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HÁSKÓLI ÍSLANDS

Alistair Darling and the Icelandic Bank Collapse

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In the extensive 2010 report on the 2008 Icelandic bank collapse published by the Parliament's Special Investigation Commission, SIC, the emphasis was on domestic factors. The SIC traced the collapse to the rapid credit expansion of the three main banks—Kaupthing, Landsbanki and Glitnir—in the preceding few years. The SIC also found that systemic risks in the Icelandic banking sector had been seriously underestimated, not least because three business groups virtually controlling the banks had obscured their real obligations under a veil of shell companies and fictitious dealings. (Hreinsson, Benediktsdottir & Gunnarsson, 2010, p. 14). While the governors of the Central Bank of Iceland, CBI, had repeatedly warned the government against the banks' rapid credit expansion (Hreinsson et al. 2010, 21, pp. 63, 69, 73), both they and leading government ministers must have realized that their options were limited. The banks were reluctant to sell assets when prices were low, and the authorities had no legal means at their disposal to force the banks to do so. Thus, the CBI and the government took the only course open to them at the time: to try to ride out the storm, stating publicly that the banks were solvent and trying quietly to obtain access to foreign currency. However, in the strained circumstances of 2008, very few foreign central banks wanted to make currency swap deals with the CBI. At the same time as the US Federal Reserve System made large such deals with other Nordic central banks (Government Accountability Office [GAO], 2011), it repeatedly refused them to the CBI (David Oddsson, personal communication, 7 October 2013). The immense credit expansion of the Icelandic banks and, after the Fed's refusal to make currency swap deals with the CBI, the absence of plausible lender-of-last-resort facilities, created a very vulnerable situation, immeditately noticed in international financial markets. Then, into that vulnerable situation entered two decisions taken by the British authorities, almost certainly (and formally) by the Chancellor of the Exchequer Alistair Darling. First, he refused to include the Icelandic-owned British banks in an immense rescue package for British banks announced in October 2008, closing them instead. In the second place, he imposed an anti-terrorism law against one of the Icelandic banks, Landsbanki, and briefly also against the CBI, with catastrophic consequences for what by then remained of the Icelandic financial sector. What was the background of Darling's two crucial decisions? It is the purpose of this paper to try to answer that question.

Darling on Icelandic bankers

Shocked by the 2008 bank collapse, the Icelanders have tended to treat it as a uniquely domestic event, not as a part of the international financial crisis. But obviously Chancellor Darling played an important role in this saga, and his book on the crisis, written in 2011, shortly after he left office, with many references to the Icelandic bank collapse, cannot be disregarded, even if surprisingly little has been said about it in Iceland. The book reveals much distrust, even hostility, towards both the Icelandic banks and the Icelandic authorities. One example is when Mr. Darling describes the operations of Landsbanki in London: "Over the years it funded a range of investments, many of which are, in 2011, being investigated by the criminal authorities. Along the way, quite a few Icelandic citizens seemed to get very rich. Some were even able to make handsome donations to the British Conservative Party" (Darling, 2011, p. 137). But no allegations of criminal activities, let alone indictments, have come forward against those whose investments in the UK Landsbanki funded. When Mr. Darling was asked what evidence he had for his remark on Icelandic donations to the Conservative Party, he referred to press reports after the bank collapse (Darling, personal communication, 11 December 2013). No prominent Icelandic businessman or banker has however acknowledged any financial support to the Conservative Party (Bjorgolfur Gudmundsson, personal communication, 20 August 2013, Sigurdur Einarsson, Armann Thorvaldsson & Bjorgolfur Thor Bjorgolfsson, personal communication, 11 December 2013). More importantly, donations to political parties are on public record in the UK, and no Icelandic businessman is found on lists available of donors to the Conservative Party.

However, there is a likely source for Mr. Darling's remark. In the spring of 2011, while he was writing his book, the British Serious Fraud Office, SFO, raided the Luxembourg business premises of Kaupthing Luxembourg, a subsidiary of Kaupthing in Iceland. In July 2009, the subsidiary had been sold to British property developer Mr. David Rowland and his family and renamed Banque Havilland. A well-known supporter of the Conservative Party, Mr. Rowland had donated almost £3 million to it. He was widely expected in 2010 to become Party Treasurer, although he eventually declined to take up the post (Bowers, 2011). The 2011 raid in Luxembourg was in connection with an investigation into the operations of Kaupthing before its 2008 collapse, and had nothing to do with Rowland and his family. Nevertheless, newspaper headlines implicated Rowland in the investigation: In one of them it was "SFO raids Tory donor David Rowland's bank over Kaupthing." (Mason, 2011). In another newspaper the headline was "SFA raid offices in Luxembourg over failed Icelandic bank." (Bowers, 2011). It appears that not only did Mr. Darling confuse Landsbanki and Kaupthing, but that he also assumed an Icelandic connection with the donations of Mr. Rowland to the Conservative Party, simply because Mr. Rowland had bought the remnants of a subsidiary of a failed Icelandic bank.

Another example is a remark made by Chancellor Darling about a meeting of EU finance ministers in Luxembourg on 7 October 2008. Observing that British ministers are normally scrupulous about taking scheduled flights to and from meetings abroad, he adds: "I was often struck by the ranks of private jets sitting at the airports at international gatherings and I noted that the smaller the country, the bigger the jet." Mr. Darling goes on to say that on this particular day he decided that chartering a flight was justified. "As we touched down, Geoffrey Spence, my special adviser, pointed out two Icelandic jumbo jets parked on the runway. We taxied alongside them in our Spitfire-sized plane" (Darling, 2011, p. 152). But if two Icelandic jumbo jets (Boeing 747) were found at Luxembourg airport on this day, they could not be there in connection with the meeting which Mr. Darling was attending: Iceland was not a member of the EU, and its finance minister did not attend the meeting. Moreover, the only Icelandic company possessing jumbo jets in 2008 was Air Atlanta which had operated such jets as cargo planes since 1993, long before the Icelandic credit boom. ("Air Atlanta. History", 2014). Air Atlanta was a successful air transport company which specialized in cargo, but also did some chartered flights. Mr. Darling's suggestion that "the smaller the country, the bigger the jet" at international gatherings was in this case both misleading and irrelevant.

Darling on the Icelandic Minister of Business Affairs

When it became clear, in early 2008, that the Icelandic banks had outgrown the CBI's lender-of-last-resort facilities, an acute problem presented itself: Landsbanki had been collecting online deposits in the UK since 2006, operating from a branch, not a subsidiary. This implied that it was regulated by Icelandic authorities and covered by the Icelandic deposit-guarantee scheme, whereas it was obvious that in the case of the bank's failure, that scheme would not be able fully to compensate depositors, at least not instantly. A straightforward solution—albeit not without complications—was to transfer the Landsbanki UK operations from a branch to a subsidiary which meant that the deposits would be covered by the British deposit-guarantee scheme. However, talks about this between Landsbanki and the FSA, the British Financial Services Authority, beginning in the spring of 2008, did not result in much progress because the FSA set conditions about a simultaneous transfer of assets which the bank found difficult, if not impossible, to fulfil (Arnason & Kristjansson, 2009). Therefore, Landsbanki asked the Icelandic Minister of Business Affairs, Bjorgvin Sigurdsson, to meet with Chancellor Darling and to try to facilitate the talks. The meeting took place 2 September 2008, the Icelandic Minister bringing with him six people.

This meeting did not go well. In his book, Chancellor Darling (2011) describes it at some length. He says that the FSA had been anxious that he should meet with the Icelanders because it was "making no headway in trying to persuade Landsbanki to put more money into its activities in the UK. But if the FSA thought the Icelandic delegation had come to show some contrition and eagerness to respond to the British regulation, it was in for a rude shock". Mr. Darling says that he was struck at what seemed like an unusually large delegation from Iceland. According to him, both Minister Bjorgvin Sigurdsson and the chief regulator, Mr. Jon Sigurdsson—neither of whom he mentions by name—spoke volubly. "I was told that considerable national pride was invested in Landsbanki. It occurred to me that if they did not realize just how bad a state Landsbanki was in, they did not know what they were doing. Alternatively, they did know". Mr. Darling says that this meeting coloured his subsequent dealings with Icelandic ministers. He had expected the Icelanders at the meeting to stick up for their country. But he had also expected them to be straightforward, "and this simply was not the case, as we were soon to find out" (pp. 137–138).

Mr. Darling has confirmed that the negative impression that he formed at this meeting influenced his later decisions on the Icelandic banks (Darling, personal communication, 11 December 2013). He said that the Icelandic minister had not had good command of English and that he had not created trust. But is Mr. Darling being fair to the minister? In his book, Mr. Darling does not explain what he meant by the "bad state Landsbanki was in". Indeed, it is true that in the case of failure the Icelandic deposit-guarantee scheme could not cover Landsbanki's obligations. But that was precisely the point of the talks: to try to move the online deposits under the shelter of the British scheme. It is not apparent that Mr. Darling had special information about Landsbanki's equity, or the lack thereof, which the Icelandic authorities did not have. Perhaps the Icelandic Minister of Business Affairs was as unaware of the precariousness of the Icelandic banks as Mr. Darling himself then was of the precariousness of major British banks such as the Royal Bank of Scotland, RBS. Moreover, while Landsbanki's UK operations are presently still being wound up, it is likely that the recovery rate will be much larger than initially envisaged. It should be noted, for example, that in early 2014 many British local authorities sold their claims on the Landsbanki estate, recovering on average more than 95 per cent of their original deposits (Local Government Association 2014). It is quite telling, also, that in

August 2014 Deutsche Bank bought large claims on the Landsbanki estate (De Nederlandsche Bank [DNB] 2014). Obviously the German bank must have thought that this was a profitable transaction.

Darling on the Icelandic Prime Minister

In his book, Chancellor Darling (2011, p. 137) writes:

> By 2008, it was clear, too, that Iceland itself was rapidly becoming insolvent. Earlier in the year Gordon [Brown] had spoken to the Icelandic prime minister, who had formerly been governor of their central bank, and urged him to go to the IMF. He was reluctant to do so, preferring to seek out Russian loans to tide the country over.

Was Iceland really becoming insolvent, as Mr. Darling asserts? It had a robust economy, based on an efficient system of individual transferable quotas in the fisheries, a large supply of energy, both hydroelectric and geothermal, tourism, and a well-educated workforce. This should not be confused with the possible insolvency of the banking sector, unless, of course, it was believed that the obligations of Icelandic banks were also the obligations of the Icelandic state. Again, Darling's information about the Icelandic Prime Minister was not correct. Mr. Geir Haarde had not been CBI Governor before he became Prime Minister, while Mr. David Oddsson had been Prime Minister before he became CBI Governor. (Mr. Haarde had however been on the CBI staff as a young economist, before he became a politician.) Mr. Darling corrected this error in his book's second edition (2012, p. 137). Mr. Darling's statement that Prime Minister Haarde was reluctant to go to the IMF, "preferring to seek out Russian loans to tide the country over", can hardly be substantiated. The reason the Icelandic government for a while discussed a possible loan from Russia was that credit lines and currency swap deals were being refused by its traditional Western allies. A loan from Russia was certainly never the first preference of the Icelandic government (Geir Haarde, personal communication, 1 October 2013).

Chancellor Darling (2011) also describes a phone call he made to Prime Minister Haarde Friday 3 October 2008:

> Meanwhile, the situation in Iceland was deteriorating. The FSA told me that undertakings given by the Icelandic authorities that sufficient money would be put into Landsbanki had not been honoured. It had been agreed that Gordon would speak to the Prime Minister, Geir Haarde, but he had to go to Paris to meet President Sarkozy, Chancellor Merkel and Silvio Berlusconi, so I was deputized to make the call instead. The Treasury and the FSA had already concluded that it would not be long before Landsbanki and Kaupthing failed. We were ready, if necessary, to use the new powers we had acquired at the time of Northern Rock to transfer their UK undertakings to another bank (p. 147).

Mr. Darling goes on:

> I told the Icelandic prime minister that it appeared that large sums of money had been taken out of the UK from the Kaupthing branches, which was a serious breach of FSA regulations. The FSA had to find out by the end of the afternoon whether or not that breach had taken place. If it had, they would close the bank. He asked whether the money was needed today and how much it was. I said it was about £600 million, small beer for us but a huge amount for him. It was urgent, I said, that he look into it immediately. His response rang alarm bells. He asked if there was any chance that the amount could be negotiated down. I said there was no chance and that the money had to be

> returned before the end of the weekend. I suspected we would end up having to close the banks the following week (p. 147).

Chancellor Darling's description of the situation is highly misleading. The Icelandic authorities had never given any undertakings "that sufficient money would be put into Landsbanki". The talks earlier in 2008 on the possible transfer of online deposits from Landsbanki's UK branch to a subsidiary had been between Landsbanki and the FSA (Arnason & Kristjansson, 2009). Again, while Mr. Darling stated that he and the FSA had concluded that probably Landsbanki and Kaupthing would fail and that he was ready to use his newly acquired powers to transfer their operations to other banks, he and the FSA were taken utterly by surprise at the imminent failure of other British banks, such as RBS, which was only avoided by a massive rescue programme (Darling, 2010, p. 2). Thirdly, Mr. Darling's account of his conversation with Prime Minister Haarde is rejected by Mr. Haarde who strongly denies having tried, on this occasion, to negiotiate down any amount of money that would have to be transferred from Iceland to the UK in order to avoid the closure of KSF, the Kaupthing UK subsidiary (Geir Haarde, personal communication, 1 October 2013). According to Mr. Haarde, upon receiving Darling's call, he immediately talked to the Kaupthing managers about Mr. Darling's accusations. They assured him that this was not true and had to be some kind of misunderstanding that ought to be easily corrected. They then proceeded to contact both the FSA directly and the Icelandic Financial Supervisory Authority, FME. Indeed, the extensive investigation of Kaupthing after the collapse did not reveal any illegal large-scale money transfers from the UK to Iceland before the collapse. What it showed was that the Icelandic parent company had, since the spring of 2008, made a running loan agreement with its subsidiary, KSF, by which it lent £1.1 billion to KSF for three months at a time while KSF lent the same amount of money to the parent company for a day at a time. This meant that this amount of money was registered in the KSF books as liquidity, whereas in fact no money had been transferred from either the UK to Iceland or from Iceland to the UK. Also, KSF had paid margin calls abroad to the amount of £500 million for the parent company. While those dealings were not above criticism, they were not illegal and did not constitute transfers from the UK to Iceland (Hreinsson et al., 2010, Ch. 21, p. 88; Armann Thorvaldsson, personal communication, 11 December 2013). Fourthly, in the phone call from Mr. Darling to Mr. Haarde, apparently Landsbanki was not mentioned, only Kaupthing. Yet again, it seems that Mr. Darling did not make the necessary distinction between Landsbanki and Kaupthing.

Darling on the Icelandic Finance Minister

In his book, Chancellor Darling (2011) writes at length about events on 7 October 2008 when he attended the meeting mentioned before of EU finance ministers in Luxembourg, while the international financial crisis was worsening:

> As I left Downing Street before dawn, arrangements were being made not only to monitor what happened when the markets opened but to keep a close eye on what was going on in Iceland. We knew we were not being told the whole story there and it was inevitable that difficult decisions, which might wrongly be interpreted as hostile acts by the Icelandic government, would have to be taken in the next day or so" (p. 152).

It is not clear to whom Mr. Darling is referring by his complaint that he had not been told the full story: Who would intentionally have been witholding information? The Icelandic authorities? Or the Icelandic banks operating in the UK? Whereas the

Icelandic banks may have tried to appear less vulnerable than they really were, as would other banks in the same circumstances, no evidence has been presented showing that the Icelandic authorities were intentionally giving misleading information to the British authorities. The passage quoted reveals however that Mr. Darling had already in the early morning of 7 October decided to make "difficult decisions". In the next two days he closed the Icelandic-owned banks in the UK and imposed the British anti-terrorism law on Landsbanki and the CBI. Be that as it may, immediately after his Luxembourg meeting, Mr. Darling called Icelandic Finance Minister Arni Mathiesen, asking him what the Icelandic government would do about Landsbanki's online accounts in the UK, as the bank was collapsing. Mr. Mathiesen responded that the Icelandic government would do what it could to resolve the problem, but that he could not make any promises. Interestingly, in the beginning of the conversation, Mr. Darling thought that he was talking to the Icelandic Minister of Business Affairs, but Mr. Mathiesen corrected him on that point.

The next day, Mr. Darling said in a radio interview: "The Icelandic government have told me, believe it or not, have told me yesterday they have no intention of honouring their obligations there" (Treasury Committee, 2009, p. 21). Unbeknownst to Mr. Darling, the conversation with Mr. Mathiesen had been taped by the Icelanders, and when it was published it became apparent that Mr. Darling had not told the truth (Ibison & Parker, 2008; Treasury Committee, 2009, p. 23). Nowhere in the conversation did Mr. Mathiesen say that the Icelandic government had no intention of honouring its obligations. Later, the House of Commons Treasury Committee explored this matter and concluded (Treasury Committee, 2009, p. 23): "In the published transcript Mr. Mathiesen did not state that Iceland would not honour its obligations. Rather, he explicitly indicated that Iceland planned to use its compensation scheme to try to meet obligations to British depositors." Unsurprisingly, therefore, in his book Mr. Darling (2011) gives a different account of his conversation with Mr. Mathiesen: "I was desperate now to get out of Luxembourg, but had to take a call first from a minister in Iceland. I wanted an assurance that they would compensate British investors in Icelandic banks. He said, yes, they would. I came off the call and told my officials, 'They won't stand behind it'" (p. 154). While this is the opposite of what Mr. Darling said to the press on 8 October 2008, it is not fully accurate, either. First, it was Mr. Darling who called Mr. Mathiesen, not the other way around. Moreover, Mr. Mathiesen had not uttered the assurances which Mr. Darling ascribes to him. He had been unwilling to make any promises on behalf of the government, while he pointed out that Iceland had a compensation scheme for depositors.

Conclusion

Even if Chancellor Alistair Darling complained that he had not been told the full story about the Icelandic banks, he does not seem to have made much effort himself to obtain information about the banks. His remarks in his book about Icelandic donations to the Conservative Party and about Icelanders travelling around in jumbo jets were wide off the mark. His accounts of conversations with Icelandic government ministers were also less than accurate. He seemed not to distinguish between Kaupthing and Landsbanki, nor between the Icelandic banks and the Icelandic government, nor between the Icelandic Ministers of Business Affairs and Finance. For him, all this seemed to be "Iceland", spoken about in an unmistakably hostile tone. One of the most revealing passages in Mr. Darling's book is on a 2010 meeting in Canada with other finance ministers: "The trip back was memorable too. After telling the pilot that on no account was he to fly into Icelandic airspace, we flew through the aurea borealis above the Arctic Circle" (Darling, 2011, p. 281). Iceland—a NATO ally of the UK—does not have, and has never had, a military, let alone an air force. What could the threat be? But if it is concluded that Mr. Darling's attitude towards Iceland was not reasonable, what then explains his hostility? A possible explanation is that the Icelandic banks were upstarts, newcomers. Lean and mean, they competed fiercely with more traditional banks in the UK, thus undoubtedly provoking much resentment. This may have been influenced Mr. Darling, although it is in the nature of things that he would never admit this. Another possible explanation is suggested by an almost gleeful comment in his book: "Iceland, along with Ireland, was part of what Scotland's nationalist first minister, Alex Salmond, like to refer to as an 'arc of prosperity', to which he yearned to attach Scotland. It was now an arc of insolvency" (Darling, 2011, p. 138). Mr. Darling was not only a Labour MP from Scotland. Adamant against Scottish nationalism, he was the leader of the "Better Together" alliance, campaigning against Scottish independence. It was important for those who opposed independence for Scotland to demonstrate the powerlessness of small nations in crises. If this was indeed Mr. Darling's motive, which remains a matter of speculation, he certainly succeeded.

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