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Explanations of the Icelandic Bank Collapse

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HÁSKÓLI ÍSLANDS

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Several explanations have been offered for the collapse of the whole Icelandic banking sector in the autumn of 2008. Robert Wade, Professor of Political Economy at the London School of Economics, and Sigurbjorg Sigurgeirsdottir (2010), Lecturer in Public Administration at the University of Iceland, write that from the early 1990s, Iceland was ruled by "zealous neoliberals, who believed that financial markets were 'efficient' and self-adjusting". Wade and Sigurgeirsdottir (2010) say that "the bankers' wild behaviour was the central factor" in the bank collapse, adding however that in the end, "the responsibility lies with the Reykjavik government and the Central Bank". Ha-Joon Chang (2010), Reader in the Political Economy of Development at Cambridge University, agrees that before the collapse Iceland conducted a "neo-liberal" experiment, which failed miserably. Here, I shall argue that blaming the collapse on neo-liberalism is implausible for two reasons: No neo-liberal experiment was conducted in Iceland and the Icelandic financial sector operated under the same legal and regulatory framework as corresponding sectors in other member-states of the European Economic Area, EEA. Blaming the collapse on "the bankers' wild behaviour" may seem more credible, but that also has its difficulties. The Icelandic banks grew rapidly in the years before the collapse, but this was because they were able to find customers. If they acted irresponsibly, did their customers not also act irresponsibly? And if so, how can we explain that it was only in Iceland that the whole banking sector collapsed, but not in other countries? I shall offer two more plausible explanations for the Icelandic bank collapse, pointing out two kinds of systemic risks particular to the Icelandic situation. One such risk was the interdependence of the three main banks and their largest domestic corporate customers, which can at least partly be attributed to the crony capitalism developing in Iceland in 2004–8. The other systemic risk was that the banks' field of operations, the whole of EEA, was much bigger than their field of institutional support, which turned out, in the end, to be only Iceland. Possibly, the former systemic risk can to some extent be blamed on regulatory capture: The Financial Supervisory Authority and the Competition Authority worked with, rather than monitored, the most powerful Icelandic capitalists. The second systemic risk proved, however, fatal: in Iceland's hour of need, it stood alone, being refused currency swap agreements with the US Federal Reserve System, and having the branches and affiliates of the Icelandic banks in the United Kingdom closed down by the British government, and one of the banks, as well as Iceland's Central Bank and the Ministry of Finance, put on a list of terrorist organisations.

The Icelandic Free Market Reforms, 1991–2004

When David Oddsson, leader of the Independence Party, formed his first government in 1991, the acknowledged aim of its free market reforms was not to conduct any neo-liberal experiment in Iceland: Rather, it was to bring Iceland, with its hitherto heavily regulated economy, into line with its neighbours in Europe, Ireland, the United Kingdom and the Scandinavian countries. The years from 1991 to 2004 saw the abolition of several public investment funds, previously being used for political patronage, especially in rural areas; the stabilisation of the economy, with inflation falling down to the same level as in neighbouring countries; the gradual elimination of the public debt; a continuing development of the system of individual transferable quotas in the fisheries, widely recognised as the most practical system of managing fisheries; the strengthening of the pension funds, in 2004 the second largest per capita in the world; the simplification and reduction of taxes; and the privatisation of many government enterprises, most importantly of two of the three commercial banks operating in Iceland, the first one having been privatised in 1990 (Gissurarson, 2004). The result was, according to an international study, that the Icelandic economy moved from having been the 28th freest one of 113 economies surveyed in 1990, to being the 13th freest one of 130 surveyed in 2004 (Gwartney, Lawson & Hall, 2012).

While these free market reforms were being implemented, Iceland's economy was opened up with the 1994 membership of the European Economic Area, EEA, which also meant that the same legal and regulatory framework of the financial sector was adopted as in other EEA countries, most of them also being EU countries. The financial sector was monitored by the Icelandic Financial Supervisory Authority, FSA, established in 1998, Iceland's Central Bank having previously performed this function. Markets in general were monitored by the Icelandic Competition Authority, CA. Both the FSA and CA served under the Ministry of Trade and Banking, during all this period in the hands of either Social Democrats or centrists from the Progressive Party, hardly qualifying as "zealous neoliberals". Be that as it may, after some initial difficulties the Icelandic economy began significantly to grow in 1995, and in 2004 Iceland enjoyed the fifth highest GDP per capita in Europe, only surpassed by Luxembourg, Norway, Ireland and Switzerland (World Bank, 2013). The 1991–2004 free market reforms did not lead to a wider gap between rich and poor than in the other Nordic countries, all quite egalitarian. In 2004, the Gini-coefficient—a commonly used, even if controversial, measure of income inequality—was slightly lower in Sweden and Denmark than in Iceland and slightly higher in Norway and Finland (Statistics Iceland, 2007). Moreover, the general affluence in Iceland was not borrowed. By 2004, public debt was negligible, and the total external debt only began to rise significantly in and after 2004, as can be seen from Figure 1, but from then and until 2008 quite dramatically. In retrospect, the year of 2004 seems to have been a turning point.

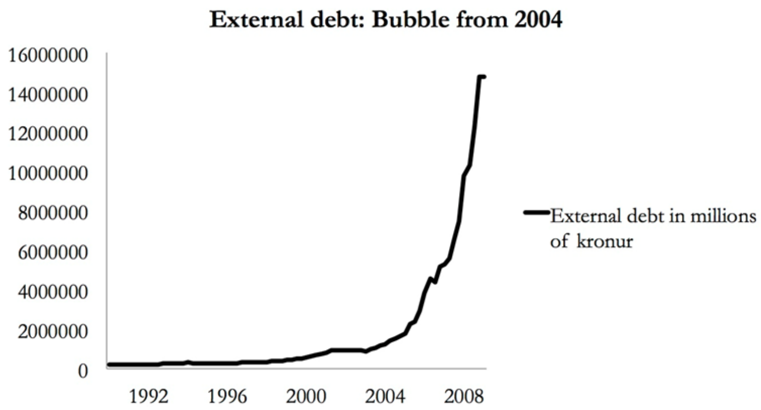

Figure 1. Iceland's External Debt 1990–2008 (Central Bank of Iceland, 2013)

From Market Capitalism to Crony Capitalism

What happened in 2004? Two events stand out. In the summer, a proposal by Prime Minister David Oddsson to amend existing laws on broadcasting and on competition in order to ensure a more competitive media market was passed by parliament. But after a fierce campaign against the proposal conducted by the media owned by wealthy retailer Jon Asgeir Johannesson, the President of Iceland, Olafur R. Grimsson, with close ties to Johannesson, refused to sign the proposal into law, whereupon it was withdrawn. For Iceland's President, normally regarded as standing above politics, this was an unprecedented act. Whereas in the 19th Century the Danish king who was then also the sovereign in Iceland had often used this prerogative, no President of the Republic, established in 1944, had refused to ratify laws passed by parliament, and this

prerogative was generally considered by political scientists to be "a dead letter" (Olafur R. Grimsson & Thorbjorn Broddason, 1977, p. 138–9). Moreover, Jon Asgeir Johannesson was no ordinary businessman. His company, Baugur, had acquired control over almost two thirds of the Icelandic retail market, and he was busily buying other companies in Iceland and also expanding abroad. His business practices and his lifestyle were not typical of an Icelandic businessman, as could be observed in the criminal investigation of his company Baugur which was going on at the same time as the media battle. Johannesson's business partner in the United States, Jon Gerald Sullenberger, an Icelandic-American, maintained a yacht in Miami, secretly owned by Johannesson, where they used to entertain visiting Icelandic bankers and businessmen, with the occasional help of hired women (Jon Thoroddsen, 2011, p. 67). But in early 2002 Sullenberger suddenly turned against Johannesson because, as he at least believed himself, Johannesson had behaved improperly to Sullenberger's wife (Solvi Tryggvason, 2010, p. 133 and 150). In the summer of 2002, Sullenberger came to Iceland and filed a charge against Johannesson at the economic crime unit of the Icelandic Police for having, in cooperation with himself, falsified an invoice for goods. So angry was Sullenberger with Johannesson that he disregarded the fact that he was incriminating himself by the charge.

Since Prime Minister David Oddsson had in January 2002 publicly criticized increasing concentration in the retail sector and since one of Oddsson's friends was Sullenberger's lawyer, Johannesson chose to believe that Oddsson was behind the criminal investigation following Sullenberger's charge. Jon G. Sullenberger (2005) strongly denied this, however. Sometime in 2002, Johannesson had secretly acquired *The Newspaper* (Frettabladid), which derived its revenue from advertisements only and which was distributed free of charge to all urban households in Iceland, thus being widely-read. In 2003, possibly to facilitate his defence in the criminal investigation, Johannesson bought the only significant private television station in Iceland and a daily tabloid, *DV*, and later also a string of popular magazines. By then, he controlled almost all the Icelandic media except one daily, and the government broadcasting service. He demonstrated his immense influence in the successful campaign against Oddsson's media proposal. The second important event happened in the autumn of 2004 when Oddsson stepped down as Prime Minister to be replaced by Halldor Asgrimsson, leader of the Progressive Party. This had been agreed in 2003 when Oddsson's Independence Party and Asgrimsson's party had formed their third coalition government. Subsequently, Oddsson served as Foreign Minister for a year, Asgrimsson then appointing him as one of the three Governors of the Central Bank. With Oddsson's departure from politics, Johannesson and his cronies, now flying around the world in private jets and partying on private yachts moored in Monaco, while spending much of their time in luxury apartments in New York and London, lost their most formidable critic. Johannesson and his cronies gained an aura of invincibility, as some commentators pointed out (Bjorn Bjarnason, 2011). In Iceland, crony capitalism was replacing market capitalism.

Debt Accumulation and Regulatory Capture

Jon Asgeir Johannesson used his huge resources to the utmost when defending himself against Sullenberger's charge. For example, he hired Jonatan Thormundsson, Professor of Law at the University of Iceland, to write a report critical of the police's investigation methods. The report was made public in 2005, soon before Johannesson expected to be brought before a court (Jonatan Thormundsson, 2005). When Johannesson was finally indicted after a long and thorough investigation, a regular columnist at his *Newspaper*, Thorvaldur Gylfason (2005), Professor of Economics at the University of Iceland, wrote: "The government attack on Jon Asgeir Johannesson failed last summer after the President refused to sign the media law. It seems that now the aim is to go after Johannesson and five other people before the courts. What is behind this? Perhaps just a lack of respect for the free market and the division of power that goes with it, and also for the necessary separation of executive, legal and judiciary powers. Who knows?" Professor Gylfason completely ignored Sullenberger's claim that he was acting on his own. When indicted, Johannesson hired a bunch of media-savvy lawyers to argue his case, in public as well as in court. Judges handled the case carefully, finding all kinds of formal faults with it, so for a long time it bounced back and forth in the judicial system. Commentators spoke of a surprising leniency towards Johannesson (Oli B. Karason, 2011). Finally, however, in early 2008 the Supreme Court convicted Johannesson on the charge, originally filed by Sullenberger, of having participated with Sullenberger in falsifying an invoice for goods. Johannesson was acquitted of various other charges brought up during the investigation. He and Sullenberger both received a suspended prison sentence of three months. Later, in early 2013, Johannesson and two of his business partners were convicted by the Supreme Court for tax evasion.

Meanwhile, from his victory in the 2004 media battle until the 2008 bank collapse, Johannesson was probably the most influential person in Iceland, with his business empire, newspapers, magazines and a television station. The Social Democrats accepted not only the support of his media, but also large donations from Baugur and other companies of his. After Oddsson's departure from politics, the Independence Party also started to accept donations from his companies. Johannesson's clan showed their political clout in the 2007 parliamentary elections. Johannesson's father then took out full-page newspaper advertisements advising voters to cross out the name of Bjorn Bjarnason, who as Justice Minister had been supportive of the police when it was criticized in the Baugur affair. The result was that Bjarnason fell by one seat on the party list. In this period, Johannesson and his cronies acquired Glitnir, one of the three Icelandic commercial banks, and continued enjoying easy credit in the other two. Regular guests at the President's residence, in-between their frequent trips to London, Monaco and New York, Johannesson and his cronies continued their spending spree abroad, financed by heavy borrowing. The Special Investigation Commission, SIC (2010b, p. 14), on the bank collapse, appointed by Parliament, concludes in its report: "Of all the business blocks, which had borrowed liberally in the Icelandic banking system, the most conspicuous one was business associated with Baugur Group. In all three banks, as well as in Straumur-Burdaras, this group had become too large an exposure. The SIC considers that this has constituted a significant systemic risk, as collapse of one enterprise could affect not only one systematically important bank but all the three systematically important banks. The financial stability, therefore, would be significantly threatened by, for instance, Baugur Group, which had as indicated in the report, … substantial liquidation problems in the latter half of 2008." Figure 2, drawn with data from the SIC report, on banks loans to Baugur and related companies from the three Icelandic banks in 2005–8, illustrates this point.

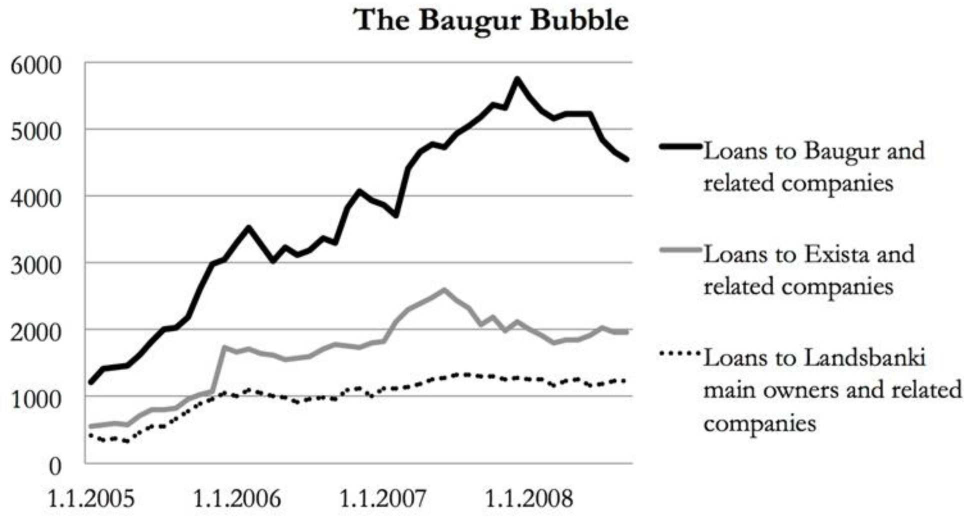

Figure 2. Loans from Icelandic banks to Baugur and related companies in comparison with loans to the two other main business groups (SIC, 2010b, pp. 6–8)

Some might argue that it is unfair to single out Johannesson and his associates. Other businessmen were playing in the field as well. But there are several reasons for focusing on this group. First, as the SIC report demonstrates, Johannesson and his cronies were by far the biggest debtors in the Icelandic banking sector. This can be seen in Figure 2, where the total bank loans to the other two main clusters of businesses in Iceland, as defined by the SIC, are shown, for comparison, below those of Johannesson's group. In the second place, Johannesson's clan controlled not only two thirds of the retail market, and several other big companies in Iceland, but also almost all the private media, acquiring much more influence over public opinion—and over those who depend on public opinion, politicians, journalists, writers and entertainers—than other groups possessed. Thirdly, Johannesson and his cronies were no ordinary businessmen, as the sordid details of the Baugur case illustrated. The two regulatory agencies entrusted with monitoring the activities of Johannesson and his cronies, as well as other businessmen, did however little. In fact, the two agencies both seem to have been subject to regulatory capture. The Financial Supervisory Authority's Chairman of the Board was Jon Sigurdsson, a former Social Democratic Minister of Trade and Banking who had overseen the privatisation of the first government bank in 1990. Sigurdsson worked diligently with the Icelandic banks on trying to improve their image abroad (SIC, 2010a, p. 55). The FSA did not in practice object to companies owned by Johannesson's wife or his cronies being classified as unrelated to his companies, as is criticized in the SIC report (2010b, pp. 12–13). The Competition Authority's Chairman of the Board was Gylfi Magnusson, Professor of Economics at the University of Iceland. Neither he nor the CA initiated any significant actions against Johannesson's dominance of several markets.

Political Responsibility

Iceland's Central Bank, where former Prime Minister David Oddsson was one of the three Governors from the autumn of 2005, consistently warned against the expansion of the banks abroad, mainly driven by Jon Asgeir Johannesson and his cronies. In a speech made a year before the collapse, Governor Oddsson (2007) said for example: "Iceland is becoming uncomfortably beleaguered by foreign debt. At a time when the

Icelandic government has rapidly reduced its debt and the Central Bank's foreign and domestic assets have increased dramatically, other foreign commitments have increased so much that the first two pale into insignificance in comparison. All can still go well, but we are surely at the outer limits of what we can sustain for the long term." In private meetings with Prime Minister Geir H. Haarde, Oddsson's successor as leader of the Independence Party, and with Foreign Minister Ingibjorg S. Gisladottir, leader of the Social Democrats, Oddsson was even more emphatic, as described in the 2010 SIC report. One such meeting was on February 7th, 2008, with the Finance Minister, the two other Governors and two officials also present, where Oddsson described the deep distrust he had encountered abroad towards the Icelandic banks, especially towards Kaupthing bank. On April 1st 2008 Oddsson met again with the two political leaders, accompanied by his two colleagues from the Central Bank, to discuss the instability of the banks, now in particular the National Bank, Landsbanki. Again, Oddsson met with the two political leaders on July 8th 2008, after a trip to Basel and a discussion with the Governor of the Luxembourg Central Bank, issuing stern warnings (SIC, 2010b, pp. 69, 73, 95 and 127).

Nevertheless, the Special Investigation Commission found the three Governors of the Central Bank negligent in that they had not obtained sufficient information about the real financial conditions of the banks, in particular the National Bank, Landsbanki, when it began taking deposits in the United Kingdom in 2006, and Glitnir, when the Central Bank bought a majority share in it in the autumn of 2008 (SIC, 2010b, pp. 152–160). The three Governors strenously objected however to these charges, arguing that they had had no legal right to demand this kind of information. It was only the Financial Supervisory Authority which could get it, under the law (SIC, Icelandic, online addenda, addendum 11-5). This controversy was in a sense resolved in the summer of 2013 when the Icelandic parliament, on the initiative of the Central Bank itself, now under new management, passed into law amendments to the existing statutes on the Central Bank, giving it the right to demand information about balance sheets of financial institutions and business companies. If it had had this right before, then it would obviously not have been necessary to pass the new law (Hannes H. Gissurarson, 2013).

The Special Investigation Commission also found some politicians and officials negligent, on various grounds. Consequently, a small majority in parliament decided, largely along party lines, to indict Prime Minister Geir H. Haarde, but not the leader of the other coalition party, Ingibjorg S. Gisladottir. Haarde was however acquitted of all but one charges before a specially convened court, consisting of Supreme Court Judges and political representatives. The court found him only guilty of not having followed a strict interpretation of the Icelandic constitution which seemed to require a discussion of the impending crisis at formal cabinet meetings—something he had not done, although of course he and other cabinet ministers spoke to one another about this more informally. A minority in the court wanted to acquit Haarde of all charges. In retrospect, many people in Iceland feel that the relevant ministers and officials should have shouldered their responsibility, as they indeed did, all losing their positions, but also that none of them was guilty of any criminal behaviour, such as deliberately falsifying records, let alone invoices.

Plausible Explanations of the Collapse

The main explanation of the collapse of the Icelandic banks is, of course, that in a grave international financial crisis countries with a relatively large financial sector, such as Iceland, are the most exposed. While the additional systemic risk created by the Icelandic 2004–8 version of crony capitalism—when a small group dominates the economy and uses its influence to curry political favours—may have contributed to the fall of the banks, it was probably not crucial. The Icelandic banks grew rapidly, but so did other banks, like Santander in Spain. They engaged in "wild behaviour", as Wade and Sigurgeirsdottir put it, but so did other banks, like the Royal Bank of Scotland into which the British government had to inject £256 million in 2007–2011 (National Audit Office, 2012), or Barclays Bank which was in 2012 fined £290 million for attempting to rig the Libor, the London inter-bank lending rate (Aldrick, 2012), or HSBC which had in 2012 to pay US authorities £1,180 million, more than one billion pounds, to settle allegations that it had failed to enforce rules against money laundering (Blackden, 2012). Again, the Icelandic banks could only grow so rapidly because they found customers, depositors as well as creditors, including big foreign banks. If the Icelandic bankers were reckless, were their foreign customers not reckless as well? However, by offering slightly higher interest rates on accounts online than were available from High Street banks, as both the National Bank, Landsbanki, and Kaupthing did in the United Kingdom and elsewhere—most famously in the "Icesave" accounts—the Icelandic banks undoubtedly created a lot of resentment in the banking sectors in those countries. This may have been reflected in the attitudes of government officials and politicians, usually not immune to vested interest.

What was crucial for the bank collapse was the systemic error in the legal and regulatory framework for the European financial common market: The Icelandic banks' field of operations was the EEA as a whole, whereas the field of institutional support, or insurance, turned out, in the end, to be Iceland alone. It is however misleading when Anne Sibert (2011), Professor of Economics at the University of London, says that Iceland was "overbanked and undersized", A large banking sector is not in itself unsustainable. Switzerland and Luxembourg had and still have relatively large banking sectors, not to mention financial centres such as Jersey and Guernsey. In 2008, the ratio of short-term bank liabilities to GDP was 285% in Belgium, 260% in Switzerland, 211% in Iceland and 156% in the United Kingdom (Norris, 2008). The Icelandic banking sector was only unsustainable because in the hour of need, nobody was willing to help, whereas for example four European countries outside the eurozone, Switzerland and the three Scandinavian countries, received much assistance from the United States Federal Reserve System, FRS, in the 2008 financial crisis, enabling the central banks in those countries to fulfill their functions as lenders of last resort. On 24th September 2008, the FRS announced that the Danish and the Norwegian Central Banks would receive $5 billion each, and the Swedish Central Bank $10 billion, in temporary currency swap lines; on 29th September, the numbers were tripled to $15 and $30 billion respectively (Federal Reserve System, 2008a, 2008b). Analysts in the international financial market immediately noticed that Iceland was not included. In the end, the Danish Central Bank swapped *kroner* for dollars to the staggering amount of $73 billion in total (Government Accountability Office, 2011, p. 205). This enabled it to save Denmark's biggest bank by far, Danske Bank, whose staff, incidentally, had been staunch critics of the Icelandic banks for over-exposure (Christiansen, 2011). Without this help Danske Bank would probably have collapsed, taking down with it the whole Danish banking sector ("Sikke en fest", 2012). Even Switzerland, with a strong currency which most people would accept, received immense amounts of money from America. During the financial crisis, its Central Bank used altogether $466 billion dollars in total in currency swap lines (Government Accountability Office, 2011, p. 205). However, unlike Sweden and Switzerland, Iceland had been a loyal ally of the United States in the Cold War, even supporting the 2003 invasion of Iraq.

A crisis does not necessarily lead to a collapse. With foreign assistance, it would perhaps have been difficult to keep all the Icelandic banks running, but it might have been possible to save one of them—possibly with the shareholders losing most or all of their equity—or at least properly to manage the closure of their operations abroad. But the British Labour government made even this utterly impossible when it ordered the British Financial Supervisory Authority, in the midst of the crisis, on 8 October 2008 to take the British affiliate of Kaupthing over, the British FSA having already seized the British branches of Landsbanki; and then it used an anti-terrorism law to freeze Icelandic assets in the United Kingdom and severely to restrict all capital transfers going to Iceland through London, an international financial centre. For a while, the Icelandic Central Bank and the Ministry of Finance even found themselves at the British Treasury website on a list of terrorist organisations, alongside Al Qaeda and the Talibans, with Landsbanki remaining for quite some time on the list (Lyall, 2008). Why did the American Federal Reserve System provide a generous credit line to the Danish, Norwegian and Swedish Central Banks, while refusing it to the Icelandic Central Bank? Why did the British Labour government save almost all banks in the United Kingdom except the two owned by Icelanders? Why did it use an anti-terrorism law against Iceland, a long-time NATO ally without an armed force? The last word on this has not been said.

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