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LESSONS FOR EUROPE FROM THE 2008 ICELANDIC BANK COLLAPSE

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1

INTRODUCTION

The 2008 Icelandic bank collapse was spectacular. Iceland, a prosperous, peaceful but tiny Nordic country suddenly found herself under siege, first from hedge funds, and then from her neighbours and long-time allies who not only denied liquidity help to her struggling banks in the international financial crisis of 2007 and 2009, but also invoked an Anti-Terrorism Act against her, putting her in the same category as the Taliban, Al-Qaida, Sudan and North Korea. In the course of three days, 6–8 October 2008, all three major Icelandic banks fell. Icelanders were not even sure whether they would be able to import vital food and medicine. To add insult to injury, the British and Dutch governments, with the connivance of the other Nordic countries, were able to prevent all assistance from the International Monetary Fund (IMF) unless the Icelandic Treasury guaranteed the obligations of the Icelandic Depositors' and Investors' Guarantee Fund (IDIGF), at the time estimated to be an enormous financial liability, probably locking Iceland in a debt prison for decades. The Icelandic government reluctantly bowed to pressure, but in two referenda Icelandic voters rejected deals based on the British and Dutch demands, and in 2013 Iceland won her case before the EFTA Court. No less spectacular has been the rapid Icelandic recovery. In 2017 Iceland again joined the ranks of the world's most prosperous countries, with a flourishing economy and profitable new banks established on the ruins of the failed ones.

The saga of the bank collapse was short, but eventful.¹ In 1991 the Independence Party leader, David Oddsson, had formed his first government with the explicit

agenda of liberalising the economy. He remained Prime Minister until 2004, becoming Foreign Minister for a year, after which he was appointed Chairman of the Board of Governors at the Central Bank of Iceland (CBI). The privatisation of the banks was completed in 2003. The new owners hired young and ambitious managers who hit on a singularly fortuitous moment: the financial markets were full to the brim of cheap money, and in addition Iceland, as a result of prudent fiscal and monetary policies since 1991, enjoyed a good reputation internationally. This implied good credit ratings for the Icelandic Treasury and improved the credit ratings for the newly privatised banks. Consequently, from 2004 to 2005 the bank managers and their major customers among Icelandic businessmen started a major expansion abroad, borrowing money in financial markets and lending it to Icelandic businessmen for foreign investments.

Early warnings that the Icelandic banks might get into difficulties were heard in late 2005. It was pointed out that it would be beyond the capacities of both the CBI and the Icelandic Treasury to rescue them in the case of a credit crunch. The banks suffered a setback in early 2006, not least as a result of negative reports and the common perception of their vulnerability. But while they did no longer enjoy easy credit in European markets, they were able to continue expanding by selling bonds in the United States, by obtaining credit from the European Central Bank (ECB) through their Luxembourg subsidiaries and by starting to collect deposits in various countries, most importantly in the United Kingdom and the Netherlands. This made them, however, unpopular in European central bank circles. And when the international credit crunch started in August 2007, they found it difficult to refinance themselves. In vain the CBI tried to make currency swap deals with European central banks (except the three Scandinavian central banks) and the US Federal Reserve Board. The death knell sounded on 24 September 2008, when the US Federal Reserve Board, in response to the credit crunch, announced dollar swap deals with the three Scandinavian central banks. The CBI was conspicuously absent. Two days

later, one of the three major Icelandic banks, Glitnir, reached the conclusion that it would be unable to meet forthcoming obligations and, therefore, asked for a €600 million emergency loan from the CBI.

Instead of extending an emergency loan to Glitnir against a less than solid collateral offered, the CBI advised that the government would buy 75% in the bank for €600 million, in the hope of calming the international markets. It could not have chosen a worse time. On Monday 29 September, when the recapitalisation of Glitnir was announced, the international credit crunch had turned into a major financial crisis with banks all around the world on the brink of collapsing and governments hastily pumping money into their economies. Credit lines to the Icelandic banks were cancelled, and a run started on deposits. The CBI, under Oddsson's leadership, advised 'ring-fencing' the Icelandic economy – as illustrated on this page – and transferring the domestic operations of the banks, both deposits and assets, to new banks, putting the foreign part into resolution if necessary.² The government hesitated for a few days, as the Social Democrats, the junior partner in a coalition presided over by the Independence Party leader, Geir H. Haarde, were reluctant to adopt Oddsson's proposal. Finally they went along with it. An 'Emergency Act' was passed by Parliament on 6 October, giving the Icelandic Financial Supervisory Authority (IFSA) full authority to take over banks and making claims by depositors priority claims on the estates of the banks which were now falling by the day: Landsbanki in the evening of 6 October, Glitnir in the evening of 7 October and Kaupthing in the evening of 8 October. There had been a weak glimmer of hope that Kaupthing, the largest bank, would survive, but when the British Labour government closed down its London subsidiary KSF in the early afternoon of 8 October, it triggered loan covenants and brought about the fall of the Icelandic parent company.

² The illustration on this page of ring-fencing, concentrating on avoiding sovereign default and maintaining the payments system, was presented by Sturla Pálsson, CBI Director of Treasury and Market Operations, in an emergency meeting at the CBI 30 September 2008.

The bank collapse came as a shock to the Icelanders, and at the end of 2008, a Special Investigation Commission (SIC) was appointed to find out what had happened. But some did not want to wait for its report, and after unprecedented street riots for weeks, the Social Democrats turned their back on their coalition partner and formed a minority government on 1 February 2009 with the Left Greens. They called for new elections, in which the two parties won a huge victory, while the Independence Party suffered a debacle. The first action taken by the minority government was to drive Oddsson and his two colleagues out of the CBI. The SIC presented its report in 2010, assigning blame to three government ministers, Prime Minister Haarde, Finance Minister Arni M. Mathiesen and Business Affairs Minister Bjorgvin G. Sigurdsson, the three CBI governors and the director of the IFSA.³ On the basis of the SIC report, a narrow majority in Parliament decided to charge Haarde alone with negligence. Eventually he was acquitted of all major charges but found guilty of a technicality: that he had not put the impending banking crisis on the agenda of cabinet meetings.

The case against Haarde was widely regarded as grossly unfair, and after the two left-wing government parties suffered a heavy defeat in 2013, a new coalition government of the Independence Party and the Progressive Party appointed Haarde as Iceland's Ambassador to the United States. Mathiesen had by then become Assistant-Director General of the Food and Agriculture Organisation (FAO), the highest position an Icelander has occupied in international organisations, while Oddsson had become editor of *Morgunbladid*, a leading newspaper and the Icelandic 'journal of record'. But still the debate rages in Iceland over the causes and consequences of the bank collapse. Perhaps there are some lessons to be drawn for Europe from this Icelandic saga.

³ Páll Hreinsson, Sigríður Benedíktsdóttir and Tryggvi Gunnarsson, *Skýrsla rannsóknarnefndar Althingis um aðdraganda og orsakir falls íslensku bankanna 2008* [Report of the Special Investigation Commission of Parliament on Events Leading Up to and Causes of the Icelandic Bank Collapse] (Reykjavik: Althingi, 2010). It will be referred to here as the SIC Report. It is all available online in Icelandic, and parts of it are available in English. <https://www.rna.is/eldri-nejndir/addragandi-og-orsakir-falls-islensku-bankanna-2008/> Whenever possible, I quote from the English extracts.

¹ In the following report I draw on a report I finished in 2017 for the Icelandic Ministry of Finance on foreign factors in the Icelandic bank collapse. I also have to declare an interest: I was, and remain, Oddsson's friend, and I often advised him during his tenure as Prime Minister. I was a member of the Board of Overseers of the CBI from 2001 to 2009. But what is important is not the affiliation of the author, but the strength of his evidence. If science is the free competition of ideas, as Karl R. Popper holds, then my arguments and conclusions should be judged on their own merits. Cf. Karl R. Popper, *The Poverty of Historicism*, 2nd edition (London: Routledge & Kegan Paul, 1962), pp. 155–159.

2

IMPLAUSIBLE NARRATIVES ON THE COLLAPSE

In trying to explain the 2008 Icelandic bank collapse, many intellectuals seem to heed the old dictum that one should never let a good crisis go to waste. They have alternatively blamed it on neoliberalism, the system of ITQs – individual transferable quotas – in the fisheries, a predominantly masculine value system, the Icelandic Constitution and blunders by the Central Bank of Iceland (CBI).⁴

Sometimes those intellectuals seem to be using the opportunity to restate long-held views that they simply insert into their narratives of the collapse. Professors Robert Wade and Sigurbjorg Sigurgeirsdottir, for example, write that from the early 1990s, Iceland was ruled by ‘zealous neoliberals, who believed that financial markets were ‘efficient’ and self-adjusting’.⁵ Another leftwinger, Professor Stefan Olafsson, asserts that, ‘From the late 1990s this already successful society became the subject of an unusual neoliberal experiment that produced an excessive bubble economy between 2003 and 2008.’⁶ Nobel Laureate Paul Krugman accepts Olafsson’s anti-liberal narrative, quoting him and blogging on Iceland that an ‘economy that produced a decent standard of living for its people was in effect hijacked by a combination of free-market ideology and crony capitalism.’⁷

Since ‘neoliberalism’ is mentioned as an important factor in the bank collapse, its meaning has to be

clarified. Possibly the way to describe neoliberalism which would be accepted both by left and right, is that it refers to the international trend in the 1980s and 1990s to reduce government intervention in the economy, not least by tax cuts, privatisations and freer international trade. This trend, or movement, was spearheaded by Ronald Reagan in the US and Margaret Thatcher in the UK and had intellectual support from two Nobel Laureates in economics, Friedrich A. Hayek and Milton Friedman.⁸ In this sense David Oddsson and his associates could certainly be regarded as ‘neoliberals’. Indeed, during the Oddsson governments from 1991 to 2004, economic freedom in Iceland increased. In 1980 the index of economic freedom showed 5.2 for Iceland, which then had the 57th freest economy in the world; in 1990 the index showed 6.9; and in 2004 the index showed 8.1 for Iceland, which then had the 9th freest economy in the world.

In 2004 Iceland had the freest economy of all the Nordic countries (though they all were relatively free), and it was one of the countries in the world where economic freedom had increased the most in the preceding 10 years. However, economic freedom decreased somewhat in the next few years up until the collapse, because of the growth of government: In 2007, for example, the index showed 7.9 for Iceland, which then had the 15th freest economy in the world.⁹ Hence it is difficult to see any causal connection between neoliberalism in this sense and the Icelandic bank collapse. In 2007, the last year before the collapse, 14 economies were freer. If economic freedom was the cause of the collapse, then why did the banking sectors of Singapore, Hong Kong, New Zealand and Switzerland – which all had freer economies than Iceland – not also collapse? Moreover,



Prime Minister David Oddsson with Margaret Thatcher in London February 1992. Oddsson in Iceland, like Thatcher in Great Britain, greatly liberalised the economy during his tenure in office, 1991–2004. Iceland gained a good reputation which was, in turn, used by the banks to obtain cheap credit abroad. Photo: Oddsson archive.

the immense debt accumulation in and of the banks really began in 2004 – the year Oddsson stepped down as Prime Minister.¹⁰

Most importantly in this context, the Icelandic banks operated under the same legal framework as their counterparts in other member states of the EEA, comprising the whole of the EU, Norway, Iceland and Liechtenstein. In terms of legislation, the ‘neoliberal experiment’ in the financial sector was really little more than bringing Icelandic banks into line with other European banks. However, the real free market reforms of the 1991–2004 Oddsson governments consisted in abolishing special government investment funds,¹¹ reducing inflation, turning budget deficits into surpluses, privatising companies, cutting taxes and strengthening both the vocational non-government pension funds and the ITQ system in the fisheries. On most criteria these reforms were successful. In 2004 before the bubble, Iceland was one of the most affluent and peaceful countries in the world.

It is also difficult to see a causal connection between the ITQ system in the Icelandic fisheries and the 2008 bank collapse. The system of individual transferable quotas was gradually adopted between the late 1970s and the early 2000s. Under the system, only holders of quotas to a particular fish stock could harvest that fish stock in Icelandic waters. The quotas were initially allocated on the basis of catch history, which meant that if one fishing firm had been harvesting 5% of the total catch in the particular fish stock over the years prior to the adoption of the system, then it received a transferable right to harvest 5% of the total allowable catch (TAC) in that very fish stock over the fishing season. The result of the system, as anyone familiar with economic analysis could predict, was that the more efficient fishing firms bought quotas from the less efficient ones, whose owners subsequently left the fisheries. Thus excess capacity was slowly reduced and effort brought down to a profitable level.

Nevertheless, left-wing intellectuals link the ITQ system to the bank collapse, criticising the initial allocation of quotas and wealth accumulation in the fisheries.¹² This is, however, a misunderstanding of the reform when fishing in Icelandic waters was confined to quota holders. It can be demonstrated that under open access to a fishery (like other limited resources), effort – for example measured by the number of boats harvesting fish – will increase to the level where there is no more profit to be had.¹³ This means that the potential gain from the resource (sometimes called the ‘resource rent’) is all, or almost all, wasted in overcapacity and excessive effort, as can actually be observed around the world. Thus the only right of which people who no longer could engage in offshore fishing were deprived was the right to harvest fish without any profit, and that right, by definition, was worthless. In other words there was no transfer of goods from the Icelandic Treasury to the fishing community – only the definition of rights under which the fishing community could in mutually agreed transactions eliminate the waste consisting in excess capacity and too much effort.¹⁴

4 I argue elsewhere against two more narratives on the collapse, that Iceland was too small and that it was corrupt, *In Defence of Small States* (Brussels: New Direction, 2016).

5 Robert Wade and Sigurbjorg Sigurgeirsdottir, *Lessons from Iceland*. *New Left Review*, Vol. 65 (September–October: 2010), pp. 5–29.

6 Stefan Olafsson, *Crisis and recovery in Iceland*, *Retrenchment or Renewal: Welfare states in times of economic crisis*, eds. Gudmundur Jonsson and Kolbeinn Stefansson (Helsinki: Nordic Centre of Excellence Nordwel, 2013), p. 106.

7 Paul Krugman, *The Icelandic Post-Crisis Miracle*. Blog 30 June 2010. <https://krugman.blogs.nytimes.com/2010/06/30/the-icelandic-post-crisis-miracle/>

8 Both Hayek and Friedman visited Iceland and gave lectures, in 1980 and 1984 respectively.

9 *Economic Freedom* (Vancouver BC: Fraser Institute, 2017). <https://www.fraserinstitute.org/economic-freedom/map>

10 This is recognised in the SIC Report, Vol. 1, Ch. 2, p. 1, and Vol. 7, Ch. 21, p. 32 (both in English).

11 These funds had made losses, as was to be expected, cf. John Burton, *Picking Losers: The Political Economy of Industrial Policy* (London: Institute of Economic Affairs, 1983).

12 Thorvaldur Gylfason, *Natural Resource Endowment: A Mixed Blessing? Beyond the Curse: Policies to Harness the Power of Natural Resources*, eds. Rabah Arezki, Thorvaldur Gylfason and Amadeu Sy (Washington DC: IMF 2011), pp. 7–34. https://notendur.hi.is/gylfason/Beyond_the_Curse_Arezki_Gylfason_Sy.pdf

13 H. Scott Gordon, *The Economic Theory of a Common Property Resource: The Fishery*, *Journal of Political Economy*, Vol. 62 (1954), pp. 124–42.

14 Hannes H. Gissurarson, *The Icelandic Fisheries: Sustainable and Profitable* (Reykjavik: University of Iceland Press, 2015). <https://books.google.com.br/books?id=j-p8CwAAQBAJ>



One of the least plausible narratives on the Icelandic bank collapse was that it was caused by male domination, or 'patriarchy'. Then, why did not banking sectors in more male-dominated societies collapse? The proponents of this narrative also ignore the fact that the political leaders with the closest ties to the banking sector both were women: Education Minister Thorgerdur K. Gunnarsdottir (left), then of the Independence Party – which she later left – and Foreign Minister Ingibjorg S. Gisladdottir of the Social Democrats. Photo: Fridrik Tryggvason, Mbl.

It is true that the ITQ system added a lot of wealth to the Icelandic economy. This was a resource which had previously been of almost zero value because total cost had been almost equal to total income, but it now became quite valuable. The ITQ system had already started in the herring fishery in 1975 and in the cod and other demersal fisheries in 1984, becoming a comprehensive system by law in 1990. In other words it had started 33 years before the bank collapse and had become a comprehensive system 18 years prior to it. Of course the quota system in the fisheries expanded the basis of possible collaterals in Iceland for bank loans, but if that is the argument, then any move towards a more productive economy – and any such move would expand this basis – could be said to be a factor in the bank collapse.

Another link that seems tenuous is made by some radical feminists between a masculine value system and the Icelandic bank collapse. In Iceland in the early 2000s, there was probably less discrimination against women than in most other countries of the world. Why did banking sectors in countries with a much stronger masculine hierarchy not collapse, for example in the Middle East, Asia or Latin America? Nevertheless, Professor Thorgerdur Einarsdottir and her associates see the 2008 bank collapse as

an expression of male domination, observing that both 'political leaders and leading bankers claimed that Icelandic male tycoons had astute intuition and business acumen that made neoliberalism the right path for Iceland.' They conclude: 'This prevailing social discourse about the unique success of the [male] Icelandic bankers contributed to the crisis.'¹⁵

Professor Einarsdottir and her associates overlook or ignore the fact that a similar discourse about seemingly successful bankers took place in many other countries without the collapse of the whole banking sector in these countries. 'The culture was fairly male dominated,' admits Kaupthing's Armann Thorvaldsson, who worked in London, but adds, crucially, 'as tends to be the case at brokerage companies and investment banks.'¹⁶ The reason for this tendency may be, as Political Psychology Professor Hulda Thorisdottir points out, that men are on average less afraid of risk than women and more

¹⁵ Janet E. Johnson, Thorgerdur Einarsdottir and Gyda Margret Petursdottir, A Feminist Theory of Corruption: Lessons from Iceland, *Politics & Gender*, Vol. 9 (2013), p. 189. Square brackets around 'male' are in the original.

¹⁶ Armann Thorvaldsson, *Frozen Assets: How I lived Iceland's Boom and Bust* (London: Wiley 2009), p. 10.

appreciative of material goods.¹⁷ But the move from this general observation to the particular case of the Icelandic bank collapse seems unwarranted.

Another fact may be relevant here. While certainly most of the bankers and businessmen prominent in Iceland before the crisis were male, their strongest political allies were female. In the 2003 election campaign, Ingibjorg S. Gisladdottir, leader of the Social Democrats, defended both Kaupthing and retail tycoon Jon Asgeir Johannesson against the alleged hostility of Oddsson, then Prime Minister.¹⁸ After Gisladdottir, now Foreign Minister, at a confidential meeting in early 2008 listened to Oddsson's warnings about the risky expansion of the banks, she dismissed them as being 'one man's venting'.¹⁹ It was Gisladdottir and Education Minister Thorgerdur K. Gunnarsdottir, then of the Independence Party – which she later left – who in early October 2008 demanded that Oddsson be dismissed when he warned the government against an imminent collapse of the banks. Both Gisladdottir and Gunnarsdottir received sizeable contributions to their personal campaigns in primaries from Kaupthing.²⁰ Gunnarsdottir held, with her husband, stock in Kaupthing and was, among members of parliament, one of the banks' biggest debtors.²¹ Indeed, of the five members of parliament with the biggest debts to the banks, three were women.²²

This information was available in 2013 when Einarsdottir and her associates published their paper. Moreover, it should be recalled that a 2005 report in praise of the expansion of Icelandic companies in the UK was conceived by a prominent female journalist,

¹⁷ SIC Report, Vol. 8, Add. II, p. 291.

¹⁸ Ingibjorg S. Gisladdottir, Speech in Borgarnes 9 February 2003. *Morgunblaðið* 8 March 2003.

¹⁹ SIC Report, Vol. 1, Ch. 2, p. 9, Vol. 6, Ch. 21, p. 63 (both in English). SIC Report, Vol. 6, Ch. 19, p. 119. Cf. pp. 118 and 137.

²⁰ *Ibid.*, Vol. 8, Add. 1, p. 165.

²¹ Soon after a confidential meeting in late 2007 with Prime Minister Geir H. Haarde, Finance Minister Arni M. Mathiesen and the CBI governors, where Oddsson expressed strong doubts about the sustainability of the banks (Interviews with David Oddsson in Reykjavik 5 October 2017 and by phone with Geir H. Haarde 8 November 2017), Gunnarsdottir and her husband moved their Kaupthing assets and liabilities to a private company, thus considerably reducing their personal risk. They were granted exemption from the rules of Kaupthing where Gunnarsdottir's husband was a senior manager. The same day as Oddsson issued his warning to the cabinet that the banks were falling, on 30 September 2008, Gunnarsdottir and her husband sold their disposable shares in Kaupthing. The transaction was revealed in a court case, *Haestarettardomar* [Supreme Court Judgements], no. 593/2013.

²² SIC Report, Vol. 2, Ch. 8, p. 200.

Sigrun Davidsdottir. Again, a much-quoted and derided 2008 report applauding Icelandic superiority in many fields was written by a committee chaired by a well-known businesswoman, Svafa Gronfeldt.²³

There is, however, possibly a grain of truth in the feminist interpretation of the collapse: By their harsh words about and brutal actions against Iceland, discussed in more detail later in this report, Scottish politicians Gordon Brown and Alistair Darling may have wanted to demonstrate to their voters that they were tough fighters, lions rather than cats, standing up for British interests against Icelandic bankers, 'Showing off to impress the girls,' as one British journalist put it.²⁴ Thus, there may in fact have been a link between masculinity ideals and the Icelandic bank collapse, although quite different from that which Einarsdottir and her associates tried to articulate.

Yet another alleged factor in the bank collapse is the Icelandic Constitution. Professor Einarsdottir and her associates write: 'Many see a new constitution as a necessary response to the financial crisis and to the messiness of the constitution that retains much of its colonial predecessor.'²⁵ But it is misleading, to say the least, to refer to the Constitution of Iceland before the foundation of the republic in 1944 as a 'colonial predecessor' of the present one. The reason is simple: Iceland was never a colony. From 1262, when the Icelanders made a covenant with the Norwegian king, and onwards Iceland was a tributary, not a colony, even if she was certainly sometimes treated as a colony, especially after the mid-16th century Reformation. In this respect the legal status of Iceland changed little after the Norwegian crown passed to the Danish king, while in the 19th century the country came to be regarded by the Danes as a dependency (*biland* in Danish, *hjalenda* in Icelandic), a part of the Danish realm with special rights, but not belonging to Denmark proper. And it certainly was not a colony, such as the Danish West Indies, or for that matter Belgian Congo, British Honduras and French Polynesia.

²³ Sigrun Davidsdottir *et al.*, *Utras íslenskra fyrirtækja til Lunduna* [The Outvasion of Icelandic Companies to London] (Reykjavik: Chamber of Commerce, 2005); Svafa Gronfeldt *et al.*, *Ímynd Íslands: Styrkur, stada og stefna* [Iceland's Image: Strengths, Present Position, Future Policies] (Reykjavik: Prime Minister's Office, 2008).

²⁴ A. A. Gill, Iceland: frozen assets, *Sunday Times* 14 December 2008.

²⁵ Johnson *et al.*, A Feminist Theory of Corruption, p. 195.

The leader of Iceland's independence struggle, Jon Sigurdsson, was adamant that Iceland was not even a dependency, but a sovereign country under the Danish king.²⁶ Crucially, both Danes and Icelanders recognised that Iceland was not a colony.²⁷ The non-colonial status of Iceland was indeed demonstrated by the Constitution given to the Icelanders in 1874 by the Danish king on the advice of his government. The Icelandic Constitution was almost identical to that adopted in Denmark in 1849, when the king renounced his absolute power. That constitution was in turn influenced by the Belgian constitution of 1830 and the Norwegian constitution of 1814, both regarded as very liberal for their times. All these constitutions served the same purpose of protecting individual rights, constraining government power and providing a framework for valid legislation.

Since the Icelandic Constitution is similar to many other European democracies, including the other Nordic countries, it is difficult to see any causal connection between it and the 2008 crash. There was no bank collapse in Denmark or in the other Nordic countries. What exactly in the Icelandic Constitution would have contributed to the bank collapse? No plausible answer has been provided. It was certainly not the 'messiness of the constitution', as Einarsdottir and her associates put it, that enabled the rapid growth of the Icelandic banks, but rather Iceland's membership of the EEA, abundant credit available abroad after 2001 and good credit ratings deriving from Iceland's good reputation.²⁸

In this context, two generally accepted views about constitutions should be recalled. First, a constitution, being the framework under which power is exercised should change slowly and by general consent. It is perhaps no coincidence that the United States has only had one constitution, whereas Venezuela has had 26 constitutions. Only the Dominican Republic has had more constitutions; Haiti and Ecuador are in third and fourth position.²⁹ These are not exactly paragons

of constitutional virtue. Second, a constitution is not about one group of society imposing its will on the rest. It should rather be considered a social contract between all members of society on what should be within the reach of government and what should not.³⁰ It is, therefore, widely recognised that a constitution requires a significantly larger majority behind it than legal acts passed by parliament.³¹

This was the case with the two important changes in Iceland's legal status after 1874, when she became a sovereign state in 1918 and a republic in 1944. After the Icelandic Parliament in 1918 made an agreement with its Danish counterpart on the Act of the Danish-Icelandic Union, it was confirmed in a plebiscite where 92.6% of those voting accepted Iceland's new status as a sovereign, constitutional kingdom in a personal union with Denmark, while 7.4% rejected it. It is likely that the opposition to the Union Act came mostly from those who wanted full independence right away. The turnout was rather low, probably because the conclusion was seen as foregone and because there were no stipulations about a minimum turnout for the results to be valid, but also because the plebiscite was held in the midst of winter and the Spanish Flu was ravaging the country.

In the Danish-Icelandic Act of Union, it was stipulated that if the Icelandic Parliament decided to revoke the Union between the two countries, the decision needed to be confirmed in a plebiscite where the turnout had to be at least 3/4 of those eligible to vote and it had to be accepted by at least 3/4 of those voting. When the Icelandic parliament decided to revoke the Union Act, it was confirmed in a 1944 plebiscite, where the turnout was an incredible 98.4%, with 99.5% wanting to revoke the Union Act and 0.5% being against it. The republican constitution was also confirmed, with 98.5% of those voting in favour of it and only 1.5% against it.³² The 1944 Icelandic Constitution was, therefore, backed by something like a real common will, in Rousseau's sense, of the nation.

By contrast, in Iceland there was little public interest in the writing of a new constitution initiated after the 2008 bank collapse. In elections to a consultative constitutional assembly in 2010, the turnout was only 36.8%. Those elected were mostly left-wing intellectuals having been frequently interviewed on Icelandic radio and television or appearing on talk shows and, therefore, with high name recognition. Several irregularities were found in the election process that led the Supreme Court, responding to complaints, to invalidate the elections. In defiance of the Supreme Court, the left-wing parliamentary majority elected after the bank collapse decided to appoint a consultative 'Constitutional Council' of the 25 people who had received the most votes in the invalidated elections. 'This, however, severely damaged the legitimacy of the process,' a member of the 'Constitutional Council', Professor Eirikur Bergmann admits.³³ This new body, starting each of its televised sessions by singing together uplifting songs, drafted a bill for a constitution with wide-ranging stipulations about various aspects of life, essentially a wish list. The bill was put to vote in 2012. Again the turnout was small, only 48.4%. Of those who voted yes or no, 67% accepted the bill as a guideline for a new constitution (which under the Icelandic Constitution parliament had to pass), while 33% rejected it. This meant that less than one third of all eligible voters accepted the bill.³⁴ This can be contrasted with the 1944 plebiscite on the republican constitution, where the turnout was 98.4% with 98.5% voting in favour of it and only 1.5% against it.

After the Icelandic Parliament received the bill from the 'Constitutional Council', it consulted the European Commission for Democracy through Law and the Venice Commission, which severely criticised it. The Commission found 'regrettable' that most of the rights provisions were 'worded in very general terms, not providing sufficient clarity on whether and which concrete rights and obligations can be derived from them', adding that it saw 'a strong risk that the public takes them as promises to ensure high living conditions. The provisions mainly state a goal, but do not deal with the means to reach it, entailing the risk of disappointing public expectations.' The Commission

also observed that the provisions on property rights were 'too general', whereas those on right of information were too detailed. It found 'regrettable that a Constitution be designed primarily in the light of an unfortunate historical experience.'³⁵

After the obvious lack of interest by the Icelandic public and the severe criticisms of the bill by the Venice Commission, the project was abandoned. Before the 2013 general elections, a political party under the leadership of Professor Thorvaldur Gylfason, one of the members of the 'Constitutional Council', was formed explicitly to fight for a new constitution on the lines of the bill drafted by the 'Council': This party received less than 2.5% of the votes. It therefore seems somewhat of an exaggeration when Einarsdottir and her associates write that 'Many see a new constitution as a necessary response to the financial crisis'. Perhaps they should have written, 'Some saw the financial crisis as an opportunity to replace Iceland's liberal constitution with a socialist one.'



In front of Government House in Reykjavik there is a statue of Danish King Christian IX who gave Iceland a constitution in 1874, on the thousandth anniversary of Iceland's settlement. The constitution was modelled on the Danish one and other liberal constitutions of Europe and has served Iceland well. Left-wing intellectuals attempted to use the opportunity provided by the bank collapse to change the constitution, but they did not have much support. A party which was formed to fight for such a change received less than 2.5% of the votes in 2013. Photo: Kristinn Ingvarsson, Mbl.

26 Jon Sigurdsson, *Hugvekja til Islendinga* [An Exhortation to the Icelanders], *Ný felagsrit*, Vol. 8 (1848), pp. 1–24.

27 Anna Agnarsdottir, *The Danish Empire: The Special Case of Iceland, Europe and its Empires*, eds. Mary N. Harris and Csaba Lévai (Pisa: Plus-Pisa University Press, 2008), pp. 59–84; Gudmundur Halfdanarson, *Iceland Perceived: Nordic, European, or a Colonial Other? The Postcolonial North Atlantic*, eds. Lill-Ann Körber and Ebbe Volquardsen (Berlin: Nordeuropa-Institut der Humboldt-Universität, 2014), pp. 39–66.

28 SIC Report, Vol. 1, Ch. 2, p. 1; Vol. 7, Ch. 21, pp. 4–5 (in English).

29 José Luis Cordeiro, *Constitutions Around the World: A View from Latin*

America, IDE Discussion Paper no. 164 (Chiba: Institute of Developing Economies, 2009).

30 Friedrich A. Hayek, *The Constitution of Liberty* (London: Routledge & Kegan Paul, 1960), esp. pp. 176–204.

31 James M. Buchanan and Geoffrey Brennan, *The Reason of Rules. Constitutional Political Economy* (Cambridge: Cambridge University Press, 1988).

32 Státice (2017). <http://statice.is/statistics/population/elections/referendal/>

33 Eirikur Bergmann, *Iceland and the International Financial Crisis* (New York: Palgrave Macmillan, 2014), p. 178.

34 Of those voting, 64.2% voted for the bill as a whole, but 4.2% did not answer. Státice (2017). http://px.hagstofa.is/pxen/pxweb/en/lbuar/lbuar_kosningar_thjodaratkv/KOS04108.px

35 *Opinion on the Draft New Constitution of Iceland* (Strasbourg: European Commission for Democracy Through Law, 11 March 2013). [http://www.venice.coe.int/webforms/documents/?pdf=CDL-AD\(2013\)010-e](http://www.venice.coe.int/webforms/documents/?pdf=CDL-AD(2013)010-e)

DID THE CENTRAL BANK FAIL?

In a survey of 25 people to blame for the 2007–2009 financial crisis, the American magazine *Time* included David Oddsson, Iceland's Prime Minister from 1991 to 2004 and one of the three governors of the Central Bank of Iceland (CBI) from 2005 to 2009.³⁶ This was probably done under the influence of some Icelandic intellectuals who disliked Oddsson as strongly as many British intellectuals did Margaret Thatcher. In the first book to be published on the 2008 Icelandic bank collapse, in April 2009, Oddsson indeed was cast as its chief culprit.³⁷ One of the claims in that book is that Oddsson made a huge mistake by the attempted recapitalisation of Glitnir in late September 2008, because it started the chain of events that eventually led to the downfall of the banks. But the decision was formally made by the government on the advice of the CBI, while the leaders of the opposition parties in parliament were consulted and all accepted it, even if not all explicitly endorsed it.³⁸ Moreover, against the proposed loan Glitnir initially offered collateral which appeared solid, but when it proved impossible for legal reasons to use that collateral, it could only replace it with assets that appeared much less solid.

It is true that the government's readiness to purchase 75% in Glitnir did not calm the markets as had been hoped, but one of the main reasons for that was that the bank's largest shareholder, retail tycoon and media mogul Jon Asgeir Johannesson, Oddsson's implacable enemy,³⁹ started a media campaign

36 25 People to Blame for the Financial Crisis, *Time* 12 February 2009. http://content.time.com/time/specials/packages/article/0,28804,1877351_1877350_1877340,00.html

37 Olafur Arnarson, *Sofandi ad feigdarosi* [Sleepwalking Into the Abyss] (Reykjavik: JPV, 2009). Arnarson had been an employee of Jon Asgeir Johannesson, and in a police raid on the premises of an unnamed company, documents were discovered, and leaked to the press, suggesting that while he was writing the book, he was on the payroll of a public relations company working for some of the business tycoons. Faer borgad fra Gunnari Steini [Receives Payments from Gunnar Steinn], *DV* 31 May 2010.

38 SIC Report, Online Addenda, No. 11, response of Eiríkur Guðnason.

39 Apparently the main reason for Johannesson's enmity was that in early 2002 Oddsson had criticised lack of competition in the retail sector.

against the transaction. It should not be ignored, either, that the very day when the Glitnir take-over was announced, Monday 29 September, international financial markets were in turmoil. The US House of Representatives had just rejected a bill to provide aid of up to \$700 billion to the financial sector. Banks in Europe were close to collapsing. The stock price of Anglo Irish bank plunged 46%, Dexia fell by 30%, Germany's Commerzbank and Deutsche Postbank by 23% and 24%, respectively, and Sweden's Swedbank by 19%.

It is difficult to argue that in the circumstances an emergency loan from the CBI to Glitnir would have been a better option. The problems at Glitnir revealed, and did not cause, the general lack of access to liquidity in the Icelandic banks. What seems to have been really crucial was the refusal by the US Federal Reserve Board – obvious to the markets even if nowhere made public – to make dollar swap deals with the CBI, whereas on 24 September it announced such deals with the three Scandinavian central banks. This alerted the markets to the fact that Iceland was virtually defenceless: Hedge funds could concentrate on the Icelandic banks at the same time as negative publicity brought about large-scale withdrawals of retail deposits. On its own, no bank can withstand a run.⁴⁰ The irony of the situation was also that now the Icelandic Treasury and the CBI were downgraded by ratings agencies as a result of the general distrust of the Icelandic banks, just as the banks had some years earlier been upgraded as a result of the good performance of the Icelandic Treasury and the CBI. A bad reputation can be just as contagious as a good one.

In this early book on the collapse, Governor Oddsson is also held responsible for the use of the 2001 Anti-Terrorism Act by the UK Labour government against Iceland: Twelve hours after Oddsson said

40 Douglas Diamond and Philip Dybvig, Bank Runs, Deposit Insurance, and Liquidity, *Journal of Political Economy*, Vol. 41 (1983), pp. 401–19.



Leaving one of many emergency meetings at CBI headquarters during the collapse. CBI Governor David Oddsson driving, with Prime Minister Geir H. Haarde at his side and Finance Minister Arni M. Mathiesen in the back. In trying to resolve the crisis, the CBI governor and the two government ministers met reluctance of their colleagues from the Social Democrats to recognise the extent of the problem. The banks could not be saved, but Iceland had to survive. Photo: Kjartan Thorbjörnsson, Mbl.

in a television interview on 7 October 2008 that the Emergency Act passed by Parliament meant that Iceland would not pay the debts of 'reckless financiers', the Anti-Terrorism Act was invoked, allegedly to protect British assets against Landsbanki and the Icelandic authorities. But this allegation against Oddsson goes against everything that is known about that fateful decision by the British government. Nowhere did any British person of authority state that the interview with Oddsson played a role in the decision. Chancellor Alistair Darling explicitly said, both in interviews with the press immediately after the fact and in testimony to a British parliamentary committee, that it had been his conversation with Finance Minister Arni M. Mathiesen that had led him to use the Anti-Terrorism Act against Iceland.⁴¹ When the transcript of the conversation was published, it became clear that Darling had misquoted Mathiesen.⁴² Irrespective of that, the conversation

41 *Banking Crisis: The Impact of the Failure of the Icelandic Banks* (London: The Stationary Office, 4 April 2009).

42 Transcript challenges UK position on Iceland, *Financial Times* 23 October 2008. <https://www.ft.com/content/42c0e23c-a153-11dd-82fd->

with Mathiesen seems more a pretext than a reason. Moreover, in his television interview, Oddsson clearly was not referring to British depositors in the Icesave accounts whose claims, along with those of other depositors, had been given priority over other creditor claims on Landsbanki by the Emergency Act. Oddsson was speaking about the bank owners and bondholders who would have to bear most of the cost of the bank collapse.

Other criticisms are perhaps directed more against the CBI as an institution, or to the three CBI governors as a group, than against Oddsson personally. It is claimed, for example, that the CBI made a huge mistake by twice lowering reserve requirements for the banks, in 2003 and 2008.⁴³ However, the circumstances of the two reductions should not be

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43 Thorvaldur Gylfason, Iceland: After the Fall, *Milken Institute Review*, Vol. 10, No. 1 (2010), pp. 40–52. Gylfason wrongly says, p. 47, that the reserve requirements were lowered in 2002. Also, Philip Bagus and David Howden, *Deep Freeze: Iceland's Economic Collapse* (Auburn AL: Ludwig von Mises Institute, 2011).

ignored. The 2003 reduction – two years before Oddsson became one of the three governors – was about bringing the reserve requirements down to the same level as in other European countries. It is true that this action released some money into the economy, but it was in no way crucial to the almost explosive growth of the banks that took mainly place between 2004 and 2005. In fact the three main banks were not much affected by this reduction in the reserve requirements. From 2003 to 2005 they could get sufficient cheap credit in international markets. The real victims of the high level of reserve requirements in Iceland before 2003 were the small savings associations which were competing with the banks for retail deposits and which did not, at that point in time, have access to international markets. The 2008 reduction, on the other hand, was about not counting retail deposits in branches abroad in the Icelandic reserve requirements base. The argument was that this money never entered the Icelandic economy and that it therefore had no inflationary effect: It was mainly used for lending customers abroad. This was also the general European practice.⁴⁴

By simply applying the same rules about the banks' reserve requirements as did other central banks in Europe, clearly the CBI did not bring about or even contribute to the bank collapse. No economist in Iceland or abroad advocated at the time that the limits on the banks' operations should be more stringent than in other EEA countries. This may at best be wisdom of hindsight.

Another common criticism of the CBI is that before the collapse it should have accumulated more foreign exchange reserves.⁴⁵ While this claim is often made by the same people who offer the criticism about the reserve requirements, the two seem to be in conflict. The former criticism, that the CBI lowered the banks' reserve requirements, is really that by changing the rules, the CBI provided the banks with more liquidity.

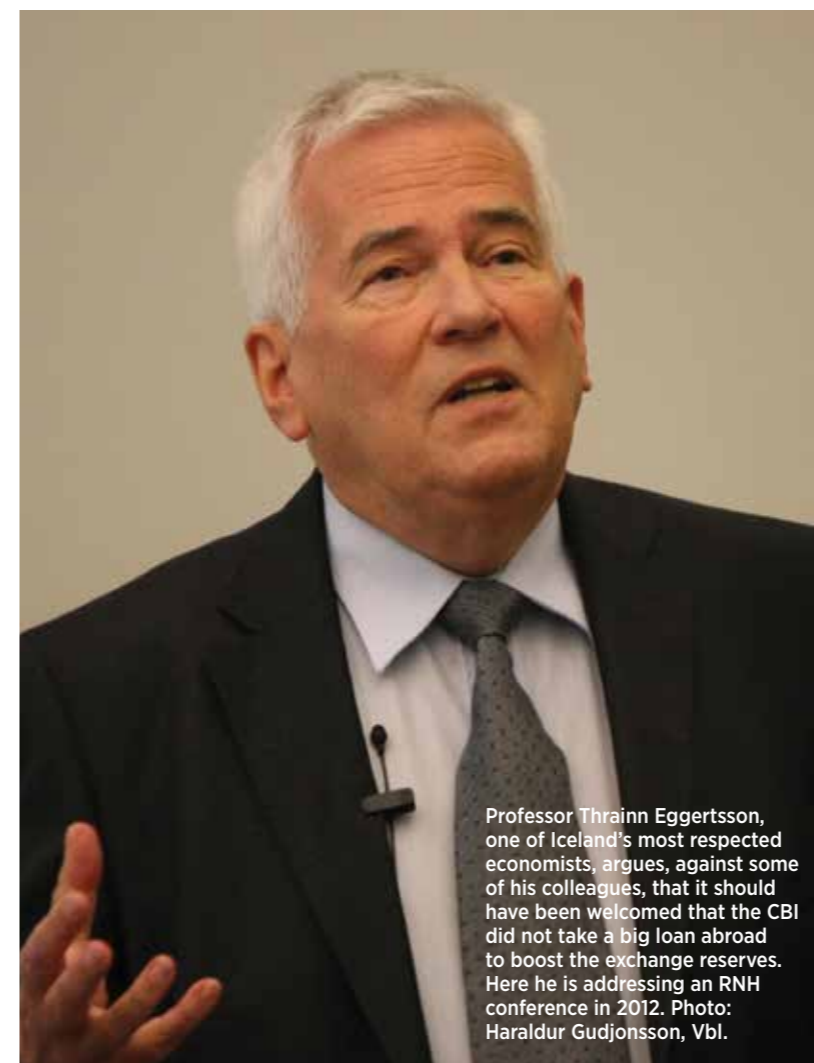
The latter criticism implies precisely the opposite – that by not accumulating larger foreign exchange reserves the CBI could not provide the banks with more liquidity (even if it is then overlooked that the main purpose of currency reserves is to uphold the value of the currency). What is undesirable on the first criterion suddenly becomes desirable on the other one. Obviously the CBI cannot win this game: heads the critic wins; tails the CBI loses.

Moreover, three points should be made about the foreign exchange reserves of the CBI. First, it should be recalled that before the collapse, they were already some of the largest in the world in proportion to GDP. They had increased from 7 billion *kronur* in mid 2001 to 400 billion in mid 2008, or to €3.5 billion.⁴⁶ The only OECD country with larger foreign exchange reserves relatively was New Zealand. While in July 2008 Iceland's reserves were 13% of GDP, those of New Zealand were 14% of GDP.

Second, it would only have been possible to increase further the foreign exchange reserves by massive foreign borrowing, which would have been very costly during the credit crunch of 2007 and 2008. In fact, the CBI was advised by JP Morgan against obtaining a big loan to bolster its foreign exchange reserves.⁴⁷ The respected Icelandic economist Professor Thrainn Eggertsson comments:

“ Indeed it ought to be welcomed that the CBI did not take a big loan abroad to create foreign exchanges reserves matching the size of the banks, trying then to rescue them by lavishing the money on them. In this time of crisis such rescue attempts merely would have increased our problems instead of solving them.⁴⁸

Third, as the CBI repeatedly emphasised, Icelandic banks and ratings agencies could not simply assume that the CBI would increase its reserves at the same rate as the banks were expanding. Not only was this made clear in a 2007 *Financial Stability* report from the



Professor Thrainn Eggertsson, one of Iceland's most respected economists, argues, against some of his colleagues, that it should have been welcomed that the CBI did not take a big loan abroad to boost the exchange reserves. Here he is addressing an RNH conference in 2012. Photo: Haraldur Gudjonsson, Vbl.

CBI,⁴⁹ but also, in the spring of 2008 when Governor Oddsson observed at a press conference that there was something peculiar about a central bank reacting to a rapid expansion of domestic banks abroad by simply increasing its foreign exchange reserves: 'It's a new development if banks are supposed to be able to expand at will and take the risk that they choose to take, and then the public, through the central bank, is believed to function as some sort of inexhaustible guarantee fund.'⁵⁰ Then the central bank has become, not the banks' partner, but their prey.

A related criticism of the CBI concerns the loans in foreign currencies extended before the collapse by the banks to their domestic customers, whose income was in Icelandic *kronur*. These loans created a great risk

for ordinary households, usually not very proficient in currency dealings, and were to cause a lot of public discontent after the depreciation of the *krona*. Professor Thorvaldur Gylfason asserts that 'the Central Bank sat by idly as the banks extended such loans in large numbers.'⁵¹

The record does not sustain this criticism. In fact, the CBI governors repeatedly warned against taking out loans in foreign currencies, for example at the annual meetings of the CBI in 2007 and 2008. At the latter meeting, Governor Oddsson said:

“ Just a year ago, at the Bank's Annual Meeting early in 2007, I warned against tempting people with foreign loans when they didn't have the income to support the risk. I have done the same on many other occasions. My colleagues here on the Board of Governors have also stressed this point repeatedly. But the thing that we have been most on the defensive against got us in the end. People set little store by our words of caution, and now many of them are licking their wounds as a result of recent developments.⁵²

It was, however, the Icelandic Financial Supervisory Authority (IFSA) that was the bank regulator, not the CBI. In their defence, however, the banks pointed out that there was great demand by the public for currency-indexed loans and loans in foreign currencies.

A sixth common criticism of the CBI is that in the year before the collapse, it accepted from the banks bonds which they had issued on one another without collateral to back them. These bonds became known under a name that Governor Oddsson gave to them, 'love letters'. The purchase of these bonds resulted in a great bookkeeping loss to the CBI when the banks collapsed, 18% of GDP according to Professor Thorvaldur Gylfason,⁵³ 14.5% according to Professor Gauti B. Eggertsson and his associates.⁵⁴

44 Thus, Ha-Joon Chang is misinformed when he writes about Iceland in *23 Things They Don't Tell You About Capitalism* (London: Allan Lane, 2010), p. 233: 'Between 1998 and 2003, the country privatized state-owned banks and investment funds, while abolishing even the most basic regulations on their activities, such as reserve requirements for the banks.' The reserve requirements were precisely the same as in other member states of the EEA. While Chang correctly identifies business tycoon Jon Asgeir Johannesson as a leading figure in the Icelandic expansion abroad, he misspells his name and leaves him out of the index.

45 Thorvaldur Gylfason, 'Iceland's blend of old and new', *VoxEU* 10 July 2008. <http://voxeu.org/article/iceland-and-its-financial-predicament-history-and-context>

46 *Monetary Bulletin*, Vol. 10, No. 2 (Reykjavik: Central Bank of Iceland, July 2008), p. 70. Included in this number is the €1.5 billion that would be available from the Scandinavian central banks through currency swap deals. The real disposable foreign exchange reserves were therefore about €2 billion. <http://www.cb.is/lisalib/getfile.aspx?itemid=6315>

47 SIC Report, Vol. 6, Ch. 19, p. 252.

48 Thrainn Eggertsson, 'Auratal a timum kreppunnar [Counting Pennies During a Crisis]', *Morgunblaðid* 11 October 2008.

49 *Financial Stability 2007* (Reykjavik: CBI, 25 April 2007), p. 46. <https://www.cb.is/library/Skraarsafn---EN/Financial-Stability-Report/2007/2007%20enska.pdf>

50 Board of governors press conference, 8 May 2008. <http://gamli.sedlabanki.is/?PageID=287&NewsID=1762> See also SIC Report, Vol. 6, Ch. 19, p. 175.

51 Thorvaldur Gylfason, 'Iceland: How Could This Happen?' CESifo Working Paper (2014), p. 12. https://notendur.hi.is/gylfason/cesifo1_wp4605.pdf (2014) Also, Gudrun Johnsen, *Bringing Down the Banking System. Lessons from Iceland* (London: Palgrave Macmillan, 2014), p. 134.

52 Speech by David Oddsson at the Annual Meeting of the CBI 28 March 2008. <http://gamli.sedlabanki.is/?PageID=287&NewsID=1707>

53 Thorvaldur Gylfason, 'Iceland: How Could This Happen?' p. 6.

54 Sigríður Benedíktsdóttir, Gauti B. Eggertsson, and Eggert Thorarinnsson, *The Rise, the Fall, and the Resurrection of Iceland, Brookings Papers on Economic Activity* (2017), p. 50. On Eggertsson's earlier and harsher

The three CBI governors, from left: Ingimundur Fridriksson, Eiríkur Guðnason and David Oddsson, suggested several ways of reducing the banking sector: that Kaupthing would move its headquarters abroad, that Landsbanki would transfer its online accounts in the United Kingdom and the Netherlands from a branch to a subsidiary (thus avoiding a major risk for Icelandic taxpayers) and that Glitnir would sell its solid Norwegian subsidiary, Glitnir Bank. In the collapse, the governors advocated 'ring-fencing' which was what ultimately saved the Icelandic economy from disaster. But instead of praising the three governors, the SIC reprimanded them for negligence: In the midst of the crisis, they had not produced enough paperwork before making decisions which the SIC however found themselves reasonable. Photo: Kjartan Thorbjörnsson, Mbl.



But in this context five considerations are relevant. First, the rules of the CBI concerning acceptable securities for repurchase deals (where the bank in question received cash against a bond, with the deal reversed at a later date) were in fact as stringent as in most other central banks, as CBI Governor Ingimundur Fridriksson points out: The CBI always required minimum ratings for its collateralised loans to the Icelandic banks.⁵⁵ It is important to bear in mind that during the financial crisis, the CBI was doing the same as almost all other central banks in the world. If it had imposed more stringent rules on those liquidity deals with the banks than previously applied, then this would have reflected lack of confidence in them (and in the validity of their accounts, accepted by the IFSA and ratings agencies and authenticated by international accounting firms), and this would have brought the banks down immediately.

criticism, see a report of his blog (no longer accessible online) in Peningaskapurinn [The Money Safe], *Frettabladid* 9 October 2009.

55 Ingimundur Fridriksson, *The Collapse of the Icelandic Banks* (Summer 2012), p. 16. Unpublished manuscript. I am much indebted to this analysis by Fridriksson who had studied economics under renowned monetary expert Leland Yeager (whom I had the pleasure of knowing personally) and who also had worked for a while at the IMF. Internationally respected, Fridriksson took up a position as a senior analyst at Norges Bank after he had been driven out of the CBI in February 2009.

During the international credit crunch, central banks everywhere were resorting to highly unusual means in their sometimes desperate attempts to provide liquidity to commercial banks. The ECB, for example, held large amounts in uncovered bonds. When the crisis intensified it decided to accept 'junk collateral' regardless of credit ratings.⁵⁶ In 2011 Professor Willem Buiter and his associates wrote: 'The ECB already has provided, since the crisis started, quasi-fiscal support to insolvent euro area banks under the guise of liquidity support, by accepting loans from insolvent banks offering as collateral securities of dubious creditworthiness.'⁵⁷ The US Federal Reserve Board also accepted collateral of uncertain value, as came out in 2011 when a US Supreme Court decision forced it to disclose this: 'At the height of the financial crisis, the Federal Reserve allowed the world's largest banks to turn more than \$118 billion in junk bonds, defaulted debt, securities of unknown ratings and stocks into

56 Jakob Funk Kirkegaard, *In Defense of Europe's Grand Bargain*, Peterson Institute Policy Brief No. 14 (Washington DC: Peterson Institute, June 2010), p. 3.

57 Willem Buiter, Ebrahim Rahbari, Jürgen Michels and Giada Giani, *The Debt of Nations* (New York: Citigroup Global Markets, January 7, 2011), p. 5.

cash.'⁵⁸ Perhaps Professors Gylfason and Eggertsson should have directed their criticisms at the ECB and the US Federal Reserve Board rather than at the CBI. At least the latter institution would not have been out of reach for Eggertsson, as he worked for the FRB of New York from 2004 to 2012.

Second, in a 2016 decision by the Icelandic Supreme Court, it was recognised that there was nothing wrong, abnormal or illegal in the CBI's acceptance of the 'love letters', contrary to what legal representatives of a small bank had argued.⁵⁹

Third, an important and obvious reason for the loss incurred by the CBI was that by the Emergency Act – passed at the initiative of the CBI – depositors got priority over other creditors to the banks, including the CBI. When the IFSA, on the basis of the Emergency Act, was establishing the new banks and transferring to them deposits (which are of course claims against the banks), it originally intended also to transfer CBI's claims against the banks to the new banks, including the 'love letters'. Then no CBI 'loss', let alone 'bankruptcy', would have occurred. In a well-researched book, finance professors Asgeir Jonsson and Hersir Sigurgeirsson comment: 'If the bonds had been transferred, the CBI would have had full recovery of its claims, at the expense of other general creditors.'⁶⁰

Fourth, the 'love letters' did not bring down the banks: they only facilitated their operations for a while. Perhaps they postponed their demise for a few months. But it is by no means certain that the bank collapse would have cost the Icelandic nation less if it had occurred earlier in 2008. Possibly it might have cost more if the government had attempted to bail out some or all of the banks.

Fifth, the Icelandic Treasury has fully recovered the loss accruing from these loans, as Jonsson and Sigurgeirsson conclude in their study of the collapse.⁶¹ It was basically a matter of bookkeeping where the

58 Matthew Leising, *Fed Let Brokers Turn Junk to Cash at Height of Financial Crisis*, Bloomberg.com, April 1, 2011. Not available on the Bloomberg website, but at some other online places, e.g. <https://www.newsmax.com/Finance/FinanceNews/FedLetBrokersTurnJunktoCashatHeightofFinancialCrisis/2011/04/01/id/391418/>

59 *Haestarettardomar* [Supreme Court Judgements], No. 130/2016.

60 Asgeir Jonsson and Hersir Sigurgeirsson, *The Icelandic Financial Crisis* (Basingstoke: Palgrave Macmillan, 2017), p. 299. This book, and Armann Thorvaldsson's *Frozen Assets*, probably are the two most informative and judicious works on the Icelandic bank collapse.

61 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, pp. 313–316.

initial loss from the bank collapse was registered. In the light of these five considerations, the criticisms by Professors Gylfason and Eggertsson on account of the 'love letters' seem misplaced.

In any discussion about the role of the CBI before the collapse, it cannot be ignored, moreover, that the CBI governors were the first people in authority to realise and warn against the vulnerability of the banks, Governor Oddsson mentioning their possible collapse at a private meeting with two leading government ministers as early as November 2005, shortly after his appointment.⁶² The CBI governors repeated such warnings in full confidentiality in private meetings with a narrow circle of leading politicians, not only in those which can be documented – in late 2007 and on 13 January, 7 February, 1 April, 16 April, 7 May, 8 July and 30 September 2008 – but also in several informal conversations.⁶³

Publicly the CBI governors had to be cautious, but nevertheless Governor Oddsson said in a speech in November 2007:

“ For a while, cheap capital was readily available, and some were bold enough to grab the opportunity. But the flip side of expansion, and the side that cannot be ignored, is that 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.”⁶⁴

This was a clear warning to the banks that they had to reduce their foreign debt. But the CBI had no powers to act against the banks, and the governors had to weigh their words and actions carefully.

62 Styrmir Gunnarsson, *Umsatrid* [The Siege] (Reykjavik: Verold, 2009), p. 72.

63 On the 2007 meeting, interviews with David Oddsson in Reykjavik 5 October 2017 and by phone with Geir H. Haarde 8 November 2017. On the 2008 meetings, the SIC Report. Meeting 13 January: Vol. 6, Ch. 19, pp. 102–103; meeting 7 February: Vol. 6, Ch. 19, p. 120; meeting 1 April: Ch. 18 (in English), p. 11, and Ch. 21 (in English), p. 57; meeting 16 April: Vol. 6, Ch. 19, pp. 163–164; meeting 7 May: Ch. 18 (in English), p. 12; meeting 8 July: Ch. 21 (in English), p. 73; meeting 30 September (a full cabinet meeting): Vol. 7, Ch. 20, pp. 68–78.

64 Speech by David Oddsson to the Icelandic Chamber of Commerce 6 November 2007. <http://www.cb.is/lisalib/getfile.aspx?itemid=5491>

Even if the charges against the CBI analysed here may have been unsubstantiated and unfair, certainly the policies of the CBI before the collapse are not above criticism. It is possible to argue that the CBI too mechanically employed in Iceland a model of economic policy that was not entirely appropriate in a small open economy with an inflationary past, reflected in comprehensive indexation of all long-term financial obligations. The model was based on inflation targeting and had been employed since 2001 with the approval of the IMF, OECD and almost all economists.⁶⁵ It implied that when the CBI faced inflationary pressures, it simply raised interest rates until the pressures diminished again to a tolerable level. But then the CBI encountered three kinds of problems.

First, since in Iceland all long-term financial deals, especially mortgages, were indexed, a rise in interest rates had limited effects on those making such deals. It did not bring down demand in any significant way in the building sector, for example.

Second, with free capital movements between Iceland and other countries, those who did not want to pay the high interest rates on offer in Iceland simply went abroad and obtained cheaper credit there. This they could at least do until the credit crunch hit in late 2007, and they presumably calculated that the currency risk they incurred was worth what they saved on interest payments. This did not only apply to big companies, but also to ordinary households that, against the explicit warnings of the CBI, borrowed in foreign currencies.

Third, the high interest rates in Iceland attracted 'hot money', which was borrowed in low-interest countries to buy bonds in high-interest countries (kiwi bonds in New Zealand, glacier bonds in Iceland). Thus, a rise in interest rates in order to cool down an overheated economy, as the analogy went, was not very effective, and it may indeed even have been counter-effective.

Nonetheless, even if this policy did not fully succeed, it certainly did not bring about the 2008 bank collapse. The banks did not grow out of proportion to their home base because interest rates in Iceland were

held either too low or too high by the CBI. Moreover, it is not fair to point out a possible flaw in CBI policies without presenting alternatives. In the last two years before the crash, contrary to economic orthodoxy, possibly the CBI should have held interest rates lower rather than higher. This would have meant an earlier depreciation of the *krona* and possibly an inflationary bout (even if inflation may have been systemically overestimated in Iceland, as some argued, because housing prices were included in the price level index). This would have served to drive out speculators issuing glacier bonds and to make Icelandic borrowers in other currencies more aware of the risks they were taking. Perhaps this, therefore, would have been the lesser of two evils.

Finally, one reason the monetary policy pursued by the CBI did not fully succeed was that it was not supported by other domestic policies. In the period before the crisis, public expenditure grew rapidly, while wage bargaining resulted in unprecedented increases in real disposable incomes and changes made in the housing finance system also had a significant expansionary impact. All of this greatly complicated the task of monetary policy. The CBI many times warned against the expansionary impact of government spending and against over-generous wage settlements. In particular it criticised the operations of the Housing Financing Fund, which provided cheap and government-guaranteed mortgages to households and contributed much to the asset bubble in the Icelandic economy from 2004 to 2007, which, in turn, drove up interest rates. But the increase and facilitation of mortgage lending had in 2003 been an election promise by the Progressive Party, the junior partner in the 1995–2007 coalition government, and if the senior partner, the Independence Party, had not accepted this, then it was clear that the Progressives would have entered a coalition with the left-wing parties and implemented these policies with them, as former Independence Party leader, Geir H. Haarde, Finance Minister in 1998–2005, testified before the SIC.⁶⁶ For better or worse, as business is about profit, politics is about power.

⁶⁵ An early critic was however Professor Ragnar Arnason, Peningastefna Sedlabankans: Svarar hun kostnadi? [The CBI Monetary Policy: Do the Benefits Outweigh the Costs?], *Rannsóknir í félagsvísindum*, Vol. VII (Reykjavik: Félagsvísindastofnun, 2006), pp. 269–80.

⁶⁶ SIC Report, Vol. 7, Ch. 21, p. 24 (in English).

4

THE SPECIAL INVESTIGATION COMMISSION

Even if the Icelanders were not as hard hit by the financial crisis as some other small European countries, the psychological impact of the crisis was strong in Iceland, which had long thought of herself as a respectable Nordic country. The unthinkable had happened. On the British Treasury's website, Iceland suddenly found herself on the same list as North Korea and Sudan, the Taliban and Al-Qaida. All this required explanations, many felt. After confidential negotiations, on 12 December 2008 the political parties in parliament unanimously voted for a law stipulating the appointment of a

Special Investigation Commission on the Icelandic bank collapse. The SIC should consist of three members, a Supreme Court judge to chair it, the Parliamentary Ombudsman, and an economist or a certified accountant or another expert with special knowledge on the economy or about financial markets. The SIC received wide-ranging powers to require confidential documents which otherwise would not have been available, to summon people to testify before it and to grant immunity to possible informants. People could not complain to the Parliamentary Ombudsman if they thought that



The SIC, Special Investigation Commission, into the bank collapse. From left: Parliamentary Ombudsman Tryggvi Gunnarsson, economist Sigríður Benedíksdóttir and Supreme Court Judge Pall Hreinsson. Only a few months into their assignment, Benedíksdóttir announced to her Yale students that the collapse was caused by greed and the "reckless complacency" of the institutions that were charged with regulating the banks (IFSA) and ensuring financial stability (CBI). Her two co-members in the SIC asked her to resign as a result of these comments, but she refused, and they backed down. Photo: Ernir Eyjólfsson, Mbl.

proper procedures had not been followed by the SIC or its members. The SIC was to deliver its report no later than 1 November 2009.⁶⁷

On 30 December 2008 the Presidency of the Parliament appointed the three SIC members: Supreme Court Judge Pall Hreinsson, Parliamentary Ombudsman Tryggvi Gunnarsson and Dr. Sigrídur Benedíksdóttir, an economics lecturer at Yale University in the US. After the SIC had operated for a year, it received at the end of 2009 full immunity for itself: People could not sue the SIC or its individual members, even if they believed that the SIC or its members had violated their rights.⁶⁸

From the start, the Commission's investigation was problematic. Already the law on the SIC was flawed: for example, the stipulation that people who thought that they had not received fair treatment by the SIC could not complain to the Ombudsman, who was indeed one of the SIC members. Even more debatable was the stipulation added later that people who believed their legal rights had been violated by the SIC could not refer the matter to the courts. Under the rule of law, this possibility is an important safeguard against abuse of power. Certainly the three people who comprised the SIC, however respectable they might seem, should have been regarded as capable of abusing power just like any other individual or group in society. Under the rule of law, nobody is above the law.

Most importantly, the decision to appoint a committee of Icelanders instead of international experts was not necessarily prudent, because Iceland is a tiny society where people can sometimes find it hard to be impartial, not least if they belong to any of the invisible networks of friends, families and allies which may be even stronger in Iceland than most other countries (as many commentators on Icelandic affairs have pointed out).⁶⁹ One illustration of how tiny Iceland is can be found in the fact that two of the three SIC members declared themselves to have

connections to people involved in the bank collapse, as they were required to do by the law on the SIC. The son of Tryggvi Gunnarsson, an economist, had worked as a securities broker at Landsbanki from 2007 to 2008, and his daughter-in-law, a lawyer, had worked at the IFSA from 2006 to 2009. The father of Sigrídur Benedíksdóttir, a lawyer, had been director of Landsbanki's legal department until 2003.⁷⁰

In written objections to the SIC, former CBI Governor David Oddsson argued that Gunnarsson should recuse himself in all matters pertaining to the IFSA and the CBI since his daughter-in-law not only had worked for the Authority, but also been prominent there and for a while in charge of communications. Therefore, her role had been general rather than specific, while an important task of the SIC was to allocate responsibility, and possibly blame, between the IFSA and the CBI – the two institutions overseeing the Icelandic financial sector. Independently, former IFSA Director Jonas Fr. Jónsson made the demand that Gunnarsson should recuse himself in all matters pertaining to the IFSA. The SIC decided, however, that Gunnarsson would only recuse himself in those matters concerning the IFSA with which his daughter-in-law had directly dealt. It decided also that Gunnarsson should not recuse himself in matters concerning the CBI since his daughter-in-law had not worked there.⁷¹

The responses by the SIC to Oddsson's and Jónsson's requests seem less than plausible. If Gunnarsson's daughter-in-law played a general role within the IFSA, then it was difficult and well nigh impossible to distinguish between matters with which she had dealt directly and other matters. The fact that she was working there before and during the bank collapse might also create for Gunnarsson a bias, even if an unconscious one, against the CBI – a tendency to shift blame to it from the IFSA, as Oddsson suggested. Moreover, the declarations in the Preliminary to the SIC Report that Benedíksdóttir's father had been director of Landsbanki's legal department until 2003 and that Gunnarsson's son had been a securities broker at Landsbanki from 2007 to 2008 leave out some facts: Benedíksdóttir's father was dismissed from his high position around the time the bank was fully

privatised in 2003; and Gunnarsson's son lost his job as a securities broker at Landsbanki as a result of the bank collapse (even if he was later rehired).

As Parliamentary Ombudsman, Tryggvi Gunnarsson in the spring of 2004 had had a public conflict with Oddsson, then Prime Minister. They had had a heated telephone conversation on 4 May about a report that the Ombudsman had sent to Oddsson who then temporarily served as Justice Minister. Oddsson thought the report, which was critical of the incumbent Justice Minister, was unfair. Subsequently, the media controlled by Oddsson's bitter enemy, Jon Asgeir Johannesson, conducted a campaign against Oddsson alleging that the conversation – for which the Ombudsman was the most likely ultimate source – had contained threats against Gunnarsson.⁷² Eventually Gunnarsson complained to the Speaker of Parliament, and the case was closed by a joint announcement from the Prime Minister and the Speaker that there was no disagreement and that the Ombudsman was independent in his work and would set rules about his office's interaction with public authorities.⁷³

Most likely though these facts would not have disqualified Tryggvi Gunnarsson or Sigrídur Benedíksdóttir even if, arguably, stricter requirements than under normal circumstances in public administration should have been applied to them about integrity, lack of bias and fitness for their task, because they were granted extraordinary powers and personal legal immunity.⁷⁴

Things took however an unexpected turn at the end of March 2009 when Benedíksdóttir granted

72 Forsætisráðherra sagdur hafa hotad umbodsmanni [Prime Minister Allegedly Threatened Ombudsman], DV 14 May 2004; Neitar ad trua thessu [Refuses to Believe This], *Frettabladid* 15 May 2004; Hotunarsímtal Davids sagt bundid trunadi [David's Phone Threats Said to Be Confidential], DV 17 May 2004; Umbodsmadur enn ekki i skjol Althingis [Ombudsman Still Not in Parliament's Shelter], DV 18 May 2004; Umbodsmadur i onad valdhafa [Ombudsman Out of Favour with the Powers that Be], DV 19 May 2004. In an interview with State Television on 15 May, Oddsson said that he and the Ombudsman often spoke on the phone, mostly at the initiative of the Ombudsman, but on 4 May at Oddsson's initiative; he said he told the Ombudsman three times during that conversation that it was strictly confidential. He would find it astonishing if the Ombudsman would betray that confidence. In an interview for this report on 19 August 2017 by phone, Illugi Gunnarsson, then Oddsson's assistant, said that he had been present when Oddsson made the call and that Oddsson had not uttered any threats and that his criticisms of the Ombudsman's report had been fair and substantial.

73 Umbodsmadur setur samskiptareglur [Ombudsman Sets Rules About Relations], *Morgunbladid* 22 May 2004.

74 SIC Report, Online Addenda, No. 11, response of David Oddsson.

an interview to the student magazine at the US university where she taught. She explained the task of the SIC:

“ We're supposed to build a case for what went wrong for this to have happened. We'll probably go back to when the banks were made into private companies. We're going to try to figure out maybe if the ownership of the banks were not regulated efficiently, and how this led to the complete failure of the banking system. We're also supposed to look at the whole regulation around it: how they regulated [the three main private banks] and how they could have done it differently; the central bank and how they regulated that system; and the mandates which were to keep the system intact.

She elaborated on this: 'It's a very complex problem that is at the same time very easy to see. You'll understand why it collapsed when I tell you the size of the system. The banks were 10 to 20 times the GDP; after the fall of the Lehman Brothers, there was no way the central bank could save them. It should have been obvious that this was not viable.'

Benedíksdóttir went on to express her personal feelings on the bank collapse:

“ I am disheartened by this failure; I feel it is a result of extreme greed on the part of many and reckless complacency by the institutions that were in charge of regulating the industry and in charge of ensuring financial stability in the country. Iceland will end up with a huge foreign debt as a result, which may not be the worst of it, since our reputation is completely tattered. This will take future generations some time to work through.

She added:

“ Many people also feel cheated and are rightfully demanding that those who got the country into this position answer for it. They want to know the truth as to what happened.

One of Benedíksdóttir's observations seemed to be in contradiction to what she had said earlier: 'I think we can actually draw lessons from America. We have a strict regulatory system in America, whereas the

67 Law No. 142/2008. <https://www.althingi.is/altxt/stjt/2008.142.html>

68 Ibid. The change seems to have been at the initiative of the SIC members.

69 Anne Sibert, *Undersized: Could Greenland be the new Iceland? Should it be?* VOXEU 10 August 2009. <http://www.voxeu.org/article/could-greenland-be-new-iceland> Also, Baldur Thorhallsson and Peadar Kirby, *Financial crises in Iceland and Ireland: Does EU and Euro membership matter?* Working paper (Reykjavik: Centre for Small State Studies, November 2011), p. 24.

70 SIC Report, Preliminary, Nefndin [The Commission].

71 SIC Report, Online Addenda, No. 12. Response of SIC members to alleged disqualifications.

Icelandic banks were allowed to do things that should have been regulated.⁷⁵ Now the regulators' lack of power was suddenly blamed, not their 'reckless complacency'.

In the interview Benediktssdottir seemed to have already found the Icelandic institutions guilty of 'reckless complacency', especially those 'that were in charge of regulating the industry and in charge of ensuring financial stability' – by which she could only mean the IFSA and the CBI, as these two institutions were by law entrusted with precisely the two tasks respectively that she mentioned. Also notable is she seemed to have concluded that the causes of the bank collapse were almost solely domestic: According to her, Icelanders had inflicted the crash upon themselves. She did not mention the refusal of central banks to make currency swap deals with the CBI at the same time as they made such deals with almost all other central banks, including Switzerland, which had a banking sector ten times the GDP. Nor did she acknowledge the abrupt close-down by British authorities of the two British banks owned by Icelanders at the same time all other British banks were rescued, bringing about the downfall of the last remaining bank, Kaupthing. Nor did she bring up the use by the British Labour government of an Anti-Terrorism Act, which isolated Iceland and greatly weakened her financial position. While observing that people wanted to know the truth about the collapse, she seemed already to have decided what the truth was. She did not seem to be interested in looking at systemic explanations for the collapse, instead apparently only wanting to search for those Icelanders who had 'cheated' their compatriots.

Furthermore, Benediktssdottir's view that the Icelanders could draw lessons from the 'strict regulatory system' in the US seems misguided. Rightly or wrongly, insufficient regulation had been blamed for the financial crisis in the US. One consequence of the crisis was that in 2010 the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, which stipulated much stricter regulation of the US financial sector.⁷⁶ Previously known as a firm advocate of the free market, Judge

75 Iceland seeks help of Yale professor. *Yale Daily News* 31 March 2009. <http://yaledailynews.com/blog/2009/03/31/qa-iceland-seeks-help-of-yale-professor/>

76 Public Law 111-203. <https://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm>

Richard Posner, a respected and prolific author, claimed that deregulation had gone too far in the 1980s and 1990s.⁷⁷ Some disagreed with him, arguing that what was needed was *better* rather than *more* regulation. Be that as it may, the 'strict regulatory system', which Benediktssdottir saw in place in the US certainly did not stop the excesses of Wall Street bankers, well documented in reports and books.⁷⁸ Moreover, Benediktssdottir did not seem to have a clear idea of the Icelandic banking sector's size prior to the collapse, saying that it was 10 to 20 times the GDP. The most plausible figure is actually that it was 7.4 times the GDP.⁷⁹

Benediktssdottir's statements about the Icelandic bank collapse were immediately noted in her home country. *Vidskiptabladid*, a business weekly, facetiously commented that the findings of the SIC had already been announced in an American student magazine.⁸⁰ Jonas Fr. Jonsson, former IFSA Director, wrote 21 April 2009 to SIC Chairman Pall Hreinsson, complaining that Benediktssdottir obviously had already made up her mind about the causes of the bank collapse and that she had a considerable personal and academic interest in the SIC reaching the same conclusions as she had divulged to her students in the interview. Therefore, she could not be trusted to be impartial in the investigation. Hreinsson and Gunnarsson seemed to agree because they contacted Benediktssdottir a day later and asked her to resign from the Commission. She refused, however, to do so.⁸¹ The SIC then referred Jonsson's complaint to the Parliament Presidency. The Legal Counsel to the Parliament Presidency wrote an opinion to the effect that the impartiality of Benediktssdottir could be doubted. Two other lawyers consulted did not

77 Richard Posner, *A Failure of Capitalism: The Crisis of '08 and the Descent into Depression* (Cambridge MA: Harvard University Press, 2009).

78 Probably the best-known of the books on Wall Street before and during the crisis is Michael Lewis, *The Big Short: Inside the Doomsday Machine* (New York: W.W. Norton & Company, 2010).

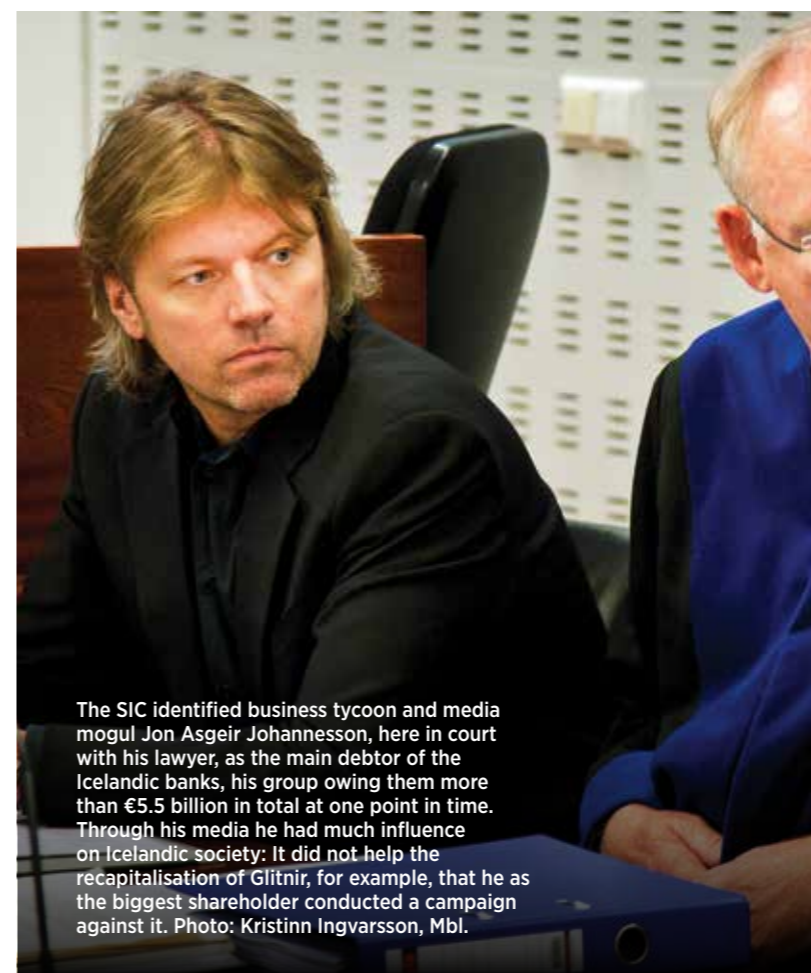
79 This was the ratio of assets to GDP in 2007, whereas that number fluctuated in 2008 as the GDP grew very little and the *krona* plummeted. The ratio was 6.9 in February 2008 and 8.7 in August 2008. Sigridur Benediktssdottir, Jon Danielsson and Gylfi Zoega, Lessons from a collapse of a financial system (October 2010), p. 11. <https://www.tcd.ie/Economics/assets/pdf/version-20-ben-dan-zoega-revised.pdf> This paper was eventually published in *Economic Policy*, Vol. 26, No. 66 (April 2011), 183–235.

80 Odinn (editorial column), Nancy Pelosi Islands og nidurstodur rannsóknarnefndar Althingis [Iceland's Nancy Pelosi and the Conclusions of the SIC], *Vidskiptabladid* 8 April 2009. <http://www.vb.is/skodun/6930/>

81 Magnús Halldórsson, Vildu Sigridur nefnd [Wanted Benediktssdottir to Quit], *Morgunbladid* 12 June 2009.

reach a firm conclusion on the matter. The Parliament Presidency decided on Monday 8 June to refer the matter again to the two other SIC members, Hreinsson and Gunnarsson.⁸²

Meanwhile, a media campaign was launched on behalf of Benediktssdottir. Four economists publicly spoke in support of her, denying that her impartiality should be doubted: Dr. Jon Steinsson and Dr. Gauti B. Eggertsson jointly in *Frettabladid*, and Professors Gylfi Zoega and Jon Danielsson jointly in *Morgunbladid* the same day.⁸³ These four economists were all known to hold strong opinions on the bank collapse, blaming it mainly on misguided domestic policies and a failure of the CBI and the IFSA properly to regulate and control the banking sector. Some of them had singled out Governor Oddsson in their criticisms.⁸⁴ The strong



The SIC identified business tycoon and media mogul Jon Asgeir Johannesson, here in court with his lawyer, as the main debtor of the Icelandic banks, his group owing them more than €5.5 billion in total at one point in time. Through his media he had much influence on Icelandic society: It did not help the recapitalisation of Glitnir, for example, that he as the biggest shareholder conducted a campaign against it. Photo: Kristinn Ingvarsson, Mbl.

82 The process is described in detail in the response of David Oddsson to the SIC Report, Online Addenda, No. 11.

83 Jon Steinsson and Gauti B. Eggertsson, Almenn almaelt tidindi eda grundvollur vanhaefis [General Comments or the Source of Disqualification], *Frettabladid* 10 June 2009; Gylfi Zoega and Jon Danielsson, Sigrar kerfid? [Does the Establishment Win?] *Morgunbladid* 10 June 2009.

84 Comments by Steinsson and Danielsson are found in, Vitneskja um hrydjuverkalogin [Knowledge of the Anti-Terrorism Act], *Frettabladid* 19

support Benediktssdottir received from economists critical of the CBI and Oddsson might have added to doubts about her credibility as a SIC member. The two other SIC members, Hreinsson and Gunnarsson, nevertheless reversed their earlier position and decided on 25 June 2009 that Benediktssdottir had not disqualified herself by her comments. Her remarks were general in nature, they argued, and not directed against any individuals or institutions.⁸⁵

This was an implausible interpretation of Benediktssdottir's words. She had in the interview spoken about the 'reckless complacency by the institutions that were in charge of regulating the industry and in charge of ensuring financial stability in the country'. Her comments were specific and not general, even if she had not named the institutions she was criticising. By law, as already noted, the IFSA was the regulator of the financial industry, while the CBI was in charge of ensuring financial stability. No other institutions had these clearly defined tasks. But the refusal by Benediktssdottir to recuse herself, even if she was asked to do so by Hreinsson and Gunnarsson, and the subsequent complete turnaround in the matter by Hreinsson and Gunnarsson suggest that the SIC members were sensitive to external pressure. From 22 April, when Hreinsson and Gunnarsson had contacted Benediktssdottir and asked her to resign from the SIC, until 25 June, when the two of them decided that she had not disqualified herself by her remarks, no new evidence had been presented whereas, certainly, a media campaign had been conducted.

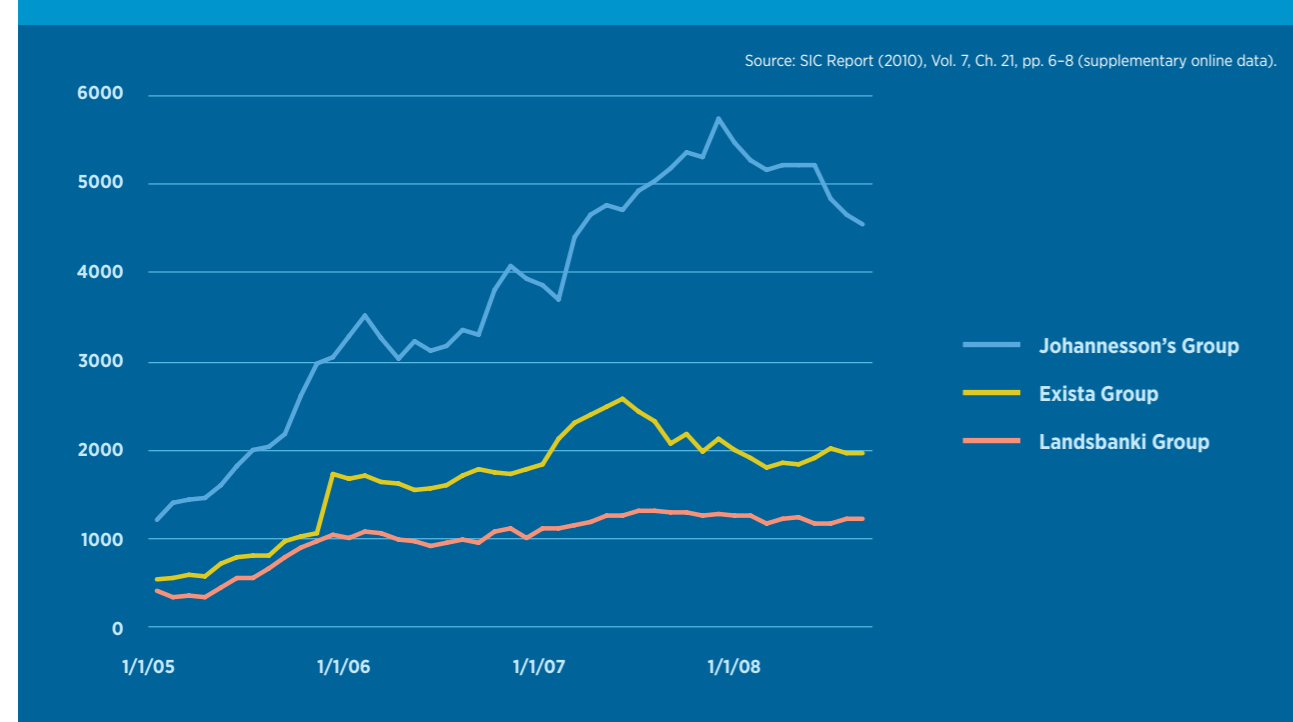
The issue re-emerged after a decision by the Icelandic Supreme Court in December 2009 where a recusal by a district judge was upheld. In a radio interview the district judge had expressed an opinion that, even if general in nature, could be interpreted as concerning a recent and much-debated appointment of another district judge. When an unsuccessful applicant for the latter judgeship filed a charge against the Justice Minister and the Icelandic government, the district judge recused herself at the request of the defendant, whereas the plaintiff referred the recusal to the Supreme Court.⁸⁶ On the basis of the Supreme Court

November 2008. Comments by Danielsson and Zoega are found in, Jon Danielsson and Gylfi Zoega, The Collapse of a Country. Working paper, 9 February 2009. Available online, http://www.si.is/media/starfsskilyrdir-idnadar/The_collapse_of_a_country.pdf

85 SIC Report, Online Addenda, No. 12, p. 7.

86 *Haestarettardomar* [Supreme Court Judgements], No. 662/2009. In the

FIGURE 1 TOTAL DEBT OF MAIN BUSINESS GROUPS



decision, in February 2010, Benediktssdottir's possible disqualification was reconsidered at the request both of former IFSA Director Jonsson and former Governor Oddsson. They argued that the two cases were similar in nature and that Benediktssdottir should have recused herself as the district judge had done. The two other SIC members, Hreinsson and Gunnarsson, decided that since Benediktssdottir's comments were general in nature and since the fitness stipulations of general public administration law applied to the SIC and not the fitness stipulations of judges, she need not recuse herself. This was yet another implausible decision: As already observed, Benediktssdottir's comments were specific in nature, not general; and in the light of their legal immunity and extraordinary powers, the SIC members would have been expected to apply to themselves strict principles of fitness.

The SIC and the Parliament Presidency sent the decision on the possible disqualification of Benediktssdottir to and forth between themselves, both entities seemingly trying to evade responsibility for the logical, but possibly unpopular, decision that she had disqualified herself by pointing out at the outset of the investigation that two institutions were responsible for the bank collapse by their 'reckless

complacency'. This is ironic in light of the fact that later the main criticism by the SIC of the various entities in the bank collapse was that they were trying to evade responsibility.⁸⁷ Two additional facts should be noted about the SIC, illustrating that it, just like the fallen banks, did not keep within its given timetable and budget. Even if the SIC was by law required to deliver its report no later than 1 November 2009, it only presented it 12 April 2010, almost six months after the first deadline. This was no big lapse, but it illustrated the fact that sometimes necessity dictates flexibility of rules, even if that was one of the main criticisms both of banks and authorities found in the SIC report. In the 2009 budget the SIC was allocated 150 million *kronur* or €834,000 (\$1.2 million).⁸⁸ The total cost of the SIC turned out to be 343.1 million *kronur* or €2 million (\$2.7 million), not counting the cost of publishing the report, or more than double what had initially been estimated.⁸⁹ Again, this was understandable, but a further illustration of the fact that sometimes necessity dictates flexibility.

87 SIC Report, Vol. 7, Ch. 21, p. 89 (in English).

88 *Fjarlog* [Budget] 2009, 20. <http://www.althingi.is/alttext/pdf/136/s/0481.pdf> The exchange rate is from 31 December 2009.

89 *Greinargerð um rannsóknarnefndir Althingis* [Report on Parliamentary Investigation Commissions] (Reykjavik: Althingi, January 2015), p. 36. https://www.althingi.is/pdf/rannsoknamefndir/Greinargerð_um_rannsoknamefndir_Althingis.pdf The exchange rate is from 12 April 2010.

SIC Report, Online Addenda, No. 12, pp. 7–8, the case number is wrongly said to be 622.

The SIC report was published less than seven weeks before the local elections in Iceland of 29 May 2010. Perhaps predictably, the political parties which public opinion associated with the bank collapse did badly, especially the Independence Party. Be that as it may, the SIC concluded that the explanations 'for the collapse of Glitnir Bank hf., Kaupthing Bank hf. and Landsbanki Islands hf. are first and foremost to be found in their rapid expansion and their subsequent size when they tumbled in October 2008.'⁹⁰ The banks' rapid growth was made possible, the SIC explained, by the good credit ratings of Iceland and by their access to the European markets on the basis of the EEA Agreement. The SIC identified three main business groups operating in the Icelandic economy, owning shares in the banks and also borrowing heavily from them: one led by Jon Asgeir Johannesson and controlling Glitnir, a second associated with investment company Exista and Kaupthing, and a third comprised of the two main shareholders in Landsbanki, Björgolfur Gudmundsson and his son Thor Björgolfsson. The total debt in the Icelandic banks of the three groups respectively, in 2005–8, is shown in Figure 1.

The SIC criticised the major shareholders in the banks for using their positions to borrow far more from them than could be regarded as prudent, thus creating special risk in the form of large exposures. Moreover, the same groups that borrowed heavily within one bank also did so from the other banks, adding to the risk, the SIC stated:

“ For that reason the systemic exposure risk attributed to the loans became significant. The clearest example is Baugur Group and affiliated companies [Johannesson's group]. The group's outstanding liabilities to the three banks amounted to EUR 5.5 billion, when at their highest level, which was at the time about 11% of total lending by the parent companies of the banks and about 53% of their aggregated equity base.⁹¹

Although the SIC does not mention it, this is essentially the same criticism that Governor Oddsson directed against the banks in a speech he gave six weeks after the collapse at the Icelandic Chamber of Commerce:

“ The anger that is seething just below the surface of our society and can be aimed in various directions is seething largely because the public have received so little information about what is happening. Why are they not being told that a single party owed one trillion Icelandic *kronur* to the domestic banking system?

Oddsson's number was close to that of the SIC. In November 2008, €5.5 billion was equivalent to 957 billion Icelandic *kronur*.

In his 2008 speech to the Chamber of Commerce, Oddsson asked how any one party had been able to accumulate such enormous debt, around one trillion Icelandic *kronur* or €5.5 billion, in the Icelandic banks: 'How in the world could this happen? What sort of stranglehold did this party have on the banks and the whole system?'⁹²

The SIC hardly considered Oddsson's pertinent question. While it documented in detail the manoeuvres or perhaps manipulations by the banks during the credit expansion, and in trying to survive during the credit crunch, it regarded it as its chief task to allocate responsibility to various Icelandic authorities. The SIC concluded that three government ministers (Prime Minister Geir H. Haarde, Finance Minister Arni M. Mathiesen and Business Affairs Minister Björgvin G. Sigurdsson) had shown negligence 'during the time leading up to the collapse of the Icelandic banks, by omitting to respond in an appropriate fashion to the impending danger for the Icelandic economy that was caused by the deteriorating situation of the banks.' The SIC also concluded that four high officials, the IFSA Director (Jonas Fr. Jonsson) and the three CBI governors (David Oddsson, Eiríkur Gudnason and Ingimundur Fridriksson) had shown negligence 'in the course of particular work during the administration of laws and rules on financial activities, and monitoring thereof.'⁹³ The SIC report was read with interest, not only in Iceland, but also in the UK. Chancellor Alistair Darling commented with barely concealed glee on the SIC: 'It examined the relationship between politicians, bankers and business people. Its report makes grim reading.'⁹⁴

92 Speech 18 November 2008 (English translation), <http://www.cb.is/lisalib/getfile.aspx?itemid=6604>

93 SIC Report, Vol. 1, Ch. 2, p. 18 (in English).

94 Alistair Darling, *Back from the Brink* (London: Atlantic Books, 2011), p. 138.

90 SIC Report, Vol. 1, Ch. 2, p. 1 (in English).

91 SIC Report, Vol. 1, Ch. 2, p. 3 (in English).

5

A PROBLEMATIC REPORT

One of the main problems with the conclusions of the SIC about the negligence of people in authority before the bank collapse could be observed in the case, based on the SIC Report, which a narrow majority of parliament eventually brought against former Prime Minister Geir H. Haarde before a specially convened Impeachment Court: It is how people could be held legally responsible for a course of events mostly beyond their control. During Haarde's trial in the spring of 2012, one witness after another testified to the effect that Haarde's options were very limited after the beginning of the international credit crunch.⁹⁵ While it may be true that Haarde did not actively respond to repeated warnings by the CBI governors about the banks, it is difficult to see what he could have done, even if he had taken these warnings seriously (as I believe he did). Usually after meetings with the CBI governors, he summoned the bankers and they reassured him that everything was in order and that their banks were fully financed. Moreover, the bank accounts were audited by well-known international audit firms. In addition, Haarde faced two political constraints: the bankers and their main clients were popular and influential and they enjoyed the support of his coalition partner, the Social Democrats, especially those bankers and businessmen thought to be hostile to CBI Governor David Oddsson, whom the Social Democrats still seemed to regard as their arch-enemy.⁹⁶

Before the trial the Impeachment Court already had dismissed two charges against Haarde: that he had shown gross negligence by not responding adequately to signs of a great and impending danger and that he had neglected to commission an analysis of the financial risks for the Icelandic Treasury from an eventual collapse.

95 *Landsdomur* [Impeachment Court], No. 3/2011, 23 April 2012, p. 360.

96 Arni Mathiesen, *Arni Matt: Fra bankahruni til byltingar* [Arni Matt: From Bank Collapse to Revolution] (Reykjavik: Verold, 2010), pp. 163–165. Mathiesen quotes insiders in the Social Democratic Alliance. This can also be deduced from the memoir of the bank collapse by Social Democrat Bjorgvin G. Sigurdsson, *Stormurinn: Reynslusaga radherra* [The Storm: A Minister's Recollections] (Reykjavik: Nytt Land, 2010).



CBI Governor David Oddsson enters Government House on 30 September 2008 to tell the cabinet that the banks are collapsing and that the CBI is preparing emergency measures. Previously, he had uttered several confidential warnings to leading politicians. The first documented warning was in November 2005, with another one in late 2007. In meetings 13 January, 7 February, 1 April, 16 April, 7 May, and 8 July (documented in the 2010 SIC Report) these warnings were repeated. The leader of the Social Democrats, Ingibjörg S. Gísladóttir, dismissed them as “one man’s venting”. Photo: Kjartan Thorbjörnsson, Mbl.

The two charges were considered to be too general in nature. One of the judges wanted to dismiss all charges.⁹⁷ The remaining charges against Haarde were that he had neglected to ensure that the Consultative Group on Financial Stability formed in 2006 produced results, that he had neglected to ensure that the banking sector would be reduced, that he had neglected to undertake measures to transfer Landsbanki's accounts in the UK and the Netherlands from a branch to a subsidiary and that he had not held cabinet meetings about warnings by the CBI governors, especially those issued 7 February and 1 April 2008, and about currency swap deals on 15 May with the Scandinavian central banks, whereas the Icelandic Constitution prescribed cabinet meetings about important matters.

The 15 judges of the Impeachment Court unanimously acquitted Geir H. Haarde of the three main charges. They concluded that the prosecutors had not been able to prove that Haarde could have done anything significant from the time he must have become aware of the danger to the banking sector, about the operations of the Consultative Group on Financial Stability, the reduction of the banking sector or the transfer of the Icesave accounts from a branch to a subsidiary. The majority of the judges, 9 out of 15, only found Haarde guilty of negligence in that he had not held cabinet meetings on a possible bank crash, whereas the constitution prescribed that important issues should be discussed in cabinet.⁹⁸ He did not receive any punishment and his legal costs were assigned to the state.⁹⁹ The minority of six judges wanted to acquit Haarde on this as well as on the other counts.¹⁰⁰ They argued that the constitutional prescription about cabinet meetings was mainly designed to ensure that important matters were adequately reported there before they were settled in the Council of State (with the President) and also to ensure that the Prime Minister accepted the request of individual government ministers to bring up important matters in cabinet.¹⁰¹

97 *Landsdomur* [Impeachment Court], No. 3/2011, 3 October 2011. <https://www.landsdomur.is/domar-og-urskurdir/nr/8>

98 The majority consisted of four Supreme Court judges, one representative of Reykjavik District Court and four people appointed in 2005 by Parliament, all from the then-opposition parties, the Social Democrats, the Liberal Party and the Left Greens.

99 *Landsdomur* [Impeachment Court], No. 3/2011, pp. 339–385.

100 The minority consisted of one Supreme Court judge, one representative of the Law Faculty of the University of Iceland and four people appointed in 2005 by Parliament, all from the then-government parties, the Independence Party and the Progressive Party.

101 It is wrong what Barry Eichengreen writes in *Hall of Mirrors* (New York: Oxford University Press, 2015), p. 397, that Haarde was convicted of ‘gross

Even if the decision of the Impeachment Court in essence could be seen as a victory for Haarde, as he was acquitted of all major charges, not punished and awarded legal costs, he appealed it to the European Court of Human Rights. In November 2017 – after deliberating for more than five years – the Court found that his rights had not been violated in the process. He had been acquitted of almost all the charges, the Court emphasised, and in the relatively minor case where he had been found guilty as charged, the letter of the law had been followed: It was true and indeed uncontested that he had not put the pending bank crisis on the official agenda at cabinet meetings. The court observed that in many countries, there were special legal stipulations about ministerial responsibility, such as in Denmark, where a similar Impeachment Court was in place.¹⁰²

The Court of Human Rights, however, largely ignored the political aspects of the case, unlike Pieter Omtzigt, a Member of the Dutch Parliament, who wrote in a 2013 report for the European Council on the trial of Haarde:

“It was indeed the new majority in parliament which decided, along party-political lines, to initiate criminal proceedings for the failure to avoid the banking crisis only against the former Prime Minister and not against the ministers who had been directly in charge of banking issues within the same (coalition) government but who belonged to parties forming part of the new majority. It would indeed appear that the new majority's objective was to somehow ‘criminalise’ their predecessors' choice of economic liberalism that had contributed to the rise and fall of the Icelandic banks. In my conversations in Reykjavik, I could sense a lot of unease even among the political supporters of the prosecution, especially concerning the fact that the Prime Minister was singled out in such a way.¹⁰³”

negligence for not holding cabinet meetings during the 2008 crisis'. He was convicted of negligence, not of gross negligence; and the conviction was for not discussing the economic problems of the banks at cabinet meetings before the collapse. Of course Haarde held several cabinet meetings about the situation during the 2008 crisis. In a postscript Eichengreen cites journalist Sigrun Davidsdottir as his main source on Iceland.

102 European Court of Human Rights, Application No. 66847/12. http://www.echr.coe.int/Documents/CP_Iceland_ENG.pdf

103 Pieter Omtzigt, Keeping political and criminal responsibility separate, Report for the Parliamentary Assembly of the European Council, 28 May 2013, p. 6. https://www.ecoi.net/file_upload/1226_1369820122_xrefviewpdf.pdf

Omtzigt's report was adopted with all votes in the Legal Affairs Committee except that of an Icelandic Member of Parliament from the Left Greens, who previously had voted for Haarde's impeachment alongside other members of her party.

Needless to say, the case against Haarde was controversial in Iceland, as Omtzigt observed. Many argued that politicians should be held responsible for their actions, or lack thereof, in elections, not in criminal courts, unless of course they had violated legal statutes. The Independence Party was adamantly opposed to the impeachment case, regarding it as an attempt by the Icelandic left-wing to stigmatise or even criminalise a whole party. There was a widespread feeling, also, that it was unfair to single out Haarde. Either all the ministers responsible for the government conduct of economic affairs before the bank collapse should have been charged, or none of them. If anyone should have brought up in cabinet the matter of the difficulties and possible collapse of the banks, then it should have been the Business Affairs Minister, to whom the banking sector was assigned. Moreover, the process seemed politicised. The eight Impeachment Court judges nominated by parliament all voted on party lines: the four from the Independence Party and Progressives against all charges, the four from the Social Democrats, Left Greens and the Liberals for the one charge which was eventually upheld (and against all the other charges).

Many Icelanders were also of the opinion that Haarde's sentence, even if it was as light as possible, without any punishment being allotted and with costs awarded, was unjust. There had not been a normal police investigation of Haarde's alleged crimes before he was indicted – only the reports of the SIC and of a Parliamentary Committee set up to respond to the findings of the SIC. These reports could hardly be a substitute for such an investigation, and the one charge eventually sustained was not even derived from the SIC report. The majority of the Impeachment Court ignored the sworn testimony of many politicians and officials that often important matters were not discussed at cabinet meetings, but outside them, before they were brought up in State Council, and that even if they were discussed at cabinet meetings, they were not always put into the minutes. To some it seemed that the sentence was not based on law properly interpreted, but solely designed to appease those who, in Sigridur Benediktsdottir's words to her

American students, 'are rightfully demanding that those who got the country into this position answer for it.'

The problem which the SIC largely ignored and which was clearly brought out in the case against Geir H. Haarde was that of limited options, succinctly captured in the old adage: 'You are damned if you do; you are damned if you don't.' Such dilemmas, well-known in game theory, are also often described as Catch-22 situations after a well-known novel on the Second World War: You are exempted from carrying out a dangerous duty if you are mad; but if you apply for an exemption on this ground, you thereby show that you are not mad.¹⁰⁴

The CBI governors, convinced that a great danger lay ahead, faced a dilemma. If they publicly uttered warnings against a possible bank collapse, or even if they were seen as preparing for it, then they almost certainly brought it about. If they kept silent, then they risked being held responsible for not taking appropriate action, as indeed happened.¹⁰⁵

Leading politicians, at least Prime Minister Haarde and Finance Minister Arni M. Mathiesen, faced another dilemma. Public opinion was strongly in favour of the banks and of business tycoons like Jon Asgeir Johannesson, who doubled as a media mogul and many times had demonstrated both his power and his readiness to use it.¹⁰⁶ Moreover, the leader of their coalition partner, Foreign Minister Gísladóttir, had publicly chastised Governor Oddsson for his criticisms of the banks, albeit when he was Prime Minister. Other prominent members of the party were known to be close to some of the bankers.¹⁰⁷ If Haarde and Mathiesen chose to take the CBI governors seriously, then they seemed to be faced with what was essentially a choice between a quick and a slow political suicide. The quick way out of politics would have been to challenge the powerful banks and to try

104 Joseph Heller, *Catch-22* (New York: Simon & Schuster, 1961). Cf. the 1970 Paramount Pictures film directed by Mike Nichols.

105 This point was repeatedly made by David Oddsson in his testimony before the SIC 7 and 12 August 2009 and 10 January 2010.

106 Johannesson's use of his media clout is documented in Björn Bjarnason (former Minister of Justice), *Fosabaugur yfir Íslandi* [Iceland in the Thrall of Baugur] (Reykjavík: Ugly, 2011), and Oli B. Karason, *Síðasta vörnin: Haestirettur a villigötum í eitruðu andrumslofti* [The Ultimate Defence: the Supreme Court on a Failed Mission in Poisonous Atmosphere] (Reykjavík: Ugly, 2011).

107 Examples of this are found in the SIC Report, Vol. 7, Ch. 20, pp. 32 and 35.



The Icelandic bankers were young, hard-working, ambitious, and aggressive. During the rapid expansion of the banks abroad from 2004 onwards, they were widely admired in Iceland as modern-day vikings. Here (from left) Káupthing's Hreidar M. Sigurdsson and Sigurdur Einarsson are receiving the 2005 Presidential Export Prize from President Ólafur R. Grimsson, their vocal supporter. Photo: Eythor Arnason, Mbl.

and reduce their size by any means at their disposal, including taking the initiative in measures that would then have been implemented by the CBI and the IFSA. The slow way out was, on the other hand, to do nothing, count one's blessings and hope that the deluge would not arrive.

This was less of a problem for the Social Democrats because they tended to dismiss the warnings of the CBI governors. They were 'one man's venting', as Gísladóttir wrote.¹⁰⁸ She also later asserted that two economists from whom she often sought advice, Professor Robert Wade of the LSE and Professor Thorvaldur Gylfason of the University of Iceland, while critical of the CBI and the Icelandic banks, never warned her against an imminent bank collapse or of any danger of such an event.¹⁰⁹ Neither did economists Willem Buiters and Anne Sibert, with whom she had discussions in the spring of 2008, predict a bank collapse, according to her.¹¹⁰ In all fairness, it should also be recalled that against the

warnings of the CBI governors, based on informed guesses rather than hard evidence, government ministers could not but recognise the facts that the banks had been audited by respected international accounting firms, rated by acknowledged rating agencies and applauded by international organisations like the IMF. Later, the Independent Evaluation Office of the IMF was to point out that in 2007, surprisingly, the massive size of the banking sector 'was not highlighted as a key vulnerability that needed to be addressed urgently' by the IMF. As late as August 2008, the IMF published an Update to its regular 2008 report on Iceland, on which the Independent Evaluation Office commented: 'Strangely, the tone of the Update was relatively reassuring.'¹¹¹

The Icelandic bankers faced a third dilemma. Most of them knew that they had overreached themselves. But if they tried to sell assets, then they risked not only a

108 Ibid., Vol. 7, Ch. 21, p. 97 (in English).

109 Ibid., Vol. 8, Add. 1, p. 301.

110 Ibid., Vol. 6, Ch. 19, pp. 198–201.

111 *Evaluation of IMF Performance in the Run-Up to the Financial and Economic Crisis* (Washington DC: Independent Evaluation Office of the IMF, January 2011), 15. [http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20\(without%20Moises%20Signature\).pdf](http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20(without%20Moises%20Signature).pdf)



Kaarlo Jännäri, former Director of the Finnish Financial Supervisory Authority, wrote, on the initiative of the IMF, a balanced and fair report on the bank collapse. He emphasised the limited options of both the Icelandic bankers and the authorities, but insisted also that none of them were blameless. Photo: Arni Saeberg, Mbl.

loss on the sales and a corresponding reduction in the registered value of remaining assets, perhaps below zero, but also the automatic cancellation of credit lines that were often dependent by contract upon no or little change in their reported financial positions. Kaarlo Jännäri, former Director of the Finnish Financial Supervisory Authority, observes in a report on the Icelandic bank collapse written at the initiative of the IMF: 'Many of the covenants in the Icelandic banks' funding arrangements would have been breached had the banks retrenched rapidly. Breach of covenants would have led to early redemption demands for an important part of the banks' funding; thus the banks were faced with a kind of Catch-22 situation.'¹¹²

¹¹² Kaarlo Jännäri, *Report on Banking Regulation and Supervision in Iceland* (Reykjavik: Prime Minister's Office, 2009), p. 16.

This does not mean, of course, that the bankers were merely hapless victims. Apart from desperate rescue attempts in the few months and even weeks before the collapse, some of which may have been illegal, two moves by the bankers in retrospect may be regarded as grave mistakes, especially as they should have known better and perhaps then still had some room to manoeuvre: an attempt by Kaupthing in August 2007 to buy the Dutch bank NIBC, which eventually had to be abandoned, and the decision by Landsbanki in May 2008 to collect Icesave deposits in the Netherlands through a branch, and not a subsidiary, which contributed to the hostility of European central bankers to the Icelandic banks. Prominent Icelandic businessman Thor Björgolfsson, before the collapse a major shareholder in Landsbanki, points out that a third crucial mistake made by all three banks was to allow one business group, that of Jon Asgeir Johannesson, to accumulate enormous debt.¹¹³ Again an old adage seems appropriate: If you owe the bank a million, then *you* have a problem. But if you owe the bank a trillion, then the *bank* has a problem. As the SIC noted, the total debt of Johannesson's group to the three Icelandic banks was for a while a little less than a trillion *kronur*, or a staggering €5.5 billion.

Another consideration is that the SIC occasionally seems to have been less than fair towards the CBI, especially towards Governor Oddsson. While the SIC confirms the many unequivocal warnings that Oddsson uttered in confidential meetings with government ministers in the year preceding the bank collapse, it faults him for being a former politician so that old political opponents tended to dismiss his advice. The SIC complains of 'a certain degree of distrust and cooperation problems' between Oddsson and leading Social Democrats.¹¹⁴ But whether or not Oddsson distrusted the Social Democrats as much as they may have distrusted him is irrelevant because the issue was that he was warning them and that they were ignoring his warnings. It was not that they were proposing something that he was dismissing for his own personal reasons. The fault, therefore, should have been found not with Oddsson, but with his old political opponents who could not set aside old grievances in the face of an approaching danger for the Icelandic nation of which he was warning them.

¹¹³ Thor Björgolfsson, *From Billions to Bust—And Back* (London: Profile Books, 2014), p. 146.

¹¹⁴ SIC Report, Vol. 1, Ch. 2, p. 9 (in English).

The clearest example of this is a dramatic cabinet meeting Tuesday 30 September 2008, which Oddsson asked to attend in order to warn of an imminent bank collapse. Some of the government ministers present seemed to be preoccupied with the fact that it was Oddsson who was issuing the warnings, not with the imminent collapse itself and how to respond to it. The SIC should have criticised them, it would seem, and not Oddsson.

Second, this criticism by the SIC is also a formal error, which is somewhat surprising coming from a group which emphasises form, at least in its admonitions. There were three CBI governors: in addition to Oddsson Eiríkur Guðnason and Ingimundur Fridriksson. If Guðnason and Fridriksson, both of them economists with long experience in central banking and not with any known political affiliation, had disagreed with Oddsson, then he would not have been able to speak on behalf of the CBI. But the two other CBI governors had become convinced, with Oddsson, of the imminent danger approaching. If old foes of Oddsson did not want to listen to him because of his past political career, then they should at least have taken his two colleagues seriously.

In general, the SIC Report is surprisingly parochial, focusing on domestic rather than international aspects of the crash. Its authors do not take much into consideration that the Icelandic banks encountered an international financial crisis from 2007 to 2009 that brought down many banks around the world and large investment banks like Bear Stearns, Lehman Brothers and Merrill Lynch in the US and small and large commercial banks like Roskilde Bank in Denmark, Northern Rock and Bradford & Bingley in the UK, Anglo Irish Bank in Ireland and Washington Mutual in the US. Again the crisis almost brought down many other banks hitherto considered invulnerable, such as Citibank in the US, UBS in Switzerland, RBS in Scotland and Danske Bank in Denmark. Without a doubt the SIC was under strong pressure to search for anything which could be used to condemn the former powers to be, in particular Oddsson. But it should be noted that even if the SIC in its report criticised some of the CBI's policies and actions, it did not adopt the already mentioned and widely discussed charges against the CBI governors: specifically the offer to recapitalise Glitnir, Oddsson's television interview on 7 October 2008, lowering the reserve requirements for the banks, not increasing the foreign exchange reserves, and extending loans to the

banks against mere 'love letters'. The reason why the SIC in effect dismissed these charges could only be that it was presented with adequate explanations and grounds for the measures taken or not taken by the CBI governors in these matters.¹¹⁵

The SIC found the three CBI governors guilty of negligence on only two counts. First, in August 2008, after the FSA had set strict conditions for a possible transfer of Landsbanki's British online accounts from its London branch to a British subsidiary and after Landsbanki had requested a credit facilitation from the CBI, the governors, before they rejected Landsbanki's request, should have verified both the reasons for FSA's demands and Landsbanki's financial position.¹¹⁶ Second, in September 2008 the CBI governors should have consulted with specialists before rejecting Glitnir's request for an emergency loan, but instead they advised the government to offer and buy 75% of Glitnir for €600 million.¹¹⁷ It should be emphasised that the SIC did not criticise the two decisions themselves by the CBI governors – rejecting in August a credit facilitation for Landsbanki and in September an emergency loan for Glitnir – but only what it saw as a proper process of arriving at these decisions.

The CBI governors strongly disputed these two criticisms. Against the first one they pointed out that, unlike the IFSA, the CBI was not the regulator of the banks. It did not have any authority to request sensitive financial information from the banks and no power to discipline or punish them, even if it felt that they were straying from their role or breaking the rules. The three governors were not the only central bankers finding themselves with limited information and powers in the period leading up to the crisis. The Chairman of the US Federal Reserve Board, Ben

¹¹⁵ SIC Report, Online Addenda, No. 11, responses of David Oddsson, Eiríkur Guðnason and Ingimundur Fridriksson.

¹¹⁶ SIC Report, Vol. 7, Ch. 21, pp. 153–160 (in English). The first criticism is stated thus, p. 154, that it 'refers to the response of the Board of Governors whereby it was on the one hand omitted to ascertain whether the position of the Financial Services Authority had been described correctly, and on the other hand, there was no attempt to examine the quality of the loan portfolio of Landsbanki in light of the aforesaid information, and consequently whether the bank was experiencing equity problems.'

¹¹⁷ The second criticism is stated thus, p. 158, that the Board of Governors 'failed to properly execute its obligation for investigation' and omitted 'to directly collect further information regarding the position of Glitnir and that bank's loan book, as well as information regarding such other matters as might be significant for the assessment of whether it was justified to grant a last resort loan to Glitnir.'

Bernanke, wrote about his worries during the summer of 2007:

“ We were hampered because we had no authority to obtain confidential data from investment banks (like Bear Stearns), which were regulated by the Securities and Exchange Commission, or over foreign banks not operating in the United States (like IKB), or over hedge funds, which were largely unregulated.¹¹⁸”

Moreover, the Icelandic legal tradition was one of a strict interpretation of the authority and power of institutions, as two SIC members repeatedly had stressed, Pall Hreinsson in scholarly publications and Tryggvi Gunnarsson in legal opinions as Ombudsman.¹¹⁹ The CBI governors emphasised that the SIC actually agreed that they had acted correctly by turning down Landsbanki's request in August 2008 to facilitate the proposed transfer of accounts, as it would have created a great risk for the CBI and would also probably have been illegal. At this time several tasks were more urgent than to verify the obvious.

Against the second allegation, the CBI governors pointed out again that the CBI did not have any authority to request sensitive financial information from the banks. The governors had to rely on the information provided by Glitnir when in September 2008 it made the request for an emergency loan, and based on that information alone it was by no means prudent to extend the loan to the bank. In the near future the bank faced more big loans maturing with no guaranteed refinancing of them, and the collateral eventually offered was less than solid. Further information becoming available later only served to strengthen the reasons for the rejection of Glitnir's request by the CBI governors. Moreover, the decision on the request had to be made within a weekend, before the markets opened. There was no 'right' price for the bank that could be found by calculations or consultations with experts. The price eventually set was found by a simple reasoning: The bank needed €600 million. The government needed to buy a controlling stake, though it did not want to write down too much the shares of present

owners. Therefore, it bought a 75% controlling share in Glitnir for €600 million. This was, in the circumstances, a perfectly appropriate process.¹²⁰ At the time, Paul Krugman wrote: 'Notice, by the way, that it was an equity injection rather than a purchase of bad debt; I approve.'¹²¹

In making the second allegation, on the lack of paperwork preceding the advice to the government to buy a controlling stake in Glitnir, the SIC obviously did not take fully into account the reality of the financial markets all around the world as the credit crunch intensified in 2008. Then, for example, the US Secretary of the Treasury Hank Paulson was making many and much larger decisions about the life and death of financial firms in a matter of a few hours, even minutes, over the phone, without any paperwork, simply because in the desperate situation in which he found himself decisions had to be made quickly.¹²² It took the FRB of New York only a few hours to decide extending \$30 billion in credit facilities to Bear Sterns so it could be taken over by JP Morgan Chase, which initially offered \$2 a share for it, and then suddenly, to avoid controversy, raised its offer to \$10 a share.¹²³ On the same weekend as the decision was made about Glitnir, the British government was dealing with Bradford & Bingley. Chancellor Alistair Darling gave himself 48 hours to resolve the issue.¹²⁴ When the US investment banks Goldman Sachs and Morgan Stanley decided to transform themselves into commercial banks in order to obtain assistance from the Federal Reserve Board, they did so overnight: The requirement of a 30-day waiting period for such applications was simply waived.¹²⁵ In the unreality of this allegation against the CBI governors, the SIC may be demonstrating the truth of an observation by US statesman Dean Acheson: 'A memorandum is written not to inform the reader but to protect the writer.'¹²⁶

It is truly remarkable that after dozens of lawyers and economists had been digging for more than

120 SIC Report, Online Addenda, No. 11, response of David Oddsson.

121 Paul Krugman, The \$850 billion bailout. Blog 30 september 2008. <https://krugman.blogs.nytimes.com/2008/09/30/the-850-billion-bailout/>

122 Hank Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (New York: Business Plus, 2010).

123 Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* (London: Random House Business Books, 2014), pp. 155–158.

124 Darling, *Back from the Brink*, p. 134.

125 Bernanke, *The Courage to Act*, p. 311.

126 Quoted in *Wall Street Journal* 8 September 1977.

a year, with a generous budget and full access to all documents and under great pressure to find something compromising for the former powers to be, they could not come up with any complaint against the Prime Minister that could be sustained by the Impeachment Court. The only charge which the Impeachment Court accepted – that Geir H. Haarde had failed to put the banking crisis on the official agenda at cabinet meetings – was not derived from the SIC Report: It was added on the advice of a legal expert when a Parliamentary Committee was deliberating on the response to the SIC Report.¹²⁷

No less remarkable is it that after all this digging, the SIC and its numerous staff could only come up with two formal complaints against the three CBI governors: that they had not asked for enough expert opinions, reports or value estimates when making two decisions that, nevertheless, were deemed to be prudent and reasonable in themselves. As Horace put it: *Parturient montes, nescetur ridiculus mus*. The mountains will be in labour, and a ridiculous mouse will be brought forth. Moreover, even if the facts on which these three complaints – one against Haarde and two against the CBI governors – are based would be undisputed, none of them made any difference for the 2008 bank collapse. It would have occurred irrespective of what was put on the agenda at government meetings and of which memoranda the CBI governors and their staff could have written.

The conclusions by the SIC on the negligence of two government ministers, Finance Minister Arni M. Mathiesen and Business Affairs Minister Bjorgvin G. Sigurdsson, were in effect rejected by the majority of parliament when it decided not to bring a case against them before the specially convened Impeachment Court. It is indeed difficult to see what exactly the two of them could have done, at least on their own, and what they had neglected to do. Mathiesen did not even have any authority over the banks. The CBI was by law the concern of the Prime Minister, and the affairs of the banks, as well as of the IFSA, were supposed to be dealt with by Business Affairs Minister Bjorgvin G. Sigurdsson. In its strictures against Mathiesen, the SIC also ignored the important fact that Iceland was virtually debtless when the international credit crunch started to hit her with immense force in 2008. It is fair to say that the two

measures which in the end made the bank collapse bearable for the Treasury, and thus for the Icelandic nation, were that the Treasury by then had paid up almost all public debt and that by the Emergency Act depositors' claims were directed against the estates of the fallen banks and not against the Treasury. Geir H. Haarde, Finance Minister in 1998–2005, and Arni M. Mathiesen, Finance Minister in 2005–9, were mainly responsible for these two measures. For this they deserved praise rather than blame.

Even if Business Affairs Minister Sigurdsson nominally was in charge of the banking sector and of the IFSA, it seems that information provided by the CBI on the situation was mostly withheld from him by the leader of the Social Democrats, Foreign Minister Ingibjorg S. Gisladdottir. For example, Sigurdsson was not summoned to an important meeting on Thursday 7 February 2008, where CBI Governor David Oddsson briefed three government ministers about the negative impact of the international credit crunch on the banks.¹²⁸ Again Sigurdsson was not even consulted during the fateful weekend of 27–8 September, when it was decided to recapitalise Glitnir. A possible reason why Gisladdottir mostly treated Sigurdsson as an outsider despite his position as Business Affairs Minister was that he belonged to, or was even leading, a faction within the Social Democrats opposed to her. Another reason mentioned in the SIC report may have been that some regarded Sigurdsson as inexperienced, rash and unable to keep a secret.¹²⁹ Nevertheless, formally he rather than the Prime Minister should have brought up in cabinet the matter of the banks in the period prior to their collapse. However, it seems somewhat unfair to accuse Sigurdsson of neglecting to respond to a crisis about which he received little information until it was too late to do anything about it.

The SIC dealt with IFSA Director Jonas Fr. Jonsson in the same way as the three CBI governors. While concluding that he was, as a public official, guilty of negligence, the Commission did not see fit to report him to the public prosecutor for such negligence or for violations in his exercise of his duties as an official, as it could have done under its brief.¹³⁰ It is hard to

128 SIC Report, Vol. 7, Ch. 21, p. 93 (in English).

129 Ibid., Vol. 6, Ch. 19, p. 146; Vol. 8, Add. 1, p. 137.

130 Law No. 142/2008 17 December. According to §14 of this Law, the SIC was expected to report to the Public Prosecutor any suspicions of criminal behaviour or of violations of the Icelandic law on the duties of public officials (Law No. 70/1996).

127 Apparently the expert was Law Professor Ragnhildur Helgadóttir.

see what Jonsson could have done to stem the tide, especially with the two constraints under which he was operating, the doctrine of strict legal authority of which two SIC members had been prominent adherents, Tryggvi Gunnarsson and Pall Hreinsson, and the strong public support for the banks and for some of their main debtors. As Parliamentary Ombudsman, Gunnarsson had even told lawyers of financial firms in May 2007 that they could always complain to his office if they thought that the IFSA was not treating their companies fairly and that IFSA was bound not only by written statutes, but also by the unwritten rules of public administration law.¹³¹

Here, as in other cases investigated by the SIC, it is important to keep in mind the written and unwritten rules and conventions in force in the years leading up to the financial collapse and not to refer to rules invented after the collapse against those involved. Under Icelandic law there is a certain accepted interpretation of negligence in one's exercise of one's duties as a public official. The SIC did not use it in its report, replacing it with its own much wider concept of negligence, which was essentially that officials should have reacted more forcefully and quickly to dangers of which there was little reliable evidence at the time.¹³² Its allegations of negligence against Jonsson were not based on any comparison with similar supervisory agencies in other EEA countries, operating under an almost identical framework, let alone on a comparison with previous practices in Iceland. Indeed Jonsson became IFSA Director only in 2005, when the banks had already grown considerably, perhaps beyond a point of return, and after important decisions and non-decisions had been made about them by the IFSA. In general, a comment by Karlo Jännäri on this seems fair, bearing in mind that what seems timidity to some may to other appear more like cautiousness: 'The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments, but the overall national pride in the success of the banks would probably have made it futile even to try while the going was good and success followed success.'¹³³

131 IFSA, Runar Gudmundsson, Minnisblad [Internal Memo], 18 May 2007. Gudmundsson, an IFSA member of staff, attended the meeting, held 16 May 2007. I obtained the document according to the Icelandic Freedom of Information Act. Cf. SIC Report, Online Addenda, No. 11, response of Jonas Fr. Jonsson.

132 SIC Report, Vol. 7, Ch. 21, pp. 118–19 (in English).

133 Jännäri, *Report*, p. 37.

Another surprising move of the SIC was to treat Foreign Minister Ingibjorg S. Gisladottir more leniently than Prime Minister Haarde, Finance Minister Mathiesen and Business Affairs Minister Sigurdsson. The three of them were found negligent in the SIC Report, and she was not. But surely as leader of the Social Democrats, Gisladottir shared with Haarde, leader of the Independence Party, the political responsibility for government actions or non-actions in the 16 months leading up to the bank collapse. It was also Gisladottir who decided not to transmit most of the relevant information about the pending bank crisis to Business Affairs Minister Sigurdsson, even if formally it was a task for his Ministry. For example, Sunday 28 September 2008, before the final decision to recapitalise Glitnir was made, the CBI governors were astonished to learn that Sigurdsson was to be excluded from the deliberation. Governor Oddsson told Prime Minister Haarde that he wanted to hear this directly from Foreign Minister Gisladottir. At the Ministry of Finance, where Haarde, Mathiesen and Oddsson were meeting, Haarde called Gisladottir to New York and after a brief conversation handed the receiver over to Oddsson. Gisladottir confirmed to Oddsson that she wanted Industry Minister Ossur Skarphedinsson, and not Sigurdsson, to participate in the decision-making process on behalf of the Social Democrats.¹³⁴

Moreover, the chain of events preceding the collapse was to a great extent about Iceland's relations with other countries, so it is an implausible response that as Foreign Minister Gisladottir had no formal say in the matter. It should be noted that as Foreign Minister, Gisladottir did little to strengthen the already weakening links between Iceland and the US. Instead, she criticised alleged human rights violations by the US and had amicable discussions with leaders of countries hostile to the US, such as Syria.¹³⁵ She

134 Interviews with David Oddsson in Reykjavik 5 October 2017 and by phone with Geir H. Haarde 8 November 2017. In his testimony before the SIC, Industry Minister Ossur Skarphedinsson said that it had been the wish of Gisladottir that he should represent the Social Democrats at the crucial meeting on Glitnir, and not Sigurdsson. However, Gisladottir denied this and said that she could not explain Sigurdsson's absence. She acknowledged that her recollections of those days were somewhat hazy, as she had been in hospital. SIC Report, Vol. 7, Ch. 20, p. 25.

135 Ingibjorg S. Gisladottir, Fridur i krafti kvenna [Peace as a Female Initiative], *Frettabladid* 20 February 2008; Hefur thungar ahyggjur af Palestínu [Deeply Worried About the Palestine], *Frettabladid* 4 March 2008. Of some interest are also some cables from the US Embassy in Reykjavik to the State Department and others, e. g. Icelandic MFA Announces Inquiry into Alleged CIA Detainee Flights, 13 July 2007, https://www.wikileaks.org/plusd/cables/07REYKJAVIK203_a.html; Iceland: Exercise Northern Viking, Russian Bomber Flights Put Spotlight on Defense, 27 August 2007, https://www.wikileaks.org/plusd/cables/07REYKJAVIK247_a.html



The impeachment case in 2012 against former Prime Minister Geir H. Haarde was regarded by many as grossly unfair, even as an attempt by the left to criminalise its opponents. The Impeachment Court acquitted Haarde of all major charges, while a majority (mostly on political lines, with all representatives of left-wing parties voting in favour) upheld a minor, technical charge: that Haarde had not put the impending banking crisis on the agenda of cabinet meetings as he should have done. Haarde is now Iceland's Ambassador to the United States. Photo: Kristinn Ingvarsson, Mbl.

did not do much, either, to maintain traditional links between the UK and Iceland. During her brief tenure as Foreign Minister, she seemed to focus on the ultimately unsuccessful attempt by Iceland to be elected to a seat in the UN Security Council and on making provisions for Iceland's membership in the European Union, a long-time aspiration of her Social Democrats.

It should be recalled that in the 2003 election campaign, Gisladottir had tried to make an issue out of Oddsson's alleged hostility to Kaupthing; and that in early 2008, when Foreign Minister, she had dismissed his repeated warnings about the banks as 'one man's venting',¹³⁶ and that she had as late as in September 2008 publicly urged the banks to continue their controversial deposit collection abroad.¹³⁷ These

[wikileaks.org/plusd/cables/07REYKJAVIK247_a.html](https://www.wikileaks.org/plusd/cables/07REYKJAVIK247_a.html) See also cable from US Embassy in Damascus to State Department, 10 July 2008, https://www.wikileaks.org/plusd/cables/08DAMASCUS491_a.html

136 SIC Report, Vol. 7, Ch. 21, p. 97 (in English). Gisladottir states that she attended five meetings with Oddsson and Haarde about the problems of the banks. SIC Report, Online Addenda, No. 11, response of Ingibjorg S. Gisladottir.

137 Ingibjorg S. Gisladottir, Unnid a thrithaettum vanda [Solving Three Kinds of Problems], *Frettabladid* 4 September 2008.

considerations do not necessarily imply that the SIC should have condemned Gisladottir for negligence, but they serve to suggest the peculiarity of treating her differently from her three government colleagues, Haarde, Mathiesen and Sigurdsson.¹³⁸

Sometimes the SIC, even unconsciously, may have had its own agenda (which should not surprise any economist familiar with the public choice school).¹³⁹ A part of such an agenda may have been that power should be transferred from politicians – the elected representatives of the people – to experts, even if few if any of them had foreseen the international financial crisis, let alone the Icelandic bank collapse. Much was, for example, made of the fact that CBI Governor Oddsson was a lawyer and not an economist. Nor did the SIC provide a level playing field for itself and those whom it called on to testify or whom it was investigating. The individuals giving testimony to

138 Many felt that Gisladottir was conspicuously absent when the SIC issued its admonitions. Indeed the Parliamentary Committee appointed to respond to the findings of the SIC, proposed charging her for negligence alongside Haarde, Mathiesen and Sigurdsson.

139 James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (Ann Arbor MI: University of Michigan Press, 1962).

the SIC were quoted verbatim in the report, at the discretion of the SIC and without permission: They did not have any opportunity to correct themselves or to improve on the formulation of their answers, as is the case, for example, in printed transcripts of the sessions of the Icelandic Parliament.

Those whom the SIC accused of negligence were given a very short time to respond to its accusations, only 12 days,¹⁴⁰ whereas the SIC itself far exceeded its deadline, by a little less than six months. The objections of those accused were not printed with the report, just made available online.

It seems as if the SIC tried in many ways to protect itself from possible criticisms. Not only were its individual members granted legal immunity, but the Commission also decided not to make its hearings public, let alone to allow live coverage of them, as is the tradition in the US and, to some extent, also in the UK.¹⁴¹ Thus the activities of the SIC became much less transparent than they should have been. Moreover, after the SIC had presented its report, the evidence given to it was locked up instead of being made available to the public.

The most important criticism of the SIC is, however, that it did not really provide a full explanation of the banking collapse, even if its report contained a lot of interesting information, especially about the operations of the banks and about the legal aspects of deposit collection abroad. The main conclusion of the SIC was that the collapse occurred because the banks were over-sized relative to the CBI and the Icelandic Treasury. But the relatively large size of the banks was a *necessary* and not a *sufficient* precondition for their collapse. It is almost a tautology to say that the Icelandic banks fell because they were vulnerable (prone to fall, in other words), and then to go on and list all their vulnerabilities. It is like saying that glass breaks because it is breakable or that opium puts people to sleep because of its sleeping power, an idea ridiculed by Molière in *The Hypochondriac*, where an arrogant doctor asks a pretentious student why opium

causes sleep, and the student replies that opium has ‘virtus dormitiva’, which is simply Latin for sleeping power.¹⁴² Banks elsewhere in Europe were also vulnerable, and they would have failed if they had not been saved, even such big banks as RBS in Scotland, UBS in Switzerland and Danske Bank in Denmark.¹⁴³

The real explicandum in the Icelandic case is why the banks were not saved from abroad, like RBS, UBS and Danske Bank. If they had been saved there would not have been a collapse (although there would certainly have been a deep recession). As Kaupthing’s Armann Thorvaldsson wrote:

“ I always believed that if Iceland ran into trouble it would be easy to get assistance from friendly nations. This was based not least on the fact that, despite the relative size of the banking system in Iceland, the absolute size was of course very small. For friendly nations to lend a helping hand would not be difficult.¹⁴⁴

What turned a predictable crisis into a collapse of the banking sector was that into an already vulnerable situation, partly created by the Icelandic banks themselves and partly the result of circumstances to which everybody would have reacted in a similar way, entered four decisions taken abroad, none of them explored, alas, in any detail by the SIC: European central banks refusing to provide liquidity to Icelandic banks or to make currency swap deals with the CBI; the US Federal Reserve Board refusing to do dollar swap deals with the CBI; the UK Labour government closing down British banks owned by Icelandic banks; and the same UK government using an Anti-Terrorism Act against not only an Icelandic bank, but also, however briefly, against the CBI and the IFSA and other Icelandic authorities. In the following chapters, these decisions will be explored and, hopefully, explained.

140 The letter with the possible admonitions or charges was sent to people 8 February 2010, and they were to respond by 19 February. On 17 February they were told that the deadline had been extended to 24 February. Normally, this would not be considered good administrative practice.

141 For example former Prime Minister Tony Blair’s testimony to the Committee of Inquiry on the Iraq war was broadcast live and is available on Youtube.

142 Molière [Jean-Baptiste Poquelin], *The Hypochondriac*, *The Works of Molière*, Vol. 5 (Glasgow: John Gilmour, 1751), p. 350.

143 On Danske Bank, see the television documentary *Sikke en fest* (2012). <http://finans.tv2.dk/nyheder/article.php?id=60667554:danske-bank-var-taet-pa-afgrund.html> Also Niels Sandøe and Thomas Svaneborg, *Andre folks penge: Historien om den danske finanskrise* (København: Jyllands-Postens Forlag, 2013).

144 Thorvaldsson, *Frozen Assets*, p. 194.

6

THE ROLE OF EUROPEAN CENTRAL BANKS

Thursday 31 July 2008 was a day of strenuous meetings at the CBI, Central Bank of Iceland. A delegation from the British Financial Services Authorities (FSA) had visited, expressing grave concerns about online deposit collection by Landsbanki in the UK. CBI Governor David Oddsson had summoned the Landsbanki managers to the CBI headquarters, bluntly telling them that they could not assume a government guarantee of the deposits they were collecting.¹⁴⁵ In the evening Oddsson had an appointment with William R. White, Deputy Director of the Bank of International Settlements (BIS) in Basel who happened to be passing by for a few days. They had dinner in Perlan, a revolving restaurant with a view over the whole of Reykjavik. White told him that the outlook in the international financial markets was bleak, but that authorities were wary of rescuing financial companies. Such bail-outs with taxpayers’ money had been severely criticised. He concluded: ‘I think that in the next few months one investment bank will be allowed to go under, and I predict it will be Lehman Brothers. I also think that in the next few months one small European country will be allowed to go under, and I predict it will be Iceland.’¹⁴⁶

Lehman Brothers was of course the least well-connected of the great Wall Street financial houses, and the Icelandic banks were becoming unpopular in European central bank circles. After the 2006 Geyser crisis, the Icelandic banks had started to collect online retail deposits abroad, Landsbanki in its branches under the brand name ‘Icesave’ started in October

2006, and Kaupthing mostly in its subsidiaries under the brand name ‘Edge’, starting in November 2006. The branches of the Icelandic banks were regulated by the IFSA and the deposits in them insured by the Icelandic Depositors’ and Investors’ Guarantee Fund (IDIGF), whereas the subsidiaries of the banks were regulated locally and the deposits also insured locally. Since the Icesave and Edge accounts were electronic, they were much cheaper to operate than regular accounts at ‘High Street’ bank offices. The Icelandic banks could, therefore, offer higher interest rates than many of their competitors. ‘Icesave looks like a hot deal,’ British journalists wrote.¹⁴⁷ The Icesave and Edge accounts certainly became quite popular. At the end of September 2008, a total of €5.4 billion were kept in Kaupthing’s Edge accounts in Europe, thereof €4.2 billion in subsidiaries. At the end of June 2008, a total of £3.6 billion was kept in Landsbanki’s Icesave accounts in the UK.¹⁴⁸

The collection of deposits in the Icesave and Edge accounts was bound to cause resentment by competitors of the Icelandic banks. ‘I am fairly confident that this annoyed the big banks in these countries no end. They had the large costs associated with their branch network and would never have been able to compete with us on pricing,’ Kaupthing’s Armann Thorvaldsson writes.¹⁴⁹ The Icelandic banks also came to the attention of European central banks. At a meeting of central bankers in Basel in March 2008, Axel Weber, governor of Germany’s Bundesbank, argued that one of the greatest threats to the stability of the banking system was the irresponsible intrusion into deposit markets and the break up of the deposit-guarantee schemes. It was

145 SIC Report, Vol. 5, Ch. 17, p. 253; Vol. 6, Ch. 18, p. 21; Vol. 6, Ch. 18, p. 18 (in English); Aetla ad daema thjodina til aevvarandi fataektar [Sentencing the Nation to Perpetual Poverty], *Morgunblaðid* 5 July 2009 (interview with Oddsson).

146 SIC Report, Vol. 6, Ch. 19, p. 272. Also, interview with David Oddsson in Reykjavik 7 October 2013. The other Icelanders at the dinner recall White’s analysis, but not the two particular predictions about Lehman Brothers and Iceland.

147 Ali Hussain, Icesave Looks Like a Hot Deal, *Sunday Times* 15 October 2006. <http://www.thesundaytimes.co.uk/sto/business/money/savings/article158555.ece>

148 SIC Report, Vol. 6, Ch. 18, pp. 3–4 (in English).

149 Thorvaldsson, *Frozen Assets*, p. 194.



Probably, at a dinner for leading central bankers on 4 May 2008 at the top floor of the BIS building in Basel, Iceland's fate was decided: Other central banks would not assist the CBI in providing liquidity to Icelandic banks. Photo: Wikipedia.

clear to CBI Governor Oddsson, who was present at the meeting, that Weber was referring to the Icelandic banks.¹⁵⁰ The European central bank governors worried about deposits in both the branches and subsidiaries of the Icelandic banks. If they were in branches, then they were insured in tiny Iceland, where the IDIGF clearly did not have the means to meet its obligations in case of failure. If the deposits were in subsidiaries, then they were insured locally by the guarantee funds of each host country, putting strain on them.

In early 2008 the international credit crunch was hitting hard the already vulnerable Icelandic banks. When the CBI governors started to try and obtain currency swap deals with European central banks and the US Federal Reserve Board, they found their foreign colleagues wary of the Icelandic banks. CBI governors David Oddsson and Ingimundur Fridriksson met Monday 3 March 2008 in London with Governor

¹⁵⁰ SIC Report, Vol. 6, Ch. 18, p. 59 (in English).

Mervyn King of the Bank of England and Sir John Gieve, the Deputy Governor of the Financial Stability Department. The CBI governors were enquiring whether the Bank of England was prepared to make currency swap deals available to the CBI. Governor King and Sir Gieve expressed misgivings about the Icesave accounts. They believed that the deposits raised in the UK had been used mostly to fund lending to Icelandic companies. They were also preoccupied with the possible consequences on a run on the Icelandic banks, including Landsbanki in London, and the arrangement of deposit guarantees.¹⁵¹ Sir John Gieve later said that it had added to their concerns about Iceland that they had observed highly leveraged buyouts in England by Icelandic businessmen. There was a lingering suspicion that the Icelandic banks were controlled by a small group of businessmen who used them for their own purposes. The banks might be not only bust, but also rotten. Sir John Gieve had also heard about a cross-border crisis management exercise the Nordic and Baltic states held in September 2007, where the Icelandic participants refused to reveal whether the authorities would save the banks in the case of a liquidity crisis.¹⁵² A Bank of England official, Andrew Gracie, had overseen the exercise. In February 2008 Gracie wrote a report at the request of the CBI, pointing out the danger of a bank collapse in Iceland the following October. Oddsson had quietly passed on the report to Prime Minister Geir H. Haarde.

Two weeks after the meeting at the Bank of England, CBI Governor Fridriksson on 17 March 2008 sent an informal request for a currency swap deal to the Bank of England. Talks began in a friendly manner, but without any tangible results. In early April the CBI also contacted the European Central Bank (ECB), the US Federal Reserve Board and the Scandinavian central banks with similar requests. Governor Oddsson spoke several times with Timothy Geithner, President of the FRB of New York, requesting a dollar swap deal of perhaps \$2–3 billion. Oddsson explained, as he had done in discussions with European central bankers, that the Icelandic banks were suffering from the perception that they had no lender of last resort and

¹⁵¹ Ibid., p. 9 (in English). Also, interview with Mervyn King in Petham Oast 14 August 2017.

¹⁵² Interview with Sir John Gieve in London 27 November 2014. While Sir John did not refer to Jon Asgeir Johannesson by name, he was obviously speaking about him when he spoke about an Icelandic businessman buying up High Street shops with loans from Iceland.

that the CBI was trying to make currency exchange deals with central banks as a trust-building measure. It would not be the goal to draw on credit lines so created, but rather to demonstrate to the markets that there were sufficient currency reserves available to the banks. Oddsson mentioned to Geithner that he was also trying to obtain such deals with European central banks, which estimated the need to be about €3–4 billion.¹⁵³ Geithner promised Oddsson that he would look into this. The Federal Reserve Board had already in late 2007 opened swap lines with the ECB and the Swiss National Bank.¹⁵⁴

When Governor Oddsson spoke with ECB Governor Jean-Claude Trichet about a possible currency swap deal, he was told, to his surprise and dismay, that the precondition for any help from the ECB would be the participation of the IMF in some kind of a programme for Iceland. The next time Oddsson met with Geithner, he told Geithner this. 'Ah, he offered you the Kiss of Death,' Geithner responded. His analysis, with which Oddsson agreed, was that an announcement that Iceland would be seeking assistance from the IMF would strengthen suspicions about the weaknesses of the Icelandic banks and could, therefore, provoke a run on them with their inevitable collapse.¹⁵⁵ When Oddsson told Bank of England Governor King that Trichet insisted on Iceland entering an IMF programme, King responded that this would not be necessary. What Iceland only needed to do, King said, was to get an IMF assessment of the state of the banks and the economy. Thereupon Governor Oddsson called IMF Director Dominique Strauss-Kahn and explained the situation to him. Strauss-Kahn was very friendly and reacted swiftly. He sent some staff members almost immediately to Iceland to write an assessment report.

At the IMF Spring Meeting in Washington DC 11–13 April 2008, CBI Governor Ingimundur Fridriksson and his staff met with several central bankers to discuss possible currency swap deals. On 11 April they met with the governors and staff members of the Scandinavian central banks. Governor Stefan Ingves of Sweden expressed concern about the Icelandic

¹⁵³ SIC Report, Vol. 1, Ch. 4, p. 169.

¹⁵⁴ *Federal Reserve System, Report to Congressional Addressees* (Washington DC: Government Accountability Office, July 2011), p. 16. Figure 1.

¹⁵⁵ SIC Report, Vol. 6, Ch. 19, p. 161. Also, interview with David Oddsson in Reykjavik 7 October 2013.

banking sector and the Icelandic economy as a whole and told the Icelanders that possibly the Scandinavian central banks would set some preconditions for currency swap deals. Nevertheless, it was agreed that the Riksbanken staff would prepare a draft for a currency swap deal between the Scandinavian central banks and the CBI.¹⁵⁶ In Washington DC, Fridriksson and his staff met with Bank of England Governor King on 12 April. The meeting was friendly, and it was Fridriksson's impression that it was more rather than less likely that the Bank of England would make a currency swap deal with the CBI. However, Governor King stressed that a plan had to be in place on how to use a possible credit line from the Bank of England.

On their way back to Iceland, CBI Governor Fridriksson and his staff met on 14 April in New York with FRB of New York President Timothy Geithner. It came out that before Geithner met the Icelanders, he had discussed the proposed dollar swap deal with the governors of the Bank of England, ECB, and Riksbanken, and also with the BIS Director. They all shared his scepticism about it. Geithner told the Icelanders that in order to build trust, they needed much more than they had previously had in mind – a dollar swap deal of at least \$10 billion. Otherwise the markets would interpret this as a sign of weakness. He added that he did not want to rule out a possible deal despite his doubts about the whole strategy.¹⁵⁷

The same day as Geithner had the meeting in New York with the Icelanders, a confidential IMF 'Preliminary Assessment' appeared that had been specially commissioned by the CBI for the central bankers to enable them to evaluate the request for currency swap deals. 'Broadly, the conclusion of the IMF was that the position of the Icelandic banks was tight but manageable,' Governor Fridriksson writes, 'and it endorsed the strategy of the Icelandic authorities, i.e. to negotiate swap agreements with other central banks in order to enhance confidence and allow the government to subsequently tap the international capital market to further strengthen its external liquidity position.'¹⁵⁸ According to the assessment, it was crucial that the safeguards of a loan facility were credible, inducing the banks to reduce the size of their balance sheets and thereby

¹⁵⁶ Ibid., Vol. 1, Ch. 4, p. 170.

¹⁵⁷ Ibid., p. 171.

¹⁵⁸ Fridriksson, *The Collapse of the Icelandic Banks*, p. 31.

increase confidence in the system. Each of the three banks should be required to prepare a plan on how they would downsize; they should stop paying dividends in the near future to improve their liquidity position; they should present plans on how quickly they could raise liquidity by selling assets, if needed; and finally, the granting of licenses to open branches abroad should be restricted.¹⁵⁹

The next day, on 15 April, Governor Oddsson sent a formal request for currency swap deals to the ECB, Bank of England and the three Scandinavian central banks. In his letter and attachments to it, it was emphasised that this strategy was intended mainly to show the markets that the CBI could provide liquidity if necessary. A possible collapse of the Icelandic banks might pose a danger to banks in other countries, not only because of the obligations of the banks, but also because it might prove contagious. A week later, on 22 April 2008, Oddsson sent a personal letter to Bank of England Governor King, telling him that currency swap deals were being negotiated with the Scandinavian central banks and that he hoped that King could respond positively to his earlier request.¹⁶⁰ King replied the next day in a long letter, where he explained why he was turning down the request by the CBI:

“ It is clear that the balance sheet of your three banks combined has risen to the level where it would be extremely difficult for you effectively to act as a lender of last resort. International financial markets are becoming more aware of this position and increasingly concerned about it. In my judgement, the only solution to this problem is a programme to be implemented speedily to reduce significantly the size of the Icelandic banking system. It is extremely unusual for such a small country to have such a large banking system.

King went on:

“ The amount of money is very small relative to the potential need for funds should a problem arise with one or more of your banks. Indeed, the announcement of a swap, especially if

restricted to a group of countries with which Iceland has good political relations, might well trigger concern in financial markets about the extent to which you and ourselves perceived a problem in the Icelandic banking system, and then attention would be drawn to the inadequate scale of financial resources available to you to deal with the problem. The swap might look rather like a political gesture rather than a credible financial strategy.

King added that he and Stefan Ingves of Sweden would initiate a discussion about Iceland's problems at the dinner of the G10 central bank governors in Basel 4 May.¹⁶¹ Privately British central bankers told Oddsson that they were also apprehensive about some of the bank owners.¹⁶²

The same day as Governor Oddsson received King's letter, he responded, saying:

“ I remain convinced that a swap arrangement with several central banks would indeed help and very significantly reduce the likelihood of serious occurrences. In fact, I have grave concerns that the absence of a swap arrangement in the current circumstances could have very severe consequences. I must emphasise my belief that this is not an isolated Icelandic concern. Difficulties in Iceland could have serious contagious effects in other countries.

Oddsson said that he believed that currency swap deals of the magnitude being sought by the CBI would be sufficient to make the situation manageable. Moreover, the international ratings agencies all thought that such currency swap deals would improve the position of Iceland. Oddsson's letter brought no response from the Bank of England.¹⁶³

Two pieces of news about the Icelandic banks in the last week of April did not much mollify European central bankers, already concerned about the sustainability of the Icelandic banks and irritated over their deposit collection. First, the ECB realised that the Icelandic banks, through their subsidiaries in

Luxembourg, had increased collateralised loans at the ECB from €1 billion to almost €4 billion, and to make matters worse from the ECB's point of view, they had partly used against the loans securities that they had issued to one another and no other collateral. Kaupthing had used securities for €200 million from Glitnir and €425 million from Landsbanki for this purpose; Landsbanki had used securities for €500 million from Glitnir and €580 million from Kaupthing; and Glitnir had used securities for €100 million from Kaupthing and €235 million from Landsbanki. In the early afternoon of 25 April 2008, ECB Governor Jean-Claude Trichet called Governor Oddsson. Clearly upset, he said that a part of the securities used as collateral by the Icelandic banks were 'artificial'. Trichet angrily demanded a meeting between the Luxembourg central bank and representatives of the three Icelandic banks, the CBI and the IFSA. Later the same day Central Bank of Luxembourg Governor Yves Mersch called Oddsson, telling him that the collateralised loans from the central bank to the Icelandic banks now amounted to almost 10% of all such loans, whereas their subsidiaries were only 1.7% of the Luxembourg banking sector. In a meeting three days later in Luxembourg between the Central Bank of Luxembourg and representatives of the Icelandic banks, the CBI and IFSA, the banks informally agreed to limit their issuance of the securities to one another to no more than 40% of all their collateralised loans, even if they insisted that they had not violated any ECB rules.¹⁶⁴ However, the banks continued to obtain collateralised loans at the ECB, mostly against asset-based securities, and at the end of June, their collateralised loans at the ECB amounted to €4.5 billion.¹⁶⁵

Five days after the angry complaint from ECB Governor Trichet about the behaviour of the Icelandic banks, Landsbanki announced that it would be offering Icesave accounts in euros in four to five European countries by the end of the year.¹⁶⁶ It opened a branch in the Netherlands in May 2008. The Icesave accounts proved very popular there, and after four months they amounted to over €1.5 billion. In talks with Icelandic bankers and with Governor Oddsson, Governor Nout Wellink of De Nederlandsche

Bank (DNB) expressed grave concerns about Landsbanki's deposit collection through its branches. It was clear, he observed, that the IDIGF could not cover its obligations in the case of Landsbanki's failure. Wellink told Oddsson that the Icelandic bankers were irresponsible and that they had to be stopped. When Oddsson observed that they were only doing what they were allowed to do under EEA law and regulations, Wellink retorted that it would not be a problem to find support in European regulations for stopping them. He added that he was not only expressing his personal opinion, but that this was also 'the common understanding all over Europe'.¹⁶⁷

When Governors King and Ingves brought up the case of the Icelandic banking sector at the dinner of the G10 central bankers in Basel Sunday 4 May 2008, not only were they themselves sceptical about the sustainability of the sector, but they were also faced with at least two angry critics of the Icelandic bankers, ECB Governor Trichet and DNB Governor Wellink. At the Basel meeting Ingves could also present a report on Iceland, which analysts at Riksbanken had delivered to him a few days earlier. In the report they pointed out that the Icelandic banks were profitable and held good assets, but that their main problem was how to survive a liquidity crisis. Even if the CBI managed to increase its exchange reserve fund considerably from €1.9 billion to €3–4 billion, it was not certain that this would suffice. The Swedish experts added, however, that swap deals between the CBI and other central banks might be a good way of increasing confidence in the Icelandic banking sector.¹⁶⁸

While discussions at the dinner of the G10 central bankers in Basel Sunday 4 May were strictly confidential, the position of the major central banks towards Iceland evidently hardened there. It became clear that the CBI could not expect any liquidity assistance from the Bank of England or the ECB. There were probably several reasons for the position taken by the G10 central bankers. The Icelandic banks, even if relatively small, were regarded as aggressive and intrusive, posing a danger to the whole European system of deposit insurance. Behind the scenes local competitors to the banks must also have encouraged central banks in their respective countries to put a

¹⁶¹ Ibid., pp. 172–3.

¹⁶² Ibid., Vol. 6, Ch. 21, p. 73 (in English). This was confirmed in my interview with Sir John Gieve in London 27 November 2014.

¹⁶³ Ibid., Vol. 1, Ch. 4, p. 174.

¹⁶⁴ Ibid., Vol. 2, Ch. 7, pp. 47–8.

¹⁶⁵ Ibid., Vol. 7, Ch. 21, p. 44 (in English).

¹⁶⁶ Icesave hleypt af stokkum í evrum í naesta manudi [Icesave Starts Next Month in Eurozone], *Frettabladid* 30 April 2008.

¹⁶⁷ SIC Report, Vol. 6, Ch. 18, pp. 56–59 (in English).

¹⁶⁸ Ibid., Vol. 6, Ch. 19, p. 171.

¹⁵⁹ Jännari, *Report*, pp. 18–19. SIC Report, Vol. 1, Ch. 4, p. 171, and Vol. 6, Ch. 19, pp. 161–162.

¹⁶⁰ SIC Report, Vol. 1, Ch. 4, p. 172.



Iceland had lost her strategic importance after the end of the Cold War, and she was small and expendable. Therefore the Icelandic banks were not provided with liquidity unlike for example Danske Bank in Denmark, RBS in Scotland and UBS in Switzerland, all of which probably would have collapsed otherwise. But it proved to be a blessing in disguise that Iceland was left out in the cold. Photo: Adobe Stock.

stop to this unwelcome challenge. Again, European central bankers may have been worried about the strain which the newcomers put on the deposit insurance schemes in host countries; and they may have interpreted the high interest rates that the Icelandic banks offered as signs of an underlying weakness rather than strength.¹⁶⁹ The central bankers were not oblivious, either, to the negative publicity the Icelandic banks and businessmen had generated in various countries, perhaps with the encouragement of hedge funds betting against Iceland. Recent developments, such as the unwelcome increase in the

¹⁶⁹ This is suggested by Fridriksson, *The Collapse of the Icelandic Banks*, p. 13.

collateralised debt of the Icelandic banks at the ECB and Landsbanki's announcement of the extension of deposit collection to the eurozone, certainly did not reduce their reluctance to help the Icelandic banks.

But the main reason the central bankers had for their adamant refusal to make currency swap deals with the CBI were probably that they had become convinced that the Icelandic banking sector was not sustainable on its own and that it would not matter much to the whole European banking sector if it collapsed. Iceland was expendable. It was too small to save. The European central bankers did not seem to find important the fact that most of the Icelandic banks' operations, both in accepting deposits and in providing credit, took place in Europe itself, so

that they could be considered European rather than Icelandic banks. As the saying goes, cross-border banks are international in life, but national in death.¹⁷⁰

Even Iceland's traditional friends in other Nordic countries were now considering abandoning her. Governor Ingves of Riksbanken in Sweden turned against completing the currency swap deals between the Scandinavian central banks and the CBI that had already been drafted. He argued that the unclear ownership of the Icelandic banks and their rapid growth had led to a dangerous situation

¹⁷⁰ Charles Goodhart, *Procyclicality and Financial Regulation, Estabilidad financiera*, No. 16 (Madrid: Banco de España, May 2009).

that the Icelandic government did not seem fully to comprehend.¹⁷¹ His Danish colleague tended to agree with him, whereas the governor of Norges Bank was more inclined to make the deals. At a meeting of Nordic central bank governors on 14 May 2008 in Oslo, Governor Oddsson had to use all his persuasive powers to bring his reluctant Scandinavian colleagues to complete the deals. In the midst of one of their meetings, he even went so far as to call the Icelandic Prime Minister, Geir H. Haarde, and to hand the phone over to Ingves. In the ensuing conversation, Haarde promised to exert pressure on the banks to reduce the overall size of their balance sheets and on the labour unions to show moderation in coming wage settlements, to restructure the Housing Finance Fund and to maintain fiscal prudence. The CBI and the government also made a commitment not to draw on the deals for the purpose of intervening in markets or of capitalising the banks. The next day a memo to the three Scandinavian central banks was signed by Haarde, Foreign Minister Ingibjorg S. Gisladottir, Finance Minister Arni M. Mathiesen and the three CBI governors. The currency swap deals were signed and announced on 16 May, enabling the CBI to draw on each of the three banks €500 million, if necessary.¹⁷² The announcement had an immediate impact on the markets. The CDS spread narrowed, and the hedge funds withdrew for a while. Their managers were not certain whether a bet against the Icelandic banks could be met with sufficient currency reserves.

In late May 2008 the CBI, assisted by consultants from Barclays, JP Morgan and Lehman Brothers, explored possibilities of increasing its exchange reserve fund by borrowing. It turned out that the only loans available would be with a large CDS spread. The consultants were unanimous in advising against borrowing on such terms, arguing that such an offer from the CBI could by itself create a run on the banks. Instead the CBI started to issue short-term bonds. It also managed to obtain for the Treasury a loan of a €300 million from a German bank. The CBI requested from the IMF a Financial Sector Assessment Program (FSAP) update on the report from 14 April. It was conducted in June, and the IMF team reached broadly the same conclusions as in the spring: While vulnerable, the banks met minimum requirements

¹⁷¹ SIC Report, Vol. 1, Ch. 2, p. 12 (in English). It should be pointed out that neither the government nor the CBI had access to detailed information about the ownership of the banks. It was only the IFSA which had such an access.

¹⁷² SIC Report, Vol. 1, Ch. 4, pp. 175–8.

on financial strength. The IMF recommended, given the significant size of cross-border activities, continued and strengthened cooperation with host supervisors, such as the FSA in the UK.¹⁷³

Two CBI governors attended the 29–30 June 2008 BIS Annual General Meeting in Basel, David Oddsson and Eiríkur Guðnason. They felt a strong hostility there towards the Icelandic banks, which was transferred over to them personally, so they were treated almost as untouchables. For example, Governor Ingves refused to acknowledge or greet Guðnason, an old acquaintance from many visits to Iceland. It was only when the two of them happened to be together in an elevator that he gave Guðnason the hand, and then it was the left one.¹⁷⁴ Ingves admitted to me later that he had been rude to the Icelanders at the Basel meeting, but that was, he said, nothing personal, only anger that the Icelandic authorities had not done any of the things that they had promised to do when the Scandinavian central banks had made the currency swap deals with the CBI in mid-May.¹⁷⁵ This was, however, not necessarily a fair judgement of the situation. The restructuring of the Housing Financing Fund was linked to changes being requested by the EFTA Surveillance Authority, and they required some time. Any fiscal measures were linked to the budget, which was to be presented in the autumn of 2008. Market conditions in the spring and summer of 2008 did not allow the government or the CBI to increase liquidity by borrowing except in relatively limited amounts in the short-term market. In the circumstances it had also become very difficult for the banks to downsize, as was recognised in the reports by experts from the IMF and Ríkisbankan.¹⁷⁶

The Basel meeting in June 2008 produced further unpleasant surprises. When Governor Oddsson was introduced to Governor Yves Mersch of the Central Bank of Luxembourg at the first session of the meeting, he started to make polite talk, only to be interrupted abruptly: ‘Your banking system – as it is called – is in serious trouble.’ Oddsson asked him to explain what he meant and the next morning, a meeting was organised with Oddsson, Mersch and the governors of the Nordic central banks. There

173 Iceland: Financial System Stability Assessment—Update, 19 August 2008 (Washington DC: IMF, December 2008).

174 Interview with Eiríkur Guðnason in Kopavogur 25 October 2011.

175 Interview with Stefan Ingves in Stockholm 8 April 2015.

176 Fridriksson, *The Collapse of the Icelandic Banks*, pp. 33 and 50. Also, SIC Report, Vol. 6, Ch. 19, p. 276.

Mersch said that nobody wanted to do business with the Icelandic banks any more; they were treated as lepers by the financial community. It was decided that Mersch would go to Iceland and speak directly to the managers of the Icelandic banks.

In the subsequent meeting in Iceland on 4 July 2008 with CBI and IFSA people, Governor Mersch expressed great concern about the Icelandic banking sector: ‘I have talked with our Nordic colleagues and know that this is not a feeling that I have alone – that either the banks are not liquid or do not want to restructure.’ Mersch stressed that there was no plausible lender of last resort to the Icelandic banks. He also described the ever-hardening position of the ECB towards Iceland: ‘Then we have the board – I feel a sense of toughness within the system against Iceland right now. If you [the CBI] say – we are taking over – then that would be a solution. If you cannot take over, then we have a serious problem.’

Mersch criticised the Icelandic bankers for their way of doing business with the Central Bank of Luxembourg (CBL) and the ECB. His complaint was essentially the same Trichet made in April. Despite Trichet’s admonitions they had continued to use the credit facilities of the ECB through their Luxembourg subsidiaries and the CBL to obtain collateralised loans in euros. Not only had they sometimes offered only securities that they had issued to one another as collateral (the ‘love letters’, as Oddsson called them), but they also sometimes had issued asset-based securities that the ECB had no way of evaluating, even involving currency exchange swaps, which might imply that the ECB would end up with *kronur* instead of euros. Now they had borrowed a total of €5 billion from the ECB. ‘Our exposure is far beyond the capital of the lender of last resort,’ Governor Mersch said. He was, as Governor Trichet before him, not persuaded by the argument of the Icelandic bankers that they were not violating any rules and that this was done by other European banks, responding: ‘They may respect the letter, but not the spirit.’¹⁷⁷

According to Mersch, it was an oversimplification always to speak about the Icelandic banks as one whole. They were different. He said that he had been informed that some of the Icelandic bank

177 SIC Report, Vol. 7, Ch. 21, pp. 44–5 and 72 (in English); SIC Report, Vol. 6, Ch. 19, pp. 187–188 (while the chapter is in Icelandic, Mersch’ comments are quoted in English).

owners were in a weaker position financially than the others and that they might be transferring money to themselves.¹⁷⁸ There is little doubt that Mersch was referring to Jon Asgeir Johannesson, the major shareholder in Glitnir.¹⁷⁹

After the meeting with the CBI and IFSA people, Mersch met separately with the managers of the three Icelandic banks, explaining to them that they had to reduce their borrowing at the ECB. He told the banks that before 15 July the collateral at the ECB that they had issued on one another had to go down to 25% of all their collateral, and then it had gradually to disappear. ‘The ECB’s reservations were not exclusive to Iceland’s activity, though; many European banks were also improvising ways to obtain central bank funding,’ Asgeir Jonsson and Hersir Sigurgeirsson write. In fact, from August 2007 to July 2008 collateralised loans to Spanish banks from the ECB increased from 4% of the total to 10.5%, and to Irish banks from 4.5% to 9.5%. Apparently some of the collateral was in risky financial structures. UK banks, outside the eurozone, used subsidiaries to obtain credit from the ECB.¹⁸⁰ Jonsson and Sigurgeirsson comment: ‘But the Icelanders’ style was especially bothersome and unpopular. Their banks behaved like motherless lambs, stealing milk from other ewes and being kicked back.’¹⁸¹

In its report the SIC states that by early July at the latest, ‘foreign governors of central banks had evidently discussed the Icelandic situation in their meetings and drawn the conclusion that the Icelandic economy was under serious threat.’ This was also the opinion which the three CBI governors expressed at the time. In meetings with Prime Minister Haarde and Foreign Minister Gísladóttir as well as with high officials on 4 and 8 July, Governor Oddsson said ‘that his feeling was that a consensus had been reached at the European Central Bank and the

178 Ibid., Vol. 2, Ch. 7, p. 54.

179 In an internal report for Kaupthing in the beginning of March 2008 it is written that ‘Looking at the cash needs for the months to come, [Johannesson’s company] Baugur is not going to be able to fulfill [sic] its obligations without outside intervention/help.’ SIC Report, Vol. 2, Ch. 8, p. 139. See also pp. 212 and 308. Indeed, Baugur defaulted 19 March 2008 on a loan from Kaupthing, whereas loans from Glitnir were simply extended. Again, Baugur defaulted 9 July 2008 on another loan from Kaupthing. SIC Report, Vol. 4, Ch. 14, pp. 156–7. Possibly Mersch had information about these matters.

180 Willem H. Buiter, *Central Banks and Financial Crises*, Discussion Paper (14 September 2008), pp. 110–11 and 26. <http://eprints.ise.ac.uk/24438/1/dp619.pdf>

181 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 47.

Nordic Central Banks that it would be better to let the Icelandic banks go into bankruptcy than to allow them to jeopardise the deposit-guarantee schemes of Europe.¹⁸² Hedge funds that had been waiting in the shadows were quick to realise this. They began again to bet against the Icelandic banks. They observed that no further currency swap deals seemed to be in the making with European central banks.

The Icelandic central bankers were taken aback by the sudden hostility which they felt from European financial leaders. In its 2008 *Financial Stability* report, the CBI pointed out that Iceland had joined the EEA on the assumption that she would be a full participant in the internal market:

“ There has been encouragement to engage in cross-border trade and enhance cross-border operations. Nowhere had it been suggested that the banking systems of individual countries should be subjected to size limitations, and protests have been made against preventing foreign investors from acquiring domestic banks. There are examples of countries whose banks are largely headquartered abroad—for instance, the Baltic nations—and of the reverse, countries whose domestic banks are active in other markets—such as Iceland, Luxembourg, Holland, Great Britain, Denmark, and Ireland.¹⁸³

Nevertheless, the CBI governors emphasised, in meetings with the Icelandic bankers in mid-July 2008, that they had to accommodate the ECB and reduce their debt in collateralised loans to it. Even if the banks had not broken any ECB rules, they accepted the demand by Governor Yves Mersch on behalf of the ECB to repay all their ‘love letters’, or mutually collateralised loans, and they had done so by the end of July 2008.¹⁸⁴ They also reduced their total debt to the ECB from €4.6 billion in the beginning of July to €3.3 billion in the beginning of September.¹⁸⁵ Landsbanki and Kaupthing used some of the money they had at their disposal through deposit collection for this purpose.¹⁸⁶ But

182 SIC Report, Vol. 7, Ch. 21, p. 73 (in English). Also, interview with David Oddsson in Reykjavík 6 October 2013.

183 *Financial Stability 2008* (Reykjavík: CBI, 2008), 7. <https://www.cb.is/library/Skraarsafn---EN/Financial-Stability-Report/2008/2008%20enska.pdf>

184 SIC Report, Vol. 7, Ch. 21, p. 45 (in English).

185 This interesting fact is nowhere to be found explicitly in the SIC Report, but it can be derived from the data underlying Fig. 61, Vol. 2, Ch. 7, p. 48.

186 Fridriksson, *The Collapse of the Icelandic Banks*, pp. 19–20.

ironically they then replaced one source of irritation in European central banks with another one. While the ‘love letters’ largely disappeared from their accounts with the ECB, they continued to collect deposits. They were sailing between Scylla and Charybdis, uneasily navigating between two hazards.

When Lehman Brothers fell on 15 September 2008 (as William White had predicted), the international credit crunch turned into a major crisis and ordinary banks joined hedge funds in taking positions against the Icelandic banks. Danske Bank, which had in 2006 cut all ties to Icelandic banks and consistently warned investors against them, decided not to agree to changes in loan covenants necessary for Glitnir’s sale of a Norwegian bank, so the Icelandic bank found itself with no money to repay loans soon maturing. When the US Federal Reserve Board announced dollar swap deals with the three Scandinavian banks on 24 September 2008, Iceland was conspicuously absent. Whatever the merit in April of Governor King’s argument that ‘the announcement of a swap, especially if restricted to a group of countries with which Iceland has good political relations, might well trigger concern in financial markets about the extent to which you and ourselves perceived a problem in the Icelandic banking system’,¹⁸⁷ it did not apply in September. Now the absence of a swap deal was perceived as a grave problem. Credit lines were cancelled, ‘haircuts’ were demanded, deposits were withdrawn: a bank run started.

Without any advance notice, a dramatic step was taken by the ECB on the evening of Friday 3 October. It abruptly issued margin calls or ‘haircuts’ on outstanding loans to Landsbanki, amounting to €400 million, and to Glitnir, amounting to €640 million. This had to be paid before the banks opened on Monday 6 October. Previously Landsbanki had borrowed €1.5 billion from the ECB against collateral with an estimated market value of €2.6 billion. The bank had planned to borrow up to €400 million more from the ECB. The sudden margin call meant that the bank suddenly had €800 million less liquidity than expected.¹⁸⁸

The alleged reason for ECB’s margin calls on Landsbanki and Glitnir was that the Icelandic state

had been downgraded by all three main ratings agencies, Standard & Poor, Moody and Fitch. The ECB staff were of course fully aware of the problems of the Icelandic banks. They knew that the banks were only able to meet those margin calls if they defaulted on other obligations. It should be noted that the ECB was making those margin calls at the same time as it was busy rescuing banks in Europe, including those outside the eurozone. For example, while Sweden is outside the eurozone, since December 2007 Riksbanken had had a secret swap deal with the ECB for €10 billion. The deal was only disclosed in June 2009 when Riksbanken found it necessary to boost confidence in its ability to help Swedish banks facing difficulties in the Baltic countries.¹⁸⁹ Again, while the ECB now moved against the Icelandic banks, it left alone banks in the UK, also outside the eurozone. Those banks had, like the Icelandic banks, used their subsidiaries in the eurozone to obtain credit.

During the hectic weekend of 3–5 October 2008, the CBI staff were told in no uncertain terms that margin calls from the ECB were irrevocable. ‘News of these margin calls spread widely as reflected in phone calls to the Central Bank of Iceland over the weekend,’ Governor Fridriksson recalls.¹⁹⁰ Then on the evening of Sunday 5 October, the ECB suddenly withdrew its margin calls. It is not likely that in the course of two days, from Friday 3 October to Sunday 5 October, the ECB had come into possession of information that would have lessened its worries about the financial positions of the Icelandic Treasury or the Icelandic banks. The decision to revoke the margin calls must have been political. But that means, of course, that the original decision to make the margin calls must have been political too. Otherwise it would indeed have been irrevocable, as the ECB staff had told the CBI staff. It is of course also a possibility that the reason for the inconsistent behaviour of the ECB was sheer chaos. The ECB staff simply may have been overwhelmed by events. Be that as it may, in the midst of their predicament, the Icelanders to their surprise and bitter disappointment saw their longtime ally, the US, standing idly by.

189 ECB activates the swap line with Sveriges Riksbank. Press Release 10 June 2009. <https://www.ecb.europa.eu/press/pr/date/2009/html/pr090610.en.html>

190 Fridriksson, *The Collapse of the Icelandic Banks*, p. 20.

THE US FED REFUSES TO HELP

During the Second World War and the Cold War, Iceland was a valued ally of the US. The North Atlantic island was strategically important, an ‘unsinkable aircraft carrier’. But when the Soviet Union collapsed in 1991 and the Cold War abruptly ended, Iceland’s strategic importance greatly diminished. The US government promptly initiated moves to reduce its military presence in the country. Warning and control military planes were promptly removed and the number of fighter jets reduced from 12–18 to only 4. The David Oddsson government demonstrated its commitment to close US-Icelandic relations in March 2003 when it declared its support for the US intervention in Iraq, risking domestic agitation. However, two months later, just before parliamentary elections, suddenly and unexpectedly US authorities told Oddsson that the remaining fighter jets would be withdrawn from the US military base in Iceland within a month. An American scholar observed that while Iraq demonstrated that it did not pay to be an enemy of the US, Iceland showed that perhaps it did not pay either to be a friend of the US.¹⁹¹ Oddsson kept the message from the US strictly secret and used his warm personal relationship with US President George W. Bush to have this decision – apparently made in the Pentagon by Defence Secretary Donald Rumsfeld – revoked for the time being.¹⁹²

In 2006, after Oddsson had left politics, US authorities finally implemented their long-standing decision of shutting down their military base in Iceland after 55 years of security cooperation. Oddsson’s successor, Prime Minister Geir H. Haarde, did not follow Oddsson’s advice of abrogating the Defence Treaty in case the US left the sparsely populated North Atlantic island defenceless. This was a true watershed. Now

191 Gudni Th. Johannesson, *To the Edge of Nowhere? U.S.-Icelandic Defense Relations during and after the Cold War*, *Naval War College Review*, Vol. LVII, No. 3–4 (Summer-Autumn 2004), p. 130. The American scholar quoted was Michael T. Corgan.

192 Valur Ingimundarson, *Iceland’s Security Identity Dilemma: The End of a U.S. Military Presence*, *The Fletcher Forum of World Affairs*, Vol. 31, No. 1 (Winter 2007), pp. 7–23.

Iceland’s ‘American Age’, which had started in 1941 when the US assumed responsibility for the defence of this North Atlantic island, seemed to be coming to an end. In Washington DC, Iceland was almost treated like a joke. For example, at a meeting of the Federal Open Market Committee on 27 March 2006, Dino Kos, Executive Vice President of the New York Federal Reserve Board and head of its markets group, reviewed market trends, including carry trade in some currencies. Showing a graph of how select foreign currencies were performing against the dollar, he included the Icelandic *krona* and said:

“Now let me confess that I hesitated to include this chart. The previous Chairman chided me once for showing a similar chart that included the New Zealand dollar—the currency of a country with a mere 4 million residents. Well, I am probably skating on very thin ice with the new Chairman, now that the kiwi has returned with that powerhouse the Icelandic krona, the currency of a country with about 250,000 residents or roughly one-tenth the size of Brooklyn. The point is not to suggest that Iceland is on the verge of joining the G7 but rather that the search for yield went to some pretty distant and unlikely places—as we are now discovering.

A member of the Federal Reserve Board, Donald Kohn, asked whether the fall in the value of the *krona* was only because the carry trade was unwinding. He mentioned a recent report by Danske Bank ‘about problems in the Icelandic banking system’.¹⁹³ Ben Bernanke, chairman of the board, interrupted him: ‘We’d like a full report on the Icelandic ...’ which was greeted with laughter. Then Kos said: ‘I thought that the Committee’s patience might be limited. Yes, there was a downgrade by one of the rating agencies of Iceland. There were some concerns about some of the Icelandic banks, and so that seemed to be part of the

193 He was presumably referring to the report by Lars Christensen, *Iceland: Geyser crisis*, repr. in *Preludes to the Icelandic financial crisis*, pp. 89–106.



Prime Minister David Oddsson and President George W. Bush at the Oval Office on 6 July 2004. I was there and since it was the President's birthday, we sang "Happy birthday to you; Happy Birthday, Mister President; etc.!" Bush, a good friend of Oddsson, revoked the decision made in Pentagon to withdraw all fighter jets from the US-operated defence force of Iceland. But after Oddsson left politics in 2005, there was little personal contact, or mutual understanding, between Icelandic and American leaders, as was demonstrated in the bank collapse. Photo: White House.

story.' When he promised to give a full report about New Zealand and Iceland at the next meeting, the audience laughed again. At the next meeting he just noted briefly that the *krona* had gone down and then up again.¹⁹⁴

The Icelanders had not only lost their defence force, but also a powerful protector and ally, the US. The exchange at the Federal Open Market Committee in 2006 showed that in Washington DC, the country was perceived as a distant and unusual place, almost a laughing matter. This was clearly brought home to the Icelanders during the financial crisis of 2008–2009. Like the Bank of England and the ECB, the Federal Reserve Board turned down the request for currency swap deals made by the CBI in mid-April.

194 Meetings of the FOMC 27–28 March and 10 May. <https://www.federalreserve.gov/monetarypolicy/fomchistorical2006.htm>

Another request was made after the Scandinavian banks in mid-May 2008 reluctantly had made currency swap deals with the CBI. Governor Oddsson wrote FRB of New York President Geithner a letter 6 June 2008 repeating the request for a dollar swap deal:

“Also, as demonstrated by the Nordic facility, the size of the arrangement is not necessarily a decisive issue at this juncture. In my view the perception of strong allies is more important. An arrangement with the Fed would therefore be of monumental significance.¹⁹⁵

Again, however, Geithner turned down the CBI request.

195 SIC Report, Vol. 1, Ch. 4, p. 179.

The reason may be found in the minutes of a meeting of the Federal Open Market Committee in Washington DC, 28–29 October 2008, where the criteria on dollar swap deals with other countries was discussed.¹⁹⁶ Nathan Sheets, Director of the Division of International Finance, said that the Federal Reserve Board's staff used three criteria about countries with which such deals were made: 1) that their economies were large and systematically important; 2) that they had pursued sensible policies and seemed just to be influenced by contagion; and 3) that the swap deals might make a difference. Sheets added:

“Now, let me just give you a concrete case of the third criterion because that's a little more abstract than the first two. Iceland came to us and requested a swap line of approximately \$1 billion to \$2 billion, which would have been 5 to 10 percent of Iceland's GDP—so it was fairly large relative to the size of the country. But the liabilities of the banking system were on the order of \$170 billion, and the underlying problem was really that there was a loss of confidence in its banks. We came to the conclusion that a \$1 billion swap line was very little ammunition to use against a potential loss in confidence in this \$170 billion financial system. For that reason, we as the staff recommended against a swap line for Iceland.

At the meeting, Geithner commented that some of the countries which did not meet the three criteria outlined by Sheets could go through an IMF programme without too much of a stigma.¹⁹⁷

In his account of the international financial crisis, Federal Reserve Board Chairman Ben Bernanke made a similar point as Sheets:

“Some small countries with large banks simply lacked the resources to go it alone. For example, tiny Iceland, with its 300,000 people, was also home to three large banks with

196 Because the minutes were of a meeting in late October, their readers probably assume that they referred to the requests in the autumn of 2008 for dollar swap deals. But later in the minutes Nathan Sheets says that the request by the CBI was made at about the same time as the CBI turned to the ECB with a similar request. The formal request to the ECB was made 15 March 2008. Informal requests were at that time also made to the FRB of New York, but a formal letter was sent to it 9 June 2008.

197 FOMC meeting 28–29 October 2008. <https://www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm>

operations extending to other Nordic countries, Britain and the Netherlands. By early October [2008], all three banks had collapsed, wiping out their shareholders (mostly domestic) and bondholders (mostly foreign). We had declined Iceland's request for a currency swap line, as did the European Central Bank and Bank of England. Iceland's financial institutions had few ties to U.S. financial institutions, and their problems were in any case too severe to be solved by currency swaps.¹⁹⁸

It should be noted that it was not entirely correct that bondholders were wiped out by the collapse of the Icelandic banks, even if depositors' claims were by law given priority over bondholders' claims. The recovery rate for general claims was 30.2% on Glitnir, 30% on Kaupthing and 14.4% on Landsbanki (because such a large proportion of the claims on Landsbanki were priority depositors' claims).¹⁹⁹ When general creditors to the banks agreed to compositions in late 2015, they were mostly hedge funds that had bought claims on the banks from original creditors at hefty discounts.

More importantly, it is by no means obvious that the repeated refusals by Ben Bernanke and Timothy Geithner to make dollar swap deals with the CBI should be taken at face value. First, to make this a 'professional decision', based on the evaluation of the staff of the Federal Reserve Board, was in itself a political decision, with a foreseeable outcome, because Iceland after the end of the Cold War had simply become expendable. When Iceland received double the Marshall aid per capita than war-ravaged Netherlands, it was a political, not a 'professional' decision. The US government then regarded Iceland as strategically important.²⁰⁰ When the UK showed uncommon restraint in using her powerful Navy against the Icelanders in the fisheries disputes of 1952, 1958, 1972 and 1975, it was a political decision. Iceland had a powerful protector and ally in the US. It is true that the Americans did not want to take sides since the UK was after all their closest European ally, but they would never have allowed the UK to use full force against the Icelanders, if that meant driving them out of NATO. When the US provided the Icelanders in the

198 Bernanke, *The Courage to Act*, p. 349. Iceland is not in the Index to the book.

199 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 189.

200 Gunnar Karlsson, *The History of Iceland* (Minneapolis MN: University of Minnesota Press, 2000), pp. 336–7.



One reason Iceland's recovery was quick was that in 2008 the Treasury was virtually debtless. Instead of praising Finance Minister Arni M. Mathiesen for this achievement, the SIC accused him of negligence. Attacking Iceland, Chancellor Alistair Darling also misquoted Mathiesen, as became clear when a transcript of their conversation on 7 October 2008 was released. Photo: Magnus Fröderberg, norden.org.

1950s with generous loans on good rates, bypassing all kinds of rules, it was a political decision, as when Loftleidir airlines got concessions in the US so it could offer cheap transatlantic flights through Iceland.²⁰¹

Second, Bernanke, Geithner and Sheets were not necessarily right that a dollar swap deal with the CBI would not have made a difference. The announcement in mid-May 2008 of the currency swap deals with the Scandinavian central banks immediately brought down the CDS spreads. It should be noted that the original request for a deal of \$1–2 billion was made under the assumption that European central banks would make similar deals so that the total liquidity provided to the CBI would be significantly greater. If \$10 billion was needed, and not \$2 billion, why did the FRB of New York not simply make it \$10 billion? The hedge funds hesitated. If they had witnessed a \$10 billion dollar swap deal between the FRB of New York and the CBI,

they would probably have abandoned their attack on the Icelandic banks and the CDS spreads would have gone down. Then, perhaps, the CBI would not have had to draw on the swap line. 'It was never the intention of the Central Bank to use funds potentially available under swap agreements to intervene in the foreign exchange market nor to strengthen the capital position of the banks,' Governor Ingimundur Fridriksson stresses.²⁰² This was also emphasised in letters from Fridriksson's colleague Oddsson to Geithner and other central bankers. Whereas it was small change for the Americans, a \$10 billion dollar swap line would have been crucial for the Icelanders.

Third, and closely connected to the second point, Bernanke correctly notes that Iceland's financial institutions had few ties to US financial institutions. But that was because they had close ties to European financial institutions. Bernanke's remark highlights the fact that even if the Icelandic banks had reinvested in Europe most of the money they had borrowed in Europe, both from financial firms and depositors, European central banks refused to provide liquidity to the CBI. They could at least not use Bernanke's stated reason for rejecting the request by the CBI.

Fourth, to take one of the criteria mentioned by Sheets, Iceland had on the whole pursued prudent fiscal and monetary policies since 1991, although the government probably should have exercised more fiscal restraint in the last few years before the crash. Even if the liabilities of the Icelandic banks certainly were immense relative to Iceland's GDP, the economy was essentially sound. And against the liabilities mentioned by Sheets stood assets, not only in Iceland, but also, and indeed mostly, in other European countries. The conclusion is that it would have been perfectly reasonable for the FRB of New York to make the dollar swap deal with the CBI, even one of \$10 billion, on all other criteria than the first one: Iceland was not systemically important. It was distant, tiny, expendable – sinkable rather than an unsinkable aircraft carrier.

Indeed, so expendable was Iceland that when the minutes from the 28–29 October 2008 meeting of the Federal Open Markets Committee were eventually published, the editors crossed out the names of several countries that unsuccessfully tried to obtain

dollar swap deals with the US – but not the name of Iceland. The names were crossed out with reference to a stipulation in the US Freedom of Information Act, sect. 552, (b)(4), that it does not apply to 'trade secrets and commercial or financial information obtained from a person and privileged or confidential'. It so happens, however, that the identities of those countries are known from other sources. In a study of the 'global liquidity safety net', Professor C. Randall Henning discusses the dollar swap deals the Federal Reserve Board made during the international financial crisis with 14 other central banks, amounting at one point to more than \$580 billion, one-quarter of the Fed's balance sheet:

“ The Federal Reserve board of governors considered the 'boundary' question at length, torn between opening itself up to additional demands for coverage from emerging markets and creating stigma against those left outside the safety net. Fed officials used economic size and connections to international financial markets as the main criteria for selecting Brazil, Mexico, Singapore and South Korea. Chile, Peru, Indonesia, India, Iceland and likely others also requested swaps but were denied. The governors wanted to deflect requests by additional countries to the IMF, which coordinated its announcement of the SLF [Short-term Liquidity Facility] with the Fed's announcement of the additional swaps at the end of October 2008. Governors and staff saw in this tiering a natural division of labour that coincided with the resources and analytical capacity of the Fed and IMF.²⁰³

It is somewhat surprising if the Federal Reserve Board officials used economic size as a criterion for separating the sheep from the goats that they then declined requests from India, the world's 6th largest economy, and from Indonesia, which has an economy almost as large as those of Switzerland and Sweden combined.²⁰⁴ While those officials would probably vehemently deny it, political considerations may have played a part in counting Brazil, Mexico, Singapore and South Korea among the sheep and Chile, Peru, Indonesia and India – not to forget Iceland – among the goats.

Having repeatedly turned down requests by the CBI for dollar swap deals, the Federal Reserve Board announced on 24 September 2008 that it had made such deals with the three Scandinavian central banks in amounts up to \$15 billion with the Swedish bank and in amounts up to \$10 billion each with the central banks of Denmark and Norway.²⁰⁵ Of course the markets immediately noticed the absence of Iceland, traditionally regarded as a part of the Nordic countries. (Finland, as a member of the eurozone, was not included.) The same day, 24 September 2008, Governor Oddsson wrote a letter to FRB of New York President Geithner, repeating his request for a dollar swap deal with the CBI: 'The announcement this morning of the new currency swaps appears to have enhanced confidence for the participating countries. However, given the perception that the Nordics are one, including Iceland, the new agreement may appear to the markets as having left us in the lurch.'²⁰⁶

The next day, Thursday 25 September 2008, Oddsson called Geithner to follow up on his letter. 'You must see that we are the odd people out,' he said to Geithner, who replied: 'No, you are not. The Scandinavians need dollars; you do not need dollars.' Oddsson then said: 'But you have to realise that we are regarded as a part of the Nordic community. If we are not included, then people will assume that we are excluded.' Geithner replied: 'We are by no means precluding an eventual deal.' The next day, 26 September 2008, Geithner called Oddsson, saying that he regretted having to tell him that his bank was not prepared to make such a deal at present. It could not be justified, neither to the FRB of New York nor the CBI. The help from the FRB of New York would only be a drop in the ocean.²⁰⁷ Accordingly, the same day the CBI released an announcement that it had had discussions with the US Federal Reserve Board in the last few weeks. It had been decided not to enter into an agreement between the two parties, but it was not ruled out that such an agreement might be made later.²⁰⁸

The crisis in Iceland intensified, not least because the markets realised what Oddsson had mentioned

201 Gudni Th. Johannesson, *To the Edge of Nowhere?* p. 124.

202 Fridriksson, *The collapse of the Icelandic banks*, p. 32.

203 C. Randall Henning, *The Global Liquidity Safety Net* (Waterloo, Ontario: Centre for International Governance Innovation, 2015), p. 7.

204 IMF, *World Economic Outlook Database*, April 2017. <http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>

205 Federal Reserve Board, Press Release 24 September. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20080924a.htm>

206 SIC Report, Vol. 1, Ch. 4, p. 179.

207 Testimony by David Oddsson before the SIC 7 August 2009, p. 55.

208 CBI, *Gjaldmiðlaskiptasamningar* [Currency Swap Deals], 26 September 2008. <http://www.sedlabanki.is/utgefingur/utgefingur-tilkynningar/frettasafn/frett/2008/09/26/Gjaldmi%C3%B0laskiptasamningar/>

in his letter to Geithner – that the Americans had left Iceland in the lurch. This was made even clearer on 29 September when the Federal Reserve Board announced that it had increased the swap lines of the Scandinavians to \$15 billion each for the Danish and Norwegian central banks and to \$30 billion for Riksbanken.²⁰⁹ The hedge funds moved against Iceland, banks cancelled credit lines, depositors withdrew their money, while the FSA in the UK and the ECB made increased demands on the Icelandic banks. More liquidity was desperately needed. Oddsson called Geithner again on 2 October 2008 to ask him whether he had reconsidered his refusal to make a dollar swap deal with the CBI. Geithner asked for more information on the situation. Subsequently, the CBI staff sent emails later in the day to William Dudley, Executive Vice President of the Markets Group at the FRB of New York and to other Federal Reserve people. But yet again the Americans turned down the requests by the CBI for liquidity assistance. Dudley called Oddsson in the afternoon of Friday 3 October and told him this. The main reason was, Dudley said, that the Icelandic banking sector was simply too big. If Iceland entered an IMF programme, however, it was possible that the FRB of New York would participate in it, especially if the ECB was also participating.²¹⁰

The only brief flicker of interest in Iceland by the US was shown in early October, when it looked as if Russia might step in. Confidential negotiations had been held between the Prime Minister's economic adviser Tryggvi Thor Herbertsson and Russian representatives about a possible loan from Russia. It was apparent in a phone call from the IMF staff made to the CBI staff on 3 October 2008 that they were at least vaguely aware of rumours about the involvement of some countries in Iceland.²¹¹ Only two days later, 5 October, a five-member team from the IMF suddenly arrived in Iceland.²¹² In the evening of the same day, UK Prime Minister Gordon Brown in a call to his Icelandic colleague Geir H. Haarde strongly advised

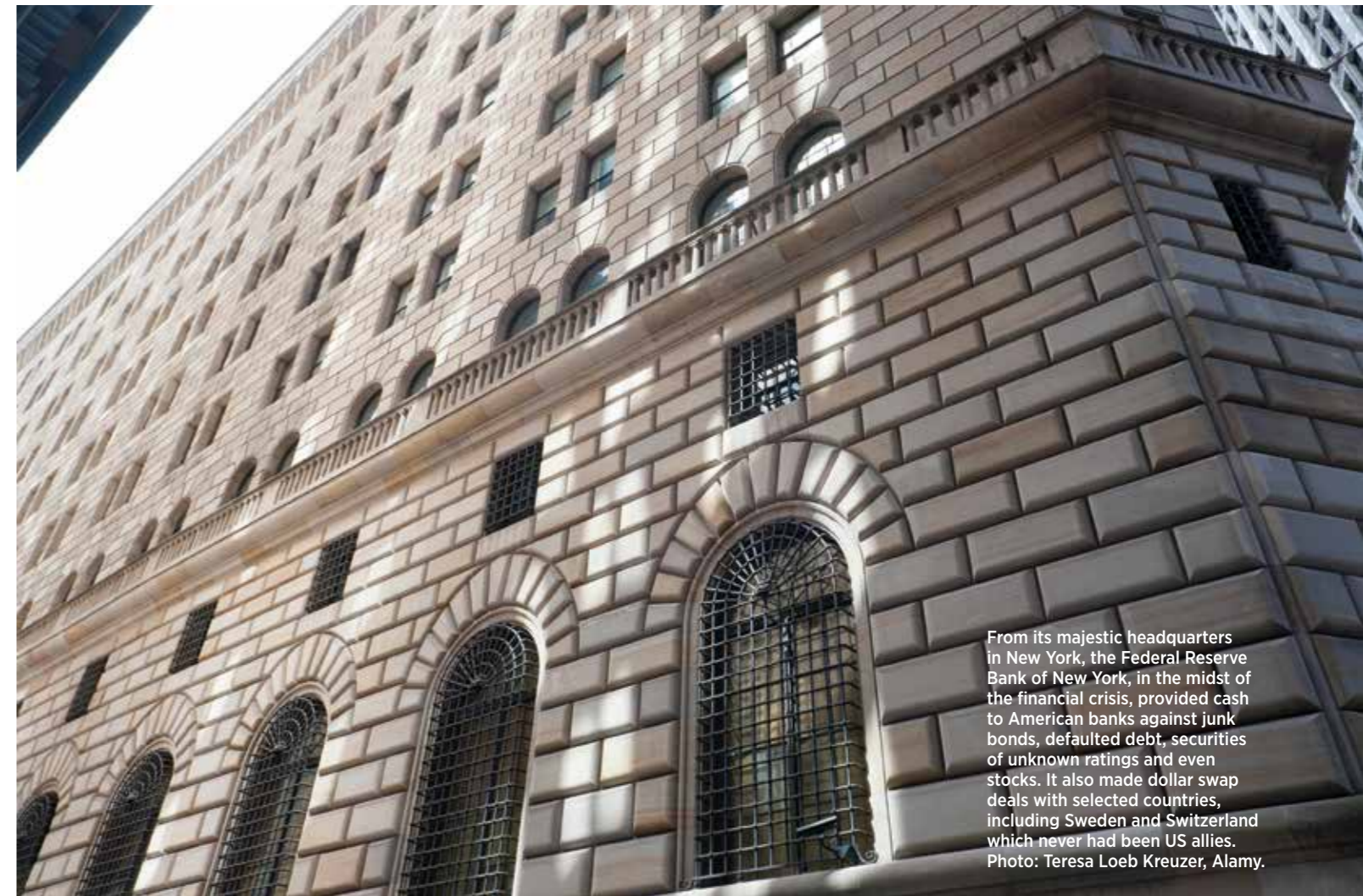
Iceland to seek help from the IMF, without of course mentioning the Russian option. In the evening of 6 October 2008, David H. McCormick, Under-Secretary for International Affairs at the US Department of the Treasury, made an urgent phone call to Finance Minister Arni M. Mathiesen, who was then participating in the parliamentary debate about the Emergency Act. McCormick asked Mathiesen whether the Americans could help in any way. Mathiesen replied that they could do what Iceland had repeatedly requested and they had always turned down, making dollar swap deals with the CBI. McCormick did not ask about any Russian option, but it was Mathiesen's strong impression that he knew something about the talks with the Russians and that he was trying to assess the situation.²¹³

On 7 October, early in the morning, Russian Ambassador Victor I. Tatarintsev woke up Governor Oddsson with a phone call to his home and told him that the Russian government was ready to extend a loan of €4 billion to Iceland for 3–4 years, with reasonable interest rates, 30–50 points above Libor. Tatarintsev also said that Oddsson was free to make a public announcement about the loan, a crucial move if a full-scale bank run was to be avoided. After his conversation with Oddsson, Ambassador Tatarintsev called the Prime Minister's Adviser Herbertsson and suggested that they should celebrate at the first convenient point in time. 'We need, not a bottle of Vodka, but a whole case,' he said.²¹⁴ After his conversation with Tatarintsev, Oddsson spoke with Prime Minister Haarde who agreed with him that the offer should be made public. Consequently, the CBI made an announcement about the Russian loan, which immediately seemed to change the situation.

Then suddenly in a matter of a few hours, something happened which caused the Russians to reconsider their offer. This something could be that they became aware, possibly through their intelligence service or through a leak from the IMF or Icelandic officials, of the talks between the Icelanders and the newly arrived IMF team about a possible rescue plan. The Russians were not interested in participating in an IMF programme. They wanted to establish a political and strategic presence in Iceland. Another possibility which has been suggested

²¹³ Mathiesen, *Arni Matt*, p. 54.

²¹⁴ Interview with Tryggvi Thor Herbertsson in Reykjavik 14 January 2015. Cf. <http://www.rnh.is/?p=7684>



From its majestic headquarters in New York, the Federal Reserve Bank of New York, in the midst of the financial crisis, provided cash to American banks against junk bonds, defaulted debt, securities of unknown ratings and even stocks. It also made dollar swap deals with selected countries, including Sweden and Switzerland which never had been US allies. Photo: Teresa Loeb Kreuzer, Alamy.

is that some representatives of the Western powers, such as French Finance Minister Christine Lagarde – then chairing the Economic and Financial Affairs Council of the EU – contacted the Russians and firmly told them to stay away from Iceland.²¹⁵ The EU had the same attitude towards Iceland as the UK traditionally had adopted: Even if it had limited interest in undertaking to protect her, it did not want anyone else to do so. It is a different matter altogether whether Russian leader Vladimir Putin would have been swayed by any such messages.

The decision to accept the unsolicited offer by the IMF to send a team to Iceland on 5 October 2008 may have weakened Iceland's bargaining position. The Russians, now knowing of the IMF involvement and facing staunch opposition from the West, abruptly changed course. Just a few hours after Ambassador Tatarintsev had told Governor Oddsson that the Russians had made the offer, he urgently contacted Oddsson again and asked him to send out another

²¹⁵ Fridriksson, *The Collapse of the Icelandic Banks*, p. 34.

and more tentative announcement which Oddsson duly did, knowing that his many critics would use this against him.²¹⁶ Oddsson's main priority was to keep the Russian option open. However, nothing came out of the following negotiations with the Russians, who had lost interest. The Icelanders were hindered in 'playing the Russian card', in a way similar to what they had done for example in 1952 when they started trading with the Soviet Union after British trawler owners – in one of the disputes about Iceland's extension of her fishing zone – had imposed a landing ban in the UK on fresh fish from Iceland.

In a period of three days, 6–8 October 2008, the Icelandic banks fell, one after another. Finance Minister Arni M. Mathiesen went to Washington DC

²¹⁶ Even in the SIC Report, Vol. 1, Ch. 4, p. 160, it says that the announcement of the Russian loan was based on a misunderstanding. There was no misunderstanding, even if Oddsson, in order to preserve the contact with the Russians, may have suggested it. The decision to offer the loan was revoked when the Russians learned about the concurrent talks with the IMF and possibly also when they were told by Western leaders to stay out of Iceland.

²⁰⁹ Federal Reserve Board, Press Release 29 September. <https://www.federalreserve.gov/newsevents/pressreleases/monetary20080929a.htm>

²¹⁰ SIC Report, Vol. 1, Ch. 4, p. 180.

²¹¹ *Ibid.*, Vol. 7, Ch. 20, p. 83.

²¹² In a confidential cable 7 October 2008 to the US State Department, US Ambassador Carol van Voorst asserts that the IMF team had been invited to Iceland by Prime Minister Geir H. Haarde, quoting a member of the delegation, Rodolfo Luzio. <http://wikileaks.velotype.nl/cable/2008/10/08REYKJAVIK219.html> However, Haarde denies this, pointing out that the CBI staff usually dealt with the IMF people. Interview by phone with Geir H. Haarde 8 November 2017.

on 9 October to attend the joint IMF and World Bank autumn meeting and to hold talks with US officials. ‘There was no help to be had from the US,’ he later wrote. ‘After the War, the Icelanders and the Americans had been close allies, but now, and without any explanations offered, they had turned their back on us. Probably there are several explanations for this, but somehow a line had simply been drawn and we ended up at the other side: Ef something went wrong, then the UK and the EU were supposed to help us resolve it.’ Mathiesen pointed out that the US did no longer view Iceland as strategically important and that possibly American leaders also accepted the tacit agreement in Europe not to rescue Iceland, while they made dollar swap deals with the three Scandinavian central banks.²¹⁷ As Kaarlo Jännäri wistfully observes, ‘After all, Iceland is a very small country in the far reaches of the cold North Atlantic, and it has few friends in high places outside the Nordic countries.’²¹⁸

After the bank collapse and the failure of talks with the Russians, the beleaguered Icelandic government decided to seek assistance from the IMF. Accordingly, Governor Oddsson – who had personally opposed IMF involvement – on 24 October sent yet another letter to New York FRB President Geithner telling him of the decision and recalling their earlier conversations about a possible dollar swap deal:

“As you explained to us, the main reasons for the Federal Reserve not wishing to enter into a swap arrangement with the Central Bank of Iceland were the relative size of the Icelandic banking system and then in September discussions the absence of an IMF arrangement. As you are no doubt well aware of, the Icelandic banking system has now shrunk significantly. Additionally, as mentioned at the outset, the Government has announced an agreement with the IMF on a standby arrangement. For it to succeed, financing beyond that provided by the IMF will be necessary. I hereby request participation from the Federal Reserve Bank in the financing of the economic program.”²¹⁹

217 Mathiesen, *Arni Matt*, pp. 84–5.

218 Jännäri, *Report*, p. 19.

219 Letter from David Oddsson to Timothy Geithner 24 October 2008. <http://wikileaks.ch/cable/2008/10/08REYKJAVIK253.html>.

US Ambassador to Iceland Carol van Voorst sent a cable to the State Department on 29 October recommending a positive response to this request for several ‘long-term national interests’. They included, 1) Iceland’s strategic importance to US security, 2) a well-positioned friend in the High North, and 3) clean energy partner and economic investment. Ambassador van Voorst concluded:

“The Icelanders take fierce pride in their flawless history of paying back their debt. Whatever the financial turmoil and uncertainty of the moment, it’s a good bet that this economy of highly-educated, imaginative, and sophisticated people will take off again. And when it does, and when the competition in the High North really gets underway, it may be more important than we can yet suppose to have the Icelanders remember us as the kind of friend who stands by in fair weather and foul.”²²⁰

But again, the Federal Reserve Board refused to extend any help to Iceland. It did not participate in the loan package put together by the IMF, the four Nordic countries, Poland and the Faroe Islands.

Iceland was out in the cold. Some other countries were not. In 2007–2008 the US Federal Reserve Board approved swap deals with 14 other foreign central banks, those of Australia, Brazil, Canada, Denmark, the UK (Bank of England), Japan, Korea, Mexico, New Zealand, Norway, Singapore, Sweden, Switzerland and the ECB.²²¹ The central banks then lent the dollars thus obtained to banks and other financial firms in their respective jurisdictions and assumed the risk. The two parties to the swap then reversed the exchange at a future prearranged date. The ECB received the largest amount of dollars under the swap line arrangements, about 80% of the total. Four central banks did not draw on their dollar swap lines, those of Brazil, Canada, Singapore and New Zealand. The use of the dollar swap lines is shown in Table 1.

For example, the Danish central bank drew 19 times on the swap line from the Americans for an aggregate of \$73 billion. Denmark was much afflicted by the international financial crisis, especially her largest bank, Danske Bank, which between 1998 and 2008

220 Cable from Ambassador Carol van Voorst to State Department 31 October 2008. <https://wikileaks.org/cable/2008/10/08REYKJAVIK255.html>

221 *Federal Reserve System, Report to Congressional Addressees*, pp. 19–20.

TABLE 1 THOSE THE US FED ASSISTED IN THE FINANCIAL CRISIS

CENTRAL BANK	TRANSACTIONS	\$ AGGREGATE TRANSACTIONS	% OF TOTAL
ECB	271	8,011,000,000,000	79.7
Bank of England	114	919,000,000,000	9.1
Switzerland	81	466,000,000,000	4.6
Japan	35	387,000,000,000	3.9
Denmark	19	73,000,000,000	0.7
Sweden	18	67,000,000,000	0.7
Australia	10	53,000,000,000	0.5
South Korea	10	41,000,000,000	0.4
Norway	8	30,000,000,000	0.3
Mexico	3	10,000,000,000	0.1
TOTAL	569	10,057,000,000,000	100

had grown sixfold under the ambitious and aggressive Peter Straarup, acquiring banks in Ireland and Northern Ireland. In early October 2004, members of the Danish parliament were hastily convened to a closed emergency meeting where they were told that if nothing was done, the Danske Bank card, Dankort, would not function the next Monday morning. As a first measure the Danish government guaranteed all bank obligations.²²² Later it provided credit to banks and other financial firms of up to 100 billion Danish *kroner* (\$6 billion), thereof 24 billion to Danske Bank.²²³ 62 Danish banks, most of them small, went under in the crisis. The total write-downs of financial institutions in 2008–2011 amounted to 147 billion Danish *kroner* (about \$8.6 billion).²²⁴

It is worth noting that Danske Bank, which played a large role in the Icelandic bank collapse – not only

222 Danske Bank i fare i 2008 [Danske Bank in Danger 2008]. *Sikke en fest* [What A Party], DR1 (2012). <http://www.dr.dk/DR1/dr1-dokumentaren/sikke-en-fest/Nyheder/20121126095526.htm>

223 Skatteyderne mistede milliarder på en nat [Taxpayers Lost Billions Overnight], *Sikke en fest* [What a Party] DR1 (2012). <https://www.dr.dk/DR1/dr1-dokumentaren/sikke-en-fest/Nyheder/20121126101352.htm>

224 *The Financial Crisis in Denmark: Causes, Consequences and Lessons*, Report of the Rangvad Commission (København: Erhvervsministeriet, 2012), pp. 4 og 14.

in 2006 by a negative but influential report and by cancellation of credit lines to Iceland, and in 2006–2008 by working with hedge funds on bets against the Icelandic *krona* and the Icelandic banks, but also by its refusal in 2008 to facilitate the sale of Glitnir’s Norwegian bank to Nordea – may have seen some of its staff in Estonia having violated laws against money laundering. Apparently they assisted Russian criminals and the Azerbaijan dictator in transferring large sums of money from Europe to tax havens, such as the Seychelles and Panama. Danske Bank is also accused of being involved in the so-called Magnitsky case.²²⁵ After revealing massive tax fraud by people close to the Russian administration, Sergei Magnitsky died under mysterious circumstances in a Russian prison. His friend and business associate William Browder took up his case in a best-selling book, *Red Notice*, and subsequently the US passed a ‘Magnitsky Act’ to

225 A team of three journalists at *Berlingske Tidende*, Michael Lund, Eva Jung and Simon Bendtsen, have investigated the cases and published articles about it in their newspaper: Laundered billions poured through Danish banks, 20 March 2017, <https://www.business.dk/finans/laundered-billions-poured-through-danish-banks>; Dictatorship sent billions through Denmark’s biggest bank, 5 September 2017, <https://www.business.dk/finans/dictatorship-sent-billions-through-denmarks-biggest-bank>; Links to dead Russian lawyer behind French money laundering probe against Danske Bank, 13 October 2017, <https://www.business.dk/global/english-links-to-dead-russian-lawyer-behind-french-money-laundering-probe>

freeze funds belonging to several powerful Russians believed to be responsible for Magnitsky's death. At least two other countries, Canada and Estonia, have passed similar laws.²²⁶

The US Federal Reserve Board also did extensive dollar swap deals with Sweden and Switzerland – two countries that have never been allies of the US, unlike Iceland. The Swedish Riksbanken drew 18 times on the swap line for an aggregate of \$67 billion. Swedish banks, especially Swedbank, Stockholms Enskilda Bank and Nordea, had large operations in the three Baltic countries that were hit hard by the international financial crisis. Riksbanken made currency swap deals with Estonia and Latvia and lent *kronor* and dollars to Swedish banks.²²⁷

The Swiss National Bank drew 81 times on the swap line for \$466 billion. US authorities noted that the dollar swap deal enabled the National Bank to provide special emergency assistance to the largest bank in the country, UBS. It used the dollars to purchase up to \$60 billion of illiquid assets from UBS.²²⁸ In the preceding years, UBS – established 1998 in a merger of two Swiss banks – had grown rapidly under the ambitious and aggressive Marcel Opel. It held assets almost fivefold the Swiss GDP. Having heavily invested in subprime loans, UBS felt the credit crunch already in August 2007 and required an immediate massive liquidity injection by the National Bank. The difficulties continued and in April 2008, Director Ospel left UBS in disgrace. Besides the \$60 billion purchase of illiquid assets, the National Bank provided UBS with a capital injection of 6 billion Swiss francs. It may, therefore, be somewhat disingenuous to contrast the Swiss banks to the Icelandic ones, as some economists have done, on the ground that the former had 'a long experience of international banking'.²²⁹ This 'long experience' did not hinder them, at least UBS (and

the other large bank, Credit Suisse, was also in great trouble) in almost collapsing, to be rescued with US dollars.

For US authorities perhaps it was of particular interest that this 'long experience of international banking' included trying to destroy records about assets belonging to Jews in Nazi Germany. In 1998 UBS and Credit Suisse settled lawsuits against them in the US by paying \$1.25 billion to Jewish victims of the Nazis and their representatives.²³⁰ Ample evidence has also been provided about the leading Swiss banks helping wealthy foreigners to evade taxes and hide assets and also about their participation in rigging Libor, the interbank interest rate.²³¹ The US assistance to Switzerland came at a price, however. In February 2009 the Swiss authorities had to relax their formerly strict rules on bank secrecy, which has long been a cornerstone of the Swiss banking sector, and to order UBS to disclose customer data sought after by US authorities. Switzerland also had to qualify the traditional differentiation under her law between tax fraud and tax evasion and to accept the intervention by American administrators into banking matters.²³² The decision to help Switzerland was a political decision, just like the decision not to help Iceland. The Swiss banks survived, not because of their 'long experience of international banking', but because they were rescued by the US Federal Reserve Board.

226 Bill Browder, *Red Notice: a true story of high finance, murder, and one man's fight for justice* (New York: Simon & Schuster, 2015).

227 Lars Nyberg, The Baltic region in the shadow of the financial crisis. <http://www.riksbank.se/en/Press-and-published/Speeches/2009/Nyberg-The-Baltic-region-in-the-shadow-of-the-financial-crisis/>; Christoph Bertsch and Johan Molin, Revisiting the role of central banks as liquidity providers—old and new challenges, *Sveriges Riksbank Economic Review*, No. 2 (2016), pp. 89–158.

228 *Federal Reserve System, Report to Congressional Addressees*, p. 129.

229 J. McCombie and M. Spreafico, Capital Controls and the Icelandic Banking Collapse, *Financial Liberalisation: Past, Present and Future*, eds. Phillip Arestis and Malcolm Sawyer (Cham, Switzerland: Springer International, 2016), p. 241.

230 Stuart Eizenstat, *Imperfect Justice: Looted Assets, Slave Labor, and the Unfinished Business of World War II* (New York: Public Affairs, 2003).

231 UBS Enters into Deferred Prosecution Agreement. Department of Justice, Department of Justice Press Release 18 February 2009. <http://www.justice.gov/opa/pr/2009/February/09-tax-136.html>; UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rates. Department of Justice Press Release 19 December 2012. <http://www.justice.gov/opa/pr/2012/December/12-ag-1522.html>

232 *The Swiss authorities under the pressure of the financial crisis and the disclosure of UBS customer data to the USA*. Report of the Control Committee of the Federal Assembly (Bern: 31 May 2010). <https://www.parlament.ch/centers/documents/en/bericht-gpk-ns-ubs-kundendaten-usa-2010-05-30-res-e.pdf>

THE CLOSE-DOWN OF ICELANDIC BANKS IN THE UK

In late 20th century, despite conflicts about Iceland's four extensions of the fishing limit from 1952 to 1975, in general relations between the UK and Iceland were good. The two countries were allies in NATO, British leaders realising as clearly as the Americans the strategic importance of Iceland in the Cold War. The UK was also one of Iceland's most important trading partners. Culturally and socially, in the post-war years Iceland moved closer to the three Anglo-Saxon powers of the North Atlantic: the US, Canada and the UK. Glasgow was only an hour and a half away by aeroplane, and London two and a half hours. English replaced Danish as the first foreign language in Icelandic schools. Icelandic newspapers and radio and television stations covered current affairs in the UK in much more detail than those in Scandinavia. Margaret Thatcher and Tony Blair became household names in Iceland. But the European country closest to Iceland was of course Scotland. When Iceland started to prosper after comprehensive economic reforms from 1991 onwards, not least because of her sustainable and profitable quota system in the fisheries, Scottish nationalists watched with interest. At the same time Ireland was having success in attracting business by lowering taxes, while Norway was becoming wealthy as a result of her oil reserves.

In 1999 a Scottish Parliament was re-established, and the Scottish National Party (SNP), which craved for Scottish independence, became the second-largest party after Labour. In the 2007 elections the SNP became the largest party in Scotland, forming a minority government. This was a significant change in the fortunes of Labour: Scotland had long been their stronghold. Without it they could hardly hope to govern the UK. The SNP had great ambitions and high hopes. In a speech in Edinburgh on 19 December 2007, Alex Salmond, SNP leader and Scottish First Minister, said:

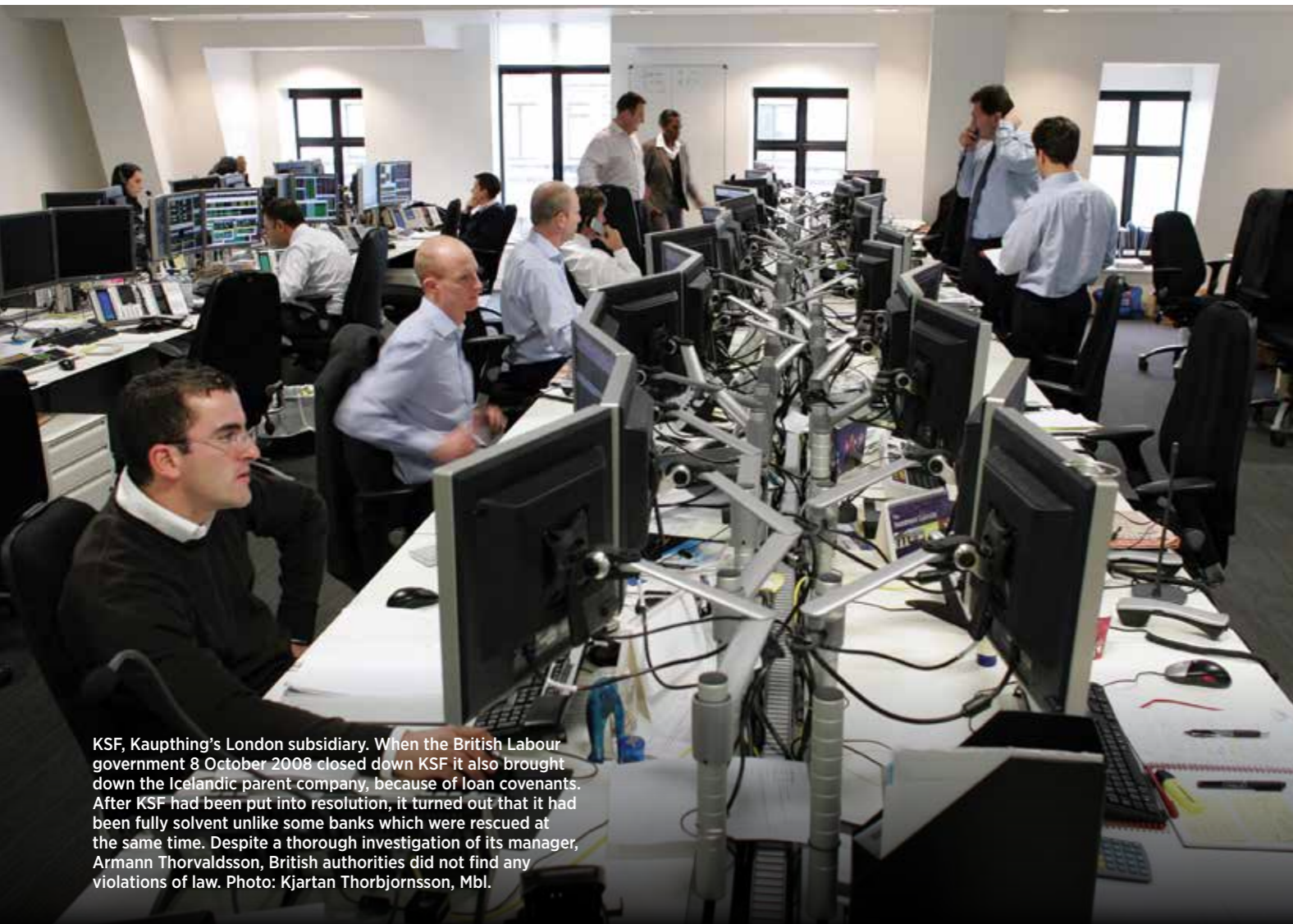
“ We have the assets, skills, knowledge and ideas to match and overtake our closest neighbours. By that I don't just mean the rest of the UK, but also the small, independent countries, Iceland, Norway, Ireland and Denmark, that form an arc of prosperity around our shores. These small independent nations have shown that in the 21st century, what matters most isn't size or geography. It's the flexibility of an economy to respond to new opportunities. Its capacity for innovation. Its stock of human capital.²³³”

The slogan 'arc of prosperity' was much-used by the Scottish nationalists for the next 10 months.

Scottish nationalists and their political rivals in the UK could observe the Icelanders nearby. The Icelandic expansion abroad was not least in the UK. Landsbanki bought Heritable Bank – a Scottish bank, though based in London – already in 2000 and started operating its own London branch in 2005. Kaupthing began operating a branch in London in 2003 and completed a purchase of Singer & Friedlander in 2005, changing the name to Kaupthing Singer & Friedlander (KSF). However, as KSF manager Armann Thorvaldsson writes: 'The man who was to become the face of the Icelandic business community abroad was Jon Asgeir Johannesson'.²³⁴ In August 2002 Johannesson had come close to buying a controlling share in the UK clothing giant Arcadia, which ran Topshop, Burton's and Dorothy Perkins, but when his British partners heard of a police investigation in Iceland against him, they bought him out for £165 million. He returned to Iceland, where he found it easy, despite his legal problems, to find business partners

233 Transcript: <http://www.gov.scot/News/Speeches/Speeches/First-Minister/sabmorsot07> Salmond had used the slogan earlier, Salmond sees Scots in 'arc of prosperity', *The Scotsman* 12 August 2006. <http://www.scotsman.com/news/salmond-sees-scots-in-arc-of-prosperity-1-1130200>

234 Thorvaldsson, *Frozen Assets*, p. 39.



KSF, Kaupthing's London subsidiary. When the British Labour government 8 October 2008 closed down KSF it also brought down the Icelandic parent company, because of loan covenants. After KSF had been put into resolution, it turned out that it had been fully solvent unlike some banks which were rescued at the same time. Despite a thorough investigation of its manager, Armann Thorvaldsson, British authorities did not find any violations of law. Photo: Kjartan Thorbjornsson, Mbl.

and creditors and to start building up a media empire, by Icelandic standards. After a while, however, Johannesson was back in the UK, where in 2003 he bought toy retailer Hamleys and women's fashion retailer Oasis and then merged Oasis with the fashion firm Karen Millen, creating Mosaic Fashion. He seemed so eager to expand by acquisitions and mergers that one of his Scottish business partners, Sir Tom Hunter, once facetiously asked him if he was dying.²³⁵

In late 2004 Johannesson bought Big Food Group and split it up into the wholesaler Booker, the frozen food retailer Iceland, and a real estate company. Johannesson had his eyes on retail giant Somerfield and was about to make a bid for it, with the help of Barclays and Kaupthing, when in July 2005 he was charged after the police investigation which had started in 2002. The charges included embezzlement and bookkeeping irregularities. Barclays made it clear

that they would not work with someone charged with embezzlement, and Johannesson had to leave the consortium of bidders, albeit selling his shares with profit. Again Johannesson returned to Iceland, where he found it easy, despite his legal problems, to find sympathisers. A columnist at his newspaper, Professor Thorvaldur Gylfason, wrote:

“ It seems that now the aim is to go after Jon Asgeir 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?²³⁶

Unlike Barclays, Kaupthing was unmoved by the charges against Johannesson. It helped Johannesson

236 Thorvaldur Gylfason, Kannski tuttugu manns [Perhaps Twenty People], *Frettabladid*, 7 July 2005.

and his business partners gain control of Glitnir in 2006 and 2007.²³⁷ Eventually, Johannesson was convicted of bookkeeping irregularities and of tax evasion and received suspended prison sentences.²³⁸

While criticism of the profligacies of the new moguls was relatively muted in Iceland, possibly because they controlled most of the media, resentment was brewing against them, as came out in two books published during and after the bank collapse about how they had transformed Iceland, to the worse according to the authors.²³⁹ Abroad people watched the Icelandic moguls in astonishment. Not least because of Johannesson's activities, Iceland began to gain some unwelcome attention in the UK. Economic commentators wondered from where all the Icelandic money came. There were some plausible explanations, such as the profitable quota system in the fisheries and the well-funded pension system, but the fact remained that the Icelandic banks, using the good reputation Iceland had established from 1991 to 2004, borrowed heavily in the international markets in 2004 and 2005 and lent aggressively to Icelandic businessmen, not least to Johannesson.

While negative publicity about Icelandic businessmen and warnings by English experts about problems in the Icelandic banks certainly did not help the CBI in obtaining a currency swap deal with the Bank of England, neither of those two factors probably were crucial in what followed. The main reason why the Bank of England refused on 23 April 2008 to make a currency swap deal with the CBI seems to be that its leadership agreed with other European central bankers that the Icelandic banks had grown too big and that their aggressive deposit collection was upsetting the European scheme of deposit insurance. They were also influenced by reports from the Swedish Riksbanken and the IMF about the basic vulnerability of the Icelandic banking sector, with no plausible lender of last resort. The Bank of England staff viewed Iceland as first and foremost a Nordic country.²⁴⁰

237 Thorvaldsson, *Frozen Assets*, pp. 123–4.

238 *Haestarettardomar* [Supreme Court Judgements], Nos. 385/2007 and 74/2012.

239 Gudmundur Magnusson, *Nyja Island: Listin ad tyna sjalfum ser* [New Iceland: The Art of Losing One's Identity] (Reykjavik: JPV, 2008); Ingi F. Vilhjalmsson, *Hamskiptin: Thegar allt varð fált a Islandi* [The Transformation: When Everything Could Be Bought in Iceland] (Reykjavik: Verold, 2014).

240 Interview with Sir John Gieve in London 27 November 2014; Interview

The very next day after the Bank of England's refusal, Prime Minister Gordon Brown promised his Icelandic colleague Geir H. Haarde to take up the matter with Governor Mervyn King, but nothing came out of it. Brown had his own reasons to be uneasy about the Icelanders. Having been Chancellor of the Exchequer since 1997, he had become Prime Minister and Leader of the Labour Party in June 2007. Both he and his successor as Chancellor, Alistair Darling, came from Scotland. Brown and Darling were bound to see the SNP as a grave threat to their political fortunes. As Brown later recalled:

“ For a time, nationalists posited an alternative view, the ‘arc of prosperity’, arguing that the Nordic states, with Ireland and Iceland, offered us a model of small northern states whose island status, long coastlines and ability to innovate, be flexible and access resources led them to perform well beyond expectations.²⁴¹

When Brown and Darling received reports about the Icelandic banks in difficulties, it must have strengthened their misgivings about the ‘arc of prosperity’ promoted by Scottish nationalists. Apparently the Prime Minister began to take direct interest in the Icelandic banks in the beginning of July 2008, after questions were raised about them in the House of Lords.²⁴² One problem was Landsbanki's deposit collection. While Kaupthing collected deposits in its Edge accounts through its UK subsidiary KSF and was, therefore, regulated by the FSA and under the British Financial Services Compensation Scheme (FSCS), Landsbanki's Icesave accounts were based in its London branch and regulated by the IFSA and under the Icelandic deposit guarantee scheme, operated by the Icelandic Depositors' and Investors' Guarantee Fund. But if Landsbanki failed and the depositors had to be compensated, the total amount in Icesave accounts in billions of pounds was clearly far beyond the capabilities of the Icelandic Fund.

Already in March 2008 the FSA had suggested transferring the Icesave accounts in the UK from Landsbanki's London branch to its subsidiary, Heritable Bank. But the FSA had requested that

with Lord Mervyn King in Petham Oast 14 August 2017.

241 Gordon Brown, *My Scotland, Our Britain: A Future Worth Sharing* (London: Simon & Schuster, 2014), p. 281.

242 Interview with Mark Sismey-Durant 28 November 2014.



Some Icelandic bankers took great interest in national culture and generously supported the arts and sciences. Björgolfur Guðmundsson, Chairman of Landsbanki's Board (second from left), is here in May 2004 with (from left) novelist Halgrímur Helgason, historian Gudjon Fridriksson and television host Eva María Jónsdóttir (holding her baby daughter, Julia Óskarsdóttir). Photo: Thorvaldur O. Kristinsson, Mbl.

against the accounts, which were of course obligations, Landsbanki transferred assets to Heritable Bank amounting to 20% of the total assets of the Icelandic parent company and the London branch. The FSA was not persuaded by Landsbanki's protests that such a huge transfer was problematic for legal reasons and also because it could trigger credit covenants. In late May the FSA reiterated its view that the transfer was desirable. Subsequently, it revoked the liquidity concession that Landsbanki previously had enjoyed and demanded that the Landsbanki London branch should always hold in an account at the Bank of England a cash reserve of 5% of the total instant access accounts. Immediately after the issue had been raised in the House of Lords, the FSA on 2 July 2008 turned its former suggestion into a formal request with the end of the year as the deadline. The FSA also requested Landsbanki to limit the total amount of Icesave deposits to a maximum of £5 billion and to avoid its Icesave instant access accounts being included in so-called 'best-buy' tables on interest rates. Landsbanki was reluctant to agree to this. But later in July the FSA raised its demand for the cash reserve from 5% to 10% of the total amount in instant access accounts. In August 2008 the FSA rejected two requests by Landsbanki. One was for an exemption on rules on large exposures. Landsbanki faced the problem that in the credit crunch, the value of the bank's assets, mainly its loan portfolio, had

gone down. The other request was that of the 20% of its total assets required to be transferred from the Icelandic parent company to the UK subsidiary against the transfer of the accounts, Landsbanki could in 2008 transfer 10% and in 2009 the remaining 10%.²⁴³

Not only did the FSA reject the two requests by Landsbanki, but it also hardened its stance. In mid-August it presented Landsbanki with a new set of demands: it should reduce its instant access deposits, stop marketing Icesave, notify the FSA of all changes in interest rates, increase the cash reserve to 20% of the total amount in instant access accounts and present a plan on how to repay fixed-term deposits when they matured. The FSA staff must have realised that it was nearly impossible for Landsbanki to meet those demands. Landsbanki's managers decided to seek the help of the Icelandic Minister of Business Affairs, Björgvin G. Sigurdsson, who came from Labour's Icelandic counterpart, the Social Democrats. Could he influence his British soulmates? Sigurdsson asked for a meeting with Chancellor Alistair Darling. However, Darling had already formed a negative opinion of the Icelanders, as clearly comes out in the book he subsequently wrote about the international financial crisis. For example, Darling writes:

²⁴³ *Landsdomur* [Impeachment Court], No. 3/2011, p. 281.

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.²⁴⁴

Iceland was not becoming insolvent, as Darling alleges. The state was almost debtless and the economy was robust, based on the quota system in the fisheries, ample supplies 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 assumed that the obligations of Icelandic banks were also the obligations of the Icelandic state.

Darling's information about the Icelandic Prime Minister was not correct, either. Geir Haarde had not been CBI Governor before he became Prime Minister.²⁴⁵ Darling's comment that Prime Minister Haarde was reluctant to go to the IMF, 'preferring to seek out Russian loans to tide the country over', is also highly misleading. A possible loan from Russia was not being discussed when Brown met Haarde in April 2008. The reason the Icelandic government in the beginning of October explored the possibility of a loan from Russia was that they had been refused credit lines and currency swap deals by traditional Western allies. 'We have not received the kind of support that we were requesting from our friends,' Haarde explained to journalists. 'So in a situation like that one has to look for new friends.'²⁴⁶ A loan from Russia was certainly never the first preference of the Icelandic government.²⁴⁷

In his book on the financial crisis, Darling writes of Landsbanki's operations in London:

Over the years it funded a range of investments, many of which are, in 2011, being investigated by the criminal authorities.

²⁴⁴ Darling, *Back from the Brink*, p. 137.

²⁴⁵ Darling corrects this error in his book's second edition in 2012. Darling, *Back from the Brink*, p. 137.

²⁴⁶ Kerry Capell, The stunning collapse of Iceland, *Bloomberg Businessweek* 10 October 2008, http://www.nbcnews.com/id/27104617/ns/business-us_business/t/stunning-collapse-iceland/#.WgxX2oZpFBw

²⁴⁷ Interview with Geir H. Haarde 1 October 2013.

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.²⁴⁸

Darling's statement about criminal investigations is not correct. No investments funded by Landsbanki's London branch were in 2011 being investigated by the criminal authorities in the UK. None have actually to this day been investigated by any criminal authorities, neither in the UK nor in Iceland.²⁴⁹ Darling was hardly referring to several investigations of the banks and their customers launched in Iceland after the collapse. They were mostly about possible market manipulations in the last year before the collapse when Icelandic bankers and businessmen were desperately trying to stay afloat; they had nothing to do with investments that Landsbanki funded in the UK prior to its collapse.

It is likely that here Darling is confusing Landsbanki with Kaupthing and its UK subsidiary KSF. Some investments in the UK funded by Kaupthing and KSF were indeed under much-reported investigation in 2011 when Darling was writing his book. The investigation was launched in 2009 in response to information provided by the FSA and the Icelandic authorities. The Serious Fraud Office (SFO) in March 2011 arrested the two brothers Robert and Vincent Tchenguiz and searched their premises. The brothers – who were subsequently released on conditional bail – were big Kaupthing and KSF customers, especially Robert who was not only Kaupthing's biggest single debtor, but also a shareholder.²⁵⁰ This investigation ended disastrously, however, for the SFO. Serious flaws in it were revealed, the search warrants were set aside, the investigation was discontinued and those officers responsible for it left the SFO.²⁵¹ The SFO had to settle for paying Vincent Tchenguiz damages of £3 million and Robert Tchenguiz damages of £1.5 million and to apologise to both of them.²⁵²

²⁴⁸ Darling, *Back from the Brink*, p. 137.

²⁴⁹ Emails to Hannes H. Gissurason from Larus Welding (Landsbanki's London Branch Manager until 2007) 19 April 2017 and from Lilja Björk Einarsdóttir (Landsbanki's London Deputy Branch Manager during the bank collapse) 24 April 2017.

²⁵⁰ SIC Report, Vol. 1, Ch. 2, p. 2 (in English). Thorvaldsson, *Frozen Assets*, pp. 127–8.

²⁵¹ High Court of Justice, Queen's Bench Division, Divisional Court, 31 July 2012, No. CO/4236/2011 and CO/4468/2011. <https://www.judiciary.gov.uk/wp-content/uploads/JCO/Documents/Judgments/tchenguiz-v-seriousfraudoffice.pdf>

²⁵² James Quinn, SFO Settles with Robbie Tchenguiz, *The Times* 31 July 2014.

Darling's statement about donations from Icelanders to the Conservative Party is also unfounded. When I asked him what evidence he had for it, he referred to press reports after the bank collapse.²⁵³ No prominent Icelandic businessman or banker has, however, acknowledged any financial support to the Conservative Party.²⁵⁴ 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 Darling's remark. In the spring of 2011, while he was writing his book, the SFO raided the Luxembourg premises of Kaupthing Luxembourg, a subsidiary of Kaupthing in Iceland. In July 2009 after the collapse, the subsidiary had been sold to British property developer David Rowland and his family and renamed Banque Havilland. A well-known supporter of the Conservative Party, 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. The 2011 raid in Luxembourg was in connection with an investigation into the operations of Kaupthing before its 2008 collapse, and it had nothing to do with Rowland and his family. Nevertheless, newspaper headlines implicated Rowland in the investigation. One said: 'SFO raids Tory donor David Rowland's bank over Kaupthing.' Another said: 'SFO raids offices in Luxembourg over failed Icelandic bank Kaupthing.'²⁵⁵ It appears that not only did Darling again confuse Landsbanki and Kaupthing, but that he also assumed an Icelandic connection with the donations of Rowland to the Conservative Party simply because Rowland had bought the remnants of a subsidiary of a failed Icelandic bank.

It was not surprising, given Chancellor Darling's hostility towards the Icelanders, that the meeting on 2 September 2008 between him and Icelandic Business Affairs Minister Bjorgvin G. Sigurdsson about Landsbanki's problems did not go well. Darling had already made up his mind that Landsbanki was likely

to fail and that then the Treasury would temporarily have to compensate British depositors, whereas the Icelandic state would have to pay the final bill. He bluntly asked Sigurdsson and his entourage where to he should send that bill.²⁵⁶ In his book Darling recalls the meeting. 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.' Darling says that he was struck at what seemed like an unusually large delegation from Iceland. According to him both Minister Sigurdsson and the chief regulator, Jon Sigurdsson – neither of whom he mentions by name – spoke volubly.²⁵⁷ 'I was told that considerable national pride was invested in Landsbanki. It occurred to me that if they did not realise just how bad a state Landsbanki was in, they did not know what they were doing. Alternatively, they did know.' 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.'²⁵⁸

Chancellor Darling told me that the negative impression that he formed at this meeting influenced his later decisions on the Icelandic banks.²⁵⁹ He said that the Icelandic government minister had not had good command of English and that he had not created trust.²⁶⁰ While Darling is possibly right that Business Affairs Minister Sigurdsson was not fully aware of the great danger facing the Icelandic banking sector, he may be somewhat unfair to the Icelandic politician. In his book 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 the point of the talks

253 Interview with Alistair Darling in London 11 December 2013.

254 Interviews with Bjorgolfur Gudmundsson in Reykjavik, 20 August 2013, and with Sigurdur Einarsson, Armann Thorvaldsson and Bjorgolfur Thor Bjorgolfsson in London 11 December 2013.

255 Rowena Mason, SFO raids Tory donor David Rowland's bank over Kaupthing, *The Telegraph* 29 March 2011. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8414550/SFO-raids-Tory-donor-David-Rowlands-bank-over-Kaupthing.html>; Simon Bowers, SFO raids offices in Luxembourg over failed Icelandic bank Kaupthing, *The Guardian* 29 March 2011. <http://www.theguardian.com/business/2011/mar/29/robert-tchenguiz-kaupthing>

256 SIC Report, Vol. 6, Ch. 18, pp. 27–8 (in English).

257 Economist Jon Sigurdsson was actually not the regulator, but the Chairman of the Board of the IFSA. He is a former politician from the Social Democrats.

258 Darling, *Back from the Brink*, pp. 137–8.

259 Interview with Alistair Darling in London 11 December 2013.

260 High officials from the UK have expressed the same opinion to former Prime Minister Geir H. Haarde, that this meeting increased the distrust of UK officials towards the Icelanders. Interview by phone with Geir H. Haarde 8 November 2017.



In London, Landsbanki operated both from a branch and a subsidiary, Heritable Bank. After Heritable Bank had been put into resolution, it turned out that it had been fully solvent. When the UK authorities had been in control of the Landsbanki London branch for a few days, they decided to lend £100 million to it to facilitate operations despite the fact that Landsbanki was listed as a terrorist organisation at the Treasury's website! Photo: Kjartan Thorbjornsson, Mbl.

was to try and facilitate the transfer of the Icesave accounts to the UK, where they would be regulated by the FSA and insured by the British guarantee scheme. Landsbanki's problem was that in the midst of an international credit crunch many of its loan covenants had stipulations that they could be cancelled in an event such as the transfer of assets from the parent company to a subsidiary. Therefore, the transfer had to be gradual. But the FSA rejected all requests by Landsbanki about a gradual transfer of assets with the accounts, while it kept raising its demands to Landsbanki about liquidity. It is not apparent that Darling had special information about Landsbanki's equity and assets, or the lack thereof, which the Icelandic authorities did not have.

Perhaps the Icelandic Business Affairs Minister was as unaware of the precariousness of the Icelandic banks as Darling himself was of the precariousness of the two big Scottish banks, Royal Bank of Scotland (RBS) and Halifax Bank of Scotland (HBOS). Or, as the leader of Darling's own party, Prime Minister Gordon Brown later wrote about the financial crisis: 'It is true we were not prepared for what was happening – or for what was going to happen in the coming months. No one was.'²⁶¹

Certainly the FSA did not soften its approach to Landsbanki after Chancellor Darling's meeting with Sigurdsson. Quite the contrary. An impasse followed

where Landsbanki could not, and the FSA would not, modify their respective positions. On 8 September 2008 Landsbanki sent a detailed proposal to the FSA about the transfer of accounts to Heritable Bank and a gradual transfer of assets against them, roughly half in 2008 and half in 2009. The FSA turned down this proposal, giving the reason that until 2009 no collateral would be provided from Landsbanki to Heritable Bank for half the total amount, about £2.4 billion.²⁶² To bring this amount of money into perspective, it should be pointed out that the building society and bank Alliance & Leicester had in November 2007 received a secret £3 billion credit line from the Bank of England to prevent insolvency and a run on the bank. If the objection is made that Alliance & Leicester was a British bank, then it may be added that it was sold to the Spanish bank Santander in July 2008.²⁶³ In September 2008, at the same time the FSA steadily increased its pressure on Landsbanki, Chancellor Darling secretly authorised the provision by the Bank of England of liquidity to three ailing banks, HBOS, RBS and Bradford & Bingley, in the case of RBS amounting to £14 billion.²⁶⁴ Bradford & Bingley had received £3 billion in liquidity from the Bank of England before it was sold to Santander on

262 Sigurjon Th. Arnason and Halldor J. Kristjansson, *Developments leading up to the Icelandic banking crisis in October 2008*, Draft (25 February, 2009), p. 91. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

263 Bank of England was unaware of impending financial crisis, BBC 7 January 2015. <http://www.bbc.com/news/business-30699476>

264 Darling, *Back from the Brink*, p. 119.

29 September.²⁶⁵ Five days earlier, on 25 September, the FSA had sent a letter to Landsbanki warning it that it was not complying with liquidity requirements in the UK and asking it to put an end to this irregular situation.

The Icelandic government's recapitalisation of Glitnir, announced on 29 September 2008 – the same day Bradford & Bingley was sold to Santander – had failed to recreate trust in the Icelandic banking sector. It had failed partly because of the media campaign against the action by Glitnir's largest shareholder, and partly because of the refusal, obvious to the markets, by the US Federal Reserve Board to make the same dollar swap deals with the CBI as it had done with the Scandinavian central banks. Landsbanki saw a reduction in wholesale deposits and cancellation of credit lines, as well as an outflow from the Icesave accounts where the total balance fell from £4.7 billion to £4.2 billion. Nevertheless, on 2 October 2008 at the request of FSA, Landsbanki transferred £200 million from its CBI account to its account with Barclays in the UK to meet possible further outflows from the Icesave accounts.²⁶⁶

In the days after the recapitalisation of Glitnir, Kaupthing's UK subsidiary, KSF, also saw a considerable outflow of deposits from its Edge accounts, even if they were protected by the British deposit insurance scheme. On 30 September alone the net outflow was £37 million. KSF managers also began to get indications that the parent company in Iceland was having liquidity problems. KSF could not draw on the credit line that it had with Kaupthing. KSF manager Armann Thorvaldsson gave immediate notice of the difficulties to the FSA. On 2 October they sent in a team of liquidity specialists that went through the KSF books. In the evening the KSF managers were summoned to a meeting at the FSA headquarters where officials told them that the FSA was becoming worried about developments in Iceland. On 3 October it was made clear to Thorvaldsson that the FSA would close down KSF if Kaupthing would not improve the liquidity position of its UK subsidiary. The same day Kaupthing transferred £100 million to KSF.²⁶⁷

²⁶⁵ Ibid., p. 132.

²⁶⁶ Arnason *et al.*, *Developments leading up to the Icelandic banking crisis in October 2008*, p. 73.

²⁶⁷ Thorvaldsson, *Frozen Assets*, pp. 209–13.

The British authorities were now moving in against both Landsbanki and Kaupthing. In the early afternoon of 3 October 2008, Chancellor Alistair Darling made a phone call to Prime Minister Geir H. Haarde, which he describes thus in his book:

“ 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.

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.²⁶⁸

Subsequently, the FSA required KSF to keep all deposits received on 2 and 3 October in a special account at the Bank of England.²⁶⁹ In discussions

²⁶⁸ Darling, *Back from the Brink*, p. 147.

²⁶⁹ While in court judgements in cases concerning Kaupthing, this is referred to as a Supervisory Notice to KSF, e.g. in cases No. EWCA 2009/1673, 1676, 1679, 1686 and 1687, this does not seem to be entirely

between FSA officials and KSF managers, it was made clear that KSF had significantly to increase its liquidity by either selling assets or obtaining money from its parent company.²⁷⁰

Darling's description in his book of the state of affairs is, however, highly misleading, both regarding Landsbanki and Kaupthing. 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, and they had reached an impasse because of the unwillingness of the FSA to allow a gradual transfer of assets from Iceland to the UK against the online deposits.²⁷¹ Indeed in August the CBI had rejected a loan facilitation that Landsbanki had sought in connection with the transfer of online deposits from its branch to its subsidiary. It should also be noted that in the phone call from Darling to Haarde, apparently Landsbanki was not mentioned, only Kaupthing: Yet again it seems that Darling did not make a proper distinction between Landsbanki and Kaupthing.

Fourth, and most importantly in this context, Prime Minister Geir H. Haarde strongly denies having tried on this occasion to negotiate down any amount of money that would have to be transferred from Iceland to the UK in order to avoid the closure of KSF.²⁷² According to Haarde, upon receiving Chancellor Darling's accusations, he immediately talked to the Kaupthing managers about them. They assured him that these accusations were not true and that this had to be some kind of misunderstanding that ought to be easily corrected. The Kaupthing managers then proceeded to contact both the FSA directly and the IFSA and came back to Haarde telling him that everything would be in order on Monday morning. Indeed the extensive investigation of Kaupthing after the collapse did not reveal any unusual or illegal large-scale money transfers from the UK to Iceland before the collapse. What it showed was that the Icelandic parent company

accurate. According to a Final Notice by the FSA to KSF (in administration) 18 June 2012, KSF had 3 October 2008 voluntarily undertaken to heed those demands by the FSA. Hence a Supervisory Notice was not issued. <https://www.fca.org.uk/publication/final-notices/kaupthing-singer-friedlander.pdf>

²⁷⁰ SIC Report, Vol. 1, Ch. 2, p. 15 (in English).

²⁷¹ Arnason *et al.*, *Developments leading up to the Icelandic banking crisis in October 2008*, pp. 90–92.

²⁷² Interview with Geir H. Haarde 1 October 2013.

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 (KSF had, in other words, provided increased collateral to foreign creditors of the parent company). While those dealings were perhaps not above criticism, they were not illegal and did not constitute transfers from the UK to Iceland.²⁷³ Moreover, Armann Thorvaldsson and other members of the KSF management team did not try to hide any of this from the FSA. In fact, the FSA had been told of the running loan agreement when it was made.

On Friday 3 October 2008 the British authorities moved on other fronts against the Icelanders, as the FSA issued to Landsbanki a so-called First Supervisory Notice. Landsbanki was ordered to put in a UK bank account, with the Bank of England or another approved bank, no less than 10% of its UK retail instant access deposits, or around £200 million. At this time Landsbanki's London Branch had deposits of £1.92 billion in instant access accounts. But this amount of money required by the FSA had to increase to no less than 20% of the instant access deposits by Monday 6 October, or to another £200 million. Landsbanki also had to put all the money that had been deposited on 2 and 3 October in a UK bank account and all the money that would be deposited there subsequently. Moreover, Landsbanki was prohibited from taking any action or entering into any arrangement in respect of any of its assets located in the UK on 3 October:

“ i) which has, or may have, the effect of transferring the assets to a location outside the United Kingdom; or ii) which has or may have, the effect of creating any charge, security interest or other similar economic interest over the assets, unless you have given the FSA at least 3 days' written notice of the proposed action and the FSA has confirmed, in writing, that it has no objection to those proposals.

²⁷³ SIC Report, Vol. 7, Ch. 21, p. 88 (in English). Interview with Armann Thorvaldsson in London 11 December 2013.



Gordon Brown's brutal treatment of Iceland in October 2008 is illustrated by Icelandic cartoonist Halldor Baldursson. Brown is shown trying to tramp down Geir H. Haarde, while the Financial Crisis ('Heimskreppan' in Icelandic) in the image of a monster observes: "I am here, Mr. Brown."

Landsbanki had to ensure that the Icesave instant access deposits were not in any 'Best Buy' tables in the UK. It also had to ensure that there was no change to interest rates on the Icesave fixed rate products without notice to the FSA. The bank had to cease all marketing of Icesave instant access deposits by 10 October and to reduce to £1 billion the overall level of such deposits. It had to ensure that deposits of all types did not at any time exceed £5 billion. It was to submit by 17 October a plan to repay the Icesave fixed term deposits, which would mature between now and the end of June 2009. At this time Landsbanki's London Branch had deposits of £1.93 billion in fixed-term deposits. Finally, it had to report its asset position on a daily basis to the FSA. The main reason given for these drastic measures was that the FSA was of the opinion that Landsbanki had

contravened, or was likely to contravene, its liquidity requirements.²⁷⁴ In effect, this meant that Landsbanki was supposed to come up with £400 million in the next few days. The FSA probably knew that the same day the ECB issued what was in effect a margin call on Landsbanki, a demand for increased collateral, or alternatively the repayment on outstanding loans, of no less than €400 million.

It is noteworthy that in the midst of the gravest financial crisis that the UK authorities had experienced for almost 80 years, government ministers found

²⁷⁴ FSA, First Supervisory Notice to Landsbanki, 3 October 2008. https://www.fca.org.uk/publication/supervisory-notices/landsbanki_3oct08.pdf

time to call their Icelandic colleagues about amounts of money which for them must have seemed almost negligible – 'small beer for us' as Chancellor Darling put it – and that their allegations turned out, on investigation, to be wrong. On the evening of Sunday 5 October, Prime Minister Gordon Brown called his Icelandic colleague Geir H. Haarde and told him that the illegal transfers from KSF to Kaupthing did not amount to £600 million as Chancellor Darling had stated two days earlier, but to £1.6 billion. When Haarde replied that he had asked the bankers about this and that they had assured him that this was not correct, Brown replied that he took his word for it and that he would not pursue that matter further in their conversation. Brown also suggested that Iceland should seek the assistance of the IMF. The same day an IMF team arrived in Iceland. As noted earlier, there seemed suddenly to be some interest abroad in Iceland, possibly because of the rumour of a loan from Russia.²⁷⁵ The IMF staff were not oblivious either to the possibility of playing a more important role because of the international financial crisis than they had done for some time. Meanwhile the FSA suddenly lowered its demand to Landsbanki for an immediate transfer of money from £400 million to £200 million, while the ECB withdrew its marginal call. On Sunday night Landsbanki's managers had a teleconference with FSA Director Hector Sants where they discussed the possibility of a fast transfer of the Icesave accounts from Landsbanki's London branch to Heritable Bank. Sants did not rule it out, provided money was being transferred to Landsbanki's London branch, although he did not commit himself.²⁷⁶

On Monday 6 October 2008, the Icelandic government had finally decided, after some hesitation, to follow the CBI advice of 'ring-fencing' Iceland – which meant that government would ensure continued operations of the domestic part of the banking sector, but if necessary put the foreign part in resolution. When Chancellor Alistair Darling learned about this, he tried to reach Prime Minister Geir H. Haarde, who was occupied however at Parliament House seeing through the Emergency Act on these measures. Haarde sent a message to Darling that he could call Finance Minister Arni M. Mathiesen in the morning. The same day the FSA prohibited

²⁷⁵ SIC Report, Vol. 7, Ch. 20, p. 83.

²⁷⁶ The teleconference was recorded by the Landsbanki people. See also Arnason *et al.*, *Developments leading up to the Icelandic banking crisis in October 2008*, p. 76.

Landsbanki's London branch from invoking the terms of its contracts with depositors, which would have enabled it to limit withdrawals for up to 60 days.²⁷⁷ This meant that the bank could not avert the run on it, which was already taking place. In the evening in Reykjavik, as Landsbanki did not get an emergency loan it had requested from the CBI, its management decided to hand over control to the IFSA. Meanwhile in London the same night, on the suggestion of the FSA, the KSF management team explored the possible acquisition of KSF by Barclays. But it turned out that Barclays was only prepared to do a quick asset purchase at a big discount – as it had done with the core operations of the failed Lehman Brothers three weeks earlier – so the idea was abandoned.²⁷⁸

In his book Chancellor Darling writes at length about events on Tuesday 7 October 2008. In the early morning he was attending a meeting of EU finance ministers in Luxembourg:

“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.”²⁷⁹

It is not clear to whom Darling is referring by his complaint that he had not been told the full story: Who would intentionally have been withholding information? The Icelandic authorities or the Icelandic banks operating in the UK? And information on what? The lack of liquidity, which was common knowledge? Whereas the Icelandic banks to the bitter end 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. It should also be noted that immediately when KSF manager Armann

²⁷⁷ FSA, First [should be Second] Supervisory Notice to Landsbanki, 6 October 2008. https://www.fca.org.uk/publication/supervisory-notices/landsbanki_6oct08.pdf

²⁷⁸ Thorvaldsson, *Frozen Assets*, pp. 217–8.

²⁷⁹ Darling, *Back from the Brink*, p. 152.

Thorvaldsson realised that the parent company had liquidity problems, while there was a net outflow from the Edge accounts, he gave notice about this to the FSA. The passage quoted reveals, however, that Darling had already in the early morning of 7 October decided to make ‘difficult decisions’ which might be ‘interpreted as hostile acts by the Icelandic government’.

While describing his arrival in Luxembourg, Chancellor Darling states that British government ministers are normally scrupulous about taking scheduled flights to and from meetings abroad, adding: ‘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.’ 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.’²⁸⁰ But if two Icelandic jumbo jets (Boeing 747) were found at Luxembourg airport on this day, then they could not be there in connection with the meeting which Darling was attending: Iceland was not a member of the EU and her 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.²⁸¹ Air Atlanta was a successful air transport company that specialised in cargo, but also did some chartered flights. Darling’s suggestion that ‘the smaller the country, the bigger the jet’ at international gatherings seems in this case both misleading and irrelevant. It is yet another example of the hostility towards Iceland repeatedly expressed by Darling.

The meeting in Luxembourg turned out to be dramatic, as Darling kept getting news of RBS shares plummeting. He left the meeting several times to take calls on the situation, including one from RBS Chairman of the Board Tom McKillop. Darling asked how long the bank could keep going. He replied: ‘A couple of hours, maybe.’ Darling rang his Treasury officials and instructed them to tell Bank of England Governor Mervyn King to put as

much money into RBS as was necessary to keep it afloat during that day. He also called Prime Minister Brown who concurred with him. As Darling was getting out of the meeting to return to London, he rang Icelandic Finance Minister Arni M. Mathiesen, asking him what the Icelandic government would do about Landsbanki’s online accounts in the UK, as the bank was collapsing. Mathiesen responded that the Icelandic government would do what it could to resolve the problem, but that he could not make any promises. In the beginning of the conversation, Darling thought that he was talking to Business Affairs Minister Bjorgvin G. Sigurdsson, whom he had met in September, but Mathiesen corrected him on that point.

On Tuesday 7 October 2008, the FSA closed down Heritable Bank in London, stating that it did not meet liquidity requirements.²⁸² The night before the staff at the FSA had suddenly realised that they had to deliver legal papers to Scotland, where Heritable was registered, in time for a court case. ‘All courier delivery firms had stopped for the night, so an FSA official jumped into his own car with the paperwork and drove through the night to Edinburgh.’²⁸³ Landsbanki’s London branch had been closed down the night before, like the parent company in Iceland, and legally the bank was now in the hands of a resolution committee appointed by the IFSA. In the evening of the same day in Reykjavik, 7 October, Glitnir’s management in Iceland decided to hand over control to the IFSA. The same evening in London, KSF managers frantically explored the possibility of selling the bank subsidiary to the investment company JC Flowers for only 10% of its book equity value, but the talks failed.²⁸⁴

Political leaders in the UK were as surprised as everyone else at the events unfolding on the financial markets. Prime Minister Gordon Brown’s special adviser Damian McBride spent the evening of Tuesday 7 October with him at 10 Downing Street. Brown looked ‘ravaged by the intensity of the work, running on a massive overdose of adrenalin.’ He closed the door to his office and said in almost a whisper to McBride that there was a serious danger of mass

panic in the UK for which he had to be ready. People might try to storm the banks: ‘We’d have to think: do we have curfews, do we put the army on the streets, how do we get order back? I’d have to resign but I couldn’t go if there was just carnage out there, someone would have to be in charge.’²⁸⁵ Brown went to bed at midnight with a mobile phone next to him in case of a disaster. When he got up the next morning, he told his wife that she would have to be ready to pack their things for a sudden move out of Downing Street. He would have to resign if the situation continued to deteriorate.²⁸⁶

On the morning of Wednesday 8 October, Brown and his fellow Scot Chancellor Darling held a joint press conference, where they announced a rescue programme for British banks, the close-down of the two British banks owned by Icelanders and the use of an Anti-Terrorist Act against Landsbanki and certain Icelandic institutions. Brown made the following comment:

“ And as people will now know, we are taking legal action against the Icelandic authorities to recover the money lost to people who deposited in UK branches of this bank. The Chancellor is saying today that he will stand behind the deposits of these customers.”²⁸⁷

In the midst of a crisis so serious according to Brown himself that he considered imposing curfews and putting troops on the streets in order to avert ‘carnage’, he found time to comment on the Icelandic bank collapse, threatening ‘legal action against the Icelandic authorities’ because of deposits in Icelandic banks. However, eventually the UK government proved unwilling to let courts resolve whether or not the Icelandic government was responsible for the deposits in Landsbanki’s Icesave accounts. Moreover, the Prime Minister assumed, without any argument, that the money deposited in the UK branches of Landsbanki was lost. The Landsbanki management always maintained that the bank had assets at least

to meet all claims by depositors – whom the Icelandic Parliament had in the Emergency Act given priority over other creditors – and they were eventually proven right.

It should also be emphasised that the British authorities at least contributed to the problems of the Icelandic banks. By closing down Kaupthing’s subsidiary in the UK, they caused the fall of the parent company. By invoking the Anti-Terrorism Act against Landsbanki, they made an orderly process of resolving the bank very difficult. If Brown wanted to provide ‘security for depositors’, the best way of doing this in the case of Kaupthing’s UK subsidiary, KSF, would have been to include KSF in the £500 billion rescue package for British banks announced at the same news conference on Wednesday 8 October. To survive, KSF would only have needed a fraction of that money. Since Landsbanki operated mostly from a branch and not a subsidiary, its case was more complicated. But some kind of assurance to depositors from the British authorities, followed by close cooperation between them and the Icelandic authorities in managing the Landsbanki estate would have been more helpful for depositors than the actions undertaken by the British authorities, and it also would have been more helpful for the staff employed by Landsbanki and employees of firms partly or wholly owned by Icelandic companies or individuals, probably close to 100,000 people at the time.

The same morning, Wednesday 8 October 2008, Chancellor Darling echoed Prime Minister Brown when he said in an interview with a breakfast television channel: ‘I am very aware of the fact Iceland has, sadly, chosen to default on its obligations here. We are pursuing Iceland and we will pursue it vigorously to make sure that we get the money due to us back.’²⁸⁸ Darling also said in a BBC 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.’²⁸⁹

Unbeknownst to Darling the conversation with Finance Minister Mathiesen, to which he was referring, was recorded, and when a transcript was published it became apparent that Darling had not told the

282 FSA, First Supervisory Notice to Heritable Bank, 7 October 2008. https://www.fca.org.uk/publication/supervisory-notices/heritable_7oct08.pdf

283 Hugh Pym, *Inside the Banking Crisis: The Untold Story* (London: Bloomsbury, 2014), p. 114.

284 Thorvaldsson, *Frozen Assets*, p. 208.

285 Damian McBride, *Power Trip: A Decade of Policy, Plots and Spin* (London: Biteback, 2013), p. 379.

286 Brown, *My Life, Our Times*, p. 317.

287 SIC Report, Vol. 7, Ch. 20, p. 151. Also <http://webarchive.nationalarchives.gov.uk/20100505183318/http://www.number10.gov.uk/news/speeches-and-transcripts/2008/10/press-conference-with-the-chancellor-of-the-exchequer-17114>. Cf. also a description of the press conference <http://www.theguardian.com/global/blog/2008/oct/08/gordonbrown.marketturmoil>

288 SIC Report, Vol. 7, Ch. 20, p. 149.

289 House of Commons Treasury Committee, *Banking Crisis: The impact of the failure of the Icelandic banks* (London: The Stationary Office, 2009), p. 21.

280 Ibid., p. 152.

281 Air Atlanta: History (2014). <http://www.atlanta.is/index.aspx?GroupID=43>

truth.²⁹⁰ Nowhere in the conversation did Mathiesen say that the Icelandic government had no intention of honouring its obligations. The question was precisely which obligations it had under English, Icelandic and international law. Later the House of Commons Treasury Committee explored this matter and concluded: ‘In the published transcript 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.’²⁹¹

Unsurprisingly, therefore, in his book three years later Darling gives a different account of his conversation with 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’.²⁹²

While this is the opposite of what Darling said to the press on 8 October 2008, it is not accurate either.

First, it was Darling who called Mathiesen, not the other way around. This is noteworthy given the circumstances. In the midst of the financial crisis, when he was preparing a rescue package of £500 billion, Chancellor Darling found time to call the Icelandic finance minister, worrying about a fraction of that sum, ‘small beer for us’ as he said himself. Moreover, Mathiesen had not uttered the assurances that Darling in his book ascribes to him. He had been unwilling to make any promises on behalf of the government, while pointing out that Iceland had a compensation scheme for depositors. Mathiesen

290 David Ibbson and George Parker, Transcript challenges UK position on Iceland, *Financial Times* 23 October 2008. <http://www.ft.com/intl/cms/s/0/42c0e23c-a153-11dd-82fd-000077b07658.html#axzz3CIV2pQMK>

291 Treasury Committee, *Banking Crisis*, p. 23. Professor Barry Eichengreen has been misinformed about this conversation. He writes in *Hall of Mirrors*, p. 221: ‘On the Tuesday morning following, the Icelandic Minister of Finance, Arni M. Mathiesen, informed the UK Chancellor, Alisdair [sic] Darling, that the Icelandic government, now the de facto owner of the banks, might not be able to come up with this kind of money.’ On Tuesday morning, actually only Landsbanki had been put into resolution. And Mathiesen pointed out to Darling, as the Treasury Committee recognises in its report, that while there might not be much money in the Icelandic Depositors’ and Investors’ Fund, which was supposed to compensate depositors in the case of Landsbanki’s failure, the government would do its best to resolve the problem. Landsbanki’s estate was eventually able fully to compensate all depositors.

292 Darling, *Back from the Brink*, p. 154.

also tried to explain to Darling that the Emergency Act gave claims of *all* depositors, including British owners of Icesave accounts, legal priority over other claims, whereas the Icelandic government had, like many other European governments, announced that it would guarantee domestic deposits. Therefore, there had been no discrimination by law between British and Icelandic depositors.²⁹³

Wednesday 8 October 2008, at approximately 12:30, Chancellor Darling made the following statement in the House of Commons:

“ I want to say something about the three Icelandic banks; Landsbanki, its UK subsidiary, Heritable, and Kaupthing, which was put into liquidation within the last hour. The Financial Services Authority decided yesterday that Heritable could not continue to meet its obligations and today it has taken exactly the same decision for Kaupthing. I have therefore used the special powers that I have under the Banking (Special Provisions) Act to transfer most of their retail deposits to ING, the Dutch bank, which is working to secure business as usual for its customers to protect its savers’ money. The rest of those Icelandic businesses have been put into administration. On Icesave, we are expecting the Icelandic authorities to put Landsbanki, which owns Icesave, into insolvency. Despite the fact that this is a branch of an Icelandic bank, I have in the exceptional circumstances that we see today guaranteed that no depositor loses any money as a result of the closure of Icesave and I am taking steps today to freeze the assets of Landsbanki in the UK until the position in Iceland becomes clearer.

Darling added:

“ I have to tell the House that getting information out of Iceland is proving to be quite difficult. That country obviously has severe difficulties,

293 Professor Barry Eichengreen has been misinformed about the nature of the Emergency Act. He writes in *Hall of Mirrors*, p. 220: ‘But this measure said nothing about the banks’ other creditors, be they institutional institutions holding the bonds of the banks or Dutch and British households with Icesave and Kaupthing Edge accounts.’ The Emergency Act gave priority to all depositors in Icelandic banks, including British and Dutch owners of Icesave accounts. And the Edge accounts in the UK were covered by the British scheme of deposit insurance, since they were collected by a British bank, KSF, a subsidiary of Kaupthing.



In front of Parliament House December 2008. After the bank collapse, in this normally peaceful Nordic country street riots drove out the coalition government of the Independence Party and the Social Democrats. Perhaps the greatest cost of the collapse was not so much economic as social. The level of trust, previously high, plummeted, and political institutions lost respect. Photo: Kjartan Thorbjornsson, Mbl.

and that is why I decided that I had to intervene. It would have been quite wrong to say to people covered by the Icelandic scheme, ‘Sorry, you’ve got to go to Reykjavik and try to get your money there.’ That is especially true when it is not clear to me whether the Icelandic scheme can be funded. So we have taken steps to freeze the assets of the bank involved [Landsbanki], and I hope that we will be able to recover some of those assets in order to offset the money that we will have to provide to help people in the meantime.²⁹⁴

Darling was not entirely accurate about Landsbanki: Its board had already on the night of Monday 6 October handed the bank over to the IFSA, which had appointed a resolution committee. The Chancellor was, however, plainly wrong that Kaupthing’s UK subsidiary, Kaupthing Singer & Friedlander (KSF), had already been put into liquidation (or rather resolution) by British authorities. This happened later in the day at approximately 14:50. It was, therefore, not a direct consequence of any decision made by the FSA in the afternoon that the Chancellor transferred most of KSF’s retail deposits to one of its competitors, the Dutch bank ING. He had already done that in the morning. Indeed, when the Chancellor was making his announcement in the House of Commons, the managers of KSF and Kaupthing believed themselves

294 Hansard 8 October 2008, Columns 279–282. <http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm081008/debtext/81008-0004.htm>

to be in the midst of negotiations with the FSA on how to relieve the pressure on KSF.²⁹⁵

It should be noted that the most important part of Chancellor Darling’s announcement in the House of Commons on Wednesday 8 October was that the British government was providing an immense rescue package of £500 billion for all British banks – except for two: Heritable Bank and KSF. They were both British banks owned by Icelandic banks and both still liquid, and as it turned out, both definitely solvent at the time. When I asked Darling why RBS was saved but not KSF, he replied that RBS was a British bank. But so was KSF. When I pointed this out to Darling, he replied that unlike KSF, RBS was systemically important.²⁹⁶ But one of the banks which received help from the British government was Bradford & Bingley, which could by no means be called systemically important to the UK banking sector and whose branches and deposits were actually sold to a Spanish bank a week before the Icelandic-owned banks in the UK were closed down. And certainly KSF was systemically important to the Icelandic banking sector. Its demise brought about the fall of the last remaining Icelandic bank and thus the collapse of the Icelandic banking sector. It should not be forgotten, also, that its demise affected the many British citizens who worked for Icelandic-owned companies and also British depositors and creditors, even if they eventually recovered most of their money.

295 SIC Report, Vol. 7, Ch. 20, p. 170.

296 Interview with Alistair Darling in London 11 December 2013.

THE USE OF AN ANTI-TERRORIST ACT AGAINST ICELAND

By two actions that UK Chancellor Alistair Darling announced on 8 October 2008, to put KSF into liquidation and to issue a Freezing Order under an Anti-Terrorism Act against Landsbanki and certain Icelandic authorities, British authorities brought about the total collapse of the Icelandic banking sector: Kaupthing in Iceland was forced into liquidation because its credit was contractually dependent on the position of its subsidiaries; and the Freezing Order against Landsbanki and certain Icelandic authorities immediately made all transfers of money to and from Iceland almost impossible and, therefore, all negotiated solutions to the many problems arising in a couple of days in the Icelandic banking sector.²⁹⁷ Needless to say, Icelandic authorities were stunned by these two actions. As soon as Prime Minister Geir H. Haarde realised what the UK government had done, he tried to contact UK Prime Minister Gordon Brown who was, however, not available. He was put through to Chancellor Darling, who later described their conversation which took place Thursday 9 October as Darling was preparing to leave for an IMF summit in Washington DC:

“ I had spoken to the prime minister [Geir H. Haarde] on the previous Thursday morning to tell him a letter outlining our plans to save UK depositors' money was on its way. We would need to work together, I told him, and I offered to send a Treasury team to Iceland to see if matters could be resolved and something salvaged from the wreckage. He would issue a statement, he said, putting on record his appreciation of the help the UK government was giving depositors—as well he might. His gratitude had been short-lived. Landsbanki,

with its UK subsidiary and Kaupthing, would be put into liquidation later in the day. We were going to use the Northern Rock legislation to transfer Kaupthing's UK subsidiary operations to the Dutch bank ING. But I saw no alternative to freezing the assets of Landsbanki, or Icesave as it was known here.²⁹⁸

It so happens that this conversation was recorded. However, the transcript is not needed to observe and correct some errors in Darling's account, the least of which is that the conversation took place in the early afternoon – not in the morning, as he says – on Thursday 9 October 2008.

In his account of the conversation with Prime Minister Haarde, Chancellor Darling reverses the sequence of events. He speaks as if Landsbanki and its UK subsidiary Heritable Bank and Kaupthing were put into liquidation 'later in the day', after his conversation with Haarde. But both the Landsbanki UK branch and Heritable Bank had been closed down in the evening of Monday 6 October, as a result of the IFSA taking Landsbanki in Iceland over and appointing a resolution committee for the bank. As a British (indeed Scottish) bank, Heritable Bank had been put formally into resolution by the FSA on Tuesday 7 October. The UK Treasury had then, on the morning of Wednesday 8 October, issued the Freezing Order against Landsbanki based on the Anti-Terrorism Act. The British bank owned by Kaupthing, KSF, was put into resolution by the FSA in the afternoon of Wednesday 8 October, after Darling had already announced it in the morning. All this had happened before Prime Minister Haarde spoke to Chancellor Darling on Thursday 9 October.

The transcript of the conversation reveals that Prime Minister Haarde told Chancellor Darling that Paul Myners, the Financial Services Secretary, had called Icelandic Finance Minister Arni M. Mathiesen the previous day to try and explain the use of the Anti-Terrorism Act against Iceland and that they had agreed that things had to be calmed down and put into proper channels. Mathiesen had suggested that the UK authorities send some people to Iceland to see for themselves how the situation was.²⁹⁹ Thus, it was not Darling, as he somewhat haughtily says himself, who 'offered to send a Treasury team to Iceland to see if matters could be resolved and something salvaged from the wreckage'. Haarde said to Darling that he had issued a statement expressing his appreciation for the concerns which the UK government had about depositors in the Icesave accounts.³⁰⁰ But he added: 'I have had to make some strong statements in the news here about your acting on authority and legislation against terrorism in our case. We don't think that's very friendly, but ...'³⁰¹ At that instance Darling interrupted him, repeating what he had said earlier in the conversation that the UK government had had to use the powers it had. Haarde returned to the use of the Anti-Terrorism Act against Iceland, expressing the hope that it would not affect the good relations between Iceland and the UK, continuing: 'But I was forced to use some strong language about this application of the terrorism law. We are not terrorists.' Darling replied: 'I know you're not, *whatever else you are*.'³⁰² The last remark cannot be said to be gracious in a conversation with an understandably shaken representative of a small nation who had ample reason to fear the collapse of the whole economy of his country and her international isolation.

The crucial point is that Chancellor Darling is mistaken in his assertion that there was no alternative to issuing the Freezing Order under the

Anti-Terrorism Act against Landsbanki and certain Icelandic institutions, such as the CBI and the IFSA. The confidential Supervisory Notice, which the FSA had issued on 3 October 2008 to the Landsbanki UK branch, had expressly prohibited all transfers of the bank's assets out of the UK without written permission by the FSA after a written advance notice of at least three days. Such supervisory notices are issued to a target bank if it is deemed to be in breach of a rule or if it is regarded as a risk. They are usually only issued to the target bank concerned and are strictly confidential because otherwise those doing business with the bank might decide to reduce exposure to it or even cease to trade with it.³⁰³ It seems that the FSA also informed Barclays about the Supervisory Notice, as that bank handled payments for the Icesave accounts. Apparently knowing about the Supervisory Notice issued on 3 October, Barclays imposed restrictions on Landsbanki's UK branch already before the Freezing Order was issued 8 October by the Treasury.³⁰⁴ A British banker with thorough knowledge of the Landsbanki operations in the UK comments: 'The Freezing Order, in my opinion, was like using a sledge-hammer to crack a nut. I don't think it should have ever been issued. The same result could have been achieved through the medium of an upgraded Supervisory Notice.'³⁰⁵

In his book on the crisis, Darling comments on the Freezing Order: 'Unfortunately, this legislation was contained in an anti-terrorism measure passed in 2001. Because of that, our action was open to the mistaken impression that we regarded Landsbanki – or, even worse, Iceland – as a terrorist organization.'³⁰⁶ The fact remains that immediately after the Freezing Order was issued on 8 October 2008, Landsbanki, the CBI, and the IFSA were put on the list of rogue states and terrorist organisations the UK Treasury maintains on its website. The CBI and the IFSA were quickly removed from the list, but on 10 October 2008 the list was the following under the headline 'Current Regimes' which were subject to financial sanctions:

299 Mathiesen, *Arni Matt*, p. 60.

300 This was a very cautiously composed statement from the Prime Minister's Office 8 October 2008. <https://eng.forsaetisraduneyti.is/news-and-articles/nr/3039>

301 Haarde said afterwards to reporters: 'I told the Chancellor that we consider this to be a completely unfriendly act.' Patrick Wintour and Audrey Gillan, *Lost in Iceland: £1 billion from councils, charities and police*, *Guardian* 10 October 2008. <http://www.theguardian.com/business/2008/oct/10/banking-iceland>

302 I obtained the transcript from the Prime Minister's Office according to the Icelandic Freedom of Information Act. Italics added.

303 FSA, First Supervisory Notice, 3 October 2008. http://www.fsa.gov.uk/static/pubs/final/landsbanki_3oct08.pdf

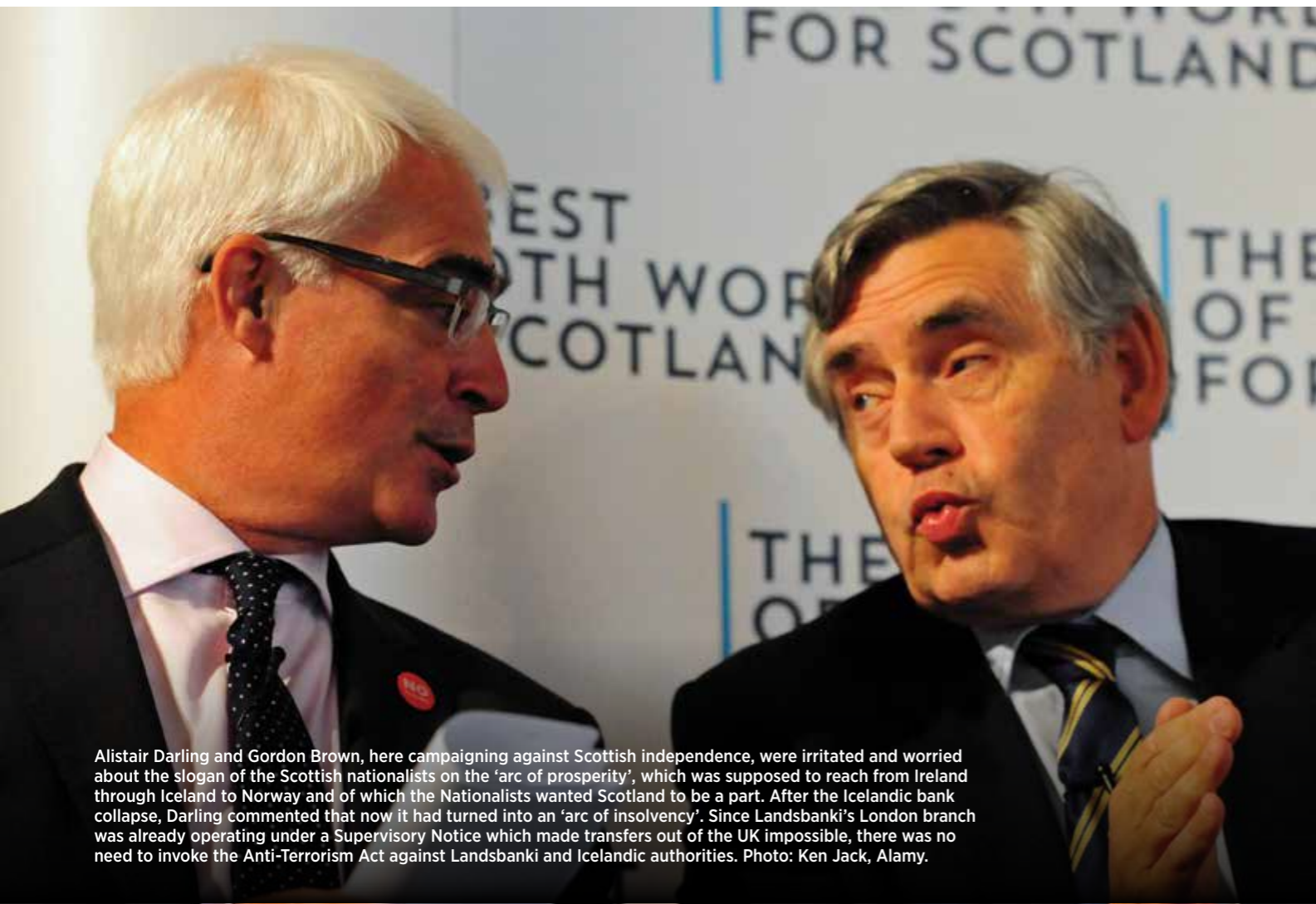
304 Information from the staff at Landsbanki's UK branch.

305 A senior British banker. Cf. Interview with Lilja Bjork Einarsdottir in London 3 March 2016.

306 Darling, *Back from the Brink*, p. 166.

297 HM Treasury, *The Landsbanki Freezing Order 2008*. <http://www.legislation.gov.uk/uk/si/2008/2668/made>.

298 Darling, *Back from the Brink*, p. 166.



Alistair Darling and Gordon Brown, here campaigning against Scottish independence, were irritated and worried about the slogan of the Scottish nationalists on the 'arc of prosperity', which was supposed to reach from Ireland through Iceland to Norway and of which the Nationalists wanted Scotland to be a part. After the Icelandic bank collapse, Darling commented that now it had turned into an 'arc of insolvency'. Since Landsbanki's London branch was already operating under a Supervisory Notice which made transfers out of the UK impossible, there was no need to invoke the Anti-Terrorism Act against Landsbanki and Icelandic authorities. Photo: Ken Jack, Alamy.

- Al-Qaida & Taliban
- Belarus
- Burma Myanmar
- Democratic Republic of Congo
- Federal Republic of Yugoslavia & Serbia
- Iran
- Iraq
- Ivory Coast
- Landsbanki
- Lebanon and Syria
- Liberia
- North Korea (Democratic People's Republic of Korea)
- Sudan
- Terrorism and terrorist financing
- Zimbabwe

Landsbanki remained on this list until 22 October 2008, when a special section was created for it on the website below the regular list of states and organisations subject to financial sanctions under the Anti-Terrorism Act. This change was not made

on a British initiative, but at the request of Icelandic authorities.³⁰⁷ The British authorities amended the Freezing Order several times, but showed great reluctance to cancel it. In fact, it was only cancelled after the British and the Icelandic government reached an agreement in June 2009 about the reimbursement by Iceland of the compensation paid by the UK government to Icesave depositors – an agreement which was later voted down by the Icelanders, even if the Freezing Order was not then reimposed.

Two other facts about the Freezing Order based on the Anti-Terrorism Act are also relevant. First, whereas both Prime Minister Brown and Chancellor Darling had prior to it phoned Icelandic ministers expressing grave concern about possible illegal transfers of money from the UK to Iceland, no evidence could be found of any such transfers or even any attempts to make them after thorough investigations both in the UK and

³⁰⁷ SIC Report, Vol. 7, Ch. 20, pp. 152–3.

Iceland, where the investigators had a strong incentive to try and find such evidence.

Second, soon after British officials had gone into Landsbanki's UK branch, they found out that many assets could be saved from losing much of their value in a possible fire sale if the bank branch was provided with some liquidity. On 12 October 2008, therefore, the Bank of England lent £100 million to the Landsbanki branch. It illustrates the absurdity of the situation that British authorities were thus giving a big loan to a company branded as a terrorist organisation and put on a list with Al-Qaida and the Taliban on the Treasury's website.

Whereas Chancellor Darling and Prime Minister Haarde politely agreed in their telephone conversation on 9 October that their two nations should try to resolve the Icesave issue without sacrificing their traditionally good relationship, the same day Prime Minister Brown made some aggressive comments. On the television station Sky he said that it was very unusual that a whole country like Iceland was basically bankrupt.³⁰⁸ He added: 'The issue is basically this. The Icelandic banks have collapsed, the Icelandic authorities have to take some responsibility for it. They cannot just default and say that they're going to take on none of the responsibility for what has happened.' Brown also said: 'But the responsibility for this lies fairly and squarely with the Icelandic authorities, and they have a duty in my view to meet the obligations that they owe to citizens who have invested from Britain in Icelandic banks.'³⁰⁹ In an interview with BBC the same day, Brown said:

“What happened in Iceland is completely unacceptable. I've been in touch with the Icelandic prime minister. I said that this is effectively illegal action that they have taken. We are freezing the assets of Icelandic companies in the United Kingdom where we can. We will take further action against the Icelandic authorities wherever that is necessary to recover the money.

He added: 'But this is fundamentally a problem of an

³⁰⁸ Abyrgdin er alfarid hja Islendingum [The Responsibility Lies Solely with the Icelanders], *Frettabladid* 10 October 2008 (account of the interview with Brown). Unfortunately, Sky Television has not kept the tapes from this interview so a transcript in English is not available.

³⁰⁹ Brown Blasts Iceland Over Banks, Sky News, 10 October 2008. <http://news.sky.com/story/640086/brown-blasts-iceland-over-banks>. See also SIC Report, Vol. 7, Ch. 20, p. 153.

Icelandic-registered company, Icelandic-registered financial services authority – they have failed not only the people of Iceland, they have failed people in Britain.'³¹⁰

There is some evidence that it was Prime Minister Brown who made the ultimate decision to invoke the Anti-Terrorism Act against Iceland.³¹¹ He showed no less hostility towards Iceland than his Chancellor. But Brown's comments to the press on 9 October are misleading or inaccurate on several counts.

First, Iceland as a country was not bankrupt. The four pillars of her economy remained sound despite the collapse of the banking sector: profitable fisheries, ample energy sources, a booming tourist industry and significant human capital.

Second, Brown seemed to assume without argument that the obligations of private companies were also the obligations of the Icelandic government – just as if losses incurred by a US company operating abroad, such as Citibank, were somehow to be transferred on to the US government. Certainly the Icelandic authorities were responsible for passing the relevant laws and regulations required by membership in the EEA and for regulating the Icelandic financial market in a proper way. But this is quite different from asserting that there was a legally binding government guarantee of deposits in the Icelandic banks. No such guarantee could be deduced from the laws and regulations then in force, as lawyers argued at the time and as courts eventually concluded.³¹²

Third, Brown had only been in contact with Prime Minister Haarde once during the crisis, on Sunday 3 October, about a possible illegal action by Kaupthing, which was supposed to be a transfer of an immense amount of money from the UK to Iceland. Haarde had told him that the bank managers maintained that this was a misunderstanding, as it turned out to be. KSF had not transferred any money to Iceland, whereas it had paid

³¹⁰ Iceland criticised by Gordon Brown, BBC 9 October 2008. http://news.bbc.co.uk/2/hi/uk_news/politics/7662131.stm; SIC Report, Vol. 7, Ch. 20, p. 152.

³¹¹ In conversations with people at the CBI this is claimed by unnamed sources close to the staff at 10 Downing Street, the Prime Minister's office. Cf. Fridriksson, *The Collapse of the Icelandic Banks*, p. 24.

³¹² SIC Report, Vol. 5, Ch. 17 (which is also published in an English translation and which is all about legal aspects of deposit guarantees); Judgement of the EFTA Court, 28 January 2013. http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf

some margin calls for its parent company and not been able to draw on a swap agreement with it, of which the FSA staff had been informed long before. In fact, in the first days of October, some money had been transferred in the opposite direction, from Iceland to the UK.

Fourth, Brown said that the British authorities were freezing ‘assets of Icelandic companies in the UK’ wherever possible. This was not in accordance with the Freezing Order, which was directed against Landsbanki on the one hand and certain Icelandic authorities on the other hand. After a conversation between the Icelandic Ambassador to the UK, Sverrir H. Gunnlaugsson, and the Prime Minister’s adviser on International Economic Affairs and Europe, Jon Cunliffe, the Ambassador received a letter on 11 October 2008 in which Cunliffe stated that the government had not taken action against Icelandic companies other than Landsbanki.³¹³ But this letter was not made public, and in practice almost all Icelandic companies doing business in the UK, and in many other places, in the next few months felt the severe repercussions of Brown’s words.

Prime Minister Brown continued to criticise Iceland. At a press conference on 12 November 2008, a reporter asked about Icelandic banks:

“ During the days that all this was happening, and they were collapsing, you talked about illegal action [sic] of the government. I would like if you could clarify that. Also, why was it necessary to use terrorist legislation against one bank when there was another legislation used against another bank? The fact that we have got this terrorist stigma has greatly aggravated the problems in Iceland and possibly brought down the value of the bank, which of course is counter to UK interests. And lastly, is the UK government in some way trying to boycott the IMF loan to Iceland?

Brown replied:

“ The answer to the last question is no, to the first two questions is we did everything completely appropriately. First of all there was an issue about money that had been taken out of London and returned to Iceland and we



Protesters at the Icelandic President’s residence in Bessastadir in 2010. They rejected demands by the British Labour government that the Icelandic government would guarantee deposits in Landsbanki’s UK online accounts. Other governments (except the Dutch one) did not make similar demands. They simply sold off the assets of the Icelandic banks and paid the depositors. Photo: Ragnar Axelsson, Mbl.

wanted back in London and it was right and proper that that should happen. Secondly, it was right that in conditions where there were huge debts owed in London, we could take powers to control the assets of the bank in London. We did everything properly by the book and within the law of our country.³¹⁴

Here again Brown’s statements are misleading or

314 Transcript of press conference 12 November 2008. <http://webarchive.nationalarchives.gov.uk/20100429150141/http://www.number10.gov.uk/news/speeches-and-transcripts/2008/11/november-press-conference-17432>

inaccurate. First, he did not really respond to the request made by the reporter that he would clarify previous comments about illegal actions taken by the Icelandic government.

Two other inaccuracies have already been pointed out: Brown simply repeated his earlier allegations that money had been illegally transferred from the UK to Iceland and that this was one reason for the use of the Anti-Terrorism Act. He also assumed that the British government needed to invoke the Anti-Terrorism Act in order to control possible transfers from the UK to Iceland at the London branch of Landsbanki, whereas

the FSA had already issued a Supervisory Notice that made such transfers practically impossible.

At his 12 November press conference, Brown categorically rejected the allegation that the UK was trying to block the implementation of an IMF programme for Iceland until Iceland had given in to British demands in the Icesave dispute. The facts of the matter are different. On 24 October 2008, an IMF staff mission and the Icelandic government reached an agreement about an economic recovery programme for Iceland, including a \$2.1 billion loan

facility.³¹⁵ But the IMF executive board several times postponed putting this agreement on its agenda. It was an open secret that the delay was because the British and Dutch governments refused to accept the agreement until the Icelandic government had given in to their demands in the Icesave dispute. Finally, the Icelandic government announced on 17 November 2009, after consultations in Brussels with the EU institutions and member states, that ‘all parties concluded that the Deposit Guarantee Directive has been incorporated in the EEA legislation in accordance with the EEA Agreement, and is therefore applicable in Iceland in the same way as it is applicable in the EU Member States.’³¹⁶ Even if somewhat ambivalent, this announcement could be interpreted as recognising a government guarantee of the obligations of the IDIGF regarding the Icesave deposits. Only two days after the Icelandic government had agreed to these so-called ‘Brussels Guidelines,’ the IMF Executive Board accepted the recovery programme for Iceland.

The staff members of the IMF indirectly admitted the connection to the Icesave dispute when they explained that the delay by the IMF Executive Board in accepting the agreement was because some countries contributing to the recovery programme had set the precondition that Iceland should recognise the British and Dutch claims in the Icesave dispute.³¹⁷ Be that as it may, Prime Minister Brown was clearly not telling the truth when he denied that the British government was blocking the IMF loan to Iceland. It was doing so behind the scenes with heavy diplomatic pressure on the IMF, Iceland and the IMF member states contributing financially to the recovery programme. The four Nordic countries bowed to the pressure, but the Faroe Islands and Poland did not.

In fact, Prime Minister Brown admitted in the House of Commons on 6 May 2009 that the UK used the IMF to put pressure on Iceland in the Icesave dispute. He was asked by a Conservative MP why nothing was being done about a hospital in the north-west of England, Christie, which stood to lose £6 million pounds in the Icelandic bank Kaupthing. Brown replied:

“ The fact is that we are not the regulatory authority and that many, many more people had finances in institutions regulated by the Icelandic authorities. The first responsibility is for the Icelandic authorities to pay up, which is why we are in negotiations with the International Monetary Fund and other organisations about the rate at which Iceland can repay the losses that they are responsible for. However, we have also agreed that we will look at the particular case of the Christie and see what we can do to understand how we can meet its need. We and the hon. Gentleman have to accept the fact that many more people who were affected by the Icelandic regulatory authority lost money as a result, which means that certain precedents would be set. We have to look at the matter in the round, and we will do so.³¹⁸ ”

Several things should be noted about this exchange.

First, when Brown said that ‘we are not the regulatory authority’, he was wrong. The hospital in question was a Kaupthing depositor. Kaupthing in the UK operated through a subsidiary, KSF, and was thus regulated by the FSA and fully covered, as much as an English bank was covered, by British law and the UK guarantee scheme. If there was a problem for some depositors there, then it was caused by the refusal of the British authorities to include KSF in their rescue package, announced the same day as they closed down KSF. Landsbanki operated, however, mostly through a branch and was regulated by the Icelandic authorities. Brown did not make, or chose to ignore, the crucial distinction between the operations of Kaupthing’s subsidiary and Landsbanki’s branch in the UK.

Second, Brown’s statement that the UK government was ‘in negotiations’ with the IMF and other organisations about how Iceland should pay up went totally against the nature and role of the IMF, which certainly was not set up as a debt collector for one member state against another. It was also in contradiction to his flat denial at the press conference on 12 November 2008 of the allegation that the British government was using its influence on the IMF to force Icelanders to recognise the British claim in the Icesave dispute.



Dr. Eamonn Butler of the Adam Smith Institute addressing an RNH conference in Iceland in the autumn of 2013. Butler was one of those who protested against the brutal treatment by the British Labour Government of a tiny, friendly neighbour. Photo: Haraldur Gudjonsson, Vbl.

Third, the Prime Minister’s statement that the Icelanders had to ‘repay the losses that they are responsible for’ was wrong, as already noted. As the EFTA Court eventually decided, ordinary Icelanders were in no way responsible for the business exchanges between depositors who wanted high interest rates and a bank which offered such high interest rates.

In retrospect, the harsh treatment of Iceland, both her banks and her institutions, by Prime Minister Gordon Brown and Chancellor Alistair Darling seems extraordinary and inexplicable on their own premise, which was to protect British depositors in Icelandic banks. All their accusations in several phone calls to Icelandic government ministers about illegal transfers turned out to be unfounded. The two Labour politicians needlessly closed down the two British banks owned by Icelanders, both of which turned out to be solvent at the time; and they needlessly invoked an Anti-Terrorism Act against an Icelandic bank, as well as against Icelandic authorities,

whereas adequate measures had already been taken to hinder any illegal transfers from the UK. While Brown accused the Icelanders of illegal actions, his government refused to refer the Icesave dispute to the courts, and both he and Darling almost consistently confused the two Icelandic banks operating in the UK, one of which (KSF) was directly regulated by UK authorities. They were also wrong in asserting that the Emergency Act passed by the Icelandic Parliament on 6 October implied illegal discrimination between Icelandic and British depositors. What the act really did was to discriminate between *all depositors* on the one hand and *other claimants*, such as bondholders, on the other hand. The announcement made by government ministers at the same time that the Icelandic state would guarantee all domestic deposits was similar to announcements made in several other European countries at the height of the financial crisis, such as in Ireland, Denmark, Germany and Greece; it was designed to reduce tension and prevent outright panic and was not in any way legally binding.

An indication of how unusually harsh the treatment of Iceland by the UK Labour government was can be found by comparing it with Germany’s response to the Icelandic crash. In fact, German banks, being the main creditors of Icelandic banks, stood to lose much more money than any British citizens from the Icelandic bank collapse and by the Emergency Act, whereby depositors, including British depositors, gained priority over all other creditors, including German banks. It is estimated that of the total \$46 billion wholesale debt of the Icelandic banks, \$21 billion, or almost half, was owed to German banks.³¹⁹ Many of the German banks extending credit to the Icelandic banks were state banks, *Landesbanken*, located in the various states of the German Federal Republic and usually partly owned by those states. They had traditionally enjoyed guarantees from their respective states, but at the insistence of the European Commission, they lost this privilege in mid-2005.³²⁰ But in the heyday of cheap credit, they had been willing lenders to the Icelandic banks. Moreover, Germany’s largest bank, Deutsche Bank, had often worked on projects with Kaupthing. Just before the credit crunch started in 2007, Deutsche Bank had also financed a leveraged buyout of a drug company

315 IMF Press Release no. 08/256, 24 October 2008. <https://www.imf.org/external/np/sec/pr/2008/pr08256.htm>

316 Agreed Guidelines reached on deposit guarantees, Press Release from the Icelandic Ministry of Foreign Affairs, 17 November 2008. <https://www.mfa.is/news-and-publications/nr/4641>

317 Conference Call with Poul Thomsen, IMF Mission Chief for Iceland and Deputy Director in the IMF European Department, 20 November 2008. <https://www.imf.org/external/np/tr/2008/tr081120.htm>

318 Hansard 6 May 2009, Column 172. <http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090506/debtext/90506-0003.htm>

319 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 46.

320 Edward Taylor, German Banks Lose an Edge, *Wall Street Journal* 14 July 2005. European Commission, 28 February 2002, ip/02/343. http://europa.eu/rapid/press-release_IP-02-343_en.htm

by one of Landsbanki's two main shareholders, Thor Bjorgolfsson. During the crisis it was stuck with this debt, a hefty €4 billion, which was indeed its largest single exposure.³²¹ In Germany, Landsbanki had not started any deposit collection into its Icesave accounts, but the Kaupthing Edge accounts offered in Germany were operated from a branch, not a subsidiary, so that they were covered by the Icelandic Depositors' and Investors' Guarantee Fund (IDIGF), just like the Icesave accounts in the UK.³²² At the end of September 2008, the total amount in Edge accounts in Germany was €532 million.³²³

Thus both Germans banks and German depositors had ample cause to worry about the Icelandic bank collapse. But unlike Gordon Brown and Alistair Darling, German government ministers did not make hostile comments about Iceland as a country, let alone close down Icelandic companies or use an Anti-Terrorism Act against the CBI, the IFSA and an Icelandic bank. There was also a great difference between the refusal, in April to September 2008, of European central banks (including the Bank of England) and the US Federal Reserve Board to provide liquidity to Icelandic banks and the actions directly undertaken against the banks, in early October, by the British Labour government with the apparent aim of bringing them down. Refusing to help someone who is struggling to keep herself afloat is not tantamount to actively pushing her down.

It certainly seems that the actions taken by Prime Minister Brown and Chancellor Darling against Iceland were politically motivated, even if the two of them would probably never admit to this and even if it perhaps could never be conclusively proved. Brown and Darling may have had several intertwined motives. One could be to divert attention from the fact that those two Scottish politicians were using taxpayers' money to rescue two big and not very popular Scottish banks, the RBS and HBOS.³²⁴ The rescue package which Brown and Darling presented on 8 October 2008 was really aimed at those two

banks because they were the ones in grave difficulties. The other big or systemically important British banks, Lloyds, HSBC and Barclays, were much sounder, even if Lloyds came to suffer from having to take on HBOS at the initiative of the Labour government.

A related motive may have been to demonstrate to the many Scottish voters who had been abandoning Labour for the Nationalists that independence certainly could have its own costs. Both Brown and Darling mentioned, in their books already quoted, the slogan coined by the Scottish Nationalists of 'an arc of prosperity' reaching from Ireland through Iceland to Norway, in which Scotland should be included. Brown commented: 'It is an idea that has been fatally undermined by events in Ireland and Iceland.'³²⁵ Darling wrote: 'Iceland, along with Ireland, was part of what Scotland's nationalist first minister, Alex Salmond, liked to refer to as an 'arc of prosperity', to which he yearned to attach Scotland. It was now an arch of insolvency.'³²⁶ The slogan 'arc of insolvency' was actually used immediately after the bank collapse by Labour's Scottish secretary Jim Murphy. 'Look at this arc of prosperity, what some commentators are now calling the arc of insolvency: Iceland, Ireland and Norway,' Murphy told a Sunday newspaper. 'Iceland as a country is on the verge of bankruptcy. Ireland is officially in recession. Ireland [sic] and Norway are trying to borrow from the US and Russia. That's not Scotland's destiny. Scotland isn't Iceland and it shouldn't be Iceland and as long as I'm doing this job, I don't want Scotland to be Iceland.'³²⁷ A headline in *Financial Times* is particularly revealing: 'Smoked Salmond; There is less sense than ever to an independent Scotland.'³²⁸

The Icelandic bank collapse in early October 2008 was water on Labour's mill in Scotland. Less than a month later, a by-election was held in the Scottish constituency of Glenrothes in Fife on 6 November 2008. The seat had fallen vacant when the previous

MP had died in August. Glenrothes, located next to Prime Minister Brown's constituency of Kirkcaldy and Cowdenbeath, had long been a Labour stronghold. Shortly before, however, in July 2008, Labour had lost a traditionally safe seat in East Glasgow to the SNP. Labour's margin in the last election had been higher in East Glasgow than in Glenrothes. Brown, apparently expecting another defeat, had set the election day unusually late, after the conferences of the main political parties and the Trade Union Congress.³²⁹

The election campaign was bitterly fought between Labour and the SNP. In the midst of the campaign, Michael White of the *Guardian* described the issues:

“ Alex Salmond, the first minister, has cited the so-called northern 'arc of prosperity' – from Ireland to Finland via Iceland and Norway as all small countries doing well: we can too, he says. Now things look different. Iceland has gone bust, Ireland has cut spending and raised taxes to pay for its unilateral bank bail-out. Even Norway's famous oil fund has shrunk as stocks, as well as oil prices, tumble. After a Scots columnist coined the phrase 'arc of insolvency' Jim Murphy, the new and keen Scottish secretary, adopted it.³³⁰

The result of the by-election was a surprise. While the SNP had been expected to win the seat, Labour retained it, albeit with a reduced margin. This was widely seen as a triumph for Prime Minister Brown. Political commentator Alex Massie of the *Spectator* wrote: 'Salmond's unfortunate past praise for Iceland came back to make him seem foolish in the extreme, while the government bailouts of HBOS and, in particular, the national champion, RBS dented the idea of Scotland and Scottish success – the kind of tartan brio that was supposed to float all boats upon a nationalist tide.'³³¹

Four years later, in 2012, Alistair Darling, now former Chancellor, officially launched the 'No' campaign before the 2014 Scottish independence referendum,



MEP Daniel Hannan at a meeting in Iceland in the spring of 2013. When the British Labour government in 2008 needlessly invoked an anti-terrorism act against Iceland, Hannan wrote an impassioned article in *The Times* calling it an abuse of power and defending the Icelanders. Photo: ACRE.

and he was one of its leading figures. A major issue in the referendum was the economy. In May 2013 the UK Treasury published a report where much was made of the 2008 bank rescue. It was pointed out that the size of the Scottish banking sector was around 12 times the GDP of Scotland, whereas the size of the Icelandic banking sector before the collapse had been almost 9 times the GDP of Iceland. In the report it was recalled that the UK government spent £45 billion recapitalising RBS, and that in addition the bank received £275 billion of state support in the form of guarantees and funding. This would have been 211% of Scotland's GDP. 'Scotland would not have been to afford such interventions alone. Other countries such as Ireland, Iceland and more recently Cyprus were unable to absorb the implications of the financial crisis on their own.' By contrast, it was also pointed out that the total interventions across the whole banking sector were £1,200 billion or 76% of the whole UK GDP.³³²

Thus, the Icelandic bank collapse proved to be very useful to Labour politicians trying to counter the strong SNP challenge in Scotland: They could

325 Brown, *My Scotland, Our Britain*, p. 281.

326 Darling, *Back from the Brink*, p. 138.

327 Murphy in 'arc of insolvency' attack on SNP, *The Herald* 12 October 2008. http://www.heraldscotland.com/news/12366669.Murphy_in__apos__arc_of_insolvency__apos__attack_on_SNP/ Whereas Murphy was quoted as saying that *Ireland* and Norway are trying to borrow from the US and Russia, he must have meant *Iceland* and Norway: Ireland, a member of the euro zone, did not try to borrow money from Russia.

328 18 October 2008. Here after Daniel Chartier, *The End of Iceland's Innocence: The Image of Iceland in the Foreign Media* (Ottawa: University of Ottawa Press, 2010), p. 52.

329 Iain Watson, Don't expect an early by-election, *BBC News*, 13 August 2008. http://news.bbc.co.uk/2/hi/uk_news/politics/7558533.stm

330 Michael White, 'Insolvency Arc' may influence Scottish poll, *The Guardian* 20 October 2008. <http://www.theguardian.com/commentisfree/2008/oct/20/snp-scotland-salmond-labour-brown>

331 Alex Massie, Glenrothes By-Election Stunner, *Spectator* 7 November 2008. <http://blogs.spectator.co.uk/2008/11/glenrothes-byelection-stunner/>

332 *Scotland analysis: Financial services and banking* (London: HM Treasury, May 2013), pp. 7–8 and 23.

321 Bjorgolfsson, *Billions to Bust*, p. 140.

322 This was also the case in Finland, Sweden, Norway, and Austria. Elsewhere, the accounts were in a subsidiary, in the UK and the Isle of Man, and in Belgium, Luxembourg, Switzerland and Denmark, and covered by the deposit-guarantee schemes of the host countries.

323 SIC Report, Vol. 6, Ch. 18, p. 3 (in English).

324 This explanation was for example suggested by Mark Sismey-Durrant in an interview in London 28 November 2014.

demonstrate the danger for a small nation of not having access to credit facilities in crises.

In addition to the ‘Scotland factor’, a ‘Falklands factor’ may also have been at play. By hitting Iceland hard, Prime Minister Brown and Chancellor Darling achieved the double goal of placating worried depositors and demonstrating their own toughness, with the advantage that there were almost no political risks or costs attached. This was clearly seen at the time. Journalist Adrian Gill who visited Iceland for the *Sunday Times* during the collapse, commented:

“ The act that tipped the last Icelandic bank off the edge of the cliff was delivered by Gordon Brown ... The Icelanders mind that – they’re hurt by that. You see, they always imagined they were one of us, not one of them. But Gordon needed to do something cheap to look competent, so he beat up a smaller kid. Not just a bit of a slap, but a vicious kicking.³³³

It is at least safe to say that if the Prime Minister had had any inkling that a US financial firm collecting deposits in the UK had been or was transferring money to the US in an irresponsible and possibly illegal way, he would not have spoken and behaved in the same way to the US Treasury and the US Federal Reserve as he did to the Icelandic authorities. Indeed, the support for Labour temporarily increased in the midst of the financial crisis and after the harsh measures taken against Iceland.³³⁴

A fifth possible motive behind the treatment of Iceland by the two Scottish Labour leaders may be discernible, in addition to those of diverting attention from the rescue of the two big Scottish banks, demonstrating to the Scots the perils of monetary independence, placating worried depositors and showing firmness at little political risk. This was to improve the bargaining position of the UK against Iceland in the Icesave dispute. The use of the Anti-Terrorism Act was very costly and difficult for Icelandic companies, even if formally it was only directed against Landsbanki and certain Icelandic institutions. This view is supported by the fact that

the UK government did not repeal the Freezing Order until the first Icesave deal had been made and signed in June 2009. If there ever had been any risk of illegal transfers from the UK to Iceland, then surely it had disappeared long before that. For example, the UK government ignored a plea jointly made by all foreign ministers of Nordic countries in early January 2009 to repeal the Freezing Order.³³⁵

Finally, whatever motives drove Prime Minister Brown and Chancellor Alistair Darling in their dealings with the Icelanders, their use of the Anti-Terrorism Act at least showed a great distrust of the Icelandic authorities. The premise in invoking the act was that even the CBI, the IFSA and other Icelandic authorities possibly could be assisting Icelandic banks in transferring assets illegally out of the UK.

It should be noted that a few voices were raised in protest against the treatment of Iceland by the British Labour government. Privately Bank of England Governor Mervyn King, as he told me, expressed his view to government ministers that it was ‘demeaning’ for the UK to behave in this way to a tiny neighbour.³³⁶ Labour MP Austin Mitchell wrote a personal letter to his party leader, Prime Minister Brown: ‘The immediate response of criticising Iceland, invoking anti-terrorist legislation and seizing assets was, in my view, heavy handed, counterproductive and excessive.’³³⁷ Dr. Eamonn Butler of the Adam Smith Institute in his *Daily Telegraph* blog strongly criticised the measures taken against Iceland.³³⁸ Perhaps the most public and impassioned protest came in an article in *The Times* by MEP Daniel Hannan, who argued that the government clearly had abused its powers in its attack on Iceland, ‘until last week perhaps the most Anglophile country in Europe’.³³⁹

335 Kristrun Heimisdottir, Icesave og umsomdu vidmidin [Icesave and the Agreed Guidelines], *Morgunblaðid* 13 August 2009.

336 Interview with Mervyn King in Petham Oast 14 August 2017. Lord King explicitly allowed me to quote him on this.

337 Austin Mitchell to Gordon Brown 17 October 2008, copy sent to a few Icelandic leaders. The letter was not made public.

338 Eamonn Butler, Financial crisis: an open letter to the people of Iceland (2008), http://blogs.telegraph.co.uk/news/eamonnbutler/5467827/Financial_crisis_An_open_letter_to_the_people_of_Iceland/

339 Daniel Hannan, Gordon Brown’s raid on Iceland was cowardice, not courage, *The Times* 15 October 2008.

333 Adrian A. Gill, Iceland: Frozen Assets, *Sunday Times* 14 December 2008. <http://agbjarn.blog.is/blog/agbjarn/entry/744252/>

334 Stephen D. Fisher, Issues in national politics, *European Journal of Political Research*, Vol. 48 (2009), pp. 1133–39. <http://onlinelibrary.wiley.com/doi/10.1111/j.1475-6765.2009.01894.x/full>

FIVE LESSONS FROM THE ICELANDIC BANK COLLAPSE

The main conclusion of this report is that the explanation of the 2008 Icelandic bank collapse provided in the 2010 SIC Report is not as much wrong as incomplete. It is true what the SIC observes that the Icelandic banks grew too rapidly and far beyond what, in a crisis, the CBI and the Icelandic Treasury could support. But while the size of the banks was a *necessary* condition for the collapse of the whole banking sector, it was not a *sufficient* one. The Icelandic banking sector certainly was vulnerable, but something had to happen so that it would fall as a whole. This something was the international financial crisis, but more precisely it turned out to be a set of decisions made abroad: a consensus was formed among European central bankers in spring 2008 that Icelandic banks ought not to be provided with the same assistance as other banks within the EEA. The US, previously Iceland’s powerful ally, had lost interest in the country and did nothing to help her in the hour of need, in the summer and autumn of 2008. In October 2008 the British Labour government closed down two British banks owned by Icelandic banks, Heritable and KSF, at the same time as it offered all other British banks a rescue package of £500 billion. As a result loan covenants were triggered so that KSF’s parent company, Kaupthing, fell as the last of the Icelandic banks. Adding insult to injury, the Labour government also needlessly used an Anti-Terrorism Act against Iceland – a NATO ally that does not even maintain her own military – not only against Landsbanki, but also Icelandic authorities. This report should, however, not be interpreted as an attempt to shift all blame for the collapse from the Icelandic banks, their owners, managers and major clients. Their recklessness and, in some cases, disregard of laws, rules and propriety, is well documented in the SIC report. It is extraordinary, for example, how the business group led by media mogul Jon Asgeir Johannesson could accumulate debts amounting to €5.5 billion – almost a trillion Icelandic

kronur – in the Icelandic banks. This created an unacceptable risk for the banks. It is also astonishing how this very group, as soon as it gained control over Glitnir in spring 2007, was able to borrow almost at will and practically empty the bank from the inside, as described in detail in the SIC Report.³⁴⁰ While other business groups also sometimes acted aggressively and irresponsibly, they did not go nearly as far as Johannesson’s group.

However, the behaviour of Icelandic bankers has to be put into perspective. They were probably no worse and no better than bankers elsewhere. There is ‘no evidence that the asset quality of the Icelandic banks – despite some missteps in connected party lending – was any better or worse than for comparable European banks,’ finance professors Asgeir Jonsson and Hersir Sigurgeirsson write.³⁴¹ Certainly some banks that could draw on a much longer tradition of banking than the Icelandic ones – such as in Scotland and Switzerland – encountered severe troubles during the financial crisis. It is ironic that some harsh critics of the Icelandic banks worked for other banks – such as Danske Bank, Bear Stearns, RBS, and Merrill Lynch – which did not do any better except that some of them were rescued with taxpayers’ money, not least with dollars from the US Federal Reserve Board. It is also ironic that the British Labour government put Landsbanki on its online list of organisations under economic sanctions with Al-Qaida, the Taliban and the governments of North Korea and Sudan, while it rescued big banks that since have had to pay hefty fines for money laundering and violations of economic sanctions.

340 Such behaviour was of course not confined to Iceland: William K. Black, *The Best Way to Rob a Bank is to Own one: How Corporate Executives and Politicians Looted the S & L* (Austin: University of Texas Press, 2014).

341 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 18.

Professor Asgeir Jonsson, Chairman of the Economics Faculty at the University of Iceland, and his co-author, Professor Hersir Sigurgeirsson, also an expert on finance, conclude in a 2017 book that probably the assets of the Icelandic banks were no worse, or no better, on average than the assets of banks abroad. According to their calculations, the Icelandic Treasury even may have made a net gain from the collapse. Photo: University of Iceland.



Thorough investigations of the Icelandic banks after the bank collapse have uncovered some questionable and even illegal manoeuvres of the bankers. But they have not substantiated any of the allegations made in the autumn of 2008 by British government ministers against the banks. There does not seem to be any causal connection, either, between such isolated misdemeanours and the collapse of the Icelandic banking sector. These misdemeanours mostly consisted in desperate attempts by some bankers and their customers to survive the credit crunch by market manipulation, instead of being about intentional direct private gain or embezzlement. Moreover, it should be recalled that what happened to other bankers in 2007 and 2008 – suddenly finding themselves deprived of most wholesale funding – had already happened to Icelandic bankers in 2006 and 2007. The difference was that the Icelanders survived a year or two longer than the others. Arguably, the Icelandic bankers were quite imaginative and resourceful from 2006 to 2008, after they had practically been deprived of access to funding in European markets. Knowing of the limited

resources of the CBI, they obtained funding in the US for a while, started collecting retail deposits in Europe and issued securities on one another, which they then used to obtain credit at the ECB. They have been judged harshly because they went under, even if they made what could be considered to be a valiant effort to survive. ‘Success has a hundred fathers, but failure is an orphan.’

Neither should this report be interpreted as an attempt to discredit the members of the SIC. There is little reason to doubt their good faith. They may have had some biases, but such biases were hardly intentional. They would be more a result of the small size and closeness of Icelandic society, where it is difficult to distance oneself from one’s past or one’s circle of family, friends and colleagues. In Iceland there is always a danger to lapse into parochialism, and this is what the SIC did. It did only fleetingly treat the 2008 bank collapse as a part of a severe international crisis. Also the SIC members had limited, if any, first-hand experience of banking or other kinds

of business. They did not see the wood for the trees, concentrating on individuals and their activities rather than on the systemic failure of the European banking system, of which the Icelandic banking sector was only a part. This European system was over-extended, without a plausible lender of last resort for all EEA member states and without a credible common scheme of deposit insurance. In Iceland, as elsewhere, individuals were acting under constraints that were not of their own making, and they participated in a chain of events over which none of them had any control. The parochial approach in the SIC Report may be contrasted, for example, with the reports by Kaarlo Jännäri on the Icelandic bank collapse and by the Rangvad Commission on the Danish bank crisis, and other similar reports: their authors stress the international nature of the crisis without exempting local bankers from blame.³⁴²

The Icelandic banking sector collapsed, not necessarily because it was unsustainable in itself (no more than their Swiss or Scots counterparts), but because nobody came to its rescue in a severe international crisis. In retrospect, it was a blessing in disguise: Iceland could scale down her banking sector, whereas some other European countries are saddled with debt created by bank bailouts. It is perhaps foolhardy to try and write hypothetical history. But if the Bank of England, the ECB and the Federal Reserve Board had followed in the footsteps of the three Scandinavian banks and in the spring of 2008 made currency swap deals with the CBI as they easily could have done, and if the British government had treated the two British banks owned by Icelanders like it treated all other British banks, then the CBI might have had the ability to meet the repeated attacks of hedge funds, like the Hong Kong Monetary Authority successfully did in August 1998.³⁴³ Then the CBI and the Icelandic government perhaps could have implemented the ‘Swedish solution’ of 1992 to financial crises, at least partly: to recapitalise the banking sector; and to nationalise, restructure and then sell off the banks. Then the crisis would not have turned into a collapse.

342 An extract in English of the already quoted Rangvad Commission Report is online, <http://em.dk/english/news/2013/18-09-13-the-financial-crisis-in-denmark>. A longer version is available in Danish.

343 Paul Krugman, *The North Atlantic Conspiracy*. Blog 31 March 2008. <https://krugman.blogs.nytimes.com/2008/03/31/the-north-atlantic-conspiracy/>

If some lessons are to be learned from the 2008 bank collapse, then one would be that decisive leadership at the helm of the CBI was crucial. As already noted the CBI governors were the first people in authority to realise and warn against the vulnerability of the banks, even if they had very limited manoeuvring room. It was the CBI that suggested to the bankers that Kaupthing should move abroad, that Glitnir should sell its Norwegian bank and that Landsbanki should transfer the Icesave accounts from a branch to a subsidiary.³⁴⁴ It was the CBI that in February 2008 invited financial expert Andrew Gracie from the Bank of England to visit and evaluate the danger of a bank collapse.³⁴⁵ It was the CBI that quietly prepared a plan, in the final stages with the help of a special liquidity crisis task force, for ring-fencing Iceland, defining four lines of defence in decreasing order of importance: the sovereign, the payment system, depositors and other bank creditors and bank shareholders.³⁴⁶ It was the CBI which, in the midst of the crisis, invited financial expert Marc Dobler from the Bank of England to Iceland to help with the plan of dividing up the banks into domestic and foreign parts.³⁴⁷

When the Social Democrats on Saturday 4 October 2008 categorically rejected a proposal by Prime Minister Geir H. Haarde to appoint a special crisis team led by CBI Governor Oddsson and seemed to be ready to split the coalition because of it, the CBI did not give up, but sent for financial analysts from JP Morgan. The leading Independence Party ministers were already convinced that the only way to tackle the imminent collapse was by ring-fencing. But in the early hours of Monday 6 October, the JP Morgan experts managed to convince the ministers from the Social Democrats that it was now inevitable to give up trying to save the banking sector and that instead the authorities should move to ring-fence Iceland.³⁴⁸ The very same day the Emergency Act was passed by Parliament. It had the intended effects: the sovereign did not

344 The evidence is in the SIC Report, all in Vol. 6, Ch. 19. On a Kaupthing move, pp. 122 and 124; on the transfer of the Icesave accounts, p. 124; on the sale of the Norwegian bank, pp. 256–7.

345 SIC Report, Vol. 7, Ch. 21 (in English), p. 138; SIC Report, Vol. 6, Ch. 19, p. 133.

346 Ibid., Vol. 7, Ch. 21, p. 81 (in English). Alongside the three CBI governors, Sturla Pálsson of the CBI and Ragnar Onundarson of the Special Liquidity Crisis Task Force apparently played a particularly important role in designing the ring-fencing plan.

347 Ibid., Vol. 7, Ch. 20, pp. 120–121.

348 Ibid., Vol. 7, Ch. 20, pp. 103–105. Cf. Bjorgvin G. Sigurdsson, *Stormurinn* (2010), pp. 49–52.

default, and the domestic depositors did not panic. In the following weeks the staff of the CBI, IFSA and the Icelandic Financial Service Centre (RB), alongside volunteers from the fallen banks, worked day and night to maintain the payments system, performing what amounted almost to a miracle.

Some might discern contradictions in the remarks above. One contradiction would be between stating the case for the Icelandic bankers on the one hand and praising the CBI governors on the other hand. Were not either the bankers or the CBI governors right, and did not the CBI governors eventually turn out to be right in their scepticism about the sustainability of the banking sector? But this is a paradox and not a contradiction. Both groups were working under conditions of radical uncertainty, a notion that former Bank of England Governor Mervyn King plausibly regards as crucial to understand financial instability.³⁴⁹ Were the banks sustainable, or were they not? A plausible answer is: it depends. Their assets were not worth much if they did not have access to liquidity, whereas they might have survived otherwise, like banks with similar assets in other countries. Under conditions of radical uncertainty, both hypotheses, that they were sustainable and that they were not, might have been plausible at certain points in time.

Some financial experts, including Professors Frederic Mishkin and Richard Portes, claimed that the Icelandic banking sector was essentially sound;³⁵⁰ other financial experts, including Professors Robert Z. Aliber and Willem H. Buiter, regarded it as unsustainable.³⁵¹ But the views of Portes and Mishkin cannot be dismissed simply because things did not turn out the way they expected. After all, neither Aliber nor Buiter foresaw the well-planned attacks of hedge funds on Iceland, the concerted refusal by central banks in Europe and North America to assist the CBI, the close-down of the Icelandic-owned banks in the UK or the use by the British government of an Anti-

Terrorism Act against Iceland. Aliber has predicted the exit of Greece from the euro since 2009, but at the time of writing, in late 2017, she remains a part of the eurozone.³⁵²

With the wisdom of hindsight, it has been argued that the efforts by the CBI governors to obtain liquidity abroad for the banks were futile because they were not only illiquid, but also insolvent so that a stronger lender of last resort (perhaps the US Federal Reserve Board, the Bank of England, the ECB and the Scandinavian banks acting jointly with the CBI through currency swap deals) would not have made a difference.³⁵³ In support of this it is pointed out that for general creditors of the Icelandic banks, such as bondholders, the recovery rate of senior unsecured claims is estimated to be 29%, whereas according to a study from 2007, the recovery rate of such claims for US financial institutions from 1982 to 1999 is estimated to be 59%.³⁵⁴

There are several reasons why such a comparison is highly misleading.³⁵⁵ First, by the Emergency Act all deposits in Icelandic banks, foreign and domestic, were made priority claims, whereas in the US until 2008 only domestic deposits for up to \$100,000 were insured. Of the €19.3 billion in insured deposits in the Icelandic banks, it would be plausible to assume that only half would have been insured under the US scheme. This just by itself would have raised the recovery rate of senior uninsured debt from 29% to more than 40%.

Second, what was done in Iceland was to divide up the banks into ‘old banks’ that were put into resolution

352 Shawn Tully, A Great Economist and Euro-fan Turns Negative on the Region, *Fortune* 4 November 2013. <http://fortune.com/2013/11/04/a-great-economist-and-euro-fan-turns-negative-on-the-region/>

353 Sigrídur Benedíksdóttir, Gauti B. Eggertsson, and Eggert Thorarínsson, *The Rise, the Fall, and the Resurrection of Iceland: Brookings Papers on Economic Activity* (Washington DC: Brookings Institute, 7–8 September 2017).

354 The study to which the authors refer is Viral V. Acharya, Sreedhar T. Bharath and Anand Srinivasan, Does industry-wide distress affect defaulted firms? Evidence from creditor recoveries, *Journal of Financial Economics*, Vol. 85 (3: 2007), pp. 787–821. In a more recent study, Nada Mora arrives at a different figure for the recovery rate of US financial institutions (not only banks) in 1970–2008: 24.6%, What Determines Creditor Recovery Rates? *Federal Reserve Bank of Kansas City Economic Review* (2: 2012), Table 1, p. 86. It is likely that the recovery rate of banks alone would be somewhat higher than Mora’s figure, as banks are typically senior creditors. There is, nevertheless, much difference between 59% and 24.6%.

355 In their paper, Benedíksdóttir, Eggertsson and Thorarínsson indeed recognise this, for some of the reasons pointed out here. They say that the 29% estimate quoted by them could be regarded as a lower limit for the recovery rate. But then it is somewhat disingenuous to make much use of it as an argument for the supposed insolvency of the banks.

and ‘new banks’ that started operating with deposits and assets transferred to them from the old ones. In the next few years the new banks flourished, despite adverse economic conditions in the beginning and court decisions against currency-indexed loans that led to a massive reduction of debt. The fact that they flourished suggests either that the assets transferred to them were on the whole more valuable than those remaining in the old banks, or that the total assets of the banks, old and new, were more valuable than had been officially calculated, with the difference that the assets of the new banks were not sold under adverse conditions. Either way the division into old and new banks was a factor in reducing the official recovery rates of the three old banks.

Third, and crucially, recovery rates depend on the state of the economy. They would be much lower in a depression than in an expansionary period. According to one study, the difference between the average recovery rates for failed US banks before and in a depression – from 1920 to 1927 on the one hand and in 1934 on the other hand – was more than 10%.³⁵⁶

Fourth, what Iceland saw was not only an economic depression in which some banks fail and others survive, but the total collapse of the banking sector, subsequently leading to numerous bankruptcies of bank debtors, some of which would otherwise not have taken place. The greatest losses incurred by the Icelandic banks were when they had lent to holding companies against shares as collateral. Some of those companies undoubtedly were empty shells, and even fraudulent entities, but others may have been quite tenable. This is suggested by the rapid recovery of the Icelandic economy.

Finally, fire sales significantly lower recovery rates. To see this, one needs only compare the sales of some foreign assets of the fallen banks. Where the resolution process was somewhat orderly, as in the cases of Heritable and KSF in the UK, the recovery rates of senior unsecured claims were 98% and 87% respectively,³⁵⁷ which means that those banks were practically solvent and that what was lost was only

356 Rodney Ramcharan and Raghuram Rajan, Financial Fire Sales: Evidence from Bank Failures, Staff Paper, Federal Reserve Board, 2014-67, p. 46, Table 4.

357 On Heritable Bank, *Twentieth progress report to all known creditors* (London: Ernst & Young, 10 March 2016); On KSF, *Kaupthing Singer & Friedlander Limited (in Administration)*. Ernst & Young report from 8 October 2016 to 7 April 2017 (London: Ernst & Young, 2017).

the value of the ongoing concern (which presumably would be more than book value of equity), in addition to the enormous cost of resolution. But where fire sales were forced on the estates of the fallen banks, as in the cases of Glitnir Bank in Norway and FIH Bank in Denmark, 80–90% of the real value of the assets were lost.

Another apparent contradiction in this report is that on the one hand the SIC is criticised for concentrating on individual responsibility instead of using the powerful analytical tools of unintended consequences and prisoners’ dilemmas to explain the Icelandic bank collapse, while on the other hand it is claimed that decisions made abroad brought the collapse about and that decisive leadership was subsequently crucial in saving the Icelandic economy from disaster and salvaging the remainder of the banking sector. But this is again a paradox rather than a contradiction. The most plausible systemic account of the bank collapse is that the operational field of the Icelandic banks was the whole of the EEA, whereas their institutional support remained tiny, vulnerable Iceland. This allowed the banks to grow much larger than the CBI and the Icelandic Treasury could back financially on their own. But this may be regarded as more of a description of the situation than an explanation for what happened. Into that situation entered decisions and personalities that made a difference, both in turning a foreseeable economic crisis into a collapse and then in responding to it. While systemic explanations usually are intellectually more satisfying than storytelling, within institutions individuals matter. As Karl R. Popper observes: ‘Institutions are like fortresses. They must be well designed and properly manned.’³⁵⁸

To foreigners it must be puzzling why Governor Oddsson’s repeated warnings went unheeded in Iceland. Previously, as a political leader, Oddsson had enjoyed unparalleled support and trust. Mayor of Reykjavík from 1982 to 1991, he had thrice led the Independence Party to victory in municipal elections in the capital, each time increasing the party’s proportion of the votes. As Prime Minister from 1991 to 2004, he had been able to form coalitions both with the Social Democrats and the Progressives. He was and remains Iceland’s longest-serving head

358 Karl R. Popper, *The Open Society and Its Enemies*, Vol. II (London: Routledge and Kegan Paul, 1945), p. 126.

The three main lessons for Europe from the Icelandic bank collapse are (1) that it does not necessarily spell disaster to allow banks to fail, and (2) that it may be prudent to establish depositors' priority in the estates of banks, but also and consequently (3) that government guarantees of deposits should be abolished. Photo: Adobe Stock.



of government, both continuously and absolutely. Usually a person with such a distinguished past would be treated with respect, not only by his fellow Independents, but also by supporters of other parties. This seemed indeed to be the case in 2005 when Oddsson was appointed CBI governor and both Steingrímur J. Sigfússon of the Left Greens and Óssur Skarphedínsson of the Social Democrats publicly observed that a man who had been in charge of economic affairs for more than 13 years as Prime Minister had to be qualified as CBI governor.³⁵⁹

By 2008, however, Oddsson had become a voice in the wilderness. One reason for this paradox probably lies in the relentless campaign that the media controlled by Jon Asgeir Johannesson had conducted against him for years. Many were ready to believe, for example, that Oddsson had somehow ordered the police investigations of Johannesson's activities. It is telling that British banks withdrew from business deals with Johannesson in 2002,

359 Heilmikil tímamót [Quite a Turning Point], *Morgunblaðið* 8 September 2005 (interview with Steingrímur J. Sigfússon); *Saddur politískra lífdaga* [Having Fulfilled his Political Ambitions], *Frettablaðið* 9 September 2005 (interview with Óssur J. Skarphedínsson).

after he had been put under police investigation, and again in 2005, after he had been charged by the Icelandic authorities, whereas Icelandic banks were happy to continue working with him in both instances. The hostility that leading Social Democrats showed to Oddsson both before and during the bank collapse can hardly be explained only by old political rivalries, which are usually set aside during a national emergency. To some extent it may have been brought about by the media campaign against his person. As Ovid observed: *Gutta cavat lapidem*. The drop hollows the stone.

A second important and general lesson from the Icelandic bank collapse is that it does not necessarily spell disaster to eschew bank bailouts. Iceland is an example of a country that refrained from bailing out banks, out of necessity rather than virtue, but she recovered quickly and as of late 2017, is flourishing. The main reason has already been noted. The Icelandic economy rests on four strong pillars: profitable fisheries, ample energy resources, accumulated human capital and booming tourism. Financial services are crucial to a well-functioning market economy, but a strong case has been made that the financial sector in Europe has grown too

large; that it is not always producing anything of value, no more than the alchemists of a bygone age; that it has become an industry trading with itself, talking to itself and judging itself by reference to self-created standards.³⁶⁰ In Iceland, this sector was radically scaled down as a result of the bank collapse, whereas in the rest of Europe it remains a great potential burden. It may be argued that the 'Icelandic model' is not fully applicable to other countries, because in Iceland depositors were mostly Icelandic and the bondholders mostly foreign, which meant that the measures made under the Emergency Act did not meet significant political resistance.³⁶¹ But that is an argument about political, and not economic, feasibility. As has frequently been observed, it is a strange situation where the banks and indirectly their bondholders have such political power that they can in good times pocket the profits, while in bad times they can pass on the losses to taxpayers. The unethical conduct that was witnessed before, during

360 King, *The End of Alchemy*; Martin Wolf, *The Shifts and the Shocks: What we've learned—and have yet to learn—from the financial crisis* (London: Penguin books, 2014); John Kay, *Other People's Money: Masters of the Universe or Servants of the People* (London: Profile Books, 2016).

361 Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, pp. 20–21.

and after the financial crisis was 'largely a response to perverse incentives imposed by lax government economic policy and strong regulation.'³⁶²

A third possible general lesson from the Icelandic bank collapse has actually been widely accepted in Europe. It is to give priority to the claims of depositors over those of other creditors, such as bondholders, as Iceland did by the 2008 Emergency Act. Depositor preference had already been in place in the US since 1993, but it had elevated the claims of domestic depositors on the assets of a failed bank over the claims of foreign depositors and general creditors, whereas the Icelandic Emergency Act had given priority to *all* depositors, foreign and domestic.³⁶³ Since the 1930s, Switzerland also has given preference to depositors over other bank creditors, but only up to the level now guaranteed, CHF 100,000. Deposits in foreign branches are also included. Deposits are guaranteed not by government, but by a scheme

362 Elaine Sternberg, *Ethical Misconduct and the Global Financial Crisis*, *Economic Affairs*, Vol. 33, No. 1 (2013), pp. 18–33.

363 James A. Marino and Rosalind L. Bennett, *The Consequences of National Depositor Preference*, *FDIC Banking Review*, Vol. 12 (1999), pp. 19–38.

based on the self-regulation of Swiss banks.³⁶⁴ The EU Council (the EU heads of government) agreed in June 2013 to draft a directive that would give preference to depositors. It was ‘aimed at transposing into EU law commitments made at the G20 summit in Washington DC in November 2008, when leaders called for a review of resolution regimes and bankruptcy laws’.³⁶⁵ The EU Bank Recovery and Resolution Directive (BRRD) from 2014, coming into force in the beginning of 2017, ensures that deposits eligible for compensation are treated as preferential debts and also that such eligible deposits are given a higher priority within the class of preferential debts than other deposits.³⁶⁶ As a member of the EU, the UK has implemented depositor preference, somewhat ironically after having invoked an Anti-Terrorism Act against Iceland for doing the same some years earlier.³⁶⁷

One general reason for preferential treatment of depositors is of course political. They are a much larger political constituency than bondholders. A related argument is perhaps theoretically more attractive. Economic and political stability requires that those who save money and keep it in banks can rest assured that they are not taking excessive risks. Some economists also argue that depositor preference – which in turn leads to greater tendency of bank creditors to take collateral for their loans – may work to reduce the cost of settling creditor conflicts in the case of resolution or bankruptcy; for operating banks, the two factors eventually may increase the real value of banks and consequently reduce funding costs and thus also the probability of distress.³⁶⁸

However, an important additional and related lesson from the Icelandic bank collapse – the fourth lesson

found in this report – apparently has not been learned or even noticed. If depositors are given priority over other creditors in the case of bank failures, then a comprehensive government-guaranteed depositors’ compensation scheme for banks does not seem to be necessary. The depositors would be compensated out of the estates of fallen banks, as was the case in Iceland. Depositors’ guarantee schemes would not be a potential burden on taxpayers, and instead self-regulating, as in Switzerland. In this matter the EU has, however, gone in the other direction after the international financial crisis, establishing government-guaranteed depositors’ compensation schemes.³⁶⁹ Generally speaking, the attempt to reduce risk by increased regulation, or by casting all financial institutions in the same mould, may actually increase risk. It is the heterogeneity of financial firms that disperses and thus reduces risk.

A fifth general lesson from the 2008 Icelandic bank collapse is about the old truth that discretionary power, once created, is liable to be abused. It was hardly the intention of the legislators passing the 2001 Anti-Terrorism Act in the UK that it could be used, without any obvious or pressing need, for domestic political purposes or to try and starve a small, friendly neighbouring country – so powerless that she does not even maintain a military – into compliance with demands that she should guarantee possible losses from private transactions for profit between some of her citizens and some British citizens. Prime Minister Brown’s and Chancellor Darling’s use of the Anti-Terrorism Act against Iceland was politically motivated, and, therefore, a blatant abuse of the weapon that had been constructed for them to defend the British Realm against real threats. Great Britain has rightfully been held up to the rest of the world as a country based on the venerable traditions of the rule of law and respect for individuals.³⁷⁰ ‘Herein, indeed, consists the excellence of the English government, that all the parts of it form a mutual check upon each other,’ English legal philosopher William Blackstone wrote.³⁷¹ In this case, alas, the checks did not work.

364 *Protection of bank deposits. Fact Sheet* (Bern: Finma, Swiss Financial Market Supervisory Authority, 17 June 2013). In 2011, only three major countries allowed depositor preference to extend to deposits in foreign branches of banks, Australia, Switzerland and Russia, according to a report by Christopher Bates, *Depositor preference in the G20* (London: Clifford Chance, September 2011).

365 Council agrees position on bank resolution (Brussels: Council of the European Union, 27 June 2013).

366 Bank Recovery and Resolution Directive 2014/59/EU. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059>

367 Banks and Building Societies (Depositor Preference and Priorities) Order 2014 (SI 2014/3486, in force since 1 January 2015).

368 Daniel D. Hardy, *Bank Resolution Costs, Depositor Preference, and Asset Encumbrance*, IMF Working Paper 13/172 (Washington DC: IMF, 2013).

369 For example, Bank Recovery and Resolution Directive 2014/59/EU, Ch. 4, Section 1, Art. 37, No. 10, says: ‘In the very extraordinary situation of a systemic crisis, the resolution authority may seek funding from alternative financing sources through the use of government stabilisation tools.’

370 Daniel Hannan, *Inventing Freedom: How the English-Speaking Peoples Made the Modern World* (New York: Broadside Books, 2013).

371 William Blackstone, *Commentaries on the Laws of England*, Bk. 1 (London: John Murray, 1873), p. 25.

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Aliber, Robert Z., and Zoega, Gylfi, eds., *Preludes to the Icelandic Financial Crisis* (New York: Palgrave Macmillan, 2011). Collection of reports and papers published by economists before the collapse. While it purports to show that some of the authors foresaw the collapse, it does the opposite: The economists worried about macroeconomic imbalances, but none of them foresaw the refusals of European and US central bankers to assist the CBI in providing liquidity to the Icelandic banks, or the close-down by the British government of Icelandic-owned banks in the UK, or its use of an Anti-Terrorism Act against Iceland.

Bagus, Philipp, and Howden, David, *Deep Freeze: Iceland’s Economic Collapse* (Auburn AL: Ludwig von Mises Institute, 2011). By two economists of the Austrian School. Supposedly an ‘Austrian’ analysis of the collapse, but suffers from the authors’ almost total ignorance of Icelandic history and society, which leads them to commit several egregious errors.

Bergmann, Eiríkur, *Iceland and the International Financial Crisis: Boom, Bust and Recovery* (Basingstoke: Palgrave Macmillan, 2014). By a prolific political scientist and frequent commentator in Iceland on current affairs. Analyses public discourse in Iceland in the period leading up to the collapse.

Björgolfsson, Thor, *From Billions to Bust—And Back* (London: Profile Books, 2014). By one of the two major shareholders in Landsbanki before the collapse. Mainly an account of his business activities in general, but with useful corrections of some misconceptions about the Icelandic banks.

Boyes, Roger, *Meltdown Iceland: How the Global Financial Crisis Bankrupted an Entire Country* (London: Bloomsbury, 2009). By a British journalist and frequent visitor to Iceland. Readable and lively, but unreliable, full of gossip fed to the gullible author by his left-wing acquaintances in Iceland.

Durrenberger, E. Paul, and Pálsson, Gisli, eds., *Gambling Debt: Iceland’s Rise and Fall in the Global Economy* (Boulder CO: University Press of Colorado, 2015). Collection of papers by academics, almost all strongly left-wing, who use the opportunity to insert the bank collapse into their already existing narratives on Icelandic society, while relying on the SIC Report for the occasional bits of data provided.

Hreinnsson, Páll, Benediktsdóttir, Sigrídur, and Gunnarsson, Tryggvi, Report of the Special Investigation Commission (SIC) on the bank collapse (Reykjavik: Icelandic Parliament, 2010). Despite its flaws, the SIC Report is a mine of information. Chapters 2, 17, 18 and 21 are also published in English. In particular, Chapters 17 and 18, on deposit collection abroad by the Icelandic banks and deposit insurance in general, are informative, well-researched and convincing.

Johnsen, Gudrun, *Bringing Down the Banking System. Lessons from Iceland* (London: Palgrave Macmillan, 2014). By a former financial analyst for the SIC. With a confusing structure, and many surprising errors or omissions, as I point out in my review in *European Political Science*, Vol. 15, No. 1 (March 2016), pp. 138–142.

Jonsson, Asgeir, *Why Iceland? How One of the World’s Smallest Countries Became the Meltdown’s Biggest Casualty* (New York: McGrawHill, 2009). By Kaupthing’s former Chief Economist. One of the best early books on the collapse, not flawless, but full of historical insights and offering a sound economic analysis.

Jonsson, Asgeir, and Sigurgeirsson, Hersir, *The Icelandic Financial Crisis: a Study into the World’s Smallest Currency Area and Its Recovery from Total Banking Collapse* (Basingstoke: Palgrave Macmillan, 2016). By two Icelandic experts on finance. A thorough and well-researched work on the cost and consequences of the collapse.

Thorvaldsson, Armann, *Frozen Assets: How I Lived Iceland’s Boom and Bust* (London: Wiley 2009). By the former manager of KSF, Kaupthing’s London subsidiary. Witty, self-deprecating, and personal, but offering a serious analysis of the collapse.



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