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Introduction

Over the span of three days in October of 2008, the three largest Icelandic banks–Kaupthing, Landsbanki, and Glitner–collapsed. The assets these three banks held constituted about 85% of the entire banking system, estimated at ten times Iceland's gross domestic product. The Icelandic people have largely attributed the collapse to the actions of the overzealous and inexperienced Icelandic bankers. In 2003, Richard Thomas, a Merrill Lynch credit analyst, described the risk-seeking behavior of Icelandic bankers as "too fast, too young, too much, too short, too connected, too volatile." (Jónsson, p. 123) But throughout the boom and eventual bust, much of the Icelandic financial sector was unrestrained and poorly regulated by its central financial authority. This article investigates the failures of those institutions that were responsible for maintaining the integrity of Iceland's financial system. It also examines the reasons for those failures and the steps taken to mediate and correct them. The main question addressed is whether the current reform is adequate to prevent another collapse or if further changes are required to ensure the future security of the Icelandic financial market.

The Need to Rebuild

With such a catastrophic collapse, Icelanders might be hesitant to rebuild a privatized financial sector, the mishandling of which devastated their economy. However, the Icelandic economy is dependent on a functioning international banking sector and, therefore, cannot shut itself off from the global financial marketplace for fear of another crisis. An international banking sector is necessary for the growth of the Icelandic economy because many of its key companies, in the aluminum smelting and fishing industries, for example, are global companies dealing in international contracts. These companies are largely exporters; thus, international banks are necessary to facilitate foreign exchange transactions. (Skulason) In addition, as domestic businesses recover from this shock to the economy, a reformed commercial banking sector will facilitate lending and business formation. Moreover, although the current generation of Icelanders may be weary of an international financial sector, the lure of cheap credit and higher returns may convince the next generation of bankers to open up Iceland's doors once more. Because of these possibilities, a far-reaching financial reform must alter not only existing legislation but also the Icelandic philosophy toward financial regulation. Reform must instill in Iceland a risk management culture that was absent in the years preceding the collapse and move the Icelandic people from an inclination toward deregulation to an affinity for more supervision.

Icelandic Regulatory Institutions

The main institution responsible for financial regulation in Iceland is the Financial Supervisory Authority (FME, its acronym in Icelandic). It was created in 1999 from a merger of the Insurance Supervisory Authority and the Banking Inspectorate of the Central Bank of Iceland (CBI). (Jännäri, p. 6) According to its website, the FME has a mandate to promote a stable financial services market, maintain a solid foundation for the financial services market, and promote credible and lawful operations. It is also responsible for surveillance of the Depositors' and Investors' Guarantee Fund. (Financial Supervisory Authority of Iceland)

Along with the FME, the CBI shares responsibility in the regulation and promotion of an efficient and secure financial system. Although most of the past supervisory activities of the CBI were passed to the newly formed FME in 1999, a financial stability function was established at the CBI, later becoming a full department in 2001. (Jännäri, p. 5) This Financial Stability Department is responsible for the liquidity and credit rules of financial institutions and overseeing compliance with these rules as well as systemic oversight of the payment and settlements system. It is also responsible for the publication of the Financial Stability Report, a yearly report on the "main vulnerabilities and resilience factors" (Central Bank of Iceland, Vol. 5, pp. 5-6) in the current macroeconomic situation. In October 2006, a cooperation agreement between the FME and CBI was established to facilitate cooperative regulation between the two authorities. (Jännäri, p. 9)

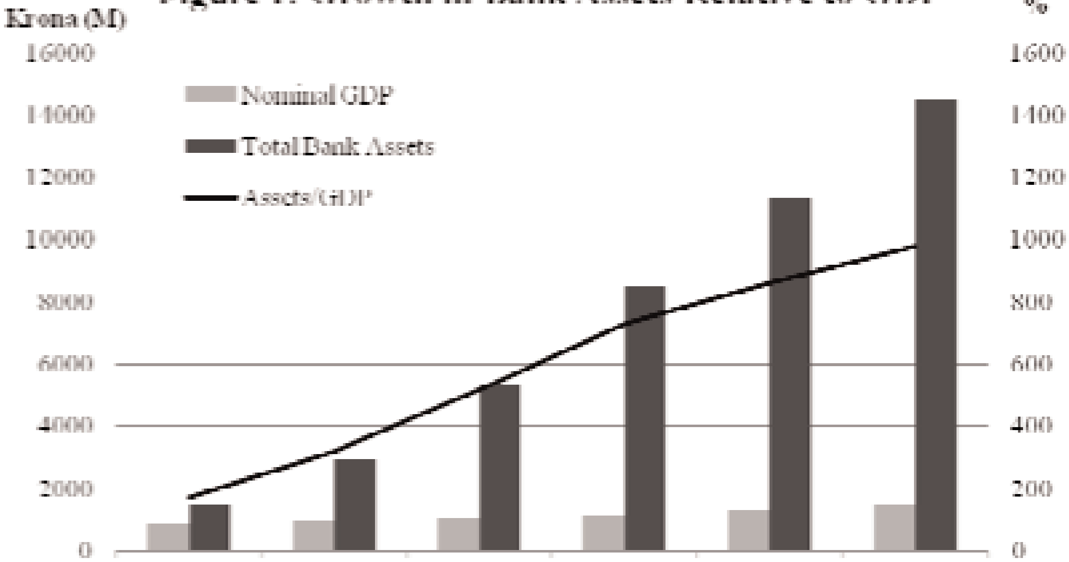
Several ministries also have a hand in financial regulation. The Prime Minister's office is responsible for legislation pertaining to the CBI, and the Ministry for Business Affairs is responsible for all other financial legislation, including legislation for the FME and financial undertakings such as the banks and deposit guarantee system. The Ministry of Finance has a central role in the budget and macroeconomic policies and is responsible for enforcing legislation pertaining to accounting and pension funds. After the crisis, the Ministry of Finance effectively became the owner of the failed banks. In February 2006, a Consultative Group consisting of representatives from the Ministry of Finance, the Ministry of Business Affairs, the FME, and the CBI was established through a Memorandum of Understanding to facilitate cooperation between these ministries in the area of financial stability. Although not a decision-making body, it was used as a forum for the exchange of information between the many regulatory authorities and to discuss the need for management of a possible crisis. (Jännäri, p. 9) The Ministry of Economic Affairs was created after the crisis and oversees both the FME and the CBI.

Liberalization of Icelandic Financial Institutions

In the late 1990s, there was a global movement to liberalize financial markets and capital movements. When it became a member of the European Economic Area in 1993, Iceland opened itself up to the European common market with the free flow of goods, labor, services, and capital. European regulation allowed Icelandic banks to operate branches in any European Economic Area state.[1] Icelandic banks were privatized in the early 2000s, with ownership of the banks centralized to a small number of well-connected individuals instead of spread out over many foreign and domestic investors. This was due to a politicized landmark decision in 2002 that allowed the investor group Samson to hold a de facto controlling interest of 45% in Landsbanki, the

[1]These states include all EU member states as well as Liechtenstein and Norway.

Figure 1: Growth in Bank Assets Relative to GDP



Source: Financial Stability Report 2009.

largest Icelandic bank at the time. The case stood as precedent when Kaupthing and Glitner were created in a process of mergers, and the FME was therefore unable to limit the concentration of ownership during the privatization process. There was little interest by international banks in entering and competing in Iceland's financial market because of the country's small volatile market and currency area. One international bank that did attempt to enter the Icelandic market was turned down, likely for protectionist reasons. The end result was three major Icelandic banks in the hands of a small group of well-connected people, who, instead of possessing the traditional commercial banking mindset, favored a strategy of risky and fast-paced growth common to investment bankers. (Jännäri, p. 9)

After the final steps of privatization took place in 2003, the largest banks went on leveraged buyout sprees across ¬Scandinavia and Britain, financing their risky endeavors through debt accumulation. The stage was set for exponential growth in the financial sector, as yield-hungry investors looked to the small country for high returns. As illustrated in Figure 1, Kaupthing, Landsbanki, and Glitner grew their assets by 20-fold in seven years, supported by favorable credit ratings from international rating agencies. But although the private sector grew rapidly, Iceland did not see an equal increase in a supervisory presence. In the years preceding the collapse, the booming financial market was patrolled by an inadequate supervisory system.

Failure of Institutions

The causes of the financial crisis and the failures of the regulatory framework have been assessed by two major reports. The first report, published in March 2009, was conducted by the former Director of the Finnish Financial Supervisory Authority, Kaarlo Jännäri, as part of the Stand-By arrangement with the International Monetary Fund and several other Nordic countries. The second inquiry, published in April 2010, was conducted by the Special Investigation Commission (SIC) created by the Icelandic Parliament to investigate and analyze what led to the collapse of the three banks. Given the central role played by Icelandic institutions before and during the financial crisis, this article examines some of the inadequacies of these institutions.

Financial Supervisory Authority

A supervisory authority for an international banking system should have knowledge of finance, economics, the operations of banks, and national and international banking legislation. Because Iceland is a small nation, the supervisory authorities had been strained in their efforts to find and retain employees with all of the appropriate qualifications. (Peterson) The rapid expansion of the banks, particularly from 2004 to 2006, intensified this deficiency. The brightest graduates and young professionals, regardless of subject area of study or experience, jumped at the chance to become bankers. Ragnar Arnason, a professor at the University of Iceland who teaches fishing economics, commented on this tendency: "Everyone was learning Black-Scholes" (referring to the options-pricing model); "The schools of engineering and math were offering courses on financial engineering. We had hundreds and hundreds of people studying finance." (Lewis) Because salaries paid to FME employees were not competitive with those in the private banking sector (Jännäri, p. 7), these graduates were lured to the private banks while their regulators struggled to attract young talent. Those who chose to work in a supervisory role were often offered much higher salaries after a few years to switch to work in the private sector. This training camp for bankers created a high influx and outflow of employees. (Óddsson)

The SIC report found that based on the operating expenses of the FME and its budget, the supervisory authority was not financially equipped to monitor the banks, given the pace of growth. The FME also lacked the technical expertise and IT systems to process and evaluate the vast amount of financial data needed in continuous financial monitoring. (Report of the Special..., p. 100) These shortcomings greatly hampered its ability to monitor financial institutions in the years preceding the collapse, which in turn allowed banks to expand in an unsustainable way. Although statutory minimum capital requirements were never breached, the capital ratios that regulators were monitoring did not reflect the true strength of the banks. This was due to the common practice of weak equity, whereby banks secured loans with collateral in their own shares as well as shares of the other Icelandic banks. This cross-financing and weak equity amounted to 70% of the core component of the capital base–about 400 billion Icelandic krónur (or about $7 billion at the height of the króna in 2007). (Baldursson) This overstatement of equity allowed the banks to grow at a more rapid pace. And although the FME had the power to increase required equity, it failed to do so.

It is also apparent that in times of legally questionable activity, the FME neglected to assert its legal dominance over these institutions. Such was the case in the FME's handling of related party lending and large exposures. Post-collapse SIC examinations of each of the three banks revealed that the principal owners were among the largest borrowers. The report was critical of this tendency:

> When it so happens that the biggest owners of a bank, who appoint members to the board of that same bank and exert for that reason strong influence within the bank, are, at the same time, among the bank's biggest borrowers, questions arise as to whether the lending is done on a commercial basis or whether the borrower possibly benefits from being an owner and has easier access to more advantageous loan facilities than others. (Report of the Special..., p. 9)

The lack of an assertive supervisor was particularly detrimental in a country as small as Iceland, because personal ties between lenders and borrowers made it difficult to have truly arms-length transactions. (Skulason) The FME was aware of this dangerous yet commonplace scenario and suggested in 2007 that the banks scale down the outstanding loans to these parties. In general, the banks did not follow the FME's suggested changes. Instead, they rejected the regulator's interpretations and maintained that the exposures were not related. By the time the banks collapsed, the FME had failed to exercise its powers to force changes in the banks' credit risk profiles. In addition, because of bank privacy rules, the FME did not inform the CBI of these known exposures, which were only brought to light during the height of the crisis in October 2008. (Report of the Special..., p. 12) This failure shows that legislation is not enough to ensure a successful regulatory system. Although Iceland had rules on these large exposures in accordance with European Union objectives, their inability (or perhaps unwillingness) to enforce discretion over the banks negated much of the legal framework.

Central Bank of Iceland

The CBI must also share responsibility for the collapse due to its inability to maintain price stability through monetary policy. The influx of foreign capital into the hands of Icelandic bankers caused the economy to over-expand after bank privatization in 2003. It was the responsibility of the CBI to cool the overheating economy. The SIC found that the bank was slow in its decisions to lift rates, and the eventual increase in rates beginning in the spring of 2004 prompted foreign investors to take advantage of the higher returns. The influx of capital only accelerated the boom in domestic consumption. (Peterson) Because it was a small currency area, the attempts of the CBI at contractionary monetary policy had an expansionary effect, so the CBI's actions further stimulated the expanding balance sheets of the banks.

With the uncertainty regarding the effect of interest rate adjustments as a policy tool, the CBI could have also responded by raising reserve requirements, as it is legally responsible for liquidity risk supervision and regulates the minimum liquid assets held by the banks. This was not attempted. The lack of action could possibly have stemmed from the inadequate liquidity stress tests conducted by the CBI and FME. Although some stress tests were conducted on the banks' liquidity, the worst scenario tested was if one of the banks would run into difficulties. They did not consider the possibility that all three banks could simultaneously face a collapse. Although the scenarios tested were in line with international best practices, the CBI could have required more stringent tests considering the large amount of foreign assets of the Icelandic banking system and the interconnectedness of the banks. These tests were also weakened because they were conducted off-site with figures supplied by the banks, because the CBI did not have an explicit legal right to conduct tests on-site to verify the validity of those figures. Instead, internal auditors performed annual checks to ensure reliable reporting by the banks and submitted results to the CBI. Internal audit reports cited few deficiencies, yet in retrospect it is apparent that in some cases the banks reported overstated and misleading figures. If the CBI had the right to conduct tests on-site, instead of relying on second-hand reports from internal auditors, some instances of fraudulent reporting may have been avoided. (Jännäri, pp. 24-25)

Given the large amount of foreign debt held by the banks, the CBI was in no position to supply the needed liquidity as a lender of last resort and was therefore unable to guarantee a stable banking system. The CBI neglected to build up foreign exchange reserves to adequately cover the international risks increasingly taken on by the banks. Foreign currency deposits grew to eight times the CBI's foreign currency reserves. (Report of the Special..., p. 5) The CBI only held 20% of the total short-term foreign liabilities in gross foreign reserves. By 2007, that number had dropped to 7%, as foreign currencies made up more than 70% of the three largest banks' balance sheets. (Jännäri, p. 15) This, in conjunction with an underfunded Depositors' and Investors' Guarantee Fund, only exacerbated the run on Icelandic banks once international credit lines dried up. After the crash, the CBI faced bankruptcy and was recapitalized at the expense of taxpayers.

Parliament

According to findings of the SIC, supervisory actions to prevent the collapse of the expanding financial sector were required no later than 2006 if Iceland was to avoid a severe impact on the value of its assets. However, national pride in the banking sector, with continued support from many politicians, may have made this sort of restriction by the FME or CBI difficult to implement. Critics believe that the close ties between the banks and the political parties that enabled their privatization "programmed virtually the entire political class and civil service to think that is was not a good idea to get in the way of the banks." (Gylfason, p. 148) According to the coalition agreement between the Independence Party and Social Democratic Alliance, it was their policy to "ensure that financial activities could continue to grow domestically and expand into new fields of competition with other market areas." (Report of the Special..., p. 2) The government also encouraged domestic multinational corporations to have their headquarters remain in Iceland, although it was known that the small government could not support a failed financial sector. In February 2006, a working group established in 2004 by Parliament delivered a report on the uneasy status of the financial markets, highlighting the size of the financial sector and the need for contingency planning for a crisis situation. The suggested amendments to the supervisory power were never formally submitted to Parliament as a bill, and there was only a short discussion of the report by Parliament. It seemed that the legislative branch did not believe tighter control over the financial sector was a priority until it was too late. The proposal was later taken up again and used as a basis for the emergency legislation in October 2008. (Jännäri, p. 15)

Shared Responsibility

There was confusion between the regulatory authorities and other government units over which entity was ultimately responsible for emergency actions during times of crisis. During the weeks leading up to the crash, there was a large amount of uncertainty about the powers and responsibilities of several of the supervisory institutions. The Consultative Group, consisting of the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME, and the CBI, had been established in February 2006 through a Memorandum of Understanding. (Jännäri, p. 9) Although it was not established for the express purpose of creating contingency plans and had no legal authority over any part of the government, the Consultative Group largely took on that role during the crisis. However, there seemed to be a lack of clarity as to who was responsible for the preparations called for in the Group's plan of action. The Group was unsuccessful in synchronizing actions that could fall under several governmental bodies, as in the case of the Landsbanki's international branch accounts, known as Icesave. The Icesave accounts were Internet saving accounts offered abroad to British and Norwegian depositors. There were several governmental institutions that may have had jurisdiction over the international branches, such as the FME, CBI, Ministry of Finance, and Ministry of Foreign Affairs. However, because jurisdiction was unclear, no governmental institution stepped forward to request that Landsbanki transfer its accounts to a subsidiary. Transferring these accounts to a subsidiary outside of Iceland would have released Iceland's government from being responsible for insuring those deposits if the bank were to default. When the bank failed, Iceland found itself responsible for not only domestic deposits but also more than 400,000 deposits in the United Kingdom and the Netherlands. Statements made to the SIC by ministers and governmental representatives after the crisis included much finger pointing, with few assuming responsibility for the lack of action. (Report of the Special..., p. 73)

Post-crisis Regulatory Reform

There have been several steps taken by the Icelandic government to make far-reaching systemic reforms, prompted by the conclusions of the two major investigative reports. Kaarlo Jännäri's report largely pointed to the deficiencies in the legal framework. His suggested changes included decreasing the number of ministries, merging the CBI and FME, granting more discretionary powers to the FME, creating a national credit registry, applying stricter rules on large exposures and lending to the banks' own large shareholders, conducting more on-site inspections to verify off-site supervision, and improving the deposit guarantee system. (Central Bank of Iceland, Vol. 5, p. 12) The SIC report had similar conclusions, arguing that the failure was largely due to reckless bank actions that were unobstructed by legislation. However, the report did identify three former ministers, three former CBI governors, and the director of the FME as having shown negligence in their duties. More importantly, the report pointed to the dangerous tendency of supervisory institutions to interpret regulatory options narrowly, thereby allowing banks to bypass regulation with ease. The Commission criticized the regulatory agencies for not making more efforts to investigate the underlying risk of the banking system and for failing to have a governmental contingency plan in place during the collapse. These findings have prompted many of the reforms, discussed in this article, which are currently under way in Iceland.

Act on Financial Undertakings

In response to the Jännäri report, the Ministry of Economic Affairs was established as the administrator responsible for both the FME and CBI, intended to enhance macroprudential supervision. Macroprudential supervision, as the CBI explained in the foreword to the 2010 Stability Report, is a concept promoting the use of "prudential tools to reduce risk in the financial system as a whole rather than in individual parts of it." (Central Bank of Iceland, Vol. 6, p. 4) Such risks include those resulting from systemically important individual financial institutions and credit and asset price cycles. A committee was appointed by the head of the newly created Ministry to review the legislative framework and draft more stringent legislation. The new bill on the financial market was proposed to the Icelandic Parliament on January 29, 2010.

Several reforms were incorporated in this bill that expanded the range of supervisory activities and intended to improve risk management and bank governance. (Ministry for Foreign Affairs) The FME was given increased discretionary powers, such as tightening credit limits for financial institutions and eligibility standards for potential investors. The bill also established a national credit registry containing data on all loans granted above a certain amount. The registry would store this information to monitor banks' credit risk and households' and firms' debt levels, allowing regulators an aggregate view to better monitor systemic risk. (Central Bank of Iceland, Vol. 5, p. 88)

The bill also addressed many of the problematic practices that banks conducted in the years preceding the crisis, clarifying the rules that were already in place and proposing new restrictions. The bill covered such actions as lending against collateral of the bank's own shares and the shares of other banks, lending to key personnel within the bank, and taking on large exposures. It also increased the provisions covering internal and external bank auditing. Members of the board of directors of financial institutions were given greater responsibility and accountability, and tighter rules on remuneration, bonus systems, and severance agreements were established. In addition to this Act on Financial Undertakings, three other bills were presented to Parliament by May 2010 concerning Deposit Insurance, Investment Funds, and Insurance Activities.

Central Bank Act

An amendment to the Central Bank Act was passed in February 2009 that changed the CBI's governance structure from a three-member Board of Governors to a two-member Board consisting of one Governor and one Deputy Governor, both appointed by the Prime Minister. The amendment also established professional requirements for both positions. A Monetary Policy Committee was established as a decision–making body for domestic interest rate policies and exchange rate policies. The Committee is composed of the Governor and Deputy Governor, one senior CBI official, and two outside experts. (Central Bank of Iceland, Vol. 6, p. 58) These changes were spurred by a political controversy surrounding the head of the CBI from 2005 to 2009, David Oddsson, who also served as Prime Minister from 1991 to 2004. Johanna Sigurdardottir, who became Prime Minister in February 2009, had made it a priority to remove the central bankers when she came to power, believing they were largely to blame for allowing the buildup of untenable debt. Mr. Oddsson refused to leave the CBI after Mrs. Sigurdardottir's call for his resignation, so the Central Bank Act was passed by Parliament to forcibly remove him from his office. (Gilmore)

Promoting Intergovernmental Cooperation

Attempts have been made to improve the relationship between the CBI, the FME, and relevant ministries, as a closer collaboration between these institutions could help prevent some of the past deficiencies in the regulatory framework from arising in the future. In September 2010, the Committee on Financial Stability was established by an agreement signed by the Prime Minister, Minister of Finance, Minister of Economic Affairs, Governor of the Central Bank, and Director of the Financial Services Authority. The aims of the Committee are stated as follows:

> The committee on financial stability shall enhance cooperation, facilitate the exchange of information and increase preparedness to maintain financial stability and coordinate crisis prevention efforts. The committee also induces more transparency regarding the institutions individual and shared responsibilities and areas for cooperation. (Central Bank of Iceland, August 2010)

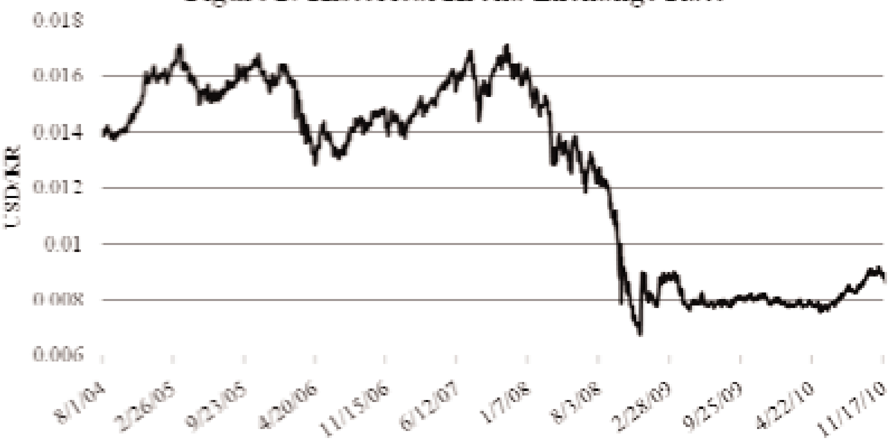
Although not a decision-making body, the Committee will hopefully increase cooperation within the government, facilitating policy making during times of financial trouble.

The CBI and FME have also made attempts to consolidate their monitoring policies in a joint task force, created in Feburary 2008. The task force is intended to improve monitoring group market liquidity. (Jännäri, p. 23) Már Guðmundsson, Governor of the CBI since August 2009, reiterated the need for this type of cooperation in his foreword to the 2009 Report on Financial Stability. He argued that for the CBI to fulfill its duty as lender of last resort and maintain financial stability, it must have access to information about distressed financial institutions, large exposures to the system, and other information possessed by financial supervisors. Because exchange rate movements can greatly affect domestic financial institutions and knowledgable personnel are limited in such a small country, the need for enhanced cooperation between the two entities is great. (Central Bank of Iceland, Vol. 5, pp. 5-6)

Judicial Decisions

A common practice of banks during the boom years was to offer loans linked to foreign currencies, such as the Japanese yen, allowing borrowers to take advantage of low international interest rates. However, beginning in 2008, the króna began declining in value and had lost more than a third of its value against these other currencies by the time of the banks' collapse (see Figure 2). The repayment costs to consumers for these loans became prohibitively expensive. In June 2010, Iceland's Supreme Court ruled that car loans linked to foreign currencies, worth 186 billion Icelandic krónur, were illegal and later clarified that banks should use domestic interest rates when calculating charges. This ruling effectively passed the liability from households to the banks. (Ward) As the case stands as precedent, the decision strongly dissuades future banks from attempting such high-risk tactics, because they will be unable to transfer the risks to their borrowers.

Figure 2: Historical Krona Exchange Rate



Source: Central Bank of Iceland.

Criminal Cases

On September 28, 2010, Parliament voted to bring charges against former Prime Minister Geir Haarde, following the suggestions of the SIC report. He will be tried for committing "economic negligence" during his tenure, from 2006 to 2009, because he allowed the financial industry to expand beyond the control of the government. Next in the process, Parliament must appoint a special prosecutor to bring the charges in the first sitting of the Landsdomur, a chamber created in 1905 to try ministers accused by Parliament of crimes. Parliament voted against trying three other ministers: Bjorgvin Sigurdsson, the former Minister of Commerce; Arni Mathiesen, the former Minister of Finance; and Ingibjorg Solrun Gisladottir, the former Minister of Foreign Affairs. ("Former Icelandic…")

Moving Forward

Iceland is a small country with its own currency and a large, internationally exposed financial industry. Although greater supervision may have lessened the severity of the collapse, its economic model, which was dependent on an oversized financial sector, was inherently flawed. Iceland has made strong attempts to correct the errors in its regulatory system, which will restrict future banks from growing to such unsustainable levels. However, legal reform alone may not be enough to prevent another crisis. The supervisory system, in particular the FME, failed to exercise power over the banks even when it had the legal capacity. A corresponding change in the society's views on regulation and supervision is needed to supplement the current financial reform. The severe consequences of the financial crisis, including a deep recession, restrictions on currency exchange, loss of real wealth, and a damaged international reputation, have helped bring that change to the Icelandic people. The ideology of a loosely regulated free market, which allowed a banking system to expand dangerously while a weak supervisory framework lost control over the banks, has been called into question. Prime Minister Johanna Sigurdardottir expressed this ideologic shift during the release of the SIC report in April 2010.

> Mistakes were certainly made. The private banks failed, the supervisory system failed, the politics failed, the administration failed, the media failed, and the ideology of an unregulated free market utterly failed. This has called for a fundamental review of many elements of our society. (Prime Minister's Office)

The regulatory system was unsuccessful because it lacked the knowledge as well as the will to enforce existing regulations. The supervisory institutions, the banks, Parliament, and the Icelandic people all failed to push for stronger regulatory enforcement until the banks reached a point of no return. Although the crisis severely harmed Iceland, it instilled a healthy sense of distrust that is at the core of financial supervision. The government and the public must demand tighter regulation over the banks, not allowing them to expand in an unrestrained manner because of apparent short-term economic benefits. The foundation of this legal reform is now in place. What remains to be seen is if Iceland keeps financial regulation a priority, maintaining and updating the legislation as financial markets and instruments evolve. Hopefully, the lessons from this crisis will entice the Iceland government and voters to insist that their government constantly regulate and supervise financial institutions, allowing a newly formed financial sector to prosper in a controlled and sustainable fashion.

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