



UNIVERSITY OF ICELAND

The 2008 Icelandic Bank Collapse

Lessons for Europe

Professor Hannes H. Gissurarson

Berlin 15 March 2014

Athens: Much Bigger than Melos



Thucydides' Classic Melian Dialogue

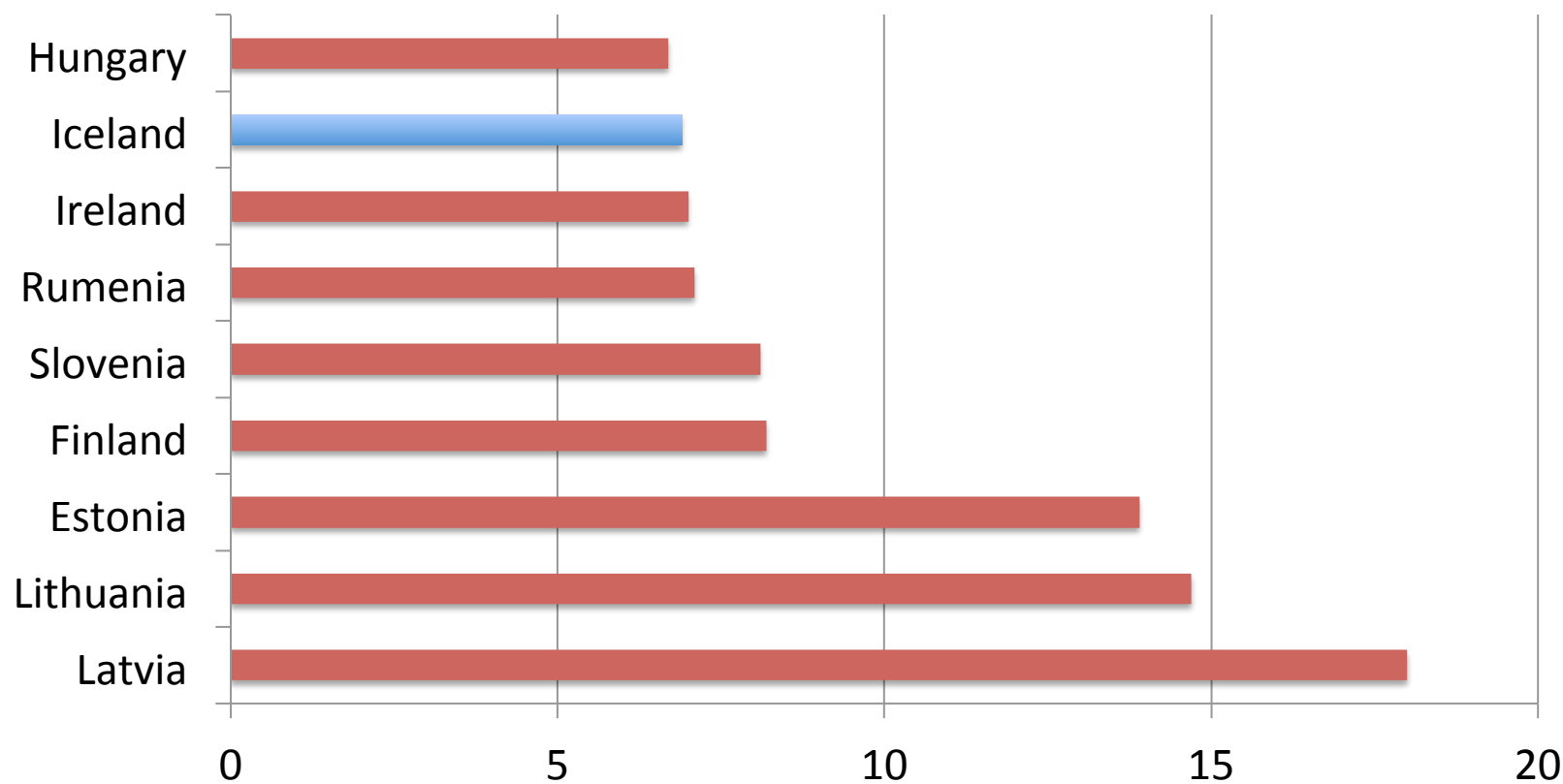
- 417 BC, Athenians demand that Melians surrender and pay tribute, or be destroyed
- Athenians: “You know as well as we do that right, as the world goes, is only in question between equals in power, while the strong do what they can and the weak suffer what they must”
- Melians refuse; and are destroyed
- Later, Athens loses the war and Melos is restored

What Happened in Iceland in 2008?

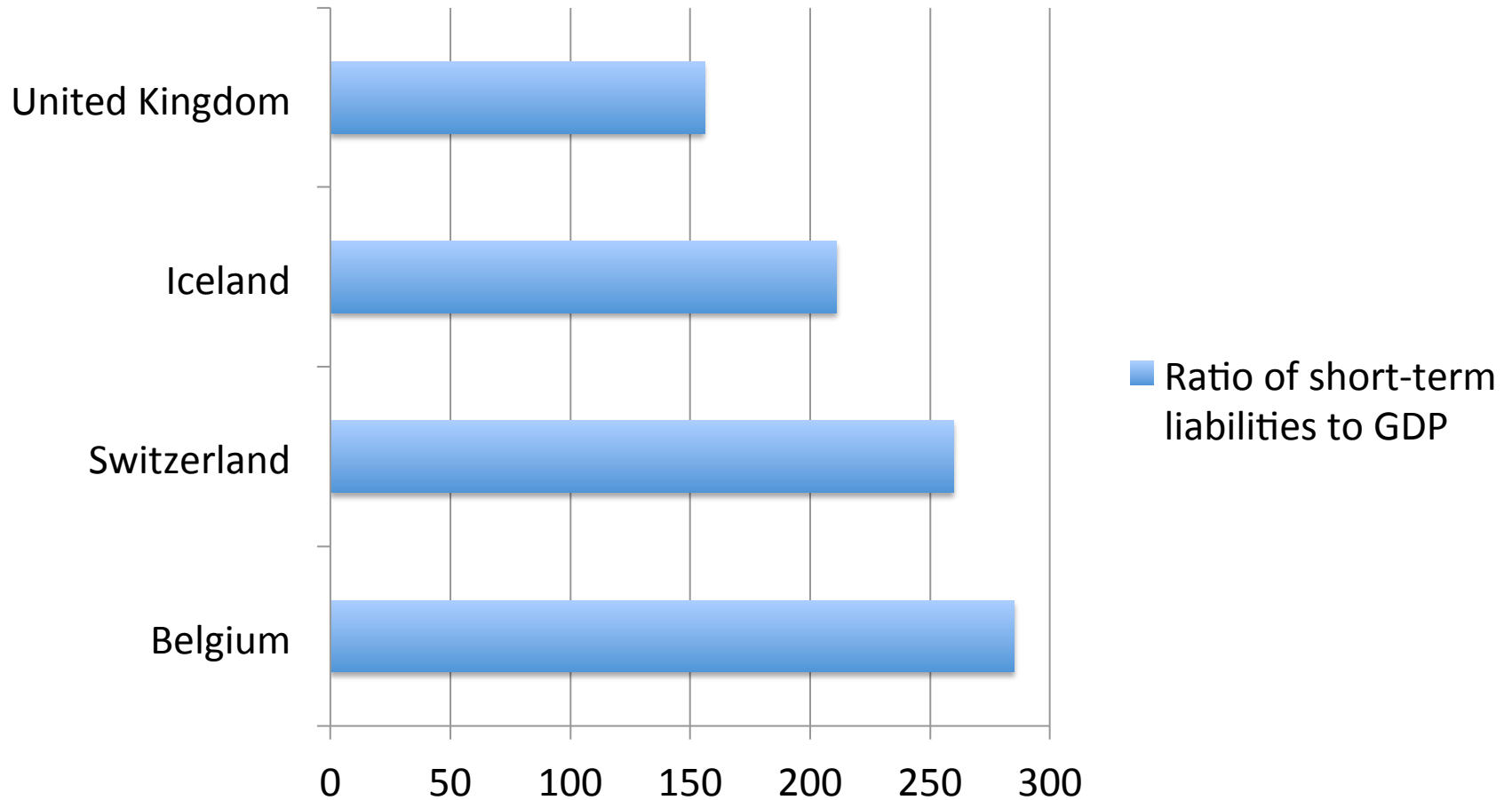
- Icelandic bank collapse no worse a crisis than in many other European countries
- Icelandic banking sector big, but so were such sectors in Switzerland and the UK
- The Icelandic bankers reckless, but not more so than in other countries
- Worked under same regulatory framework as in other EEA countries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

Seven EU countries hit harder

GDP Contraction 2009 in %



No more “oversized” than others



No more “reckless” than others

- UBS bailed out: fined \$1.25 bn for destroying documents on Jews; \$780 mn for assisting in tax evasion; \$1.5 bn, for rate rigging
- Danske Bank bailed out
- RBS bailed out, £45 billion in capital, £275 in liquidity: fines for rate rigging, money laundering for Iran and Sudan
- ING bailed out, €10 billion in capital: fines for money laundering

Others Helped: Dollar 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

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

First day: 30 April 1991



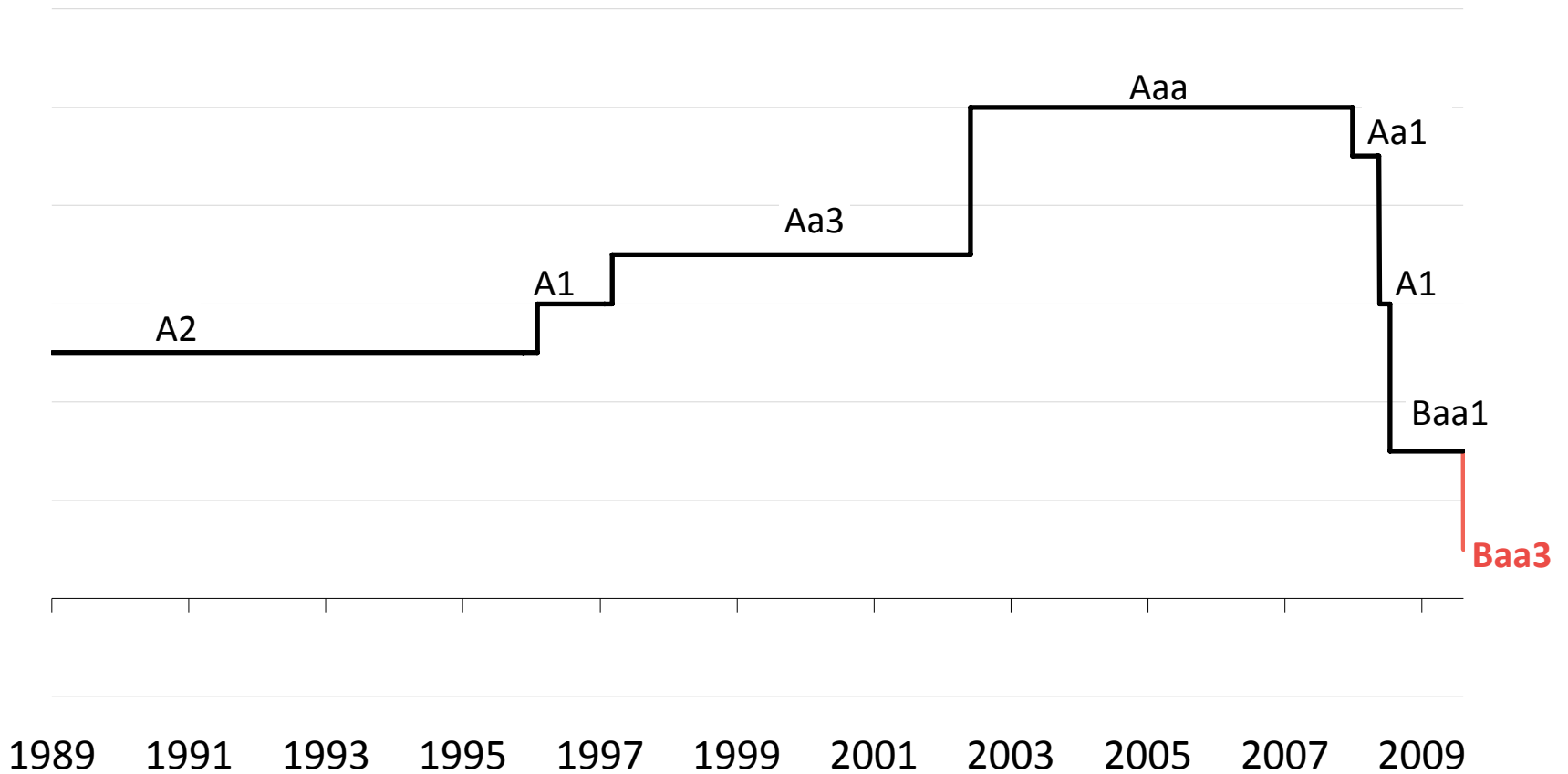
1991–2004 Reforms

- 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

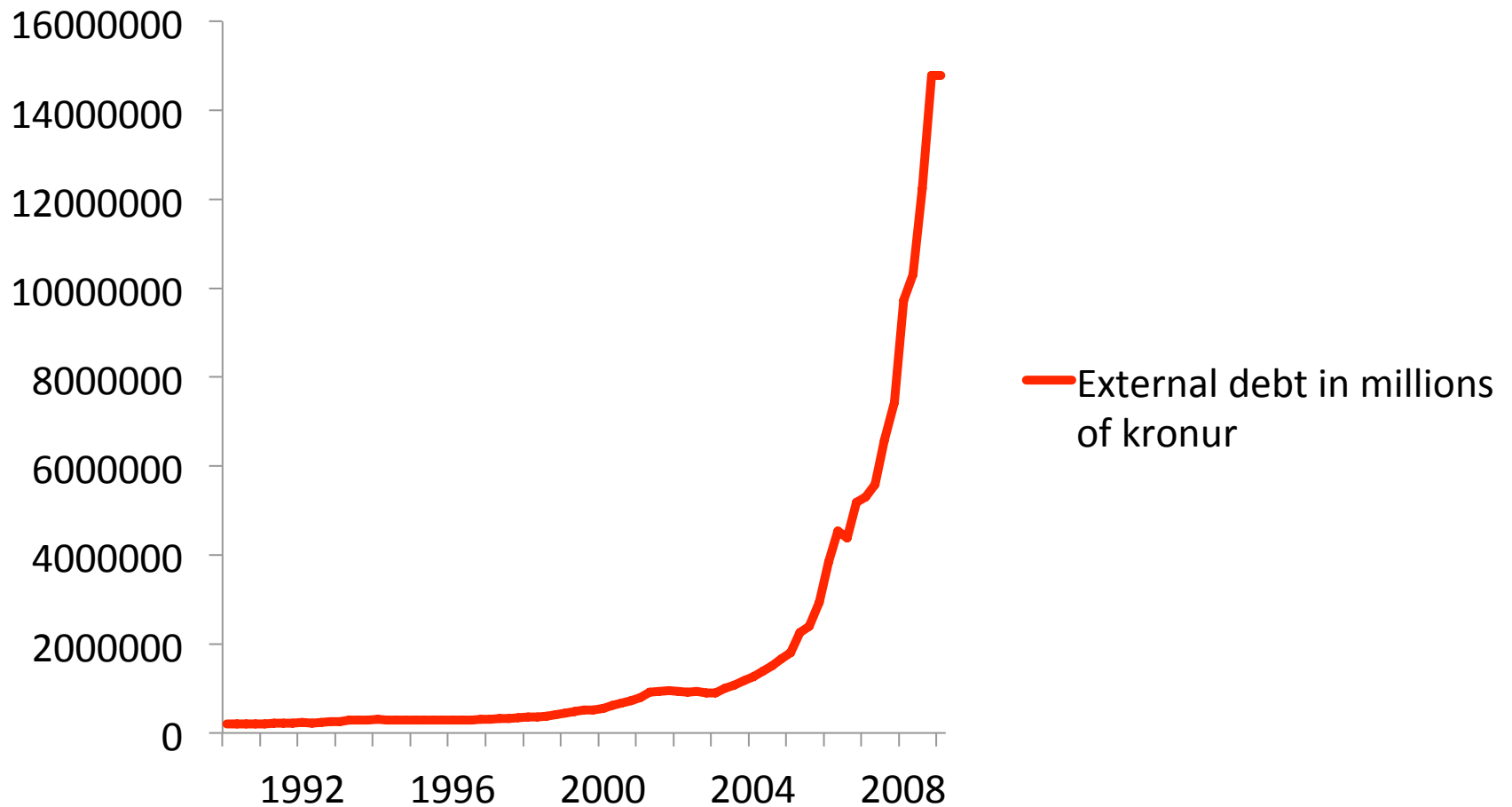
Last day: 15 September 2004



High Ratings Led to Bubble



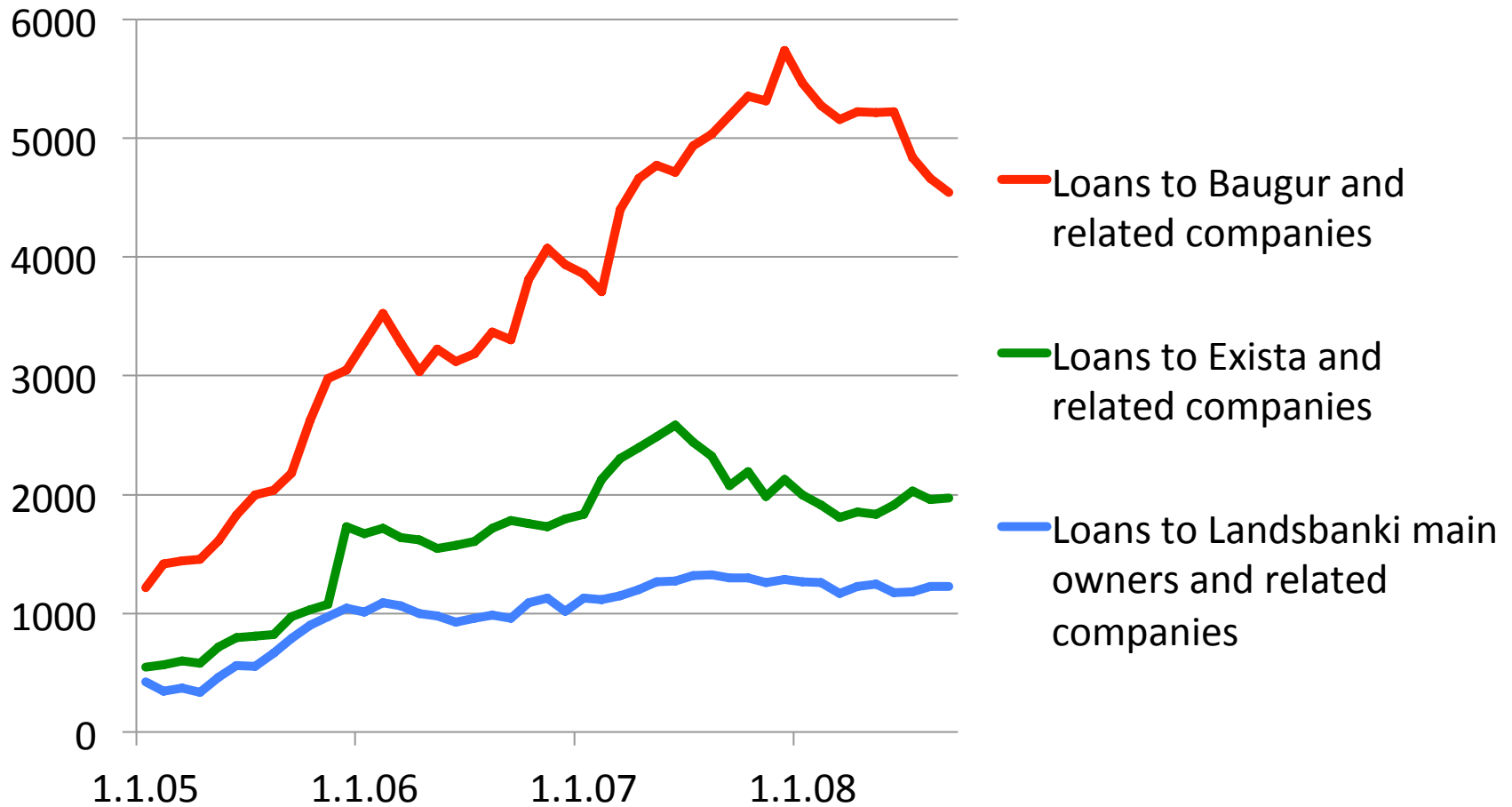
External Debt: 2004 Crucial Year



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



The Manhattan luxury penthouse



101: Johannesson's private jet



101: Johannesson's private yacht



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 bails 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 later NOK 2 billion
- Glitnir Sweden sold for SEK 60 million, had been bought 4 years earlier for SEK 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.
- The Scotland Factor, “Arc of Prosperity”
- Labour-controlled municipalities kept money in Icelandic accounts
- “Falklands Effect” without much cost?

Interesting Observations

- July 2008, a high official said to Governor Oddsson: “They will take down one bank, and I predict it will be Lehman Brothers; they will take down one small country, and I predict it will be Iceland”
- November 2008, an IMF official responded when Governor Oddsson said that an IMF loan was unnecessary: “But we have to live, too!”

Reconstruction or False Recovery?

- Key to reconstruction: sharp depreciation of currency enabling export industries to fuel recovery; and division of banks into “good” domestic banks and “bad” foreign banks
- However, petty, vengeful hard-left government came to power February 2009
- IMF became hand collector for British and Dutch governments in Icesave dispute
- Icesave deals twice voted down; finally, 2013 EFTA court decided on no obligation

Rough Waters Ahead

- Still much debt owed to foreign bank creditors
- Hard-left government did not really cut expenditure, only postponed investments
- Hard-left government scared away investors and tried to destroy the well-managed system of quotas in fisheries, “suicidal” as WSJ said
- Voted down in 2013, greatest debacle in Icelandic political history, from 50% to 25%
- New centre-right government battle-scarred

Lesson 1: Less Uniform Regulation

- Extensive regulation did not hinder crisis
- Strict regulation of financial sector creates false security
- Harmonisation of financial companies create additional systemic risk
- More correct pricing of risk, if competition and diversity in markets, also smaller units
- Only one 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 three Anglo-Saxon neighbours a better shelter: US, UK, Canada
- Mistake not to cooperate closer with UK before crisis (UK not unconstrained like Athens)
- Necessary to reestablish ties with US

