

## Chapter 21

# Causes of the Collapse of the Icelandic Banks - Responsibility, Mistakes and Negligence

## 21.1 Introduction

The aim of this report is to portray as comprehensively as possible the events that lead to the collapse of the banks and seek to answer what caused their failure. In this Chapter, the main conclusions of the Special Investigation Commission (SIC), already discussed in previous Chapters, are summarised. It must be reiterated that this is only a summary and therefore drawing wide conclusions on this chapter alone may present difficulties.

Hereunder, the SIC will begin by discussing certain aspects of the operations of the Icelandic banks which it considers the main causes for their failure in the autumn of 2008. Thereafter, the SIC adverts to the performance of government functions during the events leading to the failure of the banks, and draws further conclusions from specific aspects of it. Finally, the SIC recounts its assessment and findings regarding mistakes and negligence within the meaning of Article 1(1) of Act No 142/2008 concerning the implementation of laws and rules on the regulation and control of financial activities in Iceland.

## 21.2 Financial Markets in the Run-up to the Collapse of the Icelandic Banks

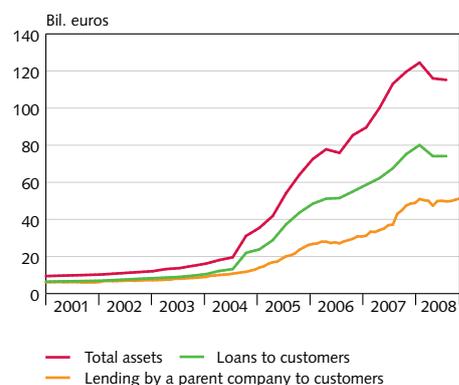
### 21.2.1 Main Reasons

#### 21.2.1.1 Growth of the Banking Industry and Credibility

Explanations for the collapse of the banks Glitnir, Kaupthing Bank and Landsbanki are first and foremost to be found in the rapid growth of their balance sheet, and hence their size at the collapse. At the turn of the century, the Icelandic banks mainly served Icelandic parties with regard to their business-related activities in Iceland. At that time, the financial position of the three big banks amounted to just over one year's gross domestic product in Iceland. As the first decade of the 21st century wore on, the foreign operations of the banks grew rapidly, both due to services rendered to Icelandic parties with increased foreign activities, and as to foreign entities that were independent of the Icelandic economic environment. The nature of the banks' activities also changed a great deal since investment banking became an ever more important part of their operations. Up until then, they had concentrated their activities on traditional commercial banking. The financial position of the banks grew rapidly. At the end of 2007, the three big banks had become international banks with total assets amounting to ninefold gross domestic product of Iceland.

The Special Investigation Commission (SIC) is of the opinion that the balance sheets and lending portfolios of the banks had grown beyond their own control and infrastructure.

Figure 1  
Aggregate size of the three big banks



Reference: The Central Bank of Iceland, Glitnir banki hf, Kaupthing banki hf and Landsbanki Íslands hf.

The rapid growth of the banks really started in 2003. At the end of that year, the privatisation of the state-run banks was finalised. That same year, Kaupthing and Bunadarbanki merged. When considering the growth of banks it is important to distinguish between internal and external growth. The internal growth of banks is mainly due to growth in existing activities; the bank itself makes more loans and thereby increases its loan portfolio. On the other hand, external growth comes from buying assets, often in the form of banks or other entities. That way an existing portfolio and operation is acquired, which support the original operation. The risk associated with acquisitions is that too high a price is paid for the acquired asset, whereas the risk associated with internal growth is of a different nature. As stated by Mark Flannery in Annex 3 to this report, the risk of rapid internal growth is that the quality of the loans decreases and the management and supervision of the loans becomes poorer. That can lead to a rise in the number of non-performing loans or defaults within a few years. In Table 1 the aggregate growth of the three big banks is divided into internal and external growth. The Table shows that there was substantial external growth in the years 2004 and 2005. During those years Kaupthing acquired the Danish bank FIH Erhvervsbank and the British bank Singer & Friedlander. Glitnir acquired the Norwegian bank BN Bank. Also, during those years, the internal growth of the banks was bigger than ever, in percentage terms, but when measured in ISK, the year 2007 saw the biggest growth. The internal growth during all those years, up until 2008, was considerable.

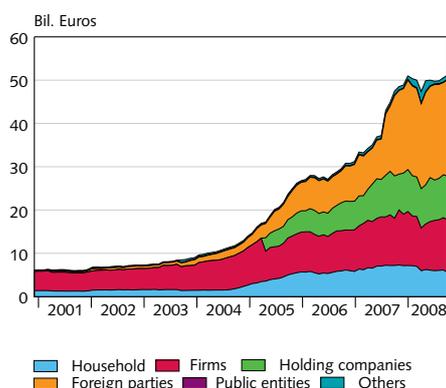
Table 1. Aggregated growth of the three banks

Year	2003	2004	2005	2006	2007	2008 <sup>1</sup>
Total Assets at year end (bln ISK.)	1,451	2,946	5,419	8,475	11,354	14,437
Assets Bought (bln. ISK)		834	726	34	26	0
External Growth (%)		57.5	24.7	0.6	0.3	0.0
Changes in assets due to cur. fluctuations (bln. ISK))		-51	-203	1,068	-231	3,302
Organic Growth (bln. ISK)		713	1,949	1,954	3,084	-219
Organic Growth (%)		49.2	66.1	36.1	36.4	-1.9
Organic Real Growth (%)		43.5	59.5	27.2	28.8	-10.0

1. 1End of second quarter.

Source: Glitnir banki hf., Kaupþing banki hf. og Landsbanki Íslands hf.

Figure 2  
 Lending by the three big banks  
 Classified by borrowers



Reference: Central Bank of Iceland.

Figure 2 shows the lending of the three big banks' parent companies, classified by type of borrowers. The lending by the parent companies amounted usually to 50-60% of all lending by the banking groups from mid-2004. As can be seen, there was substantial growth in loans to Icelandic firms with operating income and, measured in EUR, that growth was quite steady during the period.<sup>1</sup> Lending to domestic private households increased sharply in the autumn of 2004 when all the big banks started competing with the state-owned Housing Financing Fund by offering housing loans to their customers. The increase in lending to private households was substantial for a year and a half from the autumn of 2004. However, the largest and steadiest increase in

1. According to the definition by the CBI, foreign parties are parties (natural persons and companies) domiciled abroad. That is not to say that they are unrelated to Iceland. If an Icelandic-owned company in Luxembourg takes out a loan, the loan is made to a "foreign party". These loans, though, are, as a general rule, in foreign currencies.

lending was to holding companies on the one hand and to foreign parties on the other. The increase in lending to foreign parties was notably larger. The increase was especially big during the latter part of 2007. During the first part of 2007 the Icelandic banks increased their lending to foreign parties by 800 million EUR, to 8.3 billion EUR. During the latter part of that year, i.e. after the beginning of the international liquidity crisis in mid-summer 2007, the lending to foreign parties increased however by 11.4 billion EUR, to 20.7 billion EUR. Thereby, lending by the banks' parent companies to foreign parties increased by more than 120% in just six months. As stated in Chapter 8, this increase was seen in all three banks, an increase of 5 billion in Kaupthing and 3 billion each in Landsbanki and Glitnir. The SIC notes that this increased lending started at about the same time as the liquidity crisis in the international financial markets began. The increase was so substantial that it can be assumed that many of the new customers had turned to the Icelandic banks after other banks had made arrangements to reduce their lending and that these customers had therefore been refused service by other banks.<sup>2</sup>

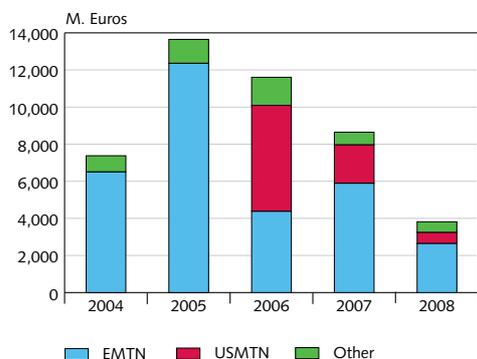
The SIC is of the opinion that the balance sheets and lending portfolios of the banks had grown beyond their own control and infrastructure. Hence management and supervision did not keep up with the rapid expansion of lending. Studies have also shown that a rapid growth of bank credit is conducive to impoverish the quality of their loan portfolio. In particular, this applies when banks venture into new markets where there is already fierce competition and one can say, as regards the growth of the Icelandic banks in 2007, that this was the case. The growing share by holding companies in the banks' loan portfolio was also a cause for concern. As a rule, the assets of holding companies are securities, often shares and loans to such entities, and generally they do not have a sound operation as collateral. The credit risk, therefore, is usually greater than when loans are made to profitable operations. The SIC is of the opinion that the big growth in lending by the banks caused their asset portfolio to develop into a very high-risk one.<sup>3</sup>

The SIC is of the opinion that such big and high-risk growth is not compatible with long-term interests of a robust bank but, on the other hand, there were strong incentives for growth within the banks. These incentives included the banks' incentive schemes, as well as heavy indebtedness by the biggest owners. The Commission is of the opinion that it should have been clear to the supervisory bodies that such incentives existed and that there was reason for concern about this rapid growth. On the other hand, it is clear that the FME, the main banking supervisor, did not grow at the same rate as the parties subject to its control and, for that reason, was not able to fulfil its tasks properly, besides being beset with other problems, as noted in greater detail in Chapter 21.4 below.

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2. Banks that grow rapidly, especially in new markets, are faced with an adverse selection of customers that have already been refused loans by other banks in the area. Only time will tell which customers are bad (the result of an adverse selection) and which are good. The hunt for a market share in a new market can, therefore, be a sign of an increase in credit depreciation at a later date. Shaffer, S.: "The Winner's Curse in Banking." *Journal of Financial Intermediation*, 7 1998, pages 359-392. See also Fernández de Lis, Santiago, and Jorge Martínez Pagés and Jesús Saurina: „Credit Growth, Problem Loans and Credit Risk Provisioning in Spain.“ Banco de España Working Papers 0018, Banco de España 2000.
  3. Jiménez, G., J. Saurina: „Credit Cycles, Credit Risk, and Prudential Regulation.“ *International Journal of Central Banking* 2:2 2006, pages 65-98.

The Icelandic banks sought capital to a great extent abroad, first in the European debt securities market and later in the American debt securities market. There were two things that facilitated that access. On the one hand, a good credit rating they inherited to some extent from the Icelandic state and, on the other hand, their access to markets in Europe, based on the EEA-Agreement. One of the main reasons for the banks' good credit rating was the sound position of the state and expectations that the state would support behind them. This access to international financial markets was the main premise of the banks' considerable growth, especially during the years 2004 to 2006, when their growth was at its height, as can be seen in Table 1. During 2005, Glitnir, Kaupthing and Landsbanki fetched around 14 billion EUR in foreign debt securities markets, a little more than that year's domestic product and twice the amount of the previous year (see Figure 3). Most of these debt securities in issue were for a period of 3 to 5 years at very reasonable rates, that is, only 15 to 25 points over the benchmark interest rate. At the end of 2005, interest rates for the Icelandic banks started rising and on 21 February 2006 they shot up when the credit-rating agency Fitch announced a negative outlook for Icelandic Treasury's credit rating. Following that, a few negative assessment reports on the banks, including from Merrill Lynch and Den Danske Bank, were published.<sup>4</sup> The banks, then, had to pay a much higher spread rate than other European financial institutions in the same risk group, cf. a report from Merrill Lynch of 7 March 2006 stating that the Icelandic banks pay a similar spread rate as banking institutions in emerging markets, i.e. a 50 point higher spread rate than the one paid by similar European Banks.<sup>5</sup> The European debt securities market as good as shut them out and, as can be seen in Figure 3 the debt securities in issue in the European market shrunk from about 12 billion EUR in 2005 to just over 4 billion EUR in 2006. Around that same time, however, a new market opened, i.e. the American debt securities market. That opening was largely due to collateralized debt obligations (CDOs) where Icelandic debt securities were taken into the CDOs because of the high credit-rating of the Icelandic financial undertakings, whereas at the same time they were generally subject to high interest rates, inspite their credit rating. Thus, the Icelandic banks were the „cheapest“ ones, based on their credit-rating from the credit-rating agencies and, therefore, ideal for raising the average rating of a collateralized debt obligation (CDO). This way, almost 6 billion EUR were borrowed in the American debt securities market. After these three years of very substantial debt securities in issue, the refinancing risk of the banks had become significant, in particular for the years 2008 to 2011. The SIC is of the opinion that the issue of debt securities in international markets was done with far too much haste, when it was evident that sooner or later interest rates would go up and that access to borrowing would become more difficult. What did they have in mind when that time came about?

Figure 3  
 Aggregate bond issues by Landsbanki, Glitnir og Kaupþing



EMTN: European Medium Term Notes; USMTN: US Medium Term Notes.  
 Reference: Landsbanki, Kaupthing Bank and Glitnir.

4. *Iceland: Geysir crisis*. Research 21 March 2006, Danske bank, [http://danskeresearch.danskebank.com/link/FokusAndreIceland21032006/\\$file/GeyserCrises.pdf](http://danskeresearch.danskebank.com/link/FokusAndreIceland21032006/$file/GeyserCrises.pdf) Thomas, Richard: *Icelandic Banks: not what you are thinking*. Merrill Lynch 7 March 2006, <http://www.scribd.com/doc/19606822/Merrill-Lynch-Icelandic-Banks-Not-What-You-Are-Thinking>.

5. Thomas, Richard: *Icelandic Banks: not what you are thinking*. Merrill Lynch 7 March 2006, <http://www.scribd.com/doc/19606822/Merrill-Lynch-Icelandic-Banks-Not-What-You-Are-Thinking>.

After the debt securities markets as good as shut out the Icelandic banks in the latter part of 2007, the banks had to seek out new ways to refinance the debt securities that were due and the increase in lending of the last six months of that year. As will be dealt with in greater detail later, foreign deposits and short-term collateralised loans became a source of capital for the three banks. Thus, the banks became ever more dependent on short-term financing that was very sensitive to market conditions. A run on the collateralised loans was just as imminent as a run on the foreign deposit accounts.

If one looks at the financing side of the banks in the context of the lending side, one can see the disparity in the development of these two sides in 2007. As the issue of debt securities was cut back and the due date of older debt securities drew closer, lending was, nevertheless, increased as never before and thereby magnifying the refinancing risk.

In early 2006, many had pointed out that the Icelandic banking system had outgrown the capacity of the CBI and there were doubts that the CBI would be able to fulfil its role as a lender of last resort. Notwithstanding these worries and their effect on the spread rate, the banks continued to grow unhindered. The CBI strengthened its foreign exchange reserves at the end of 2006 but after that there was little change. By the end of 2007 the nation's short-term debts were fifteen times larger than the foreign exchange reserves of the CBI and the biggest part of these short-term debts were incurred for financing the banks. The foreign deposits of the three banks were also eight times larger than the foreign exchange. Therefore it was clear that either the foreign exchange needed to be strengthened considerably or the banks' relations with Iceland had to be reduced. If not, the chances of a run on the Icelandic banks were significant since the CBI was not a credible sponsor. In addition, the Depositors' and Investors' Guarantee Fund had very scarce resources in comparison with the bank deposits it was meant to guarantee. Together, these factors were very likely to increase the risk of a potential run on the banks.

At the beginning of 2008, when the foreign exchange reserves of the CBI were finally to be strengthened so that a credible promise of support of the financial system could be presented, there were no loans to be had, except for a swap contract between Iceland and the Central Banks of Sweden, Norway and Denmark, as set out in Chapter 4. Iceland, a state with practically no debts at all, and its central bank were accorded no credit facilities in foreign financial markets when they needed them the most, whereas the financial system had grown to be tenfold its gross domestic product.

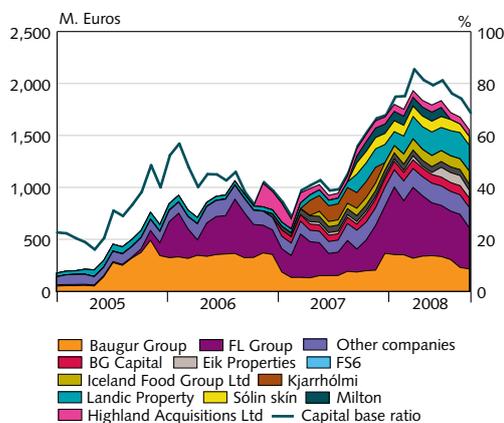
In his article in Chapter 16, professor Mark Flannery points out that most countries with a large international banking sector, one that is susceptible to experiencing similar difficulties, have built up their banking system over a longer period of time and thus their supervisory bodies have the experience of supervising big banks. The credibility of supervisory bodies could thus strengthen investors' confidence in the banks they supervise and thereby reduce the importance of the CBI as a lender of last resort. The SIC is of the opinion that in Iceland there was a lack of credibility of that nature, since there was no experience of supervising the banks through economic hard times.

The stated objective of the Icelandic banks was rapid growth and, furthermore, there were incentives for growth within the banks. Therefore, it

The Special Investigation Commission is of the opinion that the owners of all the major banks had abnormally easy access to loans in those banks, apparently in their capacity as owners.

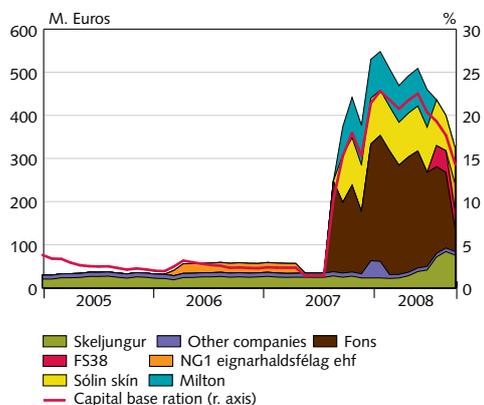
was clear that external incentives were needed to restrain the banks' growth. The SIC believes that there were several ways to restrain that growth. The FME could have, on the basis that investment banking was an ever increasing part of the banks' activities, and given that investment banking usually entails higher risk, required the banks to increase their equity ratio. The CBI could also have maintained its requirements for foreign exchange balance. The prudential rules on foreign exchange balance were originally set in order to limit the foreign exchange risk of the national economy. When the share of the foreign operations of the banks increased their capital ratio became more sensitive to fluctuations in the exchange rate of the Icelandic krona. The CBI responded by authorising the banks to increase the weight of their foreign assets in order to counterbalance the decrease in equity because of a potential weakening of the krona. This way, the banks continued to pass the stress test of the FME where their tolerance vis-à-vis, inter alia, the weakening of the krona was tested, without having to increase their capital ratio. It would have been better to maintain the requirements for foreign exchange balance without exemptions but that would have called for a higher capital ratio which would have limited the growth in lending. Thirdly, it would have been possible to restrain the banks' growth by using the so-called dynamic provisioning, as had been done in Spain and as is described in Chapter 4, to counterbalance the deterioration of lending quality which happens as the growth in lending increases. The loan loss provisions are dependent on the growth in lending by the respective banks and are intended to reduce the gains of excessive increase in lending.<sup>6</sup>

Figure 4  
 Baugur Group  
 Total lending by Glitnir to related parties



Reference: Glitnir banki hf.

Figure 5  
 Fons hf  
 Total lending by Glitnir to related parties



Reference: Glitnir banki hf.

### 21.2.1.2 The Gearing of the Banks' Owners

When one examines the largest exposures by Glitnir, Kaupthing Bank, Landsbanki and Straumur-Burdaras, one can see that in all of the banks their principal owners were among the biggest borrowers. This becomes evident, whether one looks at how the banks themselves defined groups that were deemed to be a single exposure, see supporting document 1 in Chapter 8, or whether it is based on the methodology used to analyse the cross-ownership described in Annex 2 to this report. Following are a few examples of the services the three biggest banks offered to their principal owners.

#### Glitnir Bank

Glitnir's loans to Baugur Group and related parties, in particular FL Group, were significant. Actually, all three big banks, as well as Straumur-Burdaras, did significant lending to this group. What differentiates Glitnir's lending to the group from the others' is the change that occurred in Glitnir's credit facilities to Baugur Group and related parties after a new board in Glitnir took over in the spring of 2007. The new board took over after parties related to Baugur and FL Group significantly increased their shares in the bank. In Figure 4 one sees that in the latter part of 2007 and in the beginning of 2008

6. A report by the UK Financial Services Authority recommends such provisions, inter alia, in order to prevent excessive growth in lending during times of expansion. Another way would be to have the minimum equity ratio change along with economic fluctuations according to a specific set of rules. The third possibility is to vest the Financial Services Authority with discretionary powers to determine the minimum capital ratio on the basis of the economic situation. *The Turner review: a regulatory response to the global banking crisis*. (2009)

the lending by Glitnir's parent company to Baugur and those companies deemed to be related to Baugur, according to the methodology used by the SIC, nearly doubled. The loans went from around 900 million EUR in the spring of 2007 to nearly 2 billion EUR a year later. A fairly substantial part of that increase in loans went to Baugur itself and to FL Group, the biggest shareholder in the bank, and when the lending to them was at its peak, it was more than 80% of the bank's equity base. The investment company Fons shows a similar pattern, see Figure 5. Fons worked closely with Baugur and FL Group and, inter alia, the companies had joint ownership of investment companies. The bulk of the increased lending to Fons occurred in August 2007, after the Icelandic banks, especially Glitnir, started to have liquidity and re-financing problems. The Commission is, therefore, of the opinion that Baugur, FL Group and Fons had an abnormally easy access to borrowing in Glitnir, apparently in their capacity as owners. There are also strong indications that Baugur and FL Group had tried, in their capacity as owners, to exert undue influence on the bank's management. Just before the collapse of the banks, Glitnir tried to protect its interests with regard to Landic Properties ehf. because of the situation the bank felt the company was in. As noted in the margin Mr. Jón Ásgeir Jóhannesson reacted gruffly as the principal owner of Stoðir, the largest owner of Glitnir and Landic Properties.

At the end of 2007, Baugur received a subordinated loan from all the three big banks, 5 billion ISK from Landsbanki, 5 billion ISK from Kaupthing Bank and 15 billion ISK from Glitnir, as noted in Chapter 8.12. These loans were recognised as current assets in Baugur's accounts and thereby improving the current asset position of Baugur at year's end.

In this context, the SIC also wants to point out that a subsidiary of Glitnir, Glitnir Funds, also bought a significant amount of securities issued by Baugur and FL Group. In the year 2008, Fund 9 and Fund 1 lent around 38 billion ISK or more (300 million EUR, based on the exchange rate 30.06.2008) to Baugur and FL Group. See details in Chapter 14. Since the assets of these Funds amounted to 170 billion ISK at that time, this represented more than 20% of the Funds' assets. FL Group was the biggest debtor of Fund 9 and the second biggest of Fund 1, behind the Housing Financing Fund. As will be noted later in this report there are cases where the Funds bought debt issues of these companies in their entirety, while it is difficult to see that this is in conformity with the operation mutual and of money market funds.

Furthermore, parties related to Milestone ehf., on the one hand, and BNT hf., on the other, were among the biggest borrowers from Glitnir, with parties related to these two companies being the biggest owners of the bank before the change of board in the spring of 2007. After the change of board, these companies indeed, still owned a 7% share in the bank through joint ownership of the company Þáttur International. Loans to Milestone ehf. and related companies reached 650 million EUR in March 2008 but loans to BNT hf. were around 300 million EUR for all of 2008.

### Kaupthing Bank

The biggest shareholder in Kaupthing Bank was Exista hf., with just over a 20% share in the bank. Exista was also one of the bank's biggest debtors. Figure 6 shows the development in Kaupthing Bank's lending to Exista and related parties, based on the methodology used by the SIC. As indicated in

On 12 September 2008, Mr. Magnús Arnar Arngrímsson sent an e-mail to Mr. Skarphéðinn Berg Steinarrsson, then president of Landic Property, telling him that a letter from the bank was to be expected for the purpose of ensuring increased influence of the bank as a major lender of the company. A reply came from Mr. Jón Ásgeir Jóhannesson and in it Mr. Jóhannesson says among other things:

„Hello Magnús. As the principal owner of Stoðir, which is the largest shareholder of Glitnir, I would like to know how a letter like this is supposed to serve the interests of the bank.“

Furthermore Jón asks:

„Do the directors realise that Stoðir, the principal owner of Landic, also has the approval of the FME to control a significant share of Glitnir, and what do you think this letter will look like from that viewpoint?“

This cannot be interpreted in any other way than Jón Ásgeir thought that because of Landic's connection with the principal owners of Glitnir the company should be treated differently from other debtors of the bank.

Figure 6  
 Exista hf  
 Total lending by Kaupthing to related parties

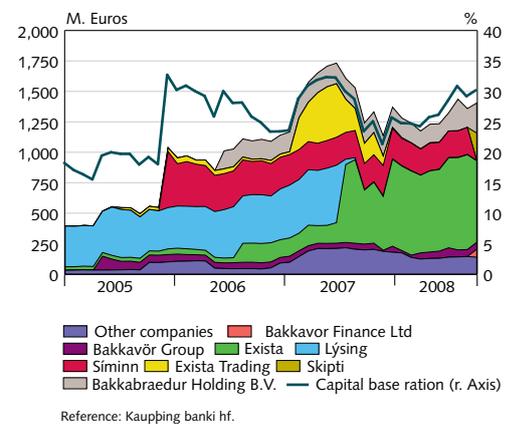
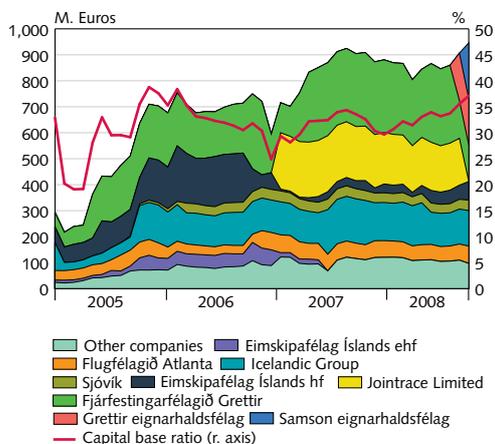


Figure 7  
 Björgólfur Guðmundsson  
 Total lending by Landsbanki to related parties



Reference: Landsbanki Íslands hf.

Chapter 8.12, the loans were often granted without any specific collateral, more than half the loans granted from the beginning of 2007 until the collapse of the banks, to be precise. At the end of 2007, the company requested, inter alia, a subordinated debenture loan of 20 billion ISK from Kaupthing Bank but the bank agreed to lend the company 250 million EUR. The purpose of the subordinated loan was to strengthen the company's capital balance.<sup>7</sup>

In January 2008, Exista was also authorised to withdraw cash that Kaupthing Bank held as a pledge for a loan facility to the amount of over 14 billion ISK; in return, the bank received shares in Bakkavör as collateral. The purpose of this, according to the minutes of the loan committee of 30 January 2008, was to strengthen the liquidity of Exista. At the same time, it was decided that the loan constituted an exposure to Bakkavör but not Exista. In May 2008, the company again requested that the bank give up the collateral in Bakkavör's shares. Thus, Exista seems to have been in need of a lot of money at that time and always be able to get service at the bank Exista also received significant loan facilities from Kaupthing Luxembourg, with the facilities amounting to around 130 million EUR at the end of August 2008.<sup>8</sup>

Kaupthing's Money Market Fund was the biggest fund of Kaupthing Bank Asset Management Company hf. In 2007 the Kaupthing's Money Market Fund invested significantly in bonds issued by Exista and at year's end it owned securities to the value of around 14 billion ISK. They represented about 20% of the fund's total assets at that time, see details in Chapter 14.

Robert Tchenguiz owned shares in Kaupthing Bank and Exista and also sat on the board of Exista.<sup>9</sup> He also received significant loan facilities from Kaupthing Bank in Iceland, Kaupthing Bank Luxembourg and Kaupthing Singer & Friedlander (KSF).<sup>10</sup> In total, the loan facilities Robert Tchenguiz and related parties had received from Kaupthing Bank's parent company at the collapse of the banks amounted to about 2 billion EUR. In addition, the loan facility from Kaupthing Bank Luxembourg amounted to about 210 million EUR and 95 million EUR from KSF. The big increase in loan facilities to Tchenguiz from January 2007 until October 2008 is noteworthy, in light of the fact that in late 2007 many of Tchenguiz's companies started going downhill. The minutes of the loan committee of Kaupthing Bank's board state, inter alia, that fairly often the bank lent money to Tchenguiz in order for him to meet margin calls from other banks.

*Landsbanki and Straumur-Burðaras Investment Bank hf.*

Samson Holding Company was the biggest shareholder in Landsbanki from the time when the bank was privatised. Father and son, Mr. Björgólfur Guðmundsson and Mr. Björgólfur Thor Björgólfsson, owned equal parts of Samson, largely through their foreign holding companies, after Mr. Magnús Þorsteinsson sold his shares in Samson. The loans from Landsbanki to them and related parties were significant. Figure 7 shows the loans from Landsbanki's parent company to Mr. Björgólfur Guðmundsson and related parties, but the

7. The minutes of Kaupthing Bank's loan committee of 28 December 2007.  
 8. The minutes of Kaupthing Bank's loan committee of 29 May 2008.  
 9. As stated in Chapter 8, Robert Tchenguiz put up shares in Kaupthing Bank as collateral for loans from that same bank.  
 10. Robert Tchenguiz owned at least 1.5% in Kaupthing Bank, based on the number of shares put up as collateral in Kaupthing Bank Luxembourg on 31 March 2008. Robert Tchenguiz was also a big shareholder in Exista, the biggest shareholder in Kaupthing Bank.

bulk of the loans went to Eimskip or related parties, Mr. Guðmundsson being owner of a third of the shares in Eimskip. The loans amounted to about 850 million EUR from mid-2007. Mr. Björgólfur Guðmundsson's obligations on account of the investment company Grettir increased significantly in 2007 and in August 2008 they were transferred to Grettir Holding Company but concomitant to that transfer, Mr. Guðmundsson put up surety and shares in Icelandic Group as pledge. Just before the collapse of Landsbanki, Mr. Björgólfur Thor Björgólfsson submitted a guarantee from Givenshire Equities Sarl, owner of half the shares in Samson, for Mr. Björgólfur Guðmundsson's obligations on account of the surety for the obligations of Grettir. This was done concomitant to the 153 million EUR loan facility, extended to Mr. Björgólfur Thor Björgólfsson, from Landsbanki Luxembourg just before the collapse of the bank.

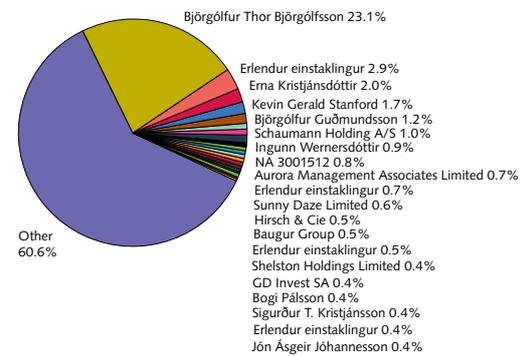
Mr. Björgólfsson had several loans from the Landsbanki's parent company but at the same time he was by far the biggest debtor of Landsbanki Luxembourg, as can be seen in Figure 8. As indicated in Chapter 8.12, the total debts of Mr. Björgólfsson and related companies to Landsbanki amounted to nearly a billion EUR in October 2008. A big part of the loans to Mr. Björgólfsson and related parties was on account of the pharmaceutical company Actavis, either directly to the company or to entities that owned shares in the company. Chapter 8.8 deals with subordinated loans that both Landsbanki and Straumur-Burdaras granted for the acquisition of Actavis by investors in mid-2007, with Mr. Björgólfsson owning more than 80% of the company that bought Actavis. The loans were very risky, with interest rates to match. In 2008, Landsbanki also granted a 153 million EUR loan to BeeTeeBee Ltd., a holding company owned by Mr. Thor Björgólfsson to inject equity into the holding company of Actavis, thereby fulfilling the increased equity requirement of the company put forth by Deutsche Bank. The loan was granted on 30 September, but by then the CBI had already made an offer for a 75% share in Glitnir and the liquidity problems of Landsbanki were growing fast, particularly in foreign currencies.

Mr. Björgólfsson was also the biggest shareholder in Straumur-Burdaras and was the chairman of the board. Mr. Björgólfur Thor Björgólfsson and Mr. Björgólfur Guðmundsson were each, along with related parties, among the biggest debtors of the bank and together they constituted the bank's largest borrowers' group. Figure 9 shows loans from Straumur to parties related to Mr. Björgólfur Guðmundsson, parties that were, as was the case with Landsbanki, mostly companies related to Eimskip. Eimskip experienced growing problems as the year 2007 wore on and into 2008. One can see that loans to related companies increased significantly around year end 2007 and beginning of 2008.

**Summary**

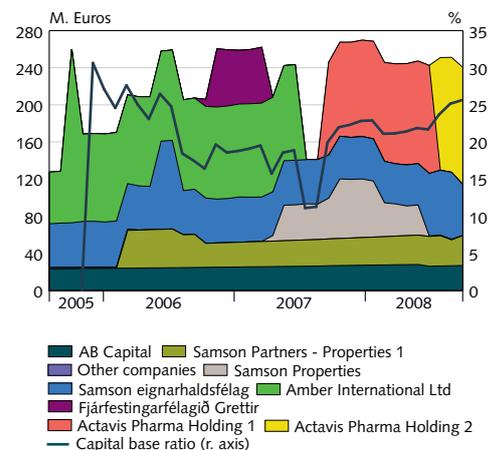
When it so happens that the biggest owners of a bank, who appoint members to the board of that same bank and exert for that reason strong influence within the bank, are, at the same time, among the bank's biggest borrowers, questions arise as to whether the lending is done on a commercial basis or whether the borrower possibly benefits from being an owner and has easier access to more advantageous loan facilities than others. This is, in reality, a

Figure 8  
 20 largest borrowers  
 Landsbanki Luxembourg



Reference: Landsbanki Íslands hf.

Figure 9  
 Björgólfur Thor Björgólfsson  
 Total lending by Straumur-Burdarás to related parties



Reference: Straumur-Burdarás hf.

case of transfer of resources to the parties in question from other shareholders and possibly from creditors. Research has shown that where big owners of banks are, at the same time, borrowers, these owners benefit from their position and get abnormally favourable deals.

The owner of one of the banks, also a member of the board, said at a hearing that he thought the bank „had been very happy with[him] as a borrower“.<sup>11</sup> The SIC is of the opinion that it can be argued that, because of their position, the employees of the bank could hardly have evaluated in an objective way whether the owner had been a good borrower or not.

When the banks were privatised it was clear that the FME was somewhat concerned about the owners of the banks running other businesses at the same time as running the banks. This can, inter alia, be seen in its original requirement to the fact that Samson ehf. would commit itself to limit the purpose and the activities of the company to managing its ownership of the bank in question. It can be assumed that this was, inter alia, done in order to prevent the owners from putting the shares in Landsbanki up as collateral for other operations they truly were engaged in. This requirement was lifted on 2 June 2006, based on certain preconditions, as stated in Chapter 6. It appears that worries about conflict of interest between the operation of the banks and the operation of other companies owned by the same parties had vanished. The SIC is of the opinion that it would have been better to maintain this requirement and thus prevent the use of Samson's shares as collateral for more loans. Furthermore, there should have been a general and active supervision of how the banks' owners used them for the benefit of their other operations. The SIC is of the opinion that the owners of all three big banks and of Straumur-Burdaras had an abnormally easy access to loans in these banks, apparently in their capacity as owners. When the banks became constricted as the autumn of 2007 and the year 2008 wore on, it seems that the boundaries between the interests of the banks and the interests of their biggest shareholders were often blurred and that the banks put more emphasis on backing up their owners than can be considered normal. The SIC is of the opinion that the operations of the Icelandic banks were, in many ways, characterised by their maximising the benefit of the bigger shareholders, who held the reins in the banks, rather than by running reliable banks with the interests of all shareholders in mind and showing due responsibility towards creditors.

### *21.2.1.3 Concentration of Risk*

The SIC is of the opinion that the concentrated risk of the Icelandic banks had been dangerously high some time before their collapse. This applies both to accommodation of loans to certain groups within each bank and that the same groups had at the same time constituted high risk exposures in more than one bank.

Risk diversification is a key element in the operation of a bank. Banks, in general, are very heavily indebted in comparison with other companies and therefore it is very important that their portfolio of assets is such that risk is widely spread. Otherwise, there is a danger that the financial difficulties of one customer, or of more interrelated customers, would cause financial difficulties for the financial undertaking in question. There is also a danger that the activities of a bank take too much note of a specific group of customers if its portfolio of assets is not varied enough. If a bank takes too much risk because of one party or a group of related parties, such that the financial performance of the bank is dependent on the performance of the group,

11. Statement of Mr. Björgólfur Guðmundsson before the SIC, 10 January 2010, p. 41.

the balance of power between the bank and the customer can change. The bank, then, stands or falls with these big borrowers and there is a risk that it will continue to grant them loans in the event that the going gets tough, in the hope that fortune will come their way. This behaviour can prove to be harmful to depositors and other creditors of the bank who will bear the loss if things go wrong.

In order to reduce concentration of risk in financial entities, Iceland adopted rules on large exposures, in accordance with the directives of the European Union. This is dealt with in greater detail in Chapter 8.6. Iceland decided not to adopt rules on large exposures that were more stringent than provided for in the directives of the European Union, although that was permitted. The adoption was, though, to a large extent, similar to the adoption of rules on large exposures in Denmark, Norway, Sweden and the United Kingdom. Rules on large exposures play a very important role in the financial system of the country. The main role of those rules is to combat risk within the banks by promoting the spread of risk in the operation of financial entities and to prevent a domino effect in case of financial difficulties. In order to achieve this objective, financial undertakings are not permitted to incur exposure in relation to one customer, or a group of customers, that are related in a certain way, in excess of 25% of their equity base at any time.<sup>12</sup>

The Investigation Commission is of the opinion that the implementation by financial undertakings of rules on large exposures up until the collapse of the banks was often interpreted in a narrow way, in particular concerning parties who held an active share in the banks, or parties related to them. This can clearly be seen in matters where there was a conflict between the FME and parties subject to its control. We will now turn to a few enlightening examples in this regard.

*Landsbanki: Actavis and Mr. Björgólfur Thor Björgólfsson*

In a letter from the FME to Landsbanki, dated 22 March 2007, serious observations were made regarding the use of rules on large exposures. Remarks were made on how Landsbanki, in a few instances, defined financially related parties. The most serious conflict addressed was whether Actavis Group hf. could be defined as being financially related to Mr. Björgólfur Thor Björgólfsson and related parties. At that time, Mr. Björgólfsson, owned a 38.84% share in Actavis Group hf. The FME considered that Mr. Björgólfsson's relations to Landsbanki and Burðarás hf. (later Straumur-Burðaras), that owned a total of 8.5% share in Actavis Group hf. were so close that their share must be defined in conjunction with Mr. Björgólfsson's share. The FME also looked to the fact that other shareholders in Actavis owned small shares and therefore this would have to be based on the presumption that Mr. Björgólfsson exercised control, as defined by the rules on large exposures. Landsbanki rejected this interpretation in a side letter dated 30 April 2007. The letter stated that Mr. Björgólfsson and related parties did not exercise control over Actavis Group hf. and that there was no risk of financial difficulties spreading between those parties because of Mr. Björgólfsson's strong financial standing, and that of the related parties. The

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12. cf. Article 30(1) of act No 161/2002 on Financial Undertakings.

SIC finds it unfortunate that the indications from the FME were not followed and outstanding loans to Mr. Björgólfsson and related parties scaled down in order to reduce the risk within the bank resulting from this situation.

In its side letter dated 22 March 2007, the FME reached the conclusion that Landsbanki's exposure to Mr. Björgólfsson and related parties had amounted to at least ISK 51.3 billion or 49.7% of the bank's CAD equity at that time.<sup>13</sup>

Notwithstanding this, the FME authorised Landsbanki to recognise these exposures separately in a report on large exposures at 31 March 2007. It is indicated that this will not be accepted at the next reporting date. Yet, it is clear from evidence in the hands of the SIC that the exposures were still separate in the bank's report to the FME at 30 June 2007 and thereby, the indication from the supervisory authority was ignored. There were no further developments in this case until September 2007 when Actavis Group hf. was taken over and refinanced. The FME, then, dropped the case.<sup>14</sup>

#### *Kaupthing Bank hf: Baugur and Mosaic Fashion*

The FME, in its report on credit risk in Kaupthing Bank hf., as at 30 June 2007, determined that Baugur Group exercised control over Mosaic Fashion hf. In addition, the companies Jötunn Holding ehf. and ISP ehf. should be considered financially related to Baugur, since the owner of ISP was Ms. Ingibjörg Pálmadóttir, the wife of Mr. Jóhannesson, the principal owner of Baugur Group.<sup>15</sup> The exposures of these parties amounted to a total of 139.5 billion ISK, equivalent of 31% of the bank's equity on 30 June 2007; large exposures may not exceed 25% of a financial undertakings equity.

At that time, F-Capital ehf (a company owned 100% by Baugur Group hf.) owned a 49% share in Mosaic Fashion and Kaupthing Bank also owned another 20% share in Mosaic. In light of the size of F-Capital's share in Mosaic Fashion, which was controlled by Baugur Group, that company assigned a 9.01% voting rights to Mr. Kevin Stanford and to Mr. Don McCarthy (the owner of Don M. Ltd.) so that F-Capital's voting right was 39.9%. Don McCarthy was, at that time, a principal member of the board of Baugur Group and also sat on the board of several other companies Baugur Group owned shares in. The FME was of the opinion that the relationship between Don McCarthy and the management of Mosaic Fashion, who owned shares in that company, was so close that they had to be regarded as one entity. Having regard to that, the FME considered that they were in control and that an exposure to Mosaic Fashion should be considered along with the exposure of Baugur Group. Kaupthing Bank disregarded that indication and continued submitting reports on large risks where these companies were treated as unrelated risks until the collapse of the bank.<sup>16</sup> The FME, however, had not exercised its powers to force Kaupthing Bank to change this situation when the bank collapsed in October 2008.

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13. This conclusion was based on the position, as it was after maximum deduction had been applied, according to rules on large exposures. Without the deduction, the exposure amounted to 52% of the bank's capital.

14. From a memo from the FME No 2 which discusses an in-house meeting on 29 March 2007.

15. FME's report on credit risk in Kaupthing Bank in January 2008. See Chapter 16 for more details.

16. Reports on large exposures from Kaupthing Bank to FME in 2007 and 2008.

*Glitni bank hf: Stím and FL Group*

According to a FME memorandum in November 2008, Glitnir did not link exposure to Stím ehf. and FL Group (Later Stoðir). In light of the fact that a significant part of the assets of Stím ehf. (about a third, at that time) consisted of shares in FL Group, the FME considered that there was considerable chance, in the event that FL Group experienced financial difficulties, that Stím ehf. would also have financial difficulties. The FME deemed that there existed a financial relationship between these parties on the basis of Article 2(b) of rules No 216/2007. The only assets of Stím ehf. at that time were shares in FL Group and Glitnir, the company having taken a loan to finance the purchase of those shares.

The FME had not exercised its powers to force changes in Glitnir’s credit risk when the bank collapsed in October 2008.

Also, Glitnir did not classify loans to companies owned by Ms. Ingibjörg Pálmadóttir with risks to Baugur Group and companies related to Mr. Jón Ásgeir Jóhannesson. This was the case, despite the fact that Mr. Jóhannesson and Ms. Pálmadóttir had often invested in conjunction and had cohabited for many years and been husband and wife since 2007. According to the memorandum of the FME from November 2008, Landsbanki did not link exposure to them in loan reports in 2007.

From above it can be deduced that the banks, in general, did not follow the indications from the FME when it came to the relationship between large exposures. On the contrary, efforts were made to convince the FME that the exposures were, in fact, not related, as noted above. It is worth reiterating that loans, that are too big, to one customer and related parties are not beneficial to the banks. There is, at the same time, increased risk that a bank will suffer serious reversals of fortune if the customer goes bankrupt and, not least, there is a risk that the balance of power between the bank and the customer will be disrupted, as discussed above. Therefore, the Special Investigation Commission is of the opinion that the objective of the management teams of the banks and their risk management teams should have been not to permit individual exposures to become too large. Instead, there is evidence that the banks themselves had taken part in trying to bypass rules on large exposures. The Investigation Commission finds this reproachable. Numerous examples are mentioned in the report, such as a loan from Glitnir to Svartháfur ehf. This resulted in significantly increasing the concentration risk within the banks.

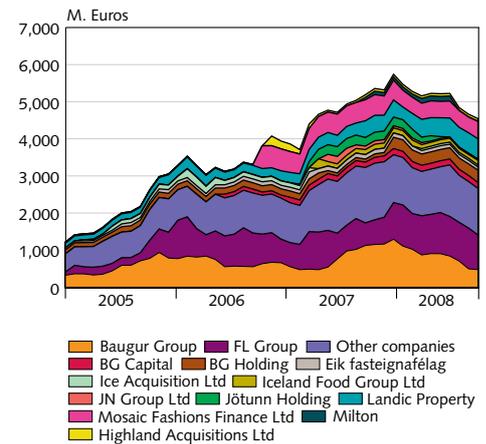
However, the SIC also considers that the FME should have applied its authority with more purpose, having concluded that the conduct of some financial institutions had been in violation of the rules on large exposures, only a small number of these cases having been concluded when the banks collapsed in October 2008. The part played by the FME is discussed in more detail in Chapter 21.4.

Rules on large exposures only apply to exposures of individual financial institutions and not to the financial system of Iceland as a whole. Therefore, the risk exposure of one or more related parties can be at a maximum in two or more financial institutions simultaneously with the associated risk of domino effect, should financial difficulties arise. Unfortunately, the monitoring of large exposures has in effect not taken note of this fact. The SIC, therefore, considers that not only had risk exposures accumulated within

Figure 10

**Baugur Group hf**

Total lending by the three big banks to related parties

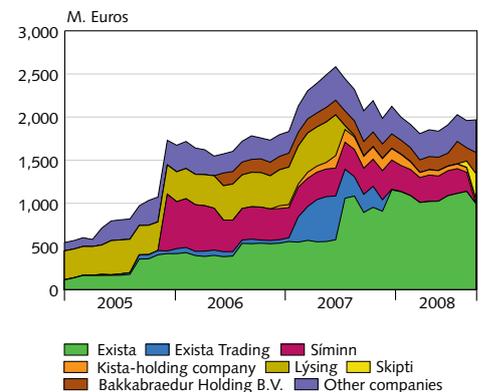


Reference: Glitnir banki hf, Kaupping banki hf and Landsbanki Íslands hf.

Figure 11

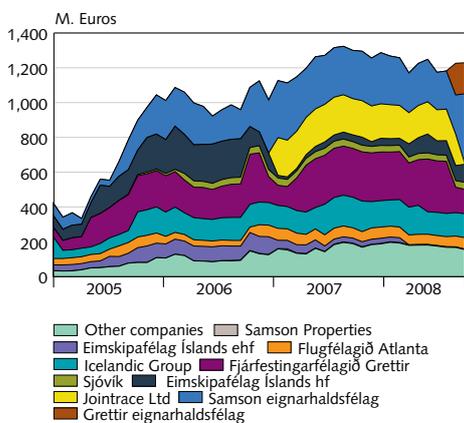
**Exista hf**

Total lending by the three big banks to related parties



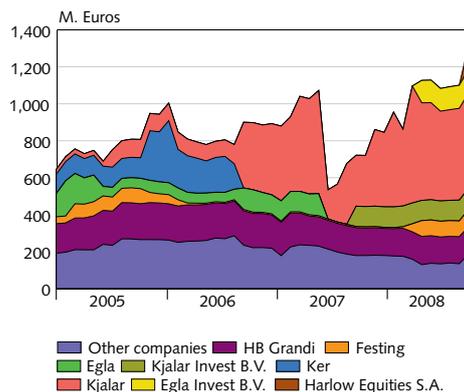
Reference: Glitnir banki hf, Kaupping banki hf and Landsbanki Íslands hf.

Figure 12  
 Björgólfur Guðmundsson  
 Total lending by the three big banks to related parties



Reference: Glitnir banki hf, Kaupþing Banki hf and Landsbanki Íslands hf.

Figure 13  
 Ólafur Ólafsson  
 Total lending by the three big banks to related parties



Reference: Glitnir banki hf, Kaupþing banki hf and Landsbanki Íslands hf.

individual banks in the country, but also there was a tremendous concentration of exposure risks between the banks. Thus, there were rather large groups of interrelated borrowers within all the banks, and, at the same time, many of these groups created large exposures in more than one bank. As a consequence, the systemic risk exposure attributable to the loan portfolios of the banks had become significant.

Of all the business blocks, which had borrowed liberally in the Icelandic banking system, the most conspicuous one was business associated with Baugur Group. In all three banks, as well as in Straumur-Burdaras, this group had become too large an exposure. Figure 10 shows the development of loans from the three big banks to the group, defined on the basis of the methodology used by the SIC, as explained in Appendix 2 on cross ownership and in Chapter 8.7.<sup>17</sup> The loans of this group from the three banks amounted up to 5.5 billion EUR, or 11 % of all the loans of the parent companies of the banks and about 53 % of their aggregated equity. The SIC considers that this has constituted a significant systemic risk, as collapse of one enterprise could affect not only one systematically important bank but all the three systematically important banks. The financial stability, therefore, would be significantly threatened by, for instance, Baugur Group, which had as indicated in the report, which had substantial liquidation problems in the latter half of 2008. The responsibility of ensuring financial stability in the country is assigned to the Central Bank of Iceland (CBI), but, as indicated in the report, the CBI had not requested the necessary data to evaluate this systemic risk. The SIC, however, rejects the assumption that the CBI had lacked the authority to obtain the data, as stated in Chapter 19.7. The FME, however, had the data to observe this systemic risk. Neither institution did in any way act to limit this risk.<sup>18</sup>

More groups were heavily indebted to more than one bank. Most of the domestic bank loans of Exista hf. and related parties were with Kaupthing Bank while at the same time the loans of Glitnir to the group were significant and some of Exista's loans were with Landsbanki. The development of loans from the three large banks to Exista and related parties can be seen in Figure 11. The amount of loans to the Exista group reached its highest in the middle of the year 2007, about 2.5 billion EUR, but by the collapse of the banks it amounted to 2 billion EUR, or a little less than 20 % of aggregated equity of the banks.

Loans to parties related to the Björgólfs, father and son, were highest in Landsbanki but were also significant in Glitnir and some were in Kaupthing Bank. Loans to these parties were also considerable in Straumur-Burdaras. Loans to Mr. Björgólfur Guðmundsson and related parties were at its highest about 1.3 billion EUR, as can be seen in Figure 12.

Loans to Mr. Ólafur Ólafsson and parties related to him were significant in all the banks, and reached its height just before the collapse of the banks, see Figure 13. Early on the highest loans were in Glitnir but as the year 2008

17. These definitions are used in SIC's analysis since they are objective, rather than using the methods which the banks themselves used to link individual firms together into same exposure, whereas their methods in categorizing individual exposures and group exposures were disputed, as referred to above.

18. Chapter 19.7 refers to how information on exposures was disseminated by the FME to the CBI that had the role of promoting an effective and safe financial system in accordance with Article 4 of Act no. 36/2001.

progressed the loans from Kaupthing Bank to the group increased dramatically. Groups affiliated to Milestone ehf., Fons hf. and Mr. Magnus Kristinsson were also voluminous borrowers with the banks.

The SIC also considers that significant concentration of exposure risk of the banks had consisted of foreign-exchange risk in relation to the Icelandic krona. The banks had extensive, positive foreign exchange balances in their books to hedge their equity rates in the last periods before their collapse. However, the SIC considers that loans in foreign currency, accommodated to parties without real liquidity in foreign currency, carried significant foreign currency risk. The loans of Icelandic business enterprises were, for the most part, in foreign currency, and this applied to enterprises with revenues in foreign currency, that could, as a consequence, endure the weakening of the krona, but there were also enterprises whose revenues in foreign currency were meagre and, at the same time, likely to face falling income in step with the worsening economic situation and lowering exchange rate of the krona. It was also quite common that loans for the acquisition of Icelandic shares were granted in foreign currency. At that time, loans in foreign currency to individuals were increasingly frequent, both in order to finance cars and real estate. Thus, the SIC considers that, as a result of high foreign exchange risks, the Icelandic banks had been exposed to credit risk in foreign currency.

The SIC is of the opinion that the concentrated risk of the Icelandic banks had been dangerously high for some time before their collapse. This applies both to accommodation of loans to certain groups within each bank and that the same groups had at the same time constituted high risk exposures in more than one bank. For that reason the systemic exposure risk attributed to the loans had become significant. The clearest example is Baugur Group and affiliated companies. In all three banks, as well as in Straumur-Burdaras, Baugur Group had become too large a risk exposure. The same can be maintained about Exista, Mr. Björgólfur Thor Björgólfsson, Mr. Björgólfur Guðmundsson and Mr. Olafur Olafsson, although the exposure risk constituted by these parties was little less than the one due to by the Baugur Group.

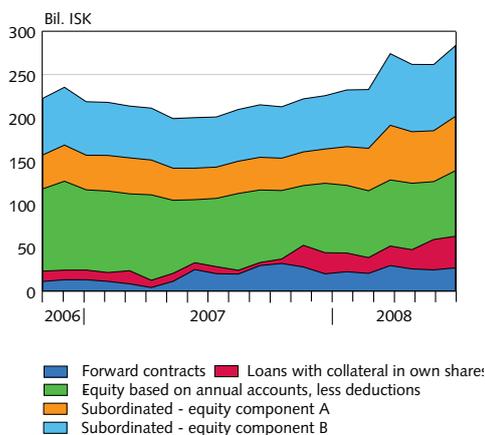
The facts described above attributed to making the banking network as a whole highly vulnerable to external setbacks, such as a sudden decline in credit lines to the country. It is the assessment of the SIC that in controlling the large exposures of the banks the controlling authorities not only should have been much more adamant in preventing the concentration of exposure risks in each bank individually, as discussed in Chapters 8.6 and 16, but they were also lacking in correctly evaluating the systemic risk of the financial system as a whole.

#### *21.2.1.4 Weak Equity*

As described in Chapter 21.1.1, the financial position of the banks grew fast and markedly in the years before their collapse. Due to superfluous supply of credit and low interest rates in international markets, the Icelandic banks borrowed ever more money which they relented to their customers. In order to achieve this growth the banks' equity capital needed to grow as well. An Act on minimum equity capital of banks was in force in Iceland and its application was elaborated by rules stipulated by the FME. The rules are based on the so-called Basel II Standards and provide that the capital base of banks should always extend more than 8 % of the risk base, which is a measure of

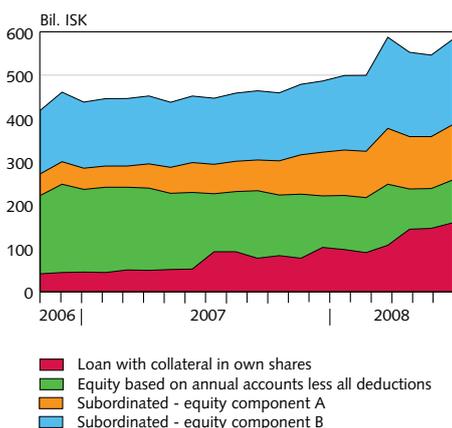
The SIC is of the opinion that the financing of owners' equity in the Icelandic bank system had in such a large portion been based on borrowing from the system itself that its stability was threatened.

Figure 14  
 Equity of Glitnir Bank hf



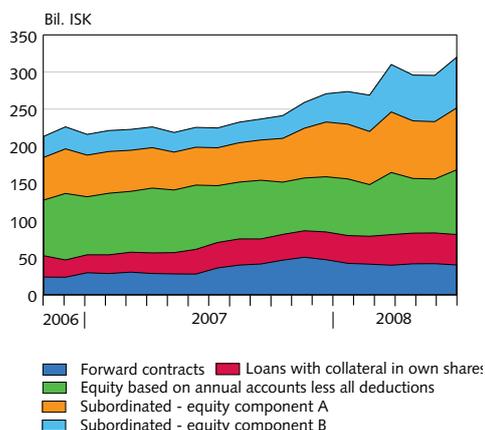
Reference: Glitnir banki hf.

Figure 15  
 Equity of Kaupthing bank



Reference: Kaupþing banki hf.

Figure 16  
 Equity of Landsbanki



Reference: Landsbanki Íslands hf.

the bank's assets and its risk exposures. The capital base consists of equity capital according to annual accounts, less intangible assets and other items that belong to the capital base, particularly subordinated long-term loans. The capital base is a measure of a bank's capacity to tackle losses, i.e. a protection of the depositors and the creditors of a bank against the loss of the bank. Banks with low capital ratio can also have the motive to engage in more risk-taking in their operations than depositors and other creditors should care for. The lower the equity capital of a bank, in relation to the risk involved in its operation, the smaller is the bank's owners share of the loss. The bank's creditors, on the other hand, bear more risk. The cost of rescuing the bank, borne by the authorities, is also higher, but it is often in the interest of authorities to rescue banks in order to secure financial stability. Thus the objective of the rules on equity capital is to safeguard the interests of parties, whose concerns the banks have no incentives to preserve, and to secure financial stability. The creditors of a bank also observe carefully the capital ratio and the combination of the equity capital as indicators of the bank's strength to withstand setbacks. Therefore, it is obvious that equity capital is a key figure in the operation of financial institutions and profoundly influences their possibilities to finance their operation, and thus their possibility to grow.

The capital ratio of Glitnir, Kaupthing and Landsbanki was, in their annual report, always slightly above the statutory minimum. However, it is the SIC's opinion that these capital ratios did not reflect the real strength of the banks and the financial system as a whole to withstand setbacks. This is due to considerable own shares risk exposure of the banks, both through direct collaterals and forward contracts on their own shares. Then, in the event of the bank's operational loss, followed by a decline in share prices, the situation may arise that the resulting loan loss increases due to share collaterals. Thereby the capacity of the bank to tackle setbacks and losses is not the same as if it was not exposed to own shares risks. It is of utmost importance to examine how much money the bank may lose on its own shares in case of bankruptcy because it is when a bank goes bankrupt that the protection of the creditors is put to the test. If equity capital does not give protection to the depositors and creditors it is not equity in the economic sense of the term. In that case it is not feasible to take capital ratio into account when evaluating the strength of a financial institution, as the loss risk from the shares of the institution lies within the financial institution itself.

Irrespective of the execution of financial statements of financial institutions in this country, the SIC concludes that important arguments point to the conclusion that loans, exclusively secured with collaterals in the institution's own shares, should be subtracted from the equity of the institution on the basis of Article 84(5) of Act No. 161/2002 on financial undertakings. The same should apply to shares, formally registered as owned by a third party and „for own account“ of the respective financial institution. Further arguments for this conclusion are set out in Chapter 11.2. In view of the SIC's conclusion, the assumed effect of the execution, according to the interpretation of the SIC, would have had on the activities of the large financial institutions, Glitnir, Kaupthing and Landsbanki, in the last few years, is examined in Chapter 9. The level of over valued equity was estimated on the basis of the data on loans, collaterals in own shares, forward contracts, and, where applicable, other data. The economic resources the banks had invested in its own

shares, is in this report termed „weak equity“, as the share capital, financed by its own bank, is not the protection against loss it is intended to be.<sup>19</sup>

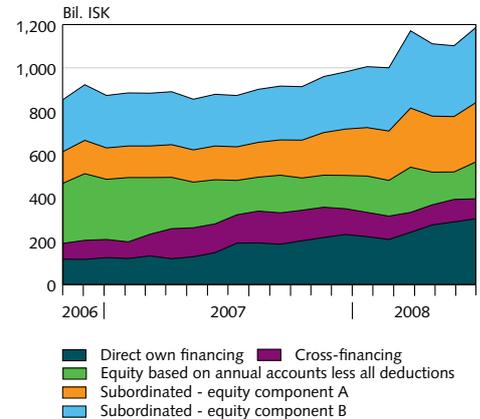
When the equity of Glitnir is examined in accordance with the interpretation of the SIC, it becomes apparent that the weak equity of Glitnir is between 20 to 60 billions from the end of 2006 to the collapse of the bank. Weak equity consists of loans with collaterals in own shares and forward contracts on own shares, see Figure 14. Glitnir does not include the core-asset of FL Group, although, evidently, the bank was one of FL Group’s biggest assets.<sup>20</sup> The capital ratio grew significantly in the spring of 2008, when, i.a., Rákungur was granted a loan for acquisition of shares in the bank, as did other companies owned by key managers of Glitnir, see Chapter 10. In mid year 2008 the weak equity amounted to just above 20 % of the capital base of Glitnir banki hf. If only the core component of the capital base is examined, i.e. shareholders’ equity, according to the annual accounts, less intangible assets, one can see that Glitnir’s weak equity had risen to 45 % of the core component in mid year 2008.

As Kaupthing subtracted an asset for hedging forward contracts from the equity, forward contracts are not included in the evaluation for the bank. The pledged shares of Kjarlar hf. and Exista’s affiliates are, however, offset against the parent companies obligations. The capital ratio of weak equity also grows in Kaupthing, from about 10 % of the capital base at the end of 2006 to almost 30 % of the capital base in mid year 2008 (see Figure 15). If only the core component of the capital base is examined it is apparent that the weak equity of Kaupthing had risen to just above 60 % of the core component in mid year 2008. The ratio grew markedly in the spring of 2008 when Kaupthing cleared the debt of Kjarlar hf. to Citibank, as is discussed in Chapter 8.8. The bank also took collateral in its own shares, owned by Egla Invest BV. Thus the bank financed directly its own shares of its second largest owner in the same way Glitnir did for its largest owners. In Chapter 9 there is a further deliberation on this development, grouped by shareholders.

In the case of Landsbanki the scale of collaterals in own shares was considerable less than with the other banks. However, the largest owner of the bank, Samson eignarhaldsfélag ehf., had a loan with the bank exceeding other assets in the company, such that the bank’s shares were the only asset balancing that part of the loans included in the so-called weak equity in this report.<sup>21</sup> The loans in question would probably be lost if the bank would go into liquidation, this being precisely what mainly characterises weak equity. The „stock option companies“ of Landsbanki, discussed later on in this chapter and in Chapter 10, also have considerable loan facilities against collaterals in own shares. The evaluation of weak own equity was at its highest over ISK 80 billion in the autumn of 2007 and stayed around 80 billion until the collapse of the bank, which amounted to about 50 % of the core component of the equity, as can be seen in Figure 16.

Therefore, weak equity in the three banks amounted to about 300 billion ISK in mid-2008. At the same time, the capital base of the banks was about 1,186 billion ISK in total. Weak equity, therefore, represented more than 25% of the banks’ capital base. If only the core component of the capital base

Figure 17  
 Systemic equity of the three big banks



Reference: Glitnir banki hf, Kaupthing banki hf and Landsbanki Íslands hf.

19. See details of the methodology of calculation in Chapter 9.

20. See deliberation on FL Group and the bank’s equity in Chapter 9.

21. See details of the calculation methodology in Chapter 9.

is examined, i.e. shareholders' equity, according to the annual accounts, less intangible assets, the weak equity of the three banks amounted to more than 50% of the base component in mid year 2008.

In addition to the risk that the banks carried on account of their own shares, an assessment was made in the same way of how large a risk of loss they carried from each other's shares, hereinafter called cross-financing. Figure 17 shows the aggregate equity of all three banks and the Figure shows the extent of direct own financing, i.e. weak equity, of all the system, as well as cross-financing. As with the weak equity of each bank, one can regard the aggregate of each bank's weak equity, as well as cross-financing, as the weak equity of the system. The Figure shows that the direct financing of own shares in the three banks increased significantly from the beginning of 2006 until mid year 2008. On the other hand, cross-financing increased from the beginning of 2006 until mid year 2007 and culminated in September 2007 in nearly 150 billion ISK. After that, it contracted by nearly a third until mid year 2008. Around midyear 2008, direct financing by the banks of their own shares, as well as cross-financing of each other's shares, amounted to about 400 billion ISK. If only the core component of the capital base is examined, i.e. shareholders' equity, according to the annual accounts, less intangible assets, one can see that the system's weak equity amounted to about 40% of the base component at the end of 2006. During the latter part of 2007, this ratio went up to 70% and fluctuated around that level until the banks collapsed.

The Special Investigation Commission is of the opinion that the financing of owners' equity in the Icelandic bank system had to such a large extent been based on borrowing from the system itself that its stability was threatened. Especially as shares owned by the biggest shareholders of the banks were especially leveraged. This resulted in the banks and their biggest owners being very sensitive to losses and lowering of share prices. As the difficulties in the banks grew from the autumn of 2007 and share prices started to fall, the banks, and Kaupthing in particular, were tempted to prop up in a systematic way the price of their own shares and granted loans for the purchase of these shares, as noted below and in Chapter 12.

The narrow interpretation that the financial entities used in their calculations of equity resulted in their equity being recorded as being higher than if the aforementioned interpretation of the Investigation Commission had been followed. A bank's equity that is registered too high increases its capacity to grow while the bank's capacity to deal with setbacks decreases at the same time, thereby increasing the risk of bankruptcy. Under these circumstances the loss to depositors and other creditors will be greater than it would otherwise have been in a bankruptcy. If the bank in question is important to the system, as was the case in Iceland, the costs to society will also be significant, as history has shown.

With reference to Article 1(1)(5) paragraph 1 of Article 1 of Act No. 142/2008, the SIC is of the opinion that, in light of discussion above, there is reason to indicate that clearer rules should be established on which own shares in financial entities shall be deducted in the calculation of their equity, as well as increasing the efficiency of supervision. There is also reason to discuss whether Icelandic banks should be prevented from granting loans to buy each others' shares.

## 21.2.2 An Environment Favouring Growth and Increased Risk-Taking

### 21.2.2.1 *Extension of the Authorised Activities of Financial Undertakings*

When Iceland became a member of the EEA Treaty the authorisations of Icelandic credit institutions, including financial undertakings, were significantly increased. This was done in conjunction with the adoption of EU's directives into Icelandic law as these directives provided in general for a minimum coordination of certain issues relating to the establishment and operation of credit institutions and for the principle of mutual recognition. However, the Directives did not prohibit the Member States to maintain or lay down stricter rules in relation to the credit institutions in the Home State as long as they fulfilled the main objectives required by the provisions of the EU and EEA Treaty. The SIC ordered a review of the adoption into Icelandic law of Acts required by the EEA Treaty in the field of financial services (see Annex 6 in the electronic edition of this report). The review reveals that the possibility, provided for in these Acts, including the Directives, of laying down stricter rules concerning the authorisation of financial institutions was in general not applied. The explanatory notes, presented in the Parliament at the time the above-mentioned amendments to the Law were adopted, made it clear that the main objective was to improve the competitive conditions of Icelandic financial institutions in the European Economic Area.

The SIC examined in particular the changes, after Iceland became a party to the EEA Treaty, to the authorisation of credit institutions in respect of seven specific issues : The first change gave credit institutions increased authorisation to invest in unrelated businesses, the second increased authorisation to extend credit to directors, the third increased authorisation to invest in real estate and real estate companies, the fourth increased authorisation to lend money to buy own shares, the fifth concerned reduced requirements concerning the operating structure of securities companies, the sixth gave increased authorisation to operate insurance companies and the seventh increased authorisation for ownership in other credit institutions. In all these cases requirements were reduced and the credit institutions' freedom of action greatly increased. The minimum requirements of the EU Directives concerning the activities of credit institutions did not directly address these extended authorisations. Therefore Iceland was not obliged under the EEA Treaty to increase the authorisations of domestic credit institutions in this manner, however it was considered necessary, for competitive reasons of competition, that the legislation concerning these matters should be comparable to the legislation in our neighbouring countries. The SIC's investigation on the Icelandic banks' operation indicates that, as a consequence of this increased authorisation, their operational risk increased significantly. It is especially noteworthy that the freedom of credit institutions to make riskier investments was greatly increased in this period, inter alia with the authorisation of investment banking in conjunction with the traditional activities of commercial banks, but this margin for increased risk-taking did not go hand in hand with satisfactory constraints and requirements of increased equity. The FME had the power to prescribe increased equity of financial corporations i.a. in case of increased operational risk. This power, however, was never exercised. The increased risk accompanying investment banking lies mainly in

The SIC's investigation on the Icelandic bank's operation indicates that, as a consequence of increased authorisations for the operations of financial institutions in the last few years, their operational risk increased significantly.

investments in assets that may be difficult to liquidate within a short period of time and/or assets that may be subject to great fluctuations in price. An example of this are positions in shares and other riskier types of financial instruments. As no limits were placed on the authorisations of the banks to invest in industries the banks could invest in unlisted shares that may be difficult to liquidate within a short period of time when needed to meet other obligations. At the time of the collapse of the banks in the autumn of 2008 financial institutions were left with numerous investments of this type which they were unable to redeem to meet their obligations and the liquidity crisis was becoming even more constrictive that autumn.

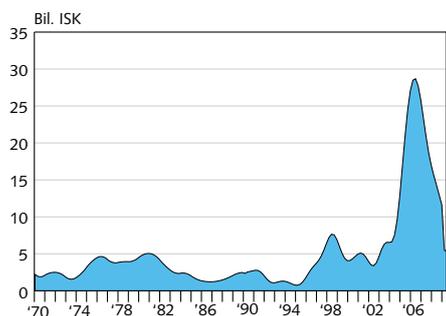
Increasing the authorisation to extend credit to directors greatly influenced the facilitation of loans by the commercial banks, savings banks and credit institutions to related parties. Although the provisions only covered facilitation of loans to CEO's they inevitably had a consequential effect on facilitation of loans to other executive officers of these companies. In the period 2004 to 2008 stock options, put options and loans with limited surety became a part of the bank employees' wage contracts. In most cases this facilitation involved significant risks and costs for the banks but the employees benefited from any resulting gains. In Chapter 10.0 this subject is given further consideration and examples cited of employment terms extended to directors of financial institutions and incentive systems used by these institutions.

#### 21.2.2.2 External Circumstances and Abundant Liquidity

The global economic development had a significant influence in Iceland in the years preceding the banking collapse. The imbalance in the world economy was considerable, the main symptoms being prolonged low interest rates and the USA's big trade deficit. The general reduction of volatile movements of economic aggregates since the early nineties resulted in a reduction of the credit spread in the financial markets and the required rate of return making an increasing number of investment possibilities seem profitable. This was one of the manifestation of less risk aversion. Specialists disagreed on the reasons for the decreased movements of volatile economic aggregates. One hypothesis was that the economies of the world had changed (structural change), others said that improved economic policy contributed to less movements of volatile economic aggregates, especially more effective monetary policy. In the opinion of Stock and Watson, the main reason was luck, and they concluded that the calmness in the economic systems of the world in the last 15 years of the last century, leading to underestimation of risk in the financial markets of the world, could just as well be the calm before the storm that was possibly to be expected.<sup>22</sup> Increased savings and descending risk premiums affected more than other things share prices by the end of the last century. Stock markets, however, began to slide in the beginning of 2001 when the „dot-com bubble“ burst. Availability of savings worldwide was still high, but it moved from stock-markets to real-estate markets. The central

In times of low interest and abundant liquidity the advancement of the financial markets became rapid.

Figure 18  
 Investment in large scal industry<sup>1</sup>  
 At constant prices of the year 2000



1. Aluminium smelters and power plants.  
 Reference: Central Bank of Iceland.

22. „But because most of the reduction seems to be due to good luck in the form of smaller economic disturbances, we are left with the unsettling conclusion that the quiescence of the past fifteen years could well be hiatus before the return to more turbulent economic times.“ (Stock and Watson: „Has the business cycle changed and why?“, NBER working paper 2002, p. 43).

bank of the United States, the Federal Reserve, reacted to fast reduction of share prices by lowering the policy rate rapidly. Lowering of policy rates lead to lower instalments of mortgage loans and competition between credit institutions increased. Higher real estate prices reacted against lowering asset values caused by the fall in the stock-market, and the demand was sustained.<sup>23</sup> The refinancing of real estates, increased leverage and equity withdrawal kept the demand active, though the share prices went down.<sup>24</sup>

Financial corporations grew and became more complex. The search for returns added fuel to the development of new financial products designed to increase returns and reduce risks. Among those were collateralized debt obligations or CDO's. CDOs are securities with underlying real-assets as collateral and known returns.<sup>25</sup> CDO's were used by the Icelandic banks, not as assets, but a lot of the bank securities were inserted into these CDO's.

As discussed above, the Icelandic banks borrowed a lot of capital on foreign debt securities markets while they could. In the years 2004-2006, or up to the so called „mini crisis“, the securities release was especially large. Continuing financing on foreign debt securities markets was connected to the above mentioned CDO's, as the securities of the Icelandic banks were included in CDO's in the United States.

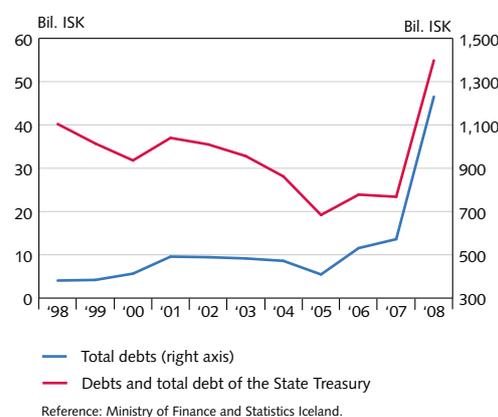
Liquidity overflow, historically low interest rates and low risk premium caused danger. A long period of stable asset prices led to increased risk-taking because of expectations of permanent lowering of volatility. Leverage also increased significantly. Sudden changes in volatility could suddenly move huge resources if market prices and investors' portfolios of assets were based on criteria involving little volatility. Increased leverage, in conditions of lowering asset prices, would in turn cause faster and greater reduction than would have been the case, as so many would need to close their positions at the same time. Carry trade with the krona (ISK) was significant and caused the risk that sudden fluctuations in the exchange rates could immediately whisk away the carry trade of the ISK.<sup>26</sup>

### 21.2.2.3 Economic Administration

#### Introduction

During the recent decade economic policy aimed at retaining strong long-term economic growth, but the SIC believes that neither the fiscal nor the monetary policy reacted sufficiently to economic fluctuations, economic over-expansion and increased imbalance in the economic system. Unfortunately it seems unavoidable to conclude that the fiscal policy increased the imbalance. The policy of the CBI was not contractionary enough and actions too limited to give the desired results in fighting increased leverage and underlying inflation. Interest rates were generally raised too late and too little, which seemed to be caused by the wishful thinking of the CBI that the government would

Figure 19  
 Debts and total debts of the State Treasury  
 Debt as percentage of GDP



At least since the year 2004, the economic administration was an influential part of the excessive economical imbalance, which led to the collapse.

23. According to the Case-Shiller index the real-estate prices doubled from the beginning of 2001 (182,39) until the index reached its maximum in June 2006 (360,22).

24. Equity withdrawal is used when real estate leverage (or leverage of another asset) is increased to convert increased value of the asset into cash, which can then be used for other investments or consumption.

25. Goodman, Fabozzi and Lucas: „Cash-collateralized debt obligations.“ In Fabozzi (editor): *The handbook of fixed income securities*. Edition 7 MacGraw Hill 2005, pp. 669-693.

26. Ferguson, Roger W. et al.: *International financial stability*, p. xxiii.

actively help fighting the economic overexpansion.<sup>27</sup> That did not happen. At the same time there was almost unrestrained access to cash in the CBI and cash seemed to be printed without limitations and in fact the banks were lent cash for debentures in the last years.

The large scale energy intensive investments that were made due to Fjarðaál and Kárahnjúkar were significant pro rata to GDP and it was clear that it would have a significant effect on the stability of the economy during the construction period. This is a very well known demand shock that would increase economic overexpansion if no precautions were made. It would have been ideal to react using fiscal policy as countermeasure and reduce public works as possible during the construction work for the large scale investments and raise the policy rate also since the work was so extensive that suspension of all intended public works would hardly have been enough as countermeasure. Nevertheless, countermeasures taken by the government were far below what was needed, actually the consequence of a number of actions taken by the government rather increased the expansion. Restraint actions were too much on the responsibility of the CBI.<sup>28</sup> CBI's interest rates increases that were among other things caused by insufficient restraints in fiscal policy, led to the strengthening of the krona and inflow of foreign short-term capital. OECD pointed out in 2005 that increased restraints in fiscal policy during large scale industry constructions would lighten the burden of the monetary policy and prevent unreasonable interest rate increases to protect price stability. Higher interest rates had already pushed the real exchange rate up and restricted the export industry and competition industry.<sup>29</sup> The restraints in the fiscal policy were almost nonexistent, that due to interest rate increases and the exchange rate strengthened significantly caused by the inflow of foreign capital. Rising purchasing power increased demand for imported consumer goods that increased the current account deficit. The imbalance in the economy increased significantly and it was clear that the internal imbalance would not be corrected except by substantial economic contraction and rising unemployment, but correcting the external imbalance would lead to the weakening of the krona.

#### *Expenditure*

Although public debt decreased from 1995 to 2005 pro rata to GDP they did not decrease nominally to any extent. In 1998 the total debt of the State Treasury was ISK 381 billion but in 2001 it had increased to ISK 491 billion

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27. The CBI, 2005. See for instance the *Monetary Bulletin* 2005/1, pp. 5-6: "In light of the development it is the opinion of the Board of Governors of the Bank that it is reasonable to increase the bank's interest by about 0.25 percentage points at this point to 9%. Additional restraints may be needed in the next months. It is therefore inevitable that circumstances for the exporting and competitive branches will continue to be difficult. It is desirable to increase constraints on public finances in order to lessen the negative side effects of the monetary constraints. This applies to both the state and local governments. Banks and public savings banks are encouraged to be careful in their credit decisions and consider thoroughly the security and financing of credit, including mortgages. Also it may be necessary to consider whether competition on the market for mortgage loans between Íbúðalánasjóður and the banks, which has contributed to excessively rapid growth in credit with unfortunate timing, is waged under natural circumstances and whether it is possible to establish a division of labour which at the same time secures the bases of the Icelandic financial system and facilitation for those who do not have the same access to mortgage loans as in general."

28. International Monetary Fund: *Iceland: Staff Report for the 2005 Article IV Consultation*. October 2005, and the International Monetary Fund: *Iceland: Staff Report for the 2006 Article IV Consultation*. August 2006.

29. OECD: *Policy Brief: Economic Survey of Iceland*. February 2005, p. 4.

The Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) pointed out repeatedly that in recent years that fiscal policy was not restrictive enough during the economic upswing. OECD repeatedly recommended that the state should put limits on expenditure in the medium term and set the target in kronur terms in accordance with the inflation target of the CBI, rather than defining expense growth in real terms.<sup>30</sup> These institutions had great concern regarding increased expenditure, in particular by local governments.<sup>31</sup> It was pointed out that the local governments had a greater incentive than the state to spend windfall gains caused by increased economic growth. The SIC agrees that restraints in fiscal policy should have been greater from 2003-2007, particularly because of the tax reductions made.

### *Taxes*

The personal income tax in the pay-as-you-go system was lowered by one percentage point each year in 2005, 2006 and 2007. Until the autumn of 2006 the aim was to lower by two percentages in 2007. The lowering of income tax rates was followed by lowering VAT on food products and other products just before the 2007 election although shortly before it was decided to reduce the intended lowering of the income tax owing to the expansion of the economy.

In Monetary Bulletin of the CBI that was released in September 2004 it was pointed out that the timing of these intended tax reductions were unfortunate with regard to status of the economy: „More important is to restrain expenditure in the next two years. It is particularly challenging since the plan is to reduce taxes in the next three years by ISK 20 billion. To counteract the effects of lower taxes at the same time as contractionary measures are needed because of the large scale industry construction the government expenditures have to be decreased significantly.<sup>32</sup>

In an International Monetary Fund report on Iceland that was released in October 2005 it is stated that it is possible to lower taxes permanently thanks to the effective fiscal policy. Supporting that opinion they pointed at low and falling public debt that were 23 percent of GDP at the end of 2004.<sup>33</sup> The International Monetary Fund considered the long-term effects of lower taxes to be positive, though it would be minor caused by great labor force participation. Therefore it would be wise to delay the intended tax reductions in 2006 and later until it would be clear that the excessive demand had disappeared. If it would not be possible to delay the tax reductions, the expenditure would have to be cut further than planned to weigh against the expansionary effects of the tax reductions.<sup>34</sup> In August 2006 the International Monetary Fund suggested that the Government should announce that the

30. OECD: *Policy Brief: Economic Survey of Iceland*. July 2006, OECD: *Policy Brief: Economic Survey of Iceland*. 2008, February and the International Monetary Fund: *Iceland: Staff Report for the 2007 Article IV consultation*. August 2007.

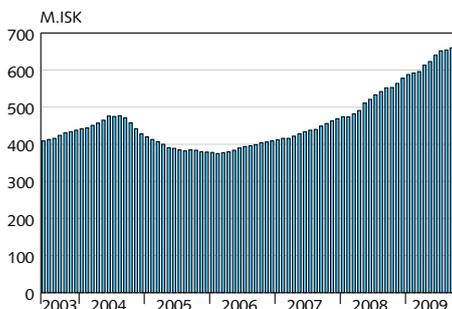
31. OECD: *Policy Brief: Economic Survey of Iceland*. February 2005, and the International Monetary Fund: *Iceland: Staff Report for the 2005 Article IV consultation*. October 2005.

32. The CBI: *Monetary Bulletin 2004/3*, p. 23.

33. International Monetary Fund: *Iceland: Staff Report for the 2005 Article IV Consultation*. October 2005, p. 11.

34. International Monetary Fund: *Iceland: Staff Report for the 2005 Article IV Consultation*. October 2005, p. 23.

Figure 20  
 Total lending by the Housing Financing Fund



Reference: Housing Financing Fund.

[...] the increase of loans from the Housing Financing Fund, the reduction of interest rates of that Fund, this was purely a mistake and unfortunately it must be admitted honestly that one had doubts about this, but this was agreed when the Government was formed in 2003, and if this hadn't been done that particular Government wouldn't have been formed. This is just a part of the politician's reality, that sometimes this issue has to be taken into consideration."

Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, p. 9.

budget for 2007 would contain actions to reduce domestic demand if the economy would not start to cool down. They suggested suspension of lowering income tax, slower growth of government consumption and less growth in public investment.<sup>35</sup> In the middle of 2007 the Fund expressed concern regarding the tax reductions in the first part of the year, the strong krona and the renewed growth of real assets pricing having caused increased consumer confidence and prevented private consumption from reaching a sustainable level.<sup>36</sup> In February 2005 the Organisation for Economic Cooperation and Development stated that tax reductions would reduce contractionary fiscal policy for the near future and stop in 2006, exactly when the expansion caused by large scale industry construction work was at its peak. The state should aim at greater fiscal surplus than it did. For that reason more emphasis should be put in reducing expenditure growth. In July 2006 the Organisation for Economic Cooperation and Development (OECD) still placed emphasis on the necessity to reduce government expenditure to counterbalance the expansionary effects of tax reductions until domestic demand pressure had disappeared.<sup>37</sup> The OECD also pointed out in February 2008 that the tax reductions in early 2007, where the income tax rates for individuals had been lowered by one percentage point for the third consecutive year and VAT on food products and other products had been substantially lowered, had been premature.<sup>38</sup>

It seems that everybody agreed on the bad timing of the tax reductions during these times of great expansion in the Icelandic economy during 2005 to 2007. The Organisation for Economic Cooperation and Development, the International Monetary Fund and the CBI all agreed that the timing of the tax reductions in 2005 to 2007 was unfortunate. It also was clear in the statement of former Minister of Finance, later Prime Minister, Mr. Geir H. Haarde that in his estimation the timing of the tax reductions at that time was unfortunate. It could act as oil to open fire, increase the expansion significantly and also the probability of a strong decline after the expansion period. Nevertheless the tax reductions were carried out although they might harm the economy because they had been promised during the competitive period preceding the general elections that turned in a „...very peculiar way into a race for tax reductions“, using Mr. Haarde's words.<sup>39</sup>

The SIC can only assume that the arguable decisions in economic policy that have been detailed above, increased the imbalance in the economy and caused a very tough adjustment. Aforementioned decisions on tax reductions were taken against specialists' advice and the persons in authority understood the dangers that could follow. The SIC is of the opinion that this is a clear example of poor decision-making regarding economic policy in Iceland in recent years.

35. International Monetary Fund: *Iceland: Staff Report for the 2006 Article IV Consultation*. August 2006, p. 15.

36. International Monetary Fund: *Iceland: Staff Report for the 2007 Article IV Consultation*. July 2007, p. 3.

37. OECD: *Policy Brief: Economic Survey of Iceland*. July 2006, p. 5.

38. OECD: *Policy Brief: Economic Survey of Iceland*. February 2008, p. 4.

39. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, pp. 9-10.

*The Icelandic Housing Financing Fund*

The government coalition agreement of 2003 proposed a reorganisation of the Icelandic real estate market in accordance with the plans for the Housing Financing Fund and to increase the loan maximum to 90% of the property value. The CBI estimated the possible economic impact of increasing the mortgage loan ratio according to the ideas of Mr. Árni Magnússon, Minister of Social Affairs and Social Security, which were the following:

- 1) Increasing the loan maximum to 90% of the property value.
- 2) Increasing the maximum loan amount from ISK 9 millions to 15.4 millions.
- 3) Loans are only provided as a first-lien mortgage.
- 4) Maximum maturity on loans to be shortened from 40 years to 30.

Points 1 and 2 are conducive to increasing demand in the housing market and lead to rising real estate prices, the other two points lessen this effect. The CBI pointed out that „minor changes that increase demand during economic over-expansion could increase the imbalance in the national economy and lead to a harsh readjustment.“<sup>40</sup> The CBI pointed out that it was important, if these changes were to take place, then raising the maximum amounts, for example, should be delayed until the positive demand shock, which was foreseeable because of the heavy-industries projects, would blow over. A summary of the conclusions that can be drawn from the report ends with these words: „Furthermore, it is important, if these changes are put into effects, that proposals addressed at slowing down their over-expansion effects, i.e. that the Housing Financing Fund loans are always the first mortgage and shortening the loan period to 30 years, must be kept.“<sup>41</sup>

The Institute Of Economic Studies at the University of Iceland produced a report in the autumn of 2003 at the request of the Confederation of Icelandic Employers and the Association of Financial Institutions in Iceland, on the impact of increased mortgage authorization for the Housing Financing Fund, namely point 1, and changed financing with issuing of HFF bonds, on real estate prices and economic policy.<sup>42</sup> The timing was considered unfortunate as it would increase expansion and demand during constructions of large heavy-industries projects and the CBI would react with a higher policy rate. Furthermore, it warned about the long-term effects of the changes, that „the debt of Icelandic households will increase, which eventually will lower the economy’s consumption level.“ This was considered important as Icelandic household’s debt was at that time very high, both historically and in international comparison.

Points one and two were carried out in 2004, while points three and four were not, against the advice of the CBI. In addition to this, interest rates were lowered when in the middle of July 2004 the HFF lowered interest rates for

40. The CBI - *Economic effects of the changes of arrangement of housing debt financing*: Report from the CBI to the Minister of Social Affairs and Social Security, 2004.

41. The CBI - *Economic effects of the changes of arrangement of housing debt financing*: Report from the CBI to the Minister of Social Affairs and Social Security, 2004.

42. Institute of economic studies at the University of Iceland: „Impact of increased mortgage authorization of the Housing Financing Fund on housing prices and economic management.“ Report no. CO3:06. 2003.

loans from 5.1% to 4.8%. In the autumn of 2004, the HFF interest rates were again lowered sharply. In the beginning of October the interest rates were down to 4.3% and were 4.15% at their lowest level, where they remained from 22 November 2004 to 24 November 2005. The HFF's maximum loan amount was also raised rapidly during that time, from ISK 9.7 million at the beginning of 2004 to 14.9 million by the end of 2004, 15.9 millions in April 2005 and 18 million one year later.

One factor that significantly increased the effects of the changes on the mortgage market was the competition between the Housing Financing Fund and the banks. During the months following the changes of the financing of the Housing Financing Fund, the lowering of interest rate on loans and promises of a significant increase of the loan maximum, the commercial banks started to offer competitive mortgage loans. The commercial banks offered higher loans than the HFF, with comparable interest rates and more liberal criteria for mortgages, at least to begin with. The banks also provided refinancing that did not require selling the property, contrary to what HFF offered.

It is clear that the effects of the HFF's changes on financing, loan amounts and mortgage ratios were more severe than initially projected when these ideas were introduced. This is because the proposals that the CBI based its estimates on did also assume actions that would counteract the expansionary effects of those changes, i.e. the shortening of the maximum loan period from 40 years to 30 and requirements of first mortgage. Indeed, the CBI did emphasise that if the changes in question were implemented by the HFF, then under no circumstances should the restrictions be excluded. The restrictive points in the plan were nevertheless omitted, even though the Minister of Finance at that time thought this highly questionable. The minister was however of the opinion that otherwise the government would not have been formed. At that time, his opinion was that the presumed damage to the economy would be an acceptable cost of keeping the ruling parties in power. The SIC is of the opinion that this is one of the most significant mistakes in economic policy in the run up to the collapse of the banks, mistakes that were committed with full knowledge of the possible effects, which later became reality and even more serious in the low interest rate environment in the global financial markets.

Other countries have battled with housing bubbles in recent years and they are closely connected to the recent international financial crisis. In a report that was made for FSA UK regarding regulation action against the international banking crisis is among other things suggested to set up rules regarding maximum amount of loans in proportion to the real estate value that is bought and as a proportion of borrower's income. This is made to prevent rapid growth in lending and real estate price in order to reduce the excessive growth in the economic fluctuation. It is also suggested to vary the loan percentages with the status of the economy. This would protect borrowers and strengthen credit institutions. In that way it is possible to lower the loan percentages as real estate prices rise borrowing increases.<sup>43</sup> SIC considers whether either CBI or FME should be allowed to set the maximum loan percentage to prevent an unreasonable increase in leverage expansion.

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43. Financial Services Authority: *The Turner review: a regulatory response to the global banking crisis* . 2009, pp. 106-111.

#### 21.2.2.4 Monetary Policy

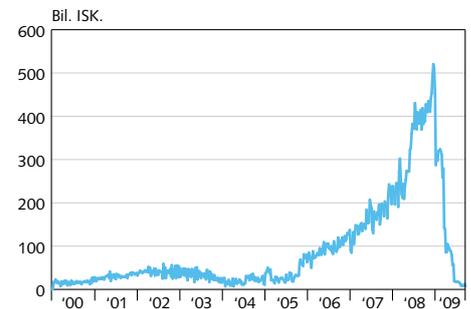
CBI experts concluded shortly before the year 2000 that the fixed exchange rate policy was outdated and that it was necessary to change the monetary policy. It would either be necessary to adopt the euro or to let the exchange rate of the ISK float and adopt an inflation target.<sup>44</sup> EU membership is a precondition for adopting the euro as a currency. That is a political decision, hence not a decision to be made by CBI. Successful adoption of the inflation target demanded an evolved financial system that could make effective interest rate decisions. At that time neither the money market nor the foreign exchange market were sufficiently evolved. At the end of March 2001 CBI was forced away from the fixed rate policy with significant outflow of foreign currencies, or 1/6 of Iceland's foreign currency reserves in a few days. On 27 March 2001, the Board of Governors of the CBI and the Prime Minister signed Letter of Intent regarding changes of the monetary policy framework in Iceland. As of 28 March 2001 the main role of the monetary policy should be to keep inflation as close to 2.5% instead of keeping the ISK exchange rate fixed with a tolerance limit. Simultaneously to changes in the monetary policy framework and increased independence of the CBI the interest rates were lowered, even though the krona was under pressure to weaken. In the report of the former head of the CBI Economics Department it was reported that interest rates were lowered at that time because of pressure from the Prime Minister's Office.

The execution of the monetary policy was such that the CBI decided the rate on week long collateralised loans to financial institutions. In chapter 4 the execution of the monetary policy is reviewed in a couple of developed countries and shown that two things are in common with all the different methods that central banks use to affect market interest rates, the economy and inflation by using their policy rate. They set a target for certain short-term interest rates on the interbank market where banks lend each other to balance their liquidity at the end of each day. The central banks also influence the total liquidity of the financial system, most of them daily or often several times a day, to prevent inter-bank swap rates to deviate too much from the policy rate, caused by occasional fluctuations in cash flow.

In Iceland the total liquidity need of the financial system has not been estimated. The banks estimate their own need by weekly requests for collateralised loans from the CBI. In practice the monetary policy in Iceland was such that the CBI provided financial institutions with unlimited access to collateralised loans as long as they provided valid collaterals, which they increasingly took advantage of starting the autumn 2005.

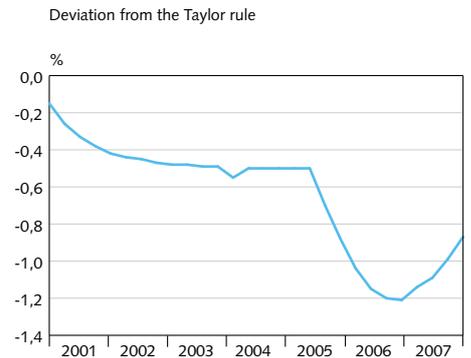
Since the autumn 2005 the banks always profited from accessing liquidity from the CBI and bringing it to market, see picture 21. From the autumn 2005 to the beginning of October 2008 the stock of loans against collaterals increased from the CBI from 30 billion ISK to 500 billion ISK. It should have been clear from this that interest rates were too low or some banks

Figure 21  
 Central Bank of Iceland collateralized lending  
 Lending institutions



Reference: Central Bank of Iceland.

Figure 22  
 The difference in the Central Bank of Iceland's policy  
 interest rate and interest rates according  
 to the Taylor rule



Reference: Central Bank of Iceland.

44. Mr. Már Guðmundsson, Mr. Þórarinn G. Pétursson and Mr. Arnór Sighvatsson find in the report "Optimal exchange rate policy: the case of Iceland", Working paper no. 8, released by the CBI in May 2000, that Iceland does not fulfill preferable conditions to be a member of a monetary union. They still point out that euro participation is not a bad idea. It depends on how the freedom of economic policy using a floating exchange rate would be used. It also matters that fluctuations in the exchange rate are at a minimum, as fluctuations could cause instability.

were accessing emergency loans increasingly from the CBI for years. If the CBI would have wanted to minimize the expansion in the economy it should have lowered liquidity in the system. This is possible by reversible repurchase agreements or by releasing certificates of deposit. For that to be effective, interest rates need to be high enough for credit institutions to have an incentive to lend CBI cash, instead injecting it in the system. In December 2003 the CBI offered two weeks certificates of deposit to withdraw liquidity and to minimize the expansionary effect of the bank's purchase of foreign currency at that time and the reduction in the reserve requirement that had been reduced significantly in the year 2003.<sup>45</sup> The demand for these certificates of deposit was not high at that time, which might suggest that as early as autumn 2003 the CBI was „lagging behind the curve“. That is the interest rates were too low.

As shown out in figure 22 it seems that the CBI did not raise interest rates rapidly enough in the years after adopting the inflation target. It is especially remarkable that in the third quarter of 2005 when it seems that changes have been made in the execution of the monetary policy the bank falls even further „behind the curve“.

Mr. Már Guðmundsson, the chief economist of the CBI until spring 2004, considered the process of raising the interest rates had started normally, but that it had slowed too much in the long run. „I think that we have mainly fallen behind in the autumn of 2004 and particularly, there is a certain delay in the raising process of the interest rates in the summer of 2005.“<sup>46</sup> Mr. Arnór Sighvatsson became the chief economist of the CBI in the spring of 2005, also says that in May 2005 he had pointed out the „necessity of increased contractionary policy [...] but it was not until September that the Board of Governors of the CBI took action and then by raising policy rates rapidly.“<sup>47</sup> Generally in SIC data it seems that within the CBI there were different views on the policy rate. The Board of Governors of the CBI often chose less contractionary policy than the chief economist of CBI suggested. It is noteworthy that the minutes of the meetings of the Board of Governors of the CBI do not show how and based on which data or information the Board made its decisions regarding other policy than suggested by the chief economist.

It is the finding of the SIC that policy rates were too low during the upswing. Surely, high policy rates cause increased profitability of carry trade and attracted foreign short-term capital. The CBI had other means to react to the negative effects of the carry trade than by using policy rates. The CBI could have reduced the profitability of foreign loans, by f. ex. restricting liquidity requirements and/or increasing the reserve requirement regarding foreign financing of the banks.

The function of monetary policy is largely based on the effects of short-term interest rates on long-term interest rates, that then affect consumption and financing decisions of individuals and companies. The monetary policy rate transmission was poor in Iceland given that outstanding government bond issues were scarce. In many other countries, such as Norway, the government maintains a minimum of certain bond issues, regardless of the government borrowing need. The release of standard government bonds builds

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45. "CBI releases certificates of deposit." News no. 34/2003 on the Central Bank webpage, 22 December 2003. [<http://sedlabanki.is/?PageID=13&NewsID=663>]

46. Statement of Mr. Már Guðmundsson before the SIC on 22 October 2009, p. 24.

47. Statement of Mr. Arnór Sighvatsson before the SIC on 27 July 2009, pp. 2-3.

the basis for interest rates and government bonds interest rates are the basis for pricing financial instruments. The CBI repeatedly asked the Ministry of Finance to ensure that the government would supply the basis for interest rates such that there would be a normal system of interest determination and to ensure the transmission of monetary policy. As set out in chapter 4 the Icelandic state did not consider it necessary to create the basis for the interest rates spectrum because it would incur outlays in the form of interest of loans that were not needed. The cost of inactive monetary policy is thought to be much higher than the minimum interest rate cost by issuing enough of government bonds to transmit monetary policy to the economy. The SIC feels that the consequences of insufficient supply of government bonds has been that using the interest rates for transmission of monetary policy was less effective than it could have been. For that reason the interest rates had to be higher and the currency exchange rate became more important in the monetary policy. The scarcity of government bonds contributed to higher policy rates and the krona got overvalued which in turn contributed to increased external imbalance in the economy.

The CBI also lacked credibility. Generally speaking central banks cannot be successful in keeping inflation close to target, except they can keep inflation expectations as close as possible to the target. When the CBI switched to inflation targeting the interest rates were lowered at the same time, that affects expectations for the process of reducing interest rates. This was not a fortunate start. In the beginning the interest rate policy-making process was not well defined, which increases uncertainty about future interest rates. It was not until the year 2005, when regular interest rates decision meetings began, that the CBI created directives regarding the decision process of the interest rates.<sup>48</sup> In the year 2007 the CBI still tried to strengthen the credibility of the monetary policy by releasing forecasts on the term structure of interest rates. The Board of Governors of the CBI itself reduced its credibility by stating in the Monetary Bulletin that „The interest rate forecast is not declaring or promising anything on behalf of the Board of Governors of the CBI“.<sup>49</sup> This was unfortunate, since it diminished the credibility of the forecast, reducing the value of releasing it.

The CBI was not successful in increasing credibility in the monetary policy. In the report certain conflicts are described between the CBI's economists and the Board of Governors of the CBI regarding the importance of credibility regarding the monetary policy. There are examples of minister's comments that did not support the monetary policy.<sup>50</sup> OECD pointed out,

48. Each interest rate decision was now made subsequent to three meetings. The first meeting was devoted to overall assessment of trends and outlooks. The second meeting discussed the interest rate decision and at that meeting the chief economist recommended actions regarding interest rates. Between the second and the third meeting the interest rate was decided by the Governors. The third meeting discussed the presentation of the decision. Since the beginning of 2006 until the banks collapsed 21 interest rates decision meetings were held and in eight times interest rates were decided that were lower than the chief economist recommended.

49. CBI: "CBI policy rates unchanged." *Monetary Bulletin* 2007/1, p. 3.

50. After raising the interest rates in the autumn 2005 the Prime Minister at that time Halldór Ásgrímsson said in public that he did not see the need for further raising of the interest rates. Among other things he criticized the CBI for raising interest rates in September. ("CBI changes its course." *Fréttablaðið* 7 December 2005, pp. 10-11). In the summer 2008 the Minister of Culture and Education at that time, Þorgerður Katrín Gunnarsdóttir, said: "We are working on creating the general budget that will show certain responsibility in regards to running the economy and what matters is that we will hopefully see the CBI lowering the interest rates for the good of Icelandic companies that have difficulties operating in this high Icelandic interest rate environment." RUV evening news in the summer 2008.

Figure 23  
 Outstanding "glacier" bonds and the exchange rate of the ISK

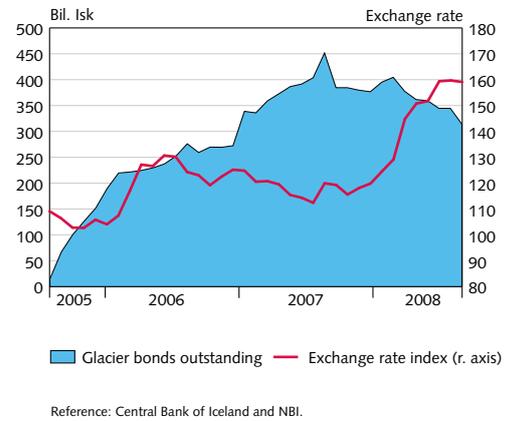


Figure 24  
 Household debts

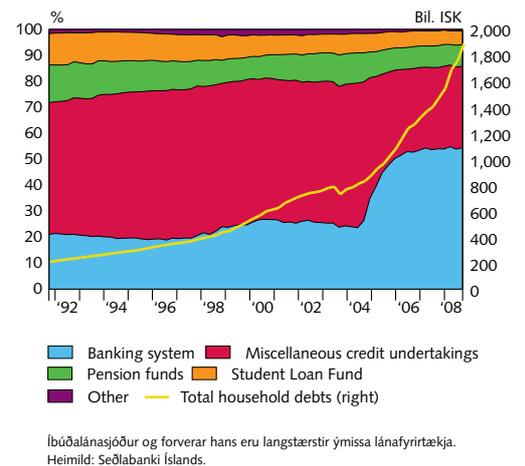


Figure 25  
 Current account 1997-2007  
 and the first nine months of 2008  
 Percentage of GDP

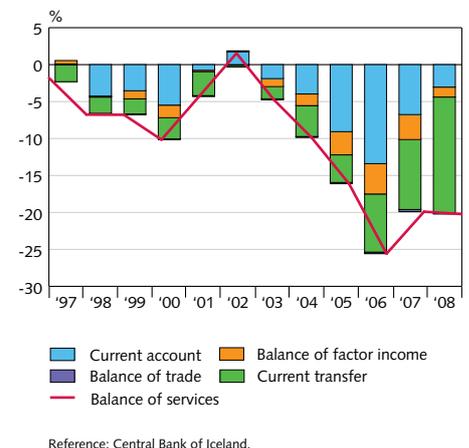
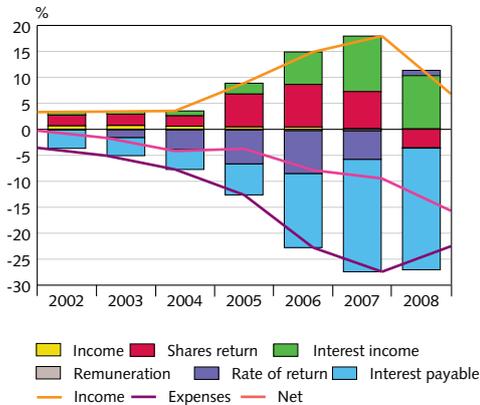


Figure 26  
 Balance of factor income 2002-2007  
 and the first nine months of 2008  
 Percentage of GDP



Reference: Central Bank of Iceland.

„In the next few years the monetary policy has to face very difficult circumstances which will be very trying for the resilience of the national economy. It is of the utmost importance that the monetary policy and the state finance policy work together under these circumstances. The heavier the burden on the monetary administration during this period, the more negative the side effects of restrictive monetary policy will be. The Central Bank has emphasised the importance of alleviating the pressure on the monetary policy with strict restraints on state finances and of public service in its entirety. Somewhat more restraint can be found in the budget bill for the year 2005, compared to the previous year. None the less there are indications that the treasury’s performance, adjusted for economic cycle, will be considerably worse in the years 2005 and 2006 than during the overly expansive years of 1999 and 2000. The restrictive measures at that time proved insufficient in light of the fact that the after effects of the expansion became clear in the years of 2001 and 2002. To act against stimulating effects of tax reductions in the next few years there is a need for very radical cuts in public expenses which will without a doubt be met with resistance. Therefore it is a matter of great concern how vague the plans for cuts are. Most years public expenses have had the tendency to exceed plans. When making decisions in monetary matters it is therefore tricky to depend on that ambitious plans on expense cuts will go precisely as they are supposed to, because if that does not happen it may be too late to respond to the consequences that will ensue in the situation which lies ahead. The Central Bank must take notice of the most plausible progression when taking measures in monetary matters.

Birgir Ísleifur Gunnarsson, chairman of the Board of Governors in the Central Bank of Iceland, at a meeting held by the Icelandic Chamber of commerce, 3 December 2004, p. 9. [http://www.vi.is/um-vi/frettir/nr/376/].

in its report on the Icelandic economy in the first-half of 2008, the problem created when minister’s talk against the CBI’s policy: „To support credibility and the effectiveness of the monetary policy it would be helpful that the government would respect the independence of the policy making of the CBI.”<sup>51</sup> That is a prerequisite for a successful monetary policy. The inflation target is not only the CBI’s responsibility, although its duty is to meet the inflation target within a certain time by all suitable means. The inflation target is also the authorities objective.

The monetary policy was thus, mostly via the currency exchange rate as stated in Monetary Bulletin 2007/1: „The effects of the monetary policy on currency exchange rates are important in an open economy. In current circumstances this effect is active and effective. If not through the exchange rate the monetary policy would not be as effective, because of the current situation in international financial markets. For that reason it is important not to restraint its effectiveness.”<sup>52</sup> The krona strengthened steadily from 2002 to the beginning of 2006, with ever increasing deficit on the current account and increased probability of the correction of the imbalance by rapid currency devaluation and a surge in inflation. Instead of acting to limit the strengthening of the krona the CBI used high interest rates to limit sudden outflow of capital. The aim of the CBI by using this policy was to prevent sudden capital flight, but it was interpreted as a promise of the CBI that it would not allow the krona to devalue. The effect was like having a put option on the krona. This was another reason for profit of carry trade. Because of this interpretation that became the norm in the market the imbalance rose which caused a further weakening of the currency when it crashed.<sup>53</sup>

The so-called glacier bonds were first released in August 2005 and at the beginning of September 2007 ISK 450 billion were outstanding. Demand for the krona increased with the ongoing release of glacier bonds. New demand had been made for the same amount of krona. This led to strengthening of the krona. Higher interest rates led to more releases of glacier bonds, that led to further strengthening of the krona and lower prices for imported goods. The transmission of monetary policy was to a greater extent through the exchange rate channel after the glacier bonds came on the market. Increased demand for Icelandic government bonds to protect the status in glacier bonds led to lower market interest rates and made the transmission of monetary policy through interest rates less important.

The CBI could have acted against the external imbalance that was caused by the strengthening of the krona by purchasing foreign currencies on the market and thereby devalue the krona, and increase the effect by releasing certificates of deposit. In that case interest rates would have needed to be higher still, particularly in 2005 and 2006. That would have caused the interest rates to be more important in the monetary policy, but would have weakened the weight of the exchange rate in the monetary policy. Liquidity overflow and the hunt for rate of return on international financial markets made such operations more complicated and therefore it was necessary

51. OECD: *Policy Brief: Economic Survey of Iceland*. February 2008, pp. 1-2: “In order to support the credibility and the effectiveness of monetary policy, it would be helpful if members of government respected the independence of Central Bank policy-making”.  
 52. The CBI: “New framework for monetary policy.” *Monetary Bulletin* 2001/2, pp. 39-44.

for the CBI to get support from fiscal policy to reduce domestic demand. That was not the case at that time as stated before, since tax reductions and increased loans for housing were on the agenda.

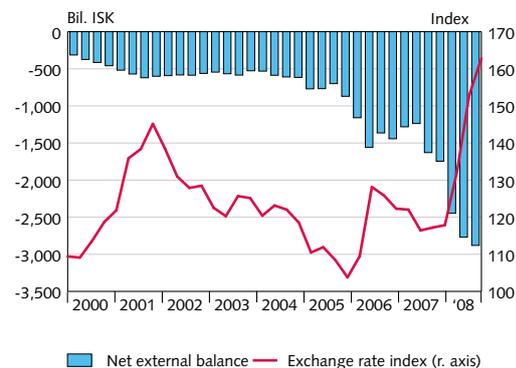
The SIC considers it is necessary to increase the co-operation of the government and CBI in economic policy to prevent mismatch of policies, as was the case in recent years when fiscal policy aimed at increasing the imbalance and expansion and the CBI had to fight the consequences alone. To create a neutral basis for cooperation in economic policy an independent institution could have the role of forecasting the economic outlook and evaluate the status of the economy and the development given assumptions on economic policy. In that case the basis for decision making, both by the CBI and the government, would be the same, which could prevent disparity in economic policy that was the case in the last years.

### 21.2.2.5 Internal and External Imbalance

In the years before 2002, until the banks collapsed, the economy was internally imbalanced. Inflation was over four percent at the end of the summer 2005 and stayed high until the banks collapsed. At the same time unemployment was less than two percent and was 0.8% at the lowest at the end of 2007<sup>53</sup>. Output gap, deviation of GDP from production capacity, became positive at the end of 2004 and was 3.7% above production capacity at the highest point in the first quarter of 2006. At the same time loans increased significantly, or from 250% of GDP at the end of year 2001 to 430% of GDP at the end of year 2007. Household debt went from ISK 700 billion to ISK 1.900 billion during the same period, see Figure 24.

The external imbalance also increased rapidly as stated before. After the decision in the year 2003 to build Kárahnjúkar power plant and Fjarðaál aluminium smelter it was clear that current account deficit would be high in the years during the construction, see Figure 25. The current account deficit increased every year from 2002 to 2008.<sup>54</sup> A part of the current account deficit can be explained by the aforementioned heavy industry construction that need a lot of imported capital goods.<sup>55</sup> The construction also led to expectations for interest rate increase among expectations for increased inflow of finance that would strengthen the krona. For that reason the inflow of short-term capital increased in order to take advantage of the interest rate differential while the krona was strengthening due to increased inflow. This resulted in further strengthening of the krona in the years 2003 to 2005. Expectations for a temporary increase in purchasing power compared to

Figure 27  
 External balance and the exchange rate of the ISK



Reference: Central Bank of Iceland.

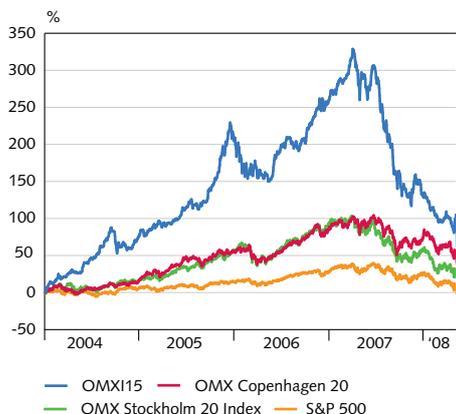
An increase in the inner and outer imbalance increased the imbalance and increased continuously the probability of a sudden retraction.

53. CBI assumes 2.5–3% natural unemployment, acc. “Calculation of output gap.” *Monetary Bulletin* 2005/1.

54. In the year 2008 current account balance is only shown for the first nine months pro rata to GDP at these months. With the collapse of the banks in the beginning of October 2008 the situation deteriorated significantly. Great loss of foreign operations caused big negative transaction in factor income in the third quarter of 2008. The current account balance was negative in the amount of ISK 310 billion in the fourth quarter 2008 and the balance on factor income was negative in the amount of ISK 340 billion, but GDP in total was ISK 398 billion in the fourth quarter of 2008. The current account balance was negative of 78% of GDP and factor income was negative of 85% of GDP in the fourth quarter of 2008. The current account deficit was 44% of GDP for 2008 in total.

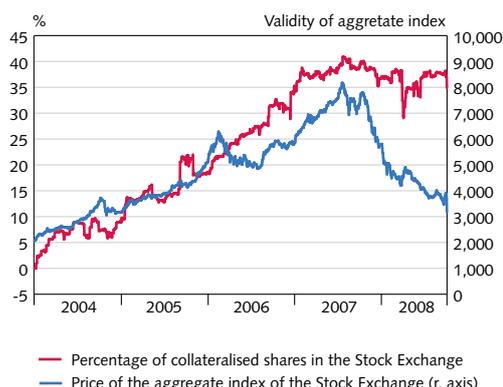
55. According to CBI estimates, one third of the current account balance in 2004 and 2005 was caused by heavy industry construction (CBI: “Annex VII: “External balance.” *Monetary Bulletin* 2006/1, p. 38). The Ministry of Finance came to a similar conclusion in its evaluation (Ministry of Finance: National economies. Spring report, 2006).

Figure 28  
 Comparison of stock price indices



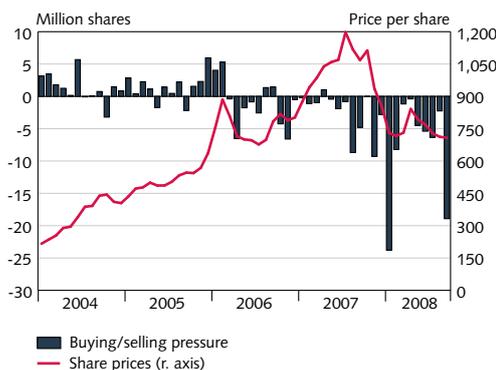
Reference: Icelandic Stock Exchange, Yahoo Finance, <http://finance.yahoo.com>

Figure 29  
 Collateralisation of Icelandic stock



Reference: Icelandic Stock Exchange.

Figure 30  
 Buying and selling pressure in Kaupthing  
 Compared with market price



other countries because of the stronger krona led to purchases of imported goods by households and firms while they were cheap because of advantageous real exchange rate. Around one third of the current account deficit can be expected to have resulted from such decisions. A current account deficit because of foreign investment is not of concern while the investment is sustainable, that is if the profitability is enough to pay foreign finance cost. The same is the case regarding a temporary shift of demand of domestic products to foreign and investment earlier than otherwise planned in imported capital goods and consumer products, especially durable and semi-durable consumption goods, like household appliances and cars. The increase in the current account deficit for that reason is temporary and the deficit will fall rapidly by the end of the expansion. Weakening of the krona by the end of the expansion plays an important role in this transition and the weakening of the krona has to run its course, just as it strengthened during the expansion when the rising interest rates directed demand out of the country. Weakening of the krona in the year 2001 played a key factor in the fast adjustment of the economy in the years 2001 and 2002 following the expansion from 1998 to 2000.

Persistent and growing deficit of factor income was created in the expansion that started in the years 2003 to 2004. Although the trade deficit increased because of the construction work and the deficit of goods and service trade grew, caused by temporary increase in purchasing power in relation to foreign countries, the deficit on factor income grew pro rata to GDP. In those years the composition of factor income changed.

When looking at changes in factor income, one can see a growth in interest rate payments to foreign countries is visible in addition to interest income and the return of shares. This is of great concern. In the years 2002 to 2004 interest cost paid to foreign countries is in total 3.5% to 4% of GDP, that is a similar ratio as in the decade before. In the year 2005 the interest cost is 6% of GDP, over 14% in 2006 and in 2007 and 2008 the interest cost is approximately 22% to 23% of GDP.

Iceland's foreign debt burden also increased rapidly during this time. The main reason being the foreign loans taken by the three Icelandic banks. The net external position of Iceland was stable in the years 2001 to 2004, but it worsened significantly in the years 2005 to 2008.<sup>56</sup>

Development of the net foreign debt position of the economy, the current account balance, the krona and the balance sheets not showing the real situation during the expansion from 2004 to 2007 was like an object lesson that was described by NBER (National Bureau of Economic Research) in articles that were released on the prelude of the currency and financial crisis in Asia in the years 1997 and 1998.<sup>57</sup>

At the beginning of the year 2006 the krona stood stronger than was sustainable, the current account deficit was over 16% of GDP and the balance sheet of the economy seemed weak as the debt in foreign currency in excess

56. Assets of Icelanders in foreign countries and liabilities of foreigners to Icelanders minus foreigners assets in Iceland and Icelanders liabilities to foreigners. This situation follows the development of the exchange rate such that the worsening status in the beginning of the year 2006 is due to weakening of the krona. The worsening situation in the year 2008 is also due to the weakening of the krona.

57. *Preventing currency crises in emerging markets*. National Bureau of Economic Research, 2002.

of assets were close to GDP in size. At that time, the ground for a financial crisis had been laid. Den Danske Bank research department focused on the economic imbalance in Iceland as they estimated 20% current account balance in the year 2006, unemployment rate was 1% and pay rises were 7% a year. As a result the krona fell rapidly in March 2006 and the CDS spreads on the Icelandic government and the banks increased. The situation got calmer in the middle of 2006, but then imbalance in the economy increased more rapidly than before. The banking system grew further, foreign leverage grew, the percentage of short-term foreign currency liabilities increased and household debt and companies' liabilities in foreign currency increased significantly in 2007. The prospects for a serious financial crisis increased.

### 21.2.3 Further on Financial Markets and Financial Institutions

This chapter includes the main conclusion of the chapters of the report that deal with financial markets and financial institutions.

#### 21.2.3.1 The Icelandic Stock Market

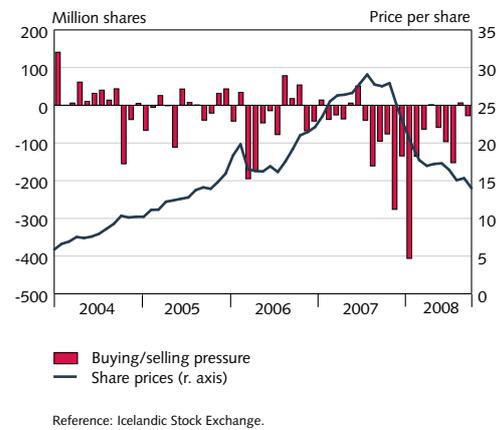
Chapter 12 of the report deals with the development of securities exchange in Iceland in the period from 2004 until the collapse of the banks in October 2008. The analysis published in that chapter first and foremost deals with the stock market, and primarily with the trading of Kaupthing, Landsbanki and Glitnir stock. Since the calculation of the stock market index (OMX Iceland 15) began in the beginning of 1998 until the start of 2004 its value rose 110.29% but the largest increases did not appear until later. Since the beginning of 2004 until the stock market index reached its highest level of 9016.48 points on 18 July 2007 the increase was 328.76% and such an increase was unprecedented among developed economies, as comparison with international indexes distinctly shows.

In Chapter 12 evidence is produced for the large increase of stock prices, in the period from the beginning of 2004 until the middle of 2007, mostly being a consequence of increased leverage in stock purchasing and underestimation of the accompanying increased risk. In figure 29 the increase of collateralization of stock accompanying the increase of stock prices until the middle of 2007, when the stock market index reached its highest level, can be distinctly seen. During that time period the collateralization of stock grew by the market value of 40% of all listed stock in the Icelandic stock exchange.<sup>58</sup>

The banks were significant participants in the lending for stock purchasing and in certain cases they took stock in themselves as collateral. As stock prices fell the quality of their loan portfolios fell, which could have considerable impact on the performance of the banks and consequently the price of their stock. In addition, the employees of the banks in many cases owned significant shares in their own bank, which the bank even financed. Therefore the SIC (SIC) concludes that the banks put themselves in a difficult position when stock prices started to fall late 2007, the collateral coverage of their equity loans decreased and their clients positions worsened.

Establishing a market maker for a stock is one way to ensure efficient pricing, diminish large fluctuations of price and secure normal trading with

Figure 31  
 Buying and selling pressure in Glitnir  
 Compared with market price



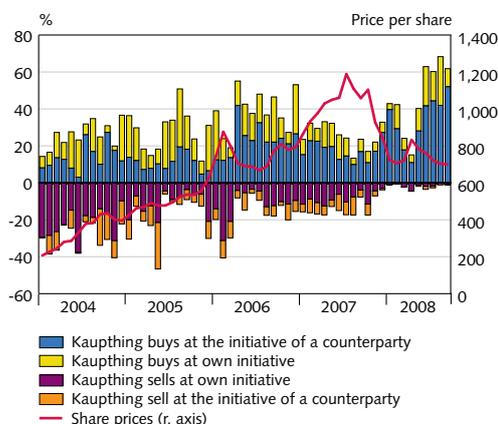
The SIC is of the opinion that all of the three major banks tried to elicit abnormal demand for their own stock and for that purpose they used the leeway that could be created by the trading of the proprietary trading desks.

Figure 32  
 Buying and selling pressure in Landsbanki  
 Compared with market price



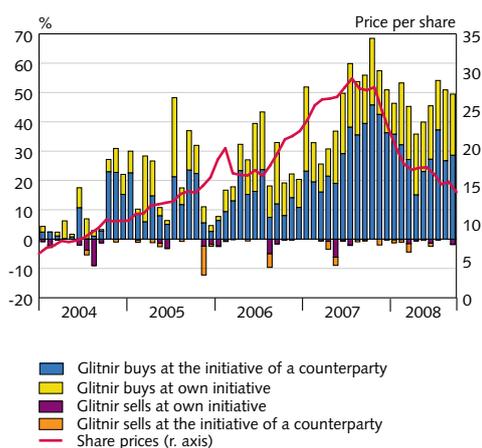
58. The opening balance is unknown so the figure shows the increase since the beginning of 2004.

Figure 33  
 Trade in Kaupthing with Kaupthing's shares  
 Percentage of matched turnover



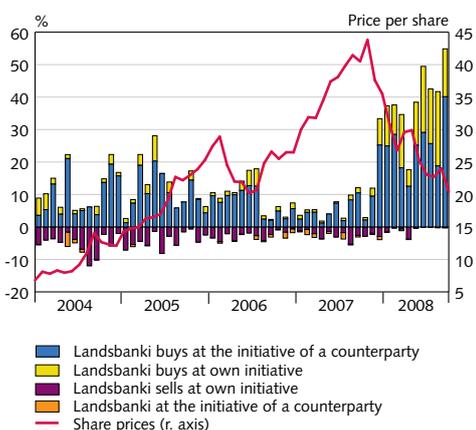
Reference: Icelandic Stock Exchange, Kaupthing banki hf, Icelandic Securities Depository.

Figure 34  
 Trade in Glitnir with Glitnir's shares  
 Percentage of matched turnover



Reference: Icelandic Stock Exchange, Glitnir, Icelandic Securities Depository.

Figure 35  
 Trade in Landsbanki with Landsbanki's shares  
 Percentage of matched turnover



Reference: Icelandic Stock Exchange, Landsbanki, Icelandic Securities Depository.

the stock. The SIC believes it unfortunate that the banks considered themselves to be market makers for their own stock, as they did, although it was not illegal to do so according to the Act on Securities Transaction. The Commission infers that conflict of interest is very probable when a company is a market maker for its own stock, and the probability of conflict of interest is even higher if the company is a credit institution, since such institutions are in a position to be lenders in related transactions. In light of the disclosures in Chapter 12 and hereinafter, the SIC cannot agree with the point of view that normal market making was conducted by the three large banks after the price of their stock started to drop late in the year 2007.

When buying and selling pressure in the orderbooks of the banks is examined, with regard to the development of stock prices, it can be seen that significant buying pressure accompanies the rise in stock prices of all of the banks until the year 2006 (see figure 30, 31 and 32). In the wake of negative discussion regarding the Icelandic financial system in the beginning of 2006 selling pressure on the stocks starts to form. In the case of Kaupthing and Glitnir the selling pressure started to intensify, especially from the end of 2007 until the collapse of the banks. It attracts attention that an imbalance seems to be between the amount of buying pressure was needed to raise prices until 2006 and the amount of selling pressure which was needed to lower the prices until the collapse of the banks. In the case of Landsbanki the development is different, where there is some buying pressure on their stock forms from the middle of 2006 until July 2007 and the price rises accordingly. In the fall of 2007 selling pressure starts to increase and is significant until the collapse of the bank in October 2008 and the price falls accordingly. It attracts attention that unlike the other two banks there appears to be more symmetry between the rise in stock prices of Landsbanki when the buying pressure is considerable and the fall in prices when the selling pressure is considerable.

The three large banks were large buyers of their own stock in automatically matched trades in the stock exchange later in the period and especially after the prices started to fall. Thus all of the three banks were on the buying side of automatically matched trades with their own stock in about 44% of the instances in 2008 (see Figures 33, 34 and 35).<sup>59</sup> The selling trades were small in all instances, and even insignificant when looking at automatically matched trades, but Kaupthing was only on the selling side of 1.61% of transactions with its own stock in the orderbook and Glitnir and Landsbanki were only on the selling side in 1.36% and 0.67% of trades with their own stock. As portrayed in table 2 the proprietary trading departments of the banks spent more than ISK100 billion more on buying their own stock in automatically matched trades than selling their own stock in automatically matched trades in 2007. The corresponding number in 2008 is ISK175 billion, even though trading only encompassed the first nine months of the year.

The magnitude of the trades was to such an extent that it would not have been possible to keep up the buying unless some selling would counterbal-

59. Trading members of the stock exchange can put in orders at the stock exchange and trades occur when two orders are matched together. Such trades are called automatically matched trades (auto trades) but it is also possible to negotiate prices outside the exchange and thereupon announce the trade in the exchange. Such trades are called manual trades.

ance it or by flagging the accumulated participating interests officially. The selling was primarily conducted in large trades outside the orderbook of the exchange and then announced to the stock exchange. The SIC believes that much of the lending for stock purchases in the banks late in the year 2007 and all of 2008 was with the purpose of increasing the leeway in the banks' trading books to buy more stock and care was not always taken to ensure that the bank would not bear all the risk of stock price fluctuations (see further discussion about specific trades and financing in Chapter 12).<sup>60</sup> The Commission therefore believes that all of the banks tried to elicit abnormal demand for their own stock and for that purpose they used the leeway they created by the trading of the proprietary trading desks. It is suspected that their objective was to reduce the speed of the decline in prices and thus buy time to sort out other affairs.

Table 2. Expenses and revenue of the bank's own trading books - paired trade with own shares

	<i>Kaupþing</i>		<i>Glitnir</i>		<i>Landsbanki</i>		<i>Samtals</i>	
	2007	2008	2007	2008	2007	2008	2007	2008
Buy	-57,223	-90,421	-72,486	-44,724	-11,061	-45,204	-140,770	-180,349
Sell	32,865	3,337	1,921	1,335	4,389	822	39,175	5,494
Net	-24,358	-87,084	-70,565	-43,389	-6,672	-44,382	-101,595	-174,855

Source: Kaupþing banki hf., Glitnir banki hf., og Landsbanki Íslands hf.

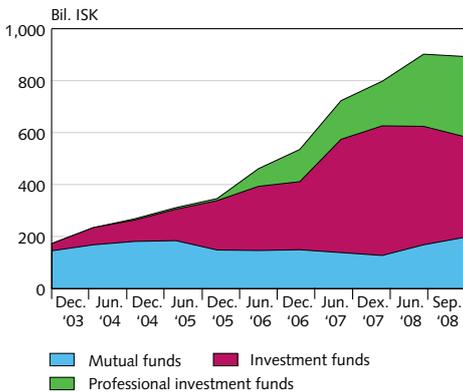
As mentioned above it is clear that the intervention of the banks in the trading of their own stock changed the perception the shareholders at that time had of the value of their stock. The shares were thus believed to be of more value than they actually were and new shareholders bought stock at too high prices. Additionally other clients of the banks can have been harmed as they believed the price development to indicate that the position of the bank was stronger than subsequently came to light. It can also be pointed out that the bank lost significant amounts of money because of their trading with their own stock, because the bank bought shares at a higher price than they sold at (see more closely the discussion in Chapter 12). The banks' arrangement of lending for various large share purchases also led to a less likely recovery of those loans, leading to appurtenant loan losses for the bank and thus for the shareholders and creditors at the time, and now the creditors of the bankrupt estate.

If a company's success in any way is directly and significantly dependent on the price of its own stock an interdependence is created between the performance of the company and the stock price which can promote abnormal price fluctuations and detract the efficiency of pricing. As disclosed in the report the performance and financial situation of the banks was in many ways dependent on the price of their own stock. The banks had loaned substantially for purchase of their own stock (Chapter 9 and 12) and the financial position

60. Examples of large trades: Kaupþing bank loaned Gift Investment Co ISK 20 billion in December to buy Kaupþing stock. Glitnir loaned Salt Investments and Salt Financials altogether ISK13 billion to finance the acquisition of Glitnir stock. Landsbanki loaned Imon plc. more than ISK5 billion at the end of September 2008 to purchase Landsbanki stock. More examples are discussed in Chapter 12.

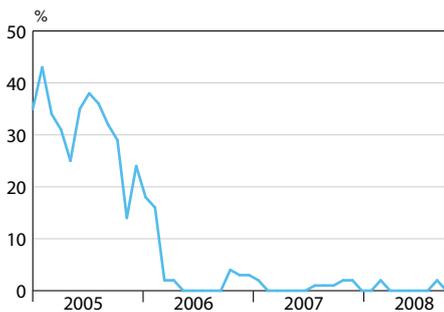
Securities' and Investment funds were used beyond other measures to finance the owners and the major clients of the relevant banks.

Figure 36  
 Assets of the different money market funds managed by the three banks by fund type



Reference: Landsvaki hf., Glitnir funds hf., Kaupthing banki hf. management company.

Figure 37  
 Fund 9 assets in government insured securities  
 Percentage of total securities assets



Reference: Glitnir funds hf.

of managers and other employees was in many cases significantly dependent on the stock price of the banks (Chapter 10). Circumstances had formed where falling stock prices could have drastic implications on the performance of the banks and the earnings of their employees. This created undesirable incentives to influence the stock price by any means, seeing that much was at stake both from the perspective of the banks and their employees. The SIC believes it is important to ensure that a comparable situation will not emerge again and in that context the regulating authorities have an important part to play in preventing that.

### 21.2.3.2 Money Market Funds

Investment funds and mutual funds are funds that accept money from the public, businesses and professional investors for mutual investments. Such funds are expected to invest in financial instruments and other assets based on spreading risk which is in accordance with a stated investment policy. Broadly delineated, these funds are structured so that a designated management company operates the funds and issues mutual-fund certificates to the funds' shareholders. Glitnir, Kaupthing and Landsbanki all had management companies that operated funds. Those management companies were: Glitnir sjodir hf., Rekstrarfelag Kaupthings banka hf. and Landsvaki hf. In the period 2004–2008 the total value of the assets of the funds managed by the three management companies grew by over 400%, or from ISK 173 billion to 893 billion, cf. Figure 36. The greatest increase in total value of funds was in Rekstrarfelag Kaupthings, or 590%, the total value of Landsvaki's funds grew by just under 400% and the total value of the funds managed by Glitnir sjodir grew by over 300%. It is noteworthy that the growth in total value and the proliferation of investment funds began in the Spring of 2006, at around the same time as European financing markets closed off financing for Icelandic companies due to negative publicity concerning the Icelandic banks as noted in Chapter 4 and elsewhere in the report. The increase was much greater in investment funds than mutual funds during this period which resulted in greater risk for the general investor.

In spite of this growth in mutual and investment funds, only one employee at the FME was charged with overseeing the funds until the end of 2007 when more employees were assigned to the role. Such limited oversight does not in any way correspond to the scale of the funds or the financial interests at stake for the general public. Furthermore, the management companies operated in close conjunction with the parent companies. That should in itself have given the FME pause when considering the operating procedures and independence of the management companies. The oversight of money market funds seems primarily to have consisted of making sure that reports were filed at the right time and in the correct manner. What few comments the FME had on the operations of the funds mostly had to do with formalities and box ticking, .e.g. that investment had not been within certain limits. The FME did not independently verify the information set out in the reports. The SIC thus concludes that the FME's oversight of mutual funds and investment funds was inadequate.

*Glitnir Sjodir hf.*

The management company’s biggest fund, Fund 9, grew extremely fast in a short period of time. From the end of 2005 until the end of 2007 when the value of the fund’s assets reached its highest point, the fund’s assets had grown fivefold. The fund’s growth was too rapid for it to be possible to create normal operating conditions for the fund given how small the domestic stock market was and the lack of available safe, marketable securities. Diversification of credit risk was significantly lacking and it is especially noteworthy how low the share of government-insured securities was in the portfolio, cf. Figure 37. Lending by Fund 9 to Glitnir and related undertakings was very extensive and raises serious questions about the independence of the management company vis-à-vis its owner (see Figure 38).

Towards the end of the period in question the Glitnir funds were operating more like banks than investment funds. This is inter alia revealed by the fact that collateral was required from certain issuers and that investments in securities were contingent upon special conditions for the disposal of proceeds from the securities.

*Rekstrarfelag Kaupthings banka hf.*

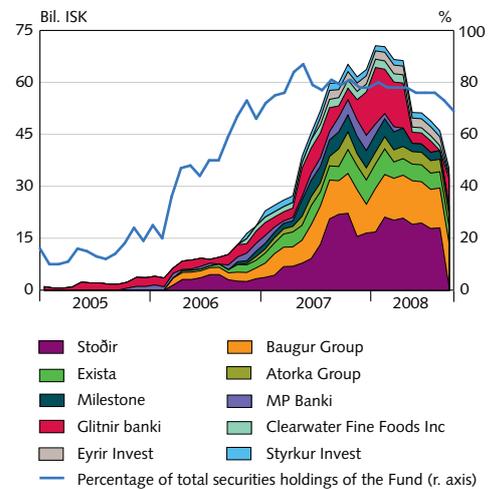
Four money market and mutual funds were examined at Rekstrarfelag Kaupthings banka hf., the Money Market Fund, High-Interest Fund, Short-Term Bond Fund and Short-Term Fund. Figure 39 shows the development of the total value of the funds from January 2005 through the end of September 2008. A large part of the total assets of Kaupthing’s Money Market Fund was used to invest in the parent company and undertakings which the Committee believes to be related to it. During the latter half of 2006 this ratio was about 50% of the total assets of the fund and significantly higher in 2008 (see Figure 40). This undeniably raises questions about the independence of the management company vis-à-vis its owner. Investments in NIBC and Norvik bank are especially noteworthy in this context since it was very rare for the fund to invest in the securities of foreign banks, and as such these investments represent a significant deviation from the fund’s other investments. This was also a case of the debtor being connected to the parent company and a large shareholder in it. There was little or no investment in government and municipal securities from 2006 to 2008.

In 2008 about half of the assets of the Money Market Fund, the biggest fund of RKB, was at any given time in the form of deposits and a large part of these deposits were in Kaupthing. If it had not been for the adoption of the Emergency Act, which made deposits priority claims against the bankruptcy estates of financial institutions, it is clear that the holders of mutual-fund certificates would have been faced with enormous losses when the banks collapsed.

*Landsvaki hf.*

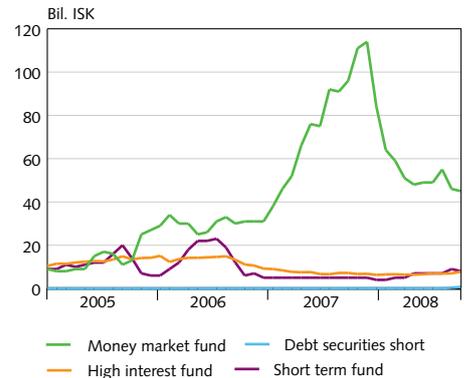
In chapter 14, the assets of two Landsvaki funds, .i.e. Money Market Instruments ISK and Corporate Securities, are discussed. The findings relating to Money Market Instruments ISK are set out below. The assets of Money Market Instruments ISK were primarily based in assets of Landsbanki and related undertakings, cf. Table 3. Large amounts of bonds were also bought from Baugur and FL Group, but Landsbanki was a primary commercial bank

Figure 38  
 Ten biggest securities holdings of Fund 9  
 By issuers



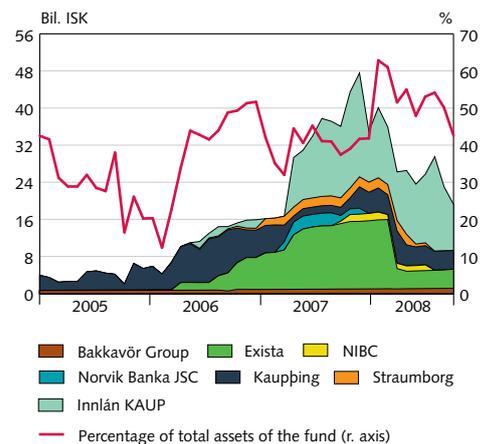
Reference: Glitnir funds hf.

Figure 39  
 Development of total value of domestic money market funds  
 Kaupthing Asset Management Company



Reference: Kaupthing banki hf. management company.

Figure 40  
 Assets of the Money Market Fund Managed by Kaupthing Asset Management Company  
 Assets in Kaupthing and related parties



Reference: Kaupthing banki hf. management company.

Table 3. Largest Assets of Peningabref Money Market Fund July 31. 2008

	<i>Ma. kr.</i>
Deposits within Landsbanki Íslands hf	77
Kaupþing banki hf	26
Straumur-Burðarás Investment Bank hf	18
Stoðir hf	17
Baugur Group hf	13
Hf Eimskipafélag Íslands	9
Samson Holding Company	8
Glitnir banki hf	8
Atorka Group hf	6
Hagar hf	3
<i>Total:</i>	185
<i>Share of Total Assets (%):</i>	98,5

Source: Landsvaki hf.

for both companies. In 2008, investments in these companies were renewed upon maturity through the taking of collateral in spite of default which cannot be considered normal fund activity.

The SIC points out that during the investigation documentation has come to light demonstrating that in a meeting of Landsbanki's loan committee it was stated concomitantly with the handling of an application for the bank's credit facilities that it had been decided that Landsvaki funds would buy bonds issued by the loan applicant, i.e. Baugur. Such linkage between the bank as the parent of the management company and influence on the investment decisions of its funds was in no way compatible with the basis on which independent money market funds are supposed to make their investments.

#### *Summary*

Examination of the investments made by the money market funds of the three management companies reveals that they mostly invested in the securities and deposits of their respective parent companies, or companies that the SIC has in its investigation concluded to be related to them or the bank's owners. This is one of the main characteristics of the investments. It is the opinion of the SIC that these investment decisions cannot have been determined by coincidence alone.

The money market funds grew fast and became, in the opinion of the SIC, much too large for the Icelandic securities market since the availability of sound, marketable securities was very limited. Another characteristic of all the funds at the time of the fall of the banks was that the ratio of government-insured securities in their portfolios was far below what may be considered normal in the operations of the types of funds under discussion.

It further characterises the last months before the collapse of the banks that the management companies reinvested in the securities of certain issuers upon the maturity of older securities. This applies in particular to Glitnir Funds and Landsvaki. The debts of the issuers were thus refinanced when their maturity dates were reached. Concurrently with the extension of the debt, further collateral was sought after from the debt issuers in order to protect the interests of those who had invested in the funds. At this point the operations of the money market funds seem to have borne closer resemblance to the traditional credit granting services of the banks. The activities described here are however not consistent with the role of money market funds. In this context it should be reiterated that a money market instrument is a liquid instrument which is traded on a money market and whose value can be determined at any time, cf. Point 1 of Paragraph 1, Article 31 of Act 30/2003 on Undertakings for Collective Investment in Transferable Securities (UCITS) and Investment Funds. It is debatable whether those securities which amounted to nothing more than a grace period for debt which the issuer could not pay upon maturity met this condition.

As stated in Chapter 14, funds were wont to buy the entire offering of certain securities. The SIC finds this highly reproachable. If a single fund, or funds belonging to the same management company, holds entire offerings of securities, it stands to reason that active price determination is not taking place in the market for the securities in question which can have an effect on the portfolio's value. Since the funds' assets are listed at market value or last recorded sales value, the price of the assets can only be updated by trading

them. The SIC also points out that the examples of purchases of entire offerings listed in Chapter 14 are usually connected to the owners of the bank which owns the management company, such as the ISK 3.5 billion purchase of Fund 9 and Fund 1 made in a bond offering designated as BAUG 06. Also when Fund 9 bought the bond category FL09 0709 in its entirety. Landsvaki Money Market Instruments then bought the entire first offerings of SAMS 07 3, SAMS 07 5 and SAMS 07 6. Those investments totalled ISK 10 billion in the middle of 2007. Money Market Instruments ISK also purchased entire first offerings of securities from Straumur-Burðarás (STRB 06 2, STRB 07 1 and STRB 07 3). That investment totalled over ISK 7 billion and remained in the fund's possession until it was wound up.

The SIC finds it noteworthy that in March 2008 Baugur was unable to pay a bill of exchange labelled BAUG 08 0319 totalling over ISK 2.6 billion. The reaction of Rekstrarfélag Kaupthings was to initiate legal procedures for debt collection. The matter was concluded when Baugur paid the bill of exchange in June 2008. In spite of Baugur's due debt amounting to over 5% of the total value of the fund's assets, its value continued to increase from month to month. In other words, no precautionary reduction was made in the claim's value or interests in other securities from the same issuer. The fund's assets in Baugur during this period totalled about 10% of the fund's total value. Baugur's default, one of the fund's biggest debtors, did thus not have a direct effect on the fund's standing according to information from the fund manager. The fund managers did not think it was their duty to intervene in the valuation of the fund's assets. It was the role of the trustee, Arion, and the valuation committee to appraise the fund's assets. The valuation committee was comprised of fund managers from Rekstrarfélag Kaupthings banka hf. and brokers from Kaupthing.

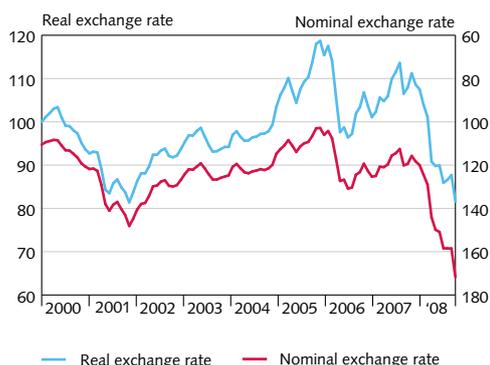
The investment of Landsvaki's Corporate Securities Fund in a bond issued by Björgólfur Guðmundsson, against the will of the fund manager, is especially perplexing in the opinion of the SIC since the investment neither conformed to the fund's investment policy nor rules on investments, cf. Article 7 of Regulation no. 792/2003. The SIC finds it especially noteworthy how long it took the FME to become aware of the bond in the fund, since the FME receives monthly reports on the asset composition of funds. It was not until January 2008, or over two years after the bond was purchased by the fund, that the FME finally sent a query about the bond to Landsvaki. According to an account by an employee of the FME, the director general of the FME did not want to take further action in the matter since no comments had been made on the investment before. The SIC believes it is clear that irrespective of how much time had passed since the bond was added to the fund, the FME should have demanded that it be sold immediately.

In the opinion of the SIC the independence of the management companies vis-à-vis the parent companies, i.e. the banks, was sorely lacking. Pay schemes, remuneration and bonuses were inter alia connected to the parent company in a number of ways, especially in the case of Landsvaki and Rekstrarfélag Kaupthings. The pay arrangement inter alia had the effect that employees of the management companies would rather take account of the interests of the parent company than the interests of the owners of mutual fund certificates. The appointments to the boards of the management companies were also conducive to lessening their independence since the boards

Securities' and Investment funds were used beyond other measures to finance the owners and the major clients of the relevant banks.

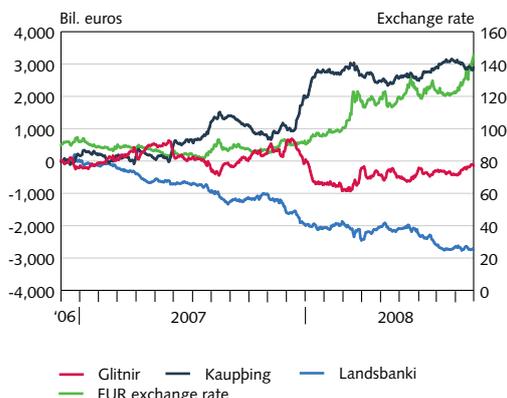
Foreign exchange risk was transferred from the banks onto domestic individuals and companies which leveraged themselves in foreign currencies without having corresponding income streams in those currencies.

Figure 41  
 The ISK



Reference: Central Bank of Iceland.

Figure 42  
 Aggregated flows of foreign currencies on the interbank market



Reference: Central Bank of Iceland.

were mostly or wholly made up of employees of the banks. In the opinion of the SIC it cannot hold any significance that they were groups in the sense of company law. Mutual funds and investment funds are subject to special legislation, Act no. 30/2003, and according to Paragraph 2, Article 15 of the act the independence of the management companies was to be ensured without regard to any group concerns. This is entirely clear when it is kept in mind that the parent and the subsidiary, the bank and the management company, are independent financial entities and that each possesses information which is not to be divulged.

### 21.2.3.3 Foreign Exchange Market

The Icelandic krona was floated at the beginning of 2001 and soon started appreciating. The real exchange rate continually grew stronger from the end of 2001 until November 2005 when it reached its highest point since 1988 (cf. Figure 41). In about four years the real exchange rate had strengthened by about 50%. During the same period, the nominal exchange rate of the krona had strengthened by about 30%. The krona weakened somewhat after this, especially towards the end of February and in March 2006, when the so-called mini-crisis hit but in that period the krona fell by 30% in a matter of weeks. In the summer of 2006 the krona started to rise again but it never reached the same heights as in late 2005.

By the end of 2007 the krona started weakening, a trend that continued unabated until the banks collapsed. The currency devaluation was especially sharp around the middle of March, when the value of the krona fell by 15% in one week. This period was therefore examined closely in Chapter 13.

The three largest banks traded on the inter-bank market for two primary reasons. On the one hand they traded for their own account to meet their own trading and investment needs and to regulate their foreign currency balance. On the other hand they acted as intermediaries for their clients in currency trading. When the aggregated currency flows between the three market makers in the inter-bank market with euros from the end of 2006 and until the collapse is examined, what emerges is that Kaupthing was a large net buyer, with about 3 billion EUR. Landsbanki was, however, a large net seller. Glitnir bought and sold currency in fairly equal measure during this period. By the end of 2007 and at the beginning of 2008 a significant amount of euros is purchased by Kaupthing or through Kaupthing, around 2 billion EUR, in the space of only a month and a half. At the same time, Kaupthing's foreign currency balance grew substantially, from 70% of equity to 85%. Kaupthing's largest clients also actively bought currency during this period. Exista purchased about 500 million EUR in forward transactions through Kaupthing and Kjarlar also bought about 250 million EUR as noted in Chapter 13. At around the same time, or from November 2007 until January 2008, Baugur, Jötunn Holding ehf. and Eignarhaldsfélagið ISP ehf. bought in the aggregate about 680 million EUR in forward transactions through Kaupthing.<sup>61</sup> The CBI sent a letter to the FME on 2 April 2008 on possible market manipulation by Kaupthing and Exista in the foreign currency market.<sup>62</sup> The FME answered

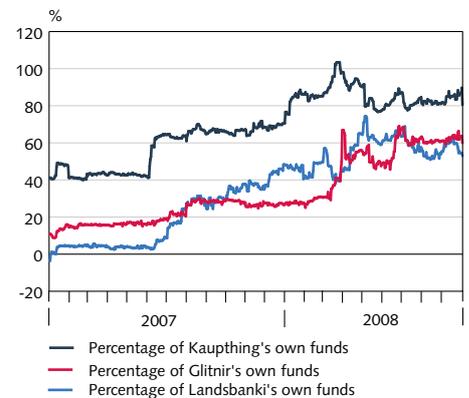
61. Jötunn Holding was 47% owned by Baugur, 35% owned by WCC Iceland and 18% owned by Fons. Eignarhaldsfélagið ISP ehf. was in 2007 wholly owned by Ingibjörg Stefania Pálmadóttir.  
 62. Letter from the CBI, signed by Davíð Oddsson, Chairman of the Board of Governors, and Eiríkur Guðnason, Governor, to the FME, 2 April 2008.

the query in a letter on 7 August 2008 stating that its investigation had not revealed any indication that legislation that the FME was charged with overseeing had been violated.<sup>63</sup>

In their foreign currency trading, banks must keep their foreign currency balance in mind since rules apply to how great the difference can be between currency linked assets and liabilities of financial institutions. The foreign currency balance of financial institutions is defined as the difference between currency linked assets and liabilities, and includes obligations both on and off the balance sheet. The goal of these rules is to prevent excessive foreign-exchange risk at domestic financial institutions and these rules therefore only apply to the parent companies. The CBI was authorised to grant exceptions from these rules to defend against the effects of changes to the exchange rate of the krona on capital ratios. The CBI granted exemptions to Kaupthing, Glitnir, and Landsbanki to have a positive foreign currency balance in order to protect their equity, and the authorisation was proportional to how large a part of each bank's operations was in foreign currency. Figure 43 shows the development of the foreign currency balance at the three largest banks. Presumably, cf. the documentation presented in Chapter 8.0, this positive balance was inter alia driven by lending to domestic companies and individuals in foreign currencies. It can also be presumed that part of these currency-linked assets was formed by purchasing currency in forward transactions from clients, i.e. export companies, pension funds and owners of glacier bonds, as stated by one bank representative.<sup>64</sup> Figure 44, which shows forward purchases and sales of foreign currencies by the three banks and forward sales of foreign currencies, demonstrates that forward purchases of foreign currency are much more voluminous than forward sales. On average, agreements on forward purchases by the banks of foreign currencies are four times more voluminous than forward sales during 2008. This difference is especially pronounced at Kaupthing and Glitnir.

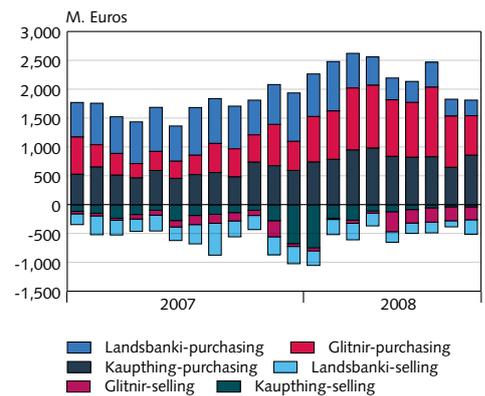
The analysis in Chapter 13 shows that the Icelandic pension funds were the biggest sellers of foreign currencies in forward agreements during 2008, especially at Kaupthing and Glitnir. The pension funds increasingly made forward exchange agreements to ensure a specific price in Icelandic krona for their foreign assets in the future since the funds' expenses are always in krona. They thus protected their earnings against short-term fluctuations in the foreign currency market. It is noteworthy however that these defenses increased as the krona weakened, as clearly demonstrated in Figure 45 which shows the outstanding forward agreements made by the pension funds. Forward agreements went from totalling about 900 million EUR in the middle of 2007 to EUR -2.2 billion when the banks collapsed. This increase suggests that these defenses were actively managed instead of a fixed ratio of the foreign asset being protected. Statements by the managers of the funds also support this conclusion, as further discussed in Chapter 13. It is therefore clear that these pension funds expected the krona to strengthen. Opinions are divided as to whether pension funds should protect their foreign assets against currency fluctuations, but the SIC is of the opinion that it merits thought that the

Figure 43  
 Foreign exchange balance of Kaupthing, Glitnir and Landsbanki as percentage of own funds



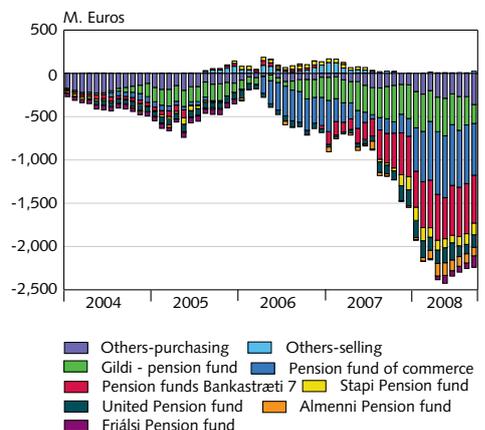
Reference: Central Bank of Iceland.

Figure 44  
 Forward foreign exchange contracts of Kaupthing, Glitnir and Landsbanki  
 Forward purchasing/selling of foreign currency



Reference: Kaupthing banki hf, Glitnir banki hf and Landsbanki Íslands hf.

Figure 45  
 Forward foreign exchange contracts of the pension funds - stock  
 Forward purchasing/selling of foreign currency



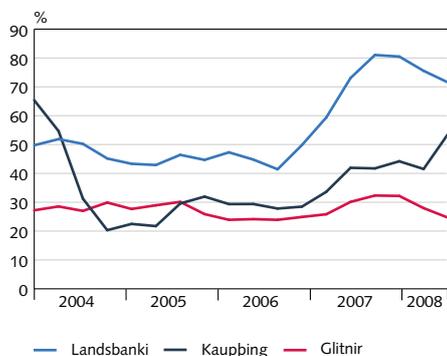
Reference: Kaupthing banki hf, Glitnir banki hf and Landsbanki Íslands hf.

63. Letter from the FME, signed by Jónas Fr. Jónsson and Guðrún Jónsdóttir, to the CBI, 7 August 2008.

64. Statement of Mr. Hreiðar Már Sigurðsson before the SIC on 21 July 2009, pp. 90-91.

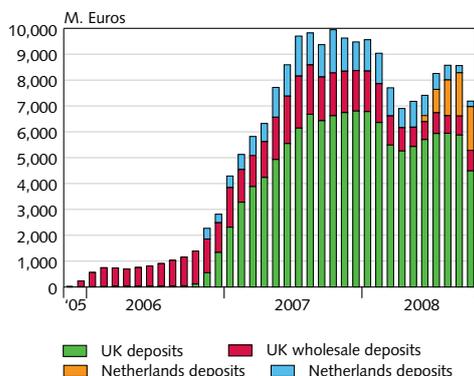
A great short-term market risk was entailed by the funding of the banks and it grew as their collapse got closer.

Figure 46  
 Deposit to total loans ratio of the banks



Reference: IceStat.

Figure 47  
 Deposits in the branches of Landsbanki  
 in the Netherlands and the UK



Reference: Landsbanki Íslands hf.

pension funds examined increased their defensive measures when the krona started weakening, which indicates that the funds, which are supposed to be guided by long-term investment goals, were hoping for a quick profit in the foreign currency market.

### 21.2.3.4 Financing

As previously pointed out, access to foreign debt securities markets was the main source of the banks' growth, particularly in the years 2003-2006. Ergo deposits became a lower percentage of the Icelandic banks' total financing. In 1998 Glitnir, Kaupthing Bank and Landsbanki, on average 45% of their financing were deposits but following the opening of debt securities markets this ratio decreased to just over 22% by the end of 2004.

At the beginning of 2006, when foreign credit-rating agencies expressed their concerns over the Icelandic economy they pointed out, among other things, that the Icelandic banks satisfied their financing needs less with deposits and that the ratio of deposits to lending was low compared with comparable foreign banks (Figure 46).<sup>65</sup> Subsequently the banks, in particular Landsbanki, began to strengthen their deposits by accumulating more deposits abroad. Up to the autumn of 2007, the ratio of deposits to lending rose in all of the banks, but particularly in Landsbanki, where it reached 80% at its peak in the autumn of 2007.

From the end of the third quarter of 2006 until mid year 2007, customer deposits in the Landsbanki group tripled, which was an increase of almost 10 billion EUR. The largest proportion of this growth was in the IceSave accounts of the Landsbanki branch in the UK. Retail deposits in the UK had grown from zero to 6.6 billion EUR and, at the same time, wholesale deposits both in British and Dutch branches of Landsbanki, had grown to 2.5 billion EUR. This development can be seen in figure 47 which shows deposits in Landsbanki's branches in the UK and the Netherlands. To put these numbers in context, the monetary reserves of the Central Bank of Iceland at the end of 2007 were just under two billion EUR. Landsbanki had therefore gathered what amounts to five times the amount of the CBI's foreign currency reserves in deposits over a period of nine months and this growth was nine-tenths in foreign deposits.

At Kaupthing Bank the growth of deposits was greatest in 2007 when deposits grew over 7 billion EUR or close to doubled for the group.<sup>66</sup> At the same time, deposits at Glitnir grew by around 3.5 billion EUR. Like in Landsbanki, Kaupthing Bank also began to collect retail deposits abroad but not until the last quarter of 2007 when the Kaupthing Edge internet deposit accounts were launched. In Figure 48 the growth in deposits at Kaupthing Edge can be seen, categorized by countries, and there you can see that the growth was largely in the UK. What was different here compared to Landsbanki was that well over 4.2 billion EUR came into Kaupthing's subsidiaries and so their deposit guarantee was not under the responsibility of the Icelandic Depositors' and Investors' Guarantee Fund.

65. For example Thomas, Richard: *Icelandic Banks: not what you are thinking*. Merrill Lynch 7 March 2006, <http://www.scribd.com/doc/19606822/Merrill-Lynch-Icelandic-Banks-Not-What-You-Are-Thinking>.

66. This does not include deposits in Kaupthing Bank's subsidiaries.

The total amount of deposits with the three banks reached their highest point in the fall of 2007, at around 38 billion EUR. Of that amount, 9.5 billion EUR were in Landsbanki's branches in the UK and the Netherlands. In spite of this extended reach into the deposit market the debt securities market was still vital for the banks. In 2006 they borrowed 11 billion EUR in the foreign debt securities markets and in 2007 around 9 billion. It was therefore very clear that when the liquidity crisis hit in the fall of 2007 and foreign debt securities markets as good as shut down, that the Icelandic banks would have to increase their deposits or find other means of refinancing. Debt securities amounting to over 2 billion EUR had a maturity date in the latter half of 2007 and in 2008 around 3 billion EUR. In spite of the success of Landsbanki's IceSave accounts and Kaupthing's Edge accounts, the total deposits in both banks decreased in 2008. Wholesale deposits were withdrawn from all the banks, so much so with Landsbanki that the outflow of wholesale deposits in the branches in the UK and the Netherlands in the year leading up to the collapse of the banks was more than the inflow of retail deposits in IceSave (Figure 47 and see more closely the discussion in chapter 7). The outflow of wholesale deposits from Glitnir in the UK was also considerable.

On the other hand, collateralised loans increased substantially as a means of funding in all three banks after the liquidity crisis began in the autumn of 2007.<sup>68</sup> Things progressed in such a manner that collateralised loans grew from being two billion EUR in the autumn of 2007 and at that time the loans were for the most part from the CBI, to being over nine billion EUR at the collapse of the banks (Figure 49) When the banks collapsed nearly half of the bank's collateralised loans were loans from the European Central Bank.

From the autumn of 2007 until the collapse of the banks the total collateralised loans of Landsbanki increased by 1 billion EUR. At the same time, collateralised loans from the European Central Bank grew around 1.3 billion EUR, figure 50. Glitnir increased its collateralised borrowing by over 2.5 billion EUR from the start of 2008 until the collapse of the banks, of which over 1 billion EUR came from the European Central Bank and over 1 billion EUR from foreign banks (Figure 51). Kaupthing Bank also increased its collateralised borrowing from 2 billion EUR in the autumn of 2007 to around 4 billion EUR at the time of the collapse (Figure 52). However, Kaupthing Bank borrowed less from the European Central Bank than the other banks, or little under 1 billion EUR.

Attention must be paid to the fundamental difference of financing on the basis of debt securities in issue on the one hand and financing with collateralised loans on the other. That difference is mostly seen in that instead of three to five year debt securities came mostly one week interbank collateralised loans, although individual loans could reach six months maturity. For the banks, this increase in financing through short-term collateralised loans increased their funding risk substantially. This is a clear example of how the

Figure 48  
 Growth in deposits at Kaupthing Edge accounts  
 In several countries

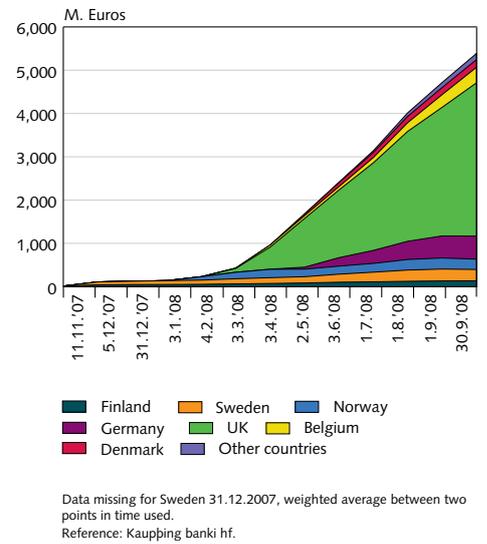


Figure 49  
 Total collateralized loans

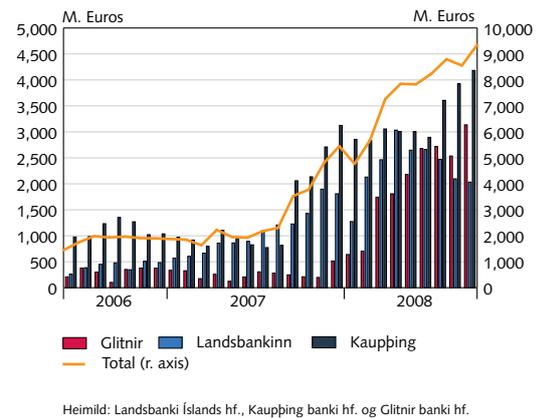
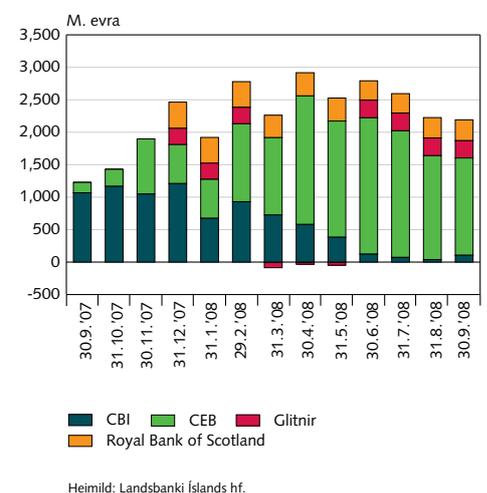
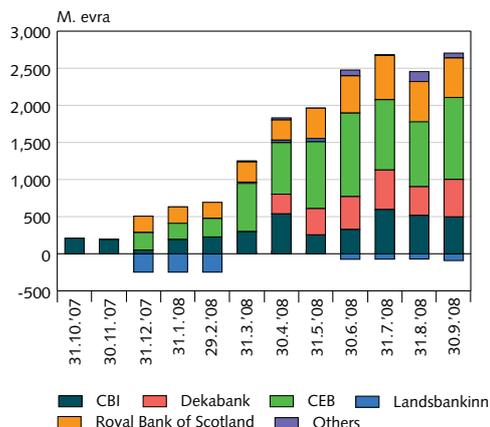


Figure 50  
 Collateralized loan - Landsbankinn



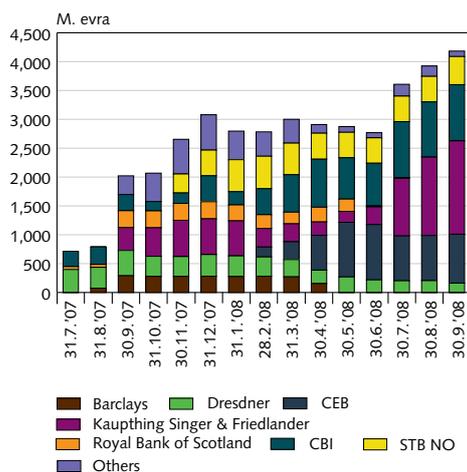
67. Collateralised loans of the Central Bank are often referred to as repurchase agreements. The term collateralised loans is used instead, since the CBI does not engage in repurchase agreement as such, as the property right of the collateral provided by the financial undertaking does not change.

Figure 51  
 Collateralized loans - Glitnir



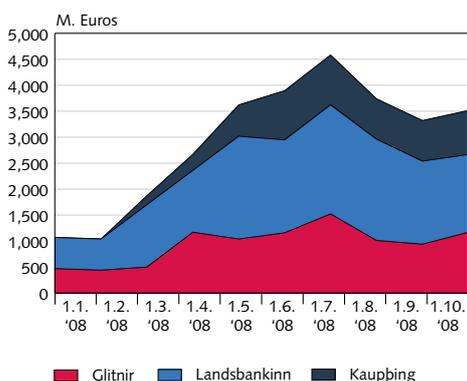
Reference: Glitnir banki hf.

Figure 52  
 Collateralized loans - Kaupthing



Reference: Kaupþing banki hf.

Figure 53  
 Collateralized loans of the banks with the ECB



Reference: Kaupþing banki hf, Glitnir banki hf og Landsbanki Íslands hf.

average maturity of the banks' funding was constantly shortened during the liquidity crisis. As deposits, collateralised loans, especially from other parties than central banks, are sensitive to changes in market conditions. Those who provide such short term collateralised loans or repurchase agreements can, for example, reject their renewal or extension on maturity or decided to increase its haircut. It is obvious that as international financial markets became more vulnerable and a liquidity crisis became more widespread that the effect of this risk began to grow. In addition, securities prices began to drop the world over. That has undeniable effects on collateralised loans where the underlying collateral is securities. This calls for increased margin calls given the decline in the prices of the underlying securities and at the next renewal of loans, lower loans are to be had against lesser valued collateral. The banks' funding risk had therefore increased substantially and was now dependent upon market conditions in the short term.

#### European Central Bank

As was previously pointed out, the Icelandic banks' collateralised loans from the European Central Bank increased substantially in 2008. The increase was particularly great at the beginning of the year when the collateralised loans grew by 2.5 billion EUR from the start of February 2008 until the end of April 2008 (Figure 53). This increase drew the attention of the ECB. At the end of April, Friday the 25th of April to be precise, at around 2 pm, the President of the European Central Bank, Mr. Jean-Claude Trichet, called Mr. Davíð Oddsson. The draft minutes from a meeting that was held an hour later with the Director General of the FME and the directors of the three banks it is stated that Mr. Oddsson told the parties present that Trichet had been „very excited, almost upset“ He had said that the Icelandic banks had close to four billion EUR in collateralised loans through the Central Bank of Luxembourg. Trichet then demanded a meeting with the representatives of the Icelandic banks, representatives of the CBI and representatives of the FME on Monday, April 28th in Luxembourg. During the April 28th meeting, it was revealed that both the scale and correlation within the portfolio put forth as collateral by the Icelandic commercial banks was drawing attention. As is pointed out in chapter 7, an informal agreement was made to limit the Icelandic banks' use of each others' debt securities as collateral with the European Central Bank.<sup>68</sup> This does not appear to have been enough to stop the Icelandic banks from collateralised borrowing through their subsidiaries in Luxembourg. Collateralised loans increased to around 4.5 billion EUR at the end of June, even though it should have been very clear to the banks that this would cause unrest, given the reaction in April.

During the summer another negative observation was made on the collateralised loans of the three banks with the European Central Bank, this time by the Governor of the Central Bank of Luxembourg who spoke with representatives of the CBI. At the end of June 2008, Governor Davíð Oddsson was in Basel, Switzerland, and there he met with Mr. Yves Mersch, Governor of the Central Bank of Luxembourg (BCL). Mr. Oddsson described their first

68. So called love letters of the Icelandic banks refer to one Icelandic bank using another Icelandic bank's debt securities as collateral to receive a loan from the European Central Bank and vice versa. This was practiced a lot in repurchase agreements between the CBI and the Icelandic banks.

encounter, during a hearing before the SIC in the following manner: „[I] had not met him but I was then introduced to him and I had just barely said hello and something nice - beautiful weather in Basel or something to that effect - and then he just says: Your banking system - as it was called - is in serious trouble.“<sup>69</sup> The next day, Mr. Oddsson met with the governor along with the Nordic Central Bank governors. There it was decided that Yves Mersch would come to Iceland a few days later.

The meeting is further described in chapter 7, but in general it can be said that here, the Governor of the Central Bank of Luxembourg reprimanded them. The problem now was not only the unprotected „love letters“ being put forth as collateral for the loans at the ECB but also the currency swap agreements that were in force inside of the asset backed securities. It is clear that the Icelandic banks had angered the governors of the Central Bank of Luxembourg and the European Central Bank. At the end of July the three banks were in fact prohibited from using each others securities as collateral for loans from the European Central Bank which was effective.

In general, the conduct of the Icelandic banks which has been described here, can be thought to have played a part in the fact that Iceland became eliminated from the scene of European Central Banks, but this, in return, made it more difficult for the CBI and the Icelandic government to raise liquid funds, see a more detailed discussion later in this chapter.

#### *The Central Bank of Iceland (CBI)*

As was previously pointed out, collateralised loans of the CBI to domestic financial institutions increased substantially after the liquidity crisis hit (Figure 54). To meet the increasing demand for liquidity the CBI changed the rules for collateralised loans a few times in 2008. This was in tune with what was happening with other central banks in the Western world. As Sturla Pálsson, Director of the International and Market Department of the CBI, stated in his hearing: „We had opened up to everything, the cellar in the CBI is filled with pellets holding bearer bonds [...] we accepted everything they could hand over.“ From the autumn of 2007 until the collapse of the banks the collateralised loans by the CBI increased from around ISK 200 billion to over ISK 500 billion. The collateralised loans of the three banks also increased during the same period and were at their highest over ISK 200 billion in spring 2008 (Figure 55). This only counts direct collateralised loans, although it can be assumed that the three large banks had to some extent utilized the services of smaller financial institutions which were then intermediaries in financing debt securities with the CBI.

In November 2007 it was clear to the CBI that the Icelandic banks were issuing unsecured debt securities on a large scale which were then sold to other financial institutions, in particular Icebank, which in return used the debt securities as collateral to obtain loans from the CBI. Through these kinds of transactions the financial institutions circumvented the CBI's rule of not giving loans against collateral of a financial institution's own debt securities. In spite of this knowledge the CBI did not try to limit such collateralization and did not seek sounder collateral. At the same time, smaller financial institutions became large creditors to the three banks, with the accompanying

Figure 54  
 Collateralized loans with the Central Bank of Iceland

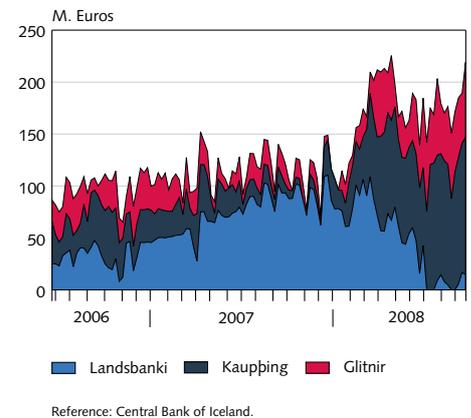
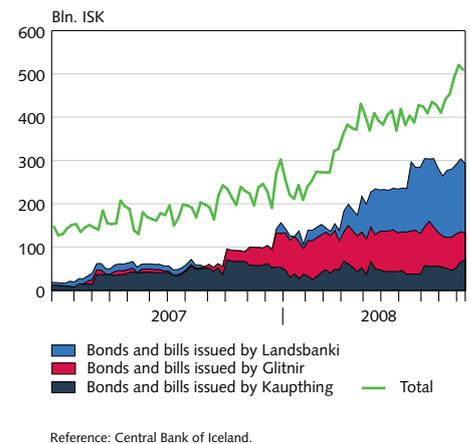
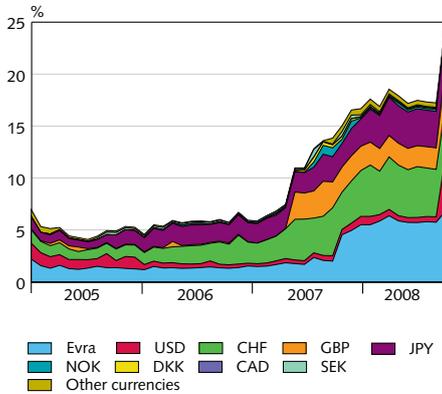


Figure 55  
 Total loans of the Central Bank of Iceland  
 Collateral in bonds and bills



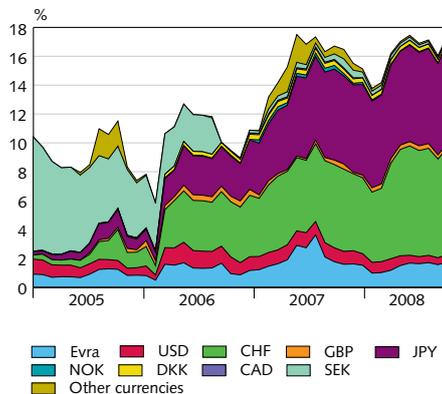
69. Statement of Mr. Davíð Oddsson before the SIC on 7 August 2009, p. 45.

Figure 56  
 Glitnir Bank's lendings to individuals  
 Classified by currency. Percentage of parent company's total lendings to individuals



Reference: Glitnir banki hf.

Figure 57  
 Kaupthing Bank's lendings to individuals  
 Classified by currency. Percentage of the parent company's total lendings to individuals



Reference: Kaupping banki hf.

The SIC points out that when the banks increased their loans in foreign currency to borrowers who did not have the ability to pay back in the currency in question, a substantial currency risk was formed in the banks' loan portfolio which neither they nor the Financial Supervisory Authority assessed as such.

risk. Figure 55 shows that when the banks collapsed the CBI had collateralised loans in bank bonds and letters of credit to the value of ISK 300 billion while total collateralised loans of the CBI were around ISK 500 billion.

The SIC points out that the CBI's authorisation to provide credit institutions with loans by buying securities according to Article 7 of Act no. 36/2001, is bound by the terms that they are granted against collateral that the bank deems valid. In chapter 7, it is argued that the CBI's attitude towards the banks' position at that time, does not comply with the notion that the collateralised loans that the CBI took were secure. The Commission also believes there is reason to point out that compared with what is generally accepted in communication between central banks and financial institutions it seems that the CBI could have limited specific collateralised loans with discretion and without leading to the collapse of the banks. In this context it can not be overlooked that the European Central Bank and the Central Bank of Luxemburg twice made changes to collateral requirements because of lending to the Icelandic banks of which the CBI had full knowledge but the general population did not. This is discussed in more detail in Chapter 7.

Other financing which is described in chapter 7 is, for example, subordinated long-term loans which were considered part of the capital base of the banks. Also, comprehensive swap agreements which the banks utilised to a different extent to finance loans on and off the balance sheet. As deposits and collateralised loans, comprehensive swap agreements are sensitive to changes in market conditions. The Commission believes that this increase in financing through short-term collateralised loans, comprehensive swap agreements and foreign deposits was conducive in increasing their funding risk substantially. The nature of such financing is that it can disappear rapidly in the case of a run on a bank. Not only was there a build up of risk of a run on deposits but also a run on the banks' collateralised loans, which at the start of September constituted around 10% of their financing, or 10 billion EUR. As an example, the risk that was carried in short-term investment when the state put forth their offer of buying 75% of Glitnir can be pointed out. Glitnir had collateralised loans from foreign financial institutions amounting to 500 billion EUR with maturity in October 2008. This does not include collateralised loans from the European Central Bank. As is also described in Chapter 20, there is no indication that the authorities were aware of this risk when representatives of the Government gave their opinion regarding the CBI's proposition for Glitnir on September 28th 2008, but that will be discussed in greater detail later in this chapter.

### 21.2.3.5 Foreign Currency Loans

As previously noted, lending grew immensely at the Icelandic banks in the years preceding the collapse. At the beginning of 2003, overall lending by the three largest banks was close to EUR 7 billion, but had grown sevenfold by the fall of the banks at the beginning of October 2008.

As stated earlier, the SIC believes that the owners of all of the three largest banks had unnatural access to credit at the banks. As this is discussed above it will not be repeated here, but it is appropriate to note a few other points relating to lending by the Icelandic banks.

At the three largest banks, between 60 and 75% of the lending was in foreign currency. Loans to foreign parties partially explain this, but not

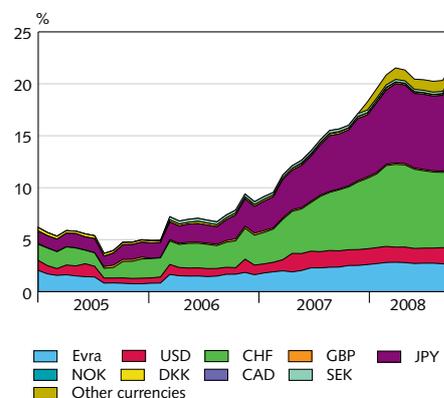
completely.<sup>70</sup> Domestic companies also took out loans in foreign currency as they often had export revenues in foreign currency. Holding companies also had over half of their loans in foreign currency. Icelandic holding companies invested both in Iceland and abroad and it is therefore difficult to generalise about any currency risk which might have been present in holding companies because of differing currency combinations in assets and liabilities. However, the minutes of the loan committees contain a multitude of examples of high loans being granted for purchases of Icelandic shares, cf. Chapters 8 and 12. Since the correlation between Icelandic shares and the krona was strong at the time the loans were granted, such loans carried significant risk. If the krona strengthened at the same time as share prices listed in krona rose, the gain from such share investment loans was substantial, but the losses were also significant when the exchange rate of foreign currencies rose concurrently with falling domestic share prices.

Loans in foreign currency as a ratio of individual borrowing grew significantly towards the end of 2006 and until the fall of the banks, as demonstrated in Figures 56, 57 and 58.<sup>71</sup> Lending in foreign currency by the three banks to households went from totalling ISK 61 billion at the end of 2006 to ISK 232 billion at the time the three banks collapsed. The impetus for borrowing in foreign currency was lower interest expense. To save on interest expense, borrowers assumed currency fluctuation risk. In fact, a case can be made that borrowers, in addition to borrowing money, were participating in carry trade. Loans in foreign currencies went from being about 5% of all loans to individuals to being over 15% by the middle of 2008. It is noteworthy that the loans are mostly in Japanese yen and Swiss francs, the so-called low-interest currencies at the time. Around this time, the risk-free interest rate in Japan was close to zero percent but around three percent in Switzerland. These currencies went from accounting for around 2% of overall lending to households at the beginning of 2006 to accounting for close to 13% by the time the banks fell. There is little to suggest that individual incomes in these currencies were growing to this extent, and thus it is clear that significant foreign-exchange risk was building among individuals in Iceland in the time leading up to the collapse.

It is clear that the incentive to lend in foreign currency was partly to increase the foreign assets of the banks, since their liabilities, i.e. financing, were mostly in foreign currency. In this context, the SIC would like to point out that if the banks' clients' liquidity does not fluctuate with the foreign currency, an argument can be made that the loans do not represent real foreign currency assets for the bank. The foreign-exchange risk which the bank had been exposed to if the loan had been granted in krona did not vanish by lending to the Icelandic clients in a foreign currency. Instead, the risk merely changed from a foreign-exchange risk to a default risk.<sup>72</sup>

Figure 58

Landsbanki Íslands hf. lendings to individuals  
 Classified by currency. Percentage of the parent company's total lendings to individuals



Reference: Landsbanki Íslands hf.

70. Significant changes took place in the krona's exchange rate during this period, but the effects of exchange rate changes were removed in the analysis by calculating loans in foreign currencies based on a fixed rate. This was done so that the figures would reflect the trend in lending operations rather than the exchange rate trend, cf. a more detailed discussion in Chapter 8.

71. One large loan by Kaupthing Bank in Swedish krona to a foreign individual is excluded at the beginning of the period.

72. Shapiro, Alan C.: „Currency Risk and Country Risk in International Banking.“ *Journal of Finance*, Vol 40, No. 3 1985, p. 881–891.

*Credit institutions' Lending and Facilitation to some of their Largest Clients.*

The total exposure of the three big banks, in addition to Straumur, Spron and Icebank, was in October 2008 ISK 14,250 billion, and half of it was in connection with 246 groups, i.e. parties that the banks connected according to regulations on related parties, and regulations on large exposures. The SIC decided for the review that is described in chapter 8.12 to make a special investigation of 46 groups, comprising 524 parties that represented 22% of the exposure, or a total of ISK 3,165 billion, which represents one fifth of the financial institution's finances (consolidated) by mid-year 2008. Minutes and supporting documentations from credit committees were utilised to shed light on lending to groups.

The facilitation by the financial institutions to the parties that were subject to the special review was in the years 2007-2008, up to the bank collapse, characterised by the refinancing of previous loans for clients that were unable to honour their contractual obligations. One third of the increased lending can be attributed to this. The investigation also revealed that 54% of the loans to groups were secured by pledging shares.

*21.2.3.6 External Audits*

The annual accounts of the financial institutions that the Commission reviewed for the fiscal years 2004 to 2007 were endorsed without reservations by the auditing firms that were elected by the general shareholder meetings of the financial institutions to audit their accounts. According to this, it is clear that the financial institutions' auditors considered that the annual accounts gave a clear overview of the performance of the companies, their financial position and changes in cash balance, in accordance with international accounting standards as enacted by the European Union, on the basis of an audit performed in accordance with law and international auditing standards.

In view of the fact that the value of the assets of the three large banks after the collapse was on average one third of their value before the collapse, as is described further in Chapter 11.2.6, the SIC decided to focus its attention especially on how decisions regarding the write-down of debts were made. As discussed in Chapter 11.2.8.2, the write-down by the three large banks was only 0.6% of the companies' total liabilities in October 2008 and 0.7% of their total assets in mid-year 2008. The question is thus whether the banks' financial statements before the collapse provided a clear picture of their financial position and performance. In this context, the Commission thought it right to specifically review how decisions were made regarding the revaluation of debt, handling of shares that had been purchased with loans with the shares themselves as collateral, and loans to employees for the purchase of shares. Furthermore, in this context, it was decided to investigate audits undertaken by external auditors regarding the efficiency of the financial institutions' internal lending controls.

The Commission's investigation of external auditors' review of the need for write-down in their review reports for 2007 (cf. Chapter 11.2.8.3) shows that the financial institutions' auditors considered that their review of write-down of loans in 2007 was basically correct as it did not reveal any significant deviation. This is also seen in the financial institutions' semi-annual statements in 2008: the external auditors do not make any comments as to whether provisions for write-downs are insufficient.

When the Commission investigated the situation of 46 groups and 524 parties connected to them (cf. Chapter 8.12), their liabilities to all of the financial institutions were ISK 1,180 billion in January 2007. In October 2008, these liabilities were ISK 3,165 or 22% of the total liabilities to the financial institutions at that time. Because of these groups, ISK 12 billion were allocated to meet write-downs in the semi-annual statements of the financial institutions in 2008. This amounts to 0.4% of the groups' liabilities to the banks in October 2008. Three months later the need for write-down was estimated at ISK 1,926 billion. This corresponds to 61% of the liabilities of these groups to the financial institutions. Since January 2007, the financial institutions had approved credits to these parties totalling ISK 3,012 billion. This includes ISK 988 billion in the form of extensions to previous loans, which is approximately one third of the amount. These transactions were generally refinancing of previous loans, as the borrowers were unable to meet their contractual obligations. Furthermore, these parties received additional loans of approximately ISK 2,026 billion in this period with shares as collateral.

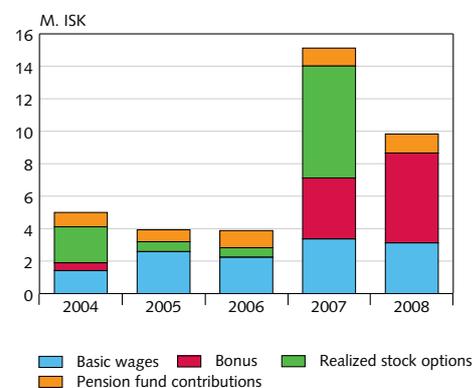
When the banks collapsed there was an inevitable and significant reduction in their assets. It is however the Commission's finding that the quality of loan portfolios had started to erode at least 12 months before the collapse and continued to erode until the collapse, even though this was not reported in the banks' financial statements. The investigation by the Commission into the finances of the banks strongly suggests that the value of loans and related liabilities was overvalued in the banks' financial statements for the year-end 2007 and the semi-annual statements for 2008. The difficulties in the operations and financing of several of the banks' clients, which had already surfaced at this time according to the Commission's investigation as mentioned previously, suggests that there were discrepancies of up to several hundred billion ISK. The Commission's investigation shows that despite a number of „rescue missions“ in both 2007 and 2008 there were no specific write-downs, let alone for their largest debtors, who included the principal owners of the banks.

### 21.2.3.7 Incentive Schemes

The main characteristics of the pay and incentive schemes for the employees of the Icelandic banks in 2004-2008 was variability of employees' wages, bonus payments without performance, as well as direct or indirect facilitation of loans by the banks to their own employees (cf. chapter 10). The owners' unrealistic requirements for rates of returns from the banks' operations, which formed the basis for the incentive payments, resulted in increased risk-taking in lending, borrowing and investment policies by the management.

Incentives payments connected to shares in the banks were implemented in different ways: with call options, loans to holding companies of employees, or by issuing put options on the bank's shares while simultaneously providing loans to managers or employees for the purchase of shares in the bank in question. The implementation and arrangement of these agreements created a buying demand for bank shares beyond reasonable expectations. The extent of these incentive payments was also significantly larger than customary for other listed corporations. As an example, stock options for managers in the United States are on average 0.17% of outstanding shares in listed corpora-

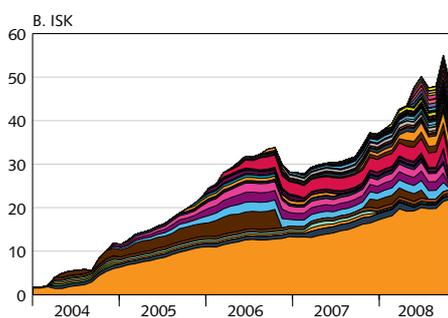
Figure 59  
 Glitnir's 1% highest wages and their combination  
 On average



Reference: Glitnir banki hf.

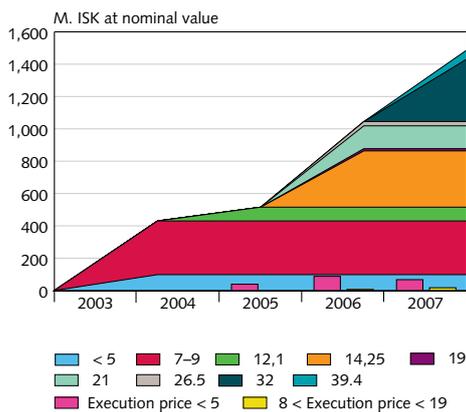
The interests of the directors and other employees of the banks were linked to the price of their stock way beyond what was considered normal for an incentive scheme.

Figure 60  
 Total lendings to employees and their holding companies  
 Glitnir



Employees with loans exceeding 100 millions with the bank.  
 Reference: Glitnir banki hf.

Figure 61  
 Issued stock option agreements  
 Landsbanki



Issued stock options at different redemption rates.  
 Reference: Landsbanki Íslands hf.

tions. Sigurður Einarsson, executive chairman of Kaupthing Bank banki hf., as an example, received in 2003 a stock option for 1.5% of Kaupthing's shares as part of the pay agreement that was made at that time.

### Glitnir

Glitnir's incentive scheme, which was a so-called EVA system and was in force to 2006, was in many ways a rational way of harmonising the objectives of both owners and managers. Certain features of the system, such as limits on bonus payments, rewards for unchanged operation and not only increased profit, and a potential negative bonus in case of bad results, are all attributes that are considered reducing excessive risk-taking by managers. The SIC is of the opinion that it was an unfortunate step, at least for the bank's minority share holders and depositors, when the bonus system was changed in 2006 from the EVA system to a so-called ROE system, which puts greater emphasis on short term profits rather than the company's long term profitability. The requirements for rate of return in the ROE incentive system are such that they encourage the negative factors that can be expected to accompany incentive payments, ie. that the managers take too much risk in the operations. The expansion in lending by the bank was a results of this, cf. chapters 10 and 8 on Glitnir's lending to employees and core investors.

Wages for the highest paid employees of Glitnir increased significantly during the time period investigated. The top 1% of the highest paid employees of Glitnir banki hf. went from receiving ISK 5 million per month in 2004 to ISK 15 million per month in 2007 (see Figure 59).<sup>73</sup> The increase in wages in 2007 is in particular due to two persons, who received very high monthly remuneration on average in 2007. On the one hand, Lárus Welding received on average ISK 84 million per month during the months he was employed by the bank, and, on the other hand, Bjarni Ármannsson received about ISK 50 million per month. Between 2007 and 2008 bonus payments to the top 1% of the highest paid employees almost doubled, from an average of ISK 3.7 million per month in 2007 to ISK 5.5 million per month in 2008, at the same time the average base salaries of this same group decreased by 7% in real terms.

The Commission finds it noteworthy that there is no mention in Glitnir's annual report for 2007 of the liabilities assumed by the bank through an employment contract with Lárus Welding, with a total amount of ISK 550 million, or the bank's liabilities in connection with bonus payments to Bjarni Ármannsson, a total of ISK 270 million. The report only mentions a lump-sum payment of ISK 300 million that Mr Welding received upon signing the employment contract and a payment of ISK 100 million to Bjarni Ármannsson.

Glitnir's loans to employees and/or employees holding companies amounted to ISK 55 billion when they reached their highest level in September 2008. This amount was at that time equal to 17% of the equity of the bank, cf. further discussion in Chapter 10 on loans to employees amounting to ISK 100 million or more. This included loans of some ISK 15 billion to employees to buy shares in the bank in order to keep key personnel employed

73. Wages are extrapolated to the year 2008.

with the bank. Initially, these loans were provided to the employees in their own names, but in some cases, however, they included put options for the shares. The employee's own exposure due to the transaction was none. Later on, the bank provided loans for the same purpose to holding companies that were 100% employee-owned.

Of the above-mentioned ISK 15 billion, the bank loaned some 8.1 billion for purchase of shares to 14 managers and key employees in May 2008. It is especially noteworthy that two of these loans were higher than the purchase price of the shares, in order to make it possible for the owners of the holding companies to pay dividend at the same time they purchased the shares. This allowed HG Holding ehf. to pay out ISK 150 million to Haukur Guðjónsson, member of Glitnir's board of directors, and KPG Holding ehf. was also allowed to pay out ISK 150 million to Kristinn Þór Geirsson, manager at Glitnir, cf. more detailed coverage of loans to employees in Chapter 10.3.4. Finally it is worth mentioning that during Glitnir's annual general shareholders meeting on 20 February 2008, Þorsteinn Már Baldvinsson, the newly elected chairman of the board of directors, said that there would be no stock option agreements with the staff under the current circumstances.<sup>74</sup>

#### Landsbanki

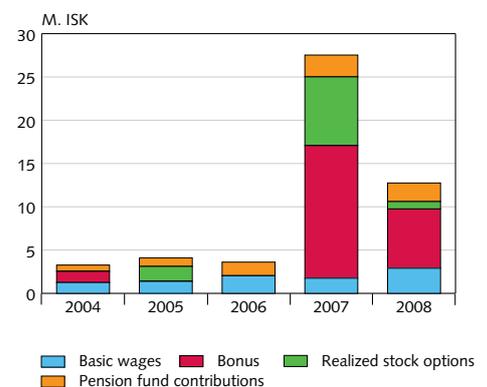
Landsbanki's incentive scheme was based on two main components: short term bonus payments and substantial stock option agreements for key employees, cf. Figure 61. Landsbanki's outstanding liabilities due to stock option agreements with employees was around ISK 1.5 billion at nominal value when the bank collapsed. Landsbanki paid out bonuses to key employees if the return on equity was between 9-14% higher than the yield to maturity on government bonds (medium term) for the accounting period.

Wages for the highest paid employees at Landsbanki were more or less unchanged during 2004-2006, or roughly ISK 4 million per month on average. This changed significantly in 2007, when the average monthly wages for the top 1% highest paid employees rose to roughly ISK 27 million (cf. Figure 62).<sup>75</sup> This substantial wage increase for the highest paid employees can more or less be attributed to payments to Lárus Welding, who was paid ISK 167 million for the month during which he was on the parent company's payroll. He was paid the profit on accumulated rights from stock option agreements in the form of a bonus payment when he resigned from his job at Landsbanki, cf. Chapter 10.4.2.

In general, Landsbanki's bonus payments increased significantly between years, while the earnings of the departments that were investigated by the Commission were unchanged. Bonus payments to security broking, for example, increased between years without being justified with increased income. It is especially noteworthy that in the fall of 2007 the bonus payments to security brokers were ISK 194 million but the department's earnings for the same period were only ISK 178 million.

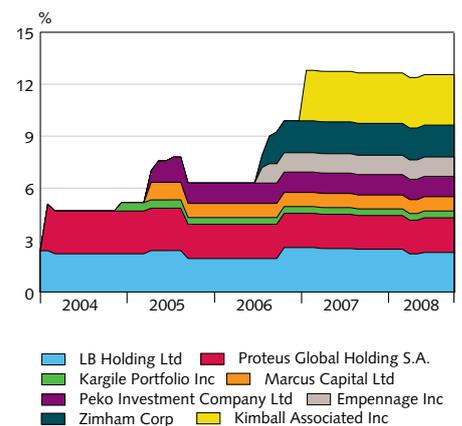
In 2000, stock option agreements were introduced into Landsbanki's pay and incentive scheme. Unlike established practices on foreign markets,

Figure 62  
 Landsbanki's 1% highest wages and their combination  
 On average



Reference: Landsbanki Íslands hf.

Figure 63  
 Hedging of call option agreements of Landsbanki  
 Ownership of different holding companies in Landsbanki in percentage of total outstanding shares

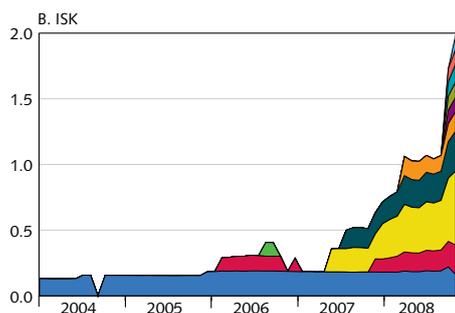


Reference: Landsbanki Íslands hf.

74. Cf. statement of Mr. Elfar Rúnarsson, Glitnir's human resources manager, before the Commission on 28 October 2009, p. 27. Cf. also "The Decoder's Role", News article in *Vidskiptablaðið*, 18 April 2008.

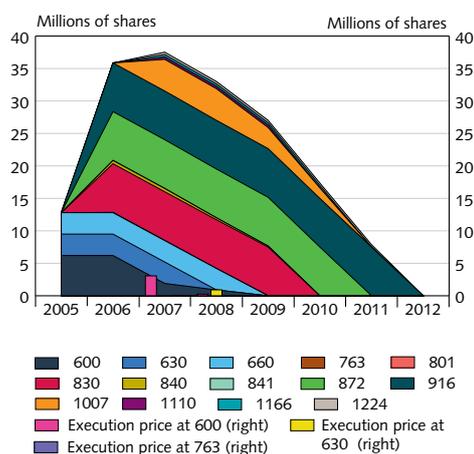
75. Wages are extrapolated to the year 2008.

Figure 64  
 Credit extended to employees and their holding companies  
 Landsbanki



Employees with loans over 100 million with the bank.  
 Reference: Landsbanki Íslands hf.

Figure 65  
 Outstanding call option agreements  
 With employees of Kaupthing Bank



Issued call options with different strike prices.  
 Reference: Kaupthing banki hf.

where companies issue new shares for the redemption of stock option agreements, it was decided, while the government was still a majority owner of the bank, to form offshore trusts. This was based on the incentive scheme of Búnaðarbanki, which had established two companies, Otris S.A and Ferradis Holding S.A., in the British Virgin Islands, a so-called offshore jurisdiction.

Landsbanki placed shares for hedging employee stock options in 8 offshore companies, which seems to have been done for the purpose of avoiding disclosure requirements. Everything indicates that these companies were effectively all under same management. As an example, power of attorney was obtained from all of the companies, who were in the hands of offshore lawyers, so that a Landsbanki employee could vote on their behalf at the bank's general share holders meeting in the spring of 2007. The connection between the management of these companies is also reflected in the fact that one of the companies, Proteus, loaned a new sister company, Kimball Associated, which had no equity capital, all of its shares as collateral for the new company's loans.<sup>76</sup> Information about the managerial control by Landsbanki of these companies was not disclosed to investors, smaller shareholders, or surveillance authorities.

The assets of these 8 offshore companies were a total of 13.2% of Landsbanki's shares from the middle of 2006 until the collapse of the bank, cf, Figure 63. The financing of these shares initially came from Landsbanki itself but from 2006 the financing of these companies came from Glitnir, Kaupthing and Straumur. Landsbanki issued sureties as securities for loans from Glitnir and Kaupthing but not for Straumur, cf. Table 9, Chapter 10.<sup>77</sup> It should however be mentioned that Landsbanki financed the same type of „stock option companies“ for Straumur.<sup>78</sup> It could thus not be seen as hedging of the bank's future liabilities since the risk associated with the shares was entirely with the bank itself the whole time.

The Commission also points out that buying shares for offshore companies, after their financing had been secured, created a buying demand for Landsbanki shares that was controlled by its managers. The buying pressure caused an increase in the bank's share price on the market or discouraged a price drop. Furthermore, the Commission is of the opinion that this arrangement was beneficial to the bank's core investor since a silent partner holding 13.2% of the shares makes the core investor's control even stronger. Furthermore, the conventional practice of issuing new shares to redeem employee stock option agreements could have resulted in the holding company, Samson ehf., losing its control of the bank due to dilution of ownership.

A small number of Landsbanki employees received loans in their own name or their holding company's name from Landsbanki's Icelandic branches, with amounts of ISK 100 million or more. Landsbanki loaned just under ISK 2 billion to employees that received more than ISK 100 million each, cf. Figure 64. It is however worth noting that 40% of Landsbanki's loans to employees were to Guðmundur Pétur Davíðsson. He is a nephew of

76. The equity had increased because of the rise in Landsbanki's share price.  
 77. As can be seen in Table 9, Chapter 10, the position of the loans on 30 September 2008 was the following: Glitnir's loan approximately 5.6 billion kronur, Kaupthing's loan approximately 7.9 billion kronur, and Straumur's loan 14 billion kronur.  
 78. Landsbanki's loans to three offshore companies that invested in Straumur shares was ISK 6.1 billion.

Björgólfur Guðmundsson. The loans to Mr. Davíðsson and his holding company, Brimholt, were at just under ISK 800 million by the end of September 2008.

*Kaupthing*

Kaupthing banki hf. paid the highest average wages of the three big banks, cf. Figure 66. It also had the greatest variability in wages. At Kaupthing it took the bottom 10% of the lowest paid employees three years to earn the same amount as the top 1% of the highest paid employees received per month on average. Kaupthing’s issuing of stock options to employee had more or less stopped by 2006, cf. Figure 65, as the managers of Kaupthing had decided, with the shareholders approval, to discontinue incentives in the form of stock options in 2005, but instead to provide loans to key employees for the purchase of shares, for the same objective. The reason for this change in incentive payments was that Kaupthing’s managers wanted the bank to avoid costs of public charges and to reduce the tax burden of their employees resulting from the change from income tax to capital income tax.

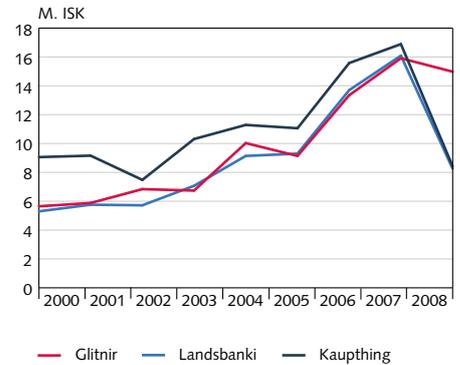
Originally, the idea was to provide the employees with put options on shares together with the loans. This would have placed all the risk with the bank. It became clear however that according to accounting standards, these options would have to be deducted from the bank’s equity.<sup>79</sup> Kaupthing’s managers thus sought alternatives and the solution was to provide loans with a 10% surety by the employee on the principal sum and interest, and in exchange the employee relinquished the put option.<sup>80</sup> The Commission points out that a loan for the purchase of shares with the shares themselves as collateral and only 10% surety by the employee is in practice the same as providing a put option for 90% of the shares. It is thus noteworthy that the bank’s auditors overlooked that the bank did not deduct these shares from its equity, as it should do in the case of actual put options

Loans to Kaupthing employees and their holding companies went from being less than ISK 10 billion in 2005 to just under ISK 60 billion when the bank collapsed, cf. Figure 67. As a rule these loans were in the names of the employees, as the bank’s rules did not allow the selling of the shares to holding companies.<sup>81</sup> In Iceland, however, four employees were allowed to transfer their loans to holding companies, with a special authorisation by Hreiðar Már Sigurðsson, CEO, and Guðný Arna Sveinsdóttir, CFO. They were Mr. Kristján Arason (in February 2008), Mr. Ingvar Vilhjálmsson (in October 2008), Mr. Hannes Frímann Hrólfsson (in October 2008) and Mr. Guðni Niels Aðalsteinsson (in October 2008). It is also worth mentioning that Ármann Þorvaldsson, CEO, Kaupthing, Singer & Friedlander transferred his loans to a holding company in January 2007, and Mr. Hreiðar Már Sigurðsson, CEO, did the same in the spring of 2006.

Kaupthing Capital Partner II Fund is an investment fund that was intended to manage Kaupthing’s investments in unlisted shares and was officially presented as a closed fund, owned by the bank, professional investors, and the

Mynd 66

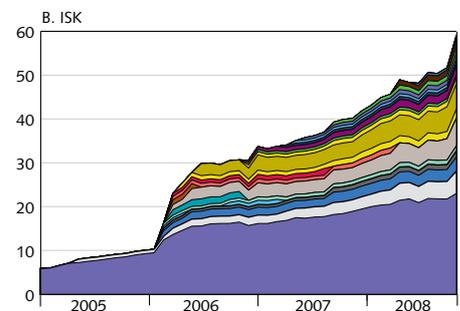
Compensation of employees  
 Average cost of full-time employees per year



Reference: Giltirnir banki hf, Landsbanki Íslands hf og Kaupþing banki hf.

Figure 67

Aggregate loans to employees and their holding companies  
 Kaupthing Bank



Employees with loans over 500 million with the bank.  
 Reference: Kaupþing banki hf.

79. Cf. statement of Mr. Sigurður Jónsson, Mr. Sæmundur Valdimarsson, and Mr. Reynir Stefán Gíslason before the SIC on 31 July 2009, p. 54.

80. A statement regarding the waiving of put options was sent to ICEX on 31 December 2005.

81. The manager of the legal department stated in a memo that it was by the instigation of the FME (explanatory memorandum by the manager of the legal department to the SIC, March 2009).

bank's private banking customers. On 14 December 2007, the credit committee of the Kaupthing board of directors approved loans from Kaupthing Luxembourg to employees or their holding companies with a total amount of £137 million for investment in KCPII. The largest individual loan was £10 million to a holding company owned by Mr. Sigurður Einarsson, Mr. Hreiðar Már Sigurðsson and Mr. Helgi Bergs. This loan to the senior executives of Kaupthing Bank for their investment in Kaupthing Capital Partners II Fund is noteworthy. E-mail communications between the employees suggest that the loans were provided without collateral and/or that Kaupthing employees pledged the bank shares more than once, cf. Chapter 10. Kaupthing Capital Partners II Fund was declared insolvent on 15 October 2008.<sup>82</sup>

#### *21.2.3.8 Debt Repatriation*

The SIC is of the opinion that lending from the foreign banks to the Icelandic investors increased the Icelandic banks' risk because in fact they often seem to have been last resort creditors for these investors.

As the credit crunch got worse in the second half of 2007 Icelandic share prices dropped sharply, as in general did asset prices globally. The position of Icelandic investors and large investment companies deteriorated significantly since most of them had substantial liabilities and were exposed to great risk because of Icelandic bank shares.

#### *Large Investment Companies find themselves in Trouble*

One of Iceland's largest investment company, FL Group, posted a record loss of roughly ISK 80 billion for the second half of 2007. Of this amount more than ISK 60 billion were losses in the last quarter. In reaction to the loss, the company's share capital was increased late that year. The largest share of this increase was through the sale of shares to its biggest owner, Baugur, and this was paid for with the real estate company Landic Property. At the same time, the Icelandic banks increased their lending to Baugur, FL Group, and connected entities, with Glitnir as the biggest lender, and from mid-year 2007 to spring 2008 the bank's lending to the group more than doubled, in respect to the bank's equity.

The investigation by the Commission into the finances of the banks strongly suggest that the worth of loans and related liabilities was exaggerated in the banks' financial statements at year-end 2007 and the semi-annual statements for 2008.

Gnúpur, a leveraged holding company with the largest portion of its assets in Kaupthing Bank and FL Group, was near collapse by the end of the year 2007. The banks started winding up the company, beginning their negotiations with Gnúpur in the beginning of January 2008. News reports on Gnúpur's troubles received considerable attention abroad, which adversely affected funding of the banks, especially for Glitnir. The company's collapse also highlighted weaknesses in the bank share trading. As an example, Kaupthing Bank had in December decided to finance a large portion of Gnúpur's shares in Kaupthing Bank (Gift and AB 57), even though Gnúpur's liabilities with the bank were only a small part of the financing of the shares.

#### *Debt Repatriation*

The largest Icelandic investment companies had, in addition to borrowing in Iceland, been doing business with foreign banks and borrowed from them as well. Several of these loans were secured by pledging Icelandic securities. As the winter of 2007-2008 progressed and the share prices fell, the quality of

82. The company was declared insolvent due to defaults on loans to Kaupthing Bank, cf. a report on specific aspects of Kaupthing's internal controls by PriceWaterhouseCoopers on behalf of the FME by year-end 2008.

the collateral declined and the foreign creditors started to perform margin calls. Early in 2008, the troubles of the investment company Milestone were increasing due to loans that the company had, through its subsidiary, received from Morgan Stanley. On the one hand, this involved a loan that Milestone's subsidiary, Racon, had taken to finance the purchase of the Swedish bank Invik (later named Moderna). On the other hand, was a loan that Þáttur International had received to finance the company's 7% share in Glitnir. Þáttur International was mainly owned by Milestone (through Sjóvá and its subsidiaries), and companies connected to the brothers Einar and Benedikt Sveinsson owned about 25% of Þáttur International. After a substantial drop in asset prices, Milestone itself made a payment on the loan, but finally sought the assistance of Glitnir to take over the financing. After some negotiation, Glitnir provided loans to the companies Földungur and Svartháfur so that they could settle their loan with Morgan Stanley, a total of 240 million EUR.

Kaupþing's second largest shareholder, Kjarlar, found itself in a similar position, as the company had, through its subsidiary Egla Invest, received a loan from the US bank Citibank, which was pledged with Kjarlar's shares in Kaupthing Bank. The loan was granted with the condition of extra collateral if the share value went below a specific percentage of the loan. As the share prices continued to drop in the fall of 2007 and the following winter, the bank issued a growing number of margin calls. Kjarlar sought the assistance of Kaupthing Bank, which loaned Kjarlar for the margin calls with a few instalments in the first months of 2008. Glitnir also loaned Egla Invest for margin calls, and according to a loan application to Kaupþing, there was in action an agreement between the banks that they would finance each others shares in the spring 2008. In the end, Glitnir and Kaupthing Bank had loaned Kjarlar and Egla Invest some 400 million EUR to pay their debts with Citibank and to prevent Citibank from taking ownership of the Kaupthing Bank shares.

Ever-increasing lending by Kaupthing Bank to the investment company Oscatello in late 2007 and early 2008 was of a similar nature. Over a period of a few months, the company received bank overdrafts that finally totalled some 600 million EUR. This bank overdraft was increased in steps that were always in response to possible margin calls by the financial institution Dawnay Day, the US investment bank Morgan Stanley, and Kaupthing Singer & Friedlander, according to Kaupþing's minutes.

In the summer and autumn of 2008, the situation of Björgólfur Thor Björgólfsson's companies was difficult due to debts to the German bank Deutsche Bank in connection with the take-over of the pharmaceutical company Actavis in 2007. For that occasion, Landsbanki loaned Björgólfur Thor Björgólfsson's company, BeeTeeBee Ltd., a total of 150 million EUR, which was then re-loaned as a subordinated loan against the Deutsche Bank debt.

The above-mentioned examples show that when the principal owners of Glitnir, Kaupþing, and Landsbanki found themselves in trouble with their debts to foreign creditors the banks responded by taking over the financing and settling the debts with the foreign banks. It can thus be said that the Icelandic banks were subordinated debtholders in relation to the foreign banks. Rather than letting the foreign banks bear possible losses and resolve the situation that had arisen the debt was repatriated with subsequent increased exposure and, ultimately, a bigger bank collapse.

### *All or Nothing*

In Chapter 21.2.1. the main reasons for the bank collapse were described. It mentions, amongst other things, how great the banks' exposure was against their own share prices and the effects of that exposure was on their actual equity. As the winter of 2007-2008 progressed, the banks were very dependent of their share prices and largest debtors. Rather than hanging on to their liquid assets, the banks provided substantial amounts as loans for own shares and to support their principal owners. Kaupthing Bank in particular loaned large amounts for the purchase of own shares. The banks were betting everything on life.

In the fall of 2008, Kaupthing Bank added even more to the risk when it loaned its key clients roughly EUR 500 million for the purpose of selling credit default swaps on Kaupthing Bank itself (cf. Chapter 7). The clients themselves took no risks but they would have made substantial profits, if the bank would have withstood the difficulties. To make the transaction, Kaupthing Bank had to come up with considerable sums in advance, as, in view of the nature of the situation, it could not pay out insurance on its own debt if it would become bankrupt. By selling these credit default swaps the bank was in a way paying up its long-term debts. The buyer of these credit default swaps on the other hand was the German bank Deutsche Bank or its foreign clients. Yet again had an Icelandic bank bought a foreign bank out of Icelandic risk troubles, and the loans and the risk had been repatriated.

### *21.2.3.9 March 2008*

Some of the banks came extremely close to insolvency at the end of March/beginning of April 2008.

After the autumn of 2007 foreign parties became increasingly concerned about the position of the Icelandic banks. Although the banks were not endangered by sub-prime mortgages they were heavily dependent on market funding which became increasingly more difficult and their size compared with that of the economy was such that there were serious doubts as to whether the Central Bank of Iceland (CBI) had the capacity to be the lender of last resort for the banks.

At the beginning of 2008 their concern became increasingly more serious. The average CDS spreads on the Icelandic banks almost doubled in January of that year, going from appr. 200 points, which was considered high at that time, to appr. 400 points. In February the CDS spreads continued to rise and the krona weakened steadily. On 22 February the British bank Northern Rock was nationalised; five months earlier it had received emergency funding from the Bank of England after there was a run on it. After mid-February there was a noticeable outflow from the Icesave accounts in the UK branch of Landsbanki. A shortage of foreign currency was increasing in the Icelandic banking system.

In the currency market this shortage of currency appeared in the pricing of currency swaps for the exchange of ISK and EUR. Effectively, a conversion agreement entails that one party lends Euros to the other party in exchange for borrowing kronur. In a standard year the party that borrowed the kronur would have paid a much higher interest rate than the party that borrowed the Euros, because the interest rate for kronur was much higher than that for Euros. However, the Icelandic banks' shortage of foreign currency was beginning to cause some reduction in the interest rate difference (see chapter 13).

In March the illiquidity increased. The outflow from the Icesave accounts

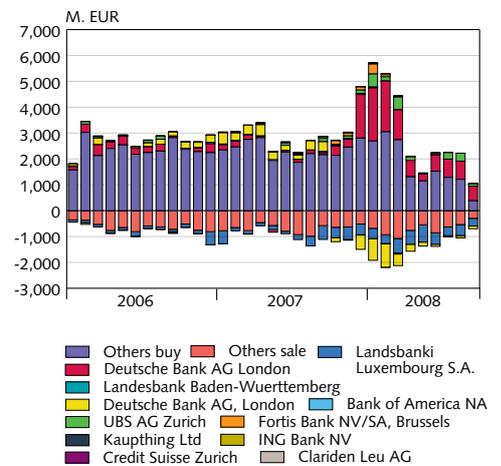
continued, the interest rate difference in the currency market decreased and the krona weakened. In the United States the uncertainty over the mortgages was increasing, and on 16 February the Bear Stearns bank was acquired by JP Morgan with the assistance of the Federal Reserve Bank. At the same time articles appeared in the British media on the risk of owning deposits in Icelandic banks. A run on Landsbanki began, both on the Icesave accounts and on foreign wholesale deposits. The shortage of foreign currency in the Icelandic banking system was total. The interest rate difference in the interest-rate swap market disappeared almost completely, which meant that the banks were willing to pay an equal interest rate for Euros and kronur. Foreign parties with currency swap agreements whereby they borrowed Euros and lent kronur to the Icelandic banks did not extend their swap agreements, as their pricing was totally altered; furthermore, their trust in the Icelandic banks as counter parties was dwindling. This decreasing position between March and April 2008 can be seen in diagram 68, but the decline in currency swap agreements whereby foreign parties borrowed Euros and lent Icelandic kronur to the Icelandic banks amounted to over EUR 2 billion. When the interest rate difference between the Euro and krona had almost disappeared from the currency swap market a party owning Euros could get „risk-free profit“ by selling its Euros for kronur, buying Icelandic government bonds and forward purchasing Euros. This „risk-free profit“ would, however, have been dependent on the Icelandic banks being able to meet their financial obligations in case of a fall in the krona. The fact that the interest rate difference continued to be so small reflects the extent of the counter party risk that foreign market participants believed was attached to the Icelandic banks.

Concomitantly with the disappearance of the interest rate difference in the currency swap market the krona fell substantially, as may be seen in Figure 69, and in a single day, the day after JP Morgan acquired Bear Stearns, the krona fell by just under 10% from the Friday vis-à-vis the Euro. On the same day Ingimundur Friðriksson sent an e-mail to Mr. John Gieve, Deputy Governor for Financial Stability of the Bank of England, requesting currency swap agreements.

In the following weeks the liquidity crisis of the Icelandic banks continued to grow, especially that of Landsbanki. Foreign deposits were rapidly withdrawn, as may be seen in Figure 70. In the period between 10 February and 22 April that same year, withdrawals amounted to close to £1 billion, or approximately 20% of the total deposits in the Icesave accounts at the London branch of Landsbanki. It is clear that it would have taken very little to push Landsbanki into insolvency at that time. A memorandum from Foreign Minister Ingibjörg Sólrún Gísladóttir from her meeting with Prime Minister Geir Haarde and Governor Davíð Oddsson states, inter alia : „Davíð Oddsson spoke for the Board and commenced by saying that £193 million had been withdrawn from the Icesave accounts over the weekend and up until that day. He claimed that Landsbanki could withstand 6 more such days.“<sup>83</sup> The CDS spreads reached its highest point up to then at the end of March/beginning of April, which is when the CDS spreads on both Glitnir and Kaupthing Bank climbed over 1000 points. There was a lot of work going on during these weeks to acquire currency swap agreements with central banks in other

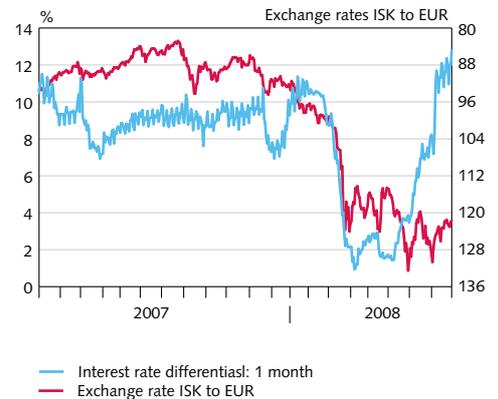
83. Undated memorandum by Ms. Ingibjörg Sólrún Gísladóttir of a meeting of 1 April 2008.

Figure 68  
 Foreign currency exchange swap agreements of foreign parties



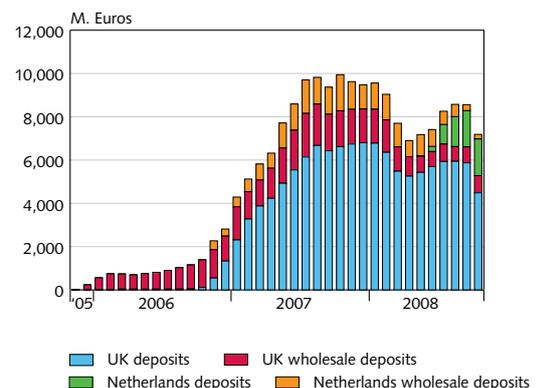
Reference: Kaupþing banki hf, Glitnir banki hf, Landsbanki Íslands hf.

Figure 69  
 The difference of derived ISK interests on swap agreements and European interbank interest rates, and exchange rates of ISK to EUR  
 Daily interest differentials and exchange rates



Reference: Genius.

Figure 70  
 Deposits in the branches of Landsbanki  
 In the Netherlands and the UK



Reference: Landsbanki Íslands hf.

countries. Around mid-April the situation in the international markets was beginning to calm down and the run on Landsbanki diminished. In the spring deposits into the Icesave-accounts in the UK rose again and when the same kinds of accounts were opened in the Netherlands in May foreign currency again flowed into the bank. The danger had passed for the moment.

Considerable effort was being made during these weeks to acquire currency swap agreements with other central banks. Around mid-April the situation in the international markets was beginning to calm down and the run on Landsbankinn diminished. In the spring deposits into the Icesave-accounts in the UK rose again and when the same kinds of accounts were opened in the Netherlands in May foreign currency again flowed into the bank. The danger had passed for now.

The Bank of England's rescue of the Northern Rock bank and the JP Morgan acquisition of Bear Stearns with the assistance of the American state had prevented the total loss of trust in the financial markets, despite the long term liquidity crisis. This would change on 15 September 2008 when the investment bank Lehman Brothers went bankrupt. Trust between banks evaporated and spreads in the interbank market soared all over the world. In addition to the uncertainty as to who was exposed to losses due to mortgage loans came the uncertainty as to who would lose money because of Lehman Brothers and what would be the next course of events. Banks all over the world endeavoured to protect their liquidity and capital position because none of them wanted to be the next to fall. Loans to other banks and to customers were therefore not renewed, credit lines were closed, properties were sold and margin calls increased. Since most banks reacted in the same way at this point, all the markets froze and asset values dropped. There was a worldwide shortage of Dollars and the main central banks renewed and expanded their currency swap agreements. The American state started a \$700 billion troubled asset relief program (TARP) for banks. On 25 September 2008 the American state took over the Washington Mutual bank (WaMu) and on 29 September the UK bank Bradford & Bingley was nationalised, having made extensive loans to real estate activities. This same day the Icelandic state announced an agreement that it would acquire a 75% share in Glitnir, and the first version of TARP was rejected by the American Congress. However, an improved version was approved on 3 October. On 8 October many central banks reduced interest rates in a coordinated effort. In the following days the main central banks greatly increased access to liquid assets and governments in Europe and the USA spent large amounts of money to refinance banks. The situation in the international financial markets in the autumn of 2008 has been described as the perfect storm. It was under this situation that the three Icelandic banks, Glitnir, Landsbanki and Kaupthing Bank, collapsed at the beginning of October 2008.<sup>84</sup>

„When the capital markets collapsed in the autumn of 2008 the fate of the Icelandic banks was sealed. The banks had leveraged themselves to the extent that it made the Icelandic authorities into an ineffectual spectator of events.“<sup>85</sup>

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84. Már Guðmundsson: „Hin alþjóðlega fjármálakreppa.“ *Skírnis*, spring 2009.

85. Jørn Astrup Hansen, accompanying document 1 to chapter 8.

## 21.3 Efforts made by the Icelandic Authorities with Regard to the Events leading to the Collapse of the Icelandic Banks

### 21.3.1 Analysis of the Efforts of the Icelandic Authorities and of Several Relevant Issues in the Year 2006

Chapter 19 describes the background of the consultative group established by the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME, and the CBI (the government consultative group). As is detailed in that Chapter representatives of the above-mentioned authorities had met for consultation since January 2004, and prepared a specific memorandum on preparedness of the government in case of possible difficulties in the financial sector. The ministers from the three mentioned ministries, representatives for the two Government authorities, together with the Minister for Foreign Affairs, were briefed on the content of the memorandum on 17 February 2006. The memorandum provided for a number of remedial actions, including enhanced powers for the FME. A proposal was made to formally establish a special consultative group, cf. discussion below on response to this proposal.

As mentioned earlier, several unfavourable signs had been emerging since the beginning of 2006 with regard to the Icelandic financial market. For instance, the analysis reports drawn up by foreign financial corporations, at the start of the so-called „mini-crisis“, portrayed a more negative picture of the Icelandic banks than had been the case before. On 21 February 2006, Fitch Ratings changed the prognosis for the state of Iceland from stable to negative. Subsequently, the exchange rate of the krona fell dramatically as did the value of domestic stock shares. That same day, an agreement was made to establish a special government consultative group, that was inter alia entrusted with the task of discussing the status and prospects of the financial market. Despite the fact that the group had been established under circumstances where the Icelandic financial market seemed to be at risk, the group convened only twice that year, i.e. on 1 June and 30 November.

In general, it is believed that spring 2006 marked a certain turning point as regards the opinion of foreign parties towards the Icelandic financial system. In this context, the report of economists Frederic S. Mishkin and Tryggvi Þór Herbertsson, *Financial Stability in Iceland*, published by Iceland's Chamber of Commerce in May 2006, has often been referred to. Following the report, things calmed down to a certain extent.

By the end of 2005, foreign credit-rating agencies and analysts had criticised that the Icelandic banks did not have sufficient deposits in their operations. The banks responded to this criticism and decided to seek deposits in foreign markets through their branches abroad. At the beginning, this was through wholesale deposits. In October 2006, Landsbanki began to offer the so-called Icesave Internet Deposit Accounts in the UK and Kaupthing Bank began to receive deposits into their so-called Edge accounts in the bank's Finland branch in November 2007. Later on, the bank offered these accounts in other countries, either via its subsidiaries or branches. In February 2008, Kaupthing Bank started receiving deposits in the UK via its subsidiary there, Kaupthing Singer & Friedlander. The legal status of depositors differed

depending on whether the accounts were in a subsidiary or a branch of the banks in the country in question. Subsidiaries established by the banks abroad were regarded as independent foreign legal entities, and accordingly parties to the deposit-guarantee scheme of the country in question. In the case of a branch of an Icelandic bank, foreign customers were in fact doing business with an Icelandic legal entity, and their deposits were therefore guaranteed by the Icelandic deposit-guarantee scheme. This is discussed in more detail in Chapter 17. In the UK, Landsbanki received deposits in its London branch. Accordingly, the deposits of its customers were guaranteed by the Investors' and Depositors' Guarantee Scheme in Iceland. The Icelandic banks offered attractive interest rates and their deposit accounts quickly became very popular, especially in the UK. At the beginning, the view was that this section of the bank's funding had been successful. It was only in late 2007, when circumstances on the financial market in the UK deteriorated, that negative publicity surfaced with regard to the deposit accounts of the Icelandic banks in the UK, cf. a more detailed discussion below.

### 21.3.2 Analysis of the Efforts of the Icelandic Authorities and of Several Relevant Issues in the Year 2007

In February 2007, the credit-rating agency Moody's upgraded the long-term credit rating of the three large Icelandic banks. This was done on the basis that the banks were systematically important for the Icelandic economy and that the state would support them if necessary. This rise was actually withdrawn by the agency at the beginning of April 2007. It is fair to say that the international credit crunch was a turning point for the Icelandic banks. From the middle of June 2007, the exchange rate of the Icelandic krona began to fall sharply as well as domestic stock prices.

Chapter 17 describes the change in the deposits ratio in the Icelandic banks as 2007 progressed, and over 50% of all deposits originated with foreign parties. The chapter deals with what effect this development had on the obligations of the Investors' and Depositors' Guarantee Scheme (TIF), which is a private foundation operating on the basis of Act No. 98/1999 on Deposit Guarantees and Investor Compensation Schemes. Iceland was obliged, in accordance with the EEA Agreement, to establish a deposit insurance scheme which would fulfil the minimum requirements of Directive 94/19/EC. When the provisions of Act No. 98/1999 are compared to the rules of the EU Directive on deposit insurance guarantee schemes, as is the case in Chapter 17.4, it seems evident to the SIC that the aforementioned minimum requirements, in so far as they can be inferred from the said Directive, have been stipulated in the Icelandic Act. It is also clear that the Icelandic Act was, with respect to these issues, in general equivalent to legal provisions on deposit-guarantee schemes, inter alia in the other Nordic countries.

However, the SIC is of the opinion that the major change in the funding of the Icelandic banks through the raising of deposits via internet accounts from 2006 onwards, should have alerted national bodies responsible for the implementation and regulation of deposit insurance schemes in Iceland, to start the process of amending the regulation of the TIF in order to strengthen its financial position. Despite the Ministry of Business Affairs' efforts in 2007 to revise the Act on the TIF, and despite the fact that later a committee was established for that task, the result, at the beginning of 2008, was that the

introduction of such a bill would be ill-advised due to unrest and difficulties that had surfaced in the financial markets.

In mid-August 2007, Kaupthing Bank announced that the bank planned to purchase the Dutch NIBC Bank for the sum of ISK 270 billion. As described more fully below, this was never materialised.

In September 2007, a run was made on the UK bank Northern Rock when depositors withdrew a great deal of their savings. It is safe to say that this run caused some anxiety among depositors in the UK, and this was reflected in the media coverage. By the end of February 2008, the British authorities announced that the bank would be taken over by the state. Chapter 18 describes in more detail the atmosphere at that time, cf. in particular, the media coverage of the Icesave deposit accounts of Landsbanki Íslands hf.

In September 2007, a pan-Nordic contingency exercise was implemented to test government response to a staged financial crisis. On Iceland's behalf, the FME, the Ministry of Finance and the CBI took part. The exercise scenario was that Kaupthing Bank had run into difficulties and the Icelandic authorities were to assess what measures should be implemented. Amongst other things, a decision had to be made as to whether the Icelandic state would come to the bank's rescue due to its poor capital balance. The supervisors of the exercise reported that a final decision on a response from the Icelandic authorities had deliberately not been taken.<sup>86</sup> In the hearing before the SIC, it was revealed that it had been decided by the Ministry of Finance and the CBI not to bring the matter to a conclusion. Baldur Guðlaugsson, Permanent Secretary of the Ministry of Finance, explained in the hearing that he had feared, if facts of the response of the Icelandic authorities had leaked out, this would adversely affect the Icelandic financial market.<sup>87</sup> The SIC is of the opinion that it would have been useful for the Icelandic authorities to see the exercise through, given the fact that they had to deal with similar events in autumn 2008. However, important questions concerning the government's contingency planning were still unanswered at that time. Therefore, the SIC is of the opinion that had been misguided by the Icelandic authorities not to see the exercise through.

In the latter half of October 2007, Kaupthing Bank applied for permission to keep its books, draw up annual accounts and consolidated financial statements in euros as from the beginning of the business year of 2008. For more details turn to Chapter 19.

In early November 2007, it seems that doubts had been raised within the CBI concerning collateralised loans taken in the CBI by certain financial entities. In its letter to the FME on 13 November that year, the Board of Governors drew attention to the fact that, in the last CBI liquidity auction, Icebank had taken a collateralised loan of the amount of ISK 105 billion. A large part of the collateral had been securities and letters of credit issued by Kaupthing Bank and Glitnir Bank. The letter states that it could be questioned whether the scope of these Icebank transactions was in accordance with the rules the bank was obliged to follow.

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86. Statement of Mr. Ingimundur Friðriksson before the SIC on 19 March 2009, p. 11. See also statement of Mr. Baldur Guðlaugsson before the SIC on 25 March 2009, pp. 13-15.

87. Statement of Mr. Baldur Guðlaugsson before the SIC on 25 March 2009, pp. 13-15.

In November 2007, Tryggvi Pálsson, Director of the Financial Stability Department of the CBI, submitted a memorandum to the Board of Governors of the CBI suggesting that the Board should establish a special working group in accordance with the Board of Governors' Resolution No. 1097 of 24 March 2006 on Responses to a Liquidity Crisis, as it was likely that the period of uncertainty with regard to funding and standing of banks would not be short-lived. The memorandum also states that it would be beneficial if the CBI made preparations for its response in case it would need to be of assistance with regard to official statements or liquidity facilitation. Subsequently, the Board of Governors summoned the group and it met for the first time on 14 November 2007. The working group held meetings frequently thereafter. Equally, meetings of the government consultative group, referred to above, became more frequent around this time.

In the latter part of November 2007, Iceland's Chamber of Commerce published a report by the economists Richard Portes and Friðrik Már Baldursson, *The Internationalisation of Iceland's Financial Sector*. The report maintains that the CDS spreads on the Icelandic banks, which at the time was between 140 and 300 points, was too high and that their operation was sound.

By the end of 2007, it was evident that the Icelandic stock market had taken a downturn. Increased value of registered shares, in the first half of the year, had fallen back to their original price and even lower.

### 21.3.3 Analysis of the Efforts of the Icelandic Authorities and of Several Relevant Issues in 2008

In January 2008, there were increasing concerns about the Icelandic financial market. Foreign media covered the difficulties facing Gnúpur Investment, and Glitnir Bank declared publically that a bond issue had been called off in consultation with the foreign banks which had worked on that project with Glitnir bank. Lastly, the merger of Kaupthing Bank and NIBC had not taken place, and the CDS spreads on the Icelandic banks was rising. During this period, meetings between the CBI and the commercial banks became more frequent, and CBI specialists prepared various documents dealing with the looming threats, cf. a more detailed account in Chapter 19.3.4. As to the work performed by the response group of the FME, which was operational at this time, the SIC refers to the discussion in Chapter 16.

The government consultative group convened on 15 January 2008. The draft minutes of the group reveal that Ingimundur Friðriksson, Governor of the CBI, had raised the question as to how the authorities would respond to a financial crisis. Governor Friðriksson is then quoted as saying that he was of the opinion that such crisis was not a distant possibility any more.

On 30 January 2008, Kaupthing Bank issued a press release announcing that the bank had cancelled the purchase of NIBC. In the SIC hearing, different views emerged explaining why the bank cancelled the purchase, and the role of the Icelandic authorities in the affair. Mr. Hreiðar Már Sigurðsson, CEO of Kaupthing Bank, declared that the FME had played a big role in the affair and signalled to the seller of NIBC that the FME did not see the purchase as a positive business affair. Mr. Sigurðsson stated that the heads of

Kaupthing had not lamented over the outcome. This is described in more detail in Chapter 19.3.4.<sup>88</sup>

In early February 2008, Mr. Davíð Oddsson, Governor of the CBI, and Mr. Sturla Pálsson, Director of the International and Market Operations Department of the CBI, went to an annual meeting in London with representatives of credit-rating agencies and banks. Governor Oddsson is said to have taken notes during this journey, but this document was not clean copied until 12 February that year. The memo describes the opinions of the representatives of the foreign banks and credit-rating agencies, i.e. that they concluded that the Icelandic banks were in a serious situation. The markets seemed to have closed the door on the banks, which meant that they would have difficulties refinancing themselves. Towards the end, the memorandum concludes that immediate action was needed to handle the current situation.

On 7 February 2008, Governor Oddsson met with Prime Minister Haarde, Foreign Minister Gísladóttir, and Finance Minister Árni Mathiesen. At the hearing, Mr. Oddsson uttered that he had been impatient to convey information from the journey to the UK to the ministers of the Government. His concern was first and foremost that it seemed that the Icelandic banks had lost all credibility.<sup>89</sup> In the hearing, a clean copy of the CBI memorandum was submitted to Mr. Haarde. He said that the memorandum had possibly been somewhat altered during clean copying, but that it was obvious that Mr. Oddsson had written the document, as his personal style had been evident. Mr. Haarde explained that the Government ministers had understood Mr. Oddsson's message, but his message had not contained any specific advice or suggestions concerning how to act in response. When asked what measures had been planned following the meeting, Mr. Haarde answered that the attendees had probably anticipated „that maybe something would subsequently emerge from“ the CBI. At the same hearing, Mr. Haarde described his position, that no measures had been available to tackle the problem. No measures had been available which would have enabled the authorities to „force the banks to do certain things“.<sup>90</sup> Ms. Gísladóttir was asked about the meeting in the hearing. She said that Governor Oddsson had described his journey to London and that he had, in her opinion, been a little dramatic in his report. Ms. Gísladóttir said that although she had understood that the information provided were a serious matter, she had not quite understood whether these were solely views of the foreign parties, whom the CBI Governor had met, or whether these were also the CBI's assessment of the situation.<sup>91</sup>

CBI's working group on response to the liquidity problems convened on 8 February 2008. In the group's minutes, Mr. Sturla Pálsson is quoted to have said that the Icelandic banks were unable to raise capital in the market. CBI's experts should therefore prepare for the worst. It was apparent that financial markets around the world were closing and big and powerful banks were busy saving themselves.

On 14 February, Prime Minister Haarde, Foreign Minister Gísladóttir, Finance Minister Mathiesen, and Sigurðsson, Minister of Business Affairs, met with representatives of the three large banks in Reykjavík. During the

88. Statement of Mr. Hreiðar Már Sigurðsson before the SIC on 21 July 2009, p. 30

89. Statement of Mr. Davíð Oddsson before the SIC on 7 August 2009, pp. 36 and 41.

90. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, pp. 40-41. and 52.

91. Statement of Ms. Ingibjörg Sólrún Gísladóttir before the SIC on 17 July 2009, pp. 3-4 and 7.

hearings before the SIC, two CEOs described their discontent with the meeting. They described discussions that had taken place at the meeting on how to explain the situation in Iceland more clearly, and explained that in fact this had been a mere public relations meeting.<sup>92</sup> The day before, Prime Minister Haarde had announced in his address at the Business Convention of the Icelandic Chamber of Commerce that the Government was prepared to work with various groups of the economy with the main aim of providing foreign analysts, investors and the media with information and analysis reports. At the same convention, Haarde also declared that the ministers of the Government were willing to attend, together with representatives of business organisations, meetings abroad and explain the state of affairs in Iceland and correct any misstatements that might have surfaced.

It seems that following the aforementioned meeting of the ministers and representatives of the banks, the Government increased its efforts to communicate the Icelandic banks' viewpoint abroad. A special Conference of Ambassadors was held on 22 February 2008 with the title „Deliberation on the Icelandic Financial Sector - Role of the Foreign Service“. Foreign Minister Gísladóttir's address at the conference had the title „All hands on deck“. At the same time, the former CEO of Icebank, Finnur Sveinbjörnsson, was hired to assist Prime Minister Haarde in disseminating information on the Icelandic financial system. As an example of the Governments increased efforts in propagating a more positive dialogue on these matters, mention can be made of Foreign Minister Gísladóttir's speech in Copenhagen on 11 March 2008, as well as Prime Minister Haarde's speech at the Congress of the Icelandic American Chamber of Commerce held in New York on 13 March the same year. Finally, it may be mentioned that in a speech at the annual meeting of the CBI on 28 March of the same year, Prime Minister Haarde said that „the Treasury and the CBI could, without any doubt, provide help if a crisis situation would emerge in the banking sector“. He also stated that under such circumstances the Icelandic authorities would, without hesitation, resort to the same measures as any responsible Government elsewhere in the world would do. As will be explained later, these assertions were not supported by any calculations made by experts.

On 22 February 2008, Landsbanki obtained a legal opinion from the law firm Allen & Overy concerning options available regarding the transfer of the deposit accounts from the bank's branch to a London based subsidiary. However, in April that year the Landsbanki directors changed their attitude as to how fast the transfer of the Icesave accounts to a subsidiary should be and the bank's emphasis in relations with the UK FSA shifted to the arrangement of liquidity management. There is no evidence that Landsbanki informed the FME or the CBI of this change in emphasis. As the year progressed, it became ever more evident in the FSA's dealings with the Landsbanki that it would be advisable to transfer the Icesave accounts to a subsidiary. At the beginning of July 2008, the FSA insisted the transfer directly, cf. a more detailed analysis below.

On 26 February 2008, the Minister of Business Affairs, Sigurðsson, appointed Ms. Áslaug Árnadóttir, the then acting Permanent Secretary of the

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92. Statement of Mr. Hreiðar Már Sigurðsson before the SIC on 21 July 2009, p. 25 See also statement of Mr. Sigurjón Þ. Árnason before the SIC on 19 August 2009, p. 77.

Ministry of Business Affairs, to serve as Chairman of the Board of Directors of the Depositors' and Investors' Guarantee Fund of Iceland (TIF). As described above in Chapter 17, it was customary to choose the Chairman of the Board of Directors of the TIF from within the Ministry of Business Affairs. It can only be concluded that this led in practice to significant and close collegial relations between the Ministry and the TIF and that in fact decreased the independence and efficiency of the Board of the TIF. Leadership in matters concerning the TIF had therefore rested with the Ministry of Business Affairs to a greater extent than with the Board of the TIF as such, including representatives of the credit institutions. The SIC is of the opinion that this was an unfortunate arrangement, which could imply that relations between the TIF, which is a private foundation, and the Ministry were more significant and closer than is permitted by law.

Towards the end of February 2008, a foreign expert on contingency preparations, Andrew Gracie, came to Iceland at the CBI's invitation. Mr. Gracie stayed in Iceland for a couple of days and worked with the Financial Stability Department of the CBI during his stay. He aggregated items to be emphasised and delivered in the form of a collection of overhead transparencies, covering issues that needed preparation in connection with formulation of a contingency plan. In the hearing, Mr. Tryggvi Pálsson, described that the transparencies had illustrated that it should be expected that the first crisis in the Icelandic financial sector would be Glitnir's repayment in mid-October the same year.<sup>93</sup> Mr. Gracie's data revealed, inter alia, that there was uncertainty as to whether the markets be opened to the Icelandic banks in good time to enable Glitnir Bank to meet a large payment in October 2008 and Kaupthing Bank in the first quarter of 2009. However, it emerged that banks had in general incentives to take risks and wait for the markets to open up again.

Mr. Davíð Oddsson and Mr. Ingimundur Friðriksson, Governors of the CBI, met with the Board of Governors of the Bank of England on 3 March 2008. Existing is a memorandum of the CBI describing the meeting, dated 5 March 2008. The memorandum states that it had been obvious that the representatives of the Bank of England were preoccupied with the consequences of possible and extensive withdrawals from accounts in banks in general, including in Landsbanki, which in turn could have a kind of domino effect. Later, it is stated that the representatives of the Bank of England had been rather preoccupied with the arrangements of the deposit guarantees and how these would work in practice.

CBI's working group on response in case of liquidity difficulties convened on 7 March 2008. The minutes describe that Mr. Tryggvi Pálsson had stated that Mr. Andrew Gracie was of the opinion that it was imperative that the authorities would adopt a generally accepted view on contingency issues as soon as possible.

On 10 March 2008, Prime Minister Haarde and Finance Minister Mathiesen met with Mr. Jónas Fr. Jónsson, Director General of the FME. Mr. Haarde explained that during the meeting Mr. Jónsson had said that the position of the banks did not look bad and that he was not of the opinion that the

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93. Statement of Mr. Tryggvi Pálsson before the SIC on 10 March 2009, p. 15-16.

banks were unhealthy, unless information was withheld from the FME, which would constitute a criminal offence, but this he thought unlikely.<sup>94</sup>

In March 2008, serious financial difficulties in the American investment bank Bear Stearns became public. Bear Stearns was later sold to J.P. Morgan on 16 March 2008, with the involvement of the US administration, after a rapid fall of the Bear Stearns shares.

In the middle of March 2008, the exchange rate of the krona began to fall. Simultaneously, some foreign financial corporations published negative prognosis reports on the Icelandic financial system and these were covered to some extent, both in domestic and foreign media.

The government consultative group convened on 18 March 2008. In the draft minutes Mr. Tryggvi Pálsson is quoted to have said that the liquidity crisis of Icelandic financial corporations was more serious than previously maintained and that a negative tone could be heard from foreign banks and investors. The Icelandic banks had been forced to secure loans to Icelandic companies as foreign banks had reduced such lending, cf. more detailed discussion in Chapter 8. Finally, Mr. Pálsson is quoted to have said that the danger had become great and imminent.

The CBI's working group on response to the liquidity crisis convened on 25 March 2008. In the minutes Mr. Pálsson is quoted to have said that negotiations concerning mergers had taken place between Icelandic financial corporations at Easter time. Chapter 20.2.5 above describes in greater detail the merger discussions that took place during 2008. As revealed in the said Chapter, profound mistrust arose between heads of the Icelandic financial corporations and seemingly doubts were raised concerning the usefulness of mergers, where as it was not certain that these would help the banks to refinance themselves, on the contrary mergers could have adverse effects.

On that day, i.e. on 25 March 2008, the government consultative group convened. The draft minutes suggest that Mr. Bolli Þór Bollason, Permanent Secretary of the Prime Minister's Office, who presided over the work of the group, had instructed the FME and the CBI to compile a list of possible critical measures to solve the difficulties at hand. As described in more detail in Chapter 19.4.4 the SIC is of the opinion that the consultative group had not adequately followed-up on the work carried out subsequently. In this context it may be mentioned that for quite a while, the seriousness of the difficulties facing the Icelandic financial system, could not have escaped the group members.

In early February, a memorandum from the CBI reveals that a decision was made to seek „some kind of overdraft facilities or credit facilities“ from foreign central banks with the aim of building up the foreign exchange reserves of the CBI, as set out in Chapter 4.5.9.<sup>95</sup> On 17 March 2008, the CBI subsequently posed the question in an e-mail to the Bank of England, if it would be possible for the bank to enter into a currency swap agreement with the CBI. On 17 March 2008, the Icelandic krona fell in value more than 6% vis-à-vis the British pound, which was the largest depreciation of the krona since the beginning of the „mini crisis“ of 22 February 2006. Moreover, in April 2008 the CBI started negotiations with the European Central Bank, the

94. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, p. 42.

95. Memorandum of the CBI of 4 February 2008: *“Indications in Moody's Report.” SI-38808.*

Federal Reserve of the United States of America, and the Central Banks of Sweden, Denmark and Norway with the same aim in mind. The negotiations took place concurrently with the meeting of the International Monetary Fund in Washington on 11-14 April 2008. In Chapter 19.8.1, it is clarified how representatives of the CBI saw the negotiations commence in a constructive manner, but witnessed a transformation in the attitude of the Governors of the foreign central banks, as it became more negative. It may be mentioned in this connection, that in a letter from Mr. Mervyn King, Governor of the Bank of England, of 23 April 2008, it is stated that it is evident that the aggregate balance sheet of Iceland's three largest banks was of such magnitude that it would be extremely difficult for the CBI to perform its role as a lender of last resort. Governor King adds that players in international financial markets have already and increasingly become aware of this and are likewise increasingly worried about the situation. Finally, Governor King mentions his interest in discussing how the international community might assist Iceland in finding a solution to the problem. Governor King announces that he intends to raise the issue at the planned meeting of the G10 Central Bank Governors in Basel on 4 May the same year. Lastly, Governor King says he has discussed the issue with Mr. Stefan Ingves, Governor of the Central Bank of Sweden. The CBI declined Governor King's offer, as explained more fully in Chapter 4.5.9.2.

In the hearing before the SIC, Governor Oddsson mentioned another example of the altered policy vis-à-vis Iceland as mentioned above. Governor Oddsson added that at the annual meeting of the Bank for International Settlements in Basel, Mr. Stefan Ingves had refused to shake hands with Mr. Eiríkur Guðnason, Governor of the CBI, cf. also a discussion of the meeting below.<sup>96</sup>

In connection with the above mentioned discussions on currency swap agreements, the CBI received, in the middle of April 2008, a report from the IMF on the situation in Iceland. In conjunction with this, the Central Bank of Sweden sent its experts to Iceland in order to draw up an explanatory report on the Icelandic banks. In short, the Central Banks of the United Kingdom, Europe and the United States of America did not consent to making currency swap agreements with the CBI; however, the Central Banks of Sweden, Denmark and Norway agreed to enter into such agreements with specific conditions. In his statement before the SIC, Prime Minister Haarde he revealed that Governor Oddsson had called him on the telephone on 14 May 2008 and told him that he was in a meeting with his Nordic colleagues and that he and they were trying to conclude a currency swap agreement. According to the Prime Minister, Governor Oddsson had told him that Governor Stefan Ingves wished to discuss with Prime Minister Haarde regarding the conditions the Nordic Central Banks wished to set out with regard to the currency swap agreements. As a result of this, Prime Minister Haarde, Foreign Minister Gísladóttir and Finance Minister Mathiesen signed an agreement, where, inter alia, it was undertaken, on behalf of Iceland, to reduce the size of the balance sheet of the Icelandic banks, to introduce changes in the operations of the Housing Financing Fund (HFF), to build up

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96. Statement of Mr. Davíð Oddsson before the SIC on 7 August 2009, p. 52.

the CBI foreign currency reserves, and to impose more constraints upon public finances. The SIC sees it as a token of increased mistrust on behalf of the governors of the foreign central banks towards the heads of state in Iceland that the words of the Icelandic Prime Minister were not deemed valid; instead the requirement was made that a statement would be signed assuring improvements of the Icelandic economy.

In the meantime, i.e. towards the end of March 2008, the CBI had concluded an agreement for a new credit line with the Bank for International Settlements (BIS) in Basel. The credit line amounted to USD 500 million. As explained in Chapters 4 and 19, the CBI lost the credit line, due to the fact that the Bank's officers forgot to extend it, which should have been done for the first time towards the end of April the same year. In a draft memorandum, Governor Ingimundur Friðriksson states that as soon as the above mentioned mistake was discovered an extension was requested. At that time the BIS had, however, rejected a request for an extension of the agreement.<sup>98</sup> The SIC is of the opinion that this was a costly mistake made by the CBI, mainly because it was known at that time that it was necessary to increase the Bank's access to foreign currency.

On 30 March 2008, the Governors of the CBI met with the CEOs of Landsbanki. In the CBI's draft minutes, CEO Halldór Kristjánsson is quoted as stating, that there had been withdrawals from the Icesave accounts that very day, and that mistrust with regard to the Depositors' and Investors' Guarantee Fund surfaced repeatedly. Later in this draft, it says that CEO Sigurjón Þ. Árnason had talked about two time-bombs, i.e. Icesave and wholesale deposits. Finally, Mr. Árnason is quoted as saying that „the likelihood that the Icelandic banks would get through this [was] very, very slim“.

A meeting was called by the government consultative group on 1 April 2008. In the group's draft minutes the Chairman of the group, Permanent Secretary of the Prime Minister's Office, Mr. Bolli Þór Bollason is quoted as stating that an action plan should be put down on paper. The same view is aired in the group's draft minutes dated 2 April 2008. The SIC is of the opinion that these plans were, however, never executed properly as explained more fully below.

Since the beginning of 2008, unfavourable publicity concerning the Icelandic economy and the Icelandic banks appeared in various analysis reports and foreign media, e.g. the UK media. This was an addition to the prevailing mistrust in the UK since the run on the British bank Northern Rock in the autumn of 2007. In the aftermath of the British Government's take-over of Northern Rock in February 2008, discussions about the difficulties of financial corporations became prominent in the UK. One of the factors that the British media focused on was the high CDS spreads on the Icelandic banks. This chain of events led to a run on the UK branch of Landsbanki from February 2008 until late April the same year, as detailed in Chapter 18. Even though Landsbanki did survive this run, the danger was still lurking and the British media later covered the weaknesses of the depositors compensation scheme in Iceland; a coverage which became the basis of a debate on the matter within a British Parliamentary Committee in the summer of 2008.

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97. A draft memorandum prepared by Mr. Ingimundur Friðriksson: "A memorandum on communications with foreign Central Banks in 2008 et al.", dated 13 October 2008.

In relation to this, it is worth mentioning that on 1 April 2008, the CBI's Board of Governors met with Prime Minister Haarde and Foreign Minister Gísladóttir. According to Foreign Minister Gísladóttir's memorandum from that meeting, Governor Oddsson revealed that over the previous weekend and up to the date of the meeting, EUR 193 million had been withdrawn from the Landsbanki Icesave accounts in London. The memorandum further states that Governor Oddsson had said that Landsbanki could endure such withdrawals for approximately six days. Furthermore, Governor Oddsson is quoted saying that the FSA wanted Landsbanki to move the Icesave accounts from its UK branch to a UK subsidiary. Chapter 18 contains a more detailed discussion on this issue. It is not clear whether the Icelandic Foreign Service took any specific measures on this occasion in order to prepare counter-measures in the UK, or to activate relations with foreign governments, e.g. in case of a continuing run on the Landsbanki Icesave accounts in the UK. The SIC is of the opinion that the Icelandic authorities also failed at that time to put pressure on the Landsbanki, through formal measures, to transfer the Icesave accounts to a UK subsidiary, or at least requested a schedule be made for the transfer from Landsbanki, in case the authorities were of the opinion that such a transfer was anticipated. Notwithstanding the Landsbanki's legal authorisation to operate a branch in London, it was clear that progress in the transfer of the Icesave accounts to a subsidiary could be of considerable importance with regard to any response and measures of the Icelandic authorities in the coming months, inter alia with regard to the Depositors' and Investors' Guarantee Fund and with regard to relations with foreign regulatory bodies.

At a meeting of the government consultative group held on 21 April 2008, a document, prepared by the FME and the CBI, under the heading: „Scenario of a Financial Crisis - Matter of Opinion, workable Measures and Conditions“ was submitted. Among the factors discussed in the document is the fact that the Government should have the authority to take over the operation of a systematically important bank, emergency plans should be reviewed, and that a comprehensive action plan needed to be prepared, together with a strategy for communication with creditors. Finally, financing of possible rescue operations should be commenced directly and public relations should be prepared in order to enhance the effectiveness and credibility of the actions. The SIC is of the opinion that these were positive goals, but, as mentioned earlier, they were regrettably not realised even though the need was impelling.

On 24 April 2008, Prime Minister Haarde had a meeting with UK Prime Minister Gordon Brown. A memorandum prepared by the Prime Minister's Office on the meeting reveals that Prime Minister Haarde asked for a credit line from the Bank of England and that he had described the dilemma of Iceland as primarily that of an image dilemma. The memorandum also reveals that Prime Minister Brown had mentioned the possibility that the IMF could help out by confirming the strong position of the Icelandic economy. In the hearing before the SIC, Mr. Haarde explained that he had understood Prime Minister Brown's comment as follows: „I am of the opinion that from his point of view this was very well meant; go to the IMF and ask them to do what they can to help you out; if your situation is favourable and everything

is in good order, then it is fine that the IMF says so. If the situation is not in order, then it is fine that the IMF comes to your assistance.<sup>498</sup>

Mr. Jean-Claude Trichet, President of the European Central Bank, got in touch with CBI Governor Oddsson towards the end of April and expressed his disappointment over collateralised loans acquired by the Icelandic Banks from the Central bank of Luxembourg. These collateralised loans will then have amounted to almost EUR 4 billion. ECB President Trichet said that the Icelandic banks' credit securities were regarded as pro forma between them. Draft minutes of the government consultative group dated 28 April 2008 reveal that this matter was discussed at the meeting. According to the draft minutes, the Central Bank of Luxembourg convened the banks to a meeting in Luxembourg on 28 and 29 April. The Icelandic banks' collateralised loans through their subsidiaries in Luxembourg were again discussed in the summer of 2008, as described in more detail below.

Later in the spring of 2008, the meetings of the government consultative group became more frequent. This is an indication of more serious concerns due to the situation of the Icelandic financial market. The draft minutes of the consultative group reveal, however, that these concerns were not followed upon sufficiently through actions, e.g. by calling for the viewpoints of the ministers or by elaborating the action plan of the Government, as would have been the obvious way forward after the consultative group's meeting on 21 April 2008. Furthermore, it may be mentioned, in this context, that during the summer more time passed between the consultative group's meetings, despite the fact that there did not seem to be any reason to reduce the group's workload. Specific conclusions of the SIC concerning the government consultative group are set out in Chapter 21.4.5 below.

On 8 May 2008, a bulletin of the CBI, *Financial Equilibrium*, was published. It states i.a.: „In *Financial Equilibrium* a year ago the result of the CBI's analysis was that the financial system was essentially sound. This result is still valid.“ The factors that mainly secure the financial system's power of resistance are according to the CBI: „Long-term trends in the Icelandic economy are positive, the standing of the banks is acceptable, sound official framework and control, as are the payment and settlement systems, and last but not least the Treasury is in a very sound position. [...] On the whole, the CBI still concludes that the financial system is essentially sound. The Icelandic banking system complies with all set requirements and passes stress-tests which the FME and the CBI have conducted.“

A meeting was called by the government consultative group on 9 May 2008. The group's draft minutes state that Ms. Áslaug Árnadóttir, acting Permanent Secretary of the Ministry of Business Affairs, had submitted and presented a document, dated 9 May 2008, under the heading: „Securing Deposits“. The minutes also state that the document reveals the fact that if the Treasury was to secure all deposits the amount would be ISK 2,318 billion, while the Depositors' and Investors' Guarantee Fund had ISK 10 billion at its disposal.

The Supervisory Board of the CBI of Iceland was summoned on 23 May 2008. In the draft minutes Governor Oddsson is quoted as stating that ISK 170 billion of the guarantees for the CBI's collateralised loans were debt secu-

98. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, pp. 46-47.

rities which the banks issued for each other and were to be submitted when the collateralised loans were acquired. The securities were otherwise not guaranteed and could be „foam“. Governor Oddsson is quoted to have said that Mr. Stefán Svavarsson, the CBI's chief auditor, was working on this matter. Next, Governor Oddsson is quoted as stating that Icebank, e.g. acquired collateralised loans of the amount of ISK 190 billion for the purpose of relending to the other banks. This would probably be called money printing. The European Central Bank had had reservations about such securities. CBI's collateralised loans amounted at that moment to almost the same amount as the state budget every week. There were concerns as to whether the guarantees were sufficient and if it would not be a wise move to slow down. In this context, the SIC wishes to mention that the CBI had good reason to share Governor Oddsson's worries as quoted above. However, it is worth noting that the CBI did nothing despite the above mentioned concerns, which in fact seem to have been roused as early as at the beginning of November 2007, as mentioned in more detail in Chapter 7.0. The SIC reproaches the CBI's Board of Governors for not taking the proper measures to address the situation.

On 26 May 2008, Finance Minister Mathiesen presented a bill in Parliament that would authorise the Treasury to acquire a foreign loan up to the amount of ISK 500 billion. The bill was passed on 29 May 2008.

A meeting was called by the government consultative group on 29 May 2008. On the very same day Landsbanki began to receive deposits into the Icesave accounts in its branch in Amsterdam in the Netherlands; this deposit-taking service was notified to the FME on 6 September 2007. The consultative group's draft minutes mention that the Landsbanki's notification concerning the marketing of the Icesave deposit accounts in the Netherlands through its Amsterdam branch had been discussed. This would add to the Depositors' and Investors' Guarantee Fund's obligations. It is mentioned that Mr. Jónas Fr. Jónsson had revealed that 10 foreign branch applications from the Icelandic banks had been filed with the FME.

In short, the Icesave accounts of Landsbanki were very well received in the Netherlands and beyond all hopes of the CEOs of Landsbanki, cf. Chapter 18.3. With regard to the Landsbanki's involvement in unfavourable publicity in the UK and to the run on the bank's London branch earlier that year, it must be concluded that it had been very unsound to start raising deposits in the Netherlands through a branch rather than through a subsidiary. In this context, it must be pointed out that the FME, in its controlling of the deposit-taking activities of the banks, did not look to the present situation of the Icelandic krona on the foreign exchange market at the time the Landsbanki branch in Amsterdam began receiving deposits. The currency swap market with the Icelandic krona had been more or less inactive from March of that same year, cf. the discussion in Chapter 13. In case of a run on the bank's branch in Amsterdam, as with the run on the bank's branch in the UK earlier that spring, it would become very difficult for the bank to use its ISK liquid assets for the purpose of meeting its obligations in foreign currencies. In other words, liquidity in the Icelandic krona was not of utmost importance when analysing the bank's liquidity in case of sudden and extensive outflow from deposit accounts at the branch. Although Landsbanki's half-year financial statement for the former half of 2008 had initially not given rise, in the opinion of the FME, to limit the licence of Landsbanki to receive further

deposits in the bank's Amsterdam branch, it had to be evident that the bank's increasingly restricted access to euros, once the currency markets started closing down, would affect the bank's possibilities to honour its deposit obligations. This should have presented ample cause for the FME to separately investigate the issues facing the Amsterdam branch.

Concerning the discussion about the Landsbanki Amsterdam branch, the SIC must point out that it was, irrespective of the functions and obligations of regulatory and administrative authorities, a business decision and the responsibility of the directors of Landsbanki to establish deposit taking and carry on raising deposits from the general public in a new market area by offering high interest rates, despite the situation that had emerged in the operations of Landsbanki and in international financial markets; a situation that kept deteriorating as 2008 progressed.

Around the time when Landsbanki started to receive deposits into its Icesave account at the Amsterdam branch, the bank had been corresponding with the UK FSA. The correspondence resulted in it that Landsbanki waived its previous FSA global liquidity concession, cf. more detailed discussion in Chapter 18.2.2.

The CBI's document of 24 June 2008, „The Ugly List“, is described in Chapter 19.3.9. The document includes a summary of criticism and negative coverage of the Icelandic financial system in foreign media in the preceding weeks. The document reveals e.g. that the falling exchange rate of the krona vis-à-vis the euro had been 30% since the turn of the year. Despite the all time high policy rate the fall of the krona could not be stopped. The inflation rate was 12.3% and had not been higher in 18 years. The Icelandic banks were subject to higher CDS spreads than other banks with the same credit rating. Of all the countries in the world, the stock market in Iceland had fallen most, save for one country, since the beginning of 2008, and, finally, it was believed that the refinancing of the banks would prove difficult.

The annual meeting of the Bank for International Settlements was held in Basel in the latter half of June 2008. As described earlier, the change of attitudes of the foreign governors of central banks surfaced was strongly felt on this occasion. Thus, the Governor of the Central Bank of Luxembourg, Mr. Yves Mersch, asked for a special meeting with the CBI's Governors. In a draft memorandum by Governor Ingimundur Friðriksson an account is given of the meeting; Governor Mersch had described how the Icelandic banks had used facilitations granted by the European Central Bank excessively and then said that no banks wanted to do business with them any more. The Icelandic banks were like a leprosy patient that nobody wanted come close to. Following this meeting, the CBI invited Governor Mersch to a meeting in Iceland for further discussions. That meeting took place on 4 July of the same year and was also attended by representatives of the FME and the Commission de Surveillance du Secteur Financier (CSSF) in Luxembourg. From the documents, acquired by the SIC, it can be concluded that Governor Mersch had talked longer than anyone else present, and that he had put forth his negative views about the Icelandic banks and expressed serious doubts that the CBI had the strength to fulfil its role as a lender of last resort. The doubt cast by Governor Mersch regarding the strength of the CBI in this regard is reminiscent of Mervyn King's views expressed in his letter to the CBI, dated 23 April 2008, described above. This all adds up to one thing,

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.

In a meeting on 8 July 2008 with Prime Minister Haarde and Foreign Minister Gísladóttir, Governor Oddsson described the aforementioned meeting with Governor Mersch. Foreign Minister Gísladóttir's memorandum from the meeting reveals that Governor Oddsson had said that Mersch had criticised the Icelandic banks harshly. The memo further reveals that Governor Oddsson had said that the reason why the Bank of England had backed out was that it would be out of the question to help the Icelandic banks because they were villains.<sup>99</sup>

A few days earlier, i.e. on 4 July 2008, the CBI's Board of Governors had met with the permanent secretaries of the Prime Minister's Office and of the Finance Ministry. In the CBI's draft minutes, Governor Oddsson is quoted as stating that his feeling was that a consensus had been reached at the European Central Bank and the 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.

It can be said that there was a definite turning point concerning the deposit accounts of Landsbanki in the UK in early July 2008. As noted earlier, the FSA established, at that time, a direct requirement that Landsbanki would transfer its deposit accounts from the branch to a subsidiary. In this period The Times in the UK had covered the Icelandic deposit-guarantee scheme and described how weak it was in light of the high deposits raised by the Icelandic banks. In mid-July, the Icelandic banks were the subject of debate in the British Parliament and markedly in a Parliamentary Committee, where the question was asked if British depositors were fully guaranteed should an Icelandic bank go into bankruptcy. In this context, the SIC likes to point out that coverage in the British media since the beginning of 2008 brought about constant danger of a run on Landsbanki, which was characterised as a major banking institution in the Icelandic economy. With the aforementioned coverage in The Times and discussions in the British Parliament in July 2008, the danger the bank was in increased dramatically. As set forth in Chapter 18, the CBI would be unable to come to the aid of Landsbanki as a lender of last resort, if put to the test. Here, it may be pointed out that Chapter 4 deals, in particular, with the fact that the three banks, Glitnir, Kaupthing Bank and Landsbanki, all became too big, relative to domestic production, for the CBI to serve as a lender of last resort. The SIC is therefore surprised by the fact that it can not be seen that at any stage of the affair did the Icelandic authorities make any formal efforts vis-à-vis Landsbanki to force the bank to transfer the deposit accounts in its London branch to a subsidiary. During the hearings before the SIC, ministers, permanent secretaries, and the directors of the FME and the CBI did not see it as their duty to put pressure on the bank concerning the transfer of the Icesave accounts and pointed the finger at each other in this regard. In late summer 2008, the Dutch authorities grew concerned as deposits flowed rapidly into the Amsterdam branch of Landsbanki.

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99. Undated memorandum by Ms. Gísladóttir: "Notes from meetings with the Board of Governors of the Central Bank in 2008 and other material and notes related thereto".

In early July 2008, Mr. Tryggvi Pálsson, Director of the Financial Stability Department of the CBI, prepared a document, „Urgent Government Decision-Making concerning the Danger of a Financial Crisis“, which was submitted to the consultative group of the Icelandic authorities on 7 July 2008. Different methods are discussed in this document and then declared that they had as yet not been outlined nor their pros and cons assessed. It would be urgent to finish that work. It is the opinion of the SIC that this document should have been implemented to a greater degree. The issues mentioned in the document as urgent, had been urgent for quite a while. The draft of the minutes of the consultative group from 7 July 2008 states that Mr. Tryggvi Pálsson had declared that the directors of the banks had been aware of the situation. However, they had not been given ultimatums by the authorities as the authorities had not decided how far they were willing to go. The attention of the SIC is drawn to the fact that Althingi did not respond to this. A possible explanation may lie in the attitude of Prime Minister Haarde, mentioned earlier, that the authorities lacked the resources to react and that the banks could not be forced to act, for instance by selling assets.<sup>100</sup> The SIC does not concur. The central authorities had various resources, for instance through the CBI which was a very important lender to the banks, furthermore, the authorities could have instructed experts within the administration to prepare government bills to underpin their powers in these matters in case the banks were not willing to cooperate.

In this context it should be remembered that Chapter 20 above describes the background when the Prime Minister presented a Bill on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances, etc. This Act is commonly known as the Emergency Act. The SIC is of the opinion that the authorities should have prepared such a bill at a much earlier stage. In fact, only a fraction of the bill was ready at the beginning of October 2008. The draft of the bill was therefore finalised to a large extent over the weekend before it was submitted to the Government. In an explanatory memorandum of 17 February 2006, which was prepared by the group that later became the consultative group of the authorities, it is evident that it was already necessary to make considerable changes to the legislation, i.a. in order to plan for the response to difficult circumstances in the financial market.

On 15 July 2008, Foreign Minister Gísladóttir proposed to Prime Minister Haarde that a group of experienced specialists be formed with the purpose of inconspicuously developing suggestions for improvements and composing a comprehensive draft of economic policy measures and structural adjustments in the field of economics, and then present them to the Government. Nothing came of this. Around the same time, Prime Minister Haarde recruited Mr. Tryggvi Þór Herbertsson, economist and then CEO of Askar Capital hf., as his economic advisor. Mr. Herbertsson started work on 1 August 2008. In the hearing, Ms. Gísladóttir stated that „this recruitment had not been to her liking at all“.<sup>101</sup>

On 17 July, the CBI wrote identical letters to the banks because of the credit facilities that the institution had granted them. In the letters it is stated,

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100. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, pp. 40-41 and 52.

101. Statement of Ms. Ingibjörg Sólrún Gísladóttir before the SIC on 17 July 2009, p. 15.

among other things, that it is not normal for financial institutions to be able to direct the liquidity facilities of the CBI via their mutual debt securities issuance. A limit would be put on the amounts of each issuer of debt securities and the banks would be granted a time period to adapt to the modified rules. It is clear that the CBI was thereby describing its intention to oppose the issuance of the so-called love letters. In the SIC's view, it must be criticised that the CBI did not take this action much sooner, seeing that there had been doubts about those collaterals within the CBI for quite some time. It is also unfortunate that it seems as if the CBI's change of direction, which was announced in the letters, was not really followed in any significant manner before the collapse of the banks, as is described in Chapter 7.5.1.

The government's consultative group held a meeting on 22 July 2008. In the draft minutes, Mr. Ingimundur Friðriksson is quoted as saying that the FSA in the UK had encouraged Landsbanki to transfer its deposit book from the branch to a subsidiary. However, that process had not begun and Landsbanki seemed opposed to the idea. It is stated that Mr. Friðriksson asked whether it were possible to bring this transfer about by changing laws or regulations. Directly thereafter it is stated that Ms. Áslaug Árnadóttir said that the establishment of branches and receipt of deposits could not be prohibited but only delayed.

In the evening news of the National Broadcasting Service on 24 July 2008, a specialist of the financial institution Merrill Lynch was interviewed. He criticised the government because he felt that it had not addressed the high CDS spreads on the Icelandic banks. The following evening, Ms. Þorgerður Katrín Gunnarsdóttir, Minister of Culture and Education and at the time acting Prime Minister in the absence of Geir H. Haarde, was interviewed on the evening news of the National Broadcasting Service. Minister Gunnarsdóttir expressed her surprise at the comments of Merrill Lynch's employee and furthermore asked whether this could be guided by some strange agenda, since the comments were completely unfounded. She also posed the question, as Minister of Education, as to whether said employee of Merrill Lynch could be in need of re-education. This kind of attitude is in many ways telling of the way in which the Icelandic authorities and the banks reacted in 2008. More often than not, it was maintained that doubts cast on the Icelandic financial system were based on strange agendas, and the alleged misunderstandings would need to be corrected, whereas the authorities should have entered into a thorough re-examination of the situation of the Icelandic financial system.

In Chapter 17.17 it is stated that in a meeting with Ms. Áslaug Árnadóttir on 31 July 2008, representatives of the FSA emphasized that the Icelandic authorities must give their reassurance that the state would grant the Depositors' and Investors' Guarantee Fund a loan if this proved necessary. Following the meeting, written correspondence took place between the Ministry of Business Affairs and HM Treasury in which the latter asked for information concerning the possible involvement of the state, were the Guarantee Fund to run into trouble. The Ministry of Business Affairs responded to this query in a letter dated 20 August of the same year, signed by Ms. Áslaug Árnadóttir. However, this letter had been prepared and approved by Prime Minister Haarde, Finance Minister Mathiesen and the Minister of Business Affairs Sigurðsson; their staff took part in its preparation as well. It stated that if the Guarantee Fund proved unable to raise funds, the Icelandic

state would do everything a „responsible government“ would do under such circumstances, including „assisting the Fund“ in raising the funds necessary to meet the obligations concerning the minimum guarantee provided for in the directive of the European Union. This is covered in greater detail in Chapter 17.

In Chapter 19.3.11 it is stated that Prime Minister Haarde met with Mr. Björgólfur Thor Björgólfsson on 6 August 2008 and with Mr. Þorsteinn Már Baldvinsson, Chairman of the Board of Directors of Glitnir on 10 August. In all probability, the Prime Minister’s intention was to explore the possibility of the merger of Landsbanki and Glitnir. In short, discussions of that nature between the aforementioned banks did not commence despite the Prime Minister’s involvement.

In a Government meeting on 12 August 2008, the Minister of Business Affairs, Sigurðsson, submitted a proposal of forming a special committee which would have the task to increase the stability of the financial system, reduce the chances of financial institutions running into trouble, but also reduce the effects of such trouble were it to occur. In the minutes from the Government meeting, it is stated that the matter had been discussed but that its resolution was postponed. The Minister of Industry Össur Skarphéðinsson, said in his statement before the SIC that the matter was probably be postponed because it had not previously been presented to other ministers. Minister Skarphéðinsson suggested that some had felt that the Minister of Business Affairs, Sigurðsson, had been rather too forward in this matter.<sup>102</sup>

On 14 August 2008, the FME held a meeting with the Dutch Central Bank (DNB), which also handles supervision of financial matters in that country. In a hearing before the SIC, Mr. Guðmundur Jónsson, Head of Credit Market at the FME, stated that the representatives of the DNB had in the meeting expressed concerns over how little money there was in the Depositors’ and Investors’ Guarantee Fund and how the CBI was lacking in ability to assist the banks in case of liquidity difficulties. For these reasons, the representatives of the DNB had wanted to put a halt to the depositing onto IceSave accounts in the Netherlands.<sup>103</sup> In an e-mail from Mr. Jónsson to the DNB, sent the following day, it is stated that the FME does not agree that the arguments of the DNB justify forcing Landsbanki to refuse further deposits in the Netherlands.

In the opinion of the SIC, everything indicates that the FME first and foremost presented and supported Landsbanki’s viewpoint. The FME was seriously lacking in putting forth adequate positions or official suggestions to the FSA, the DNB, Landsbanki, the CBI or ministers of the Government of Iceland about possible means of quickly transferring the Icesave accounts to subsidiaries.

The Financial Services Authority (FSA) wrote a letter to Landsbanki on 15 August because of the bank’s operations in Britain. Prime Minister Haarde received a copy of this letter from the CBI the following day. During the hearing, he described the letter as horrible. He stated that he had not been able to see how Landsbanki could fulfil the obligations presented in the letter.<sup>104</sup> At this point in time it had become clear that it would be very difficult for

102. Statement of Mr. Össur Skarphéðinsson before the SIC on 26 May 2009, p. 34.

103. Statement of Mr. Guðmundur Jónsson before the SIC on 10 August 2009, p. 64.

104. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, p. 55.

Landsbanki to transfer the Icesave accounts from its branch to a subsidiary. The CEOs of Landsbanki were also worried that British authorities would not accept the assets to be transferred to the subsidiary of Landsbanki against the deposits in the branch. The SIC finds it noteworthy that communications between the Icelandic and British authorities about deposit accounts in the London branch of Landsbanki took place mostly due to the initiative of the British authorities. Furthermore, the FME placed emphasis on getting the viewpoint of Landsbanki across to the FSA and the DNB, instead of presenting its own point of view or suggestions about how the matter might possibly be solved. The SIC is of the opinion that after having received the aforementioned letter of the FSA to Landsbanki, it should have been clear to Icelandic authorities that regardless of Landsbanki's expectations about an agreement with the FSA, the direct involvement of the Icelandic authorities was needed.

The CEOs of Landsbanki met with Nout Wellink, Executive Director of the DNB, on 27 August 2008. At the hearing before the SIC, Mr. Sigurjón Þ. Árnason stated that Mr. Wellink had expressed concerns about the deposit guarantee arrangements. Furthermore, he had calculated the costs that would have to be equalled out amongst Dutch banks in case things turned for the worse for Landsbanki.<sup>105</sup> The following day, i.e. the 28 of the same month, the DNB sent an e-mail to the FME stating that the DNB had taken the position that Landsbanki must put a halt to any increase in the Icesave accounts in the Netherlands. The arguments for this position as stated in the e-mail are that the DNB is concerned about the Icelandic economy and that the Icelandic state's position vis-à-vis the Depositors' and Investors' Guarantee Fund is uncertain. Thus, there is uncertainty concerning the role of the state in case the Fund cannot meet its obligations.

Minister of Business Affairs Sigurðsson and Mr. Jón Sigurðsson, Chairman of the Board of Directors of the FME, went to London on 2 September 2008 to meet with Alistair Darling, Chancellor of the Exchequer. Accompanying them were various officials, including Mr. Baldur Guðlaugsson, Permanent Secretary to the Ministry of Finance, Ms. Jónína S. Lárusdóttir, Permanent Secretary to the Ministry of Business Affairs, and Ms. Áslaug Árnadóttir, Chairperson of the Board of TIF. It should be noted that the impetus for the meeting was Landsbanki's request that the Minister of Business Affairs represent the bank vis-à-vis the British authorities. As further detailed in Chapters 18 and 19 above, Mr. Darling is said to have expressed his concerns about the deposit accounts of Icelandic banks in branches in the UK during the meeting. Mr. Jón Sigurðsson expressed the opinions of the Icelandic authorities during the meeting. A more detailed account of the meeting with Mr. Darling can be found in the draft minutes of the consultative group of the Icelandic authorities dated 4 September of that same year. Ms. Jónína S. Lárusdóttir is quoted as stating that Mr. Darling had said he expected British authorities to guarantee deposits in full and asked where the bill should then be sent. Mr. Clive Maxwell, an employee of HM Treasury, furthermore stated soon after this during a meeting with Mr. Sverrir Haukur Gunnlaugsson, the Icelandic ambassador in London, that Mr. Darling had been disappointed with this meeting that he had with the Icelandic officials. According to Mr. Maxwell, Mr. Darling's impression was that it seemed as if the Icelanders did not fully

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105. Statement of Mr. Sigurjón Þ. Árnason before the SIC on 27 August 2009, p. 54-55 and 66.

grasp the gravity of the situation. In this context the SIC wishes to mention that apparently the meeting of the Minister of Business Affairs and the Chairman of the Board of Directors of the FME did not in any way alleviate concerns about the affairs of Landsbanki within the British administration nor facilitate the solution of the problem. The Icelanders present at the meeting could not have helped but realize that Darling believed that there was significant risk that Landsbanki would not be able to honour its obligations towards depositors in Britain. Finally, nothing suggests that the Minister of Business Affairs or other ministers from the Icelandic government did in the weeks following the meeting explore what options might be available for facilitating the transfer of the Icesave accounts to a subsidiary.

#### 21.3.4 The Collapse of Glitnir hf.

Around the middle of September 2008 many financial institutions ran into serious problems. These problems became fully apparent when the American financial institution Lehman Brothers filed for bankruptcy protection on 15 September 2008. On the same day, an agreement on Bank of America's takeover of Merrill Lynch was made public. The following day it was announced that U.S. authorities would supply the insurance company AIG with emergency financial aid. Then, on 18 September 2008, it was announced that the British bank HBOS had been taken over by Lloyds TBS after the price of stocks in the aforementioned bank had fallen rapidly. It is therefore safe to say that international financial markets were very turbulent in this period.

The financing of Glitnir had proved to be problematic in 2008. The bank had cancelled a bond issue at the beginning of the year because of little interest shown by investors, among other reasons. As early as mid-September, it became irrevocably clear that the sale of assets by a subsidiary of Glitnir in Norway would not go through. At the same time, Bayerische Landesbank refused to extend two loans of the bank, estimated at a total of EUR 150 million. Finally, market conditions worsened rapidly after the collapse of Lehman Brothers. On Wednesday 24 September 2008, Mr. Þorsteinn Már Baldvinsson, Chairman of the Board of Glitnir, contacted Mr. Davíð Oddsson, Chairman of CBI's Board of Governors, and requested a meeting with him. The reason why Mr. Baldvinsson contacted Governor Oddsson was that there were indications that Glitnir would have difficulties paying back loans that were due for repayment around the middle of October of the same year. Mr. Baldvinsson and Governor Oddsson had a meeting at noon the following day in the CBI. When it had been in progress for some time, the other Governors of the CBI, Mr. Eiríkur Guðnason and Mr. Ingimundur Friðriksson, also joined the meeting. Mr. Baldvinsson is said to have presented Glitnir's potential need of funds as EUR 600 million and mentioned the so-called loan book 561 as a possible insurance for a loan, cf. more detailed discussion in Chapter 20.2.3.

After the meeting, a fast course of events commenced that came to an end a few days later, on Monday 29 September 2008, when it was publicly announced that the Icelandic government would supply Glitnir with EUR 600 million in exchange for a 75% share in the bank. This is explained in further detail in Chapter 20.

Prime Minister Haarde was in New York on official business along with Foreign Minister Gísladóttir when Glitnir brought its business to the CBI.

Governor Oddsson contacted Prime Minister Haarde and requested that he come back to attend to the matter. For this reason, Mr. Haarde cut short his visit and came to Iceland on 27 September. He met with CBI's Board of Governors on the same day. As luck would have it, employees of the National Broadcasting Service (RUV) noticed when the Governors of the CBI left the Prime Minister's Office and news of the meeting were broadcast that same evening. On the same day, the Board of Governors of the CBI met with two employees of the bank, Mr. Sturla Pálsson and Mr. Jón Þ. Sigurgeirsson, specialist, at the Board of Governors office. After that meeting, the Board of Governors charged Mr. Pálsson and Mr. Sigurgeirsson with compiling a document of the ideas that had emerged during the meeting. It describes a few options, including the one that was later chosen. The document was delivered to the home of Governor Oddsson that same evening. Mr. Sigurgeirsson stated during the hearing that when he came to work the following morning, a completed memorandum was waiting for him.<sup>106</sup> The memorandum was presented to Prime Minister Haarde and Finance Minister Mathiesen later that day. In the aforementioned memorandum draft made by Mr. Sigurgeirsson and Mr. Pálsson it is suggested, *inter alia*, that an attempt be made to negotiate an agreement with the Bank of England and the FSA about supporting the actions of the Icelandic government. However, no mention is made of this in the CBI's definitive memorandum. In the hearing before the SIC, Mr. Oddsson was asked whether the Bank of England or the FSA had been approached before a decision was made in the Glitnir affair. He stated that he believed that this had not been done.<sup>107</sup>

Foreign Minister Gísladóttir, was still in New York on this weekend. She called Minister of Industry Össur Skarphéðinsson and Mr. Jón Þór Sturluson, Assistant to the Minister of Business Affairs, on Sunday 28 September and tasked them with attending a meeting at the CBI about the affairs of Glitnir, after having discussed with the Prime Minister. Neither they nor the Prime Minister informed the Minister of Business Affairs, Sigurðsson, of the matter. Minister Sigurðsson first heard about it by chance when Ms. Jóhanna Sigurðardóttir, Minister of Social Affairs and Social Security, called him that same evening to ask him about what was going on in the CBI.

It is illustrative of the lack of preparation and for how ill equipped the ministers were before making a decision as momentous as the one the CBI charged them with making that evening, that when Minister Skarphéðinsson arrived at the meeting he supposedly declared that he „knew exactly nothing about banking matters“, cf. the discussion in Chapter 20.2.4. The ministers decided to offer Glitnir to buy a 75% share in the bank in exchange for EUR 600 million. This decision was not recorded. Representatives of Glitnir were summoned to the CBI late that same evening. When they arrived they were thoroughly photographed and filmed by reporters that were waiting for them, as noted earlier. They then had a meeting with Prime Minister Haarde and Governor Oddsson, where the government's offer was presented to them verbally. They were not shown any documentation. In fact, the offer was made in so unclear a fashion that during a meeting of the board of Glitnir later that evening, it was recorded that the CBI, instead of the government, had made

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106. Statement of Mr. Jón Þ. Sigurgeirsson before the SIC on 16 July 2009, p. 31.

107. Statement of Mr. Davíð Oddsson before the SIC on 12 August 2009, p. 62.

the bid. Those present at the meeting did not come to a conclusion on the matter. When the representatives of Glitnir left the premises of the CBI they ran into the representatives of the parliamentary opposition, on their way to a meeting in the CBI. Consent for the deal was not obtained from all of Glitnir's major shareholders until in the early morning of the following day.

A full account of the SIC's criticisms of the authorities' handling of the Glitnir affair can be found in Chapter 20.2.7. As an example, the CBI did not call for a formal presentation of the request made by Glitnir, so that there would not be any doubt about its nature. The CBI did not observe the rules of the Administration Act or the more specific unwritten principles of administrative rule despite the fact that said institution had been requested to grant a loan of last resort. Neither did the CBI follow its own contingency plan nor did the bank assemble a working party to react to the liquidity problems. The CBI did not call upon the bank's appropriate specialists and the specialists which at least did work on preparing and evaluating the matter were, for the most part, summoned late on Sunday 28 September, cf. for instance the CBI's Director of Contingency. The preparatory work that had been carried out within the CBI did therefore not prove useful when it came to resolving Glitnir's request. In the meantime, the Board of Governors only worked with two of its employees on an evaluation of Glitnir's request. The possibility of a contagious effect on other Icelandic banks was not considered in this work either. Finally, the secrecy concerning meetings of a sensitive nature during the weekend of 27-28 September was not adequate, and the meetings were covered in the media.

In the end, the actions that were suggested to the Minister concerning Glitnir on Sunday 28 September 2008 were not credible. First of all, the amount in question was nearly a quarter of the CBI's foreign currency reserves. Secondly, Glitnir had had trouble refinancing on foreign markets for about one year and had obligations estimated at approximately EUR 1.4 billion due for repayment in the coming six months, and this information was publicly available. Thirdly, the CBI had not managed to strengthen its foreign currency reserves in any significant manner despite its declarations of intending to do so, cf. the discussion in Chapter 4. From this, it can be inferred that to foreign investors and credit-rating agencies it must have seemed that the Icelandic government did not have access to financing markets either.

Attempts at mergers in the banking market are discussed in more detail in Chapter 20.2.5. In short, the three large banks did not reach a mutual agreement about merging together. It appears that there was also a great deal of distrust between the CEO's of the three banks. It was not until the beginning of October 2008, just before the collapse of the banks, that they seem to have discussed the possibility of merging in some earnest. However, in all of those ideas expressed, it was presumed that the government would take part with a financial contribution. Reference is made to Chapter 20 for a more detailed discussion of the matter.

Glitnir's situation quickly worsened after the government's proposed involvement in the bank was made public. For example, on Tuesday 30 September 2008, the credit-rating agency Moody's lowered Glitnir's credit rating with the result that the bank's various loans became due; for instance, DZ Bank and Sumitomo Bank made due two loans amounting to a total of EUR 425 million on the basis of terms in loan contracts.

Furthermore, on Friday 3 October 2008, the European Central Bank issued a margin call to the bank to the amount of EUR 640 million. However, on Sunday 5 October, that margin call was delayed. Margin calls because of the bank's outstanding collateralised loans were close to half a billion EUR as well. Originally, it was intended that the government's bid for a 75% share in the bank would be put to a shareholder's meeting on 11 October. After it became clear that the bank's position had rapidly deteriorated, its board tried to get the authorities to accept holding the shareholders' meeting at an earlier date. That request was rejected. At the same time, the situation of both Kaupthing Bank and Landsbanki worsened and the main foreign media ran news stories about the deteriorating situation in Iceland. Eventually, the board of Glitnir decided, on the evening of 7 October 2008, to turn to the FME on the basis of the so called Emergency Act, which had been adopted in the Icelandic parliament the day before. Subsequently, the FME decided to dismiss the board of Glitnir and appoint a resolution committee for the bank in its place, cf. the discussion in Chapter 20.2.6. Earlier that same day, a similar course of events had taken place concerning Landsbanki, cf. a more detailed discussion below.

Then on 8 October 2008, Finance Minister Mathiesen sent the resolution committee of Glitnir a letter rescinding the agreement between the government and Glitnir's principal shareholders. The letter states, *inter alia*, that the reasons for the rescinding are shattered and false assumptions, and that Glitnir's need for funds had been grossly underestimated by the board and representatives of the Bank.

### 21.3.5 The Authorities' Relief Work from the End of September to the Beginning of October 2008

Chapter 20.3 describes the course of events of the fateful days from when the state's bid for a 75% share in Glitnir was made public and until the Emergency Act was adopted, with a special emphasis on the authorities' relief preparations.

The Government of Iceland held a meeting on the morning of Tuesday 30 September, 2008. Governor Oddsson entered the meeting after it had begun and stated that the authorities' announcement regarding the government's proposed involvement in Glitnir had not had the desired effect. During the meeting, Governor Oddsson also made some comments, which did not sit well with some of the ministers, regarding an all party government. Towards the end of the Government meeting, Governor Oddsson stated that, in the CBI, a task force had been assembled. Besides the CBI's specialists, the group was composed of Mr. Halldór S. Magnússon, a former bank employee, Mr. Karl Axelsson, Advocate to the Supreme Court, and Mr. Ragnar Önundarson, a business graduate. The permanent secretaries of the Prime Minister's Office, the Ministry of Finance, and the Ministry of Business Affairs also worked with the group, along with Mr. Rúnar Guðmundsson, Head of Insurance Market at the FME. In its work, the group reviewed various ideas and ways of reacting to the grave situation that had arisen. One of those ideas was to examine whether claims to bankruptcy estates because of deposits could be turned into priority claims. At the same time, international media attention turned increasingly towards Iceland and the situation of Icelandic financial institutions deteriorated quickly. During that week, a

working party of the CBI met almost every day to discuss how to react to liquidity problems. Those were the so-called situation assessment meetings.

The Government of Iceland held a meeting on the morning of Friday 3 October 2008. According to the minutes, Minister of Industry Skarphéðinsson stated that comments made by Governor Oddsson regarding an all party government at the previous Government meeting were inappropriate towards the Government and that it would be prudent for Governor Oddsson to step down. The minutes also reveal that Minister of Business Affairs Sigurðsson formally objected that he, as the minister responsible for banking affairs, was not consulted in the so-called Glitnir affair. It can only be concluded that at this point the cooperation between the government parties was suffering from severe weaknesses. In the opinion of the SIC, these weaknesses had an adverse effect on the cooperation of the government during these critical times.

The CBI's task force continued working until noon on Friday 3 October, 2008. After that, the permanent secretaries were left with the „product“ of the work as Mr. Ragnar Öundurson put it in his hearing before the SIC.<sup>108</sup> The group's proposals are discussed in more detail in Chapter 20.3.3. Great amounts of cash had been withdrawn from the banks in Iceland during the whole week and one could safely talk of a run on the banks. By end of the day on Friday, cash withdrawals from banks in Iceland amounted to ISK 5.5 billion, compared to an average Friday withdrawal of ISK 200 million at the time. The consultative group met for the last time in the afternoon of 3 October, 2008. The draft minutes quote the chairman of the group as saying that at the beginning of the week, people were hoping to keep three banks, but now there were doubts as to whether they could keep one. The meeting ended with the chairman saying that there would be a meeting with ministers during the weekend.

That same day, a great shock hit Glitnir and Landsbanki when the European Central Bank issued a substantial margin call in the evening of that day. This will be discussed further in the chapter below on the collapse of Landsbanki.

During the weekend of 4-5 October 2008, a special group of experts was working under the prime minister. The prelude to the group being formed was that the economists Mr. Friðrik Már Baldursson and Mr. Jón Steinsson, on their own accord, offered the prime minister their assistance in dealing with the threats facing the country. The group also included Mr. Bogi Nils Bogason, accountant, Mr. Jón Þór Sturluson and Mr. Tryggvi Þór Herbertsson. In the opinion of the SIC, Icelandic authorities were severely lacking in leadership and focus at that time. In this context, it should also be mentioned that when the group of experts began working, its members began by heading off to Reykjavík University where they intended to print out the annual reports and interim reports of the banks. This was the third group in a short period tasked with contingency preparations. It is incomprehensible that the group was not furnished with other data that had been prepared, e.g. by the government's consultative group and the CBI's task force. Finally, no economist with expert knowledge of bank operations or other experts with knowledge or experience in the operations of commercial banks or a lawyer specialising

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108. Statement of Mr. Ragnar Öundurson before the SIC on 22 April, 2009, pp. 5-6.

in the field of insolvency law was appointed to the group. Considering the aforementioned, it can only be said that the authorities' work on contingency preparations during these decisive moments was unacceptable and did not in any way correspond to the manner in which nations with developed financial markets and governance organise their working methods in general.

At a meeting in the government guest house on Saturday 4 October 2008, Governor Oddsson described to the ministers his telephone conversation with Mervyn King, Governor of the Bank of England. The phone call had been recorded and Governor Oddsson had with him a transcript of the conversation. This is discussed in more detail in Chapter 20.3.8.

Over the weekend of 4-5 October, work continued on contingency preparations in the CBI. Experts from the bank worked, i.a., with an expert sent to the country by the Bank of England.

This same weekend, the public awaited news on the developments. The media kept a near constant presence outside the government guest house where the prime minister and other ministers were at work. Constant meetings were held, with bankers, pension funds, social partners or other authorities, cf. i.a. discussions in Chapter 20.3.9.

Early on Sunday 5 October, the prime minister's group of experts presented the results of its work to the ministers at the government guest house. The group's proposals were presented in a document called 'an Emergency plan for the Icelandic banking system'. The document, which is described further in Chapter 20.3.7, discusses how the Icelandic banking system has become too big and how a banking system of a manageable size could be created if the banks were headed for insolvency. In a hearing before the SIC, Mr. Jón Steinsson described how he felt that the group was not well received by the ministers after the presentation.<sup>109</sup>

On that same day, the Ministry of Business Affairs wrote a letter to Mr. Clive Maxwell, an employee of HM Treasury, referring to discussions between the Ministry of Business Affairs and Maxwell during the weekend. The letter, signed by Ms. Jónína S. Lárusdóttir, states that if need be, the Icelandic government will support the Depositors' and Investors' Guarantee Fund in raising the necessary funds so that the Fund can meet its minimum obligations in the event of a default of Landsbanki and its London branch. In the hearing, Mr. Sigurðsson declared that the letter had in fact been written in the government guest house. The wording of the letter had been chosen very carefully and Prime Minister Haarde, Finance Minister Mathiesen, Minister of Industry Skarphéðinsson and Minister for Business Sigurðsson himself had been involved in its composition along with permanent secretaries and Mr. Jón Sigurðsson, Chairman of the Board of the FME.<sup>110</sup> This is discussed in more detail in Chapter 17.17.5. In the opinion of the SIC, it is evident that different opinions were held within the administration with regard to the possible obligations of the government in the event that the Depositors' and Investors' Guarantee Fund could not meet its obligations. Although the sources described in Chapter 17.12 do not provide decisive or complete answers to issues concerning that matter, the SIC believes that it would have been important for the Icelandic authorities, in the events lead-

109. Statement of Mr. Jón Steinsson before the SIC on 26 August 2009, pp. 37-38.

110. Statement of Mr. Björgvin G. Sigurðsson before the SIC on 19 May, 2009, p. 25.

ing to the collapse of the banks, especially following the inquiries by foreign authorities at the end of July and beginning of August 2008, to prepare a review of what data was available on the interpretations of the obligations of the EEA member states in the event that a compensation scheme created under the EU directive on deposit guarantee schemes could not meet its payment obligations. Such a review could have shed a clearer light on the different views that were included in the available sources and held within the Icelandic administration, on the government's obligations in this matter. It was also important that those ministers and others within the administration that were involved in decision making and communicating with foreign governments on the matter could have a clear picture of the legal issues put to the test by this, and could have considered them in their decisions and their replies to questions and demands by foreign governments.

On the evening of Sunday 5 October, Mr. Gordon Brown telephoned Prime Minister Haarde. An e-mail sent by Mr. Haarde to the SIC on 17 March, 2009, states that Mr. Brown's purpose was twofold. On the one hand, he suggested that Iceland seek assistance from the IMF and offered to talk to the managing director of the IMF on the issue. On the other hand, Mr. Brown stated that the British authorities believed that Kaupthing Singer & Friedlander (KSF) had violated UK law and transferred £1.6 million from the country. Discussions on KSF are described in more detail below.

At approximately 22:00 that night, i.e. 5 October 2008, the Government of Iceland held a meeting. At that meeting, the prime minister's proposal for a declaration regarding the deposit guarantees was put forth and adopted. This is discussed in more detail in Chapter 17. The possibility of a loan from the IMF was also discussed at the meeting. Mr. Ingimundur Friðriksson, Governor of the CBI, appeared before the meeting and explained the process behind such borrowing.

That same night, the European Central Bank withdrew the margin calls it had issued on Glitnir and Landsbanki on Friday 3 October, 2008.

On Sunday 5 October, 2008, experts from J.P. Morgan arrived in the country in order to provide the CBI with expert advice. As it happened, they met with ministers from the Icelandic government at 2 a.m. on Monday morning. That meeting seems to mark a certain watershed regarding the ministers' view of the state of the Icelandic banking system, cf. further discussions in Chapter 20.3.11. The experts from J.P. Morgan advised that Althingi would pass, as soon as possible, special authorisations for the administration to react to the impending problems in the banking system.

In a vote that took place between 23:18 and 23:19 on Monday 6 October, 2008, Althingi passed Act No. 125/2008 on the Authority for Treasury Disbursements due to Unusual Financial Market Circumstances, etc., which is commonly known as the Emergency Act. The prime minister had submitted the bill earlier in the day after addressing the nation in a live TV broadcast on the Icelandic National Broadcasting Service (RUV). A draft bill for the emergency law had been ready in part for some time, but most of the bill was prepared during the weekend of 4-5 October and on the eve of Monday 6 October, 2008, by employees of the Ministry of Business Affairs and the FME with the aid of a lawyer. A detailed discussion on this is in Chapter 20.3.12. Chapter 19 discusses the proposals made a few years earlier on legislative changes in these matters which the IMF considered to be necessary as well as

the group that later became the consultative group of the Icelandic authorities. In the opinion of the SIC, it is a matter of criticism that the Icelandic authorities did not complete work on the draft bill much sooner.

The SIC believes that the Icelandic authorities were especially ill prepared to deal with a financial crisis when it struck Iceland in the autumn of 2008. A listing of some of the main reasons for this can be found in Chapter 20.3.13. It is very important in this context that the consultative group had not been successful in creating a contingency plan. This meant that sufficient thought had not been given to various factors which would inevitably be put to the test in the event of a major financial crisis in Iceland, neither by the consultative group nor within other authorities. As an example, it is not apparent that any numerical assessment had been made, during the term of the consultative group, as to the amount of funds the Icelandic state and the CBI would need to have at their disposal in order to support the Icelandic banking system if statements by the ministers were to be heeded. The same applies to the calculations of possible expenses that might fall on Icelandic society in the event of a major financial shock.

The SIC is of the opinion that work on contingency preparations for the state was far from being organised or thorough. However, it should be noted that the SIC does not find it possible to claim that the Icelandic banks could have been saved from collapse even if work on contingency preparations in the year 2008 had been more thorough. On the other hand, thorough preparations would have contributed to lessening the damage caused by the collapse of the banks. The Icelandic government would then also have been able to form policies sooner on many of the issues that needed to be decided on and would thus have been better equipped to react and reply to questions from foreign governments and those with claims against the Icelandic banks.

### 21.3.6 The Collapse of Landsbanki Íslands hf.

Landsbanki Íslands hf. and its collapse are discussed in Chapters 18 and 20.4. It should be noted that when the proposed takeover of Glitnir by the state was announced on Monday 29 September 2008, the transfer of deposit accounts in the London branch of Landsbanki into a subsidiary had not progressed any further since the summer. In this context, it cannot be overlooked that Landsbanki, like Kaupthing Bank and Glitnir, was a systemically important bank. Setbacks in its operations could therefore have a significant impact on financial stability in Iceland, but according to law it is the obligation of the CBI to ensure that stability. Here it should be mentioned that considering the vast deposit-taking of Landsbanki abroad it was clear no later than in mid-2007 that the CBI would not be able to fulfil its role as lender of last resort if Landsbanki needed facilitation due to a run on the foreign deposit accounts. Despite the fact that the key representatives of Landsbanki should also have been aware of this, they still chose to accumulate deposits in branches rather than subsidiaries. In the opinion of the SIC, this was a highly risky decision.

It should also be kept in mind that there is no indication that an evaluation or appraisal was conducted by the Icelandic regulatory authorities of how stable and secure the Icesave accounts were as a financing option for Landsbanki, and what risks they might entail for the Icelandic economy and financial system, cf. the discussion in Chapter 7 of how mercurial in character these deposits were. Here, it should also be noted that the accumulation of

deposits abroad constituted a certain fundamental shift in the financing of the Icelandic banking system which also entailed new risks for the Icelandic financial system.

On Friday 3 October, 2008, the European Central Bank issued a margin call to Landsbanki to the amount of EUR 400 million. On the evening of Sunday 5 October 2008, the margin call was withdrawn. That same evening, the CEOs of Landsbanki had a telephone conference with Mr. Hector Sants, Chief Executive Officer of the FSA. During the meeting, the CEOs expressed an interest in fast tracking the transfer of the Icesave accounts into a subsidiary with the involvement of the FSA. That was, however, too late, cf. discussions in Chapters 18.2.4 and 18.2.5. A run on the bank's London branch was ongoing at that time and Landsbanki had to hand over large amounts in British pounds to ensure its continuing operation. Landsbanki therefore sought facilitation from the CBI. This request was denied on Monday 6 October. When Landsbanki was unable to provide the funds demanded by the FSA, the British authorities had the branch closed on the evening of 6 October, cf. further discussions in Chapter 18.

In Chapter 18.3.1 it is described how, on 7 October 2008, the Dutch Central Bank (DNB) requested that an insolvency practitioner be appointed for Landsbanki's Amsterdam branch. That was done with a ruling issued on the 13th of that month.

In the morning of 7 October 2008, the FME suspended the board of directors of Landsbanki and appointed a resolution committee in its place. It was crucial in this matter that regardless of Landsbanki's liquidity in Icelandic kronur, the bank did not have enough foreign currency at its disposal to honour its obligations in foreign currencies. In this context, the SIC finds it noteworthy that a few days earlier, i.e. on 30 September 2008, Landsbanki had granted a loan to a company owned by Mr. Björgólfur Thor Björgólfsson to the amount of EUR 153 million. It is therefore apparent that the principal owners of Landsbanki were not interested in or capable of helping the bank out of the difficult situation that had arisen.

In the morning of 7 October 2008, Mr. Alistair Darling and Finance Minister Mathiesen had a telephone conversation. The conversation was recorded and a transcript of it has been published in the media.

The following day, i.e. 8 October 2008, Mr. Alistair Darling appeared in the UK media and stated that the Icelandic government had told him the day before that it would not honour its obligations in the UK. It can only be concluded that this is a reference to Mr. Darling's conversation with Minister Mathiesen. In fact, these words were not spoken during that conversation. The SIC would, in this context, like to refer to the conclusion made in a report by a UK parliamentary committee issued in April 2009, that Mr. Mathiesen had not stated in that conversation that the Icelandic government did not intend to honour its obligations, but had, on the contrary, implied that the government intended to use its guarantee fund to try and honour its obligations towards UK depositors.

On 8 October, 2008, the British authorities overtook Landsbanki's subsidiary, the Heritable Bank, and Landsbanki's London branch. The British authorities also froze the assets of Landsbanki and assets related to Landsbanki which were owned, held or controlled by the Icelandic authorities, on the basis of the Anti-terrorism, Crime and Security Act 2001.

The SIC believes that the British authorities could have avoided the use of the aforementioned Act, but instead achieved the same purpose through conventional methods for freezing assets in that country. In the afternoon of 9 October 2008, Mr. Alistair Darling and Prime Minister Haarde spoke together on the telephone after Mr. Haarde had unsuccessfully tried to reach Mr. Gordon Brown.

In an interview in a UK news medium on October 9 2008, Mr. Brown declared that the British authorities were endeavouring to freeze the assets of Icelandic companies in the UK. He also declared that further measures would be taken against the Icelandic authorities. It is worth noting that, according to Mr. Brown, the measures would not be aimed solely at Landsbanki, but at all Icelandic companies. This course of action is further outlined in Chapter 20.4, which also deals with the subsequent interactions of the Icelandic government and the British authorities, and the reasons justifying the application of the Anti-terrorism, Crime and Security Act.

In the opinion of the SIC, the above mentioned misstatement by Mr. Brown in the media, in addition to the British authorities' application of an Act that, among other things, involves defences against terrorism, was liable to cause critical damage to Icelandic companies, both in the UK and elsewhere. It only conclusion that seems possible to draw given the explanations of the British authorities is that by applying the Anti-terrorism Act they wanted to „punish“ the Icelandic government, since the British government considered the actions of the Icelandic government to have been inconsistent with their announcement of honouring their obligations. The British government also seems to have questioned the Icelandic government's authorisation to fully guarantee deposits in Iceland but not in Britain, and to have drawn the conclusion that depositors' equality was not honoured.

The SIC is of the opinion that the Icelandic government did not explain clearly enough to the British and Dutch governments both the premise of the so-called Emergency Act and the political policy that was marked by passing it. In the opinion of the SIC, the Icelandic authorities should at least have tasked the Foreign Service with explaining the situation in Iceland after the adoption of the Emergency Act by Althingi on 6 October 2008. In the opinion of the SIC, the failure to do so is highly reproachable. The relations between the Icelandic authorities and the British and the Dutch authorities are discussed further in Chapter 17.

### 21.3.7 The Collapse of Kaupthing Bank hf.

On the eve of 9 October 2008, the FME intervened in the operations of Kaupthing Bank hf. and appointed a resolution committee for the bank on the basis of authorisations in the so-called Emergency Act. The decision was made after the Board of Directors of Kaupthing Bank had requested that the FME assume the power of share holders' meetings. Three days earlier, i.e. on 6 October 2008, the CBI had granted Kaupthing Bank a loan to the amount of EUR 500 million against collateral in the Danish bank FIH.

The loan agreements and debt securities of Kaupthing Bank generally held a clause stating that in the event of one of the bank's large subsidiaries defaulting, it would constitute a default by Kaupthing Bank which could lead to the bank's loans becoming due. Mid-day on 8 October 2008, the British

authorities placed Kaupthing's subsidiary in Britain, Kaupthing Singer & Friedlander (KSF) under cessation of payments. Although Kaupthing Bank was struggling with various difficulties at that time, it must be concluded that the aforementioned decision by the British authorities had a critical effect, considering what caused the collapse of the bank. On 7 January 2009, the resolution committee of Kaupthing Bank filed a lawsuit against the British authorities over the aforementioned administrative actions. A ruling was issued on 20 October, 2009. The result was that the claims of the resolution committee were denied. The ruling states that the British authorities based their decision on a legitimate view that the UK financial system was under threat.

The aforementioned course of events is described further in Chapter 20.5. It also contains a discussion on the views of the British authorities regarding alleged illegal financial transfers and that KSF was short of large amounts needed for the bank's liquidity to fulfil the FSA's requirements. These views appear in telephone conversations between Prime Minister Haarde and Mr. Alistair Darling on 3 October 2008, in which £600 million appear to have been mentioned, and between Mr. Haarde and Mr. Brown on the 5th of that month where £1.5 billion were mentioned according to a transcript of the conversation, however £1.6 billion according to Mr. Haarde's statement. Based on the information that the British authorities provided to the FME, these were, on the one hand, liquidity swap agreements between Kaupthing Bank and KSF to the amount of £1.1 billion that KSF had declared as liquidity in its liquidity reports. When push came to shove, KSF was unable to draw on the agreement from Kaupthing Bank.<sup>111</sup> On the other hand, there were margin calls for collateralised loans from the KSF to Kaupthing Bank. The margin calls were to the amount of £500 million that FSA believed that the KSF was obliged to issue vis-à-vis Kaupthing Bank. The SIC concurs with FSA's position that it was wrong for KSF not to issue these margin calls. This neglect indicates that arms length principles were not followed in dealings between the mother company and its subsidiary.

Lastly, the SIC examined communications between Kaupthing Bank and FSA during the final days before the bank collapsed. Those communications, which mostly took place via e-mail, reveal that Kaupthing Bank explored various methods in its attempt to rescue its subsidiary from bankruptcy. These communications include, i.a., a statement from Mr. Hreiðar Már Sigurðsson, CEO of Kaupthing Bank, from 7 October 2008, to the effect that Icelandic pension funds had decided to sell assets and transfer cash in foreign currency to Kaupthing Bank in the following three days to the amount of EUR 500-1,000 million. In this context, the SIC notes that it has not received any data to support this statement of Mr. Sigurðsson.

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111. KSF made liquidity swap agreements with the mother company to the total amount of £1.1 billion. KSF agreed to give Kaupthing Bank repeated 24 hour loans and Kaupthing Bank agreed to lend KSF the same amount for three months. Liquidity rules in Britain meant that KSF could declare its claim for repayment from the mother company as liquidity. Thus, KSF fulfilled FSA's liquidity requirements for Edge deposits.

## 21.4 Further Findings of the SIC Concerning Limited Aspects

### 21.4.1 Introduction

One of the requirements for a system of governance in a democratic state is that its fixed structure or implementation of individual projects is such that the division of tasks is clear, including the ultimate responsibility for functions being carried out in a satisfactory manner. A clear division of tasks and responsibilities is not only a prerequisite for being able to hold the individuals working within the system of governance responsible for malpractice or negligence, but there is a valid argument that it is of even greater general importance that this will clarify where special improvements will be necessary if things go awry.

One of the most important functions of the system of governance, without diminishing the importance of its other functions, is to maintain stability in the economy of the state. In advanced countries, emphasis is usually placed on this function, both in consideration of the work of the authorities, in general, as well as the establishment and operation of special governmental institutions that handle specialised operations and authorisations concerning activities in the field of finance and economy. The Icelandic system of governance does not differ from the governmental systems of other advanced states in this respect. However, the SIC found it noteworthy that the administrators of the institutions of the governmental system who reported to the Commission, gave the common answer that it did not fall under the functional area of the party concerned or his institution to address, or be responsible for, the matter in question. It had been the responsibility of other institutions or officials. The same perspective had also been presented in the letters of comments the Commission received, according to Article 13 of Act No. 142/2008 and are published in Annex 11 with the electronic version of the report. Based on these answers, it may be assumed that the division of tasks and responsibilities, concerning certain aspects in various cases, was not clear with regard to those who were engaged in activities within the institutions of the Icelandic governmental system, and those who were to supervise activities on the financial market, as well as the impact of those activities on the state's economic stability. The SIC believes it is urgent to consider specifically to better delimit and prescribe the duties of individual institutions and officials in this respect.

The findings of the SIC on various aspects of the governmental and institutional activities within the Icelandic system of governance that played the abovementioned roles in the events leading to the collapse of the Icelandic banks are set out below. Furthermore, the findings on specific issues the SIC considers to have been important in the course of events that ultimately led to the collapse of the Icelandic banks are set out.

### 21.4.2 The Central Government

It has been established that within the Icelandic government there was little discussion of the banks' standing and of the liquidity crisis which began towards the end of summer 2007 and kept deepening further. Nothing suggests, either from the government's minutes or the accounts of those who reported to the SIC, that the ministers of the Icelandic government respon-

sible for economic affairs (the Prime Minister), bank affairs (the Minister of Business Affairs) or the state's finances (the Minister of Finance) submitted to the government a specific report on the problems of the banks or their possible impact on the state's economy and finances when the banks started to have difficulties and until the bank system collapsed in October 2008. However, during this period the banks received unfavourable publicity in both the national and international media, the Icelandic krona had weakened substantially, and in addition the CDS spreads of the Icelandic banks were rising. From the beginning of 2008, the leaders of the government's political parties had, in meetings with the Board of Governors of the CBI, been briefed on the problems of the financial institutions in the country. The ministers, who had representatives in the government consultative group on financial stability and contingency planning, also received information on the projects the consultative group was working on at any given point, and around this time the concerns for the standing of the Icelandic financial institutions and discussions on the necessity of contingency planning, in case of a financial shock, were rising in that area.

As an explanation as to why the affairs of the banks were not addressed in the government, the SIC has i.a., received comments from Mr. Haarde, Prime Minister at that time, in a letter dated 24 February 2010 stating that this was confidential information of a sensitive nature. If information concerning these affairs had leaked out from the government's meetings, or even news got out that they had been discussed specifically, it might have caused damage. Therefore, the banks' affairs were not formally on the agenda at the government's meetings, but they were addressed under the item „other issues“ or off-agenda, as appropriate, or if one of the ministers so requested. In keeping with longstanding practice, such discussions were not recorded. For this reason, the SIC notes, that irrespective of the government's activities in the summer of 2008, this practice does not seem to have prevented it from being entered into the government's minutes, on 12 August 2008, that the Minister of Business Affairs had submitted a memorandum, bearing the same date, concerning the setting-up of a committee on financial stability and recommended that the government accede to the proposals set out in the memorandum. The Minister of Business Affairs' recommendation did not receive any support in the government and the matter was postponed.

The SIC notes that it is generally not contested that negative reports or rumours concerning the stance or proposed actions of public bodies on the financial market may stir the market players and even add to the problem at hand. However, the ministers themselves, and in particular the Prime Minister, must be responsible for ensuring, as regards the organisation and operation of the government, that they are able to discuss in confidence important and urgent sensitive issues regarding the public interest. Whatever the case may be, such a state of affairs must substantially weaken the activities of the authorities if distrust precludes such matters from being addressed realistically at all within the government. In this context, the provisions of Article 17 of the Constitution should be noted. Pursuant to them it is obligatory to discuss new legislative proposals and „important State matters“ at the meetings of the ministers, or the government's meetings, as they are generally referred to.

Although each minister deals independently with issues falling under his or her field, in accordance with the division of issue areas within

the Government Offices, it must be presumed, in compliance with the Constitution, that „important State matters“ are taken up for discussion within the government so that other ministers will have the opportunity to react to and to have an impact on the direction of the policy-making of the government and their respective ministries. It must also be kept in mind here that it can be of importance what is recorded on various matters in the government’s minutes and documentation, should the situation later arise where it becomes necessary to see if appropriate measures were taken on part of the minister relating to a particular implementation of government action and which ministers were involved.

Even though the Constitution assumes that „important State matters“ should be discussed at the government’s meetings, it has become increasingly common within the coalition governments over the last few decades for informal meetings and consultations between the leaders of the government’s political parties, leaders of the government at any given time, to have great importance regarding the policy making and actual decision-making concerning the activities of the government. In various instances, the government’s leaders also act jointly vis-à-vis representatives of the authorities, private bodies, and stakeholders and, in relation to the issues discussed here, one can mention the meetings of the leaders with the Board of Governors of the CBI in the first half of 2008. At such meetings the leaders, and as the case may be, individual responsible ministers if they have been summoned, may be provided with information or informed of issues that can be of importance when it comes to the subsequent reaction and actions by the Icelandic authorities. Mr. Haarde, then Prime Minister, refers to this extended role of the leaders of the political parties in a letter to the SIC, dated 24 February 2010 where i.a. this arrangement is described „as a well known practice in coalition governments in Iceland“. Furthermore, in the context of the practice of the government at that time, it was stated that the leader of each government party had been considered responsible for reporting to his fellow party members in the government on issues discussed in the joint meetings of the leaders, as he considered appropriate. Furthermore, the Prime Minister stated that he had no reason to doubt that the exchange of information between Foreign Minister Gísladóttir, the leader of the Social Democratic Alliance and Minister of Business Affairs Sigurðsson, was properly conducted. It should be noted that in Minister Gísladóttir’s letter to the SIC, dated 24 February 2010, it was revealed that the Social Democratic Alliance had wanted „to accentuate clearer management and more cooperation within the government“, e.g. that more affairs were taken up for discussion in that arena, cf. enclosed quotation from her letter in the margin.

The examination of the SIC does not indicate that information on the content of meetings and consultations between the leaders of the government parties, during the period under discussion, was documented systematically, nor the stated positions of those who attended the meetings, and as the case may be, the foundations laid for policy making or individual decisions. The only documented sources the SIC has received regarding such meetings are personal notations from individual parties present at the meetings. In so far as such consultations and meetings between the leaders of the government, in fact, replace discussions of matters at the government’s meetings, the SIC points out that it might be appropriate to consider laying down rules on

„Many projects are integral and transversal between ministries. Therefore we [Samfylkingin, political party] thought it was urgent to define which cases were relevant for the Government as a whole. In that way individual ministers would not be able to decide on their own which cases were to be addressed in the Government meetings. The above mentioned cases I discussed in several meetings with the Prime Minister in the period of time which is under investigation here. Alas, the Independence party (Sjálfstæðisflokkurinn) didn’t agree with my and my party’s point of view.“

From Ms. Ingibjörg Sólrún Gísladóttir’s letter to SIC dated 24 February 2010, p. 3.

keeping records of what takes place in such consultations. The same applies to meetings where the government's leaders act jointly vis-à-vis parties from the administrative bodies or external bodies and are, as representatives of the government, provided with information or informed of issues that need to be decided on within the administration.

Examples from the government's minutes, related in Chapter 19.5.1, reveal that generally the minutes have been kept concise and superficial. Whether this has been the practice for a long time or not, it may be concluded that this arrangement has its disadvantages. As an example, during the hearings before the SIC, the parties did not agree on whether the bill amending the Act on the Depositors' and Investors' Guarantee Fund which the Minister of Business Affairs was working on at the beginning of 2008, had been taken up for discussion within the government. The Minister of Business Affairs related in his report to the SIC that he had presented the bill „to the government“ where it had been discussed at least three times. It had then been decided, i.a., at the Prime Minister's suggestion, not to submit the bill due to turbulence in the financial markets.<sup>112</sup> During the hearing the Prime Minister did not acknowledge that he had known of the bill's existence.<sup>113</sup> As related in greater detail in Chapter 17.9, the examination of the minutes from the government's meetings, did not indicate that this issue had been addressed at the time in question. This was one of the issues the Minister of Business Affairs Sigurðsson, was asked about in a letter to him from the SIC, dated 8 February 2010. In the Minister's letter of reply, dated 24 February 2010, he related these events, i.e. the presenting of the abovementioned bill to the other ministers and discussions thereof, in such a manner, that he had „[discussed] it with the leaders of the government, Prime Minister Haarde and Foreign Minister Gísladóttir“, i.e. the leaders of the government's parties at that time. He also stated that they had judged the situation to be too sensitive to risk any changes.<sup>114</sup> According to the abovementioned, Minister Sigurðsson related, for the first time during the hearing, that he had presented the bill „to the government“, which may be understood in such a manner that he had introduced the bill in a formal meeting of the government. Later, in Minister Sigurðsson letter „,he related that he had „[discussed] it“ with the leaders of the government's parties. This example may be an indication of how individual ministers experienced the informal practice described above, when they endeavoured to follow up on matters they were responsible for.

The SIC considers it important that matters that come up for discussion and are concluded within the internal functioning of the government, are related clearly in its formal minutes, since they involve some of the most important decisions taken on behalf of the nation.

The Prime Minister had quite a few meetings in 2008 with the Chairman of the CBI's Board of Governors and the CEOs of the banks. During the period February - May 2008, the CBI's Board of Governors also had at least five meetings with the Prime Minister, Minister of Finance, and the Minister for Foreign Affairs. The Minister of Social Affairs and Social Security also attended one of these meetings when issues concerning the Housing

112. Statement of Mr. Björgvin G. Sigurðsson before the SIC on 19 May 2009, pp. 24-25.

113. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, p. 62.

114. Letter from Mr. Björgvin G. Sigurðsson to the SIC, dated 24 February 2010, pp. 13-14.

Financing Fund were being discussed. The statement of Minister of Business Affairs Sigurðsson indicates that he was not summoned to attend any of these meetings, in spite of the fact that the problems the banks were facing and the liquidity crisis were discussed; matters that appertained to his ministry. In addition, the Minister of Business Affairs was apparently neither informed of the meetings nor was he informed of what took place at the meetings, with the exception that, during a Social Democratic Alliance parliamentary group meeting on 11 February 2008, the leader of the Alliance, Foreign Minister Gísladóttir, informed Minister Sigurðsson and others of a meeting she and the Prime Minister and the Minister of Finance had had with the CBI's Board of Governors on 7 February 2008.

In certain instances, it may be the case that the Prime Minister, on the basis of his leadership authority, cf. Article 2(5) of Regulation No. 177/2007 represents the government in dealings with individual authorities at the beginning of a case and during its procedure. The aforementioned meetings with the CBI's Board of Governors, over a period of several months, during which the operations of the banks and their liquidity developed unfavourably, regarded issues that came under the domain of the ministry of the Minister of Business Affairs. It is the assessment of the SIC, that the Prime Minister had a responsibility as the leader of the government to inform the Minister of Business Affairs of the aforementioned meetings so that he could attend to his duties. The SIC finds it reproachable that this was not done.

It is the assessment of the SIC that the government's actions concerning economic affairs were not systematic when the situation became more dire in the beginning of 2008. The ministers focused too much on the image dilemma of the financial institutions, rather than dealing with the obvious problem, that the Icelandic financial system was far too large in relation to the Icelandic economy. When the ministers intended to improve the country's image by partaking in public discussions, mainly abroad, it was done without any assessment of the financial capability of the state to come to the banks' assistance and without information being available on the cost of a possible financial shock. In this context, it should be mentioned that in the hearing, Minister Sigurðsson acknowledged that declarations concerning the support the state would give the banks had been based on political positions, but not on an evaluation of the genuine ability of the state, in that respect. Simultaneously, the CBI placed emphasis on the conclusion of currency swap agreements and on building up the foreign exchange reserves, in order to improve the credibility of the bank in dealing with a financial shock.<sup>115</sup> Even though there is no intention of undermining the importance of image and actions taken to improve credibility it is, on the other hand, noteworthy that the authorities did not take other actions concomitantly. Thus, there is no indication that a careful appraisal was conducted to find out if it was necessary that one or more of the larger banks moved their headquarters abroad. On the contrary, it was explicitly the official policy of the government, formed in May 2007, that the banks would continue to have their headquarters in Iceland, cf. discussion in Chapter 5. The Chairman of the CBI's Board of Governors claimed that he had personally been in favour of the relocation of Kaupthing Bank's headquarters abroad and that he had expressed that opinion. On the

115. Statement of Mr. Björgvin G. Sigurðsson before the SIC on 19 May 2009, p. 21.

other hand, there is no indication that the CBI had directly pressed for that in formal discussions on the subject with the Board of Directors of Kaupthing Bank hf. or the bank's CEOs. In his statement before the SIC, Mr. Sigurður Einarsson, Chairman of the Board of Directors of Kaupthing Bank, claimed that the CBI had not told the representatives of the bank that it was necessary to relocate the headquarters abroad. The SIC has not received any written evidence on the authorities' plans to put pressure on the financial institutions to reduce their balance sheet. In the statements of the representatives of the banks before the SIC, it was revealed that neither the CBI, nor the FME, nor ministers, had presented them with formal proposals on reducing the size of the banks. On the other hand, they either do not remember, or do not rule out, that the authorities had in a general way requested them to reduce lending and write down the balance sheet of the banks.

The incapability of the government and the authorities to reduce the size of the financial system in time before the financial shock hit is evident when looking at the history related in Chapters 19 and 20. In this context, it should be kept in mind that when a bank provides a company with a low loan, it can set the company conditions in case of default. On the other hand, if a bank provides a company with such a high loan that the bank may anticipate substantial losses if the loan defaults, it is in effect the company that has such a grip on the bank that it can have abnormal impact on the progress of its transactions with the bank. It is also clear, that when the size of the financial system of a country is threefold its national production, the competent authorities of the country have, in general, the potential to set rules for the financial system to play by and to ensure that they are complied with. When the size of the financial system of a country is nine times its national production this turns around and it appears that, both Althingi and the government lacked both the capacity and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going, because it had grown so large that to risk that even a small part of it collapsed was impossible.

### 21.4.3 The CBI

The function of the CBI is to promote a functional and safe financial system, cf. Article 4 of Act No. 36/2001 on the CBI. The tasks of the CBI regarding financial stability, are discussed in general in Chapter 16.14.6.2. On 14 November 2007, the CBI's Board of Governors decided to form a working group to respond to the liquidity problems, pursuant to the Board of Governors Adoption No. 1097 of 24 March 2006 since it was likely that a period of uncertainty with regard to funding and the general status of the banks would not be a short-term matter. Based on the documentation the SIC has received, it is clear that the CBI's Board of Governors was greatly concerned about the emerging situation and presented those concerns, either directly to the Prime Minister or to the government consultative group. In spite of these concerns, there is no indication that the CBI's Board of Governors had submitted formal proposals to the government concerning necessary actions, if the bank considered it did not have the necessary means by law, in order, in its opinion, to respond to an ever growing problem. The bank's assessment of the severity of the situation and the logical course of action and proposals, based on that assessment, did not go hand in hand.

As further discussed in Chapter 19.7.1, the CBI had serious grounds to suspect the development of a specific systemic risk due to close relations between borrowers with very high loans with many financial institutions in the country. Therefore, in the opinion of the SIC, a special reason had emerged for the CBI to request the necessary information from the FME so that an assessment of the risk would be possible. Article 35(4) of Act No. 36/2001 on the CBI and in Article 15(2) of Act No. 87/1998 on Official Supervision of Financial Activities stipulates mutual disclosure of information between the CBI and the FME. In the latter provision, it is specially stipulated that the FME should provide the CBI with all the information in its possession useful for the bank's activities. Information conveyed in this manner between institutions continues to be confidential, cf. Article 15(3) of Act No. 87/1998. Thus, it is evident that by law the FME did not lack authorisation to provide the CBI with information on large exposures in a designated form, as well as other information which was in the FME's possession and the bank needed to uphold its statutory role, to promote a functional and safe financial system, if so requested. It must be considered reproachable that the CBI neglected to request this information since no acceptable explanations have been given as to why that was not done.

In 2008, the Board of Governors of the CBI met several times with the Prime Minister and other ministers prior to the collapse. During some of the meetings, alarming news were conveyed, for instance during a meeting of the Board of Directors with three ministers in the Prime Minister's Office, on 7 February 2008, when a very bleak outlook was outlined as far as the future of the Icelandic banks was concerned, and at a meeting the Board of Directors had with the Prime Minister and the Minister for Foreign Affairs on 1 April 2008, it transpired that £193 million had poured out of the Icesave accounts in London the previous weekend, and that Landsbanki could withstand such an outflow for six days. This was indeed alarming information, and it is astonishing that it was not recorded in a document together with an outline of the bank's assessment of this information, and its proposals concerning an appropriate or possible response, as the case might be. The discharge of official duties by the Board of Governors of the CBI was, in this regard, not as thorough as might have been expected. Due to this fact, the ministers no doubt had difficulties assessing the right course of action, not in the least in view of the difficult relations between the ministers of the Social Democratic Alliance and the President of the Supervisory Board of the CBI, which will be further discussed below. On the other hand, the ministers apparently did not call for such proposals and documents from the CBI, once this information had been verbally conveyed to them, even though they had ample reason to do so.

The SIC believes that the Board of Governors of the CBI did not react adequately and should have requested further information and called for measures, with a view to the impact that the aggregation of deposits in foreign branches would have with regard to risk factors vis-à-vis the Icelandic financial system, and thus the financial stability of Iceland, in case of unexpected setbacks to the operations of the Icelandic banks. The deposits in question had been accumulated in foreign currencies, and the CBI obviously had limited resources to assist the banks with payments in foreign currencies if a run of the banks were to cause a sudden outflow from these accounts.

There is cause to reiterate that the growth in deposits happened mainly during 2007, whereas in 2008, it becomes apparent, from documents that the SIC has received, that in communications between the Board of Governors of the CBI and the directors of the banks, e.g. Landsbanki, there were discussions on means to reduce the impact and the risk entailed by the deposits in question with regard to the aforementioned factors, especially concerning the Icesave accounts in the UK. This has also been confirmed in the hearings conducted by the SIC. The SIC notes that there is nothing in the documents at hand suggesting that the Board of Governors of the CBI had, directly and in a formal manner, presented the banks, especially Landsbanki, with proposals or announced it would take actions in order to limit or restrict the negative impact that the aforementioned aggregate deposits abroad could have on the financial stability of the country, in case of major blows to the operations of the Icelandic banks, and should claims be made regarding the payment appropriations of the Depositors' and Investors' Guarantee Fund. On the contrary, the CBI decided to abolish reverse requirements on foreign deposit accounts in March 2008.

When the course of events during the year leading up to the collapse of the banks is considered, it seems evident to the SIC that communications between the Chairman of the Board of Governors of the CBI and most of the ministers of the Social Democratic Alliance were characterised by a certain degree of distrust and difficulties in cooperation. It also seems clear to the SIC, as further detailed in Chapter 19.3.5, that the previous political collaboration between the Chairman of the Board of Governors of the CBI and the Prime Minister, as well as their longstanding friendship, had an influence, as described by the latter, on the way in which people construed the information exchanged between these leaders, of the government on the one hand, and of the CBI on the other. Thus, a situation arose where, according to cabinet ministers of the government that took office in May 2007, the previous political career of former Prime Minister Davíð Oddsson had an influence on the way ministers responded to the information provided to them by Mr. Oddsson in his capacity as an official, i.e. as the Chairman of the Board of Governors of the CBI, in the run-up to the collapse of the banks.

As discussed in further detail in Chapter 19.3.3, a serious disagreement arose in a meeting at the CBI on 7 November 2007, between Minister of Business Affairs Sigurðsson and CBI Governor Oddsson over their different attitudes towards Europe. It was not until almost a year later that the two men met again in a meeting —just a few days before the collapse of the banks. In the aforementioned chapter Mr. Sigurðsson is quoted as saying that he believes that rancour was running high and that people had shunned each other. He said that it was unfortunate how venomous the atmosphere had become at that critical point in time when the banks collapsed.<sup>116</sup>

In her letter to the SIC dated 24 February 2010, former Foreign Minister Gísladóttir described the meeting of herself, Prime Minister Haarde, and Finance Minister Mathiesen with the Board of Governors of the CBI, on 7 February 2008, as follows: „No one from the CBI apart from the Chairman of the Board of Governors made any contribution to the meeting, which could aptly be described as the Chairman's monologue in which it was hard

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116. Statement of Mr. Björgvin G. Sigurðsson before the SIC on 19 May 2009, p. 7.

to disentangle his account of the facts from his personal attitudes towards people, and issues, coloured by political decisions and disputes of years past. As evidence of my assessment of what transpired at the meeting at the time it was held, it should be noted that afterwards I wrote down the following in a notebook, cf. supporting document No. 10: „Evidently, the Governor of the CBI (DO) would not mind if Kaupthing Bank collapsed or left the country. He paints a very bleak picture of future prospects in the market and wants to use that picture to justify taking action against the bank. Plainly critical of Kaupthing Bank and Glitnir but not of Landsbanki. No advice or suggestions were offered as to what action should be taken by the government about the banks. The meeting was characterised by what seemed like one man’s venting.“ It seems Apparent that Ms. Gísladóttir was very suspicious of what Governor Oddsson had to say at the meeting. In chapter 19.5.1 Ms. Gísladóttir is quoted as saying that it was no secret that relations between CBI Governor Oddsson and the Social Democratic Alliance were strained in many respects. There was however a tacit agreement not to let that get in the way. The strained relations between these parties surfaced when Governor Oddsson attended a cabinet meeting on 30 September 2008. As described in chapter 20.3.2 Governor Oddsson stated on that occasion that in all likelihood the entire Icelandic banking system would collapse within ten to fifteen days. Mr. Oddsson went on to observe that if ever there was a need for a special „Government of National Unity“ this would be the time. At the hearings, Mr. Oddsson reported how this suddenly became the main subject of the meeting. In the aforementioned chapter, the then-acting Foreign Minister Össur Skarphéðinsson is reported to have subsequently consulted his predecessor Ms. Gísladóttir, who at the time was seeking medical treatment in New York, and explained that in his view it would be impossible to successfully work through the situation with Mr. Oddsson in the CBI. <sup>117</sup>

As further elaborated in chapter 19.3.5, Mr. Haarde described his relationship with Mr. Oddsson in his statement as follows: „Of course we often spoke and you should bear in mind that we are old colleagues and have been for more than 40 years, and we’re old friends. And you could say that this complicated our cooperation, because you couldn’t always tell whether he was talking to someone he had known all these years, and with whom he had shared so many experiences or whether he was speaking as my predecessor about something he knew about. Or when was he in the capacity as the official counselling the Prime Minister? This made things complicated especially as he tends to be a bit harsh in his pronouncements and to exaggerate, he’s given to dramatics and even theatrical behaviour when he [was] „in his element“ and this meant that you couldn’t always tell which one of us was playing which role.“<sup>118</sup>

Over the weekend of 4-5 October the distrust held by part of the government towards the Chairman of the Board of Governors of the CBI had grown considerably, especially after the cabinet meetings of 30 September and 3 October and after a proposal for an emergency government was put forward by the Prime Minister on Saturday, 4 October 2008. Prime Minister Haarde presented his proposal of an emergency government at a meeting with min-

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117. Statement of Mr. Davíð Oddsson before the SIC on 12 August 2009, pp. 72–73.

118. Statement of Mr. Geir H. Haarde before the SIC on 2 July 2009, pp. 24–25.

isters at the Ministers' Residence in Reykjavík, which is further discussed in Chapter 20.3.10. The proposal entailed forming a three member emergency government, appointed to carry out the measures that would have to be taken in the following days. Prime Minister Haarde suggested Governor Oddsson as head of such an emergency government. Such an arrangement was unacceptable to Minister Sigurðsson and Minister Skarphéðinsson and allegedly Minister Skarphéðinsson threatened to break up the coalition should this proposal be put into action. For this reason the idea was not pursued further. In the opinion of the SIC a high level of distrust had obviously developed among some members of the government towards the Chairman of the Board of Governors of the CBI which is probably the main reason why the CBI did not participate in the work of the Prime Minister's expert group and generally took less part in the work of the authorities than it had done during the previous week. Without a doubt this bitter dispute had a negative effect on the progress of the authorities' crisis preparations as the CBI had on its staff experts who in view of their expertise and experience should have been involved in the preparation and drafting of the proposed Emergency Act.

The preceding paragraphs have dwelt upon events in the run-up to the collapse of the banks which serve as evidence that the previous political career of the Chairman of the Board of Governors of the CBI had a direct effect on how ministers reacted to the information which the Chairman communicated to representatives of the government on the dire situation of the Icelandic banks. In view of the vital importance of securing the independence of the CBI and the influence of the bank's monetary policy as well as its policy with regard to other aspects of the economy for which it is responsible, it cannot be considered desirable to appoint former politicians as CBI Governors, as has been the practice at the CBI for many years. Such a practice is likely to raise doubts as to their commitment to the bank's statutory goals, especially if these are inconsistent with the government's economic policy or the fulfilment of certain electoral promises. There is a further risk that the proposals of such a CBI Governor might, whether justifiably or not, be interpreted in a political way, which would not necessarily reflect the assumptions of such proposals as put forward on the basis of the CBI's statutory mission. Last but not least such a state of affairs would tend to undermine the credibility of the CBI.

#### 21.4.4 The Financial Supervisory Authority (FME)

The main role of the Financial Supervisory Authority (FME) is to ensure that regulated entities comply with the legislation that covers their business activities and otherwise organise their business activities in accordance with sound and normal business practices, cf. Articles 1 and 8 of the Act on Official Supervision of Financial Activities No. 87/1998. The FME carries out its monitoring function on the one hand with on-site inspections and on the other with continuous financial monitoring (off-site monitoring). Additionally the Authority handles various other tasks connected to its monitoring activities.

In the SIC's opinion the FME was not well enough equipped to sufficiently monitor the financial institutions when they collapsed in the autumn of 2008. Considering the operating expenses of the Authority and its income up to 2006 it is clear that the growth of the FME did not keep pace with the

rapid growth of the Icelandic financial system with its complicated ownership links within the financial market and increased activity of regulated entities abroad and was not consistent with the increasingly numerous and complex tasks that had been handed to it through legislature in the preceding years, and demanded vast expert knowledge of the operations of banks, economics, accounting and regulation of financial markets. It is clear that the increase in the FME's budgetary resources came too late for it to be able to keep pace with the financial institutions and carry out its statutory supervisory tasks. On the other hand it must be taken into account that the FME is in a special position compared with other governmental institutions in that its expenditure limit is not determined in the annual state budget but instead all its expenses are borne by the regulated entities through statutory fees. It was therefore the responsibility of the administration and Director General of the FME to request an increase in appropriations and thus put to the test whether the legislator was prepared to amend the amounts of the fees in order to ensure sufficient funds for the Authority. The increase in financial contributions requested by the FME was too small and came too late. This is not to say that the Minister of Business Affairs and Althingi had no responsibility in the matter.

An obvious consequence of the FME's lack of funds was that the increase in staff did not keep pace with the rapid growth of the financial system and the the growing number of tasks it entailed. The Authority's staff turnover was considerable, especially within two divisions, those covering the credit market and the securities market. Staff members were short on work experience and the length of employment was decreasing fast. In connection with this it is worth mentioning that the average length of employment in the credit market and securities market divisions was, at the end of the period covered by the SIC's examination, only about three to four years. All of the above issues greatly restricted the FME's ability to keep up active monitoring of financial institutions and keep them in check as needed.

However, not all of the FME's problems can be blamed on insufficient financial appropriations. As an example, the FME did not sufficiently concern itself with some basic questions, such as regarding the size of the banking system, and what reactions its rapid growth necessitated by the FME. The administration therefore did not fulfil its management obligations when it came to one of the main warning signs in the development of Icelandic financial institutions.

Additionally, the SIC is of the opinion that the FME's staff were not firm and assertive enough when carrying out their monitoring duties as regards the resolution and follow-up of cases. In reports that were written after on-site inspections which the SIC has looked at there was often a lack of reasoned resolution in the FME's findings. This was not the least the case in situations where the concepts of dominant influence and financial ties needed to be clarified for the purposes of applying regulations on large exposures. On the other hand, in cases when resolutions were reached and it was resolved that certain acts did not comply with legislation, there were occurrences of written comments having been sent to a financial institution without the proper legal process being initiated. It is not inconceivable that the FME can in less important cases resort to the means of offering financial institutions the opportunity to remedy minor mistakes in an informal way. However, it

is the opinion of the SIC that in general it must be assumed that according to the laws under which the FME operates, it has the obligation to process the case concomitantly or without much delay along legal channels in order to ensure that it can be pursued with coercive instruments and, where applicable, disciplinary actions if a financial institution fails to comply with recommendations for remedy. There are examples of cases regarding the alleged non-compliance with regulations on large exposures having been given long-term informal treatment, as described above. Cases were either left untended or correspondence with the relevant financial corporation had taken place with the FME only trying to rectify the matter through informal means. The response of the financial corporations concerned to this approach by the FME were in some cases neither quick nor efficient judging from the documents and data which the Commission has in its possession. There are examples of both substantial delays in improvements and/or resistance in these instances, where financial corporations have claimed to have a different understanding of their obligations than that on which the FME based its comments, and the Authority in such cases may not have seen cause to change its approach and apply fully the statutory coercive measures available to it in order to ensure compliance with laws and regulations. This has led to regulated entities in some cases getting away with the practice of entering large exposures into their books in violation of law, for either longer or a shorter periods of time, in the opinion of the FME. Finally, it must be stated that many of the violations could not be regarded as minor. In the opinion of the SIC this is a matter of unacceptable administrative practice that violates statutory procedure because the FME shall require remedy within a reasonable time, if it comes to light that a regulated entity is not complying with laws and other regulations that apply to its activities, cf. Article 10(1) of Act No. 87/1998 on Official Supervision of Financial Activities. If the entity does not comply with the Authority's instructions, the Authority can then apply coercive instruments and administrative penalties. Since cases were not always guided into the proper legal channels there was no basis for the application of such sanctions. The FME's operations therefore lacked impact.

Part of the FME's problems was incorrect prioritisation. Although the FME had been in the process of improving its IT systems since 2006 it is still the assessment of the SIC that much greater emphasis should have been placed on setting up advanced IT systems. Continuous financial monitoring, which is carried out by collecting data from regulated entities, data processing and specialist evaluation of the collected data, can not be fully utilised unless the Authority has at its disposal both advanced IT systems and specialists to process the data. Because the FME has had a major shortage of the technical expertise and equipment needed to produce high-quality and comprehensive surveys of the position and development of individual financial institutions from its databases the Authority did not really have the oversight of the activities of the financial institutions that was so urgently needed. The problems the FME had with processing data from its systems undoubtedly greatly reduced its ability to carry out its duty of monitoring and keeping in check the financial institutions which collapsed in the autumn of 2008. This is described in more detail in Chapter 16.8.2.

As is further discussed in Chapter 12, the development in the years leading up to the collapse of the banks was for holding companies to receive

loans against collateral in shares. It was also increasingly common for the banks to accept shares in the bank concerned as collateral to secure loans they granted with the sole purpose of buying those shares. For example, the value of Kaupthing Bank's collateral in its own shares was just under 42% of all the bank's shares at the end of September 2008, as noted in Chapter 9. This development and the risk attached to it seems to have, for the most part, gone unnoticed by the directors of the FME. It is known that in the autumn of 2007 the FME started gathering data on loans with collateral in securities (mostly shares) from the ten largest financial institutions. The average margining and largest margin calls were monitored. Despite this it is not apparent, that the FME gathered data on the liabilities and effects of these loans and collaterals in shares in financial institutions between them, as stated by Ragnar Hafliðason, Deputy Director General of the FME during the hearing before the SIC. Additionally, the words of the Deputy Director General seem to indicate the FME lacked sufficient data on the extent of loans the financial institutions granted for the buying of shares in themselves and the concomitant mortgaging after it increased greatly, or as he put it: „[...] you knew it was ... it was to some extent ... without it ... maybe the knowledge originally ... or the awareness of it was ... at the time ... in some prior stages when it was perhaps not a matter for worry because the scale was so small back then. Then it just hits you in the back, that it becomes much more extensive without you perhaps realising it until it is already just too late.“<sup>119</sup>

After the FME set up a TRS-system at the end of 2007 it appears that the Authority had access to a database containing most of the information that the SIC used for its own analysis of the securities trading, including trading of shares in the three big banks, that is, data on all securities trading segregated according to the trading parties in each bank separately. On the basis of this it must be concluded that the FME could have monitored the position-taking of all of these parties in the market and its development and therefore noticed that the proprietary trading departments of the three banks practised, from 2007, extensive buying of their own shares followed by massive disposal of those shares, apparently in order to avoid having to send out a notification on the acquisition or disposal of major proportions of voting rights. However, the database was not used since the FME had not installed the necessary equipment to read and analyse the data.

Late in 2007 a FME working group was established, called the Action Group. During the time period in which the Action Group was active considerably more data was collected by the FME than was usual. It should especially be noted that the conclusions drawn from the data collected by the Action Group do not seem to have been decisively critical. Well into the year 2008 the FME's administrators did not consider that there were any major problems threatening the banks. The SIC considers it clear that the FME's Action Group and its administrators did not evaluate the situation correctly and were far more optimistic than was reasonable. Ragnar Hafliðason, Deputy Director General of the FME, believes this happened, among other things, because there was a hidden overestimation of the financial institutions' capital. In the opinion of the SIC, the FME also utilised faulty stress-tests. The

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119. Statement of Mr. Ragnar Hafliðason before the SIC on 21 September 2009, p. 61.

FME's public disclosure of the situation of the banks was greatly affected by the results of the stress-tests which indicated that the banks were strong. The FME's faulty stress-tests gave both the market and the FME a false sense of security. This is described in more detail in Chapter 16.4.2.<sup>120</sup>

According to Article 15 of Act No. 98/1999 the FME shall monitor the operations of the Depositors' and Investors' Guarantee Fund. In 2005 the large Icelandic banks began aggregating so-called wholesale deposits in a number of their foreign branches. These soon became significant. Landsbanki then launched the Icesave accounts in the UK in October 2006. Deposits into these accounts grew quickly. The advent of these accounts greatly increased the liabilities of the Depositors' and Investors' Guarantee Fund. The SIC's investigation has not unearthed any data or information on the FME having formally intervened in the operations of the Fund as regards the Fund's board of directors, the authorities or the banks on the basis of its control obligation as provided for in Article 15 of Act No. 98/1999. In the comments sent to the SIC on behalf of Jónas Fr. Jónsson, former Director General of the FME, on 26 February 2010, it is stated that Mr. Jónsson urged the revision of the legislation covering the Fund at the end of 2006. It is also stated that Director General Jónsson brought up the issue of the Fund in meetings with the government's consultative group on 15 November 2007 and 22 July 2008. During the latter meeting Director General Jónsson stated that he believed it was advisable for the banks to pre-pay their deposits to the Fund.

Although the FME's Director General discussed the Fund's issues within the consultative group, the SIC is of the opinion that the Authority should have prepared a report on the Fund on the basis of Article 15 of Act No. 98/1999. In such a report the development of the financial institutions' deposit-taking activities should have been analysed and evaluated, especially in relation to the effects of the raising of deposits by the banks through foreign branches on the Fund's liabilities and its ability to meet the payment obligations established in the legislation that was adopted in order to introduce directive 94/19/EC into Icelandic legislation. The duties of the FME were, in this regard, not carried out as well as was to be expected. Here the SIC also takes into consideration the information revealed before the Commission in the report by Jónas Fr. Jónsson, former Director General of the FME, that his understanding of directive 94/19/EC was that the Icelandic state needed to ensure a minimum guarantee of EUR 20.887 to each depositor.<sup>121</sup> Considering this understanding of the legal position of the above-mentioned obligations there should have been even greater reason to formally apply the FME's statutory supervisory power to inform the parties concerned of the impending imbalance between the Fund's assets and its liabilities. This was especially important with respect to those authorities which had to take over the payment obligations provided for in the directive should the Fund's assets not meet them. Additionally, the former Director General of the FME considered that the Authority itself had a very limited legal authorisation to intervene in the banks' opening of deposit accounts in their foreign branches.

When Landsbanki hf. started accepting deposits into the Icesave accounts in Amsterdam on 29 May 2008, the bank had already experienced negative

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120. Statement of Mr. Ragnar Hafliðason before the SIC on 21 September 2009, p. 9.

121. Statement of Mr. Jónas Fr. Jónsson before the SIC on 23 March 2009, p. 29.

media coverage in the UK about the Icelandic economy and the Icelandic banks. The coverage focused on the high CDS spreads for the banks, in addition to which doubts had been voiced about the ability of the CBI and the State Treasury to aid the banks in case of liquidity difficulties. Doubts had also been expressed about the capacity of the Depositors' and Investors' Guarantee Fund to meet setbacks in the banks' operations. It must be presumed that the run which lasted from February until April 2008 on the Icesave accounts in Landsbanki's London branch can be attributed to this coverage. Compounding this was the risk of difficulties arising in the acquisition of foreign currency to meet sudden withdrawals from deposit accounts abroad. In a statement made by Mr. Jónas Fr. Jónsson, Director General of the FME, before the SIC it emerged that according to Article 36(4) of Act No 161/2002 on Financial Undertakings, the FME is not authorised to prohibit the establishment of a branch unless it has a legitimate reason to believe that the management and financial position of the financial institution in question is not sufficiently sound. At that time, Landsbanki had notified the proposed deposit-taking activities of the Amsterdam branch, the position of the bank had been strong, its credit rating was Aaa and its capital ratio 12.5%.<sup>122</sup> In his statement before the SIC, Mr. Guðmundur Jónsson, Head of Unit at the FME, claimed that in a discussion with Landsbanki representatives it had been made clear that the bank had intended to obtain Euros in currency swap markets to repay any withdrawals from the Landsbanki deposit accounts in Amsterdam. On the other hand the SIC points out that the currency swap market in Icelandic krona had been intermittently nearly inactive since 19 March 2008, as is further discussed in Chapter 13. There is no sign that the FME saw any reason for a specific reaction despite the significant risk to Landsbanki, which was a systemically important bank.

Although Landsbanki's half-year financial statement for the first half of 2008 had not at first given reason, in the opinion of the FME, to limit the licence of Landsbanki to receive further deposits in the bank's Amsterdam branch, it had to be evident that the bank's increasingly restricted access to euros once the currency markets started closing down, and especially once the effects of the fall of Lehman Brothers emerged, would affect its possibilities to honour its deposit obligations. This should have presented ample cause for the FME to separately investigate the issues facing the branch but this was not done and that must be criticised.

Finally the SIC believes it is important that the FME initiate regular formal meetings with the internal audit divisions of financial institutions in accordance with the views expressed in Principle 14 of the guiding principles issued by the Basel committee in 2001 regarding internal audit. It is equally important that such meetings be held with external audit divisions and the Compliance Officers of the financial institutions. Thereby, it becomes possible to better coordinate the internal and the external audit of financial institutions and thus increase the impact of their surveillance.

With reference to point 5 Paragraph 1 Act No 142/2008 in the view of the SIC, it is requisite to systematically rebuild the FME in order to prepare it to meet its statutory obligations towards the general interest of the public.

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122. Statement of Mr. Jónas Fr. Jónsson before the SIC on 6 August 2009, p. 1. It should also be mentioned that the Moody's credit rating for Landsbanki at that time was Aa3.

Preferably the institution should be subjected to an audit in approximately three years in order to assess the effectiveness of its rebuilding.

#### 21.4.5 Consultative Group of the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME and the Central Bank of Iceland on Financial Stability and Contingency Planning.

„[M]y point of view was that if the Permanent Secretaries of State, or the Ministries' representatives, preferably the Permanent Secretaries of State, were in a situation where the information was coming in and the Ministers could get information directly from their own people, that would function better than anything else. That was just what I, from my experience of the system – political ministers distrust most people if not everybody as time goes by, except they most likely trust their Permanent Secretary of State and their own people there, which they have access to because they expect them to have the best interest of the ministry in mind, as well as that of the State and the Ministers. I thought this to be crucial, that people wouldn't have to listen to us but would find out for themselves, from the information provided, the situation we thought was at hand.“

Statement of Davíð Oddsson before the SIC on 7 August 2009, p. 33.

„The fact is that the preparation of the contingency plan as well as many other tasks under the aegis of the consultative group was launched because of my suggestion as the chairman of that group.“

From Mr. Bolli Þór Bollason's letter to the SIC dated 24 February 2010.

„The consultative group was therefore not obliged to prepare a contingency plan or an action plan for the administrative authority.“

From Mr. Baldur Guðlaugsson's letter to the SIC dated 24 February 2010.

The consultative group of the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME and the CBI on financial stability and contingency planning was established by a written agreement on 21 February 2006 as further detailed in Chapter 19.2. Its purpose, according to the agreement, was to formalise consultations amongst the parties concerned by seeking to clarify the division of responsibilities, hinder duplication of effort and increase transparency. It was stated that the consultative group was a platform for the exchange of information and dialogue. Its role was consultative and it was not to make decisions on measures. The parties involved all had roles and duties in different areas where financial stability and contingency planning was of great importance. The agreement on the consultative group formed a platform for said parties to perform duties regarding consultation and coordination with the other government bodies. However no direct responsibilities were transferred to the group as such, and these continued to rest with its individual members, according to the legal position of each and their respective roles.

Each ministry was represented in the consultative group by its respective Permanent Secretary of State, i.e. senior officials who are usually also the ministers' chief assistants in setting policy and priorities. This, in and of itself, gives some indication of the importance attached to the the group in its field. Views expressed by former Governor of the CBI, Mr. Davíð Oddsson, at the hearing before the SIC in a discussion regarding the consultative group, might be mentioned in this context, as quoted in the margin.

In the agreement establishing the consultative group, the formulation of a joint contingency plan for the relevant authorities was not stated as one of its tasks. Numerous statements by representatives in the consultative group, and by ministers, before the SIC revealed that the intended role of the group as a consultative body was to make proposals for such a plan. In letters from former acting Permanent Secretary of State Ms. Áslaug Árnadóttir, dated. 24. February 2010, and former Permanent Secretary of State, Mr. Baldur Guðlaugsson, dated. 24. February 2010, to the SIC, they however denied that it had been the intended role of the consultative group to compose such a contingency plan.

It is evident that the consultative group as a whole lacked the necessary information on which to base its counselling even though such information existed, at least to some extent, in individual institutions within the group. The consultative group was not established by law nor did any law stipulate how necessary confidential data should be communicated to the group. For these reasons, the consultative group did not have access to all the information on which any decision regarding coordination and responses to financial shocks would inevitably have to rely. Thus, the consultative group did not have a clear picture of the large exposures, cross ownership or any other

weak links in the Icelandic financial system. The SIC is of the opinion that this was a serious problem in the working environment of the consultative group which must have had a negative impact on the quality of its work.

In the draft minutes of the consultative group meetings and the statements of the group's members before the SIC, there seems to be nothing to suggest that any emphasis was placed on composing a contingency plan until the group's 8th meeting on 18 March 2008. After that the consultative group sessions became much more frequent. Different attitudes surfaced at a meeting of the group on 29 May 2008 between the FME and the CBI on the one hand and the Permanent Secretary of State of the Ministry of Finance on the other. These different attitudes would later affect the work of the group. The FME and CBI called for a political policy to be drafted regarding certain issues but the Permanent Secretary of State of the Ministry of Finance stressed that such decisions were premature.

As cited in Chapter 19.4.3 Tryggvi Pálsson, director of the Finance Department of the CBI, mentioned in his statement before the SIC that the consultative group was modelled on its UK counterpart. The UK group however only consists of three institutions whereas the Icelandic group consists of five. This meant that the management of the group would have to be disciplined and organised if appropriate results were to be achieved in preparing the government's formal and organised responses to prevent a financial shock and to tackle the banks' insolvency should it occur. There is nothing in the statements of the group's representatives to indicate that this was ever the case. Agendas were not always ready when the meetings started. The meetings were said to have begun in a spontaneous fashion and ended in the same way. In this regard, special mention could be made of Mr. Pálsson's comment that the larger issues, those which demanded „a certain level of stress and courage and [were] often left until the last minute or postponed to the next meeting.“ Thus, an action plan, which repeatedly was on the agenda, was left undiscussed, meeting after meeting. There was no clear division of labour or responsibility for the implementation of tasks. All this time, actions were needed but the ministers were out of reach.<sup>123</sup> Considering these comments, it is hard to come to any other conclusion that, in the light of how important the tasks of the group were, the working methods were unacceptable. Not surprisingly then, when the financial shock hit, the group was far from completing the first preliminary draft proposal for a contingency plan. The only reliable product of the consultative group that was of any direct use, was the drafted Article 100(a) of Act No. 161/2002 on Financial Undertakings which was later used in the drafting of the Emergency Act.

It has been repeatedly described that increased raising of deposits in the Icelandic banks in branches abroad as early as 2007 resulted in a considerable increase in the obligations of the Depositors' and Investors' Guarantee Fund. The rule regarding the Fund's obligation to pay a minimum amount to each depositor was clearly stated in the law. It was also clear that the fund's assets were insufficient to meet the obligations to which the fund is liable, if large financial institutions were headed for insolvency, at least not for the time being. This applied whether or not changes in legislation had been made, for example at the beginning of 2008. Thus, inevitably it would have been one

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123. Statement of Mr. Tryggvi Pálsson before the SIC on 10 March 2009, p. 18.

of the challenges that should have been addressed in the government's contingency plan, how to meet the obligations which made the Depositors' and Investors' Guarantee Fund liable if a financial shock were to happen. One of the consequences of the fact that the contingency plan was not completed when the banks collapsed in October 2008 can be seen in the uncertainty that occurred at the time of the fall and later regarding matters of the Guarantee Fund on account of deposits in branches of Icelandic commercial banks abroad which did not fall under the guarantee that the Icelandic authorities declared with regard to deposits in Iceland.

In this context, it is necessary to point out the specific duties of the representative of the Prime Minister's Office in the group's work. According to the agreement establishing the group, he was to preside over its work. It was therefore his duty to conclude matters and work towards effectiveness in the group's work, in consultation with the Prime Minister if need be, i.a. if differences of opinion or views should emerge regarding the policy and focus of the group's work. It must be kept in mind though, that every representative of the government in the group performed their duties while working full time at relevant ministries or institutions.

As every representative in the consultative group carried a full workload they could not be expected to have unlimited time to compose a contingency plan. Thus, the consultative group had to rely on the CBI and the FME to assist with that task. In order to take on that work, both the CBI and the FME were of the opinion that it was necessary to have a political policy regarding certain issues. The CBI further proposed that one or more individuals oversee the preparation of the government's contingency planning. As discussed in Chapter 19.4.2 the communication of information from the consultative group to the ministers, did not take place on a regular basis and the ministers concerned did not hold regular meetings to review the tasks and outcomes of the consultative group's work or to administer the project to the extent of their respective responsibilities. This was a project of great importance to the Icelandic people. Proposals and documents regarding the necessity of a contingency plan which were introduced in the consultative group, did not receive formal resolution for example by ministers whose representatives were in the group. So it seems that the group seriously lacked effective and focused management. The ministers who had representatives in the consultative group of the Prime Minister's Office, Ministry of Finance, Minister of Business Affairs, FME and the CBI on financial stability and contingency planning, did not meet specifically, let alone on a regular basis, in order to review the tasks and results of the consultative group's work or to supervise projects of the group according to their respective responsibilities. Therefore, at the crucial moment when the banks collapsed no joint governmental contingency plan was in place, although desperately needed.

Based on the information obtained by the SIC and on the statements of individuals concerned, it is clear that both the CIB and the FME looked to the consultative group concerning initiative towards a joint contingency plan, not least actions which demanded political policy and coordinated actions. Thus it seems that the consultative group had in fact been accorded a more significant role in the preparation for actions than the terms of the agreement from 21 February 2006 stated. At least it is clear that nowhere else in the administration was joint work on a contingency plan being carried out. This

„[...] I firmly reject that I was negligent because of the issues which [...] on one hand concern the omission of bringing the position of the banks up for formal discussion within the Government and on the other hand by not having arranged for a formal assessment of the financial risk posed to the Icelandic State in connection with the operations of financial corporations in this country. Neither of the above-mentioned issues can be seen as part of my responsibilities [...].

From Mr. Björgvin G. Sigurðsson's letter to the SIC, dated 24 February 2010.

„As I have said before, the surveillance of liquidity is with the Central Bank [...].“

Statement of Jónas Fr. Jónsson before the SIC on August 6 2009, p. 30.

vague situation regarding the sphere of authority and the consultative group's responsibilities seems i.a. to have led to a lack of clarity concerning who was in charge, who coordinated and was responsible for contingency preparations on behalf of the government of Iceland in the event of a financial shock. In the statements of ministers and representatives of government bodies before the SIC, many people passed the blame for failure to perform duties and no one assumed responsibility. The same applies to the replies received from those who were given the opportunity to make comments pursuant to Article 13 of Act No. 142/2008, their replies are in Annex 11 of the electronic version of the report.

The consultative group does not seem to have succeeded in working in a coordinated manner on issues which obviously seemed to fall under more than one authority. Thus it seems that the group did not gain any results in coordinating actions in order to put pressure on Landsbanki Íslands hf. to transfer accounts from its London branch to a subsidiary.

By law, Landsbanki's branch in London operated under the supervision of the FME as did the Depositors' and Investors' Guarantee Fund. Although it was disclosed in the statement by Mr. Jónas Fr. Jónsson, former Director of the FME, that it was suggested to Landsbanki that the Icesave deposit accounts be transferred from the branch to a subsidiary, the SIC has no other evidence in support thereof.

Despite the fact that the aforementioned concerns had been expressed and discussed between at least three ministers, the CBI and the FME, the SIC's investigation has yielded no documents, data or unequivocal confirmation in its hearings to the effect that the Icelandic authorities at that time had indeed synchronised the group's actions nor had they requested Landsbanki formally to transfer the Icesave accounts to a subsidiary, nor called for a schedule for such a transfer from the bank if the authorities assumed the bank was preparing the transfer. Regardless of Landsbanki's legal authorisation to operate a branch in London, it was clear that the possible transfer of the Icesave accounts to a subsidiary could be of significant importance as regards the response and actions of the Icelandic authorities over the coming months, i.a. as regards the Depositors' and Investors' Guarantee Fund and also interaction with foreign regulatory bodies and central banks. At this point, it would at least have been reasonable in accordance with the principles of good governance for the authorities competent in regard to these matters to request confirmed plans concerning the timing of the transfer of the accounts to a subsidiary. This would also have enhanced the ability to monitor the bank and establish that its plans were carried out.

With reference to point 5 paragraph 1 of Article 1 of Act no. 142/2008 it is the assessment of the SIC that the basis on which the authorities are meant to formulate coordinated contingency plans must be thoroughly revised. This revision is necessary to ensure timely, coordinated and prepared counter-measures to a financial crisis and preclude misunderstanding concerning the division of functions within the government body. The revision must clearly stipulate who is in charge of organising that work and carries the responsibility for it

„From all the aforesaid it is clear that control obligation with regard to the banks and other financial corporations lies entirely with the Financial Supervisory Authority, not the Central Bank of Iceland (CBI).“

From Mr. Davíð Oddsson's letter to the SIC dated 24 February 2010.

„This consultative group was the responsibility of the Prime Minister and treatment of the matters regarding the financial system was the responsibility of other Ministries and their institutions, i.e. The Central Bank of Iceland (CBI) and the Financial Supervisory Authority, as aforesaid, not the Ministry of Finance. Therefore I had no motive to discuss the consultative group's issues with other ministers without a specific reason.“

From Mr. Árni M. Mathiesen's letter to the SIC, dated 24 February 2010.

In Hreiðar Már Sigurðsson's statement it is stated that Governors of European Central Banks were in agreement that they wanted them removed because the high interest rates of Icelandic banks on deposits in Europe were the reason why the Central Banks' interest reduction didn't come through. „Of course we know, from all over, that this was very inconvenient for all the major banks and we know that interest rates, they had begun to lower the interest rates at that time and that the interest rates were going down much slower than they wanted.“

Statement of Hreiðar Már Sigurðsson before the SIC on 21 July 2009, p. 73.

#### 21.4.6 The Isolation of the Icelandic Government in the International Community

In the first quarter of 2008 it had become clear that concerns regarding the size of the Icelandic banking system were growing among some of the governors of the major European central banks.

The Icelandic banks had also aroused a certain degree of animosity in Europe in two different ways. On the one hand, they started to raise deposits by offering higher interest rates than other banks felt they were able to offer. This conduct by the Icelandic banks was considered irresponsible and a warning sign regarding their standing; furthermore it was perceived as a threat to the stability of the markets in question. On the other hand, the banks had aroused the anger of the governors of the European Central Bank (ECB) by their conduct regarding collateral loan transactions with the ECB, through the Banque centrale du Luxembourg (BCL). In relative terms, the level of collateralised loans by the Icelandic banks with the BCL was among the highest in Europe; moreover the ECB had made serious comments concerning the securities the banks had placed as collateral in their transactions with it. These transactions are discussed in more detail in Chapter 7.

The CBI turned to the Bank of England on 17 March 2008, when it made a formal request by email for a swap agreement to strengthen its foreign exchange reserves. It is worth noting that on that day the krona (ISK) depreciated by 6%. This was the biggest depreciation of the krona since the „mini-crisis“ of 2006. There was a considerable risk that the CBI's request would not be interpreted as a deliberated, calm measure in order to enlarge its foreign currency reserves, but rather as a request for emergency aid to prevent a bank run, which seemed to be underway already.

In April 2008 the opinion gained momentum amongst the governors of central banks in Europe that the scope of the difficulties the Icelandic banks were facing was such that they would not be solved with swap agreements. This is most evident in correspondence between the CBI and the Bank of England and with Federal Reserve President Timothy F. Geithner, discussed further in Chapter 4.5.9.2. On 15 April CBI Governor Davíð Oddsson sent a formal request for a swap agreement to the Bank of England. On 23 April 2008 Mervyn King, the Governor of the Bank of England replied to Governor Oddsson's letter, turning the request down. He explained, however, that foreign central banks could find a way to help Iceland shrink its banking system. In his opinion, that would be the only realistic way to deal with this task. He added that he was willing to do everything within his power to help. The CBI did not accept the offer. Instead, the CBI asked in its reply that the Bank of England would kindly reconsider its position regarding the requested swap agreement. No reply was received from the Bank of England.

During a meeting of central bank governors in G10-countries in Basel on 4 May 2008 Iceland's affairs came under discussion.

According to Mr. Oddsson's statement before the SIC it became evident that the tide had turned, as regards the attitude of European central bank governors after that meeting. Statements by Mr. Oddsson and other quotes referred to here are discussed further in Chapter 19.8.1. A statement made by Governor Ingimundur Friðriksson also showed that an obvious change in attitude had taken place towards Iceland. Mr. Már Guðmundsson who at the time was working as an economist for the Bank for International Settlements

in Basel, confirmed that during the meeting, foreign central bank governors had expressed doubts as to how the Icelandic banks could offer interest rates as high as they did. Mr. Guðmundsson further explained:

„In this field, it is often taken as an example that if someone offers rates that are much higher than others', then they are expanding their operations. Either they have great need for funding, and are in that way stuck in a corner to an extent, or they are offering high interests and need high risk investments in order to meet their commitments. Now I know that the banks repeatedly claimed that they were able to do this because their operations were so ... their cost was low since the operations were online, and therefore they had a competitive advantage, and so on. But that doesn't matter in this context, and therefore suspicion arose.“<sup>124</sup>

After the meeting of central bank governors in G10-countries on 4 May 2008 it became clear that swap agreements with the Bank of England or any other central bank, with the exception of the Danish, Norwegian and the Swedish Central Banks, were not an option for the CBI. Only these three banks were willing to extend currency swap agreements to the CBI. But first, the Prime Minister had to pledge that pressure would be put on the Icelandic banks to shrink their balance sheets, in view of proposals from the IMF. As earlier stated, a promise by the Prime Minister of Iceland made by phone was not sufficient in the eyes of the Nordic central bankers, since they demanded a statement signed by three government ministers, which included a responsible budget policy and changes to the Housing Financing Fund. The facilities pledged by the Nordic central banks were therefore conditioned by the requirements that the Icelandic government would work towards specific political measures and actions by the CBI and the FME. The ministers signed the declaration on 15 May 2008 along with the Board of Governors of the CBI, but it was not made public or presented during a government meeting. The next day, a statement from the Prime Minister was published on the website of the Prime Minister's Office's, where the announcement of the swap agreement was celebrated. It subsequently stated that the Prime Minister „on this occasion“ wished to emphasise aspects of the government's policy, which were specified further. One of which was to „promote [...] structural reforms in the economy in view of increasing the economic stability.“

These points and others show, that reference was being made to the subject matter of the government's statement from the day before. There was no indication of its existence, however, as noted earlier. A letter from Mr. Haarde to the SIC, dated 24 February 2010, states that early on 16 May, he had briefed representatives of the opposition parties on the matter and the government's part in it. The opposition did not object to the government's handling of the matter. Jóhanna Sigurðardóttir declared during her hearing that the statement had not been discussed in a government meeting, cf. Chapter 19.8.1.

As further described in Chapter 19.8.2, the SIC wrote a letter to the Governor of the Swedish Central Bank Stefan Ingves on 4 November 2009, where he was i.a. asked to answer specific questions. He replied in a letter dated 22 January 2010 where he i.a. states his opinion that unclear ownership and rapid expansion of the banks' balance sheets had caused a hazard which the Icelandic government had neither seemed to fully grasp, nor fully understand how to deal with it by reducing the size of the banks.

„That is why everybody hated us here, we could access the market, on much better terms, with considerably lower costs and there is no competing with us because our weakness can be our strength. The only problem, in hindsight, is of course that concept, that the entire world somehow changes into that the deposit guarantees are the main issue, something that no one knew clearly what was, and no one thought of. People always thought that what mattered was not some deposit fund containing thirteen billion, the equity in the bank is only four hundred billion [...]. Therein lies the defence.“

Statement of Sigurjón Þ. Árnason before the SIC on 19 August 2009, p. 80.

124. Statement of Mr. Már Guðmundsson before the SIC on 22 October 2009, p. 3.

Taking notice of the above, it seems to have been the view by the Nordic Central Banks that the Icelandic authorities did not exert themselves sufficiently in reducing the size of the Icelandic financial institutions, had not promoted a sufficiently responsible budget policy, and had not made necessary changes to the Housing Financing Fund. To quote words that Mr. Oddsson attributes to the Danish and Norwegian Central Bank governors, the Icelandic government had done „much too little and much too slowly“ in reducing the size of the Icelandic financial institutions.<sup>125</sup> There is nothing to indicate that the governors of the Nordic Central Banks had been confident that the Icelandic government would start dealing with those issues, since they made the demand that pledges on the necessary reforms would be signed and documented. The governors of the Nordic central banks also demanded that they be informed regularly as to what the government was doing to fulfill the promises it had made. When little was done during the summer of 2008, the situation went from bad to worse. As a result, it seems as though this lack of action, when added to the prevailing attitude among foreign central banks towards Iceland, that the Icelandic government had become very isolated in this respect in the international community, and therefore, had limited options once the Icelandic banks collapsed in October 2008.

#### 21.4.7 Government Offices of Iceland

According to the Constitution the supreme management of the administration is in the hands of the ministers who are accountable for all executive acts. The ministries are, each in their own area of responsibility, the supreme administrative bodies of the state. They are run by Permanent Secretaries of State under the administration of the ministers. It is fair to say when considering the the ministries' assigned tasks in the field of the financial market and monitoring thereof, that the main changes that have taken place in the tasks and practical procedures of the ministries in the last decades are apparent. It is clear that the introduction of the EEA-Agreement, which entered into force 1 January 1994, entailed a greatly increased task load for the ministries in the field of preparation and introduction of EU acts into Icelandic legislation. Various tasks, that were carried out by the ministries themselves, e.g. licensing, have increasingly been handed over to a subordinate body. This has led to the ministries having an increased supervisory role with regard to their subordinate bodies and their decisions. As regards the financial market the main tasks and authorisations of the state have been assigned to decentralised bodies, including in the area of monitoring. This has been the trend in the past two decades. However, this does not affect the obligations of a minister and his ministry to monitor and follow the developments in his area of responsibility, which is covered by the subordinate body, and to react, where applicable, by submitting legal proposals when there are grounds for doing so.

The reform to the Icelandic administrative system which was implemented with the Administrative Procedures Act No. 37/1993 and the Information Act no. 50/1996 mostly covers the government's handling of cases where decision must be made regarding the rights and obligations of individuals and also the citizens' access to government information. On the other hand, no specific improvements have been made to regulations regarding the

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125. Statement of Mr. Davíð Oddsson before the SIC on 7 August 2009, pp. 60-61.

Government Offices of Iceland, which provide for the supreme management of the administration, apart from regulations on the roles of ministries and the regulations on derogation from the obligation to advertise positions when employees are moved from one position to another. As regards other subjects, the Government Offices of Iceland Act has changed little since 1969.

The prelude to the collapse of the Icelandic banks mainly concerned issues in the field of three ministries: the Prime Minister's Office, the Ministry of Business Affairs and the Ministry of Finance. The former two ministries are small and although the Ministry of Finance has a larger staff it is clear that the heaviest workload of the ministries, regarding the financial institutions and the government's anticipatory measures, was carried by only a handful of officials; primarily the Permanent Secretaries of State. They also participated in the government's consultative group. It must be kept in mind that the special challenges that came up due to the deteriorating position of the Icelandic banking system, came on top of the ministries' other daily tasks. Inside the ministries only a few officials, beside the Permanent Secretaries, handled these tasks. Generally, it cannot be said that there were many staff members inside those ministries who had expert knowledge that could enable them to handle such tasks. Despite this it was not until 1 August 2008 that a special economic advisor was recruited to the Prime Minister's Office. Additionally, during the SIC's examination it has frequently been observed that the workload in the ministries at that time was heavy, with reference to the comments regarding Article 13 of Act no. 142/2008 which the SIC received from the former office manager and acting Permanent Secretary of the Ministry of Economic Affairs, see the enclosed quotation in the margin. See more on the work conditions within the administration during the prelude to the collapse of the banks in Chapters 19 and 20.

As may be seen from this, the Icelandic administrative system was ill prepared for the financial disasters that occurred in 2008. One of its weaknesses was the small size of the staff in those ministries that took the worst of the strain. Almost every action taken by the Government Offices was the effort of a very small group. In this regard it should also be kept in mind that the Government Offices' means for action does not depend on the total number of its staff, but rather on the number of staff who are well educated and trained and have the ability to handle complicated and demanding tasks. It is clear that it is urgent to increase the number of such staff members. In order to do so the right work conditions must be created within the Government Offices of Iceland in order to attract staff who have these qualities.

It is assumed that the non-political officials in the ministries are experts in their field both by education and experience in the ministry's area of responsibility. Their duty is to keep up an effective and objective administration in the interest of the public. According to Article 15 of the Government Offices of Iceland Act, no. 73/1969, a minister is authorised to call for assistance, while in office, from a person outside the ministry who will be employed there as an office manager only for the duration of the minister's time in office. This office manager is commonly called the minister's (political) assistant. Other ministry staff are to be employed in accordance with the principles of administrative legislation and the most able applicant shall be chosen on the basis of qualification requirements and other objective criteria. It leads, inter alia, from Article 11(2) of the Administrative Act that the political

„The principle was that my client [Ms. Áslaug Árnadóttir, Director and acting Permanent Secretary of the Ministry of Business Affairs, in the period from December 2007 until the end of July 2008] worked every day of the week, nights and weekends included, and was constantly taking care of projects and errands on behalf of the Ministry outside regular hours, both by being in her office, by attending meetings and in addition by phone and e-mail. It should be clear that my client did her job far beyond all her obligations in accordance with laws of employment and beyond all general demands which can be made in this area.“

From the letter of Ms. Áslaug Árnadóttir's lawyer to the SIC dated 24 February 2010, p. 6.

affiliation of an applicant may not be taken into consideration. Nevertheless, it has been pointed out in scholarly discussions that overall it may be assumed that recruitment based on political principles is fairly common.<sup>126</sup> However, it can be difficult to prove, in the legal sense, that regulations have not been complied with. However, those staff members, who have been hired in such a manner, do not end their employment when the minister who hired them leaves office. This can then cause problems for the next minister. Such recruitment can also lead to diminished expert knowledge in the ministry's area of responsibility if many positions are manned by staff members who have been hired on weaker professional grounds, perhaps primarily on political terms. Such a situation can have grave consequences under the kinds of circumstances that are present in Iceland, where ministries have, generally only a handful of staff, considering the tasks they are assigned with.

In reforming the Government Offices of Iceland, the fact must be faced that many ministers seem to have believed that there was a need to increase the number of political assistants within the ministries to handle political policy development and related work. Therefore a decision must be made as to whether or not the legislation should be changed in order to permit the hiring of more staff for the minister's political bureau.

Chapter 16.1.2.7 covered the special obligations of ministry staff that are based on unwritten rules. This includes the obligation of ministry officials to give the minister information and advice that he needs in order to carry out his duties. This obligation entails the provision of information and advice at one's own initiative on issues that are important for the minister's official duties and also not to keep important information secret from the minister. A legal provision for the special duties of officials of the Government Offices of Iceland must be considered in order to make clear what these duties entail. Chapter 21.5.4.1 below will specify in more detail how the SIC thinks the current regulations on the obligations of Permanent Secretaries should be interpreted as regards their dissemination of information to the ministers on projects they are in charge of on behalf of the ministry, in this case on the co-operation with other public authorities within the government's consultative group.

The SIC's investigation of Government Office data from 2007 and 2008 revealed that there was no coordinated procedure for the recording of oral information on communications with other authorities or private bodies. The same applied for the recording of communications with foreign governments, i.e. telephone conversations. Comparable issues have already been mentioned in the discussion of the internal work of the government in a previous chapter on the government. The SIC points out that in this case the communication is a part of the carrying out of the official tasks of the concerned party. Therefore it may be of considerable importance to make clear what communications have taken place between the parties concerned. As regards to the recording of oral information within the administration system, Article 23 of the Information Act, No. 50/1996, lays down an obligation to record oral information under specified circumstances. That obligation only applies to proceedings that call for acts of administration, see Article 1(2) of the

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126. See, e.g. Gunnar Helgi Kristinsson: *Íslenska stjórnkerfið (The Icelandic System of Government)*. 2nd edition Reykjavik 2008, p. 214-220.

Administrative Procedures Act no. 37/1993. However, this provision of the Information Act only legalised an unwritten rule that had been, i.a., assumed to exist when the Administrative Procedures Act was drawn up.<sup>127</sup> Different practices regarding the record keeping of memoranda and meeting minutes have been followed within Icelandic ministries and government agencies. The same applies to oral communications between the representatives of agencies and with others, outside the cases provided for in the current rule in Article 23 of the Information Act. In Iceland no general rules have been formed on the recording of information on the internal work of the government, on communications and the handling of specific issues, at least not in the same way as, e.g., within the Danish administration. It may be pointed out that in Nordic legislation, e.g. in Denmark, the general rule is that to fulfil provisions that parallel Article 23 of the Information Act, i.e. provisions in current legislation, the unwritten principle provides for a wider obligation for the government to record information that is not limited to proceedings that lead to acts of administration.<sup>128</sup> As the interests of the state can not be properly guarded without organised recording of information and information management by the Government Offices, it is the opinion of the SIC that coordinated regulations on the recording of such information should be written.

As mentioned in chapter 16.1.2, Article 9 of the Act on the Government Offices of Iceland, no. 73/1969, stipulates that any ministry shall oversee the operations of its subordinate bodies and their assets. In reality there seems to have been some uncertainty as to whether this provision only applies to authorities that are subordinate to the concerned minister or to all authorities, including autonomous authorities. It is necessary to revise this provision and remove all doubt regarding its scope. If the provision will also be meant to apply to autonomous authorities and committees, it is necessary to put into the legislation clear provisions as to what actions a minister can take concerning such bodies. In relation to this a clear distinction must be made, on the one hand, between the overseeing of the finances and assets of autonomous authorities and the actions open to a minister in cases of deficit thereof, and, on the other hand, the monitoring of the legality of the decisions made by such authorities. It is the direct aim of many legal acts to prevent a minister from changing the rulings of autonomous authorities and administrative committees. On the other hand ministers are obliged to mind to a certain degree the finances and return of annual accounts of autonomous authorities and administrative committees, according to Articles 20 and 40 of the Government Financial Reporting Act, No. 88/1997.

The tasks ahead, in the building-up of Icelandic society, make a formidable demand on the Government Offices of Iceland. It is therefore important that the authorities be well-prepared to handle those tasks. In light of the above it is, in the opinion of the SIC, important to revise the Act on the Government Offices of Iceland, which dates back, as was stated earlier, to 1969 and has remained substantially unchanged since then.

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127. Parliamentary record 1992-1993, A-section, p. 3296

128. Jon Andersen: „Forvaltningsret – Sagsbehandling-Hjemmel-Prøvelse.“ 6. ed. Copenhagen 2006, p. 69.

#### 21.4.8 Legislation on the Financial Market

When Iceland became a party to the EEA Agreement the operating permissions of Icelandic credit institutions, including those of the financial institutions, were loosened considerably. This was done in parallel with the introduction into Icelandic legislation of EU Directives concerning the financial market, but they generally involved a minimal coordination of certain issues concerning the establishment and operation of credit institutions as well as the principle of mutual recognition. However, the directives did not prohibit the member states to retain or apply stricter regulations than the directives provided for regarding credit institutions in the member state concerned, as they would fulfil certain principles which are stipulated by the regulations of the EU and the EEA-Agreement. It is clear from the explanations made at Althingi, when the above-mentioned legislative changes were made, that the aim was to improve the competitive conditions for the Icelandic financial institutions in the EEA and thereby create uniformity and mutual working conditions for financial institutions. In discussion in Althingi in 2007, on the regulation on the financial market and operating permissions for companies in that market were discussed in Althingi in 2007, the view was again expressed that provisions specific to Iceland needed to be reduced as much as possible – see chapter 15.4 for further discussion. This was part of the government's political strategy on the legal environment it wished to create for the local credit institutions within the regulatory framework of the EU and EEA-Agreement.

It is important to formulate a political position on how to develop regulations on the financial market in the near future. Although, Iceland has an obligation to adopt a minimum of provisions from the EU Directives pursuant to commitments under the EEA-Agreement, Althingi still has considerable freedom to adapt to conditions specific to Iceland when adopting legislation. However, it is a matter of political opinion what the objectives are and how to achieve them. If such political policy is not formed here in Iceland, there is a risk that the emphasis of the regulations on the financial market will be too fragmentary and vague.

#### 21.4.9 Defects in European Union Legislation

The causes of the collapse of the Icelandic banks and the problems that have surfaced in Icelandic society in its wake are not entirely of domestic origin. In the opinion of the SIC there are various shortcomings in the European Union legislation and its framework that were conducive to creating the circumstances that led to the collapse of the banks. Hereinafter a short mention will be made of the issues the SIC considers to be of most significance.

The European Union directives on the activities of credit institutions are based on the principle of mutual recognition which substantially entails that the member states are obliged to recognise the operating licences of credit institutions of other states within the European Economic Area. Therefore credit institutions can set up branches in other member states and engage in business there on the basis of an operating licence issued in their home state. It was on the basis of this regulation on mutual recognition that Icelandic financial institutions set up branches abroad and commenced various business operations, including accepting deposits from the public, lending and securities trading.

Thus, it was easy for credit institutions to start business activities abroad in the wake of Iceland's accession to the EEA. However, European Union regulations on deposit-guarantee schemes and investor-compensation schemes are not designed for a large common financial market. Council and European Parliament Directive 97/9/EC on investor-compensation schemes does not provide for a common insurance scheme for the activities of credit institutions across borders. The directive does not make a distinction between a credit institution in a small economy, such as the Icelandic economy, that sets up a branch in a large economy or a case where it's the other way around. No provision is made for credit institutions that plan to start business activities in a different jurisdiction to make payments to a special common guarantee fund to meet losses that investors may be subjected to in case the credit institution concerned experiences financial problems. The directive merely assumes that a local guarantee fund in each member state will give satisfactory backing, regardless of whether the activities of credit institutions in the concerned state reach across borders and are independent of the size of the economy concerned. The outcome was, *inter alia*, that Icelandic credit institutions were able to start business activities abroad through branches and were able to take on considerable obligations *vis-à-vis* their investors without a corresponding guarantee of sufficient insurance for those investors. Of course the European Union directive only provides for circumstances where an individual credit institution has financial difficulties, but not for a total collapse of the biggest credit institutions of an entire nation, as was the reality in Iceland in October 2008.

It is also clear that the structure of the EEA control mechanism is such that it does not guarantee timely and synchronised actions by financial supervisory authorities in order to handle problems that may arise within financial institutions that operate across borders inside the area. Thus, regulations on the monitoring of financial institutions have not undergone necessary changes in light of the altered working environment for financial institutions in the wake of their permission to operate outside their home country on the basis of a home country operating licence.

As was discussed in Chapter 15 of this report, the EU directives did not prohibit the member states of the EEA from maintaining or applying stricter regulations regarding credit institutions in the home state concerned than is generally provided for in the directives. Iceland could therefore have applied stricter regulations on the activities of domestic credit institutions than is provided for there. On the other hand, Iceland could not have applied such regulations to the activities of foreign credit institutions with branches here, except under absolutely exceptional circumstances. If the Icelandic legislative body had decided to apply or maintain stricter regulations for domestic credit institutions, a situation could have arisen where the branches of foreign credit institutions here in Iceland would have had a more open operating permit than domestic credit institutions. As is stated in Chapter 15 it was this risk of discriminating between the operating permits of domestic institutions and comparable foreign institutions that seems to have led to it being thought necessary to allow Icelandic credit institutions to have operating permits comparable with those of credit institutions in the neighbouring countries. This was done without due consideration to the effects such an arrangement could have in a small economy like the Icelandic one, where the risk of con-

licts of interest and management and ownership links is greater than in larger economies. In the opinion of the SIC the member states of the EEA may have been given too little leeway for applying stricter regulation to the activities of credit institutions and, at the same time, to domestic and foreign credit institutions setting up branches. The current arrangement increases the possibility of the government giving in to pressure to allow global operating permits in order to prevent the disruption of the competitive position of domestic credit institutions versus comparable foreign credit institutions which enjoy more open operating permits in their respective home countries.

In EU Directive 2006/48/EC on Credit Institutions, the member states are given the leeway to define in more detail when financial ties and/or control exist with the legal consequences that risk exposure to more than one party should be defined as one exposure. This has caused a disparity between the EEA member states on how to interpret the regulations and how supervisory bodies should carry out controls. Therefore there is not complete uniformity between member states as to under which circumstances an exposure to two or more parties is defined as one risk exposure, even when the credit institution concerned operates in two or more countries through a network of branches. This has happened even though there exists a platform for cooperation between credit institution supervisory bodies, the CEBS (Committee of European Banking Supervisors). Although there may be various difficulties involved if one goes too far in setting criteria for this issue in EU regulations, the SIC considers it to be clear that it is necessary to define some minimal criteria to ensure a coordinated implementation of these important regulations within the member states.

EU regulations on large risk exposures do not provide for that the exposure of one credit institute could have a limiting effect on the permission of other credit institutions to incur exposure with the same bodies. Hence, according to the directive a legal person can theoretically, incur maximum risk exposure (25% of its capital) with more than one credit institution, both inside the same economy and in other EEA economies, with the associated risk of a domino effect in the case of financial difficulties. In the opinion of the SIC it is important to consider a revision of this regulation.

## 21.5 Mistakes or Negligence Within the Scope of Article 1(1) of Act No. 142/2008

### 21.5.1 Description of the Examination

With Article 1(1) of Act No. 142/2008, the SIC was entrusted with assessing whether mistakes or negligence had occurred in the course of implementing laws and rules on the regulation and control of financial activities in Iceland, and, if that were the case, which individuals might be responsible. In view of the events described above in this report, the SIC has further examined this issue.

In the general commentary pertaining to the bill, which was later adopted as Act No. 142/2008, it is stated that laws and rules regulating the financial market and control thereof refer inter alia to the laws on the operations of the CBI and the FME, laws on financial institutions, and regulations and administrative provisions adopted on the basis of those laws. Later the following is stated: „Here the focus is first and foremost on public institutions

and ministries operating in these fields. However, in the investigation into the causes of the banks' collapse, there is every intention to examine whether any weaknesses in their operations and policy making played a part in their collapse. However, as stated above, it is not the intention of the SIC to address possible criminal offences of bank directors as regards their operations.<sup>129</sup>

Here the SIC examination is mainly aimed at the activities of public bodies and those who may be responsible for mistakes or negligence within the meaning of the Act. As regards the activities of the financial institutions, however, an examination must take place on whether any weaknesses in their operations and policy making played a part in their failure. The report above has examined in detail miscellaneous weaknesses as well as policy making aspects in the operations of the financial institutions, in particular the three large banks, which according to the SIC played a role in their collapse. As could be expected in such cases, this concerns possible mistakes or negligence on behalf of directors or staff members of these entities. On the other hand, according to the law governing the operation of the SIC, the Commission is essentially tasked with clarifying whether any weaknesses in the operations of the banks and their policy making contributed to their failure. Given the nature of the collection of evidence and information, such an investigation is not suitable as a basis for drawing any conclusions regarding mistakes or negligence of individual directors or members of staff in the banking system. The country's competent authorities must assume the responsibility of investigating further and deciding whether the criticism presented in this report regarding weaknesses in operations and policy making of the banks and other financial entities, which were in the opinion of the Commission instrumental in their failure, constitutes a criminal or punishable violation of the law, and subsequently which directors of banks and financial institutions are responsible for any mistakes and negligence which may have been a factor in them. The SIC shall notify the State Prosecutor, in accordance with Article 14 of Act No. 142/2008, if its investigation has aroused suspicions of criminal conduct. The content of such notifications made by the Commission to the State Prosecutor is described in Chapter 22.

The part of the SIC investigation which concerns government activities is essentially aimed at clarifying the events leading to, and the causes of, the failure of the Icelandic banks in 2008. To that end, the SIC was given *inter alia* the task of assessing the control of financial activities in Iceland over the past years and reporting methods on such matters between authorities, to the Government and the parliament, Althingi. The SIC examination on possible mistakes and negligence of individuals working within the administration, including officials, has been carried out in conformity with the main mandate of the Commission, which is to outline the main aspects of the events leading to, and the causes of, the banks' failure. In this context, it is necessary to comprehensively examine how the government implemented laws on the regulation and control of financial activities and how it monitored the economic impact of such activities, as well as the impact on the state budget, in light of developments within these fields. The Icelandic authorities mainly involved in this were, on the one hand, the Prime Minister's Office,

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129. Parliamentary record 2008–2009, A-section, p. 1076.

the Ministry of Finance and the Ministry of Business Affairs, and, on the other hand, the CBI and the FME. The relevance of these five administrative authorities also is reflected in the fact that they, in early 2006, collaborated to establish a consultative group on financial stability and contingency planning, which remained active until the banks collapsed.

### 21.5.2 The Terms „Mistake“ and „Negligence“

The terms „mistake“ and „negligence“ are not clearly defined in Act No. 142/2008. Therefore, it is essential for the Commission's final opinions, with view to any possible responsibility of individuals, to define more closely the meaning of the terms „mistake“ and „negligence“. In this context, the SIC has taken view of the following points in carrying out its responsibilities:

Firstly, the Commission has kept in mind, as stated in the commentary pertaining to the bill, which was later adopted as Act no 142/2008, that it was only given the task to give its opinion on whether mistakes or negligence had occurred in the implementation of laws and rules on the regulation and control of the financial activities, and, if so, which individuals could primarily be deemed responsible for such mistakes or negligence. Therefore, the SIC does not wield judicial powers or powers to impose administrative penalties, but solely the task of submitting a report to Althingi covering the issues which were the subject of its investigation.

Secondly, the general meaning of the terms „mistake“ and „negligence“ is wider than simply meaning whether taking action or not taking action constitutes an infringement of the law, to the extent that it may give rise to relevant legal penalties of some sort, be it damages, penal measures or, as the case may be, disciplinary action such as reprimand or dismissal in case of a civil servant. In keeping with this, the commentary pertaining to Article 1 of Act No. 142/2008 states that mistakes and negligence do not only refer to certain actions not fulfilling legal requirements or negligence in following legal provisions. More scenarios can fall under the scope of these terms, such as the incorrect assessment of available information and decision-making based on inadequate assumptions. Further, failure to react appropriately to information regarding an imminent risk could also be regarded as negligence. It is emphasised that these terms were set forth in an independent legislation adopted by Althingi with the SIC investigation especially in mind. Consequently Althingi has, through special legal criteria, established the framework around the SIC's evaluation of the conduct of individuals on the grounds of Article 1(1) of Act No. 142/2008. It cannot be assumed that such criteria is fully comparable to criteria pertaining to other legal rules which may apply to the involvement of individuals in events leading to the collapse of the Icelandic banks.

Thirdly, it must be reiterated that the SIC has been given the task to identify those who are, in its opinion, accountable for any possible mistakes and those who may have been negligent in the course of their work as regards the implementation of laws and rules on the regulation and control of financial activities. In this respect, the investigation's point of view centres on individuals and their involvement in decision-making, as has already been stated in the aforementioned commentary pertaining to Article 1 of Act No. 142/2008. The questions raised here are who made certain decisions or who

should have reacted to available information. These questions will have to be answered both in terms of what actually happened and also with respect to rules on competency. When assessing whether individual public officials made mistakes or were negligent in the course of their work, it must be kept in mind that this does not involve the same criteria in every respect as those provided for in Articles 21, 26 and 38 of the Government Employees Act No. 70/1996, although these overlap to a certain extent. The SIC may have grounds to draw the conclusion that an employee has made a mistake or been negligent although this does not give rise to establishing guilt pursuant to the provisions of Act No. 4/1963 or administrative penalties pursuant to the provisions of Act No 70/1996. By the same token, employees may be in violation of their duties pursuant to these acts even though they have not made mistakes or been negligent in the course of their duties, to the extent that would merit comments by the SIC. Here, as ever, the rules every conscientious official, including ministers, should adhere to in the course of his/her duties are put to the test, even though a particular action is not expressly stipulated by law nor the omission to act prohibited by law.<sup>130</sup>

According to Article 14(4) of Act No. 142/2008, the liability of government ministers shall be governed by the Act on Ministerial Responsibility. It must be underlined that an assessment of the SIC as regards the duties of ministers based on Article 1(1) of Act No. 142/2008 is not of the same nature as an assessment made pursuant to provisions of the Act on Ministerial Responsibility. It will fall to Althingi to determine whether grounds exist to set in motion the special procedure stipulated in Icelandic constitutional provisions to handle issues concerning the legal responsibility of ministers. Notwithstanding the above, it is evident that in assessing whether individual ministers made mistakes or were negligent in the events leading to the collapse of the Icelandic banks, account must be taken, to a certain extent, of the rules on conduct stipulated in Act No. 4/1963 on Ministerial Responsibility, cf. Article 10 of the same Act, cf. discussion in Chapter 16.1.2.6.

In light of the deliberations above, the general conclusion may be drawn that the presentation of the criteria in Article 1(1) of Act No. 142/2008 on mistakes and negligence of individuals and their accountability is such that Althingi has entrusted the SIC with the task of determining, in accordance with the facts discovered during the collection of evidence, whether individuals, who according to law had a recognisable function in implementing laws and rules on the regulation and control of financial activities, adequately ensured that measures were in place to react to the imminent risk of a financial crisis. It is evident that the conclusions of the SIC in this respect are based on an analysis of the course of events revealed by the Commission, of the internal context of such events, and on an evaluation of the information which can be assumed was available at any given time regarding the status and outlook of the financial market in Iceland, and of the Icelandic economy in general.

In assessing which factors, actions or omission of actions in the course of duties of individuals may be regarded as „mistakes“ or „negligence“ within the meaning of the above, the SIC has considered especially which aspects above others had a significant effect for the events leading to the failure of

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130. Cf. Ólafur Jóhannesson: *Stjórnskipunarréttur*, 2. ed. Reykjavík 1976, p. 166 and also Gunnar G. Schram: *Stjórnskipunarréttur*, 2. ed. Reykjavík 1999, p. 174.

the banks, its causes and consequences. In this respect, the SIC emphasises that in its view it cannot be assumed to be a prerequisite for a given conclusion about a man having shown negligence, e.g. regarding public control of financial activities or in policy making in that area, that such actions or measures which the SIC believes should have been initiated can be said to have by themselves sufficed to prevent the banks' failure and the consequent damage for the Icelandic nation. Neither the SIC nor others can claim to have definitively identified a direct causal link between negligence concerning these issues and the financial crisis that hit in the autumn of 2008, nor can they conclusively describe the inter-relation of the concurrent factors leading to it. On the other hand, the SIC is expressly given the task to set forth its view as to whether certain individuals can be held accountable for mistakes or negligence where available information was incorrectly assessed, for taking decisions on insufficient grounds, or for failure to react to information about an imminent risk in an appropriate manner. Regardless of the uncertainties related above the SIC must form a view on how the government directed its preparations in view of the available information and circumstances at any given time. The conclusions of the SIC concerning such aspects are, in principle, based on an analysis of the overview of the chain of events and a description of evidence documentation as detailed in this report. The conclusions are also based on the general opinion of the members of the Commission as to whether certain individuals made mistakes or were negligent, within the meaning above, through their actions and, as the case may be, by omitting to act. In this regard, the evaluation of the SIC is its own and, as such, cannot be undisputed.

### 21.5.3 Further Description Taking Account of Comments Pursuant to Article 13 of Act No. 142/2008

A total of 12 individuals received a letter from the SIC recounting certain aspects, actions or failure to act, which the Commission was considering addressing in its report on the basis of whether or not their actions, or lack thereof, could be constituted as mistakes or negligence within the meaning these terms are given in Article 1(1) in Act No. 142/2008. A list of those individuals is provided in Chapter 23. The letters were based on information from the evidence collected and the statements given before the SIC, which were being processed based on discussion in individual chapters of this report. Such discussion aimed to gather an account as comprehensive as the SIC deemed possible, in light of available evidence and information, about the events leading to, and the causes of, the failure of the banks. Among the issues discussed were numerous matters concerning the performance of government functions and the involvement of said individuals in those matters. The SIC had the responsibility of presenting its opinion on whether mistakes had been made or whether negligence was evident based on the aforementioned provision and individual accountability.

In accordance with Article 13 of Act No. 142/2008, these individuals were given the opportunity to submit their comments in writing before the SIC made its final decision as to whether the relevant actions or failure to act would be regarded as mistakes or negligence pursuant to Article 1(1) of the Act, and also whether the individual in question was responsible pursuant

to that provision. Furthermore, the SIC believed it was appropriate to seek a written response regarding the said issues based on the functions of these individuals in the events leading to the collapse of the banks in October 2008, although the individuals in question had discussed many of those issues in the hearing before the Commission. The SIC also thought it right to give these individuals an opportunity to present their views as to which basis could be used for assessing their own accountability regarding any possible mistakes or negligence within the meaning of Article 1(1) of Act No. 142/2008, and the nature of their duties. The SIC also took this approach because the provisions of Icelandic laws on the functions and responsibilities of ministers and senior officials give a very limited description of these responsibilities. Long-standing practices, such as the procedure regarding reporting and communications between ministers and permanent secretaries within the government offices, were also considered relevant. Before any final decisions regarding accountability for possible mistakes or negligence were made, it was considered important to seek the position of these individuals regarding information provided to ministers by permanent secretaries in these cases.

The 12 individuals, in their response to the SIC, describe their views on their involvement and responsibilities on the issues recounted by the Commission in its letters to them. All these individuals stated that they had not made any mistakes or been negligent within the meaning of Article 1(1) of Act No. 142/2008 in the cases the SIC was examining and described in its letters to them. Moreover, it was repeatedly stated in the replies that other bodies and ministers or officials had the responsibility to carry out or oversee the tasks in question on behalf of the state. Also, in some of the replies, views were expressed concerning facts and applicable legal bases which differed from views previously expressed by these same individuals in the course of the investigation. In light of the above, the SIC has decided to disclose its unabridged letters to the 12 individuals and their responses in Annex 11 in the electronic edition of the report.

In certain cases, the responses or accompanying evidence gave the SIC reason to augment or change the description of the facts previously compiled on the basis of available evidence. Upon receiving the responses, the SIC also reviewed and took a final decision on how the issues it had presented to these individuals in its letters would be presented in the report. Having taken account of the clarifications and information presented in the responses and other evidence available to it, the SIC concluded that part of these issues would only be subject to general discussions in the report and, as the case may be, through the presentation of comments and criticism regarding the way in which the government and, as the case may be, individual employees, had carried out their duties. The SIC concludes that grounds do not exist to determine that mistakes or negligence were committed within the meaning of Article 1(1) of Act No. 142/2008. The SIC addressed these issues in its substantive discussions and in individual conclusions earlier in the report. The substantive discussion below will only cover issues the SIC has concluded should be defined as mistakes or negligence within the meaning of Article 1(1) of Act No. 142/2008, and those who should be held accountable in the opinion of the Commission. However, it should be pointed out that in the introduction to the discussion on ministers, the SIC takes into consideration special considerations concerning the then Minister for Foreign Affairs and

her role in the work of other ministers and government authorities concerning issues which fall under the SIC examination pursuant to Article 1(1) of Act no 142/2008.

The events leading to the collapse of the banks have been described in the chapters above. The letters sent by the SIC pursuant to Article 13 of Act No. 142/2008, referred to above, included a description of the events which the Commission believed were relevant to the issue the individual concerned was given the opportunity to comment on in response to the letters. In the following discussion, the SIC will only outline the main points relevant to each case but will otherwise refer mostly to the content of the chapters above as regards a more a detailed description of events. Furthermore, reference is made to the summaries presented in individual letters as these are disclosed in Annex 11 of the electronic edition of the report. The replies received by the SIC are likewise disclosed in their entirety in the same place. The SIC points to these for further reference as regards the issues covered in the following discussion.

The SIC points out that although certain issues are outlined here on the basis of their significance or used as an example in regard to other related aspects, the Commission otherwise refers to its summaries elsewhere in the report. It should be reiterated that a more comprehensive account of the course of events, the significance of events, and their context, can only be obtained by acquainting oneself with individual issues where these are dealt with in more detail than is possible here. Further, it is pointed out that a detailed chronological synopsis of the course of events from 1 January 2007 to 25 September 2008 is presented in Chapter 19. There, a general account is given of the principal information collected by the SIC concerning the course of events, and the sub-chapters deal specifically with most of the subject matters further examined here with a view to the provisions of Article 1(1) of Act No. 142/2008. Amongst other things, detailed reference is made to statements given before the SIC by those who are most closely involved on behalf of the government and private parties. Previous discussion in Chapter 21 outlines the performance of the functions of the government in the events leading to the collapse of the Icelandic banks and also entails further conclusions by the SIC concerning specific aspects.

## 21.5.4 Ministers

### *21.5.4.1 Legal Position of Ministers and Actual Access to Information*

The SIC examination indicates that, as regards the internal functioning of the ruling Government in the period preceding the collapse of the banks, the flow of information and communications on economic affairs, including matters concerning the Icelandic banks in critical periods, were largely limited to a small group of ministers. These were, on the one hand, Prime Minister Haarde and Finance Minister Mathiesen, and on the other hand, Foreign Minister Gísladóttir, leader of the Social Democratic Alliance. A distinction has to be made between ministers that have direct obligations and responsibility for financial market and/or economic affairs through their ministerial functions, such as Mr. Haarde and Mr. Mathiesen, and ministers involved principally through their political position within the Government and not their legal position as a minister, such as Ms. Gísladóttir.

Pursuant to the division of functions within the government at that time, the Ministry for Foreign Affairs did not exercise independent powers in regard to the implementation of laws and rules on the regulation and control of financial activities in Iceland. However, the duties of the Foreign Minister may have had relevance in some cases with reference to consultations and exchange of information on economic affairs in a broader context within this group, as well as with other public bodies. The ministry and the foreign service could e.g. have been involved in communications with foreign parties, both authorities and private parties, because of the financial activities of Icelandic companies abroad, and the impact of such activities on Icelandic interests abroad, and in relations with other countries. For reference, it is pointed out that government actions in areas under the responsibility of the foreign service in the period preceding the collapse of the banks is criticised in other parts of the report, cf. Chapter 20.4.2. Furthermore, it has been established that Ms. Gísladóttir participated as Foreign Minister in a public relations campaign, which was supported by the Icelandic authorities, to improve the public image of the banking system, cf. for example the Conference of Ambassadors hosted by the Minister for Foreign Affairs on 22 February, and the Foreign Minister's address at the Conference. This issue is discussed in more detail in Chapter 19.3. In chapter 21, the SIC criticises the emphasis the government placed on such issues at that point in time.

All things considered, the SIC believes it is clear that the involvement of Ms. Gísladóttir in regard to the issues under discussion here, cf. in particular Chapter 21.5.4.2 below, was first and foremost based on the political premise that she was the leader of one of the coalition parties, the Social Democratic Alliance, and that she could on the basis of the information obtained at these meetings decide whether there was cause to take further action at Government level on behalf of her party and/or vis-à-vis the ministers concerned. To the extent that the performing of duties by individuals of this group are put to scrutiny here, with regard to issues concerning mistakes or negligence within the meaning of Article 1(1) of Act No. 142/2008, there are not sufficient grounds, in the opinion of the SIC, to further investigate Ms. Gísladóttir's performance of her duties as Foreign Minister.

It has been established that the flow of information and communications on economic affairs and the affairs of the banks within the Government, including participation and consultation with other governmental authorities, was to a degree characterised by the fact that the Minister of Business Affairs, who was responsible for matters concerning the financial market and thereby the affairs of the Icelandic banks, was not always involved. This was true inter alia in regard to meetings with officials, including the Board of Governors of the CBI, where important issues concerning the banks were discussed amongst other things, cf. Chapter 21.5.4.2 below. Also, the Minister of Business Affairs was not consulted directly when the authorities determined their response to the request for financial facilitation submitted by Glitnir Bank hf. to the CBI during the weekend of 27-28 September 2008. The SIC expresses its opinion concerning this situation within the Government in other parts of the report, cf. Chapter 21.4.2 and Chapters 21.3.4 and 20.2.7, but does not see grounds to discuss this in the context of this Chapter, i.e. with regard to the provisions of Article 1(1) of Act No. 142/2008. Nonetheless, this may in some instances lead to it being necessary

to view the Minister of Business Affairs' access to information in the events leading to the collapse of the banks in a different light than in the instance of the Prime Minister and Minister of Finance, at least during certain periods, and thereby it being necessary to subject the opportunities the Minister of Business Affairs had to react to a special valuation in some cases.

In his response to the letter from the SIC, sent pursuant to Article 13 of Act No. 14272008, Finance Minister Mathiesen expressed his opinion that the wording of Article 1(1) of Act No. 142/2008, with respect to most of the issues addressed in the letter, would have to be interpreted in such a manner that the examination of the SIC did not apply to the functions of the Finance Minister. In this context, the SIC points out that pursuant to the then existing provisions of Regulation No 177/2007 on Icelandic Government Ministries, cf. former Regulation 3/2004, the Ministry of Finance was responsible *inter alia* for the financial affairs and assets of the state inasmuch as these have not been reposed to other bodies, as well as in regard to producing assessments of developments and future prospects in economic affairs. In addition, the SIC draws attention to the fact that the Ministry of Finance was one of three ministries, along with the Prime Minister's Office and the Ministry of Business Affairs, that agreed to establish a government consultative group on financial stability and preparedness, and that it was from the onset a participant in its functions in an equal measure to the other ministries. It must be assumed that this participation was based on the fact that the aforementioned roles of the Ministry had a bearing on the tasks entrusted to the consultative group. Views expressed in Mr. Mathiesen's letter point in the same direction, for example where it is stated: „The participation of the Ministry of Finance [in the government consultative group] was *i.a.* based on the fact that the Ministry is responsible for government financial affairs, which would be affected by consequences and reactions from events in the financial system.“ With further reference to the discussions in Chapter 21.5.1 and 21.5.2 above, which covers the framework for the examination of the SIC and its basis for assessment in that respect, the SIC maintains that it is beyond any doubt that the responsibilities of the Ministry of Finance relevant in this context fall within the framework of the provisions of Article 1(1) of Act No. 142/2008 governing the SIC examination. Views concerning the difference in importance of the roles of the three ministries in relation to each other in this respect can not alter this conclusion in the opinion of the SIC, but may, under certain circumstances, be significant when it comes to assessing the accountability of the Finance Minister.

In assessing, on the one hand, the information or circumstances it believes ministers had been or should have been aware of, and, on the other hand, the initiative or reaction that could have been expected in this regard, the SIC first of all looks to their position within the government and their respective areas of responsibility according to applicable laws at that time. Based on that position, the SIC believes that individual ministers were or should have been aware of the situation and the development of matters falling under their respective areas of responsibility. The SIC further states that in its opinion the minister and the relevant ministry were obligated, pursuant to constitutional law, to maintain general surveillance of developments in areas under their responsibility with the view of determining whether the Ministry should intervene on the basis of applicable legal rules and, where applicable, to take the initiative

regarding suggestions for amendments to laws and/or government review of the case as an important issue for the government, cf. Article 2(1) of Act No. 73/1969 on the Icelandic Government Ministries, and the provisions of Article 17 of the Constitution of the Republic of Iceland. In other respects, general reference is made to discussions in Chapters 16.1.2.3-16.1.2.5 concerning the ministries relevant in this case, i.e. the Prime Minister's Office, the Ministry of Finance and the Ministry of Business Affairs. A general overview is presented in Chapter 16.1.2.6 on the administrative and supervisory powers of ministers as well as the obligation to take initiatives under certain circumstances. As a rule, reference is made to the aforementioned discussion. It should be reiterated that the SIC generally uses these rules of law and points of view as the basis for its assessment and conclusions in this Chapter, without necessarily referring to them in each instance.

Secondly, the SIC looks to specific events applicable in each case, i.e. meetings or consultations with other authorities and the information presented, consultations with foreign bodies and other specific information or evidence, which, based on the SIC examination, appear to have been available in the period preceding the collapse of the banks.

Thirdly, the SIC considers information presented within the government consultative group, the participants of which were inter alia the permanent secretaries of the Prime Minister's Office, Ministry of Finance and the Ministry of Business Affairs, acting as special representatives of the ministers concerned for tasks entrusted to the group. Due to this structure of the group's work, the SIC deems it appropriate to recount especially the evidence in its possession concerning the dissemination of information to ministers about the work carried out by the group at any given time, and its position on aspects relevant to this.

Article 10 of Act No. 73/1969 on the Icelandic Government Ministries states that permanent secretaries run the ministries under the authority of the minister. However, it can be inferred from Article 14 of Constitution that the minister is responsible for all government actions. This is based on the premise that ministers oversee the issues falling under their areas of responsibility. Therefore, the minister carries the ultimate responsibility for the work carried out within his/her ministry, and, thereby, for the application of the ministry's administrative and supervisory powers. It is evident that the constitutional system and administrative practice in Iceland does not assume that the duties of permanent secretaries as officials vis-à-vis the minister should, as a rule, go beyond providing the current minister with professional advice and assistance in urgent governmental issues under deliberation in the ministry. For this reason, the permanent secretary should ensure that the minister is at all times informed concerning the communications and information he/she becomes aware of in the course of his/her work as the representative of the ministry, thus enabling the minister to make informed decisions in his/her political policy-making role.

The information and evidence described above in this report reveal that the permanent secretaries of the aforementioned ministries were in various ways involved as representatives of their respective ministries in tasks and events relevant to the collapse of the banks in the autumn of 2008. In the statements made by the permanent secretaries and ministers concerned in the hearing before the SIC, the Commission was especially seeking answers

on how information concerning the progress at any given time in the work of the government consultative group on financial stability and preparedness was disseminated to the ministers by the permanent secretaries, and how the opinion of the minister was sought concerning the proposals formulated within the consultative group as regards the preparation of a contingency plan in case of a financial crisis and any related proposals. Chapter 19.4.2 describes the answers provided in the hearing concerning the dissemination of information from the meetings of the consultative group to the ministers. The answers provided do not indicate clearly how much information the ministers received, although they acknowledged having discussed these meetings with the permanent secretaries. During hearings, it was further revealed that the ministers had in general not been presented with the information and proposals submitted at the meetings of the consultative group, such as about the preparation of a contingency plan.

Therefore, the SIC considered it appropriate, in the letters it sent pursuant to Article 13 of Act No. 142/2008 to the former permanent secretaries of the Prime Minister's Office, the Ministry of Finance, and the acting permanent secretary of the Minister of Business Affairs, during the period from the middle of December 2007 to the end of July 2008, and the former Prime Minister, Minister of Finance and the Minister of Business Affairs, to provide these individuals with an opportunity to explain further how the permanent secretaries disseminated information to the ministers concerning their work in the consultative group. In the replies enclosed in Annex 11 in the electronic edition of the report, the then permanent secretaries of the Prime Minister's Office and the Ministry of Finance, and the acting permanent secretary of the Ministry of Business Affairs, in the period from the middle of December 2007 to the end of July 2008, emphasised that they did provide the ministers with adequate information on topics under discussion at any given time in the consultative group.

As far as can be inferred from the responses of the relevant ministers in office at the time, they acknowledge that they received adequate information from the permanent secretaries through verbal communication, to be familiar with the tasks the consultative group was occupied with at any given time. Consequently, the SIC is of the opinion that they were in a position to be aware of if there was any cause for them as ministers, in regard to issues falling under their respective responsibilities, to initiate further collection of information or seek closer involvement in the tasks carried out by the consultative group, including vis-à-vis other ministers and agencies represented in the consultative group. In accordance with constitutional principles concerning the administrative and supervisory powers of ministers, the SIC believes that the responsibility for initiating requests for further evidence, information or advice from the permanent secretary, or, as the case may be, other officials of ministries or external experts, lies first and foremost with the minister if he/she finds that he/she does not have sufficient grounds to take informed decisions on policy issues in the work he/she is constitutionally responsible for. Inferring from the discussion above, the SIC does not see further cause to examine in more detail the activities of the said permanent secretaries, as regards the provision of information to the ministers concerning the work of the consultative group, with regard to the provisions of Article 1(1) of Act No 142/2008.

Regarding the treatment of the subject matter in what follows it should be added that chapters 21.5.4.2-21.5.4.5 should be viewed within the same context. Chapter 21.5.4.6 deals with issues which are somewhat unique in nature and therefore, to a degree, stands separate from other chapters. In chapter 21.5.4.7, the SIC presents its assessment and conclusions based on the chapters above. It is reiterated that the assessment of the SIC is based on Chapters 21.5.4.2-21.5.4.6 in their entirety insofar as it applies to individual ministers and not sub-divided relating to isolated events and issues dealt with in these chapters. The final assessment of the SIC is therefore general in nature and not specific, i.e. based on particular incidents.

#### *21.5.4.2 Ministerial Initiative and Response in General in Light of Alarming Information about the Standing of the Banks and the Prospects of the Icelandic Economy*

During the first months of 2008 and until spring 2008, very alarming information was communicated to the Icelandic authorities about the standing of the Icelandic banks and their prospects, and thereby the outlook of the Icelandic economy. On 7 February 2008, the Board of Governors of the CBI met with Prime Minister Haarde, Foreign Minister Gísladóttir and Finance Minister Mathiesen. The meeting was also attended by the Permanent Secretary to the Prime Minister's Office and the Director of the Financial Stability Department of the CBI. The occasion for the meeting was information which Mr. Davíð Oddsson, the Chairman of the Board of Governors, felt urgent need to communicate to the ministers. Governor Oddsson and an employee of the CBI had just returned to Iceland from meetings in London with representatives of banks and credit-rating agencies in the days before. During the meeting with the ministers, Governor Oddsson read out from handwritten notations he had compiled about the meetings and the viewpoints of the foreign parties on the standing of the Icelandic banks and the prognosis for their operations. His words reflected great concerns about the Icelandic banks and the critical situation they were in. In the view of the SIC, there were clear grounds to take this information particularly seriously in view of the future prospects for the Icelandic economy. A few days later, Governor Oddsson's handwritten notations were transcribed into a memorandum in the CBI. Further consideration regarding the meeting is to be found in Chapter 19.3.5 along with the memorandum in question and draft minutes written by an employee of the CBI. Both data and information gathered from the Commission's hearings is by and large in agreement as relates to the content of the information presented and discussions at the meeting of 7 February 2008, and do not give grounds to conclude otherwise than that the aforementioned chapter gives an accurate description of both.

It has been established that the CBI did not present formal proposals on how to respond to the problems described by the chairman of the Board of Governors. The draft minutes show, however, that during the course of the meeting possible responses, based on the information made available, were discussed. Besides the discussion about the situation and possible responses to it during the above-mentioned meeting, an investigation by the SIC has not revealed that the issue was taken into formal consideration or acted on during meetings of ministers or the government. Furthermore, there is no indication that requests were made to the appropriate administrative bodies, for

example the CBI, to process further or assess the information communicated at the time about the serious situation of the banks and the decidedly urgent problems in their operations.

In the case of Prime Minister Haarde, a mention should also be made of five events from 1 April to 15 May 2008 where information was communicated regarding subject matter similar to that of the meeting on 7 February 2008. The events were: (1) A meeting between the Prime Minister, the Foreign Minister and the Board of Governors of the CBI where they discussed a £193 million outflow from the Icesave accounts in the UK branch of Landsbanki Íslands hf. in the days before and the expectation that Landsbanki could withstand such an outflow for six days. (2) A report by the International Monetary Fund published on 14 April 2008. The report was classified as strictly confidential. Its summarised conclusions included detailed proposals to the Icelandic authorities on measures to address critical circumstances in the nation's economy. (3) A phone call made by the chairman of the Board of Governors of the CBI to Prime Minister Haarde on 23 April 2008 where it was disclosed that the Bank of England had declined to grant a „ facility “ to the CBI, i.e. declined to make a currency swap arrangement with the bank and that criticisms had been made by the Bank of England about the activities of the Icelandic banks. The governor is also reported to have mentioned, during the same phone conversation, information regarding negative perceptions of Iceland held by European central bank governors. (4) A phone call by the Chairman of the Board of Governors of the CBI to Prime Minister Haarde on 25 April 2008 where he is informed of a conversation between the former and the President of the European Central Bank, in which the president harshly criticised repurchase transactions between the Icelandic banks and the Banque centrale du Luxembourg, and of his demand for a meeting to discuss the issue with the heads of the banks, the CBI and the FME. (5) Events surrounding a currency swap agreement between the CBI and the central banks of Denmark, Norway and Sweden in May 2008 and a special written statement by the government from 15 May 2008, which was demanded by the central banks in question as a precondition for an agreement. The statement provided i.a. specific measures by the government, the CBI and the FME, including that pressure would be put on the Icelandic banks to shrink their balance sheets, in view of proposals made by the IMF. The foreign central bank governors demanded a written statement based on their evaluation that the Icelandic banks would have to be made smaller fast, as the banking sector was too big for the Icelandic state and the CBI to be able to cope with assisting them should they run into difficulties. See further details on these points in Chapter 19 and on the declaration by the Government of Iceland from 15 May 2008 in Chapter 4.

In the case of Finance Minister Mathiesen, he and the Foreign Minister had meetings with the CBI Board of Governors on 16 April 2008, and he and the Prime Minister and the Foreign Minister met with the Board on 7 May and 15 May of the same year. According to SIC data, borrowing by the CBI on behalf of the Treasury in order to strengthen the foreign currency reserves was discussed in the meetings on 16 April and 7 May 2008, including demands for particular priorities and conditions which had been presented to the Icelandic authorities in this context, taking account of the IMF report from 14 April 2008 and the declaration by the Icelandic government on 15

May 2008. The reason for the meeting on May 15 2008 was to finalise the above-mentioned declaration in which the government stated that it would work towards specific measures to meet the conditions in question.

It is noteworthy that the Minister of Business Affairs Sigurðsson was not present during the meetings with the CBI Board of Governors mentioned above. On the other hand, it has been demonstrated before the SIC that Foreign Minister Gísladóttir informed Minister Sigurðsson of the meeting with the Board of Governors of the CBI on 7 February 2008, which she attended along with other ministers, and broadly delineated its subject matter during a Social Democratic Alliance parliamentary group meeting on 11 February 2008.

An examination by the Commission did not indicate that the Prime Minister or the Finance Minister had deemed that information revealed at their meeting with the CBI Board of Governors on 7 February 2008 or information from the specified additional meetings or conversations they had separately with the Board of Governors, described here above, gave occasion for taking specific action as far as the affairs of the banks were concerned in areas under their respective positions of authority. In addition, there is no indication that the ministers sought to take the initiative in having other governmental bodies take action. Nothing indicates that the additional incidents which took place after the meeting on 7 February 2008 were discussed at government meetings, or that the CBI was asked to analyse the problem further and take action or suggest proposals for action to be taken. In the case of the Prime Minister, the report by the International Monetary Fund from 14 April 2008 should be taken into consideration, as well as events surrounding the statement by the government on May 15 2008 for the Danish, Norwegian and Swedish central banks, both mentioned earlier.

In light of what has been recounted above, the SIC has made special note of the presumed significance of the meeting on 7 February 2008 between the Prime Minister, the Finance Minister and the Foreign Minister and the Board of Governors of the CBI. The Commission recalls in particular (1) that the CBI, cf. its function with regard to economic policy objectives in Iceland, saw reason to request at short notice a formal meeting with the aforementioned ministers to communicate information as soon as it became available and (2) the serious content of that information regarding the situation and the prospects of the Icelandic banks and, as a result, the Icelandic economy. It is also significant in itself that as far as the SIC can see ministers did not, at any other previous point in time in a comparable situation, receive information on the whole as serious as in this case. In this respect it must however be reiterated that, as set out in Chapter 19.3, the Commission does not have information about what took place during two previous meetings between the Prime Minister and the Board of Governors at the CBI on 26 September and 20 December 2007.

It seems clear to the SIC that irrespective of the presentation or format of the information the chairman of the Board of Governors of the CBI made known to the Prime Minister and two other ministers during the aforementioned meeting on 7 February 2008, the information in question concerned the very serious situation that the Icelandic banking system was facing, which could significantly influence the development of the economy in Iceland. As can be seen in Chapter 21.5.4.5 below, it is the opinion of the SIC that it

must be assumed, taking into account that ministers are entrusted with protecting public interest, that the banking system which was oversized relative to the Icelandic economy, and the associated risks for the whole Icelandic economy should the banks run into difficulties, constituted a particularly urgent risk considering the situation evident to the ministers at the time. The position and role of minister carries an obligation to take specific action in order to secure public interest to the extent possible, if necessary, and to place those interests above the vested interests of the private undertakings in question, should the need arise. At that point, the government's role was not least to minimize the damage which might result from an impending financial collapse

Hearings by the Commission and comments submitted pursuant to Article 13 of Act No. 142/2008 indicate that once the meeting concluded the ministers expected a written memorandum, and as the case might be, proposals from the CBI. However, the Board of Governors had believed that the matter had been sufficiently outlined and that there was no need for further written disclosure. The Chairman of the Board of Governors of the CBI maintains, however, that he contacted the Prime Minister after a while and asked what he intended to do. The Prime Minister had said that he had spoken to the „bank directors“ and that their replies had pointed in a different direction than the information from the CBI. The SIC points out that if there was any doubt as to where the initiative for the next actions should come from, the ministers in question always had the option to request, or require, a written memorandum with proposals, as the case might be, from the CBI on actions to be taken in view of the information disclosed during the meeting. This applies in particular to the Prime Minister since the CBI was under the administration of the Prime Minister.

In comments pursuant to Article 13 of Act No. 142/2008 on this point received by the Commission, it was pointed out i.a. that the Board of Governors of the CBI is by law required to monitor the stability and the safety of the financial system. The SIC reiterates in this context that in view of this particular function, it is evident, in light of the special circumstances regarding the meeting outlined earlier, that the Board of Governors found the situation serious enough to feel that knowledge of it should not remain solely within the CBI itself. The statutory function of the CBI with regard to economic affairs and the monitoring of the financial market does not relieve ministers, who themselves have obligations in those fields, of their duty to initiate reactions, in cooperation with the CBI as the case may be, if they become aware of information of the kind in question here. The same reasons apply to the subsequent meetings that individual ministers had with the CBI and have already been mentioned.

The Commission also received comments to the effect that the CBI was the most obvious institution to for verify the information disclosed during the meeting between the ministers and the Board of Governors on 7 February 2008. It was considered inappropriate to expect an authority to verify its own information. The Commission reiterates in this context that ministers, cf. in particular the Prime Minister, had the option to submit a request to the CBI for a written memorandum, as well as proposals for measures on the basis of the information disclosed verbally during the meeting. To the extent possible within the administration, the information in question would thereby have

been verified, i.e. re-evaluated formally and investigated during an independent assessment within the CBI. In this respect it is not relevant whether they originated from within the bank itself or from another party.

In comments, pursuant to Article 13 of Act No. 142/2008, from the then Prime Minister, Mr. Geir. H. Haarde several tasks which were in process in the first half of 2008 in different ministries and government bodies were pointed out and described further. This included a description of measures by public bodies to strengthen the position of the banks and the national economy at the time, were listed. The comments also listed preparations by the Ministry of Finance and the CBI for borrowing on behalf of the Treasury in foreign markets and for swap agreements were also named i.a. in the comments. It was also pointed out that the Prime Minister had met with senior officials from the European Union and tried to pave the way for Iceland to join the EU's cross-border cooperation programme to secure economic stability. The government's efforts abroad to communicate information about the Icelandic financial system, were also mentioned, as it was believed that „misunderstanding regarding the Icelandic economy and financial system was widespread.“ Comments from the former prime minister also showed that the government's consultative group had been working on a contingency plan. It also emerged that „considerable pressure had been exerted“ on the banks to wind down their portfolios by selling assets, and that the possibility of one of them moving its headquarters abroad had been brought up in communications between the Prime Minister's Office and the CBI.

As far as these measures are concerned, the SIC notes that it can hardly be said that such a measure, i.e. borrowing on behalf of the Treasury in foreign markets and currency swap agreements irrespective of its merits, was conducive to tackling the problem directly, i.e. the size of the banking system. In any case, such measures alone could never suffice to unravel the inherent difficulties of a banking system this size. Joining the EU mechanism for financial stability had been a goal of the Icelandic authorities for some time. The process was delayed by the EU and was still ongoing when the Icelandic banks collapsed. The SIC points out, that signing up to an international cooperation of such kind, would not necessarily be considered a measure advantageous to dealing with the urgent crisis in the Icelandic economy, which was evident at the time. It applies even less so to public relations efforts with respect to foreign parties, which the Icelandic authorities promoted on behalf of the Icelandic banking system. In the SIC's findings about the work of the government's consultative group in Chapter 19 it was revealed, that the government had, at no point in time, formally submitted to the consultative group the task of preparing a contingency plan. To the extent that the group went ahead on its own initiative, which, on closer scrutiny, proved controversial among the group members, the SIC's data and information can suggest no other conclusion than that the work in question was unfocused. In any case, it has been demonstrated that no comprehensive contingency plan manifested as a result of the group's work and no such plan was available when the banks collapsed, cf. further discussion in Chapter 21.5.4.3 below.

Finally, in the comments made by the Prime Minister it was asserted that at that significant pressure had been put on the banks themselves to take action which could shrink the banking sector. For this reason the Commission notes that according to its data and information all such efforts by ministers

were informal. No data or further information is available as to if and how it was organised or coordinated by the ministers in question. Therefore, the Commission believes that there is nothing to demonstrate that „considerable pressure“ was placed on the banks in this respect. It is also pointed out that according to draft minutes of the meeting from 7 February 2008, referred to earlier, the ministers present and the Board of Governors of the CBI discussed various responses based the information made available, including whether structural adjustment of the banking sector could be an option. As said before, the SIC’s examination has not determined that the ministers present during this meeting, or any other meetings discussed earlier, initiated the preparation of specific interventions or any other measures by the government to solve this unique problem. The case for taking action became progressively urgent as time went by. Obviously, informal discussion was not sufficient on its own. Further action needed to be taken. Clarification of points relating to initiative by ministers to shrink the banking system is found in Chapter 21.5.4.4 below.

As regards the meeting on 7 February 2008 the SIC likewise received comments pursuant to Article 13 of Act No. 142/2008. Firstly, that the official statements by the CBI Board of Governors had not in all cases been consistent in substance with the message conveyed by the bank to other governmental bodies during private meetings. For example, reference has been made to a report from the CBI on financial stability on 8 May 2008, where the bank outlined a scenario regarding the standing of the banks which differed from the negative information the bank had disclosed to ministers, i.a. in the meeting on 7 February 2008. Secondly, reference was made to how detailed measures by the CBI had generally been in line with the former extending facilities to the banks or lifting restrictions on their operations, and had not indicated that the CBI was as anxious about their position as information provided in private meetings with ministers had demonstrated. Similar views emerged concerning communications between ministers and the director of the FME, i.e. that information from the director to ministers, or official statements by him which the ministers were aware of, had not indicated that the FME was particularly concerned about the banks’ situation.

In this regard the Commission points out that based on their capacity, ministers were independently informed of the serious information from the CBI in the meetings detailed above. Therefore, they had repeatedly received more detailed information about the problems at hand, than were to be deduced from public and general reporting by the CBI, in published reports or on other occasions. How the CBI conducted its public disclosures and announcements, could not constitute justifiable cause for ministers to doubt information disclosed to them directly by the bank. Secondly, the Commission points out that it has, in its report, also examined and commented on the actions and individual measures taken by government bodies, as well as ministers, including the CBI and the FME. Taking into account the information which had been communicated to the ministers, cf. deliberations above, measures by other authorities, before the collapse of the Icelandic banks, irrespective if they were detrimental or not, can not relieve ministers from their own accountability, in this respect. In any case, it can not be overlooked that if ministers considered information communicated to them by the CBI otherwise inconsistent with statements or measures by the bank,

they were simply obliged to request clarification. This applies in particular to the Prime Minister, in view of his authority with respect to the CBI. There is no indication that any such action was taken.

#### *21.5.4.3 Further on the Response and Initiative of Ministers in Light of the Work of the Government Consultative Group*

The consultative group of the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME and the CBI was established in an agreement between those parties on 21 February 2006. The group's role was defined in the agreement as a „platform for exchange of information and dialogue“. It was to function in an „advisory capacity and was not to decide on action“. According to the agreement, the group was not given the task to draft a proposal for a joint government contingency plan. However, it was the understanding of many who gave statements before the SIC, including individuals who were members of the group, that this task had been a part of the group's mandate. Thus, there seems to have been a discrepancy between how the group's mandate had been delineated in the agreement and how those involved experienced its execution. This had the effect i.a. that the group's work was unfocused and its duties and responsibilities were unclear.

Discussions about a contingency plan within the government consultative group seem to have been initiated especially by a group member appointed by the CBI. There is nothing to indicate that a contingency plan was a particular focal point in the group's work until in a meeting on 18 March 2008. Although the plan was discussed to some extent during subsequent meetings, no particular plans or measures were made and eventually there was no discussion of the subject from the end of April to the end of May. The meetings during the summer of 2008 also indicate that a certain inner conflict had emerged in the group's activity, which had an effect on its work. The CBI and the FME had made requests regarding policy making, in a meeting on 7 July where a discussion of such issues was initiated by a member appointed by the CBI. Members appointed by the Prime Minister's Office and the Ministry of Finance downplayed such ideas and considered them untimely. The consultative group wound up placing its main focus on completing a draft bill to fall back on in the event of a financial shock. Other aspects of a contingency plan were not focused on during the group's work. As it turned out, no such plan had been accomplished by the group when the banks collapsed. The group's efforts were also not able to produce a comprehensive draft bill in the fashion described previously. The Commission can make no other conclusion than that the supervision of the group lacked both discipline and organisation. Further conclusions by the Commission are set out in Chapter 19.4.4, regarding its opinion of what it believes necessary to refer to as inadequate working methods, during important work on behalf of the administrative authorities, which bore the brunt as far as the financial markets and the economy are concerned.

Chapter 19.3 outlines i.a. meetings by the consultative group in the period from 1 January 2007 to 25 September 2008, cf. in particular the latter half of that period. It provides a picture of the information and data which was communicated within the group, and one might say that similar to the development in general at the time, the information in question became

progressively more serious as regards the economic situation in Iceland and the prognosis for the economy.

As related further in Chapter 21.5.4.1, existing evidence and information collated by the Commission does not give rise to any other interpretation than that the information on the progress of the group's work was communicated to the ministers represented in the consultative group. And that the information was, generally speaking, sufficient to enable them to become aware of which tasks were being carried out within the group at any given time. Accordingly, it can only be concluded that it was ultimately the responsibility of the ministers to initiate, on the one hand, a response to information communicated within the group, or else request more explicit information from their representatives in the group, and, on the other hand, to mould the group's work through his representatives and react, as the case might be, to any shortcomings in its work.

It must be kept in mind in regard to the efforts of the consultative group, irrespective of its legal position and role, that the governmental authorities behind it had established the group on the basis of a special agreement and entrusted it with certain tasks pertaining to financial stability and preparedness. That measure, however, does not entail, firstly, that the said authorities had transferred any obligations or powers to the group in a legal sense. These remained pursuant to laws with the authorities themselves, including the Prime Minister's Office, the Ministry of Finance, and the Ministry of Business Affairs. Secondly, this measure by the ministries, to channel the tasks in question to a non-statutory consultative group entailed that ministers had a special obligation to ensure that this arrangement would not curb any efforts to further these tasks.

In this case, the situation was that separate surveillance authorities, the CBI and the FME, brought information and proposals on necessary actions and the preparation of a contingency plan to the consultative group. In order to channel those issues appropriately, policy-making and decision-making by the relevant ministers was needed. The same holds true for the proposals submitted to the consultative group and prepared by the Ministry of Business Affairs on whether the state should and was able to authorise a state guarantee on deposits in credit institutions to a certain limit. The handling of that matter would also have consequences in regard to the obligations of the Depositors' and Investors' Guarantee Fund.

No evidence or information has been brought to the attention of the Commission as to whether ministers represented on the consultative committee had discussed the efforts of the consultative group within the government or amongst themselves, or followed through on actions requiring political policy-making, which had been requested or brought up during the group's meetings. Nonetheless, it should be pointed out that the in the case of the Minister of Business Affairs, the Commission is aware of his attempted initiative within the government on 12 August 2008, cf. for example discussion in Chapter 19.3. Up until that time, however, there is nothing to indicate that he, not more than any other ministers involved in the consultative group, had reacted by taking the measures available to each of them, despite the information available within their respective ministries, including from the consultative group, concerning the serious situation that had emerged in the operations of the financial institutions and the risk of a financial shock.

Furthermore, there is no indication that the ministers represented on the consultative group had consulted each other on whether there was cause to direct the work of the consultative group more effectively, both within the group and by the ministers through their representatives in the group, and whether it was appropriate to change the agenda of the group. In addition, the Commission believes that special attention must be paid to the fact that according to the agreement of 21 February 2006, the Prime Minister was responsible for appointing the chairman of the group and that individual directed the work of the group.

#### *21.5.4.4 Incomplete Analysis on the Financial Risks of the State due to Operations of the Banks*

According to answers provided by the Prime Minister's Office, the Ministry of Finance and the Ministry of Business Affairs to SIC's queries, these ministries between the years 2007 and 2008 and until the collapse of the banks did not perform any assessments or other formal evaluations of the possible risks facing the Icelandic state and its Treasury because of domestic or foreign operations of the banks, or individual factors of their operations. In that respect one should keep in mind that, on the one hand, the magnitude of their operations in proportion to the small scale of the Icelandic economy should have been kept in mind, and, on the other hand, the possible changes or the changes already made to the operating environment and procedures of the banks, e.g. the establishment of deposit accounts in branches abroad and increased deposits due to their operations.

Nonetheless, Icelandic ministers made public proclamations concerning the banks that the State „had their back“ or similar statements with comparable wording. It does not seem that such statements were based on calculations which could have supported an assessment of whether the state had the capacity to provide such support and to what degree. Nothing seems to indicate either, that individual ministers, in particular the Prime Minister, the Minister of Business Affairs and the Minister of Finance had required that a professional assessment to be made concerning whether and, where applicable, to what extent, the Treasury had the capacity to financially back up one or more of the Icelandic banks, before any policy was adopted with regard to what kind of public statements would be sensible and justified regarding these matters. By the same token, it does not seem that the government, in particular the aforesaid three ministers, made any assessment of the financial risks and implications that might ensue from the CBI's increased collateralised loan transactions with the Icelandic financial corporations and the increased obligations of the Depositors' and Investors' Guarantee Fund of Iceland for the State's finances and general economic administration in the country. Cf. further discussion in Chapters 19.5.2 and -19.5.4. In Chapter 19.5.3 the above-mentioned declarations of ministers in support of the banks are discussed. It is evident, with reference to deliberations in the Chapter above, that such declarations were with such frequency by the ministers in the media or on public occasions that they can be regarded as common knowledge. Examples of individual declarations made by ministers are to be found in Chapter 19.3. The SIC's examination reveals that the above-mentioned declarations by ministers were given in order to bolster confidence in the Icelandic financial system, and therefore they were given for political reasons. The wording of the

declarations was open for interpretation and it was not anticipated that they would be put to the test by the collapse of all of the three major banks, rather it was thought that only one of them or two at the most would collapse. It is unclear if, and to what extent, the government generally considered the premises for such declarations much further.

According to what is known about information flows to the Prime Minister, the Minister of Finance and the Minister of Business Affairs from their representatives in the government consultative group on financial stability and contingency planning, cf. last chapter, the SIC believes that it must be assumed that these same ministers were, or should have been, aware of the need for their own initiative in obtaining an analysis of the financial risks of the Icelandic State and the Treasury due to domestic or foreign operations of the banks, or individual aspects of their operations. Reference is made to Chapter 19.3 for a list of individual meetings of the consultative group from 1 January 2007 to 25 September 2008, and to Chapter 19.4 regarding further discussion of the SIC concerning the group's activities. Among other things, it is pointed out that at a meeting of the government consultative group held on 21 April 2008, a document, prepared by the FME and the CBI, under the heading: „Scenario of a Financial Crisis - Matter of Opinion, workable Measures and Conditions “ was submitted. In this document, views were expressed which gave cause for an estimate to be made concerning the cost of a possible financial shock and a governmental contingency plan, and what means were available to meet such costs. With regard to the Prime Minister and the Minister of Finance, it is appropriate to mention the meetings which they attended between February and the spring of 2008 with the Board of Governors of the CBI, cf. discussion in the last chapter, and other incidents which are described there from the time of their involvement, as well as various information concerning the serious situation of the banks which came to light in various context.

In the comments according to Article 13 of Act no. 142/2008, submitted to the Commission for this reason, a reference was made to the fact that it had been difficult to get an overall picture of the risk that the State could be facing due to fluctuations in the banks' portfolio. In this regard the SIC would like to state that uncertainty was inevitably present concerning various issues regarding the position and assets of the banks, and the future progress of their affairs. However, this did not prevent a risk analysis from being conducted. This analysis could easily have been put forth in a detailed manner with regard to the uncertainty that could not be avoided regarding e.g. economic factors and possible, different courses of events. It is routine in the field of financial affairs and economics for an analysis of this kind to be conducted in such a manner. It should also be pointed out that the uncertainty was in no way absolute, and all the financial and legal issues regarding the banks were not so unclear that such an analysis would not have served its purpose. As time went by and the position of the banks became more serious, and the main issues relevant to this became more clearly defined, it became more urgent that such an analysis was conducted. Apart from other considerations it is clear that the government would at any stage have been better off with a risk analysis that was subject to uncertain preconditions to some extent, than no risk analysis at all.

The SIC is of the opinion that the ministers that publicly declared the government's support of the banks, irrespective of the wording of those

declarations and their objective, could have been expected to do so on solid grounds, which should at least have been based on a reasoned assessment of the government's ability to support the banks as well as further preconditions that a support of this kind would be contingent upon. In the opinion of the SIC, it is not relevant in this regard what the market participants' general understanding of the declarations was or could have been, since the Commission's comments do not pertain to such responses, rather they pertain to the professional work methods that should be expected from the government, in particular during the grave and uncertain circumstances that existed at the time in question.

Irrespective of the carefully worded public declarations of the government proclaiming that the State would support the banks and their political objectives, what is important here is that it was imperative that within the government's internal functioning there existed a complete and competent analysis of the financial risk that the State was facing due to the difficulties in the operation of the Icelandic banks. This was relevant to both the expected impact of this kind of crisis in a broad economic context as well as to the damage that could result from specific aspects of their operation, e.g. their obligations towards the CBI as well as other issues regarding their raising of deposits through their foreign branches. It must be presumed that this kind of complete documentation would have enabled the government to make a much better assessment of the policy which would have been advisable in the preparations for a possible financial shock. It is no less important that this kind of documentation and information would, on the one hand, have contributed to making the government more aware of the necessity for direct and timely action by the state authority, in order to unwind the problem with regard to the damage that a crisis in the operation of the banks would obviously have regarding the interests of the Icelandic state. On the other hand, had the government been in possession of this kind of documentation and information it would have been in a much stronger position to rationalise the initiative to take direct action in order to reduce the size of the banking system, or alternatively to put pressure on the banks to do so themselves according to clear, precise conditions, such as time limits, in addition to the direct intervention of the government, if their own plans or the actions of the banks would fail.

#### *21.5.4.5 Ministerial Initiative to Reduce the Size of the Banking System*

In Chapter 21.5.4.2 above, information was discussed that became available to ministers, in particular to the Prime Minister and the Minister of Finance, i.a. in meetings with the Board of Governors of the CBI, during the first months of 2008. This information should, in the opinion of the SIC, have given the respective ministers reason to conclude that the enormous size of the Icelandic banking system relative to the Icelandic economic system and the associated risk for the entire Icelandic economy if the banks were to run into difficulties, was an especially urgent threat given the circumstances at the time. In the spring of 2008, indications became clearer, i.a. from the IMF, credit-rating agencies and foreign central banks, that the Icelandic banks had become far too big relative to the size of the Icelandic economic system and the capacity of the Icelandic government to rescue them. The Danish, Norwegian and Swedish Central Banks went so far as to make currency swap agreements

conditional on credible measures being taken to reduce the size of the banking system. The Icelandic authorities agreed to the conditions in a special statement issued on 15 April 2008, as noted above. Only the swap agreement itself, not the statement, was made public. However, in a statement regarding the swap agreement published on the website of the Prime Minister's Office, an indirect reference was made to the content of the statement where it was announced that the Government was, as a part of its overall plan, „pursuing [...] structural reforms in order to increase economic stability.“

Neither specific actions, nor detailed plans to achieve this objective, seem to have been put forth by the Prime Minister's Office. In statements of the representatives of the banks before the SIC, it was revealed that neither the CBI, nor the FME, nor ministers had presented them with formal proposals on reducing the size of the banks. On the other hand they either claimed not to remember, or not to be able to rule out, whether authorities had in general terms requested them to reduce lending and shrink the balance sheet of the banks. It cannot be concluded from the independent examination of the SIC that the ministers governing the issue areas that were most relevant to the financial markets and/or the Icelandic economy and government finance, i.e. the Prime Minister, the Minister of Business Affairs and the Minister of Finance, attempted to initiate coordinated government actions to formally compel the banks to reduce their size, in the time leading up to the collapse of the Icelandic banks. This matter, and the issues described below, are elaborated further in Chapter 19.6.

The statements of the directors of the banks reflect in some ways the necessity, at least in the later stages of the this period, of direct government actions in these matters. It was thus revealed that the directors of the banks could not on their own initiative take radical actions in the market situation at the time, since they received their powers from the owners of the banks and their representatives on the boards, and could not expect that they would accept actions that would perhaps have a negative effect on the equity of the firms. If the authorities would have laid down certain rules and prescriptions in this respect, i.a. about the sales of assets, the directors, and consequently the owners, would not have had other options. At the same time it was revealed that the directors of the banks would have had difficulty with regard to the boards and their owners, for competitive reasons, to curb or stop the growth on their own initiative, taking into account the uncertainty concerning whether the other banks would follow such a precedent or would perhaps attempt to use it to gain competitive advantage.

Even if the will may have been present within the banks to react to the constantly growing problem by reducing their size through radical measures, i.e. at some expense to the owners and their financial standing as the case might be, this position indicates that the directors of the banks thought that any ideas on initiatives originating within the banks themselves were bound to be stopped by their owners. It must be concluded that this position ought to have been generally known by this time, irrespective of whether and how aware the highest state authorities were of the extent of the obligations of the owners of the banks towards them. In this context it merits mention that in an appraisal by a foreign expert, Andrew Gracie, who came to Iceland on behalf of the CBI in late February 2008, it was i.a. stated that government intervention to force the banks to take action was necessary since the banks

had an incentive under the circumstances to be careful and not to take risks in trusting that the markets would open up again. This and other information from Gracie was made directly known both to the consultative group of the Icelandic authorities and to the Prime Minister. Here it must be mentioned that the Minister of Business Affairs and Minister of Finance at the time, claimed in statements not to have been aware of Gracie's appraisal, nor his visit to the country. Following the arrival of Gracie to the country, the CBI and the FME prepared an analysis that was based on information and indications from him called „Scenario of a Financial Crisis“, that was submitted and discussed in meetings of the consultative group of the Icelandic authorities, i.a. on 21 April 2008. The draft minutes for that meeting of the group reveal i.a. that it would be preferable to separate domestic and foreign operations of the banks as soon as possible and „liquidate“ the foreign operations. Cf. further discussion in Chapters 19.3.5 and 19.3.7. In the case of the Prime Minister reference must be made again to the meetings with the Board of Governors of the CBI which were mentioned in Chapter 21.4.4.2 above. Additionally, the SIC is of the opinion that it was generally known at that time, and had i.a. been the subject of public discussion, that the size of the Icelandic banking system, relative to most macro-economic indicators, was at that point one of the main problems that the Icelandic economic administration was faced with and amongst the most serious dangers to the nation given the precarious circumstances.

At least since the beginning of 2008, the representatives of the banks had put pressure on the Icelandic authorities to take loans in order to bolster the foreign exchange reserves of the CBI. That action was primarily conducive to strengthening the position of the CBI as a lender of last resort with respect to the banks. It must be assumed that the authorities would e.g. have had the option in any dealings with the banks to tie such measures to the condition that the banks take actions on their part to reduce their size, irrespective of whether they would have to bear some costs or suffer damage in light of the unfavourable circumstances. In light of how serious the situation had become, it was unrealistic at that point to assume that actions to face the problem would be painless. It should be mentioned that on 29 May 2008, Althingi adopted Act No. 60/2008 where the State Treasury was given authorisation to take up to a £500 billion loan to bolster the foreign exchange reserves in 2008. The examination by the SIC does not indicate that the envisaged borrowing of the State Treasury was related to any independent actions by the banks themselves.

It is appropriate to stress here that the banks themselves bore most of the responsibility for the crisis that had been created, considering their relative size in the Icelandic economy and their otherwise weak position. At the same time, it is clear that as the winter 2007-2008 progressed, there was scarcely enough time to take action of the kind mentioned above. It is reiterated that at this time both the authorities and the banks had probably lost the chance to take these actions quietly or without great cost or damage for either or both parties. It is emphasised that at these later stages during the course of events it was unrealistic to assume that it was possible to avoid damage; on the contrary the objective had to have been to minimise the potential damage.

It must be kept in mind that the information about the disproportionate size of the Icelandic banking system and indications of the dangers that this

could entail had been evident for a long time. In statements of staff members of the CBI before the SIC, it was revealed that the representatives of the CBI had been „spanked“ in meetings with experts in London in early 2006, for risk-taking and the relative size of the Icelandic banking system. It is iterated that the banks were close to bankruptcy in the „mini-crisis“ in early 2006. It was also revealed by staff members of the CBI, that at this point it had already become too late to employ the tools of the CBI to force the banks to reduce their size. Cf. further discussion in Chapter 19.6.2.

In the coalition agreement of the government at the time, which was formed at the end of May 2007, it was i.a. its stated policy that financial activity could continue to grow domestically and expand into new fields of competition with other market areas. This policy was not officially amended prior to the collapse of the banks in October 2008. In hearings before the SIC, it was i.a. revealed that responsible growth and practices were presumed, but also that the government was aware that the scope for growth was limited for the banks in Iceland and that if they were to continue to grow, like other companies, it would primarily be abroad. The SIC points out that when the government was formed a little over a year had passed since the banks had almost become bankrupt. It ought to have been clear, if not according to the information available to the government, then at least according to strong indications from foreign experts to state supervisory authorities of financial activities, that the reasons for the special problems of the Icelandic banks when the recession hit the financial markets were risk-taking and unrestrained growth abroad.

Apart from reducing the size of the banking system by shrinking the balance sheet of the banks, the option of solving the problem by attempting to have one or more of the banks move their headquarters abroad was brought up in discussions at the time, i.a. by the authorities. In addition to continuing supporting the growth and expansion of the banks abroad, it was also the declared policy of the government that the banks would continue to have their headquarters in the country. This issue was addressed in Chapter 5. In hearings before the SIC it was revealed that neither the government nor individual ministers had worked towards encouraging the banks to move their headquarters out of the country and that they had in fact even been strongly opposed to it, cf. further discussion in Chapter 19.6.1.

According to the examination of the Commission, it was i.a. the position of the Minister of Business Affairs that it was possible to solve the problems resulting from the relatively oversized of the Icelandic banking system compared to the nation's economy through the membership to the European Monetary Union, which would follow accession to the European Union. This view was i.a. described as enabling „the enlargement of the monetary system rather than the reduction of the banking system“. Cf. further discussion in Chapters 19.3.2 and 19.3.5. The Commission takes no position concerning the validity of such views per se. It is sufficient to say, irrespective of their validity, that it was very doubtful at the time whether it was realistic to assume that Iceland's accession to the European Monetary Union was possible through other means than formal accession to the European Union. Such an application process would be far too time consuming for the accession to the European Union and consequently its Monetary Union to solve the urgent and looming problems that the Icelandic banking system and consequently

the national economy were facing. For this reason, ideas such as these were not realistic options in place of measures that would have involved direct actions and pressure from the state to reduce the size of the banking system, e.g. by moving the headquarters of one or more of the banks abroad. In hearings before the Commission it was stated that ideas concerning the relocation of Kaupthing's headquarters abroad had been broached i.a. in conversations of the chairman of the Board of Governors and the Prime Minister and in the consultative group of the Icelandic authorities. There is nothing to indicate that these ideas were further pursued in any way. Concerning the ideas of the banks themselves, in particular Kaupthing Bank, in this regard and their potential will to cooperate, it can be pointed out that within Kaupthing Bank, plans to relocate the headquarters were already underway in the spring of 2008, without participation from state authorities. The plan was not carried out before the bank collapsed.

It must be concluded that the Icelandic authorities had two primary options to react directly to the constantly growing peril, either by putting pressure on the banks or by taking direct action vis-à-vis them. On the one hand they could have gotten the banks to sell their assets and thus shrink their balance sheet. On the other, they could have affected a relocation of one or more bank headquarters abroad. Neither of these options was desirable nor easy to execute. They can, however, not be weighed in isolation. The seriousness of the looming threats must be taken into account, how they grew constantly, and how there was ample reason to assume that the results of not taking any action at all to combat the problem would be far worse. It is reiterated that in the later stages of events in the time leading up to the collapse of the banks, realistic objectives had to consist of minimising the damage rather than to attempt to avoid any damage. The challenges that faced the ministers at the time are thus in no way being downplayed. Neither is the value of the actions of individual ministers and other authorities in the time leading up to the collapse of the banks lessened, such as informally opposing Kaupthing's purchase of the Dutch bank NIBC, which would without a doubt have greatly exacerbated the existing problem. Even though that purchase did not go through, the serious problems present were not diminished. The authorities, including ministers of the relevant policy areas, still had to contend with them. The examination of the Commission does not show particular reactions or initiatives on their behalf in the abovementioned respect. Furthermore, in its assessment the Commission concludes that it is impossible to disregard the official policy of the government in matters relating to the banks, as mentioned above, as well as the fact that at no point in the course of events did the government turn away from the official policy or its execution.

Concerning comments according to Article 13 of Act No. 142/2008 submitted to the Commission on this matter, the Commission stresses that it is correct, per se, that news about the application of state powers on financial institutions can hurt their position and market situation in general. On the other hand, the Commission emphasises that in the later stages of the course of events the realistic issue that faced the Icelandic authorities was not whether it was possible to avoid damage but how to minimise it. In addition, ministers are required, at least to a certain extent, and where applicable in closed groups, to be able to prepare and, where applicable, execute such actions, in such a way that confidentiality is maintained with the parties concerned. It

must also be pointed out that preparations, or formally developed government plans to this effect, would probably have had an independent value, irrespective of whether they would be executed or not, in that they would have pressured the banks themselves, and in particular their owners, to take actions on their own, even though they would have had to accept some costs or damage. In other words, this is to emphasise that irrespective of whether the authorities ought to have brought these measures to bear, it cannot be disregarded that it seems that these options were not even formally considered or developed further.

#### *21.5.4.6 Follow-up and Initiative to Affect the Transfer of Landsbanki's Icesave Accounts to a Subsidiary*

The deposits in Landsbanki's Icesave accounts in the UK reached their highest point at the beginning of 2008 when they totalled £ 4.9 billion, cf. further discussion in Chapters 7 and 18.2. It is evident that in discussions with the Board of Governors of the CBI at the beginning of February 2008, Landsbanki's CEOs had themselves presented a proposal to transfer the Icesave deposit accounts from the bank's branch to a subsidiary in London. It should be mentioned that Landsbanki obtained a legal opinion around the same time on what other means were available in these matters. The conclusion there was i.a. that it would probably take six months to complete the transfer. It must be assumed that the representatives of Landsbanki subsequently knew what options were available in these matters and how long the process would take. On 3 March 2008, the chairman of the Board of Governors of the CBI met with Mr. Mervyn King, Governor of the Bank of England. There they discussed i.a. Landsbanki's raising of deposits in the UK and the concerns this raised within the Bank of England. Three days later the chairman of the Board of Governors of the CBI had a meeting with the Prime Minister where he informed the latter of the Bank of England's concerns. Following this meeting, the Prime Minister met one of the CEOs of Landsbanki on three occasions where they i.a. discussed the Icesave accounts and the financing of Landsbanki.

In the comments from the Minister of Business Affairs at the time, submitted in accordance with Article 13 of Act No. 142/2008 to the Commission, it was revealed that in February 2008 the minister had, with the aim of reacting to unrest of the financial markets, appointed a highly experienced individual as the new Chairman of the Board of Directors of the FME. The new chairman considered the transfer of the bank branches abroad to subsidiaries to be the main task ahead for the FME. This was discussed by the officials, i.a. in communications relating to their duties. From that point on and until August 2008, the minister had assumed that the FME and Landsbanki were working together on the matter.

Regarding to what extent the concerns, that the Icelandic authorities had when it came to the raising of deposits by Landsbanki in the UK, were noted and discussed in the Icelandic system of governance during the period preceding the collapse of the banks, it is unequivocally demonstrated by the Commission's data and information that the issues were repeatedly discussed within the government consultative group. This took place e.g. in the consultative group meeting held on 25 March 2008 and in the following meetings, including the group's meeting on 1 April. On that particular

day the Chairman of the Board of Governors of the CBI met with the Prime Minister and the Minister for Foreign Affairs, as mentioned earlier, where they discussed i.a. issues relating to Icesave and the large outflow of deposits from the accounts which significantly strained Landsbanki. It is appropriate to note that in the comments from the Minister of Business Affairs at the time, submitted in accordance with Article 13 of Act No. 142/2008 to the Commission, it is revealed that the minister for his part received information regarding these issues from the representative of the ministry in the consultative group and did not think they constituted a reason to interference in the work or the plan concerning the transfer of the deposits that was ongoing in collaboration with the FSA.

The investigation of the SIC did not reveal any documents, data or unequivocal confirmation in its hearings that would clarify whether and to what extent the Icelandic authorities pushed Landsbanki towards this solution. It has not been demonstrated that the three ministers who had representatives in the consultative group, called for, or requested that the CBI or the FME call for, a plan with a schedule from Landsbanki on the transfer of the Icesave accounts to a subsidiary and information on whether something was to prevent compliance with the FSA's wishes of transferring the accounts to a subsidiary. Official information on the subject must have constituted an important element in the decision making process on whether there was occasion for intervention on behalf of the Icelandic government to facilitate the transfer. In this process there is nothing to indicate that the government and the Icelandic surveillance authorities coordinated their response with special actions or plans to facilitate the transfer of the Icesave accounts. No decision was made either as to which party or parties within the Icelandic administration should lead the effort to push for a solution to the matter, nor were particular employees entrusted with working on the matter specifically. In fact, in the hearings before the SIC, it was repeatedly stated in answers by ministers and administrators of the ministries, that the FME and the CBI did not consider it the responsibility of their respective bodies to push for the transfer or lead the effort.

On 2 July 2008, the UK FSA strongly reiterated its emphasis to transfer Landsbanki deposits in the UK from the bank's local branch to its subsidiary. In a correspondence to Landsbanki on 15 August 2008, warnings were raised regarding the possibility of the FSA exercising its power with respect to deposit taking at the UK branch. It has been disclosed that the Chairman of the Board of Governors of the CBI briefed the Prime Minister on the letter immediately the following day. If it was at all the policy and will of the Icelandic authorities that the Icesave accounts be transferred as soon as possible from Landsbanki's branch in London to a subsidiary there, it should have been clear to the Prime Minister and the administrators of the CBI and the FME upon receiving the letter that regardless of Landsbanki's expectations of reaching an agreement with the FSA, the direct involvement of the Icelandic authorities in the matter was needed. That approach had to focus on determining whether and how the Icelandic authorities could through a financial facility or by other means facilitate the transfer of the accounts. Significant interests relating to the preservation of financial stability in Iceland, and therefore public interest, were at stake. It should also be mentioned that in meetings of the consultative group, both on 20 August and 4 September

2008, the view was advanced that the directors of Landsbanki did not fully grasp the situation.

It should be kept in mind that the information gathered by the SIC indicates that the motive of Landsbanki in bringing the matter to the attention of the FSA was mainly to avoid negative media coverage on the standing of the Icelandic banks and the Icesave accounts, which would have reduced deposits to the accounts. The same could be seen happening when the negative discussion in Britain quieted down temporarily during the spring months of 2008, there was a certain priority shift in the bank regarding the conclusion of this matter. The bank thus notified the FSA in a letter that the plan to transfer the deposits would fall within the bank's medium or longer term strategy, and that the transfer would have to be carefully thought out before any decisions were made. It cannot be seen that Landsbanki notified the Icelandic authorities of this priority shift despite extensive communication regarding this matter up to that point. The Governors of the CBI believed that work was progressing as planned on the matter up until July 2008. .

It is be pointed out that the interests of Landsbanki and the interests of Iceland regarding such a transfer were thus in their nature different. The bank was first and foremost defending its private interests, while the Icelandic State was duty bound to defend the general interest. Icelandic Authorities could therefore not hand this important issue exclusively over to Landsbanki and trust that the bank would pursue the matter. Regardless of the opinion held by the CEOs of Landsbanki with regard to whether and when the Icesave accounts should be transferred from the London branch to a subsidiary of the bank and their legal authority to determine the arrangement of the bank's operations, it was the position of both the UK and the Icelandic authorities that it was important, both for the public interest and the interests of depositors, that the aforementioned transfer to a subsidiary would take place. This position of the authorities had emerged in the first half of 2008. It needed to be pursued ardently. This is discussed in more detail in Chapter 18.2.5.

Earlier in the summer 2008, Landsbanki established Icesave accounts in their Dutch branch, which as a result increased the commitments of the Icelandic Guarantee Fund. The cooperation between Landsbanki and the FSA during the summer 2008, following the FSA's growing pressure, broke down as Landsbanki considered that it was not being treated fairly. On 5 August 2008, Landsbanki sought assistance from the CBI with the transfer of the Icesave accounts from the branch to the bank's subsidiary. Later that same month the directors of Landsbanki turned to the Minister of Business Affairs and had a meeting with him regarding the matter. The minister subsequently requested a meeting with the Chancellor of the Exchequer of the United Kingdom. That meeting took place in London on 2 September 2008. It must be pointed out that the meeting took place after the directors of Landsbanki requested that the Minister of Business Affairs acted directly in the matter. The Chairman of the Board of the FME spoke on behalf of the Icelandic delegation during the meeting, i.a. to follow up on Landsbanki's wish to be granted an extension for the transfer of assets to the subsidiary even if the deposits would be transferred earlier.

From the accounts of the meeting on 2 September 2008 between the Minister of Business Affairs and the delegation of the Icelandic government on the one hand, and the British Chancellor of the Exchequer on the other, it

seems that it should have been clear to the Icelandic delegates that from the standpoint of the British Chancellor there was at that time a significant risk that Landsbanki would not be able to meet its obligations vis-à-vis the owners of the Icesave accounts. The British minister stated that the intention was for the British authorities to guarantee deposits in full and simply asked the Icelanders where the bill should be sent. Even though the meeting certainly discussed Landsbanki's request to be granted a reasonable grace period to transfer the Icesave accounts to a subsidiary, and it has already been stated that the British minister was sympathetic to the viewpoint that the reaction could not be too harsh, it should have been clear to the Icelanders that the reaction of the British authorities was primarily focused on protecting the interests of British depositors and to prevent problems in the operation of the Icesave accounts from prompting runs on banks in the UK and unrest among deposit owners. This state of affairs and HM Treasury's grave estimation of the situation should have been even clearer to the Icelandic authorities after a staff member of HM Treasury contacted the Icelandic ambassador in London on 5 September 2008 and told him that the British minister had been disappointed with the meeting on 2 September 2008 since he did not sense that the Icelandic authorities fully appreciated the serious nature of the matter.

It must be underlined that the Icelandic delegation that met with the British Chancellor of the Exchequer on 2 September 2008 was in fact requesting that the British authorities would agree to insufficient assets in Heritable Bank for a certain period of time to meet the obligations arising from the deposits transferred from the branch. Judging from the discussions between Landsbanki and the FSA, this would presumably equal up to half of the assets that the FSA had required to be transferred to the subsidiary or £ 2.5 billion. The Icelanders were thus requesting that any loss resulting from this would be the responsibility of the British.

Notwithstanding the meeting in London on 2 September 2008 and indications subsequently received from the UK regarding the position of the British Chancellor of the Exchequer, there is nothing to indicate that the Minister of Business Affairs or the Prime Minister explored what options might be available to facilitate the transfer of the Icesave accounts to a subsidiary or follow them up vis-à-vis Landsbanki or the British authorities in the weeks that followed.

#### *21.5.4.7 The Findings of the SIC on Mistakes or Negligence by Ministers Within the Meaning of Article 1(1) of Act No. 142/2008 in the Period Leading up to the Collapse of the Banks*

Before discussing the Commission's conclusions concerning the actions of individual ministers, the Commission reiterates, that in its assessment for each case, it presupposes the considerations described in chapters 21.5.2-21.5.3 above, as regards the definition of the terms mistake and negligence within the meaning of Article 1(1) of Act No. 142/2008. In all cases, the discussion in Chapter 21.5.4.1 applies to events and viewpoints referred to by the Commission in its assessment, especially concerning ministers' respective areas of responsibility and the supervisory and regulatory duties and the duty to take initiative that ministers have or may have, and the further discussion of the same subject at the beginning of Chapter 16.

Mr. Haarde took over the office of Prime Minister in June 2006. During the period leading up to the collapse of the banks he was in that capacity involved in matters concerning economic administration in general. As Prime Minister, Mr. Haarde carried the primary responsibility of securing economic stability, insofar as this responsibility rests with ministers. The Prime Minister also carries certain duties as regards representation and general management of the government's activities. The functions of the CBI at this time also fell under the Prime Minister, in accordance to provisions of the Act on the Bank then in effect. This led to the fact that the consultations and disclosures of the CBI vis-à-vis the government regarding economic affairs, and therefore the issues of the banks, happened mostly via the Prime Minister. The then Prime Minister, on the basis of the relationship of his office with the CBI, was the minister who had above all the opportunity to call for specific information and proposals from the CBI regarding particular issues. It should also be kept in mind that the representative of the Prime Minister, the Permanent Secretary of the Prime Minister's Office, directed the activities of the government consultative group on financial stability and contingency planning. He therefore, above other representatives, was responsible for the efficiency of the group's activities, and reaching the desired objectives and goals pursued at any given time. The Prime Minister's representative in the consultative group was also responsible, above others, for the emphasis and priorities in its activities, as to if and how the group would make use of expertise present within the group and other means available to it, as the case might be. It must be assumed that the Prime Minister was, by way of his representative, informed to a large extent about the progress and emphasis of the activities of the consultative group at any time. Since his representative presided over the work of the consultative group, it must be considered that it was indeed the Prime Minister's responsibility, beyond other authorities participating in the group, to initiate reactions, if needed, to make the work of the group more effective and/or influence the emphasis implemented therein.

With reference to the matter discussed in Chapter 21.5.4.2, it is the conclusion of the SIC that the serious information about the standing of the banks and the prospects of the Icelandic banks and of the Icelandic economy as a whole, which became available to Prime Minister Haarde during the first months of 2008, gave him ample cause to take the initiative in keeping with his position and role as Prime Minister, and to work towards government intervention by taking specific actions, cf. Chapter 21.5.4.5 and further discussion below. It must at least be considered that the Prime Minister had in these circumstances a responsibility to call for further data and information and, as the case might be, proposals concerning whether there was need for specific actions on behalf of the bodies and authorities to which he, as a Prime Minister, had the authority to consult with cf. in particular the CBI.

Finally, with reference to the matter discussed in Chapter 21.5.4.3 the SIC notes that during the time leading up to the collapse of the Icelandic banks the government's consultative group was responsible for important assignments regarding financial stability and contingency planning in case of a financial crisis, which involved pressing matters of public interest. As the situation in the operational environment of the Icelandic banks and conditions in the Icelandic economy got worse, the activities of the group became increasingly important. As stated earlier, it is the assessment of the SIC that

the work of the consultative group had significant shortcomings. The Prime Minister bore, above others, the responsibility to ensure that the work and the emphasis of the group was well-targeted and would yield the desired results, and to work towards improvements, if necessary.

With due reference to the matter discussed in Chapter 21.5.4.4, it is the assessment of the SIC that during the time leading up to the collapse of the banks, the Prime Minister had, for his part, the responsibility to take initiative, either in his own capacity or by suggesting a course of action to other ministers, in order to ensure that a complete and competent assessment was made by the authorities regarding the financial risk that the Icelandic state was facing due to the danger of a financial shock. Furthermore, it must generally be concluded that ministers had the responsibility to base public statements they chose to make about the state supporting the banks, irrespective of how they were phrased or their purpose as such, on solid grounds.

With reference to the matter discussed in Chapter 21.5.4.2 it is the conclusion of the SIC that during the time leading up to the collapse of the Icelandic banks, at the latest during the period from 7 February to 15 May 2008, sufficient information had been communicated to the Prime Minister for him to realise that significant public interest demanded that he, at that point, should initiate dynamic action on behalf of the authorities, with the adoption of special laws if necessary, to reduce the size of the Icelandic banking system. Following the statement from the government vis-à-vis the Danish, the Norwegian and the Swedish central banks on 15 May 2008 regarding credible measures to reduce the size of the banking system, there was even greater reason for the Prime Minister to initiate such actions. It must at least be considered that the Prime Minister had in these circumstances a responsibility to work towards getting the government to develop a strategy and prepare for further actions, especially in light of that such measures would have put authorities in a better position to put realistic pressure on the banks to take such action themselves.

With reference to the matter discussed in Chapter 21.5.4.6, it is the assessment of the SIC that the Prime Minister had ample reason already in the first months of 2008 to monitor and verify that active measures were being taken to transfer the Icesave accounts of Landsbanki from the bank's UK branch to a subsidiary, on the one hand, and at least from the summer of 2008 to seek ways in his ministerial capacity to pursue the same action with active involvement of the Icelandic government on the other hand.

As discussed further in chapters 21.5.4.2-21.5.4.5, the inquiry of the SIC does not indicate that the Prime Minister took adequate steps in the period leading up to the collapse of the banks in Iceland, proportionate with the situation described in the preceding chapters. The SIC is of the opinion that by his omission to act Prime Minister Haarde neglected to respond to the imminent danger in an appropriate manner and thereby he showed negligence in the sense of Article 1(1) of Act no. 142/2008.

Mr. Árni M. Mathiesen took over the office of Minister for Financial Affairs in September 2005. In the period leading up to the collapse of the Icelandic banks he was in that capacity responsible for i.a. matters concerning the state financial affairs, to the extent that these were not assigned to other bodies. Furthermore he was responsible for assessments of economic development and outlook. The Ministry of Financial Affairs also participated

in the consultative group of the Icelandic authorities on financial stability and contingency planning. It must be assumed that the Minister of Financial Affairs was informed by the representatives of the Ministry of Financial Affairs in the consultative group about the progress and emphasis within the group at any time.

With reference to the matter discussed in Chapter 21.5.4.2, it is the assessment of the SIC that the serious information concerning the standing and prospects of the Icelandic banks and of the Icelandic economy as a whole, which became available to Finance Minister Mathiesen in the first months of 2008, should have given him ample cause to take the initiative in keeping with his position and role as Minister of Financial Affairs, and thereby to work towards government intervention by taking specific actions, cf. Chapter 21.5.4.5 and further discussion hereinafter and the summary, *mutatis mutandis*, of the assessment of the Commission regarding the content of that Chapter in the previously cited resolution with regard to the Prime Minister. This refers on the one hand to the administrative powers vested in the Finance minister himself as such, cf. Article 2(1) of Act No. 73/1969 and the provisions of Article 17 of the Constitution and his option, on the other hand, to attempt to encourage other ministers in policy areas relevant in this context to act on the basis of the same powers.

With due reference to the matter discussed in Chapter 21.5.4.4, it is the assessment of the SIC that during the time leading up to the collapse of the banks, the Finance Minister had a responsibility to take initiative, either in his own capacity or by suggesting a course of action to other ministers, in order to ensure that a complete and competent assessment was made by the authorities regarding the financial risk that the Icelandic state was facing due to the threat of a serious financial crisis. Furthermore, it must be concluded that government ministers had the responsibility to base public declarations that they chose to make regarding government support to the banks, irrespective of their wording or purpose, on solid grounds.

As discussed further in previous chapters 21.5.4.2-21.5.4.5, the inquiry of the SIC does not indicate that the Minister of Finance took adequate steps in the time leading up to the collapse of the banks in Iceland, proportionate with the situation and as the situation warranted, as described above. The SIC is of the opinion that by his omission to act, Finance Minister Mathiesen neglected to respond to the imminent danger in an appropriate manner and thereby showed negligence in the sense of Article 1(1) of Act No. 142/2008.

Mr. Björgvin G. Sigurðsson took over the office of Minister of Business Affairs in May 2007. During the time leading up to the collapse of the banks, Mr. Sigurðsson, in his capacity as Minister of Business Affairs, involved *i.a.* in matters concerning the financial market, and consequently also the affairs of the Icelandic banks. The Ministry of Business Affairs was also part of the government consultative group on financial stability and preparedness. It must be assumed that the Minister of Business Affairs was informed by the representative of the Ministry of Business Affairs in the consultative group about the process and emphasis of the group at each time. The Minister, by virtue of his office, exercises control over the affairs of the Icelandic banks. Despite the fact that independent government institutions were working in this sector, he was therefore obliged to maintain general surveillance of the overall progress of affairs in the sector with the view of determining whether there was occa-

sion for the ministry to intervene on the basis of applicable legal rules and, where applicable, to take the initiative regarding suggestions of amendments to laws and/or government review of the case as an important issue for the government, cf. Article 2(1) of the Icelandic Government Ministries Act No. 73/1969 and the provisions of Article 17 of the Constitution.

With reference to the aforesaid and also (1) to Chapter 21.5.4.2, cf. the information communicated to the Minister of Business Affairs by the Minister for Foreign Affairs during the Social Democratic Alliance parliamentary group meeting on 11 February 2008, and Chapter 21.5.4.6, cf. the available information regarding the grounds for the Minister of Business Affairs' appointment of a new Chairman of the Board of Directors of the FME, and conversations between the two parties, and (2) that which was discussed in Chapter 21.5.4.3 with regard to the work of the government consultation group and information obtained in the course of that work, it is the assessment of the SIC that the grave nature of the information regarding the state and prospects of the banks that became available to the Minister of Business Affairs in the first months of 2008 gave him ample cause to take the initiative, in keeping with his position and role as Minister of Business Affairs, to work towards government intervention in the affairs of the banks by taking specific actions, cf. Chapter 21.5.4.5, and the summary, *mutatis mutandis*, of the assessment of the Commission regarding the content of that Chapter in the previously cited resolution with regard to the Prime Minister. With regard to the Minister of Business Affairs it is stated that the SIC is aware of the initiative taken by the Minister within the government on 12 August 2008, cf. for instance discussion in Chapter 19.3, and the assessment of the Commission therefore applies particularly to the course of events during the time leading up to the collapse of the Icelandic banks up until that date.

With due reference to the matter discussed in Chapter 21.5.4.4, it is the assessment of the SIC that during the time leading up to the collapse of the banks, the Minister of Business Affairs had a responsibility to take action, either in his own capacity or by suggesting a course of action to other ministers, in order to ensure that a complete and competent assessment was made by the authorities regarding the financial risk that the Icelandic State was facing due to the danger of a financial shock. Despite the fact that the Depositors' and Investors' Guarantee Fund was a private foundation, the Fund and deposit guarantees were within the Minister's domain. The factors that had to be taken into account in the financial analysis of the risk posed by adverse effects on the economy in case of a financial shock included the manner in which the Guarantee Fund could honour its minimum payment obligation as decreed by law, and whether and in what manner the Icelandic State should be involved in enabling the Fund to do so. Furthermore, it must be concluded that ministers had a responsibility to support such public declarations as they chose to make regarding government support for the banks, irrespective of their wording or purpose, on solid grounds.

Finally, with reference to the matter discussed in Chapter 21.5.4.6, it is the assessment of the SIC that the Minister of Business Affairs had ample reason, on the one hand beginning from the first months of 2008 to monitor and ensure that active measures were being taken to transfer the Icesave accounts of Landsbanki from the bank's UK branch to a subsidiary, and on the other hand, at least since the summer of 2008, to seek ways in his ministerial

capacity in which to pursue the same action with active involvement of the Icelandic government. Despite the meeting between the Minister of Business Affairs and the Chancellor of the Exchequer of the United Kingdom on 2 September 2008, it was nonetheless necessary for the Minister to ensure further follow-up of the matter in continuation of that meeting. There is no indication of any such further efforts on the Minister's part in the documents that are in the possession of the SIC.

As discussed further in previous chapters 21.5.4.3-21.5.4.6, the inquiry of the SIC does not indicate that the Minister of Business Affairs took adequate steps in the time leading up to the collapse of the banks in Iceland, proportionate with the situation as described above. The SIC is of the opinion that by his omission to act Minister of Business Affairs Sigurðsson neglected to respond to the imminent danger in an appropriate manner and thereby showed negligence in the sense of Article 1(1) of Act No. 142/2008.

### 21.5.5 Director of the Financial Supervisory Authority (FME)

According to Article 5 of Act No. 87/1998 on Official Supervision of Financial Activities, the Director of the FME is in charge of managing day-to-day activities and operations of that institution, and is responsible for hiring its personnel.

As further discussed in Chapters 8.6.5.5 and 16.5.9, the SIC is of the opinion, that there is particular reason to comment on the manner in which the FME has proceeded formally when it has been revealed, that regulated entities are not complying with laws and other rules that apply to their operations. According to the clear instructions of Article 10(1) of Act No. 87/1998 on Official Supervision of Financial Activities, the FME shall demand that a remedy is made within a reasonable time. If a regulated entity does not comply within the allotted time limit, the FME can respond i.a. through coercive instruments as provided for in the Act.

It is noteworthy that in the course of the work of the FME, disagreements have at times arisen between the Authority and regulated entities with regard to the interpretation of rules governing large-scale risks. There are examples of such cases where the only action taken was the submission of written comments to the relevant financial corporation, after having received objections from the concerned party, without directing the matter to the proper legal channels as well. In less important cases, it is feasible for the FME to use the means of offering financial corporations the opportunity to remedy minor mistakes in an informal way. However, it is the opinion of the SIC that in general it must be assumed that according to the laws under which the FME operates, it has the obligation to process the case concomitantly or without much delay along legal channels in order to ensure that it can be pursued with coercive instruments and, where applicable, disciplinary actions if a financial corporation fails to comply with recommendations for remedy. There are examples of procedures by the FME, concerning cases involving alleged violations of rules regarding large-scale risks, where the authority, for a long period of time, sought to rectify them only through informal means. In such instances cases have either been left untended, or dealt with through correspondence with the financial institution in question. Judging by data or information that the Commission has in its possession, financial institutions,

in some cases, responded neither quickly nor seamlessly to this approach by the FME while monitoring financial activity.’ There are both examples of significant delays in remedying what has gone wrong and/or of corporations having offered resistance in this regard. Financial corporations have in such cases even claimed to have a different understanding of their obligations than that on which the FME has based its comments, and the authority in such cases may not have seen cause to change its approach and apply fully the statutory coercive measures in order to ensure compliance with laws and regulations governing financial activities, as is within the power of the FME. This has led to regulated entities in some cases getting away with the practise of entering large exposures into their books in violation of law in the opinion of the FME, for either a longer or a shorter period of time.

According to the aforesaid, it is the opinion of the SIC that it must be considered that in many cases handled by the FME the procedure, redress and follow-up was inadequate; some of these cases are described in Chapter 8.6.5.5. A targeted and clear procedure by the FME, ensuring that the procedure was in accordance with the unambiguous provisions of Article 10(1) of Act No. 87/1998, was therefore lacking. Thus, Jónsson, Director of the Financial Supervisory Authority, omitted to act with regard to the task of organising the day-to-day activities of that institution in a sufficiently reliable manner. Mr. Jónsson’s aforesaid omission must be considered as constituting negligence on his part in the sense of Article 1(1) of Act No. 142/2008, as the day-to-day management of the activities and running of the FME was his responsibility, as well as the hiring of personnel, cf. Article 5(1) of Act No. 87/1998 on Official Supervision of Financial Activities. The way in which the operations of the FME were conducted with regard to the financial corporations, as described above, lacked the force necessary to ensure that the financial corporations would comply with the law in a targeted and predictable manner commensurate with the budget of the FME.

One example of how this problem became clear in implementation is the case mentioned in Chapter 8.6.5.5.1, where the dispute was whether the liabilities of Actavis should be counted as part of the large exposure of Mr. Björgólfur Thor Björgólfsson. This case arose as a result of a search conducted on the premises of Landsbanki Íslands hf. in 2005. The FME subsequently handed in its final conclusion in March of 2007, failing to follow the clear instructions of Article 10(1) of Act No. 87/1998 by not demanding that the situation would be remedied within a reasonable time limit, instead requesting that Landsbanki would report the state of affairs to the FME no later than 20 April 2007. However, the bank did not respond until 30 April 2007. At that time, the bank had not changed its opinion and considered that the exposure of Mr. Björgólfur Thor Björgólfsson and Actavis should be kept separate in the statement regarding large exposure. Since the FME had not applied the provisions of Article 10(1) of Act No. 87/1998 and imposed a definite time limit for Landsbanki to remedy the matter or otherwise face the applicable coercive instruments and/or legal penalties, the conditions did not exist for such measures to be implemented. When the case was finally brought to a conclusion in the autumn of 2007, large exposure on the part of one of the two holding owners of Landsbanki was in the opinion of the FME greatly in excess of the legal maximum for a period of two years in the bank’s financial records. In spite of the provisions of Act No. 161/2002

on Financial Undertakings, Landsbanki suffered no consequences from this violation of law.

Another example of this kind is described in Chapter 14.5.3.3. There it is stated that in 2005 the Chairman of the Board of Directors and the Chief Executive Officer of Landsvaki decided to purchase a bond issued by Mr. Björgólfur Guðmundsson. In the first part of the year 2008, more than two years after the aforesaid bond was purchased, the FME commented on this investment. A reminder letter concerning this asset, signed by Mr. Jónas Fr. Jónsson and Ms. Sara Sigurðardóttir, was sent to Landsvaki. In the letter, no specific deadline was established for Landsvaki to sell this bond, which the fund had not been authorised to buy. In the opinion of the SIC, this case in fact indicative of the same structural problem mentioned above with regard to the FME's treatment of the case involving Landsbanki. Thus it was not ensured that the case was processed along proper legal channels after the employees of the institution had concluded that a violation of rules had taken place. Again, the clear instructions of Article 10(1) of Act No. 87/1998 on Official Supervision of Financial Activities were not followed whereby the FME is required to demand that a remedy is made within a reasonable time limit. As the aforesaid time limit was not established, the case was not followed up with any specific coercive instruments on those grounds when Landsvaki omitted to sell the bond in question. The FME therefore failed to apply sufficient power to its decision and follow-up process.

## 21.5.6 Board of Governors of the CBI

### 21.5.6.1 Introduction

The Board of Governors of the CBI was in 2008 made up of three bank directors. According to Article 23 of Act No. 36/2001 on the CBI, which was in force at the time, the Board of Governors was responsible for running the bank and had discretion regarding matters of the bank that were not assigned to other parties by law. The Board of Governors was therefore, in administrative law parlance, a multi-member administrative body or a regulatory committee, where all bank directors were jointly responsible for the tasks assigned to the Board. In Article 24 of the same Act it was stated that a meeting of the Board of Governors of the bank constituted a quorum if attended by a majority of the Members of the Board. Decisions were carried by force of votes. If votes were equal, the vote of the Chairman of the Board of Governors was the decisive vote. In Article 24(3) it is stated that the decisions of the Board of Governors of the bank should be noted and signed by the board members. At the beginning of the paragraph it is stated that the Chairman of the Board of Governors shall act as the representative of the bank and act on behalf of the Board. In light of these provisions there will now follow a discussion of the Board of Governors of the CBI, which at the time in question was composed of Chairman Davíð Oddsson, Mr. Eiríkur Guðnason and Mr. Ingimundur Friðriksson, and whether the Board made mistakes or showed negligence in the sense of Article 1 of Act No. 142/2008.

### *21.5.6.2 Reaction of the Board of Governors of the CBI to the Request from Landsbanki Íslands hf. in August of 2008 for Assistance with the Transfer of Icesave Deposit Accounts from a Branch to a Subsidiary*

As was further described in Chapter 18.2.5, it has been established that on 5 August 2008 Landsbanki Íslands submitted a request to the CBI for a certain facilitation so as to be able to transfer Icesave deposit accounts from the London branch of Landsbanki to a subsidiary in London. At this point in time it had become clear that it would be very difficult for Landsbanki to transfer the Icesave accounts from the London branch to the subsidiary, Heritable Bank. The economic outlook in Iceland had deteriorated significantly and the CEOs of Landsbanki feared that the Financial Services Authority would not accept the assets intended to be transferred from the parent company to Heritable Bank in order to cover the obligations arising from the deposit accounts. At this time, the deposits amounted to slightly less than £5 billion, and it would therefore have been necessary to transfer about 20% of the parent company's assets to Heritable Bank in order to meet the deposit obligations of the Icesave accounts. In light of covenants in the bank's debt agreements, it was feared that such a large part of the bank's assets could not be transferred without the consent of its lenders. Landsbanki therefore maintained that the transfer of assets would have to be carried out in two stages. This was unacceptable to the FSA and an exemption from the rules on large exposures in transactions between Heritable Bank and Landsbanki was not granted. This position taken by the FSA was stated in a letter from the authority to Landsbanki on 5 August 2008. It should have been clear to both the representatives of Landsbanki and the Icelandic authorities, after receiving the aforesaid letter, that the decisive moment was near as to whether the transfer of the Icesave accounts from the London branch to a subsidiary would be successful and that this could be of crucial importance for the future operations of Landsbanki and consequently for the stability of the Icelandic financial system. Mr. Sigurjón Þ. Arnason, CEO of Landsbanki, stated in a meeting with the governors of the CBI that the current situation was the most critical in the bank's history. The facilitation as requested by Landsbanki from the CBI was that the bank would take over the deposits from Heritable Bank amounting to £2.5 billion (just under ISK 390 billion) and then lend the money immediately back to Landsbanki against certain collateral.

It will now be examined further in what manner the CBI responded to the critical situation that had arisen at this point regarding the affairs of Landsbanki, which was brought to the CBI's attention in the request submitted by Landsbanki on 5 August 2008 and the information accompanying that request. The SIC does not see a reason as such to remark on the CBI's position not to go with the idea of facilitation as put forth by Landsbanki, as such action would have been very risky for the CBI. It was also subject to complications that would probably have influenced the position of the FSA if the consent of the Authority had been sought. It should also be iterated that the idea by Landsbanki presupposed that the CBI would grant the requested facilitation without announcing it publicly. It must be considered rather questionable, that this would have been in compliance with laws governing the operations of the CBI, and reporting requirements concerning the operations of financial institutions and companies listed in the stock market. On the other hand, the request from Landsbanki and the information which

the governors of the CBI and the Director of the International and Market Department of the CBI claim they received from a CEO of Landsbanki about the, at least, alleged attitude of the regulatory authorities in Britain concerning the quality of the loan portfolio of Landsbanki was of such a nature that it was imperative for the Icelandic authorities to take appropriate measures immediately. It should be iterated that Landsbanki had requested facilitation from the CBI which amounted to double the market value of Landsbanki as it was then registered at the stock exchange, and nearly a third of the GDP.

With reference to the role of the CBI to safeguard financial stability and, where applicable, to act as lender of last resort to the Icelandic banks in times of emergency, it shall now be resolved whether the conduct of the Board of Governors of the Bank in this matter constituted negligence in the sense previously described in Chapter 21.5.2. More precisely, this 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.

Comments according to Article 13 of Act No. 142/2008 from the former Board of Governors of the CBI to the SIC include, among other things, the statement that in the board's opinion the idea by Landsbanki did not make sense. The board also stated that the request of Landsbanki was not necessary to provoke anxiety among its members, because such anxiety already existed on the part of the board. The board then reiterated that monitoring the quality of the loan portfolio of financial corporations was the responsibility of the FME, not the CBI. Finally, it was stated that it would not have made much difference even if the CBI had attempted to verify whether Landsbanki was experiencing equity problems.

With due consideration of the role of the CBI to safeguard financial stability and, where applicable, to act as lender of last resort to the Icelandic banks, it is the opinion of the SIC that it was of vital importance to verify if the position of the FSA had been described correctly. Furthermore, the information previously referred to should by itself have been sufficient for the CBI to examine the quality of the loan portfolio of Landsbanki, either in its own capacity or by specifically requesting that the FME would conduct such an examination, and thereby establishing if the bank was in fact experiencing problems with its equity. It must be kept in mind that according to law, a special last-resort facilitation from the CBI can only be granted against adequate collateral from the bank concerned. In addition, the CBI had at this time already granted Landsbanki significant liquidity facilities both directly and indirectly in the form of collateralised loans. The Icelandic banking industry was also facing a general liquidity crisis.

The available documentation provides no indication that the CBI took special measures based on the aforementioned grounds to determine the quality of the loan portfolio of Landsbanki, or have it determined, or whether the alleged attitude of the FSA towards the loans was accurate. It is noteworthy that the request from Landsbanki for the facility in question was submitted on 5 August 2008 but the draft memorandum drawn up by staff members of the CBI regarding the request is dated 26 August 2008. In the meantime,

i.e. 15 August 2008, a letter came to light from the FSA to Landsbanki that was a cause for great concern. It cannot be seen that any position is taken with regard to this letter in the aforesaid memorandum. Furthermore it cannot be seen that the CBI pursued this matter, despite the critical position of Landsbanki at the time, not least in light of the threats from the FSA that it would apply its formal public prerogatives with regard to the London branch of Landsbanki. In the draft of the memorandum of the CBI it is stated that the opinion of the staff members is that the patience and flexibility of the FSA, with regard to the transfer of the loan portfolio, should be tested and the possibility explored whether the owners of Landsbanki would provide it with more funds. There is no further documentation to show that at this time, i.e. well into August 2008, representatives of the CBI made any effort to contact the British authorities directly with regard to the situation that had arisen in the matters concerning Landsbanki. However, representatives of the Bank of England did contact the CBI. Mr. Ingimundur Friðriksson, one of the governors of the CBI, is on record in the documents of the SIC as having stated that the tone of the British representatives during that conversation was particularly grave and that they even discussed the possibility of Landsbanki selling Icesave, cf. description of the meeting of the government consultative group on 11 August 2008 in Chapter 18.2.3.

The SIC is of the opinion that in light of the information regarding the critical position of Landsbanki and the attitude of the FSA towards the affairs of the bank, which according to the aforesaid had been brought to the attention of the CBI by August of 2008, it was necessary for the bank to take appropriate measures in order to verify the actual position of Landsbanki at the time, with regard to the effect that position might have on overall financial stability in Iceland.

The SIC finds that the aforesaid inaction of Governor Oddsson, Governor Guðnason and Governor Friðriksson constitutes an omission to respond in an appropriate manner to imminent danger and to make necessary arrangements, and thereby the aforesaid parties showed negligence in the sense of Article 1(1) of Act No. 142/2008.

#### *21.5.6.3 Handling of the Request from Glitnir Bank hf. by the Board of Governors of the CBI in September 2008*

As further discussed in Chapter 20.2.3, Mr. Þorsteinn Már Baldvinsson, Chairman of the Board of Directors of Glitnir banki hf., declared that he had met with the Chairman of the Board of Governors of the CBI on 25 September 2008 in order to inform him that he was concerned that the bank might not be able to make payment on a loan due on 15 October of the same year. From the reports submitted by the representatives of Glitnir it may be inferred that in their opinion, a collateralised loan was requested in accordance with Article 7(1) of Act No. 36/2001 on the CBI; however, this collateral did not fall under the scope of the rules that were in force at the time and which the CBI had established for itself with reference to that provision. The respective representatives of Glitnir and the CBI are not altogether in agreement regarding the amount of the requested loan, i.e. whether the sum of EUR 500 or EUR 600 million was requested. It may be mentioned that the latter amount represented nearly 25% of the currency reserves of the CBI on 30 September 2008. Under special circumstances, and when the

CBI is of the opinion that it is necessary in order to maintain confidence in the Icelandic financial system, the CBI may, on the basis of Article 7(2) of Act No. 36/2001, grant guarantees or other loans than those mentioned in Article 7(1) to credit institutions that are experiencing liquidity problems at special rates and against other collateral than that mentioned in the aforesaid Article 7(1), or on other terms decided by the CBI. Loans granted by the CBI to a credit institution on the basis of Article 7(2) of Act No. 36/2001 are generally known as last resort loans. As discussed further in Chapter 20.2.7, it may be inferred from the statement of Mr. Davíð Oddsson, Chairman of the Board of Governors of the CBI, before the SIC that the CBI considered the aforesaid request for credit facility to have constituted a request for a last resort loan.

Mr. Oddsson and Mr. Friðriksson both sent letters to the SIC on 24 February 2010, wherein they emphasize that no „formal request for a last resort loan“ had been submitted by Glitnir. However, in the same letter Mr. Oddsson states that during his meeting with Mr. Þorsteinn Már Baldvinsson on 25 September 2008 it was revealed that Mr. Baldvinsson was of the opinion that „the bank would most likely default in a matter of weeks“ and that he had requested a loan which amounted to „a substantial part of the currency reserves of the country“ for that reason. The SIC would like to reaffirm that Act No. 36/2001 on the CBI contains no formal conditions regarding requests for last resort loans, and the important part in this regard is by what public prerogative it was possible for the CBI to grant facilitation to Glitnir under the circumstances described by the Chairman of the Board of Directors of Glitnir.

The request for facilitation submitted by Glitnir, and with regard to the foreseeable difficulties of the Bank in honouring its commitments, meant that the CBI had received a request on which the Board of Governors was obliged to reach a decision. The provisions of Article 7(2) of Act No. 36/2001 governing last resort loans, along with the task of the CBI to grant facilitation, does not entail that a credit institution is entitled to such facilitation after fulfilling certain conditions, as the authority of the CBI in this regard is in the form of discretionary powers which the bank decides whether should be applied or not. A decision of the CBI as to whether and in what manner it should resolve a request submitted by a credit institution for facilitation as a last resort is clearly liable to have a direct effect on the future ability of the relevant credit institution to fulfil its obligations according to the government authorisation under which it operates, and also on the credit institution's right to continue to operate under said authorisation. Furthermore, the decision of the CBI under such circumstances may have a far-reaching effect on the value of the shares in the relevant credit institution, and on the interests of the profession or the banking industry as a whole.

When the points described in Article 7(2) of Act No. 36/2001 are considered, and taking into account the possibly wide-reaching effect and great financial importance of a decision regarding such a request, as previously described, it must be concluded that the decision of the CBI on the basis of the aforesaid legal provision entails the exercise of official authority, subject to acts of administration, cf. Article 1(2) of the Administrative Act No. 37/1993. On the other hand, the SIC finds that there is reason to reaffirm that even though the case was not resolved according to the Administrative

Act, the unwritten principles of administrative rule would nonetheless apply. The unwritten rules of investigation and the unwritten rule of the obligation to report on the resolution of cases lead to the same conclusion in this case as under the provisions of the Administrative Act.

It should also be reiterated that a distinction must be made between, on the one hand, the procedure that applies to the decision of whether the CBI should grant a loan or another form of facilitation as a last resort to a credit institution, and, on the other, the procedure that applies to the production of loan documents and agreement that may be made with regard to such facilitation, cf. for reference the decision of the Supreme Court of 23 March 2000, case No. 407/1999.

Glitnir had not submitted any written statement or description of the underlying cause for the request which the bank submitted to the CBI, or given any explanation as to how Glitnir considered the requested facilitation to be of use in order to remedy the liquidity problems of the bank. The CBI had the obligation to establish a responsible, appropriate and legally valid basis for the handling of Glitnir's request. This entailed among other things that it had to be ensured that the case had been made sufficiently clear before a decision was made.

According to the data submitted to the SIC, the CBI was in possession of limited information when the request from Glitnir was processed, for instance with regard to the operations of the bank, its financing, loan portfolio and the linkage (risk of contagion) of loans and collateral arrangement between the Icelandic banks and other parties, all of which could be quite significant for the future position of the Icelandic financial system. With reference to the aforesaid, it is the opinion of the SIC that the grasp of Glitnir's position was somewhat incomplete. In this regard it must be stressed that in the previous weeks, the situation had deteriorated fast as regards assessment of the banks' assets. There was reason to believe that the government did not have reliable information. Despite the fact that the CBI had a very short time to investigate and prepare the case, it would nonetheless have been possible to send personnel to Glitnir in order to review the bank's books. It also came to light that a few days later the CBI's accountant, Mr. Stefán Svavarsson, was able to obtain much clearer information regarding the position of Glitnir in one day than had been available to the CBI at the time.

Two days after the case was concluded by the government on the recommendation of the CBI, the CBI received a summary from Glitnir's loan book, listing the 30 largest debtors. Mr. Oddsson claims to have been „shocked“ to discover at this moment that the owners of the bank were in debt to the amount of ISK 170 billion, and declared that the CBI was not aware of this fact at the time.<sup>131</sup> In the memorandum of 5 October 2008, prepared by Mr. Stefán Svavarsson, chief accountant of the CBI, it was among other things revealed that the amortisation requirement of Glitnir amounted to nearly ISK 74 billion, and that the larger part of that amount was due to the plummeting of Glitnir's shares, which had been used as collateral for loans. It could therefore be said that the injection of government funds into the bank corresponded to the aforesaid need for amortisation. When the aforesaid

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131. Statement of Davíð Oddsson before the SIC on 7 August 2009, p. 26.

words of the Chairman of the Board of Governors of the CBI and the previously cited memorandum from the CBI's chief accountant are considered, it can only be concluded that the institution lacked sufficient information, among other things regarding large exposures of Glitnir, quality of credit and collateral, in order to properly assess the position of Glitnir at that point in time. Therefore, it cannot be said that the CBI was in possession of the premises that were required in order to assess whether the approach that was recommended to the government was in fact a responsible way to proceed. According to the statements of Mr. Oddsson and Mr. Sturla Pálsson, it is clear that the CBI does not seem to have believed that it had the authority to demand access to information and documents in the possession of Glitnir in connection with that bank's request for a collateral loan.<sup>132</sup> The SIC does not agree with this view. It is clearly stated in Article 29(1) of Act No. 36/2001 on the CBI that the Bank can „directly collect information from parties concluding transactions with the Bank, cf. Article 6, cf. Article 7.“ As previously described, there was no dispute that Article 7 of the Act applied to the request made by Glitnir, and that the task of the bank was performed in accordance with the purpose of Article 4 of said Act, i.e. in order to ensure an active and secure financial system. Therefore it cannot be seen that the CBI availed itself of the judicial remedies that were at the Bank's disposal in order to resolve the case in an appropriate manner. Due to lack of information, the few members of the CBI's personnel that were involved with the case were unable to adequately ascertain the position of Glitnir. Furthermore, no attempt was made to enlist the assistance of the FME, apart from the fact that the CBI sought the FME's assessment of whether the difficulties of Glitnir were solely due to lack of liquidity and not problems with regard to equity. Where the investigation of the position of Glitnir was not performed in an adequate manner, necessary information from the books of Glitnir was lacking. For these reasons, it cannot be seen that there existed adequate grounds for the decision of the CBI to reject Glitnir's request for a loan and recommending instead to the government that it should purchase a 75% share in the bank.

In the opinion of the SIC the Board of Governors of the CBI must therefore be considered negligent, in the sense of Article 1(1) of Act No. 142/2008, as it failed to properly execute its obligation for investigation and omitted, on the basis of Article 29(1) of Act No. 36/2001, 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. Such preparatory work would also have been useful when it was assessed whether it was advisable to recommend to the government that it should offer to purchase a 75% share in Glitnir.

The Board of Governors of the CBI reached the decision that lending the requested funds to Glitnir would be untenable. The grounds for that decision were, on the one hand, that the requested funds would not be sufficient to save the bank and, on the other, that the collateral as offered was not secure enough in the opinion of the CBI. Having reached the aforesaid conclusion,

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132. Statement of Mr. Davíð Oddsson before the SIC on 7 August 2009, p. 26. See also statement of Mr. Baldur Guðlaugsson before the SIC on 20 July 2009, pp. 77-78.

the Board of Governors of the CBI was required to conclude the request from Glitnir with a written decision, signed by the Board of Governors in accordance with Article 24(3) of Act No. 36/2001. The CBI was then to inform Glitnir of that conclusion. This obligation to inform Glitnir of the bank's decision applied irrespective of whether reference is made to Article 20(1) of the Administrative Act or the unwritten principle of announcing such decisions. It was an entirely different matter whether the CBI Board of Governors believed that it was proper, with respect to that decision, to inform Glitnir that the intention was to suggest to the government that other ways would be sought to resolve the difficulties of Glitnir. At that opportunity, the Board of Governors of the CBI could furthermore have given the administrative staff of Glitnir a short time limit to express their views on that decision, or what they intended to do in response to the CBI's refusal. The rule of Article 20(1) of the Administrative Act, as well as the unwritten principle on which it is based, i.e. that the party to a case shall be informed of the decision reached by a government body, is among other things supported by the fact that the party concerned is thereby given the opportunity both to seek further explanation, and also to have the case reconsidered, with reference to new documents and information. Of no less importance is the fact that a concerned party that has for instance been refused the application of a legal authorisation by a government body for certain facilitation, may while there is still time seek other ways in which to resolve foreseeable difficulties. In this regard it must be kept in mind that in the form that this case was presented to the CBI by Glitnir, the representatives of Glitnir were chiefly concerned that they might experience difficulties with honouring payment on a loan due on 15 October 2008, and information regarding this important maturity date for Glitnir had long been available on the international financial market and with Icelandic parties.

It is not fully clear at what time the decision of the Board of Governors of the CBI to grant Glitnir neither a collateral loan nor a facilitation as a last resort, pursuant to Article 7(2) of Act No. 36/2001, was reached. Judging from the answers given by the members of the personnel of the CBI that were involved with the case and those given by government ministers, it can be inferred that already in the afternoon of Friday, 26 September 2008, the Board of Governors of the CBI had resolved that it was not proper to grant Glitnir the loan as requested, cf. for instance information obtained during hearings conducted by the SIC with Governor Eiríkur Guðnason. However, it was not until around 10 o'clock pm on the evening of Sunday, 28 September, that the representatives of Glitnir were summoned to a meeting at the CBI. During that meeting they were informed of the decision that the loan would not be granted, and also of the offer from the government to purchase a 75% share in the bank. The representatives of Glitnir were thus presented with a *fait accompli*. The problems of Glitnir had to be resolved before the bank opened the next morning, among other things because the media had become aware that the dealings within the CBI on that weekend most likely involved Glitnir, as the representatives of that bank were seen entering the CBI on Sunday evening. The directors of Glitnir therefore had hardly any time to consider whether they could find other ways in which to address the problems that were looming in the operations of the company.

With reference to the aforesaid, it is the opinion of the SIC that the Board of Governors of the CBI of Iceland showed negligent in the sense of Article

1(1) of Act No. 142/2008 as they failed to follow the rules of proper administrative procedure with regard to announcing its decision that it would not grant the request of Glitnir banki hf. The Board of Governors was obliged to inform Glitnir of the CBI's decision irrespective of whether reference is made to Article 20(1) of the Administrative Act or the tacit principle of announcing such decisions.