrook Club in London May 3, 2005 the president offered a list of a dozen or so elements that he believed had been crucial to Iceland’s “success story.” One was that “Icelanders are risk takers. They are daring and aggressive.” (Grimsson, 2005, p. 4)

The President of Iceland can hardly be blamed for the collapse of the banks in the fall of 2008. But he also did not urge the bankers to show caution during a time when caution was most critical. On the contrary he encouraged further risk taking and expansion. Currently he also encourages cross border expansion of Iceland’s energy sector that would involve large and long term investment, with long repayment periods. Such investments in emerging markets can be risky, especially for companies from small countries (see e.g. Hilmarsson 2008, 2010 & 2012). The president is a highly educated man with extensive experience. He should have known what dangers the banks could face with further expansion, risk taking and aggressiveness. He should not have fueled excessive risk seeking behavior and he should have listened more to criticism. He should also know the risks energy companies may face when investing in emerging market economies.

7. The roles of the CBI and FME

So far this article has mostly focused on the action of key ministers and the president with less discussion of the role of the Central Bank of Iceland (CBI) and the Icelandic financial supervisory authority (FME). Clearly both those institutions should have played a key role in monitoring and supervising the banking system in Iceland prior to the crisis.

The fact that the banks’ headquarters remained in Iceland also meant that Iceland was responsible for their supervision. The Financial Supervisory Authority (FME), the institution that bore the main responsibility for monitoring the activities of the banks, was understaffed and its staff was inexperienced (SIC, 2010a). The FME obviously did not have the institutional capacity to do its job properly and it ought to have known that. It should have had information about the health of the banks’ balance sheets, but as Buiter and Sibert point out regulators and supervisors tend to be uninformed and out of their depth. Unfortunately Iceland was no exception to this rule (Buiter and Sibert, 2008a, p. n.p.). Also as Jännäri, the former Director General of the Finnish Financial Supervision Authority, noted “The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments,” (Jännäri, 2009, p. 37). It was also difficult to intervene forcefully when the banks were expanding
and success followed success. Moreover, according to the SIC “the FME did not sufficiently concern itself with some basic questions, such as the size of the banking system, and the Authority’s necessary reactions in regard to its much too rapid growth” and in addition to that “In its supervisory duties the FME was lacking in firmness and assertiveness, as regards the resolution of and the follow-up of cases” (SIC, 2010a, p. 17). In this situation the FME was rather powerless and did not act effectively as it should have done.

The CBI foreign reserves were low, and the deposit insurance fund was underfunded (SIC, 2010a). The CBI must have known prior to the crisis that it could not act as a credible lender of last resort. According to the SIC it was mostly left to the CBI to counteract the effects of expansion by raising interest rates. And “From November 2007 onwards the Board of Governors of the CBI became increasingly concerned about the situation that was developing in the operational environment of the banks. The Board of Governors described these concerns either directly to the Prime Minister and a small group of ministers, or within the platform of the government consultative group” (SIC, 2010b, p. 8). In spite of these concerns there is, according to the SIC, no evidence that the Board of Governors of the CBI made available to the government formal propositions for necessary measures to be taken. This is unfortunate as it could have helped the government in its response and in policy making. Given the severity of the situation the CBI should have formally notified the government with a recommended course of action based on its assessment.

Regarding both the CBI and the FME they were seen as unwilling to “share the concerns they had about the Icelandic banks with their EU counterparts before the crisis exploded.” (Jännäri, 2009, p. 12). The Icelandic authorities were thus seen as being protective of the banks and trying to tone down worries expressed by their foreign counterparts. As Jännäri points out, this undermined the credibility of the FME and the CBI in the eyes of their colleagues among foreign supervisors and central banks (Jännäri, 2009, p. 12). This lack of credibility obviously made it even more difficult to get advice and support from institutions in other countries when it was much needed.

8. Could the crisis have been prevented?

The Icelandic government should have encouraged and if necessary enforced more risk mitigation via regulations, monitoring and supervision of the banks’ cross border activities long before the crisis. It is clear that credible action to mitigate those risks was not taken. The FME did not have institutional capacity to supervise the banks and the CBI’s reserves were too low to act as a lender of last resort.

It is possible that the collapse of the banks could have been prevented had the government (the prime minister and the cabinet) taken a drastic measure and insisted on downsizing the banking sector or relocating most of the banks’ cross border operations. As Buiter and Sibert forcefully argue, it ought to have been clear to everyone that the banks’ business model was not viable long before the global economic and financial crisis hit in the fall of 2008. “This was clear in July 2008, as it was in April 2008 and in January 2008 when we first considered these issues. We are pretty sure this ought to have been clear in 2006, 2004 or 2000” (Buiter and Sibert, 2008a, p. n.p). The government effort to try to improve the image of the banks in this situation was absurd.
According to the SIC “In replies made by administrators of governmental institutions who reported to the SIC, the statement was frequently encountered that it did not fall under the functional area of the person concerned, or his institution, to address or take responsibility for the project in question. It was also repeatedly stated, that other institutions or officials were responsible for such issues or tasks” (SIC, 2010a, p. 18). Given this, it is imperative for the government of Iceland to look carefully at how the obligations of individual institutions and officials may be better defined and the division of labor clarified and made sharper. This unclarity only made things worse when the crisis hit and added to the confusion, exactly when the government needed to act swiftly and forcefully.

**Conclusions**

It is clear that, by promoting the idea that Iceland should become an international financial centre, the government expressed faith in the banking sector and encouraged its expansion. The President of Iceland was also a strong supporter of the expansion of the three largest banks as can be seen from speeches he made overseas. The government generally welcomed the expansion of the banks and did not take credible measures to protect the economy in the event of a banking crisis. Private interests via the Iceland Chamber of Commerce aided by academics, including internationally recognized scholars, also published reports that could be used to justify government inaction.

The government, including key cabinet ministers responsible for the banking sector, did not take international criticism seriously and, according to the Special Investigation Commission, ministers focused too much on the image crisis facing the banks rather than the obvious problem. They seem to have thought that foreigners needed more information to understand that the Icelandic banks were built on solid ground and therefore launched a cross border PR campaign. The president also supported this campaign in his speeches overseas. It is possible that the collapse of the banks could have been prevented had the government (the prime minister and the cabinet) taken a drastic measure and insisted on downsizing the banking sector or relocating most of their cross border operations.

Can the government of Iceland be charged with negligence before and during the crisis? The Special Investigation Commission is of the opinion that the Prime Minister, the Minister of Finance, and the Minister of Business Affairs, showed negligence during the time leading up to the collapse of the Icelandic banks by omitting to respond in an appropriate fashion to the impending danger for the Icelandic economy that was caused by the deteriorating situation of the banks. Furthermore, the SIC was of the opinion that the Director General of the FME, and the three Governors of the CBI, showed negligence in the course of particular work during the administration and monitoring of laws and rules on financial activities.

While this is a case study of Iceland, some of the lessons can have a wider relevance than for Iceland only. This is especially true for small countries with a large banking sector, using their own currency, and with limited fiscal space to support their banks during a crisis.

In the case of Iceland the so called Viking spirit of Icelandic businessmen accompanied by aggressive risk taking and bold business behavior can be highly detrimental for a small economy especially when a global economic and financial crisis hits. The combination of risk
seeking behavior of businesses, in this case in the banking sector, and an inactive or negligent
government can result in the collapse of a country’s economy.

It is imperative that the government of Iceland look carefully at how the obligations of
individual institutions and officials may be better defined and the division of labor clarified
and made sharper.

The Icelandic government should in the future encourage and enforce more risk mitigation
via regulations, monitoring and supervision of private sector cross border activities. This ap-
plies not only to the banking sector but also to other sectors such as the energy sector. More
research needs to be done to see if the government has taken sufficient steps in its legislative,
regulatory and institutional reforms to reduce the probability of another catastrophic collapse
occurring in the future.

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References


