



UNIVERSITY OF ICELAND

# Iceland's Bank Collapse

## Explanations and New Evidence

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# When the Dust Has Settled ...

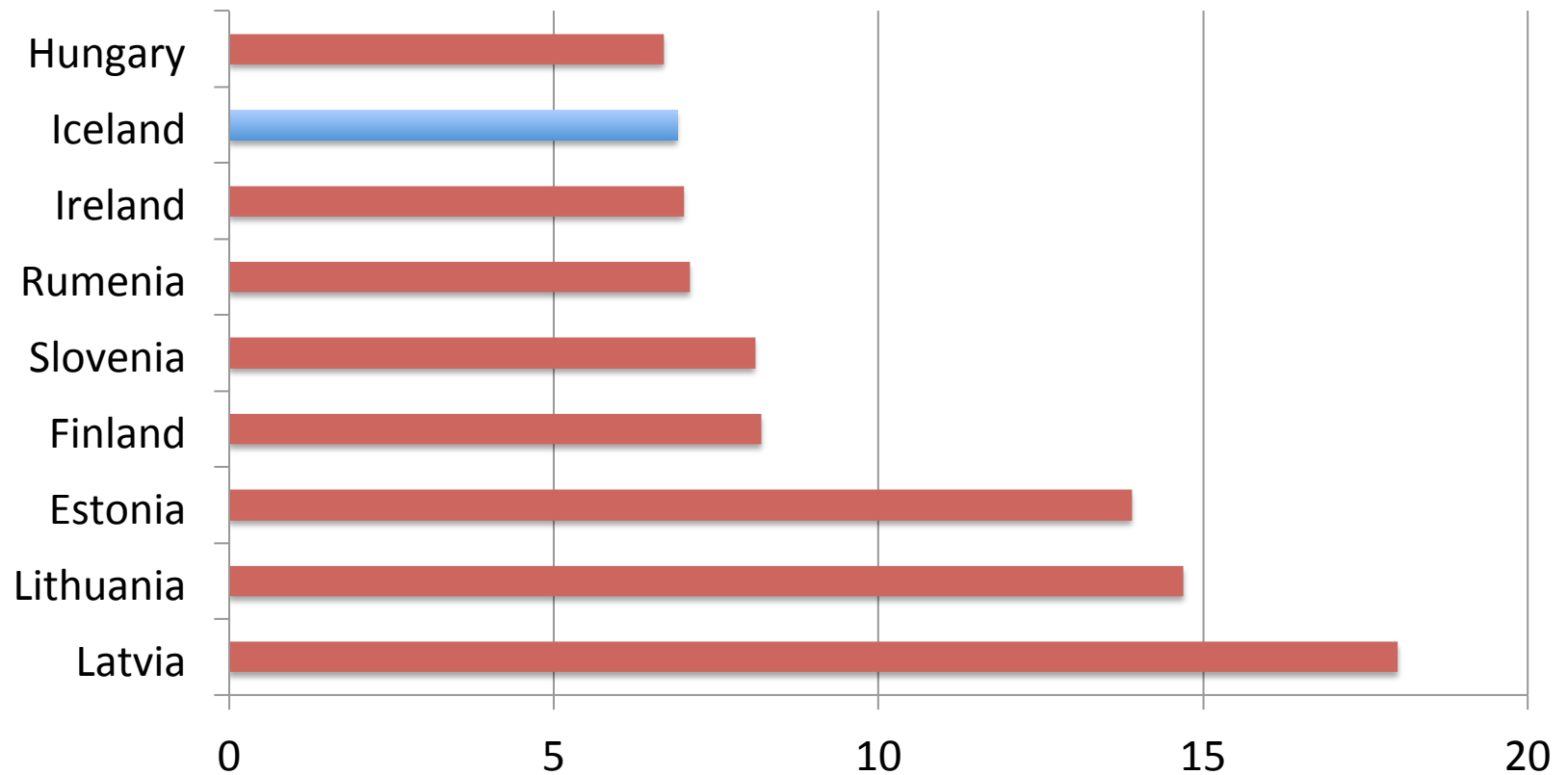
- The Icelandic bank collapse was no worse a crisis than in many other European countries
- The Icelandic banking sector was big, but so were such sectors in Switzerland and the UK
- The Icelandic bankers were reckless, but not more so than in other countries
- Worked under same regulatory framework as in other EEA countries
- Vulnerable situation, crucial decisions

# Causes of international crisis

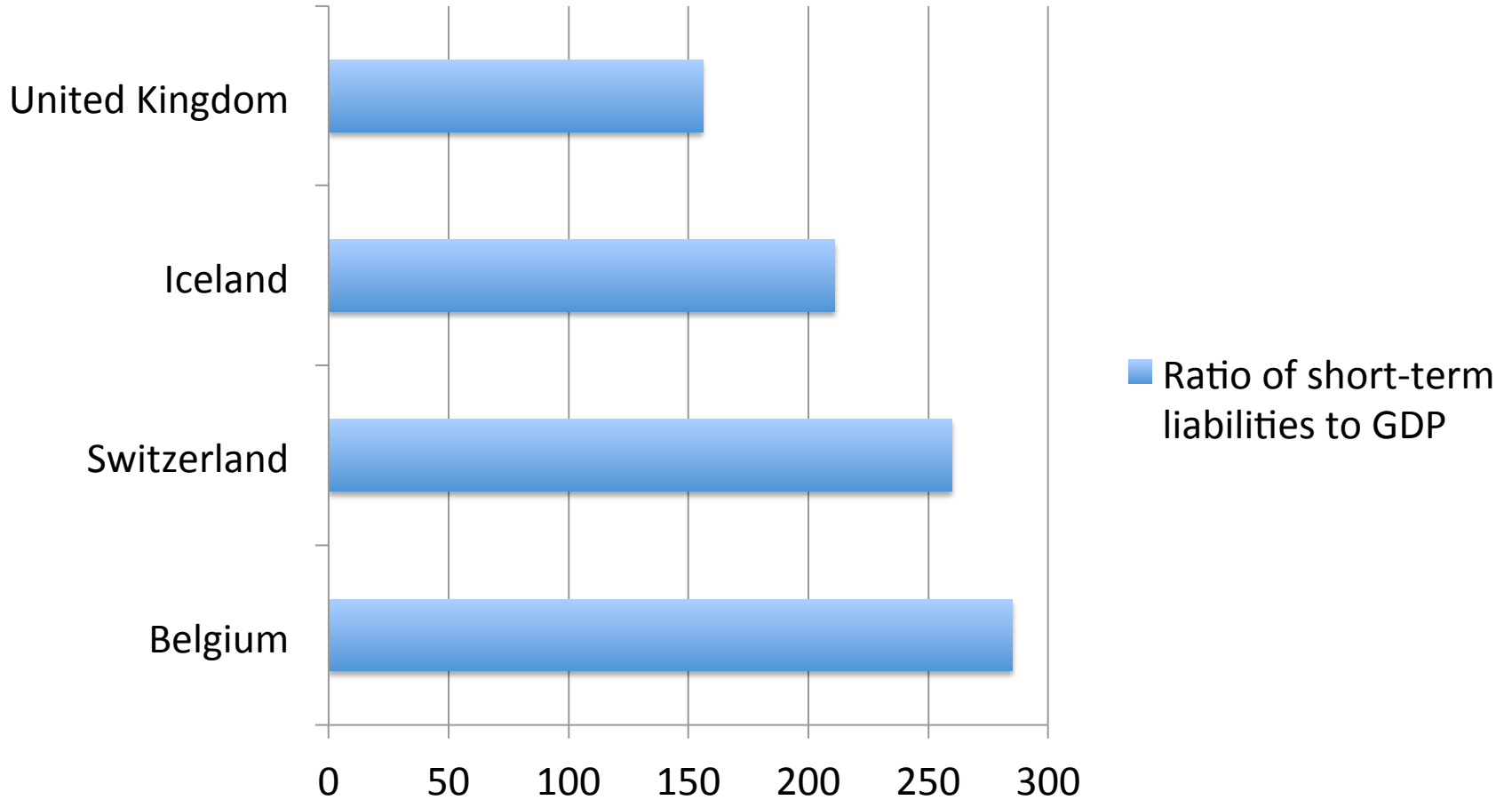
- Capitalism inherently unstable despite Friedman? Bubbles and panic
- “The too big to fail” causes moral hazard, too much risk-taking
- Government failures: subprime loans; low interest rates in US; government expenditure in EU
- Incorrect pricing of risk by new financial techniques

# Seven EU countries hit harder

**GDP Contraction 2009 in %**



# No more “oversized” than others



# Iceland as a Financial Centre

- Much commented on in SIC report
- Originally the idea of Philosophy Professor Mikael Karlsson, endorsed by me
- Our idea: Attracting capital and corporations to Iceland by political stability and low taxes, as in Guernsey, Jersey and Isle of Man
- The idea not to let Icelandic banks expand abroad, and to create a domestic bubble

# No more “reckless” than others

- Barclays fined £290 million June 2012 for fixing libor rates; CEO and chairman resigned
- HSBC fined \$1.9 billion, £1.2 billion, December 2012 for money laundering; CEO apologised
- Deutsche Bank under investigation for having manipulated books
- RBS, UBS, Credit Suisse, Danske Bank bailed out, some directors resigned

# No less regulated than others

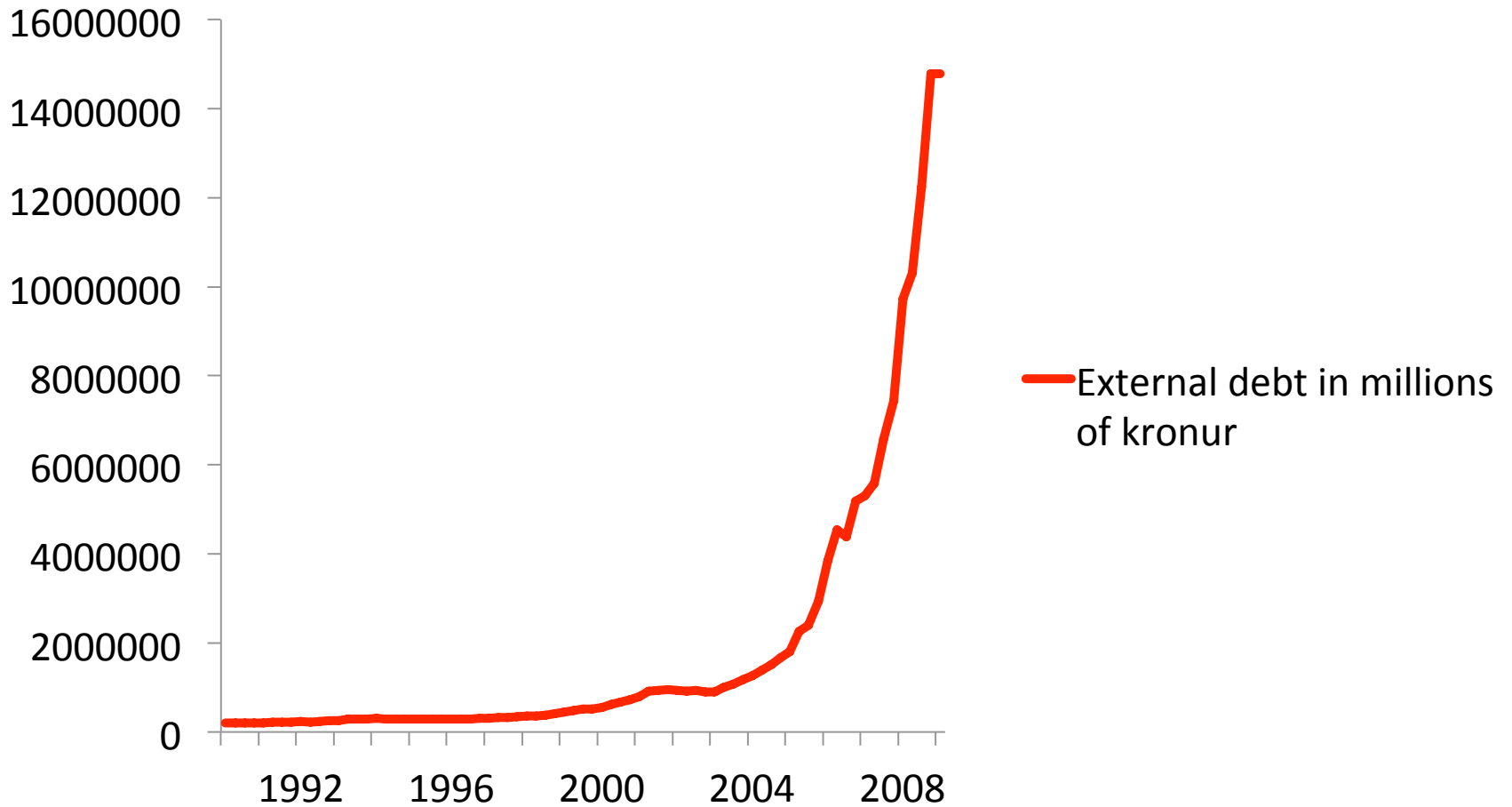
- Iceland joined EEA in 1994 and operated under same financial regulation as other member-states (including 27 EU countries)
- Reserve requirements same as in other EEA member-states; reduced, only to make them equal to those of competing European banks
- Free market reforms in 1991–2004, but only to bring Iceland into line with neighbours



# 1991–2004 Reforms

- Corporate subsidies cut
- Tax reductions: corporate tax from 45% to 18%, other taxes simplified and reduced
- Privatisation, revenue used to pay up the public debt
- Stabilisation, inflation brought down, ITQ system in fisheries further developed
- Pension reforms, pension funds made sustainable
- Legal reforms: public administration, information
- Consequence: Good reputation, high ratings

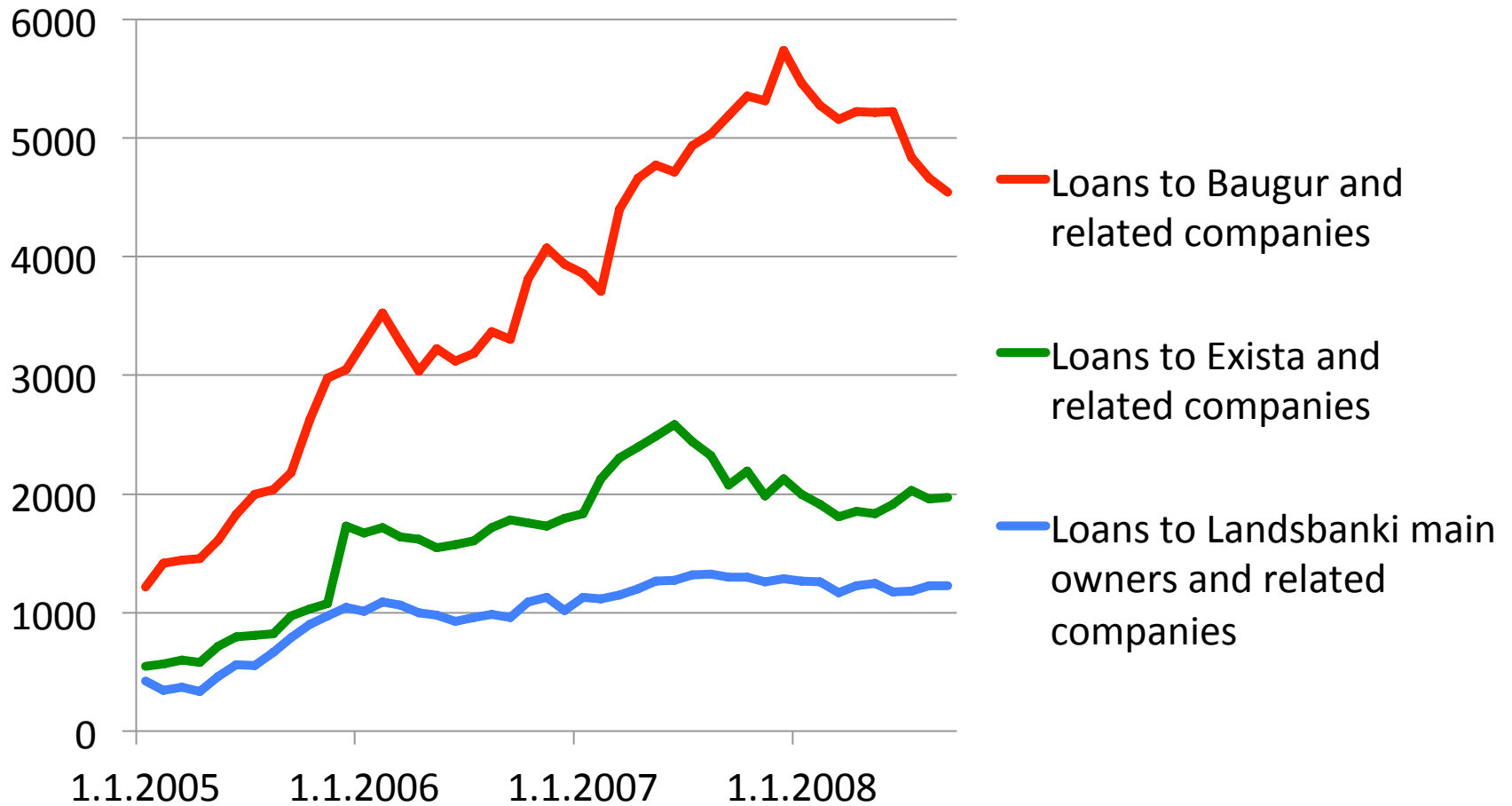
# External Debt: 2004 Crucial Year



# From Market to Crony Capitalism

- 1991–2004 market capitalism: competition, independent judiciary, free media, economic power separate from political power
- 2004 battle about media law, Oddsson loses, Jon Asgeir Johannesson of Baugur wins
- 2004–2008 crony capitalism: oligopoly, oligarchs own media, supported by politicians (and supporting them), cooperative judiciary

# It was a Baugur Bubble



# Iceland: additional systemic risks

- General international risks: moral hazard; government mistakes; difficulty of pricing risk with new techniques
- One additional risk for Iceland, SIC: too much cross-ownership, overvalued assets, Jon Asgeir Johannesson and his cronies
- Another additional risk for Iceland: field of operations all of EEA; field of institutional support Iceland alone

# Three crucial decisions abroad

- 24 September 2008, Fed refuses to make currency swap agreements with Iceland, at same time as it makes them with Scandinavia
- 7 October 2008, British Labour government closes the two Icelandic-owned banks in England, at same time as it bailes out all other banks
- 8 October 2008, British Labour government uses anti-terrorism law against Icelandic companies, stopping all transfers to or from Iceland, making recovery impossible

# Unnecessary losses

- Asset management section of Singer & Friedlander sold for £5 million, real value sixfold (£30 million)
- Glitnir Norway sold for NOK 300 million, had been bought year before for 3.1 billion
- Finn Haugan, chairman of Norwegian Guarantee Fund, also leader of savings banks buying Glitnir Norway! Valued month after 2 billion
- Glitnir Sweden sold for SEK 60 million, had been bought 4 years before for 380 million

# Iceland Taken Down?

- Icesave and Edge accounts could offer better rates, because cheaper to operate
- Icelandic banks flexible and efficient, but reckless (just like others)
- New kids on the block, antipathy from old players, unpopular with other banks
- Governments didn't like more tax competition: a new Luxembourg, Liechtenstein, Isle of Man or Guernsey? No, thanks!



# Murky waters

- MI5 investigated Icelandic banks 2005 because of suspicion of Russian mafia money
- Alistair Darling comments in memoirs that Icelandic bankers donated to Conservative P.
- Labour-controlled municipalities kept money in Icelandic accounts
- “Falklands Effect” without much cost? A show planned by Brown’s PR advisers?

# Others Helped: Currency swap lines

- Aggregate transactions with CBs: \$10,057 bn
- ECB \$8,011 (79.7% of total)
- CB of the UK \$919 bn
- CB of Switzerland \$466 bn
- CB of Denmark \$73 bn
- CB of Sweden \$67 bn
- CB of Norway \$30 bn
- Also CBs of Japan, Korea and Mexico

# Lesson 1: Less Uniform Regulation

- Extensive regulation did not hinder crisis
- Strict regulation of financial sector creates false security
- Harmonisation of financial companies create an additional systemic risk
- More correct pricing of risk, if competition and diversity in markets
- Only realistic strategy: tax cuts and economic growth

# Lesson 2: Iceland Needs Allies

- Left out in the cold, in 2008
- Needs a shelter which is not a trap
- EU more a trap than a shelter, witness Cyprus
- Close cooperation with the three Anglo-Saxon neighbours more a shelter: US, UK, Canada
- Mistake not to cooperate closer with UK before crisis
- Necessary to reestablish ties with US

