



UNIVERSITY OF ICELAND

# Lessons from the 2008 Icelandic Bank Collapse

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APEE, Las Vegas: Money and Banking

2 April 2018, 2:30–3:45 [2.F.5]

# The General Problem

- 2007–9 International Financial Crisis suggested to many that banks had grown ‘too big to fail’
- Moral hazard: Bankers seize profit, taxpayers bear losses
- Why not allow banks to fail? Because it would create chaos among depositors and undermine social stability (cf. 1930s)
- Why not limit by law banks’ ability to grow? Because they would circumvent rules and continue to use depositors as ‘human shields’

# The Icelandic Bank Expansion

- Rapid growth of Icelandic banks similar to that in other countries, RBS in Scotland, UBS in Switzerland, Danske Bank in Denmark, Irish banks
- Augmenting factors in Iceland's case:
  1. Iceland's good reputation, earned by 1991–2004 reforms, created good credit ratings
  2. Banks only privatised in 2003, then probably under-sized, and while needing to grow also encountering plenty of cheap credit abroad
  3. Banks and their biggest customers controlled media and public opinion

# The Beginning of the End

- Autumn 2005: Analysts point out no plausible lender-of-last-resort in Iceland
- ‘Geyser Crisis’ spring 2006 limits access to European credit
- Icelandic banks refinance themselves in American markets, at the ECB through Luxembourg subsidiaries and by collecting online deposits, offering high interest rates
- European commercial and central bankers increasingly irritated, even angry, at the intrusion of the Icelanders, determined to stop them

# Left Out in the Cold

- CBI, Central Bank of Iceland, tries to ease liquidity problem of banks by making foreign exchange swap deals with other central banks
- Everywhere rebuffed except in Scandinavia
- US Fed makes dollar swaps deals with Switzerland, never (like Iceland) a US ally
- 24 September 2008 Fed announces dollar swap deals with Sweden, Denmark and Norway
- Iceland, an EEA member state, left in the lurch by Fed and ECB

# Iceland the Expendable



# The Collapse

- Glitnir faces refinancing difficulties; government recapitalises it 29 September; credit downgrade
- FSA demands Icelandic banks in the UK increase liquidity (at the same time as UK government is providing liquidity to other UK banks)
- Landsbanki cannot meet demands, falls 6 October
- UK authorities close Kaupthing's UK subsidiary so Kaupthing falls 8 October

# CBI Initiatives

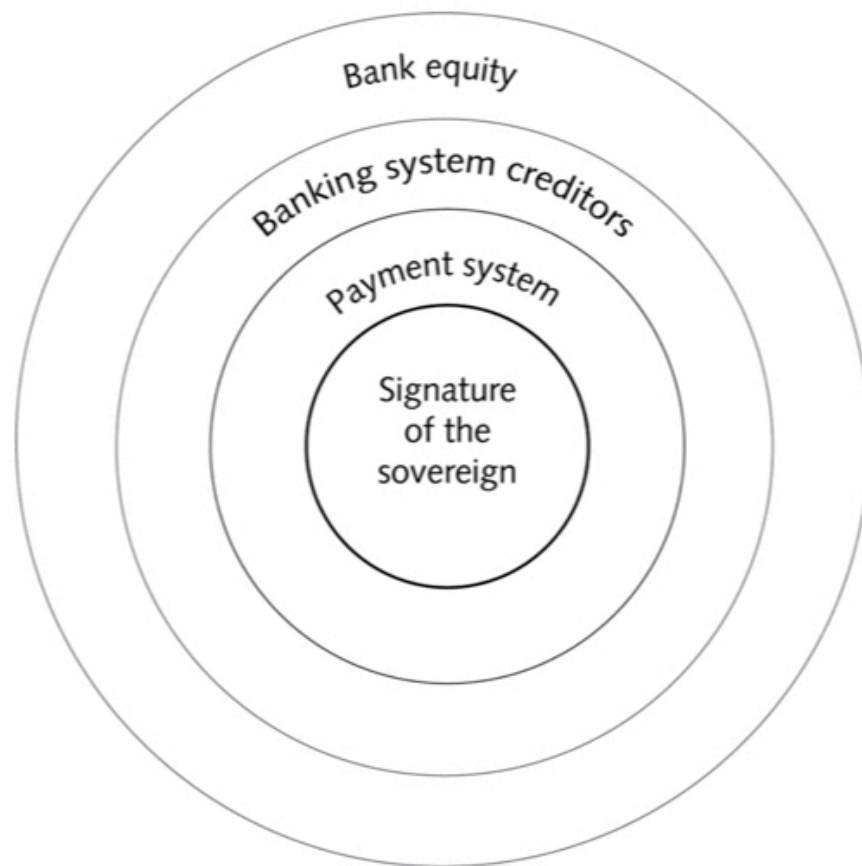
- CBI governors, especially Oddsson, had confidentially issued several warnings to political leaders about vulnerability of banking sector
- They had suggested its reduction by Kaupthing moving abroad, Glitnir selling its Norwegian bank and Landsbanki transferring its online UK deposits from branch to subsidiary
- As the collapse began, the CBI proposed 'ring-fencing' Iceland to limit the danger to sovereignty and depositors



# Oddsson 30 September 2008 on his way to cabinet meeting



# Ring-Fencing Iceland



# Political Hurdles

- Oddsson's repeated earlier warnings dismissed as "one man's venting" by Social Democrats
- When he attended cabinet meeting 30 September warning of immediate collapse of banking sector, Social Democrats demanded his dismissal
- Refused to listen to his advice on ring-fencing Iceland: A week of hesitation, until 6 October
- CBI sent for JP Morgan advisers who finally convinced Social Democrats of ring-fencing

# Emergency Act 6 October 2008

- Icelandic authorities given wide-ranging powers to take over banks and restructure them
- Idea was to divide up banks into domestic and foreign banks with government maintaining operations of domestic banks
- Depositors given priority in estates of fallen banks
- Important: all depositors, foreign as well as domestic, given priority



# Hostility in UK, Indifference in US



# UK Labour politicians ...

- Chose to misunderstand Emergency Act: No legal discrimination between Icelandic and British depositors
- Invoked Anti-Terrorism Act against not only Landsbanki, but also the CBI and the Icelandic FSA and other authorities
- Put them alongside Al-Qaida, Talibans, Sudan and North Korea on Treasury's website
- Demanded Icelandic government guaranteed deposits in Icelandic banks in UK

# Disaster Averted

- Beginning run in Iceland on banks stopped
- Smooth transfer of deposits and assets from old to new domestic banks
- Day and night, staff of CBI and IFSA worked to maintain payments mechanism, vital to Iceland
- Succeeded, despite difficulties created by UK invoking Anti-Terrorism Act
- Asset sales abroad in some places satisfactory, in other places (e.g. Norway, Finland, Denmark) not

# Several Ironies in a Sorry Saga

- Emergency Act discriminated between depositors and bondholders (mostly German banks)
- UK government protested against what was a transfer from German banks to British taxpayers
- 12 October a loan to Landsbanki's UK branch from Bank of England, while Landsbanki was on a list of terrorist organisations!
- Banks rescued (RBS, UBS, etc.) have been charged with money laundering, LIBOR tampering, etc., while UK banks owned by Icelanders (KSF and Heritable) were fully solvent



# Lesson 1: No Need to Save Banks

- Iceland made quick recovery despite collapse of banking sector
- Main reason: Icelandic economy sound
- Four pillars: efficient fisheries system (ITQs); ample power resources; accumulated human capital; booming tourist industry
- No big debts derived from bank collapse
- Banking sector not potential burden on taxpayers as in other European countries

# Sustainable and Profitable Fisheries



# Lesson 2: Give Depositors Priority

- Only discrimination in Icelandic Emergency Act between depositors and other bank creditors (bondholders)
- In Iceland, an emergency measure, but makes sense generally speaking
- Depositors coincide more or less with the public; bondholders are businessmen and should accept same risks as others
- Depositors do not have same special knowledge as could be expected in bondholders

# Lesson 3: No Government Guarantee

- Banks use depositors as 'human shields': If they are not rescued, depositors will panic
- Their anticipation that they, unlike other companies, will be rescued leads to moral hazard and excessive risk-taking
- Banks, especially in Europe, are over-grown
- But if depositors have priority, they should not be prone to panic
- Other bank creditors will also become more cautious, requiring better collateral, putting natural limits on banks growing

# Lesson 4: Power Will Be Abused

- When UK Anti-Terrorism Act passed in 2001, discretionary power was created
- Such power will sooner or later be abused
- No need to invoke Anti-Terrorism Act against Icelandic institutions
- Alleged goal to hinder illegal transfers of Landsbanki from UK to Iceland
- But already FSA in 3 October Supervisory Notice had made such transfers impossible

# Brown's Decision Politically Motivated



# Explanations for Brown's Bullying

- Brown and Darling wanted to show voters how tough they were, creating a 'Falklands Factor' without the risk
- They felt politically threatened by the Scottish National Party
- They wanted to demonstrate to Scottish voters how dangerous it was to go alone: the 'Arc of Prosperity' had become an 'Arc of Insolvency'
- Sheer chaos and limited understanding of the Icelandic issues

# Lesson 5: Small States Have No Friends

- States do not have friends; they have interests
- Despite Iceland's neutrality, the UK occupied her as soon as it was strategically important
- The US undertook defence of Iceland for her own purposes, first in WW1, then Cold War
- Then US did not allow any bullying of Iceland
- As soon as these purposes became irrelevant, the US turned her back on Iceland
- But a blessing in disguise that Iceland had to fend for herself



# Lesson 6: Leadership Is Needed

- Recovery facilitated by sound basis established in Oddsson's free-market reform era of 1991–2004
- Recovery also facilitated by government having practically no debt
- Finance Ministers: Haarde 1998–2005 and Mathiesen 2007–9
- Independence Party leaders agreed with Oddsson on 'ring-fencing' while Social Democrats stalled process
- Institutions are like fortresses: they have to be solidly built, but also well manned (Popper)

# An Icelandic Saga with a Happy End



