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The 2008 Icelandic Bank Collapse: Foreign Factors - A Report for the Ministry of Finance and Economic Affairs

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The 2008 Icelandic Bank Collapse: Foreign Factors

A Report for the Ministry of Finance and Economic Affairs

Centre for Political and Economic Research
at the Social Science Research Institute
University of Iceland
Reykjavik 19 September 2018



UNIVERSITY OF ICELAND

Summary

1. An international financial crisis started in August 2007, greatly intensifying in 2008.
2. In early 2008, European central banks apparently reached a quiet consensus that the Icelandic banking sector was too big, that it threatened financial stability with its aggressive deposit collection and that it should not be rescued. An additional reason the Bank of England rejected a currency swap deal with the CBI was that it did not want a financial centre in Iceland.
3. While the US had protected and assisted Iceland in the Cold War, now she was no longer considered strategically important. In September, the US Fed refused a dollar swap deal to the CBI similar to what it had made with the three Scandinavian central banks.
4. Despite repeated warnings from the CBI, little was done to prepare for the possible failure of the banks, both because many hoped for the best and because public opinion in Iceland was strongly in favour of the banks and of businessmen controlling them.
5. Hedge funds were active in betting against the krona and the banks and probably also in spreading rumours about Iceland's vulnerability. In late September 2008, when Glitnir Bank was in trouble, the government decided to inject capital into it. But Glitnir's major shareholder, a media magnate, started a campaign against this trust-building measure, and a bank run started.
6. On 7–8 October 2008, at the same time as the British Labour government presented a rescue package of £500 billion for all other British banks, it closed down two British banks owned by Icelanders, Heritable and KSF. Their resolution processes reveal that they had both been solvent.
7. On 8 October, the British government froze all assets of Landsbanki under an Anti-Terrorism Act. On the Treasury's website, Landsbanki (and, briefly, the CBI and other Icelandic institutions) was put on the same list as Al-Qaeda and the Talibans. The alleged purpose was to hinder money transfers to Iceland. But on 3 October a Supervisory Notice had been issued by the FSA to Landsbanki which hindered all money transfers out of the UK.
8. The Icelandic government had decided to try and save Kaupthing and allow the other banks to fail. But the decision by the British government to close down KSF brought about the downfall of its parent company Kaupthing, because of loan covenants, and hence the collapse of the whole banking sector.
9. The decisions by the British government in early October 2008 appear to be politically motivated. Prime Minister Gordon Brown and Chancellor Alistair Darling wanted: to divert attention from their rescue of big Scottish banks; to show Scottish voters the risks of independence; to placate worried depositors; to demonstrate, at little risk, their own toughness; and to improve their bargaining position against Iceland on the resolution of depositors' claims.
10. If the crucial decisions by European central bankers, the US Fed and the UK government had not been made, then Iceland might have had a chance to resolve her financial crisis in the same way as Sweden did in 1991–2, without a traumatic collapse.
11. After the collapse, in Norway, Finland and Denmark local businessmen, with the connivance of the authorities, profited by buying assets of Icelandic banks at low prices.
12. After the collapse, the British and Dutch governments—supported by four Nordic countries—tried to force Iceland into accepting liability for deposits in the fallen Landsbanki in the UK and Netherlands: The debt thus created, as initially estimated, would have been heavier per capita than reparations paid by Finland to the Soviet Union after the 1941–4 war. In two referenda, the Icelanders rejected these demands; in 2013 the EFTA Court found no government liability.
13. The collapse has been blamed on oversized banks, most importantly by a Special Investigation Commission, SIC. But Switzerland and Scotland had banking sectors of a similar relative size and even bigger, without bank collapses.
14. The collapse has been blamed on reckless bankers. While Icelandic bankers took high risks, growing their balance sheets rapidly, bankers elsewhere were reckless, too. Many banks, including RBS in Scotland, UBS in Switzerland and Danske Bank in Denmark, would have failed if not bailed out.
15. Other countries may derive a lesson from the way in which Iceland handled the collapse: If depositors gain a priority claim on bank estates, other kinds of creditors become more cautious, and government guarantees—creating moral hazard—may be unnecessary.

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Introduction

On 7 July 2014, representatives of the Icelandic Ministry of Finance and Economic Affairs and the Social Science Research Institute at the University of Iceland signed an agreement that the Centre for Political and Economic Research, affiliated with the Social Science Research Institute, would undertake to conduct research into the 2008 Icelandic bank collapse, especially its foreign factors, and to deliver a report with its findings to the Ministry. In particular, four problems were to be explored: Why did the US Federal Reserve Board make dollar swap deals with several central banks, including the three Scandinavian ones, while refusing to make such a deal with the CBI? Why did British authorities not extend the same liquidity assistance to the two British banks owned by Icelanders as they did to all other British banks in October 2008? Why did the British Labour government invoke an Anti-Terrorist Act against not only Landsbanki, but also the CBI and IFSA? What was the total loss of the Icelandic banks and the Icelandic economy as a whole from the actions or non-actions abroad preceding and perhaps partly causing the bank collapse?

The project was to be supervised, and the report written, by Professor Hannes H. Gissurarson at the University of Iceland, in collaboration with Professors Birgir Thor Runolfsson and Asgeir Jonsson, both at the University of Iceland. Later, Professor Eiríkur Bergmann at the University of Bifrost joined the project. Both Jonsson and Bergmann have published books in English on the bank collapse.¹ The report was to be 40–50 pages long and to be delivered in twelve months, on 7 July 2015. It was to be written and eventually published in English, with the aim of informing people abroad about what really happened in and to Iceland in the autumn of 2008.

Much has been written about the collapse in 6–8 October 2008 of all three major banks in Iceland, after their rapid growth in 2004–7 and a year of unsuccessful attempts by the Central Bank of Iceland, CBI, very small in proportion to the banks, to obtain liquidity assistance abroad. Nevertheless, it soon emerged that many fields had to be explored anew, even if the Icelandic Parliament had in late 2008 appointed a Special Investigation Commission into the bank collapse, the SIC, which delivered its report in the spring of 2010.² It also became clear that foreign commentators had not always had sufficient access to relevant facts about Icelandic history and society, and about the course of events before, in, and after the bank collapse. It was therefore deemed necessary to write a more extensive report than originally envisaged. A 600

¹ Asgeir Jonsson, *Why Iceland? How one of the world's smallest countries became the meltdown's biggest casualty* (New York: McGrawHill, 2009); Eiríkur Bergmann, *Iceland and the international financial crisis: boom, bust and recovery* (Basingstoke: Palgrave Macmillan, 2014); Asgeir Jonsson and Hersir Sigurgeirsson, *The Icelandic financial crisis: a study into the world's smallest currency area and its recovery from total banking collapse* (Basingstoke: Palgrave Macmillan, 2016).

² Pall Hreinsson, Sigrídur Benedíksdóttir and Tryggvi Gunnarsson, *Skýrsla rannsóknarnefndar Alþingis um addraganda og orsakir falls íslensku bankanna 2008* [Report of the Special Investigation Commission of Parliament on Events Leading Up to and Causes of the Icelandic Bank Collapse] (Reykjavik: Alþingi, 2010). It will be referred to here as the SIC Report. It is all available online in Icelandic, and parts of it are available in English. <https://www.rna.is/eldri-nefndir/addragandi-og-orsakir-falls-islensku-bankanna-2008/> Whenever possible, quotes are from the English extracts.

pages draft was indeed ready in July 2015, but it was regarded as desirable radically to cut it. A 320 pages draft was ready in late 2017, but again it was considered advisable to cut it down to the 179 pages which now contain the report itself. Several other factors contributed to the delay, including difficulties in obtaining interviews with some people and the pre-announced release of new and relevant material.³

While the main author of this report and his collaborators may not agree on everything in it, they all shared the opinion, given the lack of urgency in producing the report, that there was only gain, and really no loss, to let some time pass from the bank collapse to the production of the report. In Iceland, emotions ran high in the aftermath of the collapse, as could be gathered by events almost unprecedented in Icelandic history: A democratically elected government was driven from power by street riots and repeated attacks on the House of Parliament; the three governors of the CBI—which is supposed to be an independent institution protected from political intervention—were forced out of office by special legislation; in the absence of any obvious infringements of the law, under a quaint constitutional stipulation, never used before, the former prime minister was indicted, even if acquitted of all major charges. The more time there is allowed to pass, the more opportunity there may be for a calm and thoughtful analysis of the events of 2008.

Moreover, Iceland is a tiny society where most people are interrelated in one way or another. Before the bank collapse, few Icelanders could avoid some involvement in politics, public administration or the banking sector. Hannes H. Gissurarson was for example in 2001–9 on the Supervisory Board of the CBI, Central Bank of Iceland, and before the collapse he also organised many conferences and other events in which the commercial banks participated. Similar considerations apply to his collaborators. Asgeir Jonsson was chief economist at Kaupthing before the bank collapse, and his father was minister in the left-wing government of 2009–13. Birgir Thor Runolfsson was an alternate member of the Supervisory Board of the CBI and was also for a while on the board of a savings association in his hometown. Eirikur Bergmann worked for the European Commission for a while and sat on the Constitutional Council convened in 2011–12. All such involvements may create biases, even if they may also provide insights and special knowledge. But as the Anglo-Austrian philosopher of science Karl Popper points out, the real issue is not the background, partiality or non-objectivity of the individual scholar: The objectivity of science is brought about by the free competition of ideas, by social institutions which encourage criticism. Scholars are not judges, entrusted with making important decisions about life and liberty of other people, so they can hardly be disqualified by their personal history or known predispositions. It is the strength of the evidence and arguments which they present which should count.⁴

³ The main author of this report discusses aspects of the bank collapse not covered in any detail here, Hannes H. Gissurarson, *In Defence of Small States* (Brussels: New Direction, 2016) and *Lessons for Europe from the 2008 Icelandic Bank Collapse* (Brussels: New Direction, 2017).

http://newdirection.online/2018-publications-pdf/LESSONS_FOR_EUROPE.pdf

⁴ Karl R. Popper, *The Poverty of Historicism* (London: Routledge, 2002), p. 143.

A Note on Methodology

This report was written using mainly an historical, philosophical and qualitative analysis of the existing material on the bank collapse. One of the main sources was interviews with the main players in the collapse, including the former Icelandic Prime Minister and Finance Minister, the three former CBI governors, the former Director of the Icelandic Financial Supervisory Authority, some former owners and managers of the Icelandic banks, the governors at the time of the Bank of England and the Swedish Riksbanken and the British Chancellor of the Exchequer. Hannes H. Gissurarson conducted all the interviews. As he had started his research into the bank collapse shortly after it took place, some of the interviews preceded the signing of the agreement between the Social Science Research Institute at the University of Iceland and the Ministry of Finance and Economic Affairs. The main objective of the interviews was to get the perspective of those interviewed, not to obtain any revelations or exposures. They were therefore conducted in a friendly manner, as a discussion rather than as an interrogation. Of particular value was a long and comprehensive interview with former CBI Governor Eiríkur Guðnason in 2011. A few people interviewed wished to remain anonymous, as stated in footnotes in each case, but their identity was made known confidentially to the Director of the Social Science Research Institute, and in no case were their contributions crucial anyway to the main conclusions reached in the report. Some of those mentioned in the original agreement between the Social Science Research Institute and the Ministry of Finance and Economic Affairs as individuals who might be contacted for this report were not prepared to grant interviews, while it was felt that interviews with some others were superfluous, as the information sought had already been provided.

Another important source was the 2010 Report by the SIC in seven bulky volumes and one additional volume online. It is a mine of information about the course of events leading up to the bank collapse and empirical facts. A third source was the several books or other works published about the bank collapse, especially by participants in the process, such as politicians and bankers. A fourth source was unpublished material, such as an informative monograph on the bank collapse in English by former CBI Governor Ingimundur Fridriksson, a report in English about Landsbanki's activities by its former directors, transcripts of some testimonies before the SIC, and documents obtained under Iceland's Freedom of Information Law, such as a transcript of a conversation between the Icelandic Prime Minister and the British Chancellor of the Exchequer and a memo by an IFSA staff member on a meeting between the Icelandic Ombudsman and bankers. A fifth source was material available online, such as various reports, press releases, and newspaper articles.¹ It greatly facilitates historical research in Iceland that all Icelandic newspapers and many journals are available online. Wherever possible, links to them have been provided.

¹ The most relevant material has been put on the website of the Centre for Political and Economic Research at the University of Iceland, led by Professor Hannes H. Gissurarson.
<http://rse.hi.is/documents-on-bank-collapse/>

The collaboration in writing this report consisted in Birgir Th. Runolfsson, Asgeir Jonsson and Eiríkur Bergmann making available the results of their research to Gissurarson who also did his independent research, wrote the report and bears full responsibility alone for it. After a brief account of the main conclusions of the SIC Report, the narrative is mainly in an historical order, moving from the activities of hedge funds and European central banks to those of the US Federal Reserve Board and the British Labour government, ending with the Icesave dispute. It was deemed necessary to include a philosophical analysis of fairness in transactions conducted under duress and of the idea of collective responsibility. Throughout, what Karl R. Popper calls “the logic of situations” has been used: Actions are rendered intelligible by analysing the incentives and constraints under which individuals actors operate.² For example, the brutal and unprecedented actions by the British Labour government in closing down British banks owned by Icelanders and invoking an Anti-Terrorist Act against Icelandic banks and authorities cannot be explained by any material need for them, as the government could reach its stated objective of hindering illegal transfers from the UK to Iceland by existing remedies, such as a Supervisory Notice issued by the British Financial Services Authority, FSA, to Landsbanki’s London branch 3 October 2008. What renders these actions intelligible are the political needs of the actors: They had to seem decisive, divert attention from the rescue of two big Scottish banks and demonstrate that monetary independence for Scotland was risky. Another example is the sudden loss of interest by the Russian government in providing liquidity to the CBI after a firm initial offer on 7 October 2008: it becomes intelligible after, and as a result of, the International Monetary Fund, IMF, having entered the field. These are hypotheses, based on the logic of the situation rather than uncontestable evidence.

² Popper, *Poverty of Historicism*, p. 138.

Timeline of Events

- 1990.** One of three main government banks privatised by left-wing coalition government, merging with small private banks, becoming Islandsbanki.
- Spring 1991–Autumn 2004.** Independence Party Leader David Oddsson Prime Minister, 1991–5 in coalition with Social Democrats, 1995–2004 in coalition with Progressive Party.
- 1 January 1994.** Iceland joins EEA, European Economic Area, becomes a member country of the internal market, including financial market.
- 1998.** First half of investment bank FBA privatised. Oddsson’s objective of dispersed ownership thwarted by investment company Kaupthing buying up shares and selling as package.
- Summer 1998.** Skandinaviska Enskilda Bank expresses interest in buying controlling share in Landsbanki, but at low price and without bidding process. Government rejects idea.
- 1999.** Second half of investment bank FBA privatised, the bank subsequently merging with Islandsbanki.
- 1998–1999.** 30% of two remaining government banks, Landsbanki and Bunadarbanki, sold each in public tender.
- 2000.** Landsbanki buys London-based Heritable Bank.
- Autumn 2001.** HSBC, on behalf of Icelandic government, tries to find foreign buyers of remaining shares in Landsbanki and Bunadarbanki. No interest.
- Summer 2002.** Samson Group expresses interest in buying controlling share in Landsbanki.
- Autumn 2002.** Bidding process initiated which ends with acceptance, on advice of HSBC, of offer from Samson Group for 45.8% in Landsbanki and from S-Group for 45.8% in Bunadarbanki.
- Autumn 2002.** Kaupthing buys Swedish bank JP Nordiska.
- Early 2003.** Samson takes control of Landsbanki and S-Group of Bunadarbanki. S-Group sells its shares in Bunadarbanki to Kaupthing, which merges the two companies. New bank first called Kaupthing Bunadarbanki, then KB Bank and finally Kaupthing Bank.
- 2003–2006.** Rapid expansion of Icelandic banks abroad. In 2005 Gallup poll, 86% consider this beneficial.
- 2004.** Kaupthing buys Danish FIH Bank and doubles in size.
- 2004.** Islandsbanki buys Norwegian banks Kredittbanken and BNBank and merge them into one bank.
- 2004.** Banks start offering mortgages in competition with government-owned Housing Financing Fund.
- Autumn 2004–Spring 2007.** Coalition government of Independence Party and Progressives, until 2006 under Progressive Party Leader Halldor Asgrimsson and then under Independence Party Leader Geir H. Haarde. Former Prime Minister Oddsson Foreign Minister 2004–5.
- March 2005.** Landsbanki sets up branch in London.
- April 2005.** Kaupthing buys London-based Singer & Friedlander, renamed Kaupthing Singer & Friedlander, KSF.
- November 2005.** David Oddsson, CBI Governor since October, confidentially warns Prime Minister Halldor Asgrimsson and Foreign Minister Geir H. Haarde that banks might collapse.
- November 2005.** Financial analysts abroad express scepticism about long-term prospects of Icelandic banks. Hedge funds start betting against them.
- March 2006.** Islandsbanki changes name to Glitnir.
- March–April 2006.** ‘Geyser Crisis’: In wake of negative assessments by financial analysts, Icelandic banks experience funding problems, but weather storm.
- 5 October 2006.** Icelandic retail tycoon and media magnate Jon Asgeir Johannesson starts publishing free Danish newspaper, *Nyhedsavisen*, challenging existing Danish media. Enterprise lasts 14 months, with estimated loss of \$88 million. Provokes negative publicity about Icelandic business sector.
- October 2006.** Landsbanki starts collecting online deposits in ‘Icesave’ accounts in UK, through London branch.
- Early 2007.** Kaupthing starts collecting online deposits in ‘Edge’ accounts in many European countries, in UK through subsidiary KSF, elsewhere mostly through branches.
- May 2007.** Biggest debtor of banks, Jon Asgeir Johannesson, gains control of Glitnir.
- 16 May 2007.** At luncheon meeting organised by Kaupthing, financial historian Niall Ferguson predicts international financial crisis.
- 24 May 2007.** Geir H. Haarde forms coalition government of Independence Party and Social Democrats.
- 9 August 2007.** International credit crunch starts with French bank BNP Paribas announcing problems in pricing securities.
- 15 August 2007.** Kaupthing announces intention to buy Dutch bank NIBC.

14 September 2007. Run on British bank Northern Rock which is rescued by government and subsequently nationalised.

7 November 2007. CBI Governor Oddsson publicly issues a stern warning to banks that they have to reduce foreign debt.

Late 2007. Governor Oddsson expresses great concern about feasibility of greatly expanded banking sector in confidential meeting with Prime Minister Haarde, Finance Minister Arni M. Mathiesen and Education Minister Thorgerdur K. Gunnarsdottir.

Late January 2008. In face of opposition from CBI and IFSA, Kaupthing abandons plan to buy Dutch bank NIBC.

7 February 2008. Governor Oddsson asks for emergency meeting with Prime Minister Haarde, Finance Minister Mathiesen and Foreign Minister Ingibjorg S. Gisladottir, Leader of Social Democrats. He tells them Icelandic banks have lost all credibility abroad. Gisladottir dismisses his warning as “one man’s venting”.

February 2008. CBI invites financial expert Andrew Gracie from Bank of England to write report on problems ahead. He concludes banking sector might collapse in October 2008. Report passed on to government ministers.

14 March 2008. US investment bank Bear Sterns rescued by Fed and subsequently taken over by JP Morgan Chase.

23 April 2008. Bank of England rejects request by CBI for currency swap deal. ECB and Fed reject similar requests.

25 April 2008. ECB demands Icelandic banks immediately reduce borrowing from it against collateral in mutually issued securities.

4 May 2008. Icelandic banks discussed at closed meeting of governors of central banks of the G10 in Basel. Apparently, consensus that they should not be given liquidity assistance.

May 2008. Scandinavian central banks reluctantly make currency swap deals with CBI, against government reassurances about reforms aimed at reducing liabilities of Icelandic financial sector.

6 June 2008. Governor Oddsson requests dollar swap deal with Fed, and is turned down.

1 July 2008. Vulnerability of Icelandic banks brought up in House of Lords. Subsequently, FSA hardens position towards Landsbanki.

31 July 2008. Governor Oddsson tells Landsbanki’s directors that there is not, and should not be, government guarantee of Icesave accounts.

31 July 2008. In evening, Governor Oddsson dines with BIS economist William R. White who predicts that one big investment bank, possibly Lehman Brothers, and one small European country, possibly Iceland, will go under before governments move to rescue financial sector.

8 September 2008. In Basel, Nout Wellink, governor of Dutch central bank, tells CBI Governor Oddsson that Icelandic banks will be stopped one way or another.

15 September 2008. Lehman Brothers goes under. Bank of America takes over Merrill Lynch.

18 September 2008. Encouraged by Labour government, British bank Lloyds takes over HBOS, Halifax Bank of Scotland.

22 September 2008. Goldman Sachs and Morgan Stanley change overnight into bank holding companies to come under Fed’s supervision and protection.

24 September 2008. Fed announces dollar swap deals with three Scandinavian central banks. Icelandic central bank conspicuously absent.

25 September 2008. Glitnir asks for emergency loan of €600 million from CBI which rejects request and advises government instead to recapitalise the bank.

26 September 2008. Fed rejects request by CBI for dollar deal similar to that with Scandinavian central banks.

28 September 2008. Government offers to buy 75% of Glitnir for €600 million. Glitnir’s main shareholders accept offer, but the biggest shareholder, Jon Asgeir Johannesson, starts a media campaign against transaction.

29 September 2008. Financial markets in turmoil. Benelux countries rescue Fortis and Dexia banks. German government rescues Hypo Real Estate. British government takes over Bradford & Bingley. Rescue bill on banks defeated in the US House of Representatives. Recapitalisation of Glitnir met with scepticism in international markets. Rating agencies downgrade Icelandic banks and Treasury.

30 September 2008. Attending cabinet meeting on own initiative, Governor Oddsson tells government banking sector is about to collapse; ring-fencing Iceland is only option; CBI has appointed Liquidity Crisis Task Force to work out ring-fencing plan; and if there was ever a time for national unity government, it would be now.

3 October 2008. Liquidity Crisis Task Force presents its plan: priority assigned to depositors' claims, domestic operations of banks taken over by government, foreign operations dealt with on a case to case basis.

3 October 2008. Run on Icelandic banks after Professor Gylfi Magnusson says in radio interview at noon that they are 'technically bankrupt'. CBI almost out of banknotes following days.

3 October 2008. ECB issues margin calls (more collateral or repayment of loans) on Landsbanki and Glitnir.

3 October 2008. Prime Minister Haarde receives phone call from British Chancellor Alistair Darling who claims that Kaupthing has illegally transferred €600 million from the UK to Iceland. Kaupthing management denies allegation.

3 October 2008. FSA issues Supervisory Notice to Landsbanki, in effect prohibiting all transfers out of UK.

4 October 2008. Governor Oddsson calls Governor King of the Bank of England. Same night, King sends financial expert Marc Dobler to Iceland to assist in working out the ring-fencing option.

4 October 2008. Social Democrats reject proposal by Prime Minister Haarde that special emergency team led by Governor Oddsson should implement ring-fencing plan.

5 October 2008. Prime Minister Haarde receives phone call from British colleague Gordon Brown who claims that Kaupthing has illegally transferred €1.6 billion out of the UK. Haarde refers to denials by Kaupthing management. Brown also advises Iceland to enter an IMF programme. ECB revokes margin calls.

5 October 2008. Team from IMF arrives, apparently on own initiative.

5 October 2008. CBI flies in three experts from JP Morgan who, in wee hours of 6 October, convince government ministers from Social Democrats that ring-fencing Iceland is only feasible option.

6 October 2008. Emergency Act, based on plan worked out by Liquidity Crisis Task Force at CBI, passed by Parliament.

6 October 2008. CBI, urged by government, extends emergency loan of €500 million to Kaupthing, taking Danish FIH Bank as collateral. Consequently, CBI turns down request from Landsbanki for emergency loan. At night, Landsbanki put into resolution.

6 October 2008. KSF, a British bank, asks FSA whether the Bank of England could provide it with liquidity. Request immediately rejected.

7 October 2008. Early in morning, Russian Ambassador calls Governor Oddsson telling him that Russia is willing to extend a €4 billion loan to Iceland. Later in the day, probably after Russians learn about talks with IMF, formerly firm offer becomes tentative, and does not come to anything..

7 October 2008. Chancellor Darling calls Finance Minister Mathiesen and asks what Icelandic government will do about Landsbanki's Icesave accounts. Mathiesen replies that despite grave difficulties government will try to fulfil its legal obligations.

7 October 2008. At night, Glitnir put into resolution. Kaupthing desperately tries to stay afloat and to sell assets, including British bank KSF.

8 October 2008. At 7 in morning, UK Prime Minister Brown and Chancellor Darling announce £500 billion rescue package for British banks. KSF asks to be included. Request rejected.

8 October 2008. At 10 in morning, British television reports that Kaupthing is collapsing and that Chancellor Darling is transferring Landsbanki's Icesave accounts and KSF's Edge accounts to Dutch bank ING. At 11:30, FSA issues a Supervisory Notice, closing down KSF as from 13:30. At 12:33, Chancellor Darling announces that Kaupthing has been put into liquidation and that he has transferred Icesave and Edge accounts to ING.

8 October 2008. At night, as a result of KSF close-down, and stipulations in loan covenants, Icelandic parent company Kaupthing forced into resolution.

8 October 2008. Chancellor Darling announces use of 2001 Anti-Terrorism Act against Landsbanki, CBI, IFSA and other Icelandic authorities, freezing Landsbanki's UK assets. On Treasury's website, Icelandic authorities and Landsbanki listed with Al-Qaeda, Talibans and governments of North Korea and Sudan.

8 October 2008. Norwegian DIGF extends short-term emergency loan to Norwegian Glitnir.

8 October 2008. Swedish central bank, Riksbanken, extends emergency loan to Swedish Kaupthing which subsequently is sold to Ålandsbanken.

9 October 2008. Prime Minister Haarde tries to reach his British colleague Brown to discuss use of Anti-Terrorism Act against Iceland, but is directed to Chancellor Darling.

9 October 2008. Prime Minister Brown tells press that Iceland is bankrupt and threatens legal action against Icelandic government.

12 October 2008. Norwegian Glitnir Securities sold to management team.

12 October 2008. While Landsbanki remains on British Treasury's list of organisations subject to economic sanctions, with Al-Qaeda and Talibans, Bank of England extends short-term loan to its London branch.

14 October 2008. Finnish Glitnir Corporation is sold to management team and name changed to FIM.

21 October 2008. Norwegian Glitnir is sold to consortium of savings associations and name changed to BNBank.

October 2008. Having taken possession of FIH Bank, CBI tries to sell it, but sale postponed due to adverse market conditions. Like other Danish banks, FIH Bank receives liquidity from Danish central bank.

24 October 2008. After government decides to seek assistance from IMF, CBI Governor Oddsson requests Fed's participation, and is turned down for fourth time.

14 November 2008. In Icesave dispute, Icelandic negotiators accept 'Brussels guidelines' according to which Iceland's unprecedented difficulties should be taken into account, while government promises to do its best to reimburse British and Dutch authorities for outlays.

19 November 2008. IMF approves loan to Iceland, previously held up at insistence of UK and Netherlands.

20–23 January 2009. Unprecedented street riots in Reykjavik centre. Police almost out of pepper gas.

1 February 2009. After Social Democrats leave Haarde's coalition government, it is replaced by minority government of Social Democrats and Left Greens, under Johanna Sigurdardottir.

26 February 2009. Three CBI governors removed by special law passed by Parliament.

25 April 2009. Social Democrats and Left Greens win landslide victory in parliamentary elections and form new government, again under Johanna Sigurdardottir. Independence Party suffers debacle.

5 June 2009. Chief Icelandic negotiator in Icesave dispute, Svavar Gestsson, signs deal with British and Dutch officials.

Autumn 2009. Icesave deal meets fierce opposition, not least from former CBI Governor Oddsson. Parliament accepts deal, with preconditions. British and Dutch negotiators reject preconditions.

30 December 2009. Second Icesave deal, with little changes from first one, accepted by Parliament.

6 March 2010. Second Icesave deal overwhelmingly rejected in national referendum after President refuses to sign it into law: 98% against, 2% for.

12 April 2010. Special Investigation Commission on bank collapse delivers Report, finding three former government ministers, three former CBI governors and IFSA Director to have been negligent.

18 September 2010. CBI sells FIH Bank to consortium of investors and pension funds. New owners subsequently wind up bank.

28 September 2010. Narrow majority of Parliament decides, on basis of SIC Report, to charge former Prime Minister Geir H. Haarde for gross negligence before specially convened Impeachment Court.

8 December 2010. Chief negotiator in Icesave dispute, Lee Buchheit, signs third Icesave deal with British and Dutch officials.

9 April 2011. Third Icesave deal rejected in national referendum after President refuses to sign it into law: 60% against, 40% for.

23 April 2012. Impeachment Court acquits former Prime Minister Haarde of all major charges, only upholding charge he had not put pending bank crisis on agenda at cabinet meetings.

18 June 2012. After thorough investigation, FSA finds no particular fault with KSF management.

28 January 2013. EFTA Court delivers judgement in Icesave dispute, finding for Iceland.

27 April 2013. Social Democrats and Left Greens suffer heavy losses in parliamentary elections. Progressives and Independence Party form government under Sigmundur D. Gunnlaugsson.

9 October 2015. Iceland repays IMF in full, ahead of schedule.

End of 2015. Agreement between creditors of fallen banks and Icelandic government: Most Icelandic assets of banks relinquished to government, while creditors receive exemption from capital controls.

End of 2015. Composition agreements with creditors of fallen banks. Total accepted claims €65.1 billion. Depositors receive 100%, other creditors 26%. Mean recovery of all claims 48%.

January 2016. Final, and full, payment to British depositors in Landsbanki's Icesave accounts.

March 2016. Recovery rate for Heritable estimated 98 pence in the pound.

29 October 2016. Parliamentary elections, after which Independence Party Leader Bjarni Benediktsson forms coalition government with two small centre parties.

January–December 2016. Icelandic economy grows by 7.5%, having in 2015 grown by 4.5%.

March 2017. Capital controls, in place since the bank collapse, in effect abolished.

May 2017. Recovery rate for KSF estimated 87 pence in the pound.

28 October 2017. Parliamentary elections, after which Left Greens Leader Katrin Jakobsdottir forms government with Independence Party and Progressives.

Chapter One

The Findings of the Special Investigation Commission (SIC)

After the 2008 bank collapse, the surprised and shocked Icelandic nation turned to a Special Investigation Commission, SIC, for explanations. Its report, often regarded as the most authoritative analysis of the various factors in the collapse, domestic and foreign, cannot be ignored in an investigation of foreign factors in the bank collapse.

1. The SIC's Main Explanation: Over-sized, Reckless Banks

After confidential negotiations, on 12 December 2008 the political parties in Parliament unanimously voted for a law stipulating the appointment of a Special Investigation Commission on the bank collapse. The SIC should consist of three members, a Supreme Court judge who would chair it, the Parliamentary Ombudsman, and an economist, or a certified accountant or another expert with special knowledge on the economy or about financial markets. The SIC received wide-ranging powers to require confidential documents which otherwise would not have been available, to summon people to testify before it and to grant immunity to possible informants. People could not complain to the Parliamentary Ombudsman if they thought that proper procedures had not been followed by the SIC or its members. The SIC should deliver its report no later than 1 November 2009.¹ On 30 December the Presidency of the Parliament appointed the three SIC members: Supreme Court Judge Pall Hreinsson, Parliamentary Ombudsman Tryggvi Gunnarsson and financial expert Dr. Sigridur Benediktsdottir, an economics lecturer at Yale University. After the SIC had operated for a year, it received at the end of 2009 full legal immunity for itself: People could not sue the SIC or its individual members, even if they believed that the SIC or its members had violated their rights.²

The SIC published its Report on 12 April 2010, almost six months behind schedule. It concluded that the explanations “for the collapse of Glitnir Bank hf., Kaupthing Bank hf. and Landsbanki Islands hf. are first and foremost to be found in their rapid expansion and their subsequent size when they tumbled in October 2008.”³ The banks’ rapid growth was made possible, the SIC explained, by Iceland’s good credit ratings and by the access of the banks to the European markets, on the basis of Iceland’s membership since 1994 in the European Economic Area, EEA. The SIC identified three main business groups operating in the Icelandic economy and named each of them after its most important or visible company, Baugur led by Jon Asgeir Johannesson, Exista, an investment company with a lot of shares in Kaupthing, and Landsbanki, consisting of the two major shareholders in Landsbanki, Bjorgolfur

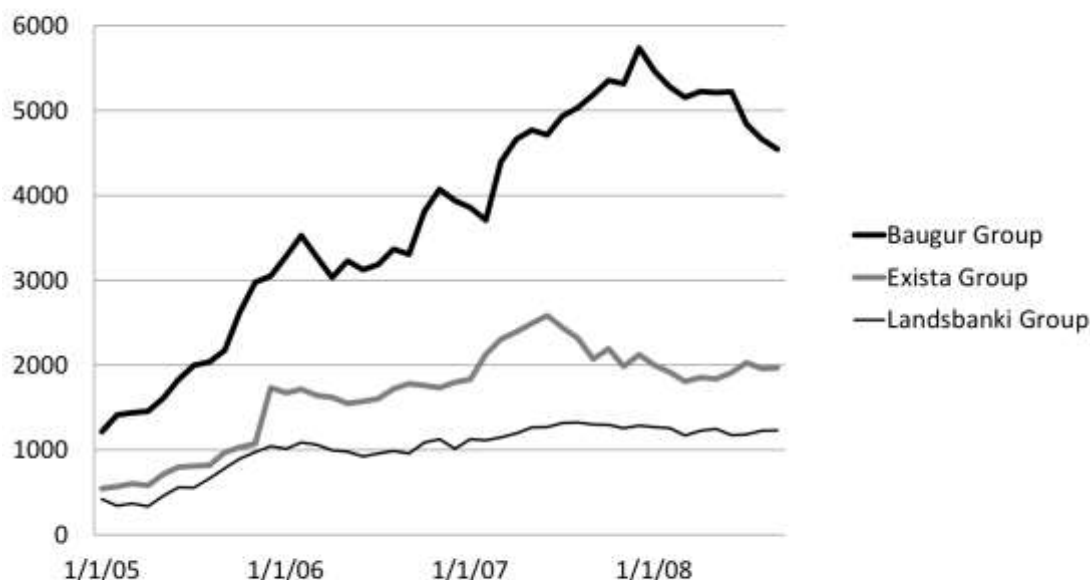
¹ Law No. 142/2008. <https://www.althingi.is/altext/stjt/2008.142.html>

² Law No. 146/2009. <https://www.althingi.is/altext/stjt/2009.146.html>

³ SIC Report, Vol. 1, Ch. 2, p. 1 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf>

Gudmundsson and his son Thor Bjorgolfsson. The development of the total debt to the banks of the three groups in 2005–2008 is shown in Figure 1.

Figure 1: Total Debt of Main Business Groups, €million



Source: SIC Report (2010), Vol. 7, Ch. 21: Calculated from Online Supplementary Data.

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

For that reason the systemic exposure risk attributed to the loans became significant. The clearest example is Baugur Group and affiliated companies. The group's outstanding liabilities to the three banks amounted to EUR 5.5 billion, when at their highest level, which was at the time about 11% of total lending by the parent companies of the banks and about 53% of their aggregated equity base.⁴

This is essentially the same criticism that then CBI Governor David Oddsson had directed against the banks in a speech shortly after the collapse:

The anger that is seething just below the surface of our society and can be aimed in various directions is seething largely because the public have received so little information about what is happening. Why are they not being told that a single party owed one trillion Icelandic kronur to the domestic banking system?⁵

Oddsson's number was close to that of the SIC: In November 2008, €5.5 billion was equivalent to 957 billion Icelandic *kronur*. In his speech, Oddsson had asked how any

⁴ Ibid., p. 3 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf>

⁵ Speech to the Icelandic Chamber of Commerce 18 November 2008 (English translation), <http://www.cb.is/lisalib/getfile.aspx?itemid=6604>

one party had been able to accumulate such enormous debt, around one trillion Icelandic *kronur* or €5.5 billion, in the Icelandic banks: “How in the world could this happen? What sort of stranglehold did this party have on the banks and the whole system?”⁶

However pertinent this question may have been, the SIC did not take it up. While it documented in detail the maneuvers or perhaps manipulations by the banks during the credit expansion, and in trying to survive during the credit crunch, it obviously regarded it as its chief task to allocate responsibility to various Icelandic authorities regarding the bank collapse. The SIC found three government ministers, Prime Minister Geir H. Haarde, Finance Minister Arni M. Mathiesen and Business Affairs Minister Bjorgvin G. Sigurdsson, to have shown negligence “during the time leading up to the collapse of the Icelandic banks, by omitting to respond in an appropriate fashion to the impending danger for the Icelandic economy that was caused by the deteriorating situation of the banks.” The SIC also found four high officials, IFSA Director Jonas Fr. Jonsson, and the three CBI governors, David Oddsson, Eiríkur Guðnason and Ingimundur Fríðriksson, to have shown negligence “in the course of particular work during the administration of laws and rules on financial activities, and monitoring thereof.”⁷

The conclusions of the SIC Report were received with great interest in Iceland, and also elsewhere. In a book about the international financial crisis, Chancellor Alistair Darling commented on the SIC: “It examined the relationship between politicians, bankers and business people. Its report makes grim reading.”⁸ However, some of the politicians and high officials whom the SIC investigated and eventually found to have shown negligence, uttered several criticisms of its composition and procedures when interviewed for this report.⁹ They took exception to the original stipulation that people who thought that they had not received fair treatment by the SIC could not complain to the Ombudsman, who was indeed one of the SIC members, and also to the stipulation added later that people who believed their legal rights had been violated by the SIC could not refer the matter to the courts. Under the Rule of Law, they argued, such a possibility would normally be regarded as an important safeguard against abuse of power.

Moreover, some of those investigated by the SIC held that it had been unwise to appoint a committee of Icelanders instead of international experts, because Iceland is a tiny society where people could sometimes find it hard to be impartial, not least if they belonged to any of the invisible networks of friends, families and allies which might be even stronger in Iceland than most other countries (as many commentators

⁶ Op. cit.

⁷ SIC Report, Vol. 1, Ch. 2, p. 18 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf> In both cases, the SIC referred to negligence “within the meaning of Article 1(1) of Act No 142/2008”, which was the law passed by Parliament on the SIC and its investigation, after the collapse. By this, arguably the SIC used a retroactive rule. Interview with Jonas Fr. Jonsson in Reykjavík 6 October 2016.

⁸ Alistair Darling, *Back from the Brink* (London: Atlantic Books, 2011), p. 138.

⁹ Interviews with Eiríkur Guðnason in Kópavogur 25 October 2011, with Geir H. Haarde in Reykjavík 1 October 2013 and by phone 13 November 2017, with David Oddsson in Reykjavík 7 October 2013 and 5 October 2017, and with Jonas Fr. Jonsson in Reykjavík 6 October 2016.

on Icelandic affairs indeed had pointed out).¹⁰ One illustration of how tiny Iceland is can be gathered from the fact that two of the three SIC members declared themselves to have connections to people involved in the bank collapse, as they were required to do by the law on the SIC.¹¹ Also, both former CBI Governor David Oddsson and former IFSA Director Jonas Fr. Jonsson criticised comments about the bank collapse made by one of the SIC members, Sigridur Benediktsdottir, shortly after her appointment. These comments suggested, according to them, that Benediktsdottir had already reached the conclusion that the CBI and the IFSA were largely to blame for the collapse.¹² The other two SIC members held, however, that by these comments Benediktsdottir had not become unfit to serve on the Commission.¹³

Some of those investigated and eventually reprimanded by the SIC also felt that it had not provided a level playing field. The individuals giving testimony to the SIC were quoted verbatim in the report, at the discretion of the SIC and without permission: They did not have any opportunity to correct themselves or to improve on the formulation of their answers, as is the case for example in printed transcripts of the sessions of the Icelandic Parliament. The objections of those accused were not printed with the report, just made available online. Again, not only were the individual SIC members granted legal immunity, but they also decided not to make their hearings public, let alone to allow live coverage of them, as is the tradition in the US and, to some extent, also in the UK.¹⁴ Thus, the activities of the SIC became much less transparent than they should have been, according to some. Moreover, after the SIC had presented its report, the evidence given to it was locked up instead of being made available to the public.¹⁵

¹⁰ Anne Sibert, *Undersized: Could Greenland be the new Iceland? Should it be?* Voxeu.org 10 August 2009. <http://www.voxeu.org/article/could-greenland-be-new-iceland> Also, Baldur Thorhallsson and Peadar Kirby, *Financial crises in Iceland and Ireland: Does European Union and Euro membership matter?* *Journal of Common Market Studies*, Vol. 50, No. 5, pp. 801–18. <http://ams.hi.is/wp-content/uploads/2014/03/j.1468-5965.2012.02258.x.pdf>

¹¹ SIC Report, Preliminary, Nefndin [The Commission]. <https://www.rna.is/eldri-nefndir/addragandi-og-orsakir-falls-islensku-bankanna-2008/nefndin/>

¹² SIC Report, Online Addenda, No. 11. From Oddsson, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-5DO.pdf>, and Jonsson, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-12JFJ.pdf>. In their responses, Governors Eiríkur Guðnason, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-7EG.pdf>, and Ingimundur Fridriksson, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-6IF.pdf>, declared themselves to be in agreement with Oddsson’s criticism of Benediktsdottir’s comments. Benediktsdottir had commented that she felt the collapse was “a result of extreme greed on the part of many and reckless complacency by the institutions that were in charge of regulating the industry and in charge of ensuring financial stability in the country.” Eileen Shim, *Iceland seeks help of Yale professor*. *Yale Daily News*, 31 March 2009. <http://yaledailynews.com/blog/2009/03/31/qa-iceland-seeks-help-of-yale-professor/>

¹³ SIC Report, Online Addenda, No. 12. Initially, the other two SIC members had concluded that by these comments Benediktsdottir had become unfit to serve on the Commission, but she refused to resign, and subsequently they reversed their initial position. Magnus Halldorsson, Vildu Sigríði úr nefnd [Wanted Benediktsdottir to Quit], *Morgunblaðið* 12 June 2009, p. 6. http://timarit.is/view_page_init.jsp?pageId=5254897

¹⁴ For example, former Prime Minister Tony Blair’s testimony to the Committee of Inquiry on the Iraq war was broadcast live and is available on Youtube.

¹⁵ Interviews with Eiríkur Guðnason in Kópavogur 25 October 2011, with Geir H. Haarde in Reykjavík 1 October 2013 and by phone 13 November 2017, with David Oddsson in Reykjavík 7 October 2013 and 5 October 2017, and with Jonas Fr. Jonsson in Reykjavík 6 October 2016.

2. The Impeachment Case Against Geir H. Haarde

After the SIC delivered its report to Parliament in April 2010, a parliamentary committee was appointed to respond to its findings. A majority in the committee recommended bringing charges of negligence against four former government ministers, Prime Minister Geir H. Haarde, Foreign Minister Ingibjorg S. Gisladottir, Finance Minister Arni M. Mathiesen and Business Affairs Minister Bjorgvin G. Sigurdsson, before a special Impeachment Court which had never been convened but whose task under the Constitution was to judge government ministers in special cases outside the scope of normal legal procedures.¹⁶ A narrow majority of Parliament eventually voted for the proposal to bring a case against Haarde alone before the Impeachment Court. In the ensuing trial, one of the main problems with the conclusions of the SIC could be observed: how people could be held legally responsible for a course of events mostly beyond their control. One witness after another testified that Haarde's options were very limited after the beginning of the international credit crunch.¹⁷ While it may be true that he did not actively respond to repeated warnings by the CBI governors about the precariousness of the banks,¹⁸ it is difficult to see what he could have done, even if he may have taken these warnings quite seriously.¹⁹ Usually, after meetings with the CBI governors he summoned the bankers and they repeatedly reassured him that everything was in order and that their banks were fully financed. Moreover, the bank accounts were audited by well-known international audit firms. In addition, Haarde faced two political constraints: the bankers and their main clients were popular and influential and they enjoyed the support of many politicians, both in his own party and among his coalition partners since 2007, the Social Democrats.²⁰

Before the trial, the Impeachment Court already had dismissed two charges against Haarde: that he had shown gross negligence by not responding adequately to signs of a great and impending danger; and that he had neglected to commission an analysis

¹⁶ The report of the parliamentary committee is found (in Icelandic) on the Parliament website. <https://www.althingi.is/altext/pdf/138/s/1501.pdf>

¹⁷ *Landsdomur* [Impeachment Court], No. 3/2011, 23 April 2012, p. 359. <https://www.landsdomur.is/media/skyrslur/nr.-3-2011-Domur-a-vef.pdf>

¹⁸ In the SIC Report, some meetings between the CBI governors and leading government ministers where warnings were uttered are documented. Meeting 13 January 2008: Vol. 6, Ch. 19, pp. 102–103. Meeting 7 February: Vol. 6, Ch. 19, p. 120. Meeting 1 April: Ch. 18 (in English), p. 11, <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli18Enska1.pdf> and Ch. 21 (in English), p. 57, <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>. Meeting 16 April: Vol. 6, Ch. 19, pp. 163–164, Meeting 7 May: Ch. 18 (in English), p. 12, <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli18Enska1.pdf>. Meeting 8 July: Ch. 21 (in English), p. 73, <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>. Meeting 30 September (a full cabinet meeting): Vol. 7, Ch. 20, pp. 68–78. In addition, it is on record that CBI Governor David Oddsson as early as November 2005 told the two leaders of the then government coalition parties, Halldor Asgrimsson and Geir H. Haarde, that he thought the banking sector might collapse. Styrmir Gunnarsson, *Umsatrid* [The Siege] (Reykjavik: Verold, 2009), p. 72. Moreover, in late 2007 Oddsson met with three leading government ministers from the Independence Party, expressing grave concerns about the future of the banking sector. Interviews with David Oddsson in Reykjavik 5 October 2017 and with Geir H. Haarde by phone 8 November 2017.

¹⁹ Former Finance Minister Arni M. Mathiesen insists that both he and Haarde took the warnings by the CBI very seriously, not least because they knew and trusted Governor David Oddsson. Interview with Mathiesen by phone 8 September 2017.

²⁰ In 2005, 86% of those interviewed by Gallup thought the bank expansion abroad was good. SIC Report, Vol. 8, Online Addenda, No. 2, p. 281.

of the financial risks for the Icelandic Treasury from an eventual collapse. The two charges were considered to be too general in nature. One of the judges wanted to dismiss all charges.²¹ The remaining charges against Haarde were that he had neglected to ensure that a Consultative Group on Financial Stability formed in 2006 produced results; that he had neglected to ensure that the banking sector would be reduced; that he had neglected to undertake measures to transfer Landsbanki's popular Icesave online accounts in the United Kingdom and the Netherlands from a branch to a subsidiary; and that he had not held cabinet meetings about warnings by the CBI governors, especially those issued 7 February and 1 April 2008, and about currency swap deals 15 May with the Scandinavian central banks, whereas the Icelandic Constitution prescribed cabinet meetings about important matters.

The fifteen judges of the Impeachment Court unanimously acquitted Geir H. Haarde of the three main charges. They concluded that the prosecutors had not been able to prove that Haarde could have done anything significant, from the time he must have become aware of the danger to the banking sector, about the operations of the Consultative Group on Financial Stability, or the reduction of the banking sector, or the transfer of the Icesave accounts from a branch to a subsidiary. The majority of the judges, nine out of fifteen, only found Haarde guilty of negligence in that he had not held cabinet meetings on a possible bank crash, whereas the Constitution prescribed cabinet meetings about important matters.²² He did not receive any punishment and his legal costs were assigned to the state.²³ The minority of six judges wanted to acquit Haarde on this as well as on the other counts.²⁴ They argued that the constitutional prescription about cabinet meetings was mainly designed to ensure that important matters were adequately reported there before they were settled in the Council of State (with the President) and also to ensure that the Prime Minister accepted the request of individual government ministers to bring up important matters in cabinet: after all, the Ministry of Business Affairs was formally in charge of the commercial banks.²⁵

Even if the decision of the Impeachment Court could be seen as a victory for Haarde, as he was acquitted of all major charges, not punished and awarded legal costs, he referred it to the European Court of Human Rights which in November 2017—after deliberating for more than five years—found that his rights had not been violated in the process. He had been acquitted of almost all the charges, the Court emphasised, and in the relatively minor case where he had been found guilty as charged, the letter

²¹ *Landsdomur* [Impeachment Court], No. 3/2011, 3 October 2011. <https://www.landsdomur.is/domar-og-urskurdir/nr/8>

²² The majority consisted of four Supreme Court judges, one representative of Reykjavik District Court and four people appointed in 2005 by Parliament, all from the then-opposition parties, the Social Democrats, the Liberal Party and the Left Greens.

²³ *Landsdomur* [Impeachment Court], No. 3/2011, 23 April 2012, pp. 339–385. <https://www.landsdomur.is/media/skyrslur/nr.-3-2011-Domur-a-vef.pdf>

²⁴ The minority consisted of one Supreme Court judge, one representative of the Law Faculty of the University of Iceland and four people appointed in 2005 by Parliament, all from the then-government parties, the Independence Party and the Progressive Party.

²⁵ These points were also stressed by Arni M. Mathiesen who had served in government for ten years, as Fisheries Minister 1999–2003 and Finance Minister 2005–9. He found it extraordinary that the majority of the Impeachment Court could ignore the testimony of many government ministers about accepted practices at cabinet meetings. Interview with Arni M. Mathiesen in Reykjavik 6 August 2015.

of the law had been followed: It was true, and indeed uncontested, that he had not put the pending bank crisis on the official agenda at cabinet meetings.²⁶

The Court of Human Rights however largely ignored the political aspects of the case, unlike Pieter Omtzigt, a Member of the Dutch Parliament, who commented on it in a report for the Legal Affairs Committee of the European Council:

It was indeed the new majority in parliament which decided, along party-political lines, to initiate criminal proceedings for the failure to avoid the banking crisis only against the former Prime Minister and not against the ministers who had been directly in charge of banking issues within the same (coalition) government but who belonged to parties forming part of the new majority. It would indeed appear that the new majority's objective was to somehow "criminalise" their predecessors' choice of economic liberalism that had contributed to the rise and fall of the Icelandic banks.²⁷

Omtzigt's report was adopted with all votes in the Legal Affairs Committee except that of an Icelandic Member of Parliament from the Left Greens, who previously had voted for Haarde's impeachment alongside other members of her party.²⁸

3. Strictures Against Other Government Ministers

Arguably, the conclusions of the SIC on the alleged negligence of two other politicians, Finance Minister Arni M. Mathiesen and Business Affairs Minister Bjorgvin G. Sigurdsson, were rejected by the majority of Parliament when it decided not to bring a case against them before the Impeachment Court. It is indeed difficult to see what exactly the two of them could have done, at least on their own, and what therefore they had neglected to do. Mathiesen did not even have any authority over the banks: The CBI was by law the concern of the Prime Minister, and the affairs of the banks, as well as of the IFSA, were supposed to be dealt with by Business Affairs Minister Bjorgvin G. Sigurdsson. In its strictures against Mathiesen, the SIC also ignores the important, even crucial, fact that Iceland was virtually debtless when the international credit crunch which had started in late 2007 hit her with immense force in 2008. It is fair to say that the two measures which made the bank collapse bearable for the Treasury, and thus for the Icelandic nation as a whole, were that the Treasury by then had paid up almost all public debt and that by an Emergency Act passed by Parliament on 6 October 2008 depositors' claims were directed against the estates of the fallen banks and not against the Treasury.²⁹ Geir H. Haarde, Finance Minister in

²⁶ European Court of Human Rights, Application No. 66847/12.

http://www.echr.coe.int/Documents/CP_Iceland_ENG.pdf

²⁷ Pieter Omtzigt, Keeping political and criminal responsibility separate, Report for the Parliamentary Assembly of the European Council, 28 May 2013, p. 6.

https://www.ecoi.net/file_upload/1226_1369820122_xrefviewpdf.pdf See also Omtzigt's more personal memorandum on the case, 25 September 2012.

http://www.assembly.coe.int/CommitteeDocs/2012/ajdoc28_2012.pdf

²⁸ Ibid., pp. 22–24.

²⁹ Besides the three CBI governors, Sturla Palsson, CBI Director of Treasury and Market Operations, and Ragnar Onundarson, member of the Special Liquidity Crisis Task Force, apparently played an important role from 30 September to 6 October in designing the ring-fencing plan contained in the Emergency Act. In the final stages, the bill passed by Parliament as the Emergency Act was drafted by officials at the CBI and in the Ministry of Business Affairs. Interviews with Eirikur Gudnason in Kopavogur 25 October 2011 and with Sturla Palsson in Reykjavik 11 July 2014. Also email to Hannes H. Gissurarson from Ragnar Onundarson 20 September 2017.

1998–2005, and Mathiesen, Finance Minister in 2005–9, were mainly responsible for these two measures. Some would argue that for this they deserved praise rather than blame.

Formally, Business Affairs Minister Sigurdsson was in charge of the banking sector and of the IFSA, so that he rather than the Prime Minister should have brought up in cabinet the matter of the banks, before the collapse. But apparently information repeatedly provided by the CBI governors on the dire situation was mostly withheld from him by the leader of the Social Democrats, Foreign Minister Ingibjorg S. Gisladottir. For example, Sigurdsson was not summoned to the important meeting on 7 February 2008 where CBI Governor David Oddsson briefed three government ministers about the negative impact of the international credit crunch on the banks.³⁰ Again, on 28 September 2008, before the final decision to recapitalise Glitnir was made, Sigurdsson was excluded from the deliberations. In interviews for this report the CBI governors said that they were astonished to hear this.³¹ Governor Oddsson told Prime Minister Haarde that he wanted to hear this directly from Foreign Minister Gisladottir. At the Ministry of Finance, where Haarde, Mathiesen and Oddsson were meeting, Haarde called Gisladottir to New York and after a brief conversation handed the receiver over to Oddsson. Gisladottir confirmed to Oddsson that she wanted Industry Minister Ossur Skarphedinsson, and not Sigurdsson, to participate in the decision-making process on behalf of the Social Democrats.³² It seems somewhat unfair to accuse Sigurdsson of neglecting to respond to a crisis about which he received little information until it was too late to do anything about it.

The parliamentary committee appointed to respond to the SIC Report decided to add former Foreign Minister Ingibjorg S. Gisladottir to the list of government ministers who should be charged for negligence, even if this proposal eventually was rejected by Parliament.³³ It would seem that Gisladottir, as leader of the Social Democrats, shared with Haarde, leader of the Independence Party, the political responsibility for government actions or non-actions in the sixteen months leading up to the bank collapse. Moreover, the chain of events preceding the collapse was to a great extent about Iceland's relations with other countries, so it is an implausible response that as Foreign Minister Gisladottir had no formal say in the matter. Critics said that as Foreign Minister, Gisladottir did little to repair the weakening links between Iceland and the US nor to maintain traditional links between the UK and Iceland.³⁴ During her tenure as Foreign Minister in 2007–9 she seemed to focus on the ultimately

³⁰ SIC Report, Vol. 7, Ch. 21, p. 93 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

³¹ Interviews with Eirikur Gudnason in Kopavogur 25 October 2011 and with David Oddsson in Reykjavik 7 October 2013 and 5 October 2017.

³² Interview with David Oddsson in Reykjavik 5 October 2017; interview by phone with Geir H. Haarde 8 November 2017. In his testimony before the SIC, Industry Minister Ossur Skarphedinsson said that it had been Gisladottir's wish that he should represent the Social Democrats at the crucial meeting on Glitnir, and not Sigurdsson. However, Gisladottir denied this and said that she could not explain Sigurdsson's absence. SIC Report, Vol. 7, Ch. 20, p. 25.

³³ The parliamentary committee split into three parts, on political lines. The majority of 5 (2 from the Progressive Party, 2 from the Left Greens and 1 from the so-called Movement) wanted to press charges against all four former ministers. A minority of 2, both from the Social Democrats, wanted to press charges against Haarde, Mathiesen and Gisladottir, but not against Sigurdsson. A minority of 2, both from the Independence Party, did not want to press any charges.

³⁴ Interview with David Oddsson in Reykjavik 5 October 2017. Oddsson was Foreign Minister in 2004–5.

unsuccessful attempt by Iceland to be elected to a seat in the UN Security Council. Again, in government, Gisladdottir appeared at times to be the strongest supporter of the banks, as late as 4 September 2008 publicly urging them to continue their controversial deposit collection abroad.³⁵ These considerations do not necessarily imply that the SIC should have condemned Gisladdottir for negligence, but they may strengthen the position that the parliamentary committee on the SIC Report took against treating her differently from her three government colleagues, Haarde, Mathiesen and Sigurdsson.

4. *Strictures Against the CBI Governors*

While the SIC in its Report confirms many of the unequivocal warnings that the CBI governors uttered in confidential meetings with government ministers in the year preceding the bank collapse, in its general discussion it faults one of them, David Oddsson, for being a former politician so that old political opponents tended to dismiss his advice. The SIC complains of “a certain degree of distrust and cooperation problems” between Oddsson and leading Social Democrats.³⁶ But whether or not Oddsson distrusted the Social Democrats as much as they may have distrusted him seems of little relevance because the issue was that he was warning them and that they were ignoring his warnings. It was not that they were proposing something which he was dismissing for his own personal reasons. The fault therefore should have been found not with Oddsson, but with his old political opponents who apparently could not set aside old grievances in the face of an approaching danger for the Icelandic nation of which he was warning them. The clearest example of this is a dramatic cabinet meeting on 30 September 2008, which Oddsson asked to attend in order to warn of an imminent bank collapse. Some of the government ministers present seemed to be preoccupied with the fact that it was Oddsson who was issuing the warnings, but not with the imminent collapse itself and how to respond to it.³⁷ The SIC should have criticised them, some would argue, and not Oddsson.

In the second place, this criticism by the SIC also may be regarded as a formal error: There were three CBI governors, in addition to Oddsson Eiríkur Gudnason and Ingimundur Fríðriksson. If Gudnason and Fríðriksson, both of them economists with long experience in central banking and not with any known political affiliation, had disagreed with Oddsson, then he would not have been able to speak on behalf of the CBI. But the two other CBI governors had become convinced, with Oddsson, of the imminent danger.³⁸ If old foes of Oddsson did not want to listen to him because of his past political career, then they should at least have taken his two colleagues seriously.

Be that as it may, even if the SIC in its report certainly uttered criticisms of the CBI’s policies and actions, it did not adopt some charges made in the Icelandic debate after the collapse against the CBI governors: about their rejection of a request by Glitnir

³⁵ Ingibjörg S. Gisladdottir, Unnid a thríðaættum vanda [Solving Three Kinds of Problems], *Frettabladid* 4 September 2008, p. 30. http://timarit.is/view_page_init.jsp?pageId=4006348

³⁶ SIC Report, Vol. 1, Ch. 2, p. 9 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf>

³⁷ SIC Report, Vol. 7, Ch. 20, p. 71; Gudni Th. Jóhannesson, *Hrunid: Island a barmi gjaldþrots og upplausnar* [The Collapse: Iceland on the Verge of Bankruptcy and Chaos] (Reykjavik: JPV, 2009), p. 83.

³⁸ Eiríkur Gudnason emphasised this in an interview in Kopavogur 25 October 2011.

for an emergency loan shortly before the collapse, advising the government instead to recapitalise the bank; or about allegedly inflammatory statements by Governor Oddsson in a television interview on 7 October 2008;³⁹ or about the CBI having lowered the reserve requirements for the banks in 2003 and early 2008;⁴⁰ or about the CBI not having increased sufficiently the foreign exchange reserves;⁴¹ or about the CBI having in 2008 extended loans to the banks against mere ‘love letters’, resulting in large losses after the collapse.⁴² The reason why the SIC in effect dismissed these charges would seem to be that it was presented with what it found to be adequate explanations for the measures taken or not taken by the CBI governors in these matters.⁴³

The SIC found the three CBI governors to have shown negligence on two counts. First, in August 2008, after the British Financial Services Authority, FSA, had set strict conditions for a possible transfer of Landsbanki’s British online accounts from its London branch to a British subsidiary and after Landsbanki had requested a credit facilitation of £2.5 billion from the CBI, the governors, before they rejected Landsbanki’s request, should have verified both the reasons for FSA’s demands and Landsbanki’s financial position.⁴⁴ Second, in September 2008 the CBI governors should have consulted with specialists before rejecting Glitnir’s request for an emergency loan, instead advising the government to recapitalise the bank.⁴⁵ It should be emphasised that the SIC did not criticise the two decisions themselves by the CBI governors—rejecting in August a credit facilitation for Landsbanki and in September an emergency loan for Glitnir—but only what it saw as a proper process of arriving at these decisions.

The CBI governors strongly disputed these two charges. Against the first one, they pointed out that, unlike the IFSA, the CBI was not the bank regulator. It did not have

³⁹ Both these charges against the CBI are advanced in the first book published on the collapse, Olafur Arnarson, *Sofandi ad feigdarosi* [Sleepwalking Into the Abyss] (Reykjavik: JPV, 2009).

⁴⁰ The CBI lowered the reserve requirements in order to bring them down to the same level as in other European countries. The critics include Thorvaldur Gylfason, Iceland: After the Fall, *Milken Institute Review*, Vol. 10, No. 1 (2010), pp. 40–52.

<https://assets1c.milkeninstitute.org/assets/Publication/MIRReview/PDF/40-51mr45.pdf>

⁴¹ The critics include Thorvaldur Gylfason, Iceland’s blend of old and new, VoxEU 10 July 2008.

<http://voxeu.org/article/iceland-and-its-financial-predicament-history-and-context>

⁴² The critics include Gauti Eggertsson, then an economist at the FRB of New York, in his blog, no longer available online, but quoted in Peningaskapurinn [The Money Safe], *Frettabladid* 9 October 2009, p. 18. http://timarit.is/view_page_init.jsp?pageId=4390487

⁴³ SIC Report, Addenda Online, No. 11, responses by David Oddsson, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-5DO.pdf> Eirikur Guðnason, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-7EG.pdf> and Ingimundur Fridriksson, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-6IF.pdf>

⁴⁴ SIC Report, Vol. 7, Ch. 21, pp. 153–160 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> The first criticism is stated thus, p. 154, that it “refers to the response of the Board of Governors whereby it was on the one hand omitted to ascertain whether the position of the Financial Services Authority had been described correctly, and on the other hand, there was no attempt to examine the quality of the loan portfolio of Landsbanki in light of the aforesaid information, and consequently whether the bank was experiencing equity problems.”

⁴⁵ The second criticism is stated thus, SIC Report, Vol. 7, Ch. 21, p. 158, <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> that the Board of Governors “failed to properly execute its obligation for investigation” and omitted “to directly collect further information regarding the position of Glitnir and that bank’s loan book, as well as information regarding such other matters as might be significant for the assessment of whether it was justified to grant a last resort loan to Glitnir.”

authority to request sensitive financial information from the banks and no power to discipline or punish them even if it felt that they were straying from their role or breaking the rules. The three governors were not the only central bankers finding themselves with limited information and powers in the period leading up to the crisis. The Chairman of the US Federal Reserve Board, Ben Bernanke, wrote about his worries during the summer of 2007:

We were hampered because we had no authority to obtain confidential data from investment banks (like Bear Stearns), which were regulated by the Securities and Exchange Commission, or over foreign banks not operating in the United States (like IKB), or over hedge funds, which were largely unregulated.⁴⁶

Moreover, the Icelandic legal tradition was one of a strict interpretation of the authority and power of institutions, as two SIC members repeatedly had stressed, Pall Hreinsson in scholarly publications and Tryggvi Gunnarsson in legal opinions as Ombudsman.⁴⁷ This very point was made in a report Kaarlo Jännäri, former Director of the Finnish Financial Supervisory Authority, wrote on the collapse, at the initiative of the International Monetary Fund, IMF:

Iceland, like the other Nordic countries, is a nation where the actions of the authorities must be based on law. Discretionary powers are strictly limited. In retrospect, it is easy to assert that the Icelandic banks' expansion abroad should have been restricted, but in the European Single Market framework and with the European Passport, this was simply not something that could be readily accomplished within the existing legal environment.⁴⁸

In their responses, the CBI governors also emphasised that the amount requested by Landsbanki, £2.5 billion, was enormous by Icelandic standards and that SIC actually agreed that they had acted correctly by turning down the request, as it would have created a great risk for the CBI and also probably been illegal. At this time several tasks were more urgent than to verify the obvious, they said.

Against the second allegation, the CBI governors pointed out, again, that the CBI did not have any authority to request sensitive financial information from the banks. The governors had to rely on the information provided by Glitnir when in September 2008 it made the request for an emergency loan. Based on that information alone it was by no means prudent to extend the loan to the bank: In the near future the bank faced more big loans maturing, with no guaranteed refinancing of them; and the collateral eventually offered apparently was not sufficiently solid. Further information, becoming available later, only served to strengthen the reasons for the rejection of Glitnir's request by the CBI governors. Moreover, the decision on the request had to be made within a weekend, before the markets opened. There was no 'right' price for

⁴⁶ Ben Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* (New York: W. W. Norton & Co., 2015), p. 141.

⁴⁷ For example, Pall Hreinsson, Valdmork stjórnvalda [Limits on Administrative Authority], *Timarit logfraedinga*, Vol. 55, No. 4 (2005), p. 448; Tryggvi Gunnarsson, *Skýrsla umbodsmanns Althingis fyrir arid 2004* [2004 Report of Parliamentary Ombudsman], p. 15.
<https://www.umbodsmadur.is/arsskyrslur/storf-umbodsmanns/arid-2004> (Ch. 3.3).

⁴⁸ Kaarlo Jännäri, *Report on Banking Regulation and Supervision in Iceland* (Reykjavik: Prime Minister's Office, 2009), p. 16.
https://www.island.is/media/frettir/KaarloJannari%202009_%20Final.pdf

the bank which could be found by calculations or consultations with experts. The price eventually set was found by a simple reasoning: The bank needed €600 million. The government needed to buy a controlling stake while it did not want to write too much down the shares of the existing owners. Therefore it bought a 75% controlling share in Glitnir for €600 million. In the circumstances, this seemed to many to be a perfectly appropriate process.⁴⁹ At the time, Paul Krugman wrote: “Notice, by the way, that it was an equity injection rather than a purchase of bad debt; I approve.”⁵⁰

In making the second allegation, on the lack of paperwork preceding the advice to the government to buy a controlling stake in Glitnir, the SIC has been criticised for not fully taking into account the reality of the financial markets all around the world as the credit crunch intensified in 2008.⁵¹ Then, for example, the US Secretary of the Treasury, Hank Paulson, was making many and much larger decisions about the life and death of financial firms in a matter of a few hours, even minutes, over the phone, without any paperwork, simply because in the desperate situation in which he found himself decisions had to be made quickly.⁵² It took the FRB of New York only a few hours to decide extending \$30 billion in credit facilities to Bear Sterns, so that it could be taken over by JP Morgan Chase which initially offered \$2 a share for it, and then suddenly, to avoid controversy, raised its offer to \$10 a share.⁵³ On the same weekend as the decision was made about Glitnir, the British government was dealing with Bradford & Bingley. Chancellor Alistair Darling gave himself forty-eight hours to resolve the issue.⁵⁴ When the US investment banks Goldman Sachs and Morgan Stanley decided to transform themselves into commercial banks in order to obtain assistance from the Federal Reserve Board, they did so overnight: The requirement of a 30-day waiting period for such applications was simply waived.⁵⁵

Be that as it may, while finding that the three CBI governors had, as public officials, shown negligence on these two counts, the SIC did not see fit to report them to the Public Prosecutor for such negligence or for violations in their exercise of their duties as officials, as it could have done under its brief.⁵⁶ Perhaps it is also significant that in 2013, at the initiative of the CBI, now under new leadership, Parliament amended the

⁴⁹ It was CBI Governor Eiríkur Guðnason who suggested setting the price in this way. Interview with Eiríkur Guðnason in Kopavogur 25 October 2011. Also, SIC Report, Online Addenda, No. 11, response by Eiríkur Guðnason, p. 6, <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-7EG.pdf>

⁵⁰ Paul Krugman, The \$850 billion bailout. Blog 30 september 2008.

<https://krugman.blogs.nytimes.com/2008/09/30/the-850-billion-bailout/> Among the Icelandic economists who concurred were Gylfi Magnússon, Jon Steinsson and Jon Danielsson, according to Johannesson, *Hrunid*, p. 54.

⁵¹ This criticism is found, for example, in Styrmir Gunnarsson, *Hrunadans og horfið fe* [Wild Dances and Disappeared Money] (Reykjavik: Verold, 2010), as well as in the responses of the CBI governors to the strictures of the SIC.

⁵² Hank Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (New York: Business Plus, 2010).

⁵³ Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* (London: Random House Business Books, 2014), pp. 155–158.

⁵⁴ Darling, *Back from the Brink*, p. 134.

⁵⁵ Bernanke, *The Courage to Act*, p. 311.

⁵⁶ Law No. 142/2008. <https://www.althingi.is/altext/stjt/2008.142.html> According to §14 of this Law, the SIC was expected to report to the Public Prosecutor any suspicions of criminal behaviour or of violations of the Icelandic law on the duties of public officials (Law No. 70/1996).

law on the CBI, giving it explicit authority to request from banks and other financial companies all financial information it deemed relevant.⁵⁷

5. Strictures Against the IFSA Director

The SIC dealt with IFSA Director Jonas Fr. Jonsson in the same way as the three CBI governors: While finding that he had, as a public official, shown negligence, it did not see fit to report him to the Public Prosecutor for such negligence or for violations in his exercise of his duties as an official. It is indeed hard to see what Jonsson could have done to stem the tide, especially with the two constraints under which he was operating, the strong public and political support for the banks and for some of their main debtors and the doctrine of strict legal authority of which two SIC members, Tryggvi Gunnarsson and Pall Hreinsson, had been prominent adherents. Indeed, Parliamentary Ombudsman Gunnarsson was quoted as telling lawyers of financial firms in May 2007 that they could always complain to his office if they thought that the IFSA was not treating their companies fairly and that IFSA was bound not only by written statutes, but also by the unwritten rules of public administration law.⁵⁸

Here, as in other cases investigated by the SIC, it is important to keep in mind the written and unwritten rules and conventions in force in the years leading up to the financial collapse and not to refer to rules invented after the collapse against those involved. Under Icelandic law, there is a certain accepted interpretation of negligence in one's exercise of one's duties as a public official. The SIC did not use it in its report, replacing it with its own and wider concept of negligence which was essentially that officials should have reacted more forcefully and quickly to dangers of which there was little reliable evidence at the time: It included "incorrect assessment of available information and decision-making based on inadequate assumptions."⁵⁹ The SIC's allegations of negligence against Jonsson were not based on any comparison with similar supervisory agencies in other EEA countries, operating under an almost identical legal and statutory framework, let alone on a comparison with previous practices in Iceland.

Indeed, Jonsson became Head of the IFSA only in mid-2005 when the banks had already grown considerably, perhaps beyond a point of return, and after important decisions and non-decisions had been made about them by the IFSA.⁶⁰ One example of an important non-decision was not to undertake any disciplinary action against those who, in 1998, during the privatisation of the investment bank FBA, had collected share subscriptions in the names of various people and thus had thwarted

⁵⁷ Law No. 92/2013, §4. <https://www.althingi.is/altext/stjt/2013.092.html>

⁵⁸ IFSA, Runar Gudmundsson, Minnisblad [Internal Memo], 18 May 2007. Gudmundsson, an IFSA member of staff, attended the meeting, held 16 May 2007. The document was made available to the author of this report under the Icelandic Freedom of Information Act. Cf. SIC Report, Online Addenda, No. 11, response of Jonas Fr. Jonsson. <http://rse.hi.is/wp-content/uploads/2017/11/RNAvefVidauki11-12JFJ.pdf>

⁵⁹ SIC Report, Vol. 7, Ch. 21, pp. 118–19 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> As pointed out earlier, some might regard this as the use of a retroactive rule. Interview with Jonas Fr. Jonsson in Reykjavik 6 October 2016.

⁶⁰ This was emphasised by former Chief Manager of Islandsbanki Bjarni Armannsson in an interview in Reykjavik 4 November 2016.

the government's stated objective of dispersed ownership.⁶¹ Another example was not to follow up on an internal report from 2004 about a hidden risk resulting from Kaupthing and Landsbanki not counting together, in their estimates of large exposures, various companies controlled by Jon Asgeir Johannesson.⁶²

The SIC offers two specific examples where Jonsson and the IFSA should have intervened more decisively: They should have insisted on counting the liabilities of the medical company Actavis as a part of the large exposure of Landsbanki's major shareholder Thor Bjorgolfsson; and they should have taken action regarding a bond issued by Landsbanki's other major shareholder, Bjorgolfur Gudmundsson, in 2005 and bought by Landsbanki. But the SIC's position which led it to regard Actavis and Bjorgolfsson as parts of the same large exposure, was rejected by the Icelandic Supreme Court in a different case in 2011.⁶³ The other example, of Gudmundsson's bond, has not given rise to a criminal charge or even to an administrative fine. In general, the appropriate comment may be that of Kaarlo Jännäri in his aforementioned report on the Icelandic bank collapse:

The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments, but the overall national pride in the success of the banks would probably have made it futile even to try while the going was good and success followed success.⁶⁴

In all fairness though, what some would consider timidity, others would call cautiousness and strictness in interpreting the law.

6. The Limited Options of Decision Makers

The problem which the SIC largely ignored in its strictures (even if occasionally noting it) and which was clearly brought out in the case against Geir H. Haarde was that of limited options, succinctly captured in the old adage: 'You are damned if you do; you are damned if you don't.' Such dilemmas, well-known in game theory, are also often described as Catch-22 situations after a well-known novel on the Second World War: You are exempted from carrying out a dangerous duty if you are mad; but if you apply for an exemption on this ground, you thereby show that you are not mad.⁶⁵

The CBI governors, convinced that a great danger lay ahead, faced a dilemma. If they publicly uttered warnings against the rapid expansion of the banks and their possible collapse, or even if they were seen as preparing for such a collapse, then they almost

⁶¹ Vidskipti Kaupthings vid fjarvorsluthega 12. november 1998 ekki i samraemi vid edlilega og heilbrigða vidskiptahaetti [Trade between Kaupthing and Asset Owners 12 November 1998 Not According to Proper and Good Business Practices], *Morgunbladid* 26 July 2000, pp. 12–13 and 30. The whole IFSA Report on the matter was printed there.

http://timarit.is/view_page_init.jsp?pageId=1974081

⁶² SIC Report, Vol. 2, Ch. 8, pp. 124–6.

⁶³ *Haestarettardomar* [Supreme Court Judgements], No. 593/2011.

<https://www.haestirettur.is/default.aspx?pageid=347c3bb1-8926-11e5-80c6-005056bc6a40&id=435cdfb-1d9a-42ad-ba9d-1f40669c9423>

⁶⁴ Jännäri, *Report*, p. 37.

⁶⁵ Joseph Heller, *Catch-22* (New York: Simon & Schuster, 1961). Cf. the 1970 Paramount Pictures film directed by Mike Nichols.

certainly brought it about. If they kept silent, then they risked to be held responsible for not taking appropriate action, as indeed happened.⁶⁶ Bound by Iceland's strict legal tradition and the sensitivity of their situation, they had to convey information to leading politicians at confidential meetings and to make suggestions rather than issue orders to the bankers. This is precisely what the so-called Rangvad Commission, appointed to study the financial crisis in Denmark, found about the Danish central bank. "Nationalbanken has no way of effectively controlling the financial institutions' lending. Consequently, Nationalbanken could not have halted the growth in lending during the years before the crisis even if it had considered there to be a need to do so."⁶⁷ Iceland, having been a Danish dependency for centuries, shared many traditions with Denmark, even if the SIC took a different stance to that of the Rangvad Commission.

Leading politicians, at least Prime Minister Geir H. Haarde and Finance Minister Arni M. Mathiesen, faced another dilemma. Public opinion was strongly in favour of the banks and of business tycoons, not least the banks' biggest debtor Jon Asgeir Johannesson, who doubled as a media mogul and who many times had demonstrated both his power and his readiness to use it.⁶⁸ If Haarde and Mathiesen chose to take the CBI governors seriously, then they seemed to be faced with what was essentially a choice between a quick and a slow political suicide. The quick way out of politics would have been to challenge the dominant business groups in the economy and to try and reduce the size of the banks by any means at their disposal, including taking the initiative in measures which would then have been implemented by the CBI and the IFSA. The slow way out was, on the other hand, to do nothing, count one's blessings and hope that the deluge would not arrive.

This was less of a problem for leading Social Democrats because they tended to dismiss the warnings of the CBI governors: They were "one man's venting", as Foreign Minister Ingibjorg S. Gisladdottir wrote.⁶⁹ She also later asserted that two economists from whom she often sought advice, Professor Robert Wade of the LSE and Professor Thorvaldur Gylfason of the University of Iceland, never warned her against an imminent bank collapse or of any danger of such an event.⁷⁰ Neither did economists Willem Buitter and Anne Sibert, with whom she had discussions in the spring of 2008, predict a bank collapse, according to her.⁷¹ In all fairness, it should also be recalled that against the numerous warnings by the CBI governors, based on informed guesses rather than hard evidence, government ministers could not but recognise the facts that the banks had been audited by respected international accounting firms, rated by acknowledged rating agencies and applauded by

⁶⁶ This point was repeatedly made by David Oddsson in his testimony before the SIC 7 and 12 August 2009 and 10 January 2010. Transcript in possession of the main author of this report.

⁶⁷ Rangvad Commission, *The financial crisis in Denmark — causes, consequences and lessons* (København: Erhvervsministeriet, 2013), p. 10. <http://em.dk/english/publications/2013/13-09-18-financial-crisis>

⁶⁸ Johannesson's use of his media clout is documented in Bjorn Bjarnason (former Minister of Justice), *Rosabaugur yfir Islandi* [Iceland in the Thrall of Baugur] (Reykjavik: Uglya, 2011), and Oli B. Karason, *Sidasta vornin: Haestirettur a villigötum i eitruðu andrumslofti* [The Ultimate Defence: the Supreme Court on a Failed Mission in Poisonous Atmosphere] (Reykjavik: Uglya, 2011).

⁶⁹ SIC Report, Vol. 7, Ch. 21, p. 97 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

⁷⁰ SIC Report, Vol. 8, Addenda Online No. 1, p. 301.

⁷¹ SIC Report, Vol. 6, Ch. 19, pp. 198–201.

international organisations like the IMF. Later, the Independent Evaluation Office of the IMF was to point out that in 2007, surprisingly, the massive size of the banking sector “was not highlighted as a key vulnerability that needed to be addressed urgently” by the IMF. As late as August 2008, the IMF published an Update to its regular 2008 report on Iceland, on which the Independent Evaluation Office commented: “Strangely, the tone of the Update was relatively reassuring.”⁷²

The Icelandic bankers faced their own dilemma. Most of them knew that they had overreached themselves.⁷³ But if they tried to sell assets, then they risked not only a loss on the sales and a corresponding reduction in the registered value of remaining assets, perhaps below zero, but also the automatic cancellation of credit lines which were often dependent by contract upon no or little change in their reported financial positions. As Kaarlo Jännäri observes in his report, “many of the covenants in the Icelandic banks’ funding arrangements would have been breached had the banks retrenched rapidly. Breach of covenants would have led to early redemption demands for an important part of the banks’ funding; thus the banks were faced with a kind of Catch-22 situation.”⁷⁴

This does not mean that the bankers were only hapless victims of the bank collapse. Apart from desperate rescue attempts in the few months and even weeks before the collapse, some of which may have been illegal,⁷⁵ in retrospect two moves by the bankers may be regarded as grave mistakes, especially as they should have known better and perhaps then still had some room to maneuver:⁷⁶ 1) an attempt by Kaupthing in August 2007 to buy the Dutch bank NIBC which eventually had to be abandoned 2) and the decision by Landsbanki in May 2008 to start collecting online deposits in the Netherlands through a branch, and not a subsidiary, which increased the already existing hostility of European central bankers to the Icelandic banks. Prominent Icelandic businessman Thor Björgolfsson, before the collapse a major shareholder in Landsbanki, holds that a third crucial mistake made by all three banks was to allow one business group, that of Jon Asgeir Johannesson, to accumulate enormous debt.⁷⁷ Again, an old adage seems appropriate: If you owe the bank a million, then *you* have a problem. But if you owe the bank a trillion, then *the bank*

⁷² *Evaluation of IMF Performance in the Run-Up to the Financial and Economic Crisis* (Washington DC: Independent Evaluation Office of the IMF, January 2011), p. 15. [http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20\(without%20Moises%20Signature\).pdf](http://www.ieo-imf.org/ieo/files/completedevaluations/Crisis-%20Main%20Report%20(without%20Moises%20Signature).pdf)

⁷³ Interviews with Sigurjon Th. Arnason in Reykjavik 15 November 2011, with Björgolfur Gudmundsson in Reykjavik 20 August 2013, and with Sigurdur Einarsson, Armann Thorvaldsson and Thor Björgolfsson in London 11 December 2013.

⁷⁴ Jännäri, *Report*, p. 16.

⁷⁵ Former Supreme Court Judge Jon Steinar Gunnlaugsson points out, however, that to find people guilty of ‘mandate fraud’ or ‘authority fraud’ (which is one of the most common economic crimes allegedly committed before or during the bank collapse) requires the prosecutor to produce proof that the accused had intentionally tried to enrich themselves personally. In many of the cases prosecuted in Iceland, this was not what happened, Gunnlaugsson holds. *Med lognid i fangid: Um afglop Haestarettar eftir hrún* [Stony Silence: On the Blunders of the Supreme Court After the Collapse] (Reykjavik: Almenna bokafelagid, 2017).

⁷⁶ On 16 May 2007, Kaupthing had organised a luncheon meeting for its biggest customers with Scottish historian Niall Ferguson as speaker. In his talk, Ferguson said that there were many signs of an impending depression similar to that of the Great Depression starting in 1929. The main author of this report, while not a Kaupthing customer, was invited to the luncheon.

⁷⁷ Thor Björgolfsson, *From Billions to Bust—And Back* (London: Profile Books, 2014), p. 146.

has a problem. As the SIC noted, the total debt of Johannesson's group to the three Icelandic banks was a little less than a trillion *kronur*, or a staggering €5.5 billion.

7. The SIC's Incomplete Explanation

It may seem remarkable after dozens of lawyers and economists had been digging for more than a year, with a generous budget and full access to all documents, and probably under great pressure to find something compromising for the former powers to be, that they could not come up with any complaint against the Prime Minister which would eventually be sustained by the Impeachment Court. The only charge which the Impeachment Court accepted—that Geir H. Haarde had failed to put the banking crisis on the official agenda at cabinet meetings—was not derived from the SIC Report: It was added on the advice of legal experts when a parliamentary committee was deliberating on the response to the SIC Report.⁷⁸

No less remarkable may it seem that after all this digging the SIC and its numerous staff could only come up with two formal complaints against the three CBI governors: that they had not asked for sufficiently many expert opinions, reports and value estimates when making two decisions which nevertheless in themselves were deemed to be prudent and reasonable. Moreover, even if the facts on which these three complaints—one against Haarde and two against the CBI governors—are based would be undisputed, none of them would have made any difference for the 2008 bank collapse. It would have occurred irrespective of what was put on the agenda at government meetings and of which memoranda the CBI governors could have had written.

The most relevant criticism of the SIC is, however, that it did not really provide a full explanation of the banking collapse, even if its report is a mine of information, especially about the operations of the banks and about the legal aspects of deposit collection abroad. The main conclusion of the SIC was that the collapse occurred because the banks were over-sized relative to the CBI and Icelandic Treasury. But the relatively large size of the banks was a *necessary* and not a *sufficient* precondition for their collapse. It is almost a tautology to say that the Icelandic banks fell because they were vulnerable (prone to fall, in other words), and then to go on and list all their vulnerabilities. It is like saying that glass breaks because it is breakable or that opium puts people to sleep because of its sleeping power, an idea ridiculed by Molière in *The Hypochondriac*: An arrogant doctor asks a pretentious student why opium causes sleep, and the student replies that opium has 'virtus dormitiva' which is simply Latin for sleeping power.⁷⁹

⁷⁸ The legal experts assisting the committee were Bryndis Hlodversdottir, a law professor at Bifrost University (and a former member of parliament for the Social Democrats), Ragnhildur Helgadóttir, a law professor at the University of Reykjavik, Jonatan Thormundsson, a former law professor at the University of Iceland, Sigrídur Fríðjónsdóttir, Deputy State Prosecutor, and Bogi Nilsson, former State Prosecutor. Report of the Parliamentary Committee on Responses to the SIC Report, p. 3.

<https://www.althingi.is/altext/pdf/138/s/1501.pdf> According to documents in possession of the main author of this report, Helgadóttir was the expert most in favour of prosecuting, while Nilsson advised against it.

⁷⁹ Molière, *The Hypochondriac*, *The Works of Moliere*, Vol. 5 (Glasgow: John Gilmour, 1751), p. 350.

In general, the SIC Report has been criticised for focusing overly on domestic rather than international aspects of the crash.⁸⁰ Its authors do not take much into consideration that the Icelandic banks encountered an international financial crisis in 2007–9 which brought down many banks around the world, large investment banks like Bear Sterns, Lehman Brothers and Merrill Lynch in the US and small and large commercial banks like Roskilde Bank in Denmark, Northern Rock and Bradford & Bingley in the UK, Anglo Irish Bank in Ireland and Washington Mutual in the US. Again, the crisis almost brought down many other banks hitherto considered almost invulnerable, such as UBS in Switzerland, RBS in Scotland and Danske Bank in Denmark.⁸¹

The real explicandum in the Icelandic case would therefore seem to be why the banks were not saved from abroad, like RBS, UBS and Danske Bank. If they had been saved there would not have been a collapse (although there would certainly have been a deep recession with whose likes Icelanders are used to cope). Kaupthing's Armann Thorvaldsson wrote in his book on the collapse:

I always believed that if Iceland ran into trouble it would be easy to get assistance from friendly nations. This was based not least on the fact that, despite the relative size of the banking system in Iceland, the absolute size was of course very small. For friendly nations to lend a helping hand would not be difficult.⁸²

What turned a predictable crisis into a collapse of the banking sector was that into an already vulnerable situation, partly created by the Icelandic banks themselves and partly the result of circumstances to which everybody would have reacted in a similar way, entered five decisions taken abroad, none of them explored, alas, in any detail by the SIC: 1) hedge funds betting against Iceland; 2) European central banks refusing to provide liquidity to Icelandic banks or to make currency swap deals with the CBI; 3) the US Federal Reserve Board refusing to do dollar swap deals with the CBI; 4) the UK Labour government closing down British banks owned by Icelandic banks; 5) and the same UK government invoking an Anti-Terrorism Act against not only an Icelandic bank, but also, briefly, against the CBI and the IFSA. In the following chapters, these five decisions will be explored.

⁸⁰ Interview with Eiríkur Guðnason in Kopavogur 25 October 2011.

⁸¹ On Danske Bank, see the television documentary *Sikke en fest* (2012).

<http://nyheder.tv2.dk/nyheder.tv2.dk/nyheder.tv2.dk/nyheder/article.php/id-60667554> Also, Niels Sandøe and Thomas Svaneborg, *Andre folks penge: Historien om den danske finanskrise* (København: Jyllands-Postens Forlag, 2013).

⁸² Thorvaldsson, *Frozen Assets*, p. 194.

Chapter Two

Hedge Funds Bet on Icelandic Collapse

One foreign factor in the Icelandic bank collapse was the relentless and concerted betting by hedge funds against both the Icelandic banks and the currency, *krona*, from 2005 to the end. In other jurisdictions, hedge funds had engaged in similar bets, sometimes successfully, as against the UK in 1992, sometimes unsuccessfully, as against Hong Kong in 1998.¹

1. The Drobny Conference in Santa Monica 2003

Hedge funds—private and largely unregulated investment companies that typically compensate management in proportion to annual profits and that engage in active trading of financial instruments—are relatively recent phenomena.² They are however by no means insignificant in the world economy: In 2007, it was claimed that the total value of assets managed by them amounted to 2.1 trillion dollars.³ In addition to their own equity, owners of hedge funds often manage assets of pension funds, endowed colleges and wealthy individuals. Probably the best known hedge fund manager is the Hungarian-American George Soros, who incidentally worked as a young man at Singer & Friedlander, the forerunner of the Icelandic-owned British bank KSF, Kaupthing Singer & Friedlander. He became world-famous when he in 1992 bet against the British pound and won: The pound was devalued, and he pocketed a profit of £1 billion, while the British Treasury made a loss of £3.3 billion.⁴

Iceland came to the attention of hedge funds in early 2003, around the same time as two government banks were privatised, Landsbanki and Bunadarbanci (which subsequently merged with Kaupthing and eventually took on its name). Since the spring of 2002, a group of hedge fund managers had been attending the semiannual, by-invitation-only Drobny Global Conferences. These conferences are organised by investors Andres and Steven Drobny (who are not related despite sharing a surname). At the conferences, discussions are completely confidential: While hedge fund managers like to ‘hunt’ in a pack, like wolves, and are therefore comfortable with

¹ Paul Krugman, The North Atlantic Conspiracy. Blog 31 March 2008.

<https://krugman.blogs.nytimes.com/2008/03/31/the-north-atlantic-conspiracy/>

² Birgir T. Petursson and Andrew P. Morriss, Global Economies, Regulatory Failure, and Loose Money: Lessons for Regulating the Finance Sector from Iceland’s Financial Crisis, *Alabama Law Review*, Vol. 63, No. 3 (2012), p. 721.

<https://www.law.ua.edu/pubs/lrarticles/Volume%2063/Issue%204/2%20Morriss%20Petursson%20691%20-%20800.pdf>

³ Value of assets managed by hedge funds worldwide from 1997 to 2016.

<https://www.statista.com/statistics/271771/assets-of-the-hedge-funds-worldwide/>

⁴ David Litterick, Billionaire who broke the Bank of England, *The Telegraph* 13 September 2002.

<http://www.telegraph.co.uk/finance/2773265/Billionaire-who-broke-the-Bank-of-England.html>

Matthew Tempest, Treasury papers reveal cost of Black Wednesday, *Guardian* 9 February 2005.

<https://www.theguardian.com/politics/2005/feb/09/freedomofinformation.uk1>

sharing some trade secrets with a selected few of their competitors, they do not want outsiders to know anything about their investment plans.⁵

At a Drobny Global Conference in Santa Monica in the spring of 2003, Jim Leitner drew the attention of his colleagues to Iceland. Leitner who had for a while worked for Soros, but was now running his own company, Falcon, had first visited Iceland in 1989.⁶ He pointed out that Iceland had a strong economy, with the trade deficit turning into a surplus, a *krona* which was rapidly recovering from a previous plunge and a big aluminium factory about to be built. The Icelandic index-linked housing bonds yielded around 5% in real terms, well above the next highest index-linked yield offered in New Zealand at below 4%. They were guaranteed by government and freely circulating, with a decent volume of around \$4 billion in total. At the moment it was profitable to buy them, Leitner said, but they might be offered on the European financial market which might push down the yield on them. “In the meantime, you earn very nice carry waiting for these events in an economy with excellent fundamentals,” Leitner observed. (In the financial world, it is called a carry when someone borrows money at a low interest rate and invests in an asset with a higher rate of return.) Leitner informed his colleagues that he was financing half of his purchases by Icelandic credit, with carry of 1.5%, and the other half by US credit, with carry of 6%.⁷ Apparently, a few hedge fund managers followed Leitner’s advice and made some profit.

2. The First Bets Against the Banks

In 2004 and 2005, the newly privatised Icelandic banks borrowed extensively on the international markets and expanded rapidly. However, in the summer of 2005, financial journalist Ian Griffiths of *The Guardian* wrote about persistent rumours that they were connected to the Russian mafia.⁸ In his book about the bank collapse, journalist Roger Boyes writes: “The British activated a secret agent in Iceland—not in the embassy or attached to it—in 2005 with a brief to watch cash flows between Russia and Iceland.”⁹ Nothing was in fact found to substantiate the rumours, and they faded away.

⁵ Steven Drobny, *Inside the House of Money: Top Hedge Fund Traders on Profiting in the Global Markets* (Hoboken NJ: John Wiley & Sons, 2006).

⁶ Sjalfkjorid i stjorn Straums-Burdarass [No Contestants for Straumur-Burdaras Board], *Morgunbladið* 8 March 2007, p. 15. http://timarit.is/view_page_init.jsp?pageId=4155820

⁷ *Grobny Global Monitor*, 4 April 2003.

http://www.drobny.com/assets/control/content/files/6_Conference-Review-April-2003.pdf Cf.

Drobny, *Inside the House of Money*, p. 66.

⁸ Ian Griffiths, Next-Generation Viking Invasion, *The Guardian* 16 June 2005.

<https://www.theguardian.com/business/2005/jun/16/marksspencer> One source for this rumour may have been an Icelandic detective novel published a year earlier by Thrainn Bertelsson, former editor of the socialist newspaper *Thjodviljinn*, *Daudans ovissi timi* [Death’s Uncertain Hour] (Reykjavik: JPV, 2004), where one of the characters, Haraldur Ruriksson, seems to have been based on Bjorgolfur Gudmundsson who had in fact made his money in post-communist Russia. This character, Ruriksson, had ties to the Russian mafia. Professor Thorvaldur Gylfason also wrote, after the bank collapse: “Persistent rumours about money laundering by Icelandic banks for Russian oligarchs are now regarded differently than before.” Loglegt? Sidlegt? [Legal? Moral?], *Frettabladið* 25 June 2009, p. 20. http://timarit.is/view_page_init.jsp?pageId=4276266 Thor Bjorgolfsson discusses such rumours in *Billions to Bust*, pp. 55–7 and 64–5.

⁹ Roger Boyes, *Meltdown Iceland* (London: Bloomsbury, 2009), p. 55. The identity of the secret agent (British by nationality, but with close ties to many Icelanders) is known to the main author of this report. It is telling that Boyes hastens to point out that the secret agent was not in the embassy or

Shortly thereafter, in the autumn of 2005, Iceland came to the attention of hedge fund managers. A financial analyst at the Petroleum Fund of Norway, Herleif Håvik, decided to bet against Kaupthing, even if the Fund did not own a single bond issued by the bank. Håvik noticed that Barclays and Kaupthing had outstanding bonds traded at the same premium, 20 basis points over Libor. The crucial difference between the two banks was however, as Håvik realised, that in difficult times the tiny Icelandic state could hardly back up Kaupthing whereas Barclays was a British bank which could presumably expect support from local authorities. Therefore, Håvik sold a CDS (Credit Default Swap) protection on Barclays and bought one on Kaupthing, enabling him to accumulate an almost costless ‘short’ on Kaupthing. (In the financial world, it is called a short when someone sells bonds which he or she does not own, but typically borrows, with the obligation to repurchase them later, gambling on profiting from a price decrease in the meantime.) In other words, Håvik could bet on Kaupthing’s loss in value at negligible cost. The result was that the Kaupthing’s CDS spread—which expresses the markets’ belief in the possible default of the company—went up to about 40 points above Libor. Soon thereafter, in late November 2005, negative reports about the Icelandic banks appeared in the international press.¹⁰

Jim Leitner wrote a piece on Iceland 8 February 2006 which was circulated to Drobny Global Conferences participants. He noted that three years earlier a good profit had been made by buying Icelandic index-linked housing bonds and then selling them. Now the price of the bonds had gone down. But the real danger for Iceland lay in the *krona*. Leitner said that it would be increasingly difficult for the CBI to maintain its value, for two main reasons. First there was a big current account deficit, close to 15% of GDP. Second, Icelandic pension funds and local investors were investing their growing assets abroad, 15% of GDP in 2005. In other words, there was little inflow of foreign currency into the economy. Leitner pointed out that the three Icelandic banks borrowed aggressively in 2005, issuing \$20 billion of bonds internationally, in a country with a GDP of \$15 billion. “If they are not able to issue at similar terms to the past, *and in vast amounts*, there is nothing to feed the local credit bubble. That should lead to a big correction in the currency,” Leitner said.¹¹

It seems that many ‘Drobnites’ took his advice and bet against the krona which depreciated, while the CDS spread on Kaupthing widened, going up to 67 above Libor on 21 February 2006, when Fitch Ratings changed Iceland’s outlook from “stable” to “negative”. The report of the agency mentioned some of the points also made by Leitner such as the current account deficit and the immense borrowing by the banks abroad.¹² Merrill Lynch published a report 7 March 2006 by Richard Thomas under the title “Icelandic Banks—Not What You Think”. Thomas argued

connected to it, and that the British Ambassador to Iceland at the time, in 2004–8, Alp Mehmet, read the manuscript of his book. In Wikileaks, files are also to be found on Bjorgolfur Gudmundsson and Bjorgolfur Thor Bjorgolfsson, although it is unknown who opened those files (possibly the US Embassy in Reykjavik). <https://file.wikileaks.org/file/landsbanki-dossier-2009.pdf> But the files reveal nothing about any mafia connections: they are only about a legal battle for ownership of a brewing company which Gudmundsson and Bjorgolfsson controlled in St. Petersburg.

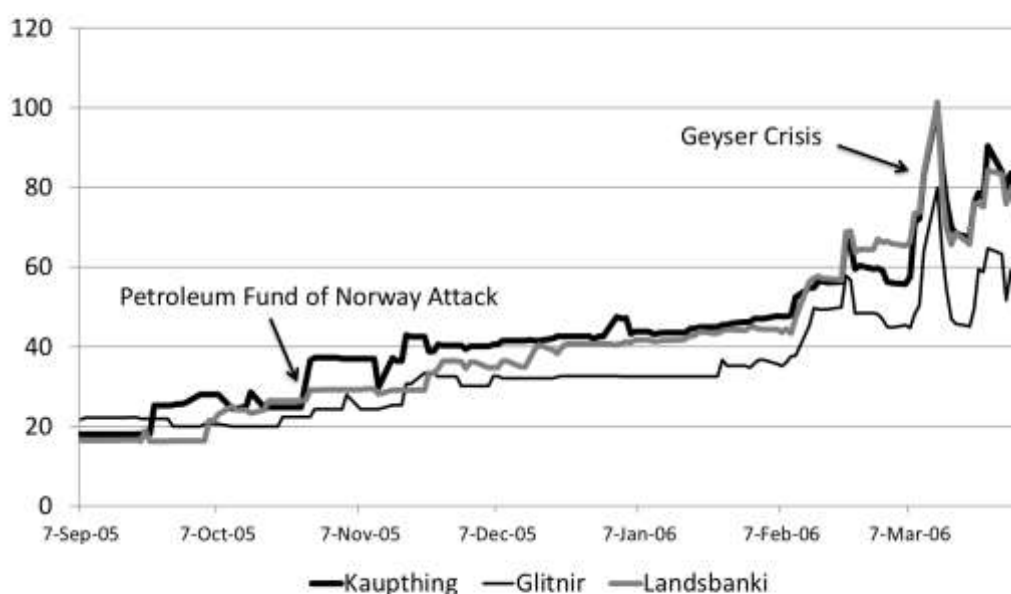
¹⁰ Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, pp. 54–55.

¹¹ Jim Leitner, *Icelandic krona danger*, Drobny Guest Research, 8 February 2006. Underlined by Leitner. http://www.drobny.com/assets/_control/content/files/Guest-Research-020806-12.pdf

¹² The report is reprinted in *Preludes to the Icelandic Financial Crisis*, eds. Robert Z. Aliber and Gylfi Zoega (New York: Palgrave Macmillan, 2011), pp. 77–88.

that the systemic risk in Iceland had been underestimated by ratings agencies. The banking sector was most similar to that of an emerging country, he said, with concentrated ownership, cross ownership and cross lending. Therefore, the Icelandic banks should be shorted. The report had an almost immediate impact, the CDS spread of Kaupthing going 13 March 2006 up to 100, as can be seen in Figure 2. Incidentally, Merrill Lynch was one of the prime brokers of the hedge funds betting against Iceland; Petroleum Fund of Norway.¹³ It was at least clear that in March some hedge funds were shorting the Icelandic banks. A number of negative news reports about Iceland appeared.¹⁴ It is difficult to say whether some of these reports were written with the help of hedge funds.

Figure 2: CDS Spreads of Icelandic Banks, 2005–6



Source: SIC Report, Vol. 2. Ch. 7.

From its foundation in 1886, Iceland’s first bank, Landsbanki, had done business with Denmark’s biggest bank, Danske Bank (or its forerunners). Suddenly, however, in late March 2006 Danske Bank cancelled all credit lines to Iceland, and on 21 March it published a report predicting a financial crisis in Iceland that would however not much affect the outside world. It would, the report’s main author, economist Lars Christensen, said, be similar to the crises in Thailand in 1997 and Turkey in 2001.¹⁵ The following week was difficult for the Icelandic banks whose managers asked for an emergency meeting at the home of CBI Governor David Oddsson on the night of Sunday 26 March 2006. He advised them to stay calm and wait and see what would happen. While the bankers fully expected that other banks would follow the example

¹³ Jonsson, *Why Iceland?* p. 75.

¹⁴ For example, Jeremy Batstone, Is Iceland facing a meltdown? *Money Week* 18 May 2006. <https://moneyweek.com/is-iceland-facing-a-meltdown/>

¹⁵ Christensen’s report is reprinted in *Preludes to the Icelandic Financial Crisis*, eds. Aliber and Zoega, pp. 89–106, although the name of the author is misspelt Christiansen.

of Danske Bank and cancel credit lines to Iceland, to their great relief nothing of that sort happened when the markets opened Monday 27 March.¹⁶

However, the hedge funds were still observing Iceland. A participant in the Drobny Global Conferences, Hugh Hendry, manager of Eclectica, sent out a report on 31 March 2006 that he was engaged in a short against the Icelandic *krona*: About one-fourth of his fund was used in the short. Later Hendry told the British press that he wanted to be ‘known as the man who bankrupted Iceland’, comparing himself to George Soros who had broken the Bank of England in 1992.¹⁷

Danske Bank published a note on 20 April 2006 where they said the Icelandic economy was collapsing even faster than they had forecast, and recommended shorting the Icelandic *krona*. Now, the Scandinavian banks joined the hedge funds in shorting the *krona*—selling *kronur* which they had obtained at a certain price, and with a repurchase agreement to buy them back later when they had become cheaper. It so happened that 20 April was a public holiday in Iceland. The next day, hedge funds and the Scandinavian banks bet relentlessly against the *krona*. But now the Icelandic banks were prepared. They had joined forces with pension funds, fishing firms and others and accumulated a lot of currency reserves so each sales offer was met. The *krona* held its value during the day. The Scandinavian banks made heavy losses, and most of the Drobnytes abandoned their attempts at shorting the *krona*. Moreover, Iceland’s Prime Minister, Halldor Asgrimsson, complained to his Norwegian colleague about the CDS shorts that the Petroleum Fund of Norway had accumulated against the Icelandic banks. The Norwegian government intervened, and Håvik left the Fund.¹⁸

3. Negative Publicity in Denmark

In January 2005, Jon Asgeir Johannesson and his associates completed a purchase of the shares in the parent company of Magasin Du Nord, a well-known and upscale department store in Copenhagen. Subsequently, they went on a buying spree in Denmark. In July 2005, Johannesson, again with associates, bought a little less than 30% of the Danish real estate company Keops.¹⁹ In August 2005, Johannesson and his associates bought 80% in the prestigious department store Illum, located on Copenhagen’s main shopping street, *Strøget*, and specialising in expensive designer goods. Johannesson and his associates had previously controlled 20% of Illum through their ownership of the parent company of Magasin Du Nord.²⁰ In September 2005, Johannesson and two of his associates bought the Danish retail chain Merlin operating 48 stores in Denmark, specialising in consumer electronics.²¹ In November

¹⁶ Gunnarsson, *Umsatrid*, p. 75. Transcript of testimony by David Oddsson before the SIC 7 August 2009, p. 19. In the possession of the main author of this report.

¹⁷ Jonsson, *Why Iceland?* pp. 73–4.

¹⁸ *Ibid.*, pp. 78–9.

¹⁹ Jonas Schrøder, *Islendinge kober op i Keops* [Icelanders Buy in Keops], *Berlingske Tidende* 20 July 2005. <https://www.business.dk/diverse/islaendinge-koerber-op-i-keops>

²⁰ Baudur leidir kaup a Illum (Baugur Leads Illum Purchase), *Frettabladid* 4 August 2005, p. 1. http://timarit.is/view_page_init.jsp?pageId=3858019

²¹ Gengid fra Merlinkaupum [Merlin Purchase Completed], *Frettabladid* 17 September 2005, p. 21. http://timarit.is/view_page_init.jsp?pageId=3861278 Jørgen Andresen, *Islandske Baugur sætter sig på Merlin* [Icelandic Baugur Takes Over Merlin], *Børsen* 16 September 2005.

2005, Johannesson and a Danish partner bought 22% in the company Nordicom which specialized in commercial housing.²² In January 2006, one of Johannesson's companies bought Denmark's biggest real estate company, Atlas Ejendomme. Later, when Johannesson had gained control of the bank Glitnir, he bought out some of his partners and merged his real estate companies into one, Landic Property.²³

It generated much publicity when Johannesson announced 15 February 2006 that his media company would launch a Danish newspaper, *Nyhedsavisen*, which would be distributed free of charge.²⁴ The new free paper would be different from other free Danish papers which were mainly distributed to commuters: It would be a real newspaper challenging the three traditional Danish dailies, *Berlingske Tidende*, *Jyllandsposten* and *Politiken*. It would be distributed to all households in Denmark, relying on a distribution network which could then also be used to deliver other kinds of advertising material to potential customers. This announcement came only a month before Danske Bank severed all ties to Icelandic banks and published its negative report on them. Predictably, Johannesson's announcement did not create any enthusiasm in the traditional Danish dailies which decided on a counter-attack, publishing their own free newspapers. For a while, it seemed that Johannesson would have to abandon his ambitious plan. But he was adamant that he would see it through: "And we intend to put money in, as and when it becomes necessary. Whether it is a question of 350 or 600 million [Danish *kroner*], it does not matter," he said.²⁵ *Nyhedsavisen* finally appeared 5 October 2006. It was published for fourteen months, at a huge loss. Apparently, Johannesson spent 450 million Danish *kroner* (\$88 million or £49 million) on it, getting only a fraction back. Johannesson's Danish partners also made huge losses.²⁶

http://borsen.dk/nyheder/generelt/artikel/1/77928/islandske_baugur_saetter_sig_paa_merlin_2_opd.html

²² Jonas Schrøder, Vagner og Baugur køber massivt op i Nordicom [Vagner and Baugur Buy Massively in Nordicom], *Berlingske Tidende* 30 November 2005.

<https://www.business.dk/diverse/3011-05-vagner-og-baugur-koerber-massivt-op-i-nordicom> Landic Properties took out full-page advertisements in the main Icelandic newspapers, *Morgunbladid* and *Frettabladid*, 24–27 November 2007, with the information that it was one of the biggest real estate companies in the Nordic countries.

²³ Palmi i Fons kaupir 32% i Keops [Palmi in Fons Buys 32% in Keops], *Morgunbladid* 24 May 2007 (Business Section), p. 4. http://timarit.is/view_page_init.jsp?pageId=4162101 Baugur eykur vid sig i Nordicom og Keops [Baugur Increases Its Shares in Nordicom and Keops], *Morgunbladid* 26 May 2007, p. 16. http://timarit.is/view_page_init.jsp?pageId=4162273 Officielt köbstilbud på Keops fremsat [Public Offer for Keops Made], *Berlingske Tidende* 27 July 2007; Stodir kaupa Keops [Stodir Buys Keops], *Morgunbladid* 4 September 2007, p. 14.

http://timarit.is/view_page_init.jsp?pageId=4169707 Laurits Harmer Lassen, Heftige vækstmaal fra ny Keops-ejer [Ambitious Growth Plans of New Keops Owner], *Berlingske Tidende* 18 October 2007. <https://www.business.dk/finans/heftige-vaekstmaal-fra-ny-keops-ejer>

²⁴ Dagsbrun hyggst gefa ut okeypis dagblad i Danmorku [Dagsbrun Plans to Publish a Free Paper in Denmark], *Morgunbladid* 16 February 2006, p. 4. http://timarit.is/view_page_init.jsp?pageId=4122677

²⁵ Rune Skyum-Nielsen *et al.*, *Alt går efter planen. Sagaen om Nyhedsavisen* (København: Politikens forlag 2009), p. 91. This mostly reliable work by journalists at *Nyhedsavisen*, written after the paper's demise, is drawn upon in this account.

²⁶ Aevintyraeyjan — fjarfestingar i ffolmidlum erlendis [Adventure Island – Investments in Foreign Media], *Visbending*, Vol. 26, No. 34 (2008), p. 3.

http://timarit.is/view_page_init.jsp?gegnirId=001073849 Una Sighvatsdottir, "Thad enda vist ekki oll aevintyri vel" [Not All Adventures Have a Happy End], *Morgunbladid* 2 September 2008, p. 15. http://timarit.is/view_page_init.jsp?pageId=4197860

Johannesson's buying spree in Denmark and his costly media adventure did hardly instil in Danish financial analysts much respect for the Icelandic banks which seemed for quite a while to be ready to lend him as much money as he wanted. Many articles critical of Johannesson and reporting on his legal battles in Iceland appeared in the Danish press. Some Icelanders however came to Johannesson's defence. Thorsteinn Pálsson, Iceland's Ambassador to Denmark, publicly suggested that the negative attitude towards Johannesson of *Berlingske Tidende* in Denmark was an echo of the critical attitude towards him of *Morgunbladid* in Iceland.²⁷ Pálsson who had been Justice Minister in Oddsson's two first governments, in 1991–9 (after Oddsson had ousted him as Leader of the Independence Party), returned to Iceland in 2006 and became editor of Johannesson's *Frettabladid*, while his new employer continued his legal battles.

4. Hedge Fund Managers Visit Iceland

The Icelandic banks survived the 'Geyser Crisis' in the spring of 2006, as can be seen from Figure 2. The CDS spreads on them fell, and in the latter half of 2006 the *krona* started to climb upwards and seemed to become overvalued. Hedge funds still kept an eye on Iceland. The Drobny Global Conference was held in Reykjavik 12–13 October 2006. One of the participants was hedge fund manager Hugh Hendry who had previously spoken about his dream to bankrupt Iceland.²⁸ In late January 2007, George Soros and another famous hedge fund manager, Bruce Kovner of the large Caxton fund, in New York, looked at shorting the Icelandic *krona*, and discussed the idea with Icelandic financial analysts. Eventually, they decided not to place bets against the *krona*.²⁹ Their decision turned out to be prudent, because the *krona* held steady for most of 2007. If some hedge funds tried to short it, then they must have made a considerable loss.

Nevertheless, hedge funds had not averted their gaze from Iceland. At the end of March 2007, Barclays Capital and UBS brought a group of asset managers to Iceland. When they visited the biggest bank, Kaupthing, a presentation by the CEO, Hreidar M. Sigurdsson, turned into a shouting match, with some of the guests interrupting with exclamations like, "This is not a bank but a hedge fund!" Armann Thorvaldsson comments: "With its big banking system and small Central Bank, Iceland had clearly been singled out by the hedge funds."³⁰ According to economist Barry Eichengreen, the experience of this trip to Iceland in March 2007 led "a group of fifty macro hedge funds organized by Drobny Global Advisors of Manhattan Beach, California" to start shorting the Icelandic currency and the Icelandic banks.³¹

²⁷ Thorsteinn Pálsson, Their sletta skyrinu sem eiga það [Those who Attack are Talking about Themselves], *Morgunbladid* 18 January 2005, p. 27. http://timarit.is/view_page_init.jsp?pageId=3650221

²⁸ Drobny Global Conference. While these slides have been removed from the Internet, the main author of this report was able to obtain copies. http://rse.hi.is/wp-content/uploads/2018/08/Drobny_global_conference_reykjavik.pdf

²⁹ Það freistar theirra að radast á kronuna [They are Tempted to Attack the Krona], *DV* 18 October 2010, p. 10–12. http://timarit.is/view_page_init.jsp?pageId=6418724 Apparently, an email from Heidar Gudjonsson, a financial analyst, to some Icelandic investors had been leaked to the newspaper.

³⁰ Thorvaldsson, *Frozen Assets*, p. 172.

³¹ Barry Eichengreen, *Hall of Mirrors* (New York: Oxford University Press, 2015), pp. 218–219.

At the end of January 2008, the time came for another trip to Iceland. Then Bear Sterns organised a tour of hedge fund managers. They did not hide their negative attitude towards the Icelandic banks. “All the people in this party are shorting Iceland, except me,” one of the participants said to an Icelandic observer, adding that these people thought Iceland would become “a new financial Armageddon.”³² The funds represented, in addition to Bear Sterns, were DA Capital Europe, King Street Capital Management, Merrill Lynch GSRG and Sandelman Partners. Ironically, in March 2008 Bear Sterns itself became the victim of hedge funds and had to be rescued by the US Federal Reserve Board and taken over by JP Morgan Chase. “The hedge funds had claimed their first victim. The search for the next one began. Iceland stayed in the firing line,” Thorvaldsson observed.³³

5. Betting Against the Banks and the krona, 2008

As the English economist Professor Richard Portes—who had written a report on the Icelandic financial sector—explained to journalists, a hedge fund would play Iceland by simultaneously shorting both the currency and the equity markets. This forced the CBI to raise interest rates which in turn pushed down the equity markets. Portes also observed that the CDS market was highly distorted, governed by small amounts of trade and rumour-mongering.³⁴ In early 2008, the *krona* started a rapid slide downwards. *The Daily Telegraph* asked in a headline: “Is Iceland headed for meltdown?”³⁵ By now, some London hedge funds were shorting the Icelandic banks, and Icelandic bankers expressed their suspicion that these funds were the sources of negative reports in the British press on the banks in late March 2008, for example that a run had begun on Landsbanki’s Icesave accounts and Kaupthing’s Edge accounts, both online.³⁶ A Kaupthing economist writes: “Icelanders were convinced the story had been planted, but it took a phone call with a friendly UK journalist to confirm that a number of ‘helpful’ hedge funds had voluntarily provided the press with information about Icelandic banks.”³⁷ Sigurdur Einarsson, Kaupthing’s Chairman of the Board, went so far as to name four hedge funds that, he said, were betting against the Icelandic banks and spreading false rumours about them: Trafalgar Funds, Cheney Capital, Lansdowne Fund and Ako Capital. The funds either did not respond or denied Einarsson’s charges of rumour-mongering.³⁸

At the end of March 2008, financial analyst Richard Thomas of Merrill Lynch wrote a comment on the Icelandic banks:

³² Jonsson, *Why Iceland?* p. 114; Thorvaldsson, *Frozen Assets*, p. 187. It is possible, and indeed likely, that their source is the same person.

³³ Thorvaldsson, *Frozen Assets*, pp. 190–1.

³⁴ Neil Barnett, Tantamount to financial terrorism, *Spectator* 23 April 2008.

<https://www.spectator.co.uk/2008/04/tantamount-to-financial-terrorism/>

³⁵ Iain Dey, Is Iceland headed for meltdown? *The Telegraph* 3 February 2008.

<http://www.telegraph.co.uk/finance/economics/2783787/Is-Iceland-headed-for-meltdown.html>

³⁶ Icesave gets the chill from the credit crisis, *Sunday Times* 30 March 2008; Icelandic banks feel the chill as credit crunch stretches north, *Observer* 30 March 2008. Both news items were subsequently corrected. <http://www.thetimes.co.uk/article/kaupthing-edge-a-correction-zf3kfb1ws0j> and <https://www.theguardian.com/money/2008/mar/30/savings.creditcrunch>

³⁷ Jonsson, *Why Iceland?* p. 118.

³⁸ Atlogu vogunarsjoda hrundid [Hedge Fund Attack Repelled], *Frettabladid* 9 April 2008, p. 1. http://timarit.is/view_page_init.jsp?pageId=3993872

When clients ask us why the Icelandic banks are considered to have a higher risk profile than their other European peers, one does not have to search hard for answers: rapid expansion, inexperienced yet aggressive management, high dependence on external funding, high gearing to equity markets, connected party opacity. In other words: too fast, too young, too much, too short, too connected, too volatile.³⁹

While some took offence at Thomas' remarks, others found a ring of truth in them, including privately the CBI governors.⁴⁰ It provided little comfort to the Icelandic bankers that in fact Merrill Lynch went down before them, being acquired by Bank of America Sunday 14 September 2008. Merrill Lynch had suffered enormous losses because of subprime loans.

It was around this time, in the spring of 2008, that Professor Portes received a phone call from the senior partner of a hedge fund, asking him why he was not more negative about the Icelandic banks. "Are you shorting Iceland?" Portes asked the caller. The next day he reported the conversation to Icelandic authorities, on the grounds that it might constitute market manipulation.⁴¹ The British magazine *Spectator* published a story that a partner of an unnamed hedge fund telephoned at least two people with market influence and helpfully informed them that the Icelandic banks were about to tank. "He suggested that the famous Landsbanki IceSave and Kaupthing Edge internet savings accounts, currently beloved of British savers, were vulnerable to run if Northern Rock-esque trouble were revealed—as, he suggested, inevitably it would be."⁴² In the spring of 2008, economic commentator Paul Krugman openly wondered whether a similar attack was being organised against Iceland as in August 1998 against Hong Kong, when several major hedge funds shorted both the city state's stock market and its currency, ultimately unsuccessfully because the Hong Kong Monetary Authority met them on both fronts.⁴³ But if the Icelandic monetary authority, the CBI, was to be able to meet hedge funds in the same way, then it needed help from European central banks and possibly also from the US Federal Reserve Board. On their own, the Icelandic banks could hardly survive the international credit crunch. The hedge funds watched their moves as closely as a pack of hyenas would a herd of wildebeest.

³⁹ Richard Thomas, *Resolving Iceland's banking "crisis"* (London: Merrill Lynch 31 March 2006), p. 2. <https://notendur.hi.is/ajonsson/kennsla2006/Iceland%20resolve%2029%20Mar08.pdf>

⁴⁰ Interview with Eiríkur Guðnason in Kopavogur 25 October 2011.

⁴¹ Mark Landler, Iceland, a Tiny Dymomo, Loses Steam, *New York Times* 18 April 2008. <http://www.nytimes.com/2008/04/18/business/worldbusiness/18iceland.html>

⁴² Neil Barnett, Tantamount to financial terrorism, *Spectator* 23 April 2008. <https://www.spectator.co.uk/2008/04/tantamount-to-financial-terrorism/>

⁴³ Paul Krugman, The North Atlantic Conspiracy. Blog 31 March 2008. <https://krugman.blogs.nytimes.com/2008/03/31/the-north-atlantic-conspiracy/>

Chapter Three

The Role of European Central Banks

The Icelandic banks had come to the attention of alert hedge fund managers as early as in the autumn of 2005. But when they responded to funding problems in 2006–7 by starting to collect deposits abroad and by obtaining credit in the European Central Bank, ECB, through their foreign subsidiaries, they came to the attention of European central banks whose subsequent refusal to provide liquidity to them through the CBI certainly was an important foreign factor in the Icelandic bank collapse.

1. CBI Requests for Currency Swap Deals

After the 2006 Geysir crisis the Icelandic banks had started to collect online retail deposits abroad, Landsbanki in its branches under the name ‘Icesave’, starting in October 2006, and Kaupthing mostly in its subsidiaries under the name ‘Edge’, starting in November 2006. The branches of the Icelandic banks were regulated by the IFSA and the deposits in them insured by the Icelandic Depositors’ and Investors’ Guarantee Fund, IDIGF, whereas the subsidiaries of the banks were regulated locally and the deposits also insured locally. Since the Icesave and Edge accounts were electronic, they were much cheaper to operate than regular accounts at ‘High Street’ bank offices. The Icelandic banks could therefore offer higher interest rates than many of their competitors. “Icesave looks like a hot deal,” British journalists wrote.¹ The Icesave and Edge accounts certainly became quite popular: At the end of September 2008, a total of €5.4 billion were kept in Kaupthing’s Edge accounts in Europe, thereof €4.2 billion in subsidiaries. At the end of June 2008, a total of £3.6 billion were kept in Landsbanki’s Icesave accounts in the UK.²

The collection of deposits in the Icesave and Edge accounts caused however resentment by competitors of the Icelandic banks. “I am fairly confident that this annoyed the big banks in these countries no end. They had the large costs associated with their branch network and would never have been able to compete with us on pricing,” Kaupthing’s Armann Thorvaldsson writes.³ Now, the Icelandic banks also came to the attention of European central banks, preoccupied with the international credit crunch starting in late summer 2007. At a meeting of central bankers in Basel in March 2008, Axel Weber, Governor of the Central Bank of Germany, argued that one of the greatest threats to the stability of the banking system was the irresponsible intrusion into deposit markets and the break up of the deposit-guarantee schemes. It was clear to CBI Governor Oddsson who was present at the meeting that

¹ Ali Hussain, Icesave Looks Like a Hot Deal, *Sunday Times* 15 October 2006.

<http://www.thesundaytimes.co.uk/sto/business/money/savings/article158555.ece>

² SIC Report, Vol. 6, Ch. 18, pp. 3–4 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

³ Thorvaldsson, *Frozen Assets*, p. 194. This was also what Bjarni Armannsson, Chief Manager of Islandsbanki, later Glitnir, felt. He gave some examples of this from discussions with foreign bankers. Interview with Bjarni Armannsson in Reykjavik 4 November 2016.

Weber was referring to the Icelandic banks.⁴ The European central bank governors worried about deposits in both the branches and subsidiaries of the Icelandic banks. If they were in branches, then they were insured in tiny Iceland, where the IDIGF clearly did not have the means to meet its obligations in case of failure. If the deposits were in subsidiaries, then they were insured locally, by the guarantee funds of each host country, putting strain on them.

In early 2008, the international credit crunch was hitting hard the already vulnerable Icelandic banks. The CBI could print kronur, but it could not on its own provide dollars, euros or pounds. When the CBI governors started to try and obtain currency swap deals with European central banks and the US Federal Reserve Board, they found their foreign colleagues wary of the Icelandic banks. CBI governors David Oddsson and Ingimundur Fridriksson met on 3 March 2008 in London with Governor Mervyn King of the Bank of England and Sir John Gieve, the Deputy Governor, the Financial Stability Department. The CBI governors were enquiring whether the Bank of England was prepared to make currency swap deals available to the CBI. Governor King and Sir John expressed misgivings about the Icesave accounts. They believed that the deposits raised in the UK had been used mostly to fund lending to Icelandic companies. They were also preoccupied with the possible consequences on a run on the Icelandic banks, including Landsbanki in London, and the arrangement of deposit guarantees.⁵

Sir John Gieve later said that it had added to their concerns about Iceland that they had observed highly leveraged buyouts in England by Icelandic businessmen. There was a lingering suspicion that the Icelandic banks were controlled by a small group of businessmen who used them for their own purposes. The banks might be not only bust, but also rotten. Sir John Gieve had also heard about a cross-border crisis management exercise the Nordic and Baltic states held in September 2007 where the Icelandic participants did not take a position at the end of the exercise on whether the authorities would save the banks in the case of a grave liquidity crisis.⁶ A Bank of England official, Andrew Gracie, had overseen the exercise and had in February 2008 written a report for the CBI pointing out the danger of a bank collapse in Iceland the following October. Oddsson had quietly passed on the report to Prime Minister Geir H. Haarde.⁷

Two weeks after the meeting at the Bank of England, CBI Governor Fridriksson on 17 March 2008 sent an informal request for a currency swap deal to the Bank of England. Talks began, in a friendly manner, but without any tangible results. In early April the CBI also contacted the ECB, European Central Bank, the US Federal Reserve Board and the Scandinavian central banks with similar requests. CBI Governor Oddsson spoke several times with Timothy Geithner, President of the FRB of New York, requesting a dollar swap deal of perhaps \$2–3 billion. Oddsson

⁴ SIC Report, Vol. 6, Ch. 18, p. 59 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

⁵ Ibid., p. 9 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf> Also, interview with Mervyn King in Petham Oast 14 August 2017.

⁶ Interview with Sir John Gieve in London 27 November 2014. While Sir John did not refer to Jon Asgeir Johannesson by name, he presumably was speaking about him when he referred to an Icelandic businessman buying up High Street shops with loans from Iceland.

⁷ SIC Report, Vol. 7, Ch. 21, pp. 65 and 139 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

explained, as he had done in discussions with European central bankers, that the Icelandic banks were suffering from the perception that they had no lender of last resort and that the CBI was trying to make currency exchange deals with central banks as a trust-building measure. It would not be the goal to draw on credit lines so created, but rather to demonstrate to the markets that there were sufficient currency reserves available to the banks. Oddsson mentioned to Geithner that he was also trying to obtain such deals with European central banks which estimated the need to be about €3–4 billion.⁸ Geithner promised Oddsson that he would look into this. The Federal Reserve Board had already in late 2007 when the credit crunch began opened swap lines with the ECB and the Swiss central bank.⁹

2. The IMF Preliminary Assessment

When CBI Governor Oddsson spoke with ECB Governor Jean-Claude Trichet about a possible currency swap deal, he was told that the precondition for any help from the ECB would be the participation of the IMF, in some kind of a programme. The next time Oddsson met with Geithner, he told Geithner that Trichet had insisted, to his surprise, that Iceland had to enter into a programme with the IMF. “Ah, he offered you the Kiss of Death,” Geithner said. His analysis, with which Oddsson agreed, was that an announcement that Iceland would be seeking assistance from the IMF would strengthen suspicions about the weaknesses of the Icelandic banks and could therefore provoke a run on them, with their inevitable collapse.¹⁰ When Oddsson told Bank of England Governor King that Trichet insisted on Iceland entering an IMF programme, King responded that this would not be necessary. What Iceland only needed to do, King said, was to get an IMF assessment of the state of the banks and the economy. Thereupon Governor Oddsson called IMF Director Dominique Strauss-Kahn and explained the situation to him. Strauss-Kahn was very friendly and reacted swiftly. He sent some staff members almost immediately to Iceland to write an assessment report.

At the IMF Spring Meeting in Washington DC 11–13 April 2008, CBI Governor Ingimundur Fridriksson and his staff met with several central bankers to discuss possible currency swap deals. Friday 11 April they met with the governors and staff members of the Scandinavian central banks. Governor Stefan Ingves of Sweden expressed concern about the Icelandic banking sector and the Icelandic economy as a whole and told the Icelanders that possibly the Scandinavian central banks would set some preconditions for currency swap deals. Nevertheless, it was agreed that Riksbanken staff would prepare a draft for a currency swap deal between the Scandinavian central banks and the CBI.¹¹ In Washington DC, CBI Governor Fridriksson and his staff met with Bank of England Governor King Saturday 12 April. The meeting was friendly and it was Fridriksson’s impression that it was more rather than less likely that the Bank of England would make a currency swap deal with the CBI. However, Governor King stressed that a plan had to be in place on how to use a possible credit line from the Bank of England.

⁸ SIC Report, Vol. 1, Ch. 4, p. 169.

⁹ Federal Reserve System, *Report to Congressional Addressees* (Washington DC: Government Accountability Office, July 2011), p. 16. Figure 1. <http://rse.hi.is/wp-content/uploads/2017/11/FederalReserveSystem.pdf>

¹⁰ SIC Report, Vol. 6, Ch. 19, p. 161. Interview with David Oddsson in Reykjavik 7 October 2013.

¹¹ SIC Report, Vol. 1, Ch. 4, p. 170.

On their way back to Iceland, CBI Governor Fridriksson and his staff met on 14 April in New York with FRB of New York President Timothy Geithner. It came out that before Geithner met the Icelanders, he had discussed the proposal of a dollar swap deal with the governors of the Bank of England, ECB and the Swedish central bank and also with the BIS Director. They were all, as was he, sceptical about it. Geithner told the Icelanders that in order to build trust, they needed much more than they had previously had in mind, a dollar swap deal of at least \$10 billion. Otherwise the markets would interpret this as a sign of weakness. He added that he did not want completely to rule out a possible deal despite his doubts about the whole strategy.¹²

The same day as Geithner had the meeting in New York with the Icelanders, a confidential IMF ‘Preliminary Assessment’ appeared which had been specially commissioned by the CBI for the central bankers to enable them to evaluate the request for currency swap deals. “Broadly, the conclusion of the IMF was that the position of the Icelandic banks was tight but manageable,” CBI Governor Ingimundur Fridriksson writes, “and it endorsed the strategy of the Icelandic authorities, i.e. to negotiate swap agreements with other central banks in order to enhance confidence and allow the government to subsequently tap the international capital market to further strengthen its external liquidity position.”¹³ According to the Assessment, it was crucial that the safeguards of a loan facility were credible, inducing the banks to reduce the size of their balance sheets and thereby increase confidence in the system. Each of the three banks should be required to prepare a plan on how they would downsize; they should stop paying dividends in the near future, to improve their liquidity position; they should present plans on how quickly they could raise liquidity by selling assets, if needed; and finally, the granting of licenses to open branches abroad should be restricted.¹⁴

3. CBI Request Turned Down in London

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

King replied the next day, in a long letter, where he explained why he was turning down the request by the CBI:

¹² SIC Report, Vol. 1, Ch. 4, p. 171.

¹³ Ingimundur Fridriksson, *The Collapse of the Icelandic Banks*, Notes (Summer 2012), p. 31.

¹⁴ Jännari, *Report on Banking Regulation and Supervision in Iceland*, pp. 18–19.

https://www.island.is/media/frettir/KaarloJannari%202009_%20Final.pdf SIC Report, Vol. 1, Ch. 4, p. 171; SIC Report, Vol. 6, Ch. 19, pp. 161–162.

¹⁵ SIC Report, Vol. 1, Ch. 4, p. 172.

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

King went on:

The amount of money is very small relative to the potential need for funds should a problem arise with one or more of your banks. Indeed, the announcement of a swap, especially if restricted to a group of countries with which Iceland has good political relations, might well trigger concern in financial markets about the extent to which you and ourselves perceived a problem in the Icelandic banking system, and then attention would be drawn to the inadequate scale of financial resources available to you to deal with the problem. The swap might look rather like a political gesture rather than a credible financial strategy.

King added that he and Stefan Ingves, governor of the Swedish central bank, would initiate a discussion about Iceland's problems at the dinner of the G-10 central bank governors in Basel 4 May.¹⁶ Privately, British central bankers told Oddsson that they were also apprehensive about some of the bank owners.¹⁷

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

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

Oddsson said that he believed that currency swap deals of the magnitude being sought by the CBI would be sufficient to make the situation manageable. Moreover, the international ratings agencies all thought that such currency swap deals would improve the position of Iceland. Oddsson's letter brought no response from the Bank of England.¹⁸

Perhaps two pieces of news about the Icelandic banks in the last week of April did not much mollify European central bankers, already concerned about the sustainability of the Icelandic banks and irritated over their deposit collection. First, the ECB, European Central Bank, found out that the Icelandic banks, through their subsidiaries in Luxembourg, had increased collateralised loans at the ECB from €1 billion to almost €4 billion, and, to make matters worse from the ECB's point of view, partly against securities that they had issued to one another and without any

¹⁶ Ibid., pp. 172–3.

¹⁷ SIC Report, Vol. 6, Ch. 21, p. 73 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> This was confirmed in an interview with Sir John Gieve in London 27 November 2014.

¹⁸ SIC Report, Vol. 1, Ch. 4, p. 174.

other collateral: Kaupthing had used securities for €200 million from Glitnir and €425 million from Landsbanki for this purpose; Landsbanki had used securities for €500 million from Glitnir and €580 million from Kaupthing; and Glitnir had used securities for €100 million from Kaupthing and €235 million from Landsbanki.

In the early afternoon of 25 April 2008, ECB Governor Jean-Claude Trichet called CBI Governor Oddsson. Clearly upset, he said that a part of the securities used as collateral by the Icelandic banks were “artificial”. Trichet angrily demanded a meeting between the Luxembourg central bank and representatives of the three Icelandic banks, the CBI and the IFSA. Later in the same day, Central Bank of Luxembourg Governor Yves Mersch, called Oddsson, telling him that the collateralised loans from the central bank to the Icelandic banks now amounted to almost 10% of all such loans, whereas their subsidiaries were only 1.7% of the Luxembourg banking sector. It was decided to hold a meeting three days later in Luxembourg between the Central Bank of Luxembourg and representatives of the Icelandic banks, the CBI and IFSA. Even if the Icelandic banks had not violated any ECB rules, they informally agreed to limit their issuance of the securities to one another to no more than 40% of all their collateralised loans.¹⁹ However, the banks continued to obtain collateralised loans at the ECB, mostly against asset-based securities, and at the end of June, their collateralised loans at the ECB amounted to €4.5 billion.²⁰

Five days after the angry complaint from ECB Governor Trichet about the behaviour of the Icelandic banks, Landsbanki announced that it would be offering Icesave accounts in euros in four to five European countries by the end of the year.²¹ It opened a branch in the Netherlands in May 2008. The Icesave accounts proved very popular there, and after four months they amounted to over €1.5 billion. In talks with Icelandic bankers and with CBI Governor David Oddsson, Central Bank of the Netherlands Governor Nout Wellink expressed grave concerns about Landsbanki’s deposit collection through its branches. It was clear, he observed, that the IDIGF could not cover its obligations in the case of Landsbanki’s failure. Wellink told Oddsson that the Icelandic bankers were irresponsible and that they had to be stopped. When Oddsson said that they were only doing what they were allowed to do under EEA law and regulations, Wellink retorted that it would not be a problem to find support in European regulations for stopping them. He added that he was not only expressing his personal opinion, but that this was also “the common understanding” all over Europe.²²

4. A Fateful Dinner in Basel

When Governors Mervyn King and Stefan Ingves brought up the case of the Icelandic banking sector at the dinner of the G-10 central bankers in Basel Sunday 4 May 2008, not only were they themselves sceptical about the sustainability of the

¹⁹ SIC Report, Vol. 2, Ch. 7, pp. 47–8.

²⁰ SIC Report, Vol. 7, Ch. 21, p. 44 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

²¹ Bjorn I. Hrafnsson, Icesave hleypt af stokkum í evrum í næsta manudi [Icesave Starts Next Month in Eurozone], *Frettabladid* 30 April 2008, p. 6. http://timarit.is/view_page_init.jsp?pageId=3997991

²² SIC Report, Vol. 6, Ch. 18, pp. 56–59 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

sector, but they were also faced with at least two angry critics of the Icelandic bankers, ECB Governor Jean-Claude Trichet and Central Bank of the Netherlands Governor Nout Wellink. At the Basel meeting, Ingves could also present a report on Iceland which analysts at the Swedish central bank had delivered to him a few days earlier. In the report, they pointed out that the Icelandic banks were profitable and held good assets, but that their main problem was how to survive a liquidity crisis. Even if the CBI managed to increase its exchange reserve fund considerably, from €1.9 billion to €3–4 billion, it was not certain that this would suffice. The Swedish experts added, however, that swap deals between the CBI and other central banks might be a good way to increase confidence in the Icelandic banking sector.²³

While discussions at the dinner of the G-10 central bankers in Basel Sunday 4 May were strictly confidential, the position of the major central banks towards Iceland evidently hardened there. It became clear then that the CBI could not expect any liquidity assistance from the Bank of England or the ECB. There were probably several reasons for this decision by the G-10 central bankers to deny assistance to the CBI. The Icelandic banks, even if relatively small, were regarded as aggressive and intrusive, posing a danger to the whole European system of deposit insurance. Behind the scenes, local competitors to the banks must also have encouraged the central banks in their respective countries to put a stop to this unwelcome challenge. Again, the European central bankers may have been worried about the strain which the newcomers put on the deposit insurance schemes in host countries; and they may have taken the high interest rates that the Icelandic banks offered as signs of an underlying weakness rather than strength.²⁴ The central bankers were not oblivious, either, to the negative publicity the Icelandic banks and businessmen had generated in various countries, perhaps with the encouragement of hedge funds betting against Iceland. Recent developments, such as the unwelcome increase in the collateralised debt of the Icelandic banks at the ECB and Landsbanki's announcement of the extension of deposit collection to the eurozone, certainly did not reduce their reluctance to help the Icelandic banks.

But the main reason the central bankers had for their adamant refusal to make currency swap deals with the CBI were probably that they had become convinced that the Icelandic banking sector was not sustainable on its own and that it would not matter much to the whole European banking sector if it collapsed. Iceland was expendable. It was too small to save. The European central bankers did not seem to find important the fact that most of the Icelandic banks' operations, both in accepting deposits and in providing credit, took place in Europe itself, so that they could be considered European rather than Icelandic banks. As the saying goes: Cross-border banks are international in life, but national in death.²⁵

Even Iceland's traditional friends in the Nordic countries were now considering abandoning her. Central Bank of Sweden Governor Ingves turned against completing the currency swap deals between the Scandinavian central banks and the CBI that had

²³ SIC Report, Vol. 6, Ch. 19, p. 171.

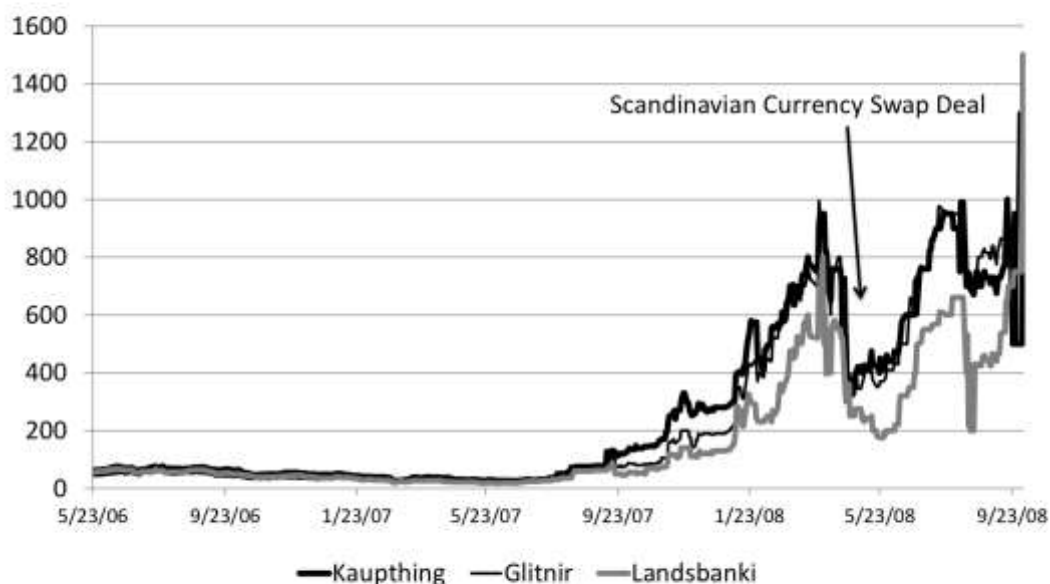
²⁴ This is suggested by Fridriksson, *The Collapse of the Icelandic Banks*.

²⁵ Charles Goodhart, *Procyclicality and Financial Regulation*, *Estabilidade financeira*, No. 16 (Madrid: Banco de España, May 2009).

<https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/09/May/Fic/ief0116.pdf>

already been drafted. He argued that the unclear ownership of the Icelandic banks and their rapid growth had led a dangerous situation that the Icelandic government did not seem fully to comprehend.²⁶ His Danish colleague tended to agree with him whereas the governor of the Norwegian central bank was more inclined to make the deals. At a meeting of central bank governors of the Nordic countries 14 May 2008 in Oslo, CBI Governor Oddsson had to use all his persuasive powers to bring his reluctant Scandinavian colleagues to accept the deals. In the midst of one of their meetings, he even went so far as to call the Icelandic Prime Minister, Geir H. Haarde, and to hand the phone over to Ingves. In the conversation with Ingves, Haarde promised to exert pressure on the banks to reduce the overall size of their balance sheets and on the labour unions to show moderation in coming wage settlements, to restructure the Housing Finance Fund and to maintain fiscal prudence. The CBI and the government also made a commitment not to draw on the deals for the purpose of intervening in markets or of capitalising the banks. The next day, a memo to the three Scandinavian central banks was signed by Haarde, Foreign Minister Ingibjorg S. Gisladottir, Finance Minister Arni M. Mathiesen and the three CBI governors. The currency swap deals were signed and announced 16 May, enabling the CBI to draw on each of the three banks €500 million, if necessary.²⁷ The announcement had an immediate impact on the markets: The CDS spread narrowed, as can be seen on Figure 3, and the hedge funds withdrew for a while. Their managers were not certain whether a bet against the Icelandic banks could be met with sufficient currency reserves.

Figure 3: CDS Spreads of Icelandic Banks, 2006–8



Source: SIC Report, Vol. 2, Ch. 7.

²⁶ SIC Report, Vol. 1, Ch. 2, p. 12 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf> Perhaps it should be pointed out that neither the government nor the CBI had access to detailed information about the ownership of the banks. It was only the IFSA which had such an access.

²⁷ SIC Report, Vol. 1, Ch. 4, pp. 175–8.

5. Increased Hostility Towards the Icelandic Banks

In late May 2008, the CBI, with the help of consultants from Barclays, JP Morgan and Lehman Brothers, explored possibilities of increasing its exchange reserve fund by borrowing. It turned out that the only loans available would be with a large CDS spread. The consultants were unanimous in advising against borrowing on such terms, arguing that such an offer from the CBI could by itself create a run on the banks. Instead, the CBI started to issue short-term bonds; it also managed to obtain for the Treasury a loan of a €300 million from a German bank. The CBI requested from the IMF a FSAP (Financial Sector Assessment Program) Update on the report from 14 April. It was conducted in June, the IMF team reaching broadly the same conclusions as in the spring: While vulnerable, the banks met minimum requirements on financial strength. The IMF recommended, given the significant size of cross-border activities, continued and strengthened cooperation with host supervisors, such as the FSA in the UK.²⁸

Two CBI governors attended the 29–30 June 2008 BIS Annual General Meeting in Basel, David Oddsson and Eiríkur Guðnason. They felt a strong hostility there towards the Icelandic banks which was transferred over to them personally so they were treated almost as untouchables: For example, Stefan Ingves refused to acknowledge or greet Governor Guðnason, an old acquaintance from many visits to Iceland. It was only when the two of them happened to be together in an elevator that he gave Guðnason the hand, and then it was the left one.²⁹ Later, Ingves admitted that he had been rude to the Icelanders at the Basel meeting, but that was, he said, nothing personal, only anger that the Icelandic authorities had not done any of the things that they had promised to do when the Scandinavian central banks had made the currency swap deals with the CBI in mid-May.³⁰

This was however not necessarily a fair judgement of the situation. The restructuring of the Housing Financing Fund was linked to changes being requested by the EFTA Surveillance Authority and they required some time. Any fiscal measures were linked to the budget which was to be presented in the autumn of 2008. Market conditions in the spring and summer of 2008 did not allow the government or the CBI to increase liquidity by borrowing except in relatively limited amounts in the short-term market. In the circumstances it had also become very difficult for the banks to downsize, as was recognised in the reports by experts from the IMF and the Swedish central bank.³¹

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

²⁸ Iceland: Financial System Stability Assessment—Update, 19 August 2008 (Washington DC: IMF, December 2008). <https://www.sedlabanki.is/lisalib/getfile.aspx?itemid=6686>

²⁹ Interview with Eiríkur Guðnason in Kopavogur 25 October 2011.

³⁰ Interview with Stefan Ingves in Stockholm 8 April 2015.

³¹ Fridriksson, *The Collapse of the Icelandic Banks*. SIC Report, Vol. 6, Ch. 19, p. 276.

with Oddsson, Mersch and the governors of the Nordic central banks. There, Mersch said that nobody wanted to do business with the Icelandic banks any more; they were treated as lepers by the financial community. It was decided that Mersch would go to Iceland and speak directly to the managers of the Icelandic banks.³²

In the subsequent meeting in Iceland 4 July 2008 with CBI and IFSA people, Governor Mersch expressed great concern about the Icelandic banking sector: “I have talked with our Nordic colleagues and know that this is not a feeling that I have alone—that either the banks are not liquid or do not want to restructure.” Mersch pointed out that there was no plausible lender of last resort to the Icelandic banks. He also described the ever-hardening position of the ECB towards Iceland: “Then we have the board—I feel a sense of toughness within the system against Iceland right now. If you [the CBI] say—we are taking over—then that would be a solution. If you cannot take over, then we have a serious problem.”³³

Mersch criticised the Icelandic bankers for their way of doing business with the Central Bank of Luxembourg and the ECB. His complaint was essentially the same as Trichet made in April: Despite Trichet’s admonitions, they had continued to use the credit facilities of the ECB through their Luxembourg subsidiaries and the Luxembourg Central Bank to obtain collateralised loans in euros. As collateral they had sometimes offered only securities that they had issued to one another, the ‘love letters’ as Oddsson called them. Sometimes they had issued asset-based securities that the ECB had no way of evaluating, even involving currency exchange swaps which might imply that the ECB would end up with *kronur* instead of euros. Now they had borrowed a total of €5 billion from the ECB. “Our exposure is far beyond the capital of the lender of last resort,” Governor Mersch said. He was, as Governor Trichet before him, unpersuaded by the argument of the Icelandic bankers that they were not violating any rules, and that this was done by other European banks, responding: “They may respect the letter, but not the spirit.”³⁴

According to Mersch, it was however an over-simplification always to speak about the Icelandic banks as one whole. They were different. He said that he had been informed that some of the Icelandic bank owners were in a weaker position financially than the others and that they might be transferring money to themselves.³⁵ There is little doubt that Mersch was referring to Jon Asgeir Johannesson, the major shareholder in Glitnir.³⁶

³² SIC Report, Vol. 7, Ch. 21, pp. 44–5 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

³³ Ibid., p. 72 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> SIC Report, Vol. 6, Ch. 19, p. 188 (while the chapter is in Icelandic, Mersch’s comments are quoted in English).

³⁴ Op. cit.

³⁵ SIC Report, Vol. 2, Ch. 7, p. 54.

³⁶ In an internal report for Kaupthing in the beginning of March 2008 it is written that “Looking at the cash needs for the months to come, Baugur is not going to be able to fulfill [sic] its obligations without outside intervention/help.” SIC Report, Vol. 2, Ch. 8, p. 139. See also pp. 212 and 308. Indeed, Baugur defaulted 19 March 2008 on a loan from Kaupthing, whereas loans from Glitnir were simply extended. Again, Baugur defaulted 9 July 2008 on another loan from Kaupthing. SIC Report, Vol. 4, Ch. 14, pp. 156–7. Possibly Mersch had information about these matters.

After the meeting with the CBI and IFSA people, Mersch met separately with the managers of the three Icelandic banks, explaining to them that they had to reduce their borrowing at the ECB. He told the banks that before 15 July the collateral at the ECB that they had issued on one another had to go down to 25% of all their collateral, and then they had gradually to disappear. “The ECB’s reservations were not exclusive to Iceland’s activity, though; many European banks were also improvising ways to obtain central bank funding,” Asgeir Jonsson and Hersir Sigurgeirsson write. In fact, from August 2007 to July 2008 collateralised loans to Spanish banks from the ECB increased from 4% of the total to 10.5%, and to Irish banks from 4.5% to 9.5%. Apparently, some of the collateral was in risky financial structures. UK banks, outside the eurozone, used subsidiaries to obtain credit from the ECB.³⁷ Jonsson and Sigurgeirsson comment, however: “But the Icelanders’ style was especially bothersome and unpopular. Their banks behaved like motherless lambs, stealing milk from other ewes and being kicked back.”³⁸

6. *Consensus in Europe Against the Icelandic Banks*

In its report, the SIC states that by early July at the latest, “foreign governors of central banks had evidently discussed the Icelandic situation in their meetings and drawn the conclusion that the Icelandic economy was under serious threat.” This was also the opinion which the three CBI governors expressed at the time. In meetings with Prime Minister Haarde and Foreign Minister Gísladóttir as well as with high officials, 4 and 8 July, Governor Oddsson said “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.”³⁹ Hedge funds that had been waiting in the shadows were quick to realise this. They began again to bet against the Icelandic banks. They observed that no further currency swap deals seemed to be in the making with European central banks.

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

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

³⁷ Willem H. Buiter, *Central Banks and Financial Crises*, Discussion Paper (14 September 2008), pp. 110–11 and 26. <http://eprints.lse.ac.uk/24438/1/dp619.pdf>

³⁸ Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 47.

³⁹ SIC Report, Vol. 7, Ch. 21, p. 73 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> The only written source for the meeting with Haarde and Gísladóttir is a memo by Gísladóttir where all this is not to be found. But there is no reason to suppose that Oddsson said anything else to the two government ministers than he said to the high officials he met 4 July.

Ireland.⁴⁰

Nevertheless, the CBI governors emphasised, in meetings with the Icelandic bankers in mid-July 2008, that they had to accommodate the ECB and reduce their debt in collateralised loans to it. Even if the banks had not broken any ECB rules, they accepted the demand by Governor Yves Mersch on behalf of the ECB to repay all their ‘love letters’, or mutually collateralised loans, and they had done so by the end of July 2008.⁴¹ They also reduced their total debt to the ECB by €1.3 billion from €4.6 billion in the beginning of July to €3.3 billion in the beginning of September.⁴² Landsbanki and Kaupthing used some of the money they had at their disposal through deposit collection for this purpose.⁴³ But ironically they then switched from one cause of irritation for the European central bankers to another one: While the ‘love letters’ disappeared from their accounts with the ECB, they continued to collect deposits. They were sailing between Scylla and Charybdis, uneasily navigating between two hazards.

At the end of July, William R. White, a deputy director of the Bank of International Settlements, BIS, in Basel was in Iceland on a private visit. Governor Oddsson invited him to dinner on 31 July. White told him that the outlook in the international financial markets was bleak, but that authorities were wary of rescuing financial companies. Such bail-outs with taxpayers’ money had been severely criticised. He concluded, according to Oddsson: “I think that in the next few months one investment bank will be allowed to go under, and I predict it will be Lehman Brothers. I also think that in the next few months one small European country will be allowed to go under, and I predict it will be Iceland.”⁴⁴

When Lehman Brothers fell 15 September 2008 (as White had predicted), the international credit crunch turned into a major crisis and ordinary banks joined hedge funds in taking positions against Icelandic banks. Danske Bank which had in 2006 cut all ties to Icelandic banks and consistently warned investors against them, refused to agree to changes in loan covenants necessary for Glitnir’s sale of a Norwegian bank, so the Icelandic bank found itself with no money to repay loans soon maturing. When the US Federal Reserve Board announced dollar swap deals with the three Scandinavian banks 24 September 2008, Iceland was conspicuously absent. Whatever the merit in April of Bank of England Governor Mervyn King’s argument against a currency swap deal with Iceland that “the announcement of a swap, especially if restricted to a group of countries with which Iceland has good political relations, might well trigger concern in financial markets about the extent to which you and

⁴⁰ *Financial Stability 2008* (Reykjavik: CBI, 2008), p. 7. <https://www.cb.is/library/Skraarsafn---EN/Financial-Stability-Report/2008/2008%20enska.pdf>

⁴¹ SIC Report, Vol. 7, Ch. 21, p. 45 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

⁴² This interesting fact is nowhere to be found explicitly in the SIC Report, but it can be derived from the data underlying Fig. 61, Vol. 2, Ch. 7, p. 48.

⁴³ Fridriksson, *The Collapse of the Icelandic Banks*.

⁴⁴ SIC Report, Vol. 6, Ch. 19, p. 272. Also, interview with David Oddsson in Reykjavik 7 October 2013. Oddsson was sufficiently startled by White’s observations to write a memo about them afterwards. In an email to Hannes H. Gissurason 10 October 2017, William R. White recalls having expressed deep concerns about the financial crisis, and about possible bail-outs, but does not remember having made these specific predictions, about Lehman Brothers and Iceland.

ourselves perceived a problem in the Icelandic banking system”,⁴⁵ it did not apply in September. Now the absence of a swap deal was perceived as a grave problem. Credit lines were cancelled, ‘haircuts’ were demanded, deposits were withdrawn: A bank run started. Finance experts agree that without support, hardly any bank can withstand a run.⁴⁶

7. *The ECB Moves Against the Icelandic Banks*

Without any advance notice, a dramatic step was taken by the ECB on the evening of Friday 3 October. Then it suddenly issued margin calls or ‘haircuts’ on outstanding loans to Landsbanki, amounting to €400 million, and to Glitnir, amounting to €640 million. This had to be paid before the banks opened on Monday 6 October. Previously, Landsbanki had borrowed €1.5 billion from the ECB against collateral with an estimated market value of €2.6 billion. The bank had therefore planned to borrow up to €400 million more from the ECB. The sudden margin call therefore meant that the bank had €800 million less liquidity than expected.⁴⁷

The alleged reason for ECB’s margin calls on Landsbanki and Glitnir was that the Icelandic state had been downgraded by all three main ratings agencies, Standard & Poor, Moody and Fitch. The ECB staff were of course fully aware of the problems of the Icelandic banks. They knew that the banks were only able to meet those margin calls if they defaulted on other obligations. It should be noted that the ECB was making those margin calls at the same time as it was busy rescuing banks in Europe, also banks outside the eurozone. For example, while Sweden is outside the eurozone, since December 2007 the Swedish central bank had had a secret swap deal with the ECB of €10 billion. The deal was only disclosed in June 2009 when the Swedish central bank found it necessary to boost confidence in its ability to help Swedish banks facing difficulties in the Baltic countries.⁴⁸ Again, while the ECB now moved against the Icelandic banks, it left alone UK banks which, like the Icelandic banks, used their subsidiaries in the eurozone to obtain credit.

During the hectic weekend of 3–5 October 2008, the CBI staff were told in no uncertain terms that margin calls from the ECB were irrevocable. “News of these margin calls spread widely as reflected in phone calls to the Central Bank of Iceland over the weekend,” CBI Governor Ingimundur Fridriksson recalls.⁴⁹ Then, in the evening of Sunday 5 October, the ECB suddenly withdrew its margin calls. It is not likely that in the course of two days, from Friday 3 October to Sunday 5 October, the ECB had come into possession of information that would have lessened its worries about the financial positions of the Icelandic Treasury or the Icelandic banks. The decision to revoke the margin calls must have been political. But that means, of course, that the original decision to make the margin calls must have been political too. Otherwise, it would indeed have been irrevocable, as the ECB staff had told the CBI staff. It is of course also a possibility that the reason for the inconsistent

⁴⁵ From King’s letter to CBI Governor David Oddsson, SIC Report, Vol. 1, Ch. 4, pp. 172–3.

⁴⁶ Douglas Diamond and Philip Dybvig, Bank Runs, Deposit Insurance, and Liquidity, *Journal of Political Economy*, Vol. 41 (1983), pp. 401–19. <https://www.jstor.org/stable/1837095>

⁴⁷ SIC Report, Vol. 2, Ch. 7, p. 62.

⁴⁸ ECB activates the swap line with Sveriges Riksbank. Press Release 10 June 2009.

<https://www.ecb.europa.eu/press/pr/date/2009/html/pr090610.en.html>

⁴⁹ Fridriksson, *The Collapse of the Icelandic Banks*.

behaviour of the ECB was sheer chaos. The ECB staff simply may have been overwhelmed by events. Be that as it may, in the midst of their predicament, the Icelanders, to their surprise and bitter disappointment, saw their longtime ally, the United States, standing idly by.

Chapter Four

The Role of the US Federal Reserve Board

An important foreign factor in the Icelandic bank collapse was that Iceland could no longer rely on the support of the United States, her traditional ally and protector. The reason was simple: The country had lost its strategic importance. Iceland had become expendable. This was reflected in the repeated refusals by the US Federal Reserve Board to provide liquidity through the CBI to the Icelandic banks.

1. An expendable, remote island

During the Second World War and the Cold War, Iceland was a valued ally of the United States. The North Atlantic island was strategically important, an ‘unsinkable aircraft carrier’. But when the Soviet Union collapsed in 1991 and the Cold War abruptly ended, Iceland’s strategic importance greatly diminished, almost overnight. The US government promptly initiated moves to reduce its military presence in the country. Warning and control military planes were promptly removed and the number of fighter jets reduced from 12–18 to only 4. The David Oddsson government demonstrated its commitment to close US-Icelandic relations in March 2003 when it declared its support for the US intervention in Iraq, risking some domestic trouble. However, two months later, just before parliamentary elections, suddenly and unexpectedly US authorities told Oddsson that the remaining fighter jets would be withdrawn from the US military base in Iceland within a month. An American scholar observed that while Iraq demonstrated that it did not pay to be an enemy of the US, Iceland showed that perhaps it did not pay either to be a friend of the US.¹ Oddsson kept the message from the US strictly secret and used his warm personal relationship with US President George W. Bush to have this decision—apparently made in the Pentagon by Defence Secretary Donald Rumsfeld—revoked for the time being.²

In 2006, after Oddsson had left politics, the US authorities finally implemented their long-standing decision of shutting down their military base in Iceland, after 55 years of security cooperation with Iceland. Oddsson’s successor, Prime Minister Geir H. Haarde, did not follow Oddsson’s advice of abrogating the Defence Treaty in case the US left the sparsely populated North Atlantic island defenceless. This was a true watershed in Icelandic history whose implications became only too clear in the bank collapse. Now, Iceland’s ‘American Age’ which had started in 1941 when the US assumed responsibility for the defence of this North Atlantic island seemed to be coming to an end.

¹ Gudni Th. Johannesson, To the Edge of Nowhere? U.S.-Icelandic Defense Relations during and after the Cold War, *Naval War College Review*, Vol. LVII, No. 3–4 (Summer-Autumn 2004), p. 130. http://rse.hi.is/wp-content/uploads/2017/11/Johannesson.USIcelandTo_the_Edge_of_Nowhere_2004-libre.pdf The American scholar quoted was Michael T. Corgan.

² Valur Ingimundarson, Iceland’s Security Identity Dilemma: The End of a U.S. Military Presence, *The Fletcher Forum of World Affairs*, Vol. 31, No. 1 (Winter 2007), pp. 7–23. https://ams.hi.is/wp-content/uploads/old/V_Ingimundarson_Iceland's_Security_Identity_Dilemma.pdf

In Washington DC, Iceland was almost treated like a joke. For example, at a meeting of the Federal Open Market Committee 27 March 2006, Dino Kos, Executive Vice President of the New York Federal Reserve Board and Head of its Markets Group, reviewed market trends, including carry trade in some currencies. Showing a graph of how select foreign currencies were performing against the dollar, he included the Icelandic *krona* and said:

Now let me confess that I hesitated to include this chart. The previous Chairman chided me once for showing a similar chart that included the New Zealand dollar—the currency of a country with a mere 4 million residents. Well, I am probably skating on very thin ice with the new Chairman, now that the kiwi has returned with that powerhouse the Icelandic krona, the currency of a country with about 250,000 residents or roughly one-tenth the size of Brooklyn. The point is not to suggest that Iceland is on the verge of joining the G7 but rather that the search for yield went to some pretty distant and unlikely places—as we are now discovering.³

A member of the Federal Reserve Board, Donald Kohn, asked whether the fall in the value of the *krona* was only because the carry trade was unwinding. He mentioned a recent report by Danske Bank “about problems in the Icelandic banking system”.⁴ Ben Bernanke, Chairman of the Board, interrupted him: “We’d like a full report on the Icelandic ...” which was greeted with laughter. Then Kos said: “I thought that the Committee’s patience might be limited. Yes, there was a downgrade by one of the rating agencies of Iceland. There were some concerns about some of the Icelandic banks, and so that seemed to be part of the story.” When he promised to give a full report about New Zealand and Iceland at the next meeting, the audience laughed again.⁵ At the next meeting, he just noted briefly that the *krona* had gone down and then up again.⁶

2. CBI Turned Down by the US Fed

The Icelanders had not only lost their defence force, but also a powerful protector and ally, the United States. The exchange at the Federal Open Market Committee in 2006 showed that in Washington DC the country was perceived as a distant and unusual place, almost a laughing matter. This was clearly brought home to the Icelanders during the financial crisis of 2008–2009. Like the Bank of England and the ECB, the Federal Reserve Board turned down the request for currency swap deals made by the CBI in mid-April. Another request was made after the Scandinavian banks in mid-May 2008 reluctantly had made currency swap deals with the CBI. Governor Oddsson wrote FRB of New York President Geithner a letter 6 June 2008 repeating the request for a dollar swap deal:

Also, as demonstrated by the Nordic facility, the size of the arrangement is not necessarily a decisive issue at this juncture. In my view the perception of strong allies

³ Meeting of the FOMC 27 March 2006, pp. 4–5.

<https://www.federalreserve.gov/monetarypolicy/fomchistorical2006.htm>

⁴ He was presumably referring to the report by Lars Christensen, Iceland: Geyser crisis, repr. in *Preludes to the Icelandic financial crisis*, eds. Aliber and Zoega, pp. 89–106.

⁵ Meeting of the FOMC 27 March 2006, pp. 8–9.

⁶ Meeting of the FOMC 10 May 2006, p. 5.

<https://www.federalreserve.gov/monetarypolicy/fomchistorical2006.htm>

is more important. An arrangement with the Fed would therefore be of monumental significance.⁷

Again, however, Geithner turned down the CBI request.

The reason may be found in the minutes of a meeting of the Federal Open Market Committee in Washington DC 28–29 October 2008, where the criteria on which dollar swap deals with other countries were discussed.⁸ Nathan Sheets, Director of the US Federal Reserve Board’s Division of International Finance, said that the Board’s staff used three criteria about countries with which such deals were made: 1) that their economies were large and systematically important; 2) that they had pursued sensible policies and seemed just to be influenced by contagion; 3) and that the swap deals might make a difference. Sheets added:

Now, let me just give you a concrete case of the third criterion because that’s a little more abstract than the first two. Iceland came to us and requested a swap line of approximately \$1 billion to \$2 billion, which would have been 5 to 10 percent of Iceland’s GDP—so it was fairly large relative to the size of the country. But the liabilities of the banking system were on the order of \$170 billion, and the underlying problem was really that there was a loss of confidence in its banks. We came to the conclusion that a \$1 billion swap line was very little ammunition to use against a potential loss in confidence in this \$170 billion financial system. For that reason, we as the staff recommended against a swap line for Iceland.⁹

At the meeting, Geithner commented that some of the countries which did not meet the three criteria outlined by Sheets could go through an IMF programme without too much of a stigma.¹⁰

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

Some small countries with large banks simply lacked the resources to go it alone. For example, tiny Iceland, with its 300,000 people, was also home to three large banks with operations extending to other Nordic countries, Britain and the Netherlands. By early October [2008], all three banks had collapsed, wiping out their shareholders (mostly domestic) and bondholders (mostly foreign). We had declined Iceland’s request for a currency swap line, as did the European Central Bank and Bank of England. Iceland’s financial institutions had few ties to U.S. financial institutions, and their problems were in any case too severe to be solved by currency swaps.¹¹

It should be noted that it was not entirely correct that bondholders were wiped out by the collapse of the Icelandic banks, even if depositors’ claims were by law given

⁷ SIC Report, Vol. 1, Ch. 4, p. 179.

⁸ Because the minutes were of a meeting in late October, their readers probably assume that they referred to the requests in the autumn of 2008 for dollar swap deals. But later in the minutes Nathan Sheets says that the request by the CBI was made at about the same time as the CBI turned to the ECB with a similar request. The formal request to the ECB was made 15 March 2008. Informal requests were at that time also made to the FRB of New York, but a formal letter was sent to it 9 June 2008.

⁹ FOMC meeting 28 October 2008, p. 33.

<https://www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm>

¹⁰ Ibid., p. 35. <https://www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm>

¹¹ Ben Bernanke, *The Courage to Act*, p. 349. Iceland is not in the Index to the book.

priority over bondholders' claims. The recovery rate for general claims was 30.2% on Glitnir, 30% on Kaupthing and 14.4% on Landsbanki (because so many of the claims on Landsbanki were priority depositors' claims).¹² When general creditors to the banks agreed to compositions in late 2015, they were mostly hedge funds which had bought claims on the banks from original creditors at hefty discounts.

More importantly, it is by no means obvious that the repeated refusals by Ben Bernanke and Timothy Geithner to make dollar swap deals with the CBI should be taken at face value. First, to make this a 'professional decision', based on the evaluation of the staff of the Federal Reserve Board, was in itself a political decision, with a foreseeable outcome, because Iceland, after the end of the Cold War, had simply become expendable. When Iceland received double the Marshall aid per capita than war-ravaged Netherlands, it was a political, not a 'professional' decision: The US government then regarded Iceland as strategically important.¹³ When the UK showed uncommon restraint in using her powerful Navy against the Icelanders in the fisheries disputes of 1952, 1958, 1972 and 1975, it was a political decision: Iceland had a powerful protector and ally in the US. It is true that the Americans did not want to take sides, since the UK was after all their closest European ally, but they would never have allowed the UK to use full force against the Icelanders, if that meant driving them out of NATO. When the US provided the Icelanders in the 1950s with generous loans on good rates, bypassing all kinds of rules, it was a political decision; also when Loftleidir got concessions in the US so it could offer cheap transatlantic flights through Iceland.¹⁴

In the second place, Bernanke, Geithner and Sheets were not necessarily right that a dollar swap deal with the CBI would not have made a difference. The announcement in mid-May 2008 of the currency swap deals with the Scandinavian central banks immediately brought down the CDS spreads. It should be noted that the original request for a deal of \$1–2 billion was made under the assumption that European central banks would make similar deals so that the total liquidity provided to the CBI would be significantly greater. If \$10 billion was needed, and not only \$2 billion, why did the FRB of New York not simply make it \$10 billion? The hedge funds hesitated: If they had witnessed a \$10 billion dollar swap deal between the FRB of New York and the CBI, they would probably have abandoned their attack on the Icelandic banks and the CDS spreads would have gone down. Then, perhaps, the CBI would not have had to draw on the swap line. "It was never the intention of the Central Bank to use funds potentially available under swap agreements to intervene in the foreign exchange market nor to strengthen the capital position of the banks," CBI Governor Ingimundur Fridriksson writes.¹⁵ This was also emphasised in letters from Fridriksson's colleague Oddsson to Geithner and other central bankers. Whereas it was small change for the Americans, a \$10 billion dollar swap line would have been crucial for the Icelanders.

Thirdly, and closely connected to the second point, Bernanke correctly notes that Iceland's financial institutions had few ties to US financial institutions. But that was

¹² Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 189.

¹³ Gunnar Karlsson, *The History of Iceland* (Minneapolis MN: University of Minnesota Press, 2000), pp. 336–7.

¹⁴ Gudni Th. Johannesson, *Naval War College Review*, p. 124.

¹⁵ Fridriksson, *The collapse of the Icelandic banks*, p. 32.

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

Fourthly, to take one of the criteria mentioned by Sheets, Iceland had on the whole pursued prudent fiscal and monetary policies since 1991, although the government probably should have exercised more fiscal restraint in the last few years before the crash. Even if the liabilities of the Icelandic banks certainly were immense relative to Iceland's GDP, the economy was essentially sound. And against the liabilities mentioned by Sheets came assets, not only in Iceland, but also, and indeed mostly, in other European countries. The conclusion is that it would have been perfectly reasonable for the FRB of New York to make the dollar swap deal with the CBI, even one of \$10 billion, on all other criteria than the first one: Iceland was not systemically important. It was distant, tiny, expendable—sinkable rather than an unsinkable aircraft carrier.¹⁶

3. Iceland Out in the Cold

Indeed, so expendable was Iceland that when the minutes from the 28–29 October 2008 meeting of the Federal Open Markets Committee were eventually published, the editors crossed out the names of several countries that unsuccessfully tried to obtain dollar swap deals with the US—but not the name of Iceland. The names were crossed out with reference to a stipulation in the US Freedom of Information Act, sect. 552, (b)(4), that it does not apply to “trade secrets and commercial or financial information obtained from a person and privileged or confidential”. It so happens, however, that the identities of those countries are known from other sources. In a study of the ‘global liquidity safety net’, Professor C. Randall Henning discusses the dollar swap deals the Federal Reserve Board made during the international financial crisis with 14 other central banks, amounting at one point to more than \$580 billion, one-quarter of the Fed's balance sheet:

The Federal Reserve board of governors considered the “boundary” question at length, torn between opening itself up to additional demands for coverage from emerging markets and creating stigma against those left outside the safety net. Fed officials used economic size and connections to international financial markets as the main criteria for selecting Brazil, Mexico, Singapore and South Korea. Chile, Peru, Indonesia, India, Iceland and likely others also requested swaps but were denied. The governors wanted to deflect requests by additional countries to the IMF, which coordinated its announcement of the SLF [Short-term Liquidity Facility] with the Fed's announcement of the additional swaps at the end of October 2008. Governors and staff saw in this tiering a natural division of labour that coincided with the resources and analytical capacity of the Fed and IMF.¹⁷

¹⁶ This point is stressed by Frederic Mishkin, Professor of Finance at Columbia University and Member of the Federal Reserve Board in 2006–8. He says that there was a simple and obvious reason the Federal Reserve Board had not assisted the CBI: Iceland was not deemed important enough. Interview with Frederic Mishkin by phone 9 October 2014.

¹⁷ C. Randall Henning, *The Global Liquidity Safety Net* (Waterloo, Ontario: Centre for International Governance Innovation, 2015), p. 7.
https://www.cigionline.org/sites/default/files/new_thinking_g20_no5_web.pdf

It is somewhat surprising if Federal Reserve Board officials used economic size as a criterion for separating the sheep from the goats that they declined requests from India, the world's 6th largest economy, and from Indonesia, which has an economy almost as large as that of Switzerland and Sweden combined.¹⁸ While those officials would probably vehemently deny it, political considerations may have played a part in counting Brazil, Mexico, Singapore and South Korea among the sheep and Chile, Peru, Indonesia and India—not to forget Iceland—among the goats.

Having repeatedly turned down requests by the CBI for dollar swap deals, the Federal Reserve Board announced on 24 September 2008 that it had made such deals with the three Scandinavian central banks, in amounts up to \$15 billion with the Swedish bank and in amounts up to \$10 billion each with the central banks of Denmark and Norway.¹⁹ Of course, the markets immediately noticed the absence of Iceland, traditionally regarded as a part of the Nordic countries. (Finland, as a member of the eurozone, was not included.) The same day, 24 September 2008, CBI Governor Oddsson wrote a letter to FRB of New York Governor Geithner, repeating his request for a dollar swap deal with the CBI: “The announcement this morning of the new currency swaps appears to have enhanced confidence for the participating countries. However, given the perception that the Nordics are one, including Iceland, the new agreement may appear to the markets as having left us in the lurch.”²⁰

The next day, 25 September 2008, Oddsson called Geithner to follow up on his letter. “You must see that we are the odd people out,” he said to Geithner who replied: “No, you are not. The Scandinavians need dollars; you do not need dollars.” Oddsson then said: “But you have to realise that we are regarded as a part of the Nordic community. If we are not included, then people will assume that we are excluded.” Geithner replied: “We are by no means precluding an eventual deal.” The next day, 26 September 2008, Geithner called Oddsson, saying that he regretted having to tell him that his bank was not prepared to make such a deal at present: It could not be justified, neither to the FRB of New York nor the CBI. The help from the FRB of New York would only be a drop in the ocean.²¹ Accordingly, the same day the CBI released an announcement that it had had discussions with the US Federal Reserve Board in the last few weeks. It had been decided not to enter into an agreement between the two parties, but it was not ruled out that such an agreement might be made later.²²

The crisis in Iceland intensified, not least because the markets realised what Oddsson had mentioned in his letter to Geithner—that the Americans had left Iceland in the lurch. This was made even clearer on 29 September when the Federal Reserve Board announced that it had increased the swap lines of the Scandinavians, to \$15 billion

¹⁸ IMF, World Economic Outlook Database, April 2017.

<http://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>

¹⁹ Federal Reserve Board, Press Release 24 September.

<https://www.federalreserve.gov/newsevents/pressreleases/monetary20080924a.htm>

²⁰ SIC Report, Vol. 1, Ch. 4, p. 179.

²¹ Testimony by David Oddsson before the SIC 7 August 2009, p. 55. Transcript in possession of the main author of this report.

²² Gjaldmiðlaskiptasamningar [Currency Swap Deals], 26 September 2008.

<http://www.sedlabanki.is/utgefing-efni/frettir-og-tilkynningar/frettasafn/frett/2008/09/26/Gjaldmi%C3%B0laskiptasamningar/>

each for the Danish and Norwegian central banks and to \$30 billion for the Swedish central bank.²³ The hedge funds moved against Iceland, banks cancelled credit lines, depositors withdrew their money, while the FSA in the UK and the ECB made increased demands on the Icelandic banks. Increased liquidity was desperately needed. Oddsson called Geithner again on 2 October 2008 to ask him whether he had reconsidered his decision not to make a dollar swap deal with the CBI. Geithner asked for more information on the situation. Subsequently, the CBI staff sent emails later in the day to William Dudley, Executive Vice President of the Markets Group at the FRB of New York, and to other Federal Reserve people. But yet again, the Americans turned down the requests by the CBI for liquidity assistance. Dudley called Oddsson in the afternoon of 3 October and told him this. The main reason was, Dudley said, that the Icelandic banking sector was simply too big. If Iceland entered an IMF programme, however, it was possible that the FRB of New York would participate in it, especially if the ECB was also participating.²⁴

4. The Russian Loan Offer

The only brief flicker of interest in Iceland by the US was shown in early October when it looked as if Russia might step in. Confidential negotiations had been held between the Prime Minister's economic adviser Tryggvi Thor Herbertsson and Russian representatives about a possible loan from Russia. Most likely, the intelligence agencies of the US and the UK and perhaps of other countries learned about the talks. It was apparent in a phone call from the IMF staff made to the CBI staff Friday 3 October 2008 that they were aware of rumours about the involvement of some countries in Iceland.²⁵ Only two days later, Sunday 5 October, a five member team from the IMF suddenly arrived in Iceland.²⁶ In the evening of the same day, UK Prime Minister Gordon Brown in a call to his Icelandic colleague Geir H. Haarde strongly advised Iceland to seek help from the IMF, without of course mentioning the Russian option. In the evening of Monday 6 October 2008, David H. McCormick, Under-Secretary for International Affairs at the US Department of the Treasury, made an urgent phone call to Finance Minister Arni M. Mathiesen who was then participating in the parliamentary debate about the Emergency Act. McCormick asked Mathiesen whether the Americans could help in any way. Mathiesen replied that they could do what Iceland had repeatedly requested and they always turned down, making the dollar swap deals with the CBI. McCormick did not ask about any Russian option, but it was Mathiesen's strong impression that he knew something about the talks with the Russians and that he was trying to assess the situation.²⁷

²³ Federal Reserve Board, Press Release 29 September.

<https://www.federalreserve.gov/newsevents/pressreleases/monetary20080929a.htm>

²⁴ SIC Report, Vol. 1, Ch. 4, p. 180.

²⁵ SIC Report, Vol. 7, Ch. 20, p. 83.

²⁶ In a confidential cable 7 October 2008 to the US State Department, US Ambassador Carol van Voorst asserts that the IMF team had been invited to Iceland by Prime Minister Geir H. Haarde, quoting a member of the delegation, Rodolfo Luzio.

https://wikileaks.org/plusd/cables/08REYKJAVIK219_a.html However, Haarde denies this, pointing out that the CBI staff usually dealt with the IMF people. He was under the impression that this was a regular visit by the IMF people. Interview by phone with Geir H. Haarde 8 November 2017. Former CBI Governor Ingimundur Fridriksson says that the CBI knew of IMF's interest to dispatch a team to Iceland and that he and his colleagues had not objected to such a visit. Email to Hannes H. Gissurason from Ingimundur Fridriksson 19 May 2018.

²⁷ Mathiesen, *Arni Matt*, p. 54. Interview with Arni M. Mathiesen in Reykjavik 1 August 2014.

Tuesday 7 October, early in the morning, Russian Ambassador Victor I. Tatarintsev woke up CBI Governor David Oddsson with a phone call to his home and told him that the Russian government was ready to extend a loan of €4 billion to Iceland for 3–4 years, with reasonable interest rates, 30–50 points above Libor. Tatarintsev also said that Oddsson was free to make a public announcement about the loan, a crucial move if a full-scale bank run was to be avoided. After his conversation with Oddsson, Ambassador Tatarintsev called the Prime Minister’s Adviser Herbertsson and suggested that they should celebrate at the first convenient point in time. “We need, not a bottle of Vodka, but a whole case,” he said.²⁸ After his conversation with Tatarintsev Oddsson spoke with Prime Minister Haarde who agreed with him that the offer should be made public. Consequently, the CBI made an announcement about the Russian loan which immediately seemed to change the situation.

Then suddenly, in a matter of a few hours, something happened which caused the Russians to reconsider their offer. This something could be that they became aware, possibly through their intelligence service, or possibly through a leak from the IMF or Icelandic officials, of the talks between the Icelanders and the newly arrived IMF team about a possible rescue plan. The Russian were not interested in participating in an IMF programme: They wanted to establish a political and strategic presence in Iceland.²⁹ Another likely possibility which by its nature will probably never be confirmed, or refuted, is that some representatives of the Western powers, such as French Finance Minister Christine Lagarde—then chairing the Economic and Financial Affairs Council of the EU—contacted the Russians and firmly told them to stay away from Iceland. The EU had the same attitude towards Iceland as the UK traditionally had adopted: Even if it had limited interest in undertaking to protect her, it did not want anyone else to do so.³⁰

The decision to accept the unsolicited offer by the IMF to send a team to Iceland on 5 October 2008 thus may have weakened Iceland’s bargaining position. The Russians, now knowing of the IMF involvement and facing staunch opposition from the West, abruptly changed course. Just a few hours after Ambassador Tatarintsev had told Governor Oddsson that the Russian had made the offer, he urgently contacted him again and asked him to send out another and more tentative announcement which Oddsson duly did, knowing however that his many critics would use this against him.³¹ Oddsson’s main priority was to keep the Russian option open. Nothing came however out of the following negotiations with the Russians who had lost interest. The Icelanders were hindered in ‘playing the Russian card’, as they had done for example in 1952 when they started trading with the Soviet Union after British trawler owners—in one of the disputes about Iceland’s extension of her fishing zone—had imposed a landing ban in the UK on fresh fish from Iceland.

²⁸ Interview with Tryggvi Thor Herbertsson in Reykjavik 14 January 2015. Cf.

<http://www.rnh.is/?p=7684>

²⁹ This conclusion or explanation is derived from what was in the Note on Methodology was called ‘logic of the situation’. But also, interview with David Oddsson in Reykjavik 6 August 2015.

³⁰ This happened according to unnamed sources at the CBI.

³¹ In the SIC Report, Vol. 1, Ch. 4, p. 160, it says that the announcement of the Russian loan was based on a misunderstanding. There was no misunderstanding, even if CBI Governor Oddsson, in order to preserve the contact with the Russians, may have suggested it. The initial firm decision to offer the loan was immediately reconsidered when the Russians learned about the concurrent talks with the IMF and possibly also when they were firmly told by Western leaders to stay out of Iceland.

5. Yet Another Rejection

In a period of three days, 6–8 October 2008, the Icelandic banks fell, one after another. Finance Minister Arni M. Mathiesen went to Washington DC on 9 October, both to attend the joint IMF and World Bank autumn meeting and to hold talks with US officials. “There was no help to be had from the US,” he later wrote. “After the War, the Icelanders and the Americans had been close allies, but now, and without any explanations offered, they had turned their back on us. Probably there are several explanations for this, but somehow a line had simply been drawn and we ended up at the other side: If something went wrong, then the UK and the EU were supposed to help us resolve it.” Mathiesen pointed out that the US did no longer view Iceland as strategically important and that possibly American leaders also accepted the tacit agreement in Europe not to rescue Iceland, while they made dollar swap deals with the three Scandinavian central banks.³² As Kaarlo Jännäri wistfully observes, “After all, Iceland is a very small country in the far reaches of the cold North Atlantic, and it has few friends in high places outside the Nordic countries.”³³

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

As you explained to us, the main reasons for the Federal Reserve not wishing to enter into a swap arrangement with the Central Bank of Iceland were the relative size of the Icelandic banking system and then in September discussions the absence of an IMF arrangement. As you are no doubt well aware of, the Icelandic banking system has now shrunk significantly. Additionally, as mentioned at the outset, the Government has announced an agreement with the IMF on a standby arrangement. For it to succeed, financing beyond that provided by the IMF will be necessary. I hereby request participation from the Federal Reserve Bank in the financing of the economic program.³⁴

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

The Icelanders take fierce pride in their flawless history of paying back their debt. Whatever the financial turmoil and uncertainty of the moment, it's a good bet that this economy of highly-educated, imaginative, and sophisticated people will take off again. And when it does, and when the competition in the High North really gets underway, it may be more important than we can yet suppose to have the Icelanders remember us as the kind of friend who stands by in fair weather and foul.³⁵

³² Mathiesen, *Arni Matt*, pp. 84–5.

³³ Jännäri, *Report*, p. 19.

³⁴ Letter from David Oddsson to Timothy Geithner 24 October 2008. Repr. in https://wikileaks.org/plusd/cables/08REYKJAVIK253_a.html

³⁵ Cable from Ambassador Carol van Voorst to State Department 31 October 2008. <https://wikileaks.org/cable/2008/10/08REYKJAVIK255.html>

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

6. US Help to Other Countries in the Crisis

Iceland was out in the cold. Some other countries were not. In 2007–2008, the US Federal Reserve Board approved swap deals with 14 other foreign central banks, those of Australia, Brazil, Canada, Denmark, the UK (Bank of England), Japan, Korea, Mexico, New Zealand, Norway, Singapore, Sweden, Switzerland and the ECB.³⁶ The central banks then lent the dollars thus obtained to banks and other financial firms in their respective jurisdictions and assumed the risk. The two parties to the swap then reversed the exchange at a future prearranged date. The ECB received the largest amount of dollars under the swap line arrangements, about 80% of the total. Four central banks did not draw on their dollar swap lines, those of Brazil, Canada, Singapore and New Zealand. The use of the dollar swap lines is shown in Table 1.

Table 1: *The US Fed's Dollar Swap Lines, 2007–2012*

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

Source: Federal Reserve System, *Report*, p. 205, Table 24.

For example, the Danish central bank drew 19 times on the swap line from the Americans, for an aggregate of \$73 billion. Denmark was hit hard by the international financial crisis, especially her largest bank, Danske Bank, which between 1998 and 2008 had grown sixfold under the ambitious and aggressive Peter Straarup, acquiring banks in Ireland and Northern Ireland. In early October 2004, members of the Danish parliament were hastily convened to a closed emergency meeting where they were told that if nothing was done, the Danske Bank cards, Dankort, would not function the next Monday morning. As a first measure, the Danish government guaranteed all bank obligations.³⁷ Later, it provided credit to banks and other financial firms of up to

³⁶ Federal Reserve System, *Report to Congressional Addressees*, pp. 19–20. <http://rse.hi.is/wp-content/uploads/2017/11/FederalReserveSystem.pdf>

³⁷ Danske Bank i fare i 2008 [Danske Bank in Danger 2008], *Sikke en fest* [What A Party], DR1 (2012). <http://www.dr.dk/DR1/dr1-dokumentaren/sikke-en-fest/Nyheder/20121126095526.htm>

100 billion Danish *kroner* (\$6 billion), thereof 24 billion to Danske Bank.³⁸ 62 Danish banks, mostly small, went under in the crisis. The total write-downs of financial institutions in 2008–11 amounted to 147 billion Danish *kroner* (about \$8.6 billion).³⁹

It is worth noting that Danske Bank which played a large role in the Icelandic bank collapse—not only in 2006 by a negative but influential report and cancellation of credit lines to Iceland nor by working in 2006–8 with hedge funds on bets against the Icelandic *krona* and the Icelandic banks, but also by its refusal in 2008 to facilitate the sale of Glitnir’s Norwegian bank to Nordea—has had some serious legal problems. Some of its staff in Estonia seem to have violated laws against money laundering. Danish journalists have found that members of the staff actively assisted businessmen, some of whom may have been criminals, from Russia and other former Soviet countries, including Azerbaijan, in transferring large sums of money to various destinations, possibly illegally.⁴⁰ The findings of the journalists have been confirmed by a team of Danish lawyers investigating the bank on its own initiative: It was discovered, for example, that Danske Bank ignored warnings about its Estonian operations uttered as early as 2007 and that the amount of transfers was much greater than previously envisaged, about \$230 billion.⁴¹ Danske Bank is also accused of being involved in the so-called Magnitsky case.⁴² After revealing massive tax fraud by people close to the Russian administration, Sergei Magnitsky died under mysterious circumstances in a Russian prison. His friend and business associate William Browder took up his case in a best-selling book, *Red Notice*, and subsequently, the US passed a “Magnitsky Act” to freeze funds belonging to and to ban entry for several powerful Russians believed to be responsible for Magnitsky’s death. At least two other countries, Canada and Estonia, have passed similar laws.⁴³

The US Federal Reserve Board also did extensive dollar swap deals with Sweden and Switzerland—two countries which have never been allies of the US, unlike Iceland. The Swedish central bank drew 18 times on the swap line, for an aggregate of \$67 billion. Swedish banks, especially Swedbank, SEB (Stockholms Enskilda Bank) and Nordea, had large operations in the three Baltic countries which were hit hard by the international financial crisis. The Swedish central bank made currency swap deals

³⁸ Skatteyderne mistede milliarder på en nat [Taxpayers Lost Billions Overnight], *Sikke en fest* [What a Party] DR1 (2012). <https://www.dr.dk/DR1/dr1-dokumentaren/sikke-en-fest/Nyheder/20121126101352.htm>

³⁹ Rangvad Commission, *The Financial Crisis in Denmark: Causes, Consequences and Lessons*, pp. 4 og 14. <http://em.dk/english/publications/2013/13-09-18-financial-crisis>

⁴⁰ A team of three journalists at *Berlingske Tidende*, Michael Lund, Eva Jung and Simon Bendtsen, investigated the cases and published articles about it in their newspaper, including: Laundered billions poured through Danish banks, 20 March 2017, <https://www.business.dk/finans/laundered-billions-poured-through-danish-banks> and: Dictatorship sent billions through Denmark’s biggest bank, 5 September 2017, <https://www.business.dk/finans/dictatorship-sent-billions-through-denmarks-biggest-bank>

⁴¹ *Report on the Non-Resident Portfolio at Danske Bank’s Estonian Bank* (Copenhagen: Bruun and Hjejle, 19 September 2018). <http://rse.hi.is/wp-content/uploads/2018/09/Report-on-the-Non-Resident-Portfolio-at-Danske-Banks-Estonian-branch.pdf>

⁴² Michael Lund, Eva Jung and Simon Bendtsen, Links to dead Russian lawyer behind French money laundering probe against Danske Bank, 13 October 2017, <https://www.business.dk/global/english-links-to-dead-russian-lawyer-behind-french-money-laundering-probe>

⁴³ Bill Browder, *Red Notice: a true story of high finance, murder, and one man’s fight for justice* (New York: Simon & Schuster, 2015).

with Estonia and Latvia and lent *kronor* and dollars to Swedish banks.⁴⁴

The Swiss central bank drew 81 times on the swap line, for \$466 billion. The US authorities noted that the dollar swap deal enabled the Swiss central bank to provide special emergency assistance to the largest bank in the country, UBS: It used the dollars to purchase up to \$60 billion of illiquid assets from UBS.⁴⁵ In the preceding years, UBS—established 1998 in a merger of two Swiss banks—had grown rapidly under the ambitious and aggressive Marcel Opél. It held assets almost fivefold the Swiss GDP. Having heavily invested in subprime loans, UBS felt the credit crunch already in August 2007 and required an immediate massive liquidity injection by the Swiss central bank. The difficulties continued, and in April 2008, Director Ospel left UBS in disgrace. Besides the \$60 billion purchase of illiquid assets, the Swiss central bank provided UBS with a capital injection of 6 billion Swiss francs. It may therefore be somewhat disingenuous to contrast the Swiss banks to the Icelandic ones, as some economists have done, on the ground that the former had “a long experience of international banking”.⁴⁶ This “long experience” did not hinder them, at least UBS (and the other large bank, Credit Suisse, was also in great trouble) in almost collapsing, to be rescued with dollars from the US Federal Reserve Board.

For US authorities, perhaps it was of particular interest that this “long experience of international banking” included trying to destroy records about assets belonging to Jews in Nazi Germany. In 1998, UBS and Credit Suisse settled lawsuits against them in the US by paying \$1.25 billion to Jewish victims and their representatives.⁴⁷ Ample evidence has also been provided about the leading Swiss banks helping wealthy foreigners to evade taxes and hide assets and also about their participation in rigging Libor, the interbank interest rate.⁴⁸ The US assistance to Switzerland came at a price, however. In February 2009, the Swiss authorities had to relax their formerly strict rules on bank secrecy, long a cornerstone of the Swiss banking sector, and to order UBS to disclose customer data sought after by US authorities. Switzerland also had to qualify the traditional differentiation under her law between tax fraud and tax evasion and to accept the intervention by American administrators into banking matters.⁴⁹ The decision to help Switzerland was a political decision, just like the

⁴⁴ Lars Nyberg, The Baltic region in the shadow of the financial crisis.

<http://www.riksbank.se/en/Press-and-published/Speeches/2009/Nyberg-The-Baltic-region-in-the-shadow-of-the-financial-crisis/> Christoph Bertsch and Johan Molin, Revisiting the role of central banks as liquidity providers—old and new challenges, *Sveriges Riksbank Economic Review*, No. 2 (2016), pp. 89–158. https://www.riksbank.se/globalassets/media/rapporter/pov/filer-fore-2017/artiklar/rap_pov_artikel_3_160922_eng.pdf

⁴⁵ Federal Reserve System, *Report to Congressional Addressees*, p. 129. <http://rse.hi.is/wp-content/uploads/2017/11/FederalReserveSystem.pdf>

⁴⁶ J. McCombie and M. Spreafico, Capital Controls and the Icelandic Banking Collapse, *Financial Liberalisation: Past, Present and Future*, eds. Phillip Arestis and Malcolm Sawyer (Cham, Switzerland: Springer International, 2016), p. 241.

⁴⁷ Stuart Eizenstat, *Imperfect Justice: Looted Assets, Slave Labor, and the Unfinished Business of World War II* (New York: Public Affairs, 2003).

⁴⁸ Department of Justice, UBS Enters into Deferred Prosecution Agreement. Press Release 18 February 2009. <http://www.justice.gov/opa/pr/2009/February/09-tax-136.html> Department of Justice, UBS Securities Japan Co. Ltd. to Plead Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rates. Press Release 19 December 2012. <http://www.justice.gov/opa/pr/2012/December/12-ag-1522.html>

⁴⁹ *The Swiss authorities under the pressure of the financial crisis and the disclosure of UBS customer data to the USA*. Report of the Control Committee of the Federal Assembly (Bern: 31 May 2010).

decision not to help Iceland. The Swiss banks survived, not because of their “long experience of international banking”, but because they were rescued by the US Federal Reserve Board.

<https://www.parlament.ch/centers/documents/en/bericht-gpk-ns-ubs-kundendaten-usa-2010-05-30-res-e.pdf>

Chapter Five

The Role of the British Government

While the concerted, relentless bets by hedge funds against Iceland and the refusal both of European central banks and the US Federal Reserve Board to provide any liquidity through the CBI to the Icelandic banks greatly weakened Iceland's position, this was not what brought about the collapse of her banking sector. It was the decision of the UK government to close down two Icelandic-owned British banks.

1. 'The Arc of Prosperity'

In late 20th century, despite conflicts about Iceland's four extensions of the fishing limit in 1952–1975, in general relations between the UK and Iceland were good. The two countries were allies in NATO, British leaders realising as clearly as the Americans the strategic importance of Iceland in the Cold War. The UK was also one of Iceland's most important trading partners. Culturally and socially, in the post-war years Iceland moved closer to the three Anglo-Saxon powers on the North Atlantic, the US, Canada, and the UK. Glasgow was only an hour and a half away by aeroplane, London two and a half hours. English replaced Danish as the first foreign language in Icelandic schools. Icelandic newspapers and radio and television stations covered current affairs in the UK in much more detail than those in Scandinavia. Margaret Thatcher and Tony Blair became household words in Iceland. But the European country closest to Iceland was of course Scotland. When Iceland started to prosper after comprehensive economic reforms were implemented from 1991 onwards, not least because of her sustainable and profitable quota system in the fisheries,¹ Scottish nationalists watched with interest. At the same time, Ireland was having success in attracting business by low taxes, while Norway was becoming wealthy as a result of her oil reserves.

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

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

¹ Hannes H. Gissurarson, *The Icelandic Fisheries: Sustainable and Profitable*. Reykjavik: University of Iceland Press, 2015. https://books.google.com.br/books/about/The_Icelandic_Fisheries.html?id=j-p8CwAAQBAJ

economy to respond to new opportunities. Its capacity for innovation. Its stock of human capital.²

The slogan ‘arc of prosperity’ was much-used by the Scottish nationalists for the next ten months.

The Scottish nationalists, and not only them but also their political rivals in the United Kingdom, could also observe the Icelanders nearby. The Icelandic expansion abroad after the bank privatisations was not least in the UK. Landsbanki bought Heritable Bank—a Scottish bank, even if based in London—already in 2000, and started operating its own London branch in 2005. Kaupthing began operating a branch in London in 2003 and bought Singer & Friedlander in 2004–5, changing the name to KSF, Kaupthing Singer & Friedlander. However, as KSF manager Armann Thorvaldsson writes: “The man who was to become the face of the Icelandic business community abroad was Jon Asgeir Johannesson.”³ In August 2002, Johannesson had come close to buying a controlling share in the UK clothing giant Arcadia, which ran Topshop, Burton’s and Dorothy Perkins, but when his British partners heard of a police investigation against him, they bought him out for £165 million and he returned to Iceland where he found it easy, despite his legal problems, to find business partners and creditors and to start building up a media empire, by Icelandic standards. After a while, however, Johannesson was back in the UK, where in August 2003 he bought the toy retailer Hamleys and in November 2003 the women’s fashion retailer Oasis. In June 2004, Johannesson merged Oasis with the fashion firm Karen Millen and created Mosaic Fashion. In late 2004, he bought Big Food Group and split it up into the wholesaler Booker, the frozen food retailer Iceland and a real estate company.

Johannesson had his eyes on retail giant Somerfield and was about to make a bid for it, with the help of Barclays and Kaupthing, when he was in July 2005 charged after the police investigation which had started in 2002. The charges included embezzlement and bookkeeping irregularities. Barclays made it clear that they would not work with someone charged with embezzlement, and Johannesson had to leave the consortium of bidders, albeit selling his shares with profit. Again, Johannesson returned to Iceland where he did not find it difficult, despite his legal problems, to find sympathisers, business partners and creditors.⁴ Unlike Barclays, Kaupthing was unmoved by the charges against Johannesson. It helped Johannesson and his business partners gain control of Glitnir in 2006–7.⁵

While criticism of the profligacies of the new moguls was relatively muted in Iceland, possibly because they controlled most of the media, resentment was brewing against them, as came out in two books which were published during and after the bank collapse about how they had transformed Iceland, for the worse according to the

² Transcript: <http://www.gov.scot/News/Speeches/Speeches/First-Minister/sabmorsot07> Salmond had used the slogan earlier, Salmond sees Scots in ‘arc of prosperity’, *The Scotsman* 12 August 2006. <http://www.scotsman.com/news/salmond-sees-scots-in-arc-of-prosperity-1-1130200>

³ Thorvaldsson, *Frozen Assets*, p. 39.

⁴ Eventually, Johannesson was found guilty of bookkeeping irregularities and given a suspended three months prison sentence. *Haestarettardomar* [Supreme Court Judgements], No. 385/2007. <https://www.haestirettur.is/default.aspx?pageid=347c3bb1-8926-11e5-80c6-005056bc6a40&id=75655b13-7d59-4d21-ab3e-2c4e7b0afdb3>

⁵ Thorvaldsson, *Frozen Assets*, pp. 123–4.

authors.⁶ Abroad people watched the Icelandic moguls in astonishment. Iceland began to gain some unwelcome attention, even notoriety. Economic commentators wondered wherefrom all the money came.⁷ There were some perfectly plausible explanations, such as the profitable quota system in the fisheries, and the financially strong pension system, but the fact remained, as the SIC pointed out in its Report, that the Icelandic banks, using the good reputation Iceland had established in 1991–2004, borrowed heavily in the international markets in 2004–2005 and lent aggressively to Icelandic businessmen.

2. Concerns in London about Landsbanki

While negative publicity about Icelandic businessmen and warnings by English experts about problems in the Icelandic banks certainly did not help the CBI in its endeavour to obtain a currency swap deal with the Bank of England, neither of those two factors probably were crucial in what followed. The main reason why the Bank of England refused on 23 April 2008 to make a currency swap deal with the CBI seems to be, as Governor Mervyn King wrote in his letter that day to CBI Governor David Oddsson,⁸ that its leadership agreed with other European central bankers that the Icelandic banks had grown too big and that their aggressive deposit collection was upsetting the European scheme of deposit insurance. The central bankers were also influenced by reports from the Swedish central bank and the IMF about the basic vulnerability of the Icelandic banking sector, with no plausible lender of last resort. The Bank of England staff viewed Iceland as first and foremost a Nordic country.⁹

A further possible reason for the refusal, and indeed for the Bank of England's general scepticism about the Icelandic banks, came to light in 2015 when minutes from the regular meetings of the Bank's non-executive directors in 2008 were released. At a meeting on 15 October 2008 the following discussion took place:

The number of smaller countries that promoted themselves as centres for financial services ought to reduce. Iceland was a very telling example. It was noted that the Icelandic central bank had visited the Bank at the beginning of the year and had been told that they should sell their banks now. Iceland's balance sheet was far too large. It was stated that the Bank would be supportive of efforts to constrain the use of tax and regulatory havens. It was noted, however, that there was a legacy of Foreign & Commonwealth Office advice, which had encouraged former dependencies to enter financial services as a means of reducing their reliance on commodity products.¹⁰

In other words: While British authorities had actively encouraged places like the Cayman Islands and Bahamas, not to speak of Guernsey, Jersey and the Isle of Man,

⁶ Gudmundur Magnusson, *Nyja Island: Listin ad tyna sjalfum ser* [New Iceland: The Art of Losing One's Identity] (Reykjavik: JPV, 2008); Ingi F. Vilhjalmsón, *Hamskiptin: Thegar allt vard falt a Islandi* [The Transformation: When Everything Could Be Bought in Iceland] (Reykjavik: Verold, 2014).

⁷ Thorvaldsson, *Frozen Assets*, Chapter 6; Richard Portes and Fridrik M. Baldursson, The Internationalization of Iceland's Financial Sector (November 2007), repr. in *Preludes to the Icelandic Financial Crisis*, pp. 203–4

⁸ SIC Report, Vol. 1, Ch. 4, pp. 172–3.

⁹ Interview with Sir John Gieve in London 27 November 2014; Interview with Lord Mervyn King in Petham Oast 14 August 2017.

¹⁰ Bank of England Court of Directors, Minutes 15 October 2008, p. 330.

<https://www.bankofengland.co.uk/-/media/boe/files/minutes/2008/court-2008-book2.pdf>

and for that matter London as well, to be competitive in providing financial services, Iceland had to be barred from that field. It is likely that these concerns about financial centres were shared by other European central bankers.

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

For a time, nationalists posited an alternative view, the 'arc of prosperity', arguing that the Nordic states, with Ireland and Iceland, offered us a model of small northern states whose island status, long coastlines and ability to innovate, be flexible and access resources let them to perform well beyond expectations.¹¹

When Brown and Darling received reports about the Icelandic banks in difficulties, it must have strengthened their misgivings about the 'arc of prosperity' promoted by Scottish nationalists.

Apparently, the Prime Minister began to take direct interest in the Icelandic banks in the beginning of July 2008, after questions were raised about them in the House of Lords.¹² One problem was Landsbanki's deposit collection. While Kaupthing collected deposits in its Edge accounts through its UK subsidiary KSF and was therefore regulated by the FSA and under the British FSCS, Financial Services Compensation Scheme, Landsbanki's Icesave accounts were based in its London branch,¹³ regulated by the IFSA and under a combination of the Icelandic deposit guarantee scheme, operated by the Icelandic Depositors' and Investors' Guarantee Fund, and the UK deposit protection fund operated by the UK authorities. But if Landsbanki failed and the depositors had to be compensated, the total amount in Icesave accounts, in billions of pounds, was clearly far beyond the capabilities of the Icelandic Fund.

Already in March 2008 the FSA had discussed transferring the Icesave accounts in the UK from Landsbanki's London branch to its subsidiary, Heritable Bank. But the FSA had requested that against the accounts which were of course obligations, Landsbanki transferred assets amounting to 20% of the total assets of the Icelandic parent company and the London branch to Heritable Bank. The FSA was unpersuaded by Landsbanki's protests that such a huge transfer was problematic for legal reasons and also because it could trigger credit covenants. In late May the FSA

¹¹ Gordon Brown, *My Scotland, Our Britain: A Future Worth Sharing* (London: Simon & Schuster, 2014), p. 281.

¹² Interview with Mark Sismey-Durant in London 28 November 2014.

¹³ It is thus wrong what Professor Stefan Olafsson writes, *The political economy of Iceland's boom and bust, Iceland's Financial Crisis: Politics of Blame, Protest, and Reconstruction*, ed. by Valur Ingimundarson, Philippe Urfalino and Irma Erlingsdóttir (New York: Routledge, 2016), p. 66: "Landsbanki was the frontrunner in this [online deposit collection], and offered the accounts through its UK subsidiary." This is no trivial error. It was crucial that Landsbanki offered the accounts through its branch and not a subsidiary.

reiterated its view that the transfer was desirable. Subsequently, it revoked the liquidity concession that Landsbanki previously had enjoyed and demanded that the Landsbanki London branch should always hold, in an account at the Bank of England, a cash reserve of 5% of the total instant access accounts.

Immediately after the issue of deposit insurance had been raised in the House of Lords, the FSA on 2 July 2008 turned its former suggestion to Landsbanki into a formal request with the end of the year as deadline. The FSA also requested Landsbanki to limit the total amount of Icesave deposits to a maximum of £5 billion and to avoid its Icesave instant access accounts being included in so-called ‘best-buy’ tables on interest rates. Landsbanki was reluctant to agree to this. But later in July, the FSA raised its demand for the cash reserve from 5 to 10% of the total amount in instant access accounts. In August 2008, the FSA rejected two requests by Landsbanki. One was for an exemption on rules on large exposures. Landsbanki faced the problem that in the credit crunch, the value of the bank’s assets, mainly its loan portfolio, had gone down. The other request was that of the 20% of its total assets required to be transferred from the Icelandic parent company to the UK subsidiary against the transfer of the accounts, Landsbanki could in 2008 transfer 10% and in 2009 the remaining 10%.¹⁴ In support of the latter request, Landsbanki’s chief managers pointed out to the FSA that about half of the Icesave accounts were fixed-term deposits which would only be accessible in 2009 for the depositors.¹⁵

Not only did the FSA reject the two requests by Landsbanki, but it also hardened its stance. In mid-August it presented Landsbanki with a new set of demands: It should reduce its instant access deposits; stop marketing Icesave; notify the FSA of all changes in interest rates; increase the cash reserve to 20% of the total amount in instant access accounts; and present a plan on how to repay fixed-term deposits when they matured. The FSA staff must have realised that it was nearly impossible for Landsbanki to meet those demands. In an internal memo, CBI members of staff commented: “The FSA’s action seems destined to bring about the chain of events that it sets out to avoid.”¹⁶ Landsbanki’s chief managers decided to seek the help of the Icelandic Minister of Business Affairs, Bjorgvin G. Sigurdsson, who came from Labour’s Icelandic counterpart, the Social Democrats. Could he influence his British soulmates? Sigurdsson asked for a meeting with Chancellor Alistair Darling.

3. Darling’s Misconceptions about Iceland

The British Chancellor had already formed a negative opinion of the Icelanders, as clearly comes out in the book he subsequently wrote about the international financial crisis. For example, Darling writes:

By 2008, it was clear, too, that Iceland itself was rapidly becoming insolvent. Earlier in the year Gordon [Brown] had spoken to the Icelandic prime minister, who had

¹⁴ SIC Report, Vol. 6, Ch. 18, pp. 20–27 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enskali.pdf> Landsdomur [Impeachment Court], No. 3/2011, 23 April 2012, p. 281. <https://www.landsdomur.is/media/skyrslur/nr.-3-2011-Domur-a-vef.pdf>

¹⁵ Email to Hannes H. Gissurarson from Halldor J. Kristjansson 4 August 2018.

¹⁶ SIC Report, Vol. 6, Ch. 18, p. 24 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enskali.pdf>

formerly been governor of their central bank, and urged him to go to the IMF. He was reluctant to do so, preferring to seek out Russian loans to tide the country over.¹⁷

Iceland was not becoming insolvent, as Darling alleges. The state was almost debtless and the economy was robust, based on the profitable quota system in the fisheries, ample supplies of energy, both hydroelectric and geothermal, tourism, and a well-educated workforce. This should not be confused with the possible insolvency of the banking sector, unless, of course, it was assumed that the obligations of Icelandic banks were also the obligations of the Icelandic state.

Darling's information about the Icelandic Prime Minister was not correct, either. Geir Haarde had not been CBI Governor before he became Prime Minister.¹⁸ Darling's comment that Prime Minister Haarde was reluctant to go to the IMF, "preferring to seek out Russian loans to tide the country over", is also highly misleading. A possible loan from Russia was not being discussed when Brown met Haarde in April 2008. The reason the Icelandic government in the beginning of October explored the possibility of a loan from Russia was that they had been refused credit lines and currency swap deals by its traditional Western allies. "We have not received the kind of support that we were requesting from our friends," Haarde explained to journalists. "So in a situation like that one has to look for new friends."¹⁹ A loan from Russia was certainly never the first preference of the Icelandic government.²⁰

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

Over the years it funded a range of investments, many of which are, in 2011, being investigated by the criminal authorities. Along the way, quite a few Icelandic citizens seemed to get very rich. Some were even able to make handsome donations to the British Conservative Party.²¹

Darling's statement about criminal investigations is not correct. No investments funded by Landsbanki's London branch were in 2011 being investigated by the criminal authorities in the UK. None have actually to this day been investigated by any criminal authorities, neither in the UK nor in Iceland.²² Darling was probably not referring to several investigations of the banks and their customers launched in Iceland after the collapse: They were mostly about possible market manipulations in the last year before the collapse when Icelandic bankers and businessmen were desperately trying to stay afloat, and had nothing to do with investments which Landsbanki funded in the UK prior to its collapse.

¹⁷ Darling, *Back from the Brink*, p. 137.

¹⁸ Without comment, Darling corrects this error in his book's second edition. Alistair Darling, *Back from the Brink* (London: Atlantic Books, 2012), p. 137.

¹⁹ Kerry Capell, The stunning collapse of Iceland, Bloomberg Businessweek 10 October 2008, http://www.nbcnews.com/id/27104617/ns/business-us_business/t/stunning-collapse-iceland/#.WgxX2oZpFBw

²⁰ Interview with Geir H. Haarde in Reykjavik 1 October 2013.

²¹ Darling, *Back from the Brink*, p. 137.

²² Emails to Hannes H. Gissurarson from Larus Welding (Landsbanki's London Branch Manager until 2007) 19 April 2017 and from Lilja Bjork Einarsdottir (Landsbanki's London Deputy Branch Manager during the bank collapse) 24 April 2017.

It is most likely that here Darling is confusing Landsbanki with Kaupthing and its UK subsidiary KSF. Some investments in the UK funded by Kaupthing and KSF were indeed under much-reported investigation in 2011 when Darling was writing his book. The investigation was launched in 2009 in response to information provided by the FSA and the Icelandic authorities. The SFO, Serious Fraud Office, in March 2011 arrested the two brothers Robert and Vincent Tchenguiz and searched their premises. The brothers—who were subsequently released on conditional bail—were big Kaupthing and KSF customers, especially Robert who was not only Kaupthing’s biggest single debtor, but also a shareholder.²³ This investigation ended however disastrously for the SFO. Serious flaws in it were revealed, the search warrants were set aside, the investigation was discontinued, and those officers responsible for it had to leave the SFO.²⁴ The SFO had to settle for paying Vincent Tchenguiz damages of £3 million and Robert Tchenguiz damages of £1.5 million and to apologise to both of them.²⁵

Darling’s statement about donations from Icelanders to the Conservative Party is also unfounded. When he was later asked what evidence he had for it, he referred to press reports after the bank collapse.²⁶ No prominent Icelandic businessman or banker has however acknowledged any financial support to the Conservative Party.²⁷ More importantly, donations to political parties are on public record in the UK, and no Icelandic businessman is found on lists available of donors to the Conservative Party. However, there is a likely source for Darling’s remark. In the spring of 2011, while he was writing his book, the SFO raided the Luxembourg premises of Kaupthing Luxembourg, a subsidiary of Kaupthing in Iceland. In July 2009, after the collapse, the subsidiary had been sold to British property developer David Rowland and his family and renamed Banque Havilland. A well-known supporter of the Conservative Party, Rowland had donated almost £3 million to it. He was widely expected in 2010 to become Party Treasurer, although he eventually declined to take up the post. The 2011 raid in Luxembourg was in connection with an investigation into the operations of Kaupthing before its 2008 collapse, and had nothing to do with Rowland and his family. Nevertheless, newspaper headlines implicated Rowland in the investigation. One said: “SFO raids Tory donor David Rowland’s bank over Kaupthing.” Another said: “SFO raids offices in Luxembourg over failed Icelandic bank Kaupthing.”²⁸ It appears that not only did Darling again confuse Landsbanki and Kaupthing, but that he also assumed an Icelandic connection with the donations of Rowland to the

²³ The SIC Report, Vol. 1, Ch. 2, p. 2 (in English). <http://rse.hi.is/documents-on-bank-collapse/Thorvaldsson,FrozenAssets,pp.127-8>.

²⁴ High Court of Justice, Queen’s Bench Division, Divisional Court, 31 July 2012, No. CO/4236/2011 and CO/4468/2011. <https://www.judiciary.gov.uk/wp-content/uploads/JCO/Documents/Judgments/tchenguiz-v-seriousfraudoffice.pdf>

²⁵ James Quinn, SFO Settles with Robbie Tchenguiz, *The Times* 31 July 2014. <https://www.telegraph.co.uk/finance/financial-crime/11002371/SFO-settles-with-Robbie-Tchenguiz.html>

²⁶ Interview with Alistair Darling in London 11 December 2013.

²⁷ Interviews with Bjorgolfur Gudmundsson in Reykjavik, 20 August 2013, and with Sigurdur Einarsson, Armann Thorvaldsson and Bjorgolfur Thor Bjorgolfsson in London 11 December 2013.

²⁸ Rowena Mason, SFO raids Tory donor David Rowland’s bank over Kaupthing, *The Telegraph* 29 March 2011. <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8414550/SFO-raids-Tory-donor-David-Rowlands-bank-over-Kaupthing.html> Simon Bowers, SFO raids offices in Luxembourg over failed Icelandic bank Kaupthing, *The Guardian* 29 March 2011. <http://www.theguardian.com/business/2011/mar/29/robert-tchenguiz-kaupthing>

Conservative Party, simply because Rowland had bought the remnants of a subsidiary of a failed Icelandic bank.

4. Darling Meets the Icelanders

It was not surprising, given Chancellor Darling's hostility towards the Icelanders, that the meeting on 2 September 2008 between him and Icelandic Business Affairs Minister Bjorgvin G. Sigurdsson about Landsbanki's problems did not go well. Darling had already made up his mind that Landsbanki was likely to fail and that then the Treasury would temporarily have to compensate the British depositors, whereas the Icelanders should pay the final bill. He bluntly asked Sigurdsson and his entourage where to he should send that bill.²⁹ In his book, Darling recalls the meeting. He says that the FSA had been anxious that he should meet with the Icelanders because it was "making no headway in trying to persuade Landsbanki to put more money into its activities in the UK. But if the FSA thought the Icelandic delegation had come to show some contrition and eagerness to respond to the British regulation, it was in for a rude shock."³⁰ Darling says that he was struck at what seemed like an unusually large delegation from Iceland. According to him, both Minister Sigurdsson and the chief regulator, Jon Sigurdsson—neither of whom he mentions by name—spoke volubly.³¹ "I was told that considerable national pride was invested in Landsbanki. It occurred to me that if they did not realize just how bad a state Landsbanki was in, they did not know what they were doing. Alternatively, they did know." Darling says that this meeting coloured his subsequent dealings with Icelandic ministers. He had expected the Icelanders at the meeting to stick up for their country. But he had also expected them to be straightforward, "and this simply was not the case, as we were soon to find out."³²

Chancellor Darling has confirmed that the negative impression that he formed at this meeting influenced his later decisions on the Icelandic banks.³³ He said that the Icelandic government minister had not had good command of English and that he had not created trust.³⁴ While Darling is possibly right that Business Affairs Minister Sigurdsson was not fully aware of the great danger facing the Icelandic banking sector, he may be somewhat unfair to the Icelandic politician. In his book, Darling does not explain what he meant by the "bad state Landsbanki was in". Indeed, it is true that in the case of failure the Icelandic deposit-guarantee scheme could not cover Landsbanki's obligations. But the point of the talks was to try and facilitate the transfer of the Icesave accounts to the UK where they would be regulated by the FSA and insured by the British guarantee scheme.

Landsbanki's real problem was that in the midst of an international credit crunch many of its loan covenants had stipulations that they could be cancelled in an event

²⁹ SIC Report, Vol. 6, Ch. 18, pp. 27–8 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Ensk1.pdf>

³⁰ Darling, *Back from the Brink*, pp. 137.

³¹ Economist Jon Sigurdsson was actually not the regulator, but the Chairman of the Board of the IFSA. He is a former politician (and government minister) from the Social Democrats.

³² Darling, *Back from the Brink*, pp. 137–8.

³³ Interview with Alistair Darling in London 11 December 2013.

³⁴ High officials from the UK have expressed the same opinion to former Prime Minister Geir H. Haarde, that this meeting increased the distrust of UK officials towards the Icelanders. Interview by phone with Geir H. Haarde 8 November 2017.

such as the transfer of assets from the parent company to a subsidiary. Therefore the transfer had to be gradual. But the FSA rejected all requests by Landsbanki for a gradual transfer of assets with the accounts, while it kept raising its demands to Landsbanki about liquidity. It is not apparent that Darling had special information about Landsbanki's equity and assets, or the lack thereof, which the Icelandic authorities did not have.

Perhaps the Icelandic Business Affairs Minister was as unaware of the precariousness of the Icelandic banks as Darling himself then was of the precariousness of the two big Scottish banks, RBS, Royal Bank of Scotland, and HBOS, Halifax Bank of Scotland. Or, as the leader of Darling's own party, Prime Minister Gordon Brown, later wrote about the financial crisis: "It is true we were not prepared for what was happening—or for what was going to happen in the coming months. No one was."³⁵

Certainly, the FSA did not soften its approach to Landsbanki after Chancellor Darling's meeting with Sigurdsson. Quite the contrary. An impasse followed where Landsbanki could not, and the FSA would not, modify their respective positions. On 8 September 2008 Landsbanki sent a detailed proposal to the FSA about the transfer of accounts to Heritable Bank and a gradual transfer of assets against them, roughly half in 2008 and half in 2009. The FSA turned down this proposal giving the reason that until 2009 no collateral would be provided from Landsbanki to Heritable Bank for half the total amount, about £2.4 billion.³⁶ To bring this amount of money into perspective, it should be pointed out that the building society and bank Alliance & Leicester had in November 2007 received a secret £3 billion credit line from the Bank of England to prevent insolvency and a run on the bank. If the objection is made that Alliance & Leicester was a British bank, then it may be added that it was sold to the Spanish bank Santander in July 2008.³⁷ In September 2008, at the same time as the FSA steadily increased its pressure on Landsbanki, Chancellor Darling secretly authorised the provision by the Bank of England of liquidity to three ailing banks, HBOS, RBS and Bradford & Bingley, in the case of RBS amounting to £14 billion.³⁸ Bradford & Bingley had received £3 billion in liquidity from the Bank of England before it was sold to the Spanish bank Santander Monday 29 September.³⁹ Five days earlier, on 25 September, the FSA had sent a letter to Landsbanki warning it that it was not complying with liquidity requirements in the UK and asking it to put an end to this irregular situation.⁴⁰

After the Icelandic government's recapitalisation of Glitnir which was announced 29 September 2008—the same day Bradford & Bingley was sold to Santander—had failed to recreate trust in the Icelandic banking sector, not least because of the media campaign against the action by Glitnir's largest shareholder, but also because of the

³⁵ Gordon Brown, *My Life, Our Times* (London: Random House, 2017), p. 297. Kindle Edition.

³⁶ Halldor J. Kristjansson and Sigurjon Th. Arnason, *Developments leading up to the Icelandic banking crisis in October 2008*, Draft (25 February, 2009), p. 91. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

³⁷ Bank of England was unaware of impending financial crisis, BBC 7 January 2015. <http://www.bbc.com/news/business-30699476>

³⁸ Darling, *Back from the Brink*, p. 119.

³⁹ *Ibid.*, p. 132.

⁴⁰ Kristjansson and Arnason, *Developments leading up to the Icelandic banking crisis*, p. 92. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

refusal, obvious to the markets, by the US Federal Reserve Board to make the same dollar swap deals with the CBI as it had done with the Scandinavian central banks, Landsbanki saw a reduction in wholesale deposits and cancellation of credit lines, as well as an outflow from the Icesave accounts where the total balance fell from £4.7 billion to £4.2 billion. Nevertheless, 2 October 2008 at the request of FSA, Landsbanki transferred £200 million from its CBI account to its account with Barclays in the UK to meet possible further outflows from the Icesave accounts.⁴¹

In the days after the recapitalisation of Glitnir, Kaupthing's UK subsidiary, KSF, also saw a considerable outflow of deposits from its Edge accounts, even though they were protected by the British deposit insurance scheme. Tuesday 30 September alone the net outflow was £37 million. KSF managers also began to get indications that the parent company in Iceland was having liquidity problems. KSF could not draw on the credit line that it had with Kaupthing. KSF manager Armann Thorvaldsson gave immediate notice of the difficulties to the FSA. Thursday 2 October they sent in a team of liquidity specialists that went through the KSF books. In the evening, the KSF managers were summoned to a meeting at the FSA headquarters where officials told them that the FSA was becoming worried about developments in Iceland. On Friday 3 October, it was made clear to Thorvaldsson that the FSA would close down KSF if Kaupthing would not improve the liquidity position of its UK subsidiary. The same day Kaupthing transferred £100 million to KSF.⁴²

5. Darling's Phone Call to Haarde

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

Meanwhile, the situation in Iceland was deteriorating. The FSA told me that undertakings given by the Icelandic authorities *that sufficient money would be put into Landsbanki* had not been honoured. It had been agreed that Gordon would speak to the prime minister, Geir Haarde, but he had to go to Paris to meet President Sarkozy, Chancellor Merkel and Silvio Berlusconi, so I was deputized to make the call instead. The Treasury and the FSA had already concluded that it would not be long before Landsbanki and Kaupthing failed. We were ready, if necessary, to use the new powers we had acquired at the time of Northern Rock to transfer their UK undertakings to another bank.

Darling goes on:

I told the Icelandic prime minister that it appeared that large sums of money had been taken out of the UK from the Kaupthing branches, which was a serious breach of FSA regulations. The FSA had to find out by the end of the afternoon whether or not that breach had taken place. If it had, they would close the bank. He asked whether the money was needed today and how much it was. I said it was about £600 million, small beer for us but a huge amount for him. It was urgent, I said, that he look into it immediately. His response rang alarm bells. He asked if there was *any chance that the amount could be negotiated down*. I said there was no chance and that the money had

⁴¹ Ibid., p. 73.

⁴² Thorvaldsson, *Frozen Assets*, pp. 209–13.

to be returned before the end of the weekend. I suspected we would end up having to close the banks the following week.⁴³

Subsequently, the FSA required KSF to keep all deposits received on 2–3 October in a special account at the Bank of England.⁴⁴ In discussions between FSA officials and KSF managers, it was made clear that KSF had to increase its liquidity by the required £1.6 billion by either selling assets or obtaining money from its parent company.⁴⁵

Darling's description in his book of the state of affairs is however highly misleading, both regarding Landsbanki and Kaupthing. The Icelandic authorities had never given any undertakings "that sufficient money would be put into Landsbanki". The talks earlier in 2008 on the possible transfer of online deposits from Landsbanki's UK branch to a subsidiary had been between Landsbanki and the FSA and they had reached an impasse because of the unwillingness of the FSA to allow a gradual transfer of assets from Iceland to the UK against the online deposits.⁴⁶ It should also be noted that in the phone call from Darling to Haarde, apparently Landsbanki was not mentioned, only Kaupthing. Yet again, it seems that Darling did not make a proper distinction between Landsbanki and Kaupthing.

Fourthly, and most importantly in this context, Prime Minister Geir H. Haarde strongly denies having tried, on this occasion, to negotiate down any amount of money that would have to be transferred from Iceland to the UK in order to avoid the close-down of KSF, Kaupthing's UK subsidiary.⁴⁷ According to Haarde, upon receiving Chancellor Darling's accusations, he immediately talked to the Kaupthing managers about them. They assured Haarde that these accusations were not true and that this had to be some kind of misunderstanding that ought to be easily corrected. The Kaupthing managers then proceeded to contact both the FSA directly and the IFSA and came back to Haarde assuring him that everything would be in order on Monday morning.

Indeed, the extensive investigation of Kaupthing after the collapse did not reveal any unusual or illegal large-scale money transfers from the UK to Iceland before the collapse. What it showed was that the Icelandic parent company had, since the spring of 2008, made a running loan agreement with its subsidiary, KSF, by which it lent £1.1 billion to KSF for three months at a time while KSF lent the same amount of money to the parent company for a day at a time. This meant that this amount of money was registered in the KSF books as liquidity, whereas in fact no money had

⁴³ Darling, *Back from the Brink*, p. 147. Italics added.

⁴⁴ While in court judgements in cases concerning Kaupthing, this is referred to as a Supervisory Notice to KSF, e.g. in cases No. EWCA 2009/1673, 1676, 1679, 1686 and 1687, this does not seem to be entirely accurate. According to a Final Notice by the FSA to KSF (in administration) 18 June 2012, KSF had 3 October 2008 voluntarily undertaken to heed those demands by the FSA. Hence a Supervisory Notice was not issued. <https://www.fca.org.uk/publication/final-notices/kaupthing-singer-friedlander.pdf>

⁴⁵ SIC Report, Vol. 1, Ch. 2, p. 15 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli2Enska-1.pdf>

⁴⁶ Kristjansson and Arnason, *Developments leading up to the Icelandic banking crisis*. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

⁴⁷ Interview with Geir H. Haarde 1 October 2013.

been transferred from either the UK to Iceland or from Iceland to the UK. Also, KSF had paid margin calls abroad to the amount of £500 million for the parent company (KSF had, in other words, provided increased collateral to foreign creditors of the parent company). While those dealings were perhaps not above criticism, they were not illegal and did not constitute transfers from the UK to Iceland. Moreover, Armann Thorvaldsson and other members of the KSF management team did not try to hide any of this from the FSA. In fact, the FSA had been told of the running loan agreement when it was made.⁴⁸

6. A Crucial Document: The First Supervisory Notice to Landsbanki

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

i) which has, or may have, the effect of transferring the assets to a location outside the United Kingdom; or ii) which has or may have, the effect of creating any charge, security interest or other similar economic interest over the assets, unless you have given the FSA at least 3 days' written notice of the proposed action and the FSA has confirmed, in writing, that it has no objection to those proposals.⁴⁹

Landsbanki had to ensure that the Icesave instant access deposits were not in any 'Best Buy' tables in the United Kingdom. It also had to ensure that there was no change to interest rates on the Icesave fixed rate products without notice to the FSA. The bank had to cease all marketing of Icesave instant access deposits by 10 October and to reduce to £1 billion the overall level of such deposits. It had to ensure that deposits of all types did not at any time exceed £5 billion. It was to submit by 17 October a plan to repay the Icesave fixed term deposits which would mature between now and the end of June 2009. At this time, Landsbanki's London Branch had deposits of £1.93 billion in fixed term deposits. Finally, it had to report its asset position on a daily basis to the FSA. The main reason given for these drastic measures was that the FSA was of the opinion that Landsbanki had contravened, or was likely to contravene, its liquidity requirements.⁵⁰ In effect, this meant that Landsbanki was supposed to come up with £400 million in the next few days. The FSA probably knew that the same day the ECB issued what was in effect a margin

⁴⁸ SIC Report, Vol. 7, Ch. 21, p. 88 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> Interview with Armann Thorvaldsson in London 11 December 2013.

⁴⁹ First Supervisory Notice to Landsbanki, 3 October 2008. https://www.fca.org.uk/publication/supervisory-notices/landsbanki_3oct08.pdf

⁵⁰ Op. cit.

call on Landsbanki, a demand for increased collateral, or alternatively the repayment on outstanding loans, of no less than €400 million.

7. Brown's Phone Call to Haarde

It is noteworthy that in the midst of the gravest financial crisis that the UK authorities had experienced for almost eighty years, government ministers found time to call their Icelandic colleagues about amounts of money which for them must have seemed almost negligible—“small beer for us” as Chancellor Darling put it—and that their allegations turned out, on investigation, to be wrong. On Sunday 5 October, in the evening Prime Minister Gordon Brown called his Icelandic colleague Geir H. Haarde and told him that the illegal transfers from KSF to Kaupthing did not amount to £600 million as Chancellor Darling had stated two days earlier, but to £1.6 billion. When Haarde replied that he had asked the bankers about this and that they had assured him that this was not correct, Brown replied that he took his word for it and that he would not pursue that matter further in their conversation. Brown also suggested that Iceland should seek the assistance of the IMF. The same day an IMF team arrived in Iceland: There seemed suddenly to be some interest abroad in Iceland, possibly because of the rumour of a loan from Russia.⁵¹ The IMF staff were not oblivious, either, to the possibility of playing a more important role because of the international financial crisis than they had done for some time. Meanwhile the FSA suddenly lowered its demand to Landsbanki for an immediate transfer of money from £400 million to £200 million, while the ECB withdrew its marginal call. On Sunday night, Landsbanki's managers had a teleconference with FSA Director Hector Sants where they discussed the possibility of a fast transfer of the Icesave accounts from Landsbanki's London branch to Heritable Bank. Sants did not rule it out, if money was transferred to Landsbanki's London branch, but did not commit himself.⁵²

On Monday 6 October 2008 the Icelandic government had finally decided, after some hesitation, to follow the CBI advice of ‘ring-fencing’ Iceland—which meant that government would ensure continued operations of the domestic part of the banking sector, but if necessary put the foreign part in resolution. This was done with the help of an expert, Marc Dobler, sent from the Bank of England after a conversation on Saturday 4 October between CBI Governor David Oddsson and Governor Mervyn King.⁵³ When Chancellor Alistair Darling learned about this proposed measure, he tried to reach Prime Minister Geir H. Haarde, but Haarde was occupied at Parliament House seeing through the Emergency Act already mentioned. Haarde sent a message to Darling that he could call Finance Minister Arni M. Mathiesen in the morning. The same day, the FSA prohibited Landsbanki's London branch from invoking the terms of its contracts with depositors which would have enabled it to limit withdrawals for up to 60 days.⁵⁴ This meant that the bank could not avert the run on it which was already taking place. In the evening in Reykjavik, as Landsbanki did not get an emergency loan it had requested from the CBI, its management decided to hand over

⁵¹ SIC Report, Vol. 7, Ch. 20, p. 83.

⁵² The teleconference was recorded by the Landsbanki people. See also Kristjansson and Arnason, *Developments leading up to the Icelandic banking crisis*, p. 76. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

⁵³ SIC Report, Vol. 7, Ch. 20, pp. 120–22.

⁵⁴ First [should be Second] Supervisory Notice to Landsbanki, 6 October 2008. https://www.fca.org.uk/publication/supervisory-notices/landsbanki_6oct08.pdf

control to the IFSA. Meanwhile in London, the same night, on the suggestion of the FSA, the KSF management team explored the possible acquisition of KSF by Barclays. But it turned out that Barclays was only prepared to do a quick asset purchase at a big discount—as it had done with the core operations of the failed Lehman Brothers three weeks earlier—so the idea was abandoned.⁵⁵

8. *Darling's Phone Call to Mathiesen*

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

As I left Downing Street before dawn, arrangements were being made not only to monitor what happened when the markets opened but to keep a close eye on what was going on in Iceland. We knew we were not being told the whole story there and it was inevitable that difficult decisions, which might wrongly be interpreted as hostile acts by the Icelandic government, would have to be taken in the next day or so.⁵⁶

It is not clear to whom Darling is referring by his complaint that he had not been told the full story: Who would intentionally have been withholding information? The Icelandic authorities? Or the Icelandic banks operating in the UK? And information on what? The lack of liquidity which was common knowledge? Whereas the Icelandic banks to the bitter end may have tried to appear less vulnerable than they really were, as would other banks in the same circumstances, no evidence has been presented showing that the Icelandic authorities were intentionally giving misleading information to the British authorities. It should also be noted that immediately when KSF manager Armann Thorvaldsson realised that the Icelandic parent company had liquidity problems, while there was a net outflow from the Edge accounts, he gave notice about this to the FSA. The passage quoted reveals however that Darling had already in the early morning of 7 October decided to make “difficult decisions” which might be “interpreted as hostile acts by the Icelandic government”.

While describing his arrival in Luxembourg, Chancellor Darling states that British government ministers are normally scrupulous about taking scheduled flights to and from meetings abroad, adding: “I was often struck by the ranks of private jets sitting at the airports at international gatherings and I noted that the smaller the country, the bigger the jet.”⁵⁷ Darling goes on to say that on this particular day he decided that chartering a flight was justified. “As we touched down, Geoffrey Spence, my special adviser, pointed out two Icelandic jumbo jets parked on the runway. We taxied alongside them in our Spitfire-sized plane.”⁵⁸ But if two Icelandic jumbo jets (Boeing 747) were found at Luxembourg airport on this day, then they could not be there in connection with the meeting which Darling was attending: Iceland was not a member of the EU, and her finance minister did not attend the meeting. Moreover, the only Icelandic company possessing jumbo jets in 2008 was Air Atlanta which had operated such jets as cargo planes since 1993, long before the Icelandic credit

⁵⁵ Thorvaldsson, *Frozen Assets*, pp. 217–8.

⁵⁶ Darling, *Back from the Brink*, p. 152.

⁵⁷ Op. cit.

⁵⁸ Op. cit.

boom.⁵⁹ Operating in Luxembourg, Air Atlanta was a successful air transport company which specialised in cargo, but also did some chartered flights. Darling's suggestion that "the smaller the country, the bigger the jet" at international gatherings seems in this case both misleading and irrelevant. It is yet another example of the hostility towards Iceland repeatedly expressed by Darling.

The meeting in Luxembourg turned out to be dramatic, as Darling kept getting news of RBS shares collapsing. He left the meeting several times to take calls on the situation, including one from RBS Chairman of the Board Tom McKillop. Darling asked how long the bank could keep going. He replied: "A couple of hours, maybe."⁶⁰ Darling rang his Treasury officials and instructed them to tell Bank of England Governor Mervyn King to put as much money into RBS as was necessary to keep it afloat during that day. He also called Prime Minister Brown who concurred with him. As Darling was getting out of the meeting to return to London, he rang Icelandic Finance Minister Arni M. Mathiesen, asking him what the Icelandic government would do about Landsbanki's online accounts in the UK, as the bank was collapsing.⁶¹ Mathiesen responded that the Icelandic government would do what it could to resolve the problem, but that he could not make any promises. In the beginning of the conversation, Darling thought that he was talking to Business Affairs Minister Bjorgvin G. Sigurdsson, whom he had met in September, but Mathiesen corrected him on that point.⁶²

Tuesday 7 October 2008, the FSA closed down Heritable Bank in London, stating that it did not meet liquidity requirements.⁶³ The night before, the staff at the FSA had suddenly realised that they had to deliver legal papers to Scotland where Heritable was registered, in time for a court case. "All courier delivery firms had stopped for the night, so an FSA official jumped into his own car with the paperwork and drove through the night to Edinburgh."⁶⁴ Landsbanki's London branch had been closed down the night before, like the parent company in Iceland, and legally the bank was now in the hands of a resolution committee appointed by the IFSA. In the evening of the same day in Reykjavik, 7 October, Glitnir's management in Iceland decided to hand over control to the IFSA. The same evening in London, KSF managers frantically explored the possibility of selling the bank subsidiary to the investment company JC Flowers for only 10% of its book equity value, but the talks failed.⁶⁵

8. All British Banks But Two Rescued

Political leaders in the UK were as surprised as everyone else at the events unfolding on the financial markets. Prime Minister Gordon Brown's special adviser Damian McBride spent the evening of Tuesday 7 October with him at 10 Downing Street.

⁵⁹ Air Atlanta: History (2014). <http://www.atlanta.is/index.aspx?GroupId=43>

⁶⁰ Darling, *Back from the Brink*, p. 152.

⁶¹ Op. cit.

⁶² David Ivison and George Parker, Transcript challenges UK position on Iceland, *Financial Times* 23 October 2008. <http://www.ft.com/intl/cms/s/0/42c0e23c-a153-11dd-82fd-000077b07658.html#axzz3CIV2pQMK>

⁶³ First Supervisory Notice to Heritable Bank, 7 October 2008. https://www.fca.org.uk/publication/supervisory-notices/heritable_7oct08.pdf

⁶⁴ Hugh Pym, *Inside the Banking Crisis: The Untold Story* (London: Bloomsbury, 2014), p. 114.

⁶⁵ Thorvaldsson, *Frozen Assets*, p. 208.

Brown looked “ravaged by the intensity of the work, running on a massive overdose of adrenalin.” He closed the door to his office and said in almost a whisper to McBride that there was a serious danger of mass panic in the UK for which he had to be ready. People might try to storm the banks: “We’d have to think: do we have curfews, do we put the army on the streets, how do we get order back? I’d have to resign but I couldn’t go if there was just carnage out there, someone would have to be in charge.”⁶⁶ Brown went to bed on midnight with a mobile phone next to him in case of a disaster. When he got up the next morning he told his wife that she would have to be ready to pack their things for a sudden move out of Downing Street. He would have to resign if the situation continued to deteriorate.⁶⁷

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

And as people will now know, we are taking legal action against the Icelandic authorities to recover the money lost to people who deposited in UK branches of this bank. The Chancellor is saying today that he will stand behind the deposits of these customers.⁶⁸

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

It should also be emphasised that the British authorities at least contributed to the problems of the Icelandic banks. By closing down Kaupthing’s subsidiary in the UK, they caused the fall of the parent company. By invoking the Anti-Terrorism Act against Landsbanki, they made an orderly process of bank resolution very difficult. If Brown wanted to provide “security for depositors”, the best way of doing this in the case of Kaupthing’s UK subsidiary, KSF, would have been to include KSF in the £500 billion rescue package for British banks announced at the same news conference, on 8 October. To survive, KSF would only have needed a fraction of that money. Since Landsbanki operated from a branch and not a subsidiary, its case was

⁶⁶ Damian McBride, *Power Trip: A Decade of Policy, Plots and Spin* (London: Biteback, 2013), p. 379.

⁶⁷ Gordon Brown, *My Life, Our Times* (2017), p. 317. Kindle Edition.

⁶⁸ SIC Report, Vol. 7, Ch. 20, p. 151. Also

<http://webarchive.nationalarchives.gov.uk/20100505183318/http://www.number10.gov.uk/news/speeches-and-transcripts/2008/10/press-conference-with-the-chancellor-of-the-exchequer-17114> Cf. also a description of the press conference

<http://www.theguardian.com/global/blog/2008/oct/08/gordonbrown.marketturmoil>

more complicated. But some kind of assurance to depositors from the British authorities, followed by close cooperation between them and the Icelandic authorities in managing the Landsbanki estate, would have been more helpful for depositors than the actions undertaken by the British authorities, and also more helpful for the staff employed by Landsbanki and employees of firms partly or wholly owned by Icelandic companies or individuals, probably close to 100,000 people at the time.

Darling's Inaccurate Account of His Dealings with the Icelanders

The same morning, Wednesday 8 October 2008, Chancellor Darling echoed Prime Minister Brown when he said in an interview with a breakfast television channel: "I am very aware of the fact Iceland has, sadly, chosen to default on its obligations here. We are pursuing Iceland and we will pursue it vigorously to make sure that we get the money due to us back."⁶⁹ Darling also said in a BBC radio interview: "The Icelandic government have told me, believe it or not, have told me yesterday they have no intention of honouring their obligations there."⁷⁰ Unbeknownst to Darling, the conversation with Finance Minister Mathiesen to which he was referring was recorded, and when it was published it became apparent that Darling had not told the truth.⁷¹ Nowhere in the conversation did Mathiesen say that the Icelandic government had no intention of honouring its obligations. The question was precisely which obligations it had under English, Icelandic and international law. Later, the House of Commons Treasury Committee explored this matter and concluded: "In the published transcript Mathiesen did not state that Iceland would not honour its obligations. Rather, he explicitly indicated that Iceland planned to use its compensation scheme to try to meet obligations to British depositors."⁷²

Unsurprisingly, therefore, in his book three years later Darling gives a different account of his conversation with Mathiesen:

I was desperate now to get out of Luxembourg, but had to take a call first from a minister in Iceland. I wanted an assurance that they would compensate British investors in Icelandic banks. He said, yes, they would. I came off the call and told my officials, 'They won't stand behind it'.⁷³

⁶⁹ SIC Report, Vol. 7, Ch. 20, p. 149.

⁷⁰ House of Commons Treasury Committee, *Banking Crisis: The impact of the failure of the Icelandic banks* (London: The Stationary Office, 2009), p. 21.

<https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/402.pdf>

⁷¹ David Ibson and George Parker, Transcript challenges UK position on Iceland, *Financial Times* 23 October 2008. <http://www.ft.com/intl/cms/s/0/42c0e23c-a153-11dd-82fd-000077b07658.html#axzz3CIV2pQMK>

⁷² Treasury Committee, *Banking Crisis*, p. 23. Professor Barry Eichengreen has been misinformed about this. He writes in *Hall of Mirrors*, p. 221: "On the Tuesday morning following, the Icelandic Minister of Finance, Arni M. Mathiesen, informed the UK Chancellor, Alisdair [sic] Darling, that the Icelandic government, now the de facto owner of the banks, might not be able to come up with this kind of money." On Tuesday morning, actually only Landsbanki had been put into resolution. And Mathiesen pointed out to Darling, as the Treasury Committee recognises in its report, that while there might not be much money in the Icelandic Depositors' and Investors' Fund, which was supposed to compensate depositors in the case of Landsbanki's failure, the government would do its best to resolve the problem. Landsbanki's estate was eventually able fully to compensate all depositors.

⁷³ Darling, *Back from the Brink*, p. 154.

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

First, it was Darling who called Mathiesen, not the other way around. This is noteworthy given the circumstances: In the midst of the financial crisis, when he was preparing a rescue package of £500 billion, Chancellor Darling found time to call the Icelandic finance minister, worrying about a fraction of that sum, “small beer for us” as he said himself.

Second, Mathiesen had not uttered the assurances which Darling now ascribes to him (contradicting his previous account). The Icelandic Finance Minister had been unwilling to make any promises on behalf of the government, while pointing out that Iceland had a compensation scheme for depositors. Mathiesen also tried to explain to Darling that the Emergency Act gave claims of all depositors, including British owners of Icesave accounts, legal priority over other claims, whereas the Icelandic government had, like many other European governments, announced that it would guarantee domestic deposits. Therefore there had been no discrimination by law between British and Icelandic depositors.⁷⁴

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

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

Darling added:

I have to tell the House that getting information out of Iceland is proving to be quite difficult. That country obviously has severe difficulties, and that is why I decided that I had to intervene. It would have been quite wrong to say to people covered by the Icelandic scheme, “Sorry, you've got to go to Reykjavik and try to get your money there.” That is especially true when it is not clear to me whether the Icelandic scheme can be funded. So we have taken steps to freeze the assets of the bank involved

⁷⁴ Professor Barry Eichengreen is one of many who has been misinformed about the nature of the Emergency Act. He writes in *Hall of Mirrors* (2015), p. 220: “But this measure said nothing about the banks' other creditors, be they institutional institutions holding the bonds of the banks or Dutch and British households with IceSave and Kaupthing Edge accounts.” The Emergency Act gave priority to *all* depositors in Icelandic banks, including British and Dutch owners of Icesave accounts. And the Edge accounts in the UK were covered by the British scheme of deposit insurance, since they were collected by a British bank, KSF, a subsidiary of Kaupthing.

(Landsbanki], and I hope that we will be able to recover some of those assets in order to offset the money that we will have to provide to help people in the meantime.⁷⁵

Darling was not entirely accurate about Landsbanki: Its board had already in the night of Monday 6 October handed the bank over to the IFSA which had appointed a resolution committee. The Chancellor was however plainly wrong that Kaupthing's UK subsidiary, KSF, Kaupthing Singer & Friedlander, had already been put into liquidation (or rather resolution) by British authorities. This happened later in the day, at approximately 14:50. It was therefore not a direct consequence of any decision made by the FSA in the afternoon that the Chancellor transferred most of KSF's retail deposits to one of its competitors, the Dutch bank ING. He had already done that in the morning. Indeed, when the Chancellor was making his announcement in the House of Commons, the managers of KSF and Kaupthing believed themselves to be participating in negotiations with the FSA on how to relieve the pressure on KSF.⁷⁶

It should be noted that the most important part of Chancellor Darling's announcement in the House of Commons on Wednesday 8 October was that the British government was providing an immense rescue package of £500 billion for all British banks—except for two, Heritable Bank and KSF. They were both British banks, both owned by Icelandic banks and both still liquid, and as it turned out, both definitely solvent at the time. When Darling was later asked why RBS was saved, but not KSF, he replied that RBS was a British bank. But so was KSF. When this was pointed out to Darling, he replied that unlike KSF, RBS was systemically important.⁷⁷ But one of the banks which received help from the British government was Bradford & Bingley which could by no means be called systemically important to the UK banking sector and whose branches and deposits were actually sold to a Spanish bank a week before the Icelandic-owned banks in the UK were closed down. And certainly KSF was systemically important to the Icelandic banking sector: Its demise brought about the fall of the last remaining Icelandic bank and thus the collapse of the Icelandic banking sector. It should not be forgotten, also, that its demise affected the many British citizens who worked for Icelandic-owned companies and also British depositors and creditors, even if they eventually recovered most of their money.

⁷⁵ Hansard 8 October 2008, Columns 279–282.

<http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm081008/debtext/81008-0004.htm>

⁷⁶ SIC Report, Vol. 7, Ch. 20, p. 170.

⁷⁷ Interview with Alistair Darling in London 11 December 2013.

Chapter Six

The Use of an Anti-Terrorism Act Against Iceland

By two actions which UK Chancellor Alistair Darling announced on Wednesday 8 October 2008, to put the Icelandic-owned British bank KSF into liquidation, while other British banks were bailed out, and to issue a Freezing Order under an Anti-Terrorism Act against Landsbanki and certain Icelandic authorities, the British government made any kind of a rescue of the Icelandic banking sector impossible.

1. Haarde's Phone Call to Darling

As a result of KSF's close-down, Kaupthing in Iceland was forced into liquidation, because its credit was contractually dependent on the position of its subsidiaries. The Freezing Order against Landsbanki and certain Icelandic authorities immediately made all transfers of money to and from Iceland almost impossible and therefore all negotiated solutions to the many problems arising in a couple of days in the Icelandic banking sector.¹ Needless to say, the Icelandic authorities were stunned by these two actions. As soon as Prime Minister Geir H. Haarde realised what the UK government had done, he tried to contact UK Prime Minister Gordon Brown who was however not available.

Haarde was put through to Chancellor Darling who later described their conversation which took place Thursday 9 October, as Darling was preparing to leave for an IMF summit in Washington DC:

I had spoken to the prime minister [Geir H. Haarde] on the previous Thursday morning to tell him a letter outlining our plans to save UK depositors' money was on its way. We would need to work together, I told him, and I offered to send a Treasury team to Iceland to see if matters could be resolved and something salvaged from the wreckage. He would issue a statement, he said, putting on record his appreciation of the help the UK government was giving depositors—as well he might. His gratitude had been short-lived. Landsbanki, with its UK subsidiary and Kaupthing, would be put into liquidation later in the day. We were going to use the Northern Rock legislation to transfer Kaupthing's UK subsidiary operations to the Dutch bank ING. But I saw no alternative to freezing the assets of Landsbanki, or Icesave as it was known here.²

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

In his account of the conversation with Prime Minister Haarde, Chancellor Darling

¹ The Landsbanki Freezing order. <http://www.legislation.gov.uk/ukxi/2008/2668/made>

² Darling, *Back from the Brink*, p. 166.

reverses the sequence of events. He speaks as if Landsbanki and its UK subsidiary Heritable Bank and Kaupthing were put into liquidation “later in the day”, after his conversation with Haarde. But both the Landsbanki UK branch and Heritable Bank had been closed down in the evening of Monday 6 October, as a result of the IFSA taking Landsbanki in Iceland over and appointing a resolution committee for the bank. As a British (indeed Scottish) bank, Heritable Bank had been put formally into resolution by the FSA Tuesday 7 October. The UK Treasury had then, in the morning of Wednesday 8 October, issued the Freezing Order against Landsbanki based on the Anti-Terrorism Act. The British bank owned by Kaupthing, KSF, was put into resolution by the FSA in the afternoon of Wednesday 8 October, after Darling had already announced it in the morning.³ All this had happened before Prime Minister Haarde spoke to Chancellor Darling on Thursday 9 October.

The transcript of the conversation reveals that Prime Minister Haarde told Chancellor Darling that Paul Myners, the Financial Services Secretary, had called Icelandic Finance Minister Arni M. Mathiesen the previous day to try and explain the use of the Anti-Terrorism Act against Iceland and that they had agreed that things had to be calmed down and put into proper channels. Mathiesen had suggested that the UK authorities send some people to Iceland to see for themselves how the situation was.⁴ It was not Darling, as he somewhat haughtily says himself, who “offered to send a Treasury team to Iceland to see if matters could be resolved and something salvaged from the wreckage”. Haarde said to Darling that he had issued a statement expressing his appreciation for the concerns which the UK government had about depositors in the Icesave accounts.⁵ But he added: “I have had to make some strong statements in the news here about your acting on authority and legislation against terrorism in our case. We don’t think that’s very friendly, but ...”⁶ Then, Darling interrupted him, repeating what he had said earlier in the conversation that the UK government had had to use the powers it had. Haarde returned to the use of the Anti-Terrorism Act against Iceland, expressing the hope that it would not affect the good relations between Iceland and the UK, continuing: “But I was forced to use some strong language about this application of the terrorism law. We are not terrorists.” Darling replied: “I know you’re not, *whatever else you are*.”⁷ The last remark cannot be said to be gracious, in a conversation with an understandably shaken representative of a small nation who had ample reason to fear the collapse of the whole economy of his country and her international isolation.

2. *There Was an Alternative to the Freezing Order*

The crucial point is that Chancellor Darling is mistaken in his assertion that there was no alternative to issuing the Freezing Order under the Anti-Terrorism Act against Landsbanki and certain Icelandic institutions, such as the CBI and the IFSA. The

³ Cf. Ch. 5 in this report.

⁴ Mathiesen, *Arni Matt*, p. 60.

⁵ This was a very cautiously composed statement from the Prime Minister’s Office 8 October 2008. <https://eng.forsaetisraduneyti.is/news-and-articles/nr/3039>

⁶ Haarde said afterwards to reporters: “I told the Chancellor that we consider this to be a completely unfriendly act.” Patrick Wintour and Audrey Gillan, Lost in Iceland: £1 billion from councils, charities and police, *Guardian* 10 October 2008. <http://www.theguardian.com/business/2008/oct/10/banking-iceland>

⁷ The transcript was made available by the Prime Minister’s Office under the Icelandic Law of Information Act. Italics added.

confidential Supervisory Notice which the FSA had issued on 3 October 2008 to the Landsbanki UK branch had expressly prohibited all transfers of the bank's assets out of the UK without the written permission by the FSA, after a written advance notice of at least three days. Such supervisory notices are issued to a target bank if it is deemed to be in breach of a rule or if it is regarded as a risk. They are usually only issued to the target bank concerned and are strictly confidential because otherwise those doing business with the bank might decide to reduce exposure to it or even cease to trade with it.⁸ It seems that the FSA also informed Barclays about the Supervisory Notice because that bank handled payments for the Icesave accounts. Since Barclays knew about the Supervisory Notice issued on 3 October, it imposed restrictions on Landsbanki's UK branch before the Freezing Order was issued on 8 October by the Treasury.⁹ A British banker with thorough knowledge of the Landsbanki operations in the UK comments: "The Freezing Order, in my opinion, was like using a sledge hammer to crack a nut. I don't think it should have ever been issued. The same result could have been achieved through the medium of an upgraded Supervisory Notice."¹⁰

In his book on the crisis, Darling comments on the Freezing Order: "Unfortunately, this legislation was contained in an anti-terrorism measure passed in 2001. Because of that, our action was open to the mistaken impression that we regarded Landsbanki—or, even worse, Iceland—as a terrorist organization."¹¹ The fact remains, however, that immediately after the Freezing Order was issued on 8 October 2008, Landsbanki, the CBI, and the IFSA were put on the list of terrorist organisations the UK Treasury maintains on its website. The CBI and other Icelandic institutions were quickly removed from the list, but on 10 October 2008 the list was the following under the headline "Current Regimes" which were subject to financial sanctions:

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

Landsbanki remained on this list until 22 October 2008 when a special section was created for it on the website below the regular list of organisations subject to financial

⁸ FSA, First Supervisory Notice, 3 October 2008.

http://www.fsa.gov.uk/static/pubs/final/landsbanki_3oct08.pdf

⁹ Information from the staff at Landsbanki's UK branch.

¹⁰ A senior British banker. Cf. Interview with Lilja Bjork Einarsdottir in London 3 March 2016.

¹¹ Darling, *Back from the Brink*, p. 166.

sanctions under the Anti-Terrorism Act. This change was not made on a British initiative, but at the request of Icelandic authorities.¹² The British authorities amended the Freezing Order several times, but showed great reluctance to cancel it. In fact, it was only cancelled after the British and the Icelandic government reached an agreement in June 2009 about the reimbursement by Iceland of the compensation paid by the UK government to Icesave depositors—an agreement which was later voted down by the Icelanders, even if the Freezing Order was not then reimposed.

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

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

3. Brown's Hostile and Inaccurate Comments about Iceland

Whereas Chancellor Darling and Prime Minister Haarde politely agreed in their telephone conversation on 9 October that their two nations should try to resolve the Icesave issue without sacrificing their traditionally good relationship, the same day Prime Minister Brown made some aggressive comments. On the television station Sky he said that it was very unusual that a whole country like Iceland was basically bankrupt.¹³ He added: "The issue is basically this. The Icelandic banks have collapsed, the Icelandic authorities have to take some responsibility for it. They cannot just default and say that they're going to take on none of the responsibility for what has happened." Brown also said: "But the responsibility for this lies fairly and squarely with the Icelandic authorities, and they have a duty in my view to meet the obligations that they owe to citizens who have invested from Britain in Icelandic banks."¹⁴

In an interview with BBC the same day, 9 October 2008, Brown said:

What happened in Iceland is completely unacceptable. I've been in touch with the Icelandic prime minister. I said that this is effectively illegal action that they have

¹² SIC Report, Vol. 7, Ch. 20, pp. 152–3.

¹³ Gudsteinn Bjarnason, *Abyrgdin er alfarid hja Islendingum* [The Responsibility Lies Solely with the Icelanders], *Frettabladid* 10 October 2008 (account of the interview with Brown). http://timarit.is/view_page_init.jsp?pageId=4008512 Unfortunately, Sky Television has not kept the tapes from this interview so a transcript in English is not available.

¹⁴ Brown Blasts Iceland Over Banks, Sky News, 10 October 2008. <http://news.sky.com/story/640086/brown-blasts-iceland-over-banks> See also SIC Report, Vol. 7, Ch. 20, p. 153.

taken. We are freezing the assets of Icelandic companies in the United Kingdom where we can. We will take further action against the Icelandic authorities wherever that is necessary to recover the money.

He added: “But this is fundamentally a problem of an Icelandic-registered company, Icelandic-registered financial services authority — they have failed not only the people of Iceland, they have failed people in Britain.”¹⁵

There is some evidence that it was Prime Minister Brown who made the ultimate decision to invoke the Anti-Terrorism Act against Iceland.¹⁶ He showed no less hostility towards Iceland than his Chancellor. But Brown’s comments to the press on 9 October are misleading or inaccurate on several counts.

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

In the second place, Brown seemed to assume, without argument, that the obligations of private companies were also the obligations of the Icelandic government—just as if losses incurred by a US company operating abroad, for example Citibank, were somehow to be transferred on to the US government. Certainly, the Icelandic authorities were responsible for passing the relevant laws and regulations required by membership in the EEA, and for regulating the Icelandic financial market in a proper way. But this is quite different from asserting that there was a legally binding government guarantee of deposits in the Icelandic banks. No such guarantee could be deduced from the laws and regulations in force at the time, as lawyers argued at the time and as courts eventually concluded.¹⁷

Thirdly, Brown had only been in contact with Prime Minister Haarde once during the crisis, Sunday 3 October, about a possible illegal action by Kaupthing, which was supposed to be a transfer of an immense amount of money from the UK to Iceland. Haarde had told him that the bank managers maintained that this was a misunderstanding, as it turned out to be: KSF had not transferred any money to Iceland, whereas it had paid some margin calls for its parent company and not been able to draw on a swap agreement with it of which the FSA staff had been informed long before. In fact, in the first days of October, some money had been transferred in the opposite direction, from Iceland to the UK.

Fourthly, Brown said that the British authorities were freezing “assets of Icelandic companies in the UK” wherever possible. This was not in accordance with the Freezing Order, which was directed against Landsbanki on the one hand and certain Icelandic authorities on the other hand. After a conversation between the Icelandic Ambassador to the UK, Sverrir H. Gunnlaugsson, and the Prime Minister’s adviser

¹⁵ Iceland criticised by Gordon Brown, BBC 9 October 2008.

http://news.bbc.co.uk/2/hi/uk_news/politics/7662131.stm SIC Report, Vol. 7, Ch. 20, p. 152.

¹⁶ In conversations with people at the CBI this is claimed by unnamed sources that were close to the staff at 10 Downing Street, the Prime Minister’s Office.

¹⁷ SIC Report, Ch. 17 (which is also published in an English translation and which is all about legal aspects of deposit guarantees), <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli17Enska.pdf> Judgement of the EFTA Court, 28 January 2013. http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf

on International Economic Affairs and Europe, Jon Cunliffe, the Ambassador received a letter 11 October 2008 where Cunliffe stated that the government had not taken action against Icelandic companies other than Landsbanki.¹⁸ But this letter was not made public, and in practice almost all Icelandic companies doing business in the UK, and in many other places, in the next few months felt the severe repercussions of Brown's words.

4. Brown Reveals British Pressure on the IMF

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

During the days that all this was happening, and they were collapsing, you talked about illegal action [sic] of the government. I would like if you could clarify that. Also, why was it necessary to use terrorist legislation against one bank when there was another legislation used against another bank? The fact that we have got this terrorist stigma has greatly aggravated the problems in Iceland and possibly brought down the value of the bank, which of course is counter to UK interests. And lastly, is the UK government in some way trying to boycott the IMF loan to Iceland?¹⁹

Brown replied:

The answer to the last question is no, to the first two questions is we did everything completely appropriately. First of all there was an issue about money that had been taken out of London and returned to Iceland and we wanted back in London and it was right and proper that that should happen. Secondly, it was right that in conditions where there were huge debts owed in London, we could take powers to control the assets of the bank in London. We did everything properly by the book and within the law of our country.²⁰

Here again, Brown's statements are misleading or inaccurate. First, he did not really respond to the request made by the reporter that he would clarify previous comments about illegal actions taken by the Icelandic government.

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

At his 12 November press conference, Brown categorically rejected the allegation that the UK was trying to block the implementation of an IMF programme for Iceland until Iceland had given in to British demands in the Icesave dispute. The facts of the matter are different. On 24 October 2008, an IMF staff mission and the Icelandic

¹⁸ SIC Report, Vol. 7, Ch. 20, pp. 158–9.

¹⁹ Transcript of press conference 12 November 2008.

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

²⁰ Op. cit.

government reached an agreement about an economic recovery programme for Iceland, including a \$2.1 billion loan facility.²¹ But the IMF Executive Board several times postponed putting this agreement on its agenda. It was an open secret that the delay was because at the IMF the British and the Dutch governments refused to accept the agreement until the Icelandic government had given in to their demands in the Icesave dispute. Finally, the Icelandic government announced on 17 November 2009 after consultations in Brussels with EU institutions and member states, that “All parties concluded that the Deposit Guarantee Directive has been incorporated in the EEA legislation in accordance with the EEA Agreement, and is therefore applicable in Iceland in the same way as it is applicable in the EU Member States.”²² Even if somewhat ambivalent, this announcement could be interpreted as recognising a government guarantee of the obligations of the IDIGF regarding the Icesave deposits. Only two days after the Icelandic government had agreed to these so-called “Brussels Guidelines,” the IMF Executive Board accepted the recovery programme for Iceland.

Staff members of the IMF indirectly admitted the connection to the Icesave dispute when they explained that the delay by the IMF Executive Board in accepting the agreement was because some countries contributing to the recovery programme had set the precondition that Iceland should recognise the British and Dutch claims in the Icesave dispute.²³ Be that as it may, Prime Minister Brown was clearly not telling the truth when he denied that the British government was blocking the IMF loan to Iceland. It was doing so, behind the scenes, with diplomatic pressure on the IMF, Iceland and the IMF member states contributing financially to the recovery programme. The four Nordic countries bowed to the pressure, but neither the Faroe Islands nor Poland.²⁴

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

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

²¹ IMF, Press Release no. 08/256, 24 October 2008.

<https://www.imf.org/external/np/sec/pr/2008/pr08256.htm>

²² Icelandic Ministry of Foreign Affairs, Agreed Guidelines reached on deposit guarantees, Press Release 17 November 2008. <https://www.mfa.is/news-and-publications/nr/4641>

²³ IMF, Conference Call with Poul Thomsen, IMF Mission Chief for Iceland and Deputy Director in the IMF European Department, 20 November 2008.

<https://www.imf.org/external/np/tr/2008/tr081120.htm>

²⁴ It did not help, according to then Finance Minister Arni M. Mathiesen that the representative of the Nordic and Baltic countries on the IMF Executive Board, Jens Henriksson from Sweden, was openly hostile to Iceland. Interview with Arni M. Mathiesen in Reykjavik 1 August 2014. Henriksson later became director of Swedish pension fund and insurance company Folksam, one of the buyers of FIH Bank in Denmark.

authority lost money as a result, which means that certain precedents would be set. We have to look at the matter in the round, and we will do so.²⁵

Several things should be noted about this exchange.

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

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

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

5. The Brutal Treatment of the Icelanders in a European Perspective

In retrospect, the harsh treatment of Iceland, both her banks and her institutions, by Prime Minister Gordon Brown and Chancellor Alistair Darling seems extraordinary and inexplicable on their own premise which was to protect British depositors in Icelandic banks. All their accusations in several phone calls to Icelandic government ministers about illegal transfers turned out to be unfounded. The two Labour politicians needlessly closed down the two British banks owned by Icelanders both of which turned out to have been solvent at the time; and they needlessly invoked an Anti-Terrorism Act against an Icelandic bank as well as against Icelandic authorities whereas adequate measures had already been taken to hinder any illegal transfers from the UK. While Brown accused the Icelanders of illegal actions, his government refused to refer the Icesave dispute to the courts, and both he and Darling almost consistently confused the two Icelandic banks operating in the UK, one of which was directly regulated by UK authorities.

Brown and Darling were also wrong in asserting that the Emergency Act passed by the Icelandic Parliament Monday 6 October implied illegal discrimination between

²⁵ Hansard 6 May 2009, Column 172.

<http://www.publications.parliament.uk/pa/cm200809/cmhansrd/cm090506/debtext/90506-0003.htm>

Icelandic and British depositors. What the Act really did was to discriminate between *all depositors* on the one hand and *other claimants*, such as bondholders, on the other hand. The announcement made by government ministers at the same time that the Icelandic State would guarantee all domestic deposits was similar to announcements made in several other European countries at the height of the financial crisis, for example in Ireland, Denmark, Germany and Greece; it was designed to reduce tension and was not in any way legally binding.

An indication of how unusually harsh the treatment of Iceland by the UK Labour government was can be found by comparing it with Germany's response to the Icelandic crash. In fact, German banks, being the main creditors of Icelandic banks, stood to lose much more money than any British citizens from the Icelandic bank collapse and by the Emergency Act, whereby depositors, including British depositors, gained priority over all other creditors, including German banks. It is estimated that of the total \$46 billion wholesale debt of the Icelandic banks, \$21 billion, or almost half, was owed to German banks.²⁶ Many of the German banks extending credit to the Icelandic banks were states banks, *Landesbanken*, located in the various states of the German Federal Republic and usually partly owned by those states. They had traditionally enjoyed guarantees from their respective states, but at the insistence of the European Commission, they lost this privilege in mid-2005.²⁷ But in the heyday of cheap credit, they had been willing lenders to the Icelandic banks. Moreover, Germany's largest bank, Deutsche Bank, had often worked on projects with Kaupthing Bank. Just before the credit crunch started, in 2007, Deutsche Bank had also financed a leveraged buyout of a drug company by one of Landsbanki's two main shareholders, Thor Bjorgolfsson. During the crisis, it was stuck with this debt, a hefty €4 billion, which was indeed its largest single exposure.²⁸

In Germany, Landsbanki had not started any deposit collection into its Icesave accounts, but the Kaupthing Edge accounts offered in Germany were operated from a branch, not a subsidiary, so that they were covered by the IDIGF, Icelandic Depositors' and Investors' Guarantee Fund, just like the Icesave accounts in the United Kingdom.²⁹ At the end of September 2008, the total amount in Edge accounts in Germany was €532 million.³⁰

Thus, both German banks and German depositors had ample cause to worry about the Icelandic bank collapse. But unlike Brown and Darling, German government ministers did not make hostile comments about Iceland as a country, let alone close down Icelandic companies or use an Anti-Terrorism Act against the CBI, the IFSA and an Icelandic bank. There was also a great difference between the refusal, in April to September 2008, of European central banks (including the Bank of England) and the US Federal Reserve System to provide liquidity to Icelandic banks and the actions directly undertaken against the banks, in early October, by the British Labour

²⁶ Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 46.

²⁷ Edward Taylor, German Banks Lose an Edge, *Wall Street Journal* 14 July 2005. European Commission, 28 February 2002, ip/02/343. http://europa.eu/rapid/press-release_IP-02-343_en.htm

²⁸ Bjorgolfsson, *Billions to Bust*, p. 140.

²⁹ This was also the case in Finland, Sweden, Norway, and Austria. Elsewhere, the accounts were in a subsidiary, in the UK and the Isle of Man, and in Belgium, Luxembourg, Switzerland and Denmark, and covered by the deposit-guarantee schemes of the host countries.

³⁰ SIC Report, Vol. 6, Ch. 18, p. 3 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enskal.pdf>

government with the apparent aim of bringing them down. Not helping someone who is struggling to keep herself afloat is not tantamount to actively pushing her down.

6. Political Motives

It seems that the actions taken by Prime Minister Gordon Brown and Chancellor Alistair Darling against Iceland were politically motivated, even if the two of them would probably never admit to this and even if it perhaps could never be conclusively proved, only deduced from ‘the logic of the situation’ in Karl Popper’s sense.³¹ Brown and Darling may have had several intertwined motives. One could be to divert attention from the fact that those two Scottish politicians were using taxpayers’ money to rescue two big and not very popular Scottish banks, the RBS and HBOS.³² The rescue package which Brown and Darling presented Wednesday 8 October 2008 was really aimed at those two banks because they were the ones in grave difficulties. The other big or systemically important British banks, Lloyds, HSBC and Barclays, were much sounder, even if Lloyds came to suffer from having to take on HBOS, at the initiative of the government.

A related motive may have been to demonstrate to the many Scottish voters who had been abandoning Labour for the Nationalists that independence certainly could have its own costs. Both Brown and Darling mentioned, in their books already quoted, the slogan coined by the Scottish nationalists of ‘an arc of prosperity’ reaching from Ireland through Iceland to Norway, in which Scotland should be included. Brown commented: “It is an idea that has been fatally undermined by events in Ireland and Iceland.”³³ Darling wrote: “Iceland, along with Ireland, was part of what Scotland’s nationalist first minister, Alex Salmond, liked to refer to as an ‘arc of prosperity’, to which he yearned to attach Scotland. It was now an arch of insolvency.”³⁴ The slogan ‘arc of insolvency’ was actually used immediately after the bank collapse by Labour’s Scottish secretary Jim Murphy. “Look at this arc of prosperity, what some commentators are now calling calling the arc of insolvency: Iceland, Ireland and Norway,” Murphy told a Sunday newspaper. “Iceland as a country is on the verge of bankruptcy. Ireland is officially in recession. Ireland [sic] and Norway are trying to borrow from the US and Russia. That’s not Scotland’s destiny. Scotland isn’t Iceland and it shouldn’t be Iceland and as long as I’m doing this job, I don’t want Scotland to be Iceland.”³⁵ A headline in *Financial Times* is particularly revealing: “Smoked Salmond; There is less sense than ever to an independent Scotland.”³⁶

The Icelandic bank collapse in early October 2008 was water on Labour’s mill in Scotland. Less than a month later, a by-election was held in the Scottish constituency

³¹ See Note on Methodology in the beginning of this report.

³² This possible explanation was for example speculated by Mark Sismey-Durrant in an interview in London 28 November 2014.

³³ Gordon Brown, *My Scotland, Our Britain*, p. 281.

³⁴ Darling, *Back from the Brink*, p. 138.

³⁵ Murphy in ‘arc of insolvency’ attack on SNP, *The Herald* 12 October 2008.

http://www.heraldscotland.com/news/12366669.Murphy_in_apos_arc_of_insolvency_apos_attack_on_SNP/ When Murphy is quoted as saying that Ireland and Norway are trying to borrow from the US and Russia, he must have meant Iceland and Norway: Ireland, a member of the euro zone, did not try to borrow money from Russia.

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

of Glenrothes in Fife, on 6 November 2008. The seat had fallen vacant when the previous MP had died on 13 August. Glenrothes, located next to Prime Minister Brown's constituency of Kirkcaldy and Cowdenbeath, had long been a Labour stronghold. Shortly before, however, in July 2008, Labour had lost a traditionally safe seat in East Glasgow to the SNP. Labour's margin in the last election had been higher in East Glasgow than in Glenrothes. Brown, apparently expecting another defeat, had set the election day unusually late, after the conferences of the main political parties and the Trade Union Congress.³⁷

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

Alex Salmond, the first minister, has cited the so-called northern 'arc of prosperity' — from Ireland to Finland via Iceland and Norway as all small countries doing well: we can too, he says. Now things look different. Iceland has gone bust, Ireland has cut spending and raised taxes to pay for its unilateral bank bail-out. Even Norway's famous oil fund has shrunk as stocks, as well as oil prices, tumble. After a Scots columnist coined the phrase 'arc of insolvency' Jim Murphy, the new and keen Scottish secretary, adopted it.³⁸

The result of the by-election was a surprise: While the SNP had been expected to win the seat, Labour retained it, albeit with a reduced margin. This was widely seen as a triumph for Prime Minister Brown. A political commentator, Alex Massie of the *Spectator*, wrote: "Salmond's unfortunate past praise for Iceland came back to make him seem foolish in the extreme, while the government bailouts of HBOS and, in particular, the national champion, RBS dented the idea of Scotland and Scottish success—the kind of tartan brio that was supposed to float all boats upon a nationalist tide."³⁹

Four years later, in 2012, Alistair Darling, now former Chancellor, officially launched the 'No' campaign before the 2014 Scottish independence referendum, and he was one of its leading figures. One of the principal issues in the referendum was the economy. In May 2013, the UK Treasury published a report where much was made of the 2008 bank rescue. It was pointed out that the size of the Scottish banking sector was around 12 times the GDP of Scotland, whereas the size of the Icelandic banking sector before the collapse had been almost 9 times the GDP of Iceland. In the report it was recalled that the UK government spent £45 billion recapitalising RBS, and that in addition the bank received £275 billion of state support in the form of guarantees and funding. This would have been 211% of Scotland's GDP. "Scotland would not have been able to afford such interventions alone. Other countries such as Ireland, Iceland and more recently Cyprus were unable to absorb the implications of the financial crisis on their own." By contrast, it was also pointed out that the total interventions across the whole banking sector were £1,200 billion or 76% of the

³⁷ Iain Watson, Don't expect an early by-election, BBC News, 13 August 2008. http://news.bbc.co.uk/2/hi/uk_news/politics/7558533.stm

³⁸ Michael White, 'Insolvency Arc' may influence Scottish poll, *The Guardian* 20 October 2008. <http://www.theguardian.com/commentisfree/2008/oct/20/snp-scotland-salmond-labour-brown>

³⁹ Alex Massie, Glenrothes By-Election Stunner, *Spectator* 7 November 2008. <http://blogs.spectator.co.uk/2008/11/glenrothes-byelection-stunner/>

whole UK GDP.⁴⁰

Thus, the Icelandic bank collapse proved to be very useful to Labour politicians trying to counter the strong SNP challenge in Scotland: They could demonstrate the danger for a small nation of not having access to credit facilities in crises. In addition to the ‘Scotland factor’ a ‘Falklands factor’ may also have been at play. By hitting Iceland hard, Prime Minister Brown and Chancellor Darling achieved the double goal of placating worried depositors and demonstrating their toughness, with the advantage that there were almost no political risks or costs attached. This was clearly seen at the time. Journalist Adrian Gill who visited Iceland for the *Sunday Times* during the collapse, commented:

The act that tipped the last Icelandic bank off the edge of the cliff was delivered by Gordon Brown. ... The Icelanders mind that—they’re hurt by that. You see, they always imagined they were one of us, not one of them. But Gordon needed to do something cheap to look competent, so he beat up a smaller kid. Not just a bit of a slap, but a vicious kicking. Showing off to impress the girls. He would never have started it if the banks had been German or French, or even from Liechtenstein.⁴¹

It is at least safe to say that if the Prime Minister had had any inkling that a US financial firm collecting deposits in the UK had been or was transferring money to the US in an irresponsible and possibly illegal way, he would not have spoken and behaved in the same way to the US Treasury and the US Federal Reserve as he did to the Icelandic authorities. Indeed, the support for Labour temporarily increased in the midst of the financial crisis and after the harsh measures taken against Iceland.⁴²

A fifth possible motive behind the treatment of Iceland by the two Scottish Labour leaders may be discernible, in addition to those of diverting attention from the rescue of the two big Scottish banks, demonstrating to the Scots the perils of monetary independence, placating worried depositors and showing firmness at little political risk. This was to improve the bargaining position of the UK against Iceland in the Icesave dispute. The use of the Anti-Terrorism Act was very costly and difficult for Icelandic companies, even if formally it was only directed against Landsbanki and certain Icelandic institutions. This view is supported by the fact that the UK government did not repeal the Freezing Order until the first Icesave deal had been made and signed in June 2009. If there ever had been any risk of illegal transfers from the UK to Iceland, then surely it had disappeared long before that. For example, the UK government ignored a plea jointly made by all foreign minister of Nordic countries in early January 2009 to repeal the Freezing Order.⁴³ Finally, whatever motives drove Prime Minister Brown and Chancellor Alistair Darling in their dealings with the Icelanders, their use of the Anti-Terrorism Act at least showed a

⁴⁰ *Scotland analysis: Financial services and banking* (London: HM Treasury, May 2013), pp. 7–8 and 23.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/200491/scotland_analysis_financial_services_and_banking_200513.pdf

⁴¹ Adrian A. Gill, Iceland: Frozen Assets, *Sunday Times*, 14 December 2008. Repr. at <http://agbjarn.blog.is/blog/agbjarn/entry/744252/>

⁴² Stephen D. Fisher, Issues in national politics, *European Journal of Political Research*, Vol. 48 (2009), pp. 1133–39. <http://onlinelibrary.wiley.com/doi/10.1111/j.1475-6765.2009.01894.x/full>

⁴³ Kristrun Heimisdottir, Icesave og umsomdu vidmidin [Icesave and the Agreed Criteria], *Morgunbladid* 13 August 2009, p. 21. http://timarit.is/view_page_init.jsp?pageId=5260694

great distrust of the Icelandic authorities: The premise in invoking the Act was that even the CBI, the IFSA and the Icelandic Ministry of Finance possibly could be assisting Icelandic banks in transferring assets illegally out of the UK.

7. *Voices in Protest*

It should be noted, however, that a few voices were raised protesting against the treatment of Iceland by the British Labour government. Privately, Bank of England Governor Mervyn King expressed his view to government ministers that it was demeaning for the United Kingdom to behave in this way to a tiny neighbour.⁴⁴ Labour MP Austin Mitchell wrote a personal letter to his party leader, Prime Minister Brown: “The immediate response of criticising Iceland, invoking anti-terrorist legislation and seizing assets was, in my view, heavy handed, counterproductive and excessive.”⁴⁵ Dr. Eamonn Butler of the Adam Smith Institute in his *Daily Telegraph* blog strongly criticised the measures taken against Iceland.⁴⁶ Perhaps the most public and impassioned protest came in an article in *The Times* by MEP Daniel Hannan who argued that the government clearly had abused its powers in its attack on Iceland, “until last week perhaps the most Anglophile country in Europe”.⁴⁷

⁴⁴ Interview with Mervyn King in Petham Oast 14 August 2017. Lord King explicitly gave permission to quote him on this.

⁴⁵ Austin Mitchell to Gordon Brown 17 October 2008, copies sent to a few Icelandic leaders. The letter was not made public, but a copy is in the possession of the main author of this report.

⁴⁶ Eamonn Butler, Financial crisis: an open letter to the people of Iceland (2008), http://blogs.telegraph.co.uk/news/eamonnbutler/5467827/Financial_crisis_An_open_letter_to_the_people_of_Iceland/

⁴⁷ Daniel Hannan, Gordon Brown’s raid on Iceland was cowardice, not courage, *The Times* 15 October 2008.

Chapter Seven

Sale of Bank Assets in Norway, Finland and Sweden

After the bank collapse, in Norway, Finland and Sweden assets of the fallen Icelandic banks were quickly sold, sometimes for a fraction of their real worth, with local businessmen in some cases apparently receiving special favours from the authorities.

1. Icelandic Investments in the Nordic Countries

When Kaupthing and the other two Icelandic banks, Landsbanki and Glitnir, started expanding abroad in the early 2000s, they sought to define themselves as Nordic rather than Icelandic banks.¹ This was perhaps not surprising because the four other Nordic countries, Denmark, Sweden, Norway and Finland, are in many ways much closer to Iceland than other European countries: Iceland originally had been settled mostly from Western Norway, and briefly it had been a tributary of the Swedish king, and for centuries a Danish dependency. From the 1870s to the beginning of the First World War, the three Scandinavian countries (and Iceland as a part of the Danish realm) formed what was for most purposes a common market with a single currency, as the three Scandinavian countries maintained a monetary union with interchangeable and equivalent “Crowns” (*kroner*, *kronor* or *kronur*), all based on the gold standard. Danish, mutually intelligible with Norwegian and Swedish, was long the first foreign language in Icelandic schools, and many Icelanders were educated or had worked in the three Scandinavian countries.

While the five Nordic countries each went her own way during the Second World War and while the three Scandinavian countries could not agree on establishing a defence alliance after the War, the Nordic Council, a symbol of shared values and common aspirations and mostly a forum for cultural cooperation, was set up in 1952, with Finland joining in 1955. More importantly, from the Icelandic bankers’ point of view, all five Nordic countries were members of the European Economic Area, EEA, which was supposed to be an internal market governed by the same rules, “on the basis of equality and reciprocity,” irrespective of the nationality of individual businesses, even if Norway and Iceland, unlike Sweden, Denmark and Finland, remained outside the European Union, EU.²

The rapidly expanding Icelandic banks were received coolly in the other four Nordic countries, however. Even if they brought considerable amounts of money into the

¹ This was explicitly stated in an interview with Sigurdur Einarsson, Kaupthing’s Chairman of the Board, Haraldur Johannessen and Soffia Haraldsdottir, “Taekifaerissinnadur banki” [A Bank Seizing Opportunities], *Morgunbladid* 24 June 2004 (Business Section). pp. 4–5.

http://timarit.is/view_page_init.jsp?pageId=3567479

² The EEA Agreement, <http://www.efta.int/media/documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.pdf>

local economies, they were regarded by many as upstarts or even intruders. “Their aggressive tactics, most akin to American broker-dealers, were bound to stir resentment in Scandinavia,” Kaupthing’s Chief Economist Asgeir Jonsson says.³ When the Icelandic banks started also to collect retail deposits in the Nordic countries, the hostility of local competitors increased, although the money was mainly invested in local businesses. Be that as it may, the idea of an internal market governed by the same rules, with no discrimination between businesses in terms of nationality, was put severely to the test during the Icelandic bank collapse. Then the Icelanders suddenly discovered that they were treated differently than local businessmen, at least in Norway, Finland and Denmark, with the foreseeable result that assets of the Icelandic banks were sold at very low prices, a fact which was then used against the Icelandic bankers to demonstrate their foolhardiness.

Interesting moral questions arise in such a situation: Would the banks and financial firms in the Nordic countries owned by Icelandic banks have survived if they had received similar help as local companies could expect? When local authorities favoured local businesses over the Icelandic ones, were they acting in the spirit of the EEA Agreement? Were local businessmen playing by the rules, and just acting as alert entrepreneurs, when they seized the opportunities to capture the assets of the Icelandic banks at bargain prices? Some guidance to answering these questions may be sought in the works of the philosophers St. Thomas Aquinas, Friedrich A. Hayek and Robert Nozick, discussed in Chapter 10. In this and the following chapter, the facts of the matter are set out.

2. The Sale of Glitnir Bank in Norway

In Norway, Icelandic Glitnir had a strong presence. Glitnir’s Norwegian subsidiary, Glitnir Bank ASA, had come into being by the purchase and subsequent merger of two Norwegian banks, BNbank in Trondheim and Kredittbanken in Ålesund. Those two banks had been bought by Icelandic Glitnir for NOK 3.4 billion in total. In September 2008, Norwegian Glitnir had book value of equity amounting to NOK 3.1 billion. As a subsidiary, it was regulated by Norwegian authorities and paid taxes in Norway. When Icelandic Glitnir collapsed on 7 October 2008, the NOK 2 billion credit line which Norwegian Glitnir had from it was closed. The management of Norwegian Glitnir contacted the Norwegian Financial Supervisory Authority, NFSA (Kredittilsynet), to inform it that it anticipated liquidity problems. The Norwegian central bank, Norges Bank, refused a request by Norwegian Glitnir to extend an emergency credit line to it and referred it instead to the Norwegian Depositors’ and Investors’ Guarantee Fund, NDIGF (Sikringsfondet). The NDIGF steering board came from Norwegian financial firms. The NFSA informed the NDIGF board that it considered Norwegian Glitnir solvent and recommended that the NDIGF support it until the time a “structural solution” could be found.

The NDIGF board decided on 8 October 2008 to provide a credit line of NOK 5 billion to Norwegian Glitnir and to push for a ‘structural solution’ before 19 October 2008. The credit line was financed by Norges Bank and guaranteed by claims which Norwegian Glitnir had on two of its Norwegian subsidiaries, dealing in household and commercial mortgages considered very solid. To avoid possible problems arising

³ Jonsson, *Why Iceland?* p. 56; cf. Thorvaldsson, *Frozen Assets*, pp. 95 and 99.

out of Norwegian Glitnir's existing loan covenants, the credit was not in the form of a loan or an overdraft facility with collateral: It was the nominal purchase by the NDIGF of Norwegian Glitnir's safest assets with a repurchase option. According to the minutes of the NDIGF board, "The board was also concerned that bank assets would not be reduced in value by selling some parts of the bank in the meantime."⁴ Apparently, Glitnir's Icelandic resolution committee also received a clear message from the NDIGF that the credit line would not be extended.⁵

From 8 to 19 October 2008, outflow from Norwegian Glitnir amounted to NOK 1.5 billion, less than one third of the total credit provided. When the NDIGF board met again 19 October 2008, it concluded that the credit line was sufficient in amount. It was extended to 22 October. At the 19 October 2008 meeting chairman of the board Finn Haugan recused himself, since he was leading a consortium of savings associations which in the meantime had made an offer for the bank. The board decided to recommend accepting Haugan's offer. There was another tentative offer, from another Norwegian consortium of savings associations and mutual insurance companies, but to prepare a final version of it was supposed to require more time. The sale was concluded 21 October, with the consent of the Icelandic Glitnir resolution committee. Haugan's Sparebank 1 SMN bought 25% of the bank and other members of the consortium the remaining 75%. The total price paid for the bank was NOK 300 million, less than 10% of book value of equity. The sale was not handled by Glitnir's resolution committee in Iceland, but by a Norwegian company, Arctic Securities ASA, led by Jon Gunnar Pedersen. Apparently, potential buyers were told that they would only get the consent of Norwegian authorities to buy the bank if they could guarantee 15 billion Norwegian *kroner*, the total sum of securities claims on the bank which could be cancelled in the case of a change in ownership.⁶

After the sale, the credit line from NDIGF was extended to 5 November and then to 30 November. The new owners hastened to change its name to that of one of its forerunners, BNbank. Three months later, in January 2009, they announced that the bank was valued at NOK 2 billion. When interviewed by an Icelandic newspaper on this extraordinary increase in value over such a short time, Finn Haugan pointed out that he had recused himself from decisions in the NDIGF about the credit line to Glitnir and asserted that he had had no information about how long it was to be in force, only that it was to be for a limited period of time. "Everybody could make a bid for the bank, and some did. The biggest offer was 300 million." He thought there was nothing wrong with the price. "Glitnir in Iceland was in trouble and could not support the Norwegian subsidiary. The Norwegian subsidiary was however perfectly

⁴ *Evaluering av håndteringen av krisen i Glitnir Bank ASA og Kaupthing Bank hf NUF* [Evaluation of the management of the crises in Glitnir and Kaupthing Banks] (Oslo: Bankenes sikringsfond [NDIGF], 9 November 2009), p. 9. This report does not seem to be available on the NDIGF website any more, but before it disappeared it was downloaded by the main author of this report. <http://rse.hi.is/wp-content/uploads/2018/07/Evaluering-av-ha%CC%8Andteringen-av-krisen-sikringsfondet.pdf>

⁵ Thordur Snaer Juliusson, Norskir kaupendur fengu lan framlengt [Norwegian buyers got a loan extension], *Morgunbladið* 4 February 2009, p. 16.

http://timarit.is/view_page_init.jsp?pageId=5246596 NDIGF Director Sonja Lill Flø Myklebust, in an email to Hannes H. Gissurarson 18 February 2014, denies knowledge of any such message. It is not mentioned, either, in the NDIGF report already quoted.

⁶ Thordur Snaer Juliusson, Seldur a brot af raunvirði [Sold for a fraction of real worth], *Morgunbladið* 21 January 2009, p. 4. http://timarit.is/view_page_init.jsp?pageId=5245816 In her email, Myklebust denies knowledge of any such message.

sound, and everybody knew that. But as the mother company could not support its subsidiary, the subsidiary had to be sold.”⁷ A Norwegian business magazine called the purchase “a real bargain”.⁸ The chairman of the board of Haugan’s company said to the magazine: “The purchase of Glitnir Bank was a very good strategic move. It was one of the cheapest bank purchases in the whole of Europe, and it was done by the savings associations with Haugan as the leader.”⁹ However, Arni Tomasson, chairman of Glitnir’s resolution committee, told an Icelandic newspaper that neither he nor anyone else on the committee had known that Finn Haugan had been both chairman of the NDIGF board—the body which in effect forced the quick sale of the bank—and leader of the consortium that bought the bank. Tomasson added that the resolution committee had tried to avoid at all cost that the Norwegian subsidiary would go into receivership because then a £600 million loan from the Icelandic mother company to this Norwegian subsidiary which was due in the summer of 2009 would perhaps not have been paid.¹⁰

3. *The Sale of Glitnir Securities and Other Activities in Norway*

Another Norwegian subsidiary of Icelandic Glitnir was Glitnir Securities. Its book value of equity was about NOK 200 million in early October 2008, when Glitnir collapsed. Immediately afterwards, Sveinung Hartvedt, Executive Vice President of Glitnir Markets, formed a management team offering to buy the company. Hartvedt told a Norwegian newspaper that the price would be “fair” and applauded Glitnir’s resolution committee in Iceland for its “flexibility”.¹¹ The group under Hartvedt’s leadership bought Glitnir Securities on 12 October for NOK 50 million, one fourth of the company’s book value of equity. Glitnir’s Icelandic resolution committee thought that it had no option but to sell: In the circumstances the managers could simply leave the company and take with them the major clients and the knowledge of the company’s operations.¹² Eight days later, the new owners sold 50,01% of the company to the investment company RS Platou ASA for NOK 50 million.¹³ In other words, the management team that bought the company ended up with paying nothing for owning half of a sizeable Norwegian financial firm. According to Norwegian sources this had been the plan all the time.¹⁴ The two companies were merged into a company under the name of RS Platou Markets ASA. It probably facilitated the two deals that Glitnir Securities and RS Platou ASA both were located in the same building, Haakon VII’s gate 10, in Oslo so the staff had had ample opportunities to get acquainted. Only a few months after the merger, Hartvedt sold his shares in the

⁷ Juliusson, *Morgunbladid* 21 January 2009, p. 4.

⁸ Ole-Morten Fadnes, Sparebankenes røverkjøb [The Saving associations’ Real Bargain], *Dagens næringsliv* 16 January 2009. <https://www.dn.no/nyheter/2009/01/16/sparebankenes-roverkjop>

⁹ Sparebanksjef får skryt [Banker Receives Praise], *Dagens næringsliv* 6 April 2009. <https://www.dn.no/nyheter/naringsliv/2009/04/06/sparebanksjef-far-skryt>

¹⁰ Thordur Snaer Juliusson, Vissu ekki um stodu Haugan [Did Kot Know of Haugan’s position], *Morgunbladid* 24 January 2009, p. 20. http://timarit.is/view_page_init.jsp?pageId=5246000

¹¹ Mysen-mann kjøber Glitnir Securities [Local Mysen Boy buys Glitnir Securities], *Smaalenenes Avis* 10 October 2008. <https://www.smaalenene.no/lokale-nyheter/mysen-mann-kjoper-glitnir-securities/s/1-87-3845200>

¹² Interview with Arni Tomasson by phone 28 May 2017.

¹³ Thordur Snaer Juliusson, Eignudust helming Glitnir Securities fritt a atta dogum [Acquired half of Glitnir Securities in Eight Days Without Paying Anything], *Morgunbladid* 29 January 2009 (Business Section), p. 2. http://timarit.is/view_page_init.jsp?pageId=5246306

¹⁴ Gert Ove Mollestad, Fikk gratis meglerhus [Received a Brokerage Free], TV 2 [Television news] 30 October 2008. <http://www.tv2.no/a/2347480/>

company and started his own brokerage.

The two other Icelandic banks also had a presence in Norway. Both Kaupthing and Landsbanki had initiated deposit collection in their Norwegian branches, although only Kaupthing had started it in its Edge accounts. Since deposits in the Edge accounts were collected in a branch, they were guaranteed by the Icelandic Depositors' and Investors' Guarantee Fund, IDIGF, up to the EEA minimum requirement of €20,887, while there was an additional guarantee by the Norwegian fund, NDIGF, up to NOK 2 million (so-called topping up). At the end of September 2008, deposits in Kaupthing's Edge Accounts in Norway amounted to a total of €239 million or almost NOK 2 billion.¹⁵ When Kaupthing collapsed 9 October, the NDIGF, backed by the Norwegian government, guaranteed all deposits, also that part of them nominally covered by the Icelandic Fund which in the circumstances was seen as unable to fulfil its obligations. Kaupthing's Norwegian branch was put into administration. Most deposits were transferred to other banks and others were paid out. In March 2009, the Icelandic Kaupthing estate had paid back all outlays by the NDIGF. The Director of the NFSA, Bjørn Skogstad Aamo, publicly contrasted the successful cooperation between the Norwegian and Icelandic authorities with the heavy-handed treatment of Iceland, including the use of an Anti-Terrorism Act, by the British authorities.¹⁶

Aamo and other Norwegian officials and politicians seem however to have been under the same mistaken impression about the Icelandic Emergency Act of 6 October 2008 as UK Chancellor Alistair Darling: They thought that foreign depositors were being discriminated against by the Act, whereas it in fact expressly established the priority of their claims, whether Norwegian, British or Icelandic, over those of other creditors such as the CBI and bondholders.¹⁷ Aamo suggested, also, that after the collapse "the Icelanders" were busy transferring assets from other countries to Iceland. The truth of the matter was rather that local authorities in some countries, including Norway, were bringing about the transfer of Icelandic-owned assets in their countries at very low prices to well-connected local businessmen.

4. The Sale of FIM in Finland

Glitnir Bank and Glitnir Securities were not the only Nordic examples of real bargains for local businessmen as a result of the Icelandic bank collapse. Such examples could also be found in Finland. In February 2007 Icelandic Glitnir had bought Finnish investment services group FIM for €341 million.¹⁸ The name was changed to Glitnir Corporation, while the firm remained Finnish, subject to Finnish law, paying taxes in Finland and being covered by the Finnish deposit-guarantee scheme. The book value of equity of Glitnir Corporation was €108 million at the end

¹⁵ SIC Report, Vol. 6, Ch. 18, 2 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Ensk1.pdf>

¹⁶ Bjørn Skogstad Aamo and Ole-Jørgen Karlsen, Ingen tapte én krone [Nobody Lost Even a Penny], *Aftenposten* 19 January 2010. <https://www.aftenposten.no/meninger/debatt/i/R9e8a/Ingen-tapte-n-krone>

¹⁷ See also the answer by Finance Minister Kristin Halvorsen to a question in the Norwegian Parliament 19 December 2008. <https://www.stortinget.no/no/Saker-og-publikasjoner/Sporsmal/Skriftlige-sporsmal-og-svar/Skriftlig-sporsmal/?qid=42049>

¹⁸ Glitnir Press Release 5 February 2007. <http://www.vb.is/frettir/glitnir-acquires-majority-in-the-listed-fim-group-31761/>

of 2007 (much less than its price earlier in the year, which means that an Icelandic bank had been pumping €233 million into the Finnish economy). Finnish Glitnir faced the same liquidity problem after the 7 October 2008 collapse of the mother company in Iceland as other subsidiaries and branches of Icelandic banks. A week after the collapse, 14 October 2008, the Finnish Financial Supervisory Authority, FFSA—a unit within the Central Bank of Finland, CBF, with some independence—practically forced the Glitnir resolution committee to sell Finnish Glitnir to a consortium of the firm’s employees for €3,000.¹⁹ They changed the name back to FIM, and at the end of 2008, the book value of equity was €43 million, less than half the book value of equity at the end of 2007, but of course much higher than the price of €3,000 for which the staff had bought the bank.²⁰

One of the first actions of the new owners of FIM, the former Glitnir Corporation, was to obtain permission publicly to use a certificate that the company was truly Finnish.²¹ At the end of 2009, the book value of equity had increased to €49.8 million, and at the end of 2010 to €50.6 million.²² The value of the bank continued to increase as the international financial markets recovered. In May 2013, the owners—the employees who bought the firm 14 October 2008—sold the firm to the Finnish bank S-Pankki, the bank of Finland’s cooperative movement, for €200 million.²³ This was an enormous profit in only four and a half years, more than €199 million. The FFSA refused to answer any enquiries for this report about these transactions.²⁴

5. The Sale of Other Icelandic Assets in Finland

Three other financial firms in Finland were owned by Icelandic banks. In 2007, the investment bank Straumur-Burdaras bought eQ Bank for €260 million, a price far above the book value of equity which was in 2007 €71 million.²⁵ Again, this meant that an Icelandic bank had been pumping money into the Finnish economy. As a subsidiary and not a branch, eQ Bank was regulated by the FFSA. It specialised in internet brokerage and asset management for retail clients.²⁶ Landsbanki had a small Finnish branch which mostly did securities intermediation. Already in 2001, Kaupthing had moved into Finland when it bought the investment company Sofi, paying with its own shares worth €23 million.²⁷ In 2003, it bought a controlling share

¹⁹ Interview with Arni Tomasson by phone 28 May 2017.

²⁰ *Translation of Financial Statements Release. FIM Group Financial Statements Bulletin* (Helsinki: FIM 2008), p. 2. Previously available online, and downloaded by the main author of this report. http://rse.hi.is/wp-content/uploads/2018/07/FIM_acq2008.pdf

²¹ *Ibid.*, p. 3. The organisation that gives out these certificate is called Suomalaisen Työn Liitto.

²² *Translation of Financial Statements Release. FIM Group Financial Statements Bulletin* (Helsinki: FIM 2010), p. 1. Previously available online, and downloaded by the main author of this report. http://rse.hi.is/wp-content/uploads/2018/07/FIM_EN-2010.pdf

²³ T. Kinnunen, T., Finland’s S-Pankki to buy financial group FIM. Reuters 26 May 2013.

<http://www.reuters.com/article/2013/05/28/finland-spankki-idUSL5N0E912E20130528>

²⁴ Terhi Lambert-Karjalainen, Email to Hannes H. Gissurason 25 July 2014. He said that the FFSA had nothing to add to the article by Jukka Vesala, quoted later, to which he referred.

²⁵ *eQ Annual Report 2007* (Helsinki: eQ, 18 March 2008), p. 58. <http://rse.hi.is/wp-content/uploads/2018/07/EeqBank.AnnualReport.2007-1.pdf>

²⁶ Bjarni Olafsson, Straumur kaupir finnska eQ-bankann fyrir 22 milljarda [Straumur Buys Finnish eQ Bank for 22 Billion], *mbl.is* 23 May 2017. <https://www.mbl.is/greinasafn/grein/1146779>

²⁷ Kaup Kaupthings a Sofi stadfest [Kaupthing Purchase of Sofi Concluded], *Morgunbladid* 26 January 2002, p. 16. http://timarit.is/view_page_init.jsp?pageId=3432009 The price was 164 million shares in Kaupthing which amounted to ISK 2.1 billion, or €23 million.

in another Finnish investment company, Norvestia, also paying with its own shares worth 62 million.²⁸ Kaupthing Bank Oyj received its licence and started operating as a subsidiary in 2004, but in 2008 it merged with the parent company and became its Finnish branch. Kaupthing's Finnish branch provided investment services and from November 2007, while still a subsidiary, it also started collecting deposits into Edge accounts. Since the deposits were collected by a branch and not a subsidiary, they were mainly covered by the Icelandic guarantee scheme and only partly by the Finnish one. At the end of September 2008, these deposits amounted to a total of €134 million.²⁹ They were all invested in Finland.

Monday 6 October 2008, with the mounting crisis in the Icelandic banking sector, the FFSA prohibited Glitnir Bank, Kaupthing Bank Branch and eQ Bank from transferring assets out of Finland to their parent banks or to foreign subsidiaries of their parent groups. On 9 October 2008, in the morning, Finnish depositors in Kaupthing's Edge accounts could not access them, as the parent bank had closed down its online banking connection. Consequently, the FFSA suspended the operations of the Kaupthing Finnish Branch, with the consent of the IFSA. On 20 October 2008 the Kaupthing Finnish Branch started again providing investment services, but the deposits remained inaccessible. The Finnish authorities—the FFSA, the Central Bank of Finland, the Finnish Finance Ministry and the Finnish Deposit Guarantee Fund—considered two options for the retail activities of the Kaupthing Finnish Branch, to have recourse to the Finnish deposit-guarantee scheme or to ensure branch liquidity with a loan guaranteed against branch assets.

The conclusion was that the three largest Finnish commercial banks, OP-Pohjola Group, Nordea Bank Finland and Sampo bank, organised a loan of about €100 million which was used to pay out all deposits other than those of other financial institutions. Total claims, or deposits with accrued interest, amounted to about €115 million. Of guaranteed deposits, about €67 million would have fallen within the Icelandic deposit-guarantee scheme and about €3 million within the Finnish scheme, because the IDIGF covered deposits up to €20,887, and the Finnish scheme covered deposits up to €25,000.³⁰ As security, the three banks received the Kaupthing Finnish Branch's loan portfolios and other asset items. The banks committed themselves to bearing the financial risks of the loan issuance, in case the assets did not fully cover the loan repayment. The Finnish government guaranteed however that they would not have to bear the legal risks, if there was a successful challenge to this action. This meant that if some amounts of money, for legal reasons, were claimed back from depositors (for example from other creditors of the bank, such as bondholders), the Finnish government would reimburse those depositors. At the end of October 2008, full reimbursement was paid out to depositors, with interest. Of course, neither Finnish Kaupthing's deposits or assets vanished into thin air. It seems that this resolution of the problem implied, or at least facilitated, the transfer of Finnish Kaupthing's deposits and its assets to the three largest Finnish commercial banks.

²⁸ Greidir 5,5 milljarða fyrir hlutinn [Pays 5.5 Billion for the Share], *Morgunbladid* 30 September 2003, p. 56. http://timarit.is/view_page_init.jsp?pageId=3480447

²⁹ SIC Report, Vol. 6, Ch. 18, p. 2 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

³⁰ Jukka Vesala, FIN-FSA's Action in Response to Icelandic Banking Crisis, *FSA Newslines* 8/2008 (5 December 2008), pp. 1–2. Not available on the internet, but downloaded by the main author of this report, http://rse.hi.is/wp-content/uploads/2018/08/Nro_8_en.pdf

They gained new customers, both depositors and borrowers.

The investment services of Kaupthing's Finnish branch were performing well. They were run efficiently and profitably by a staff of seventeen. In 2007, this unit looked after 12% of the total assets managed by Kaupthing which then registered a total profit of ISK 7.511 million or €82 million.³¹ The 2007 profit of the asset management unit in Finland alone would presumably therefore have been around €10 million. An individual company generating that amount of net income would probably be worth about €100 million, to use a rule of thumb. But this was of course in the midst of the bubble. At the end of October 2008, the asset management portfolio was sold to Finnish savings bank Aktia Bank Plc for an undisclosed price. The seventeen employees in the asset management division became partners in Aktia Institutional Services, continuing for a while as an independent group and later being integrated into Aktia Asset Management. A part of Kaupthing's loan portfolio was also sold. The remainder of the loan portfolio was transferred to the parent company in Iceland. The branch was closed down at the end of January.³² It is fair to assume that Kaupthing's asset management division might have been worth at least half what Kaupthing paid for Sofi and Norvestia, or around €42 million. It is also fair to assume, even if the price paid for the unit was not disclosed, that it was not much above the price the staff paid for Glitnir Corporation in Finland, or €3,000. Therefore, this seems to have been yet another real bargain for local businessmen.

Another bargain was offered to them in March 2009, when the IFSA took over Straumur-Burdaras Investment Bank. Two months later, the bank's Finnish subsidiary, eQ Bank, was sold to Nordnet for €37 million, or about 15% of the price which Straumur-Burdaras had paid for it.³³ It should be noted that if that proportion of the original purchase price had been paid for Kaupthing's asset management unit, the combined price for Sofi and Norvestia, then this would have amounted to about €12–13 million.

6. The Sale of Icelandic Assets in Sweden

The treatment of the subsidiaries and branches of Icelandic banks by authorities in Sweden was somewhat different from that in Norway and Finland. In 2000, Kaupthing started operating a subsidiary in Stockholm. A year later, it bought a small securities company, Aragon, for SEK 230 million. In 2002, it merged that company with JP Nordiska Bank, becoming in return its biggest shareholder, with 28% of the shares. Subsequently Kaupthing took the bank over, paying with its own shares, but offering a nominal price which was 40% above the current market price of shares in JP Nordiska. It paid SEK 720 million for the 72% it did not already own. The new bank was called Kaupthing Sverige. For the take-over, Kaupthing was fiercely criticised, not least after the JP Nordiska director and some of his staff were fired by the new owners. One investor objected to the Icelandic take-over on the ground that

³¹ *Kaupthing Annual Report 2007* (Reykjavik: Kaupthing, March 2008).
http://tools.euroland.com/arinhhtml/is-kaup/2007/ar_eng_2007/

³² Vesala, *FSA Newslinje* 8/2008, pp. 1–2. Email to Hannes H. Gissurarson from Pia Michelsson, former head of Kaupthing's Finnish investment services, 8 June 2017.

³³ Fa brot af kaupverdi eQ til baka [Get Only a Fraction of the Purchase Price Back], *Morgunblaðid* 16 May 2009, p. 26. http://timarit.is/view_page_init.jsp?pageId=5252978

the Swedish stock market was “not a fish market”.³⁴ Over the next five years, the bank’s balance sheet increased from 2 to 20 billion SEK. In December 2007, Kaupthing started in Sweden to collect deposits in its Edge accounts, but through its local branch, not its subsidiary. The deposits were therefore covered by the Icelandic rather than the Swedish guarantee scheme. At the end of September 2008, these deposits amounted in total to €262 million.³⁵

In early October 2008, Kaupthing’s subsidiary and branch experienced liquidity problems which their parent company in Iceland was unable to resolve. Both the Swedish Financial Services Authority, SFSA, and the Swedish central bank, Riksbanken, determined that the Swedish operations of Kaupthing were essentially sound. Unlike their Norwegian and Finnish counterparts, Riksbanken decided to provide Kaupthing with liquidity, consisting in a credit line of up to SEK 5 billion. Riksbanken took collateral in Kaupthing’s assets in Sweden.³⁶ Thus the Swedish authorities did not force a fire sale of the assets. It may have helped that at the same time, the Riksbanken had to provide another Swedish bank, the struggling Carnegie Investment Bank, with liquidity, also consisting in a credit line of up to SEK 5 billion. Unlike Carnegie Bank, however, Kaupthing Sverige was liquidated. Depositors in the Edge accounts were compensated, and in December 2008 Kaupthing’s Swedish subsidiary was sold to Ålandsbanken, or rather its 20,000 personal customers, whereas the more risky business customers were transferred to the parent company. Ålandsbanken paid SEK 388 million for it, or a little less than half the book value of equity which was then SEK 832 million. This was a much higher proportion of book value of equity than Icelandic-owned assets had been sold for in Norway and Finland. The credit extended from the Riksbanken to Kaupthing Sverige was promptly paid back: It had only needed SEK 1.5 billion of the 5 billion provided.³⁷

Glitnir also operated in Sweden. In 2006, it bought the brokerage Fischer Partners for

³⁴ Thorvaldsson, *Frozen Assets*, pp. 93–8. Kaupthing opnar verdbrefafyrirtaeki i Stokkholmi [Kaupthing Opens a Securities Firm in Stockholm], *Morgunbladid* 19 September 2000, p. 23. http://timarit.is/view_page_init.jsp?pageId=1978768 Kaupthing kaupir Aragon i Svithjod [Kaupthing Buys Aragon in Sweden], *Morgunbladid* 10 January 2002, p. 64. http://timarit.is/view_page_init.jsp?pageId=3430917 Kaupthing undirritar kaup a Aragon [Kaupthing Signs Aragon Deal], *Morgunbladid* 9 February 2002, p. 23.

http://timarit.is/view_page_init.jsp?pageId=3432984 Kaupthing med 28% i JP Nordiska-bankanum [Kaupthing with 28% in JP Nordiska Bank], *Morgunbladid* 8 June 2002, p. 22. http://timarit.is/view_page_init.jsp?pageId=3446347 Kaupthing gerir tilbod i allt hlutafe JP Nordiska [Kaupthing Makes an Offer for All Shares in JP Nordiska], *Morgunbladid* 30 August 2002, p. 16. http://timarit.is/view_page_init.jsp?pageId=3451845 Kaupthing kaupir JP Nordiska [Kaupthing Buys JP Nordiska], *Morgunbladid* 20 November 2002, p. 14.

http://timarit.is/view_page_init.jsp?pageId=3457746

³⁵ SIC Report, Vol. 6, Ch. 18, 2 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Ensk1.pdf>

³⁶ Riksbanken ger likvidetsstöd till Kaupthing Bank Sverige AB [CBS Provides Liquidity to Kaupthing Bank Sverige], Press Release 8 October 2008. <http://www.riksbank.se/sv/Press-och-publicerat/Pressmeddelanden/2008/Riksbanken-ger-likviditetsstod-till-Kaupthing-Bank-Sverige-AB/>

³⁷ Ålandsbanken: Press Release 27 March 2009 (in Swedish). <https://www.alandsbanken.fi/sv/b%C3%B6rsmeddelanden/sv-27-03-2009-alandsbanken-pressmeddelande-alandsbanken-slutfor-forvarvet-av-kaupthing-bank-sverige> *Kaupthing Bank HF: Creditors’ Report* (March 2011), p. 56. <http://www.kaupthing.com/library/Files/pdf/Creditors-2011/Kaupthing%20Creditors%27%20Report%20-%20March%202011%20-%20FINAL-KJM.pdf>

SEK 425 million and changed its name to Glitnir Sverige. Anders Holmgren was hired as CEO. Almost immediately after the bank collapse in Iceland in early October 2008, Glitnir Sverige was put up for sale. While it had a book value of equity of SEK 190 million, it was sold to HQ Bank for SEK 60 million, or less than one third of book value of equity. HQ Bank registered an almost instant profit of SEK 84 million by taking over Glitnir, as its CEO, Mikael König, publicly acknowledged. If the company had not been acquired, then HQ Bank would have made a hefty loss in the last quarter of 2008.³⁸ König also said that the deal had been reached in cooperation with the staff at Glitnir.³⁹ It must have facilitated the deal that Glitnir Sverige's CEO, Anders Holmgren, was the brother-in-law of Mats Qviberg, one of the two chief owners of HQ bank (which was named after him and his business partner Sven Hagströmer). Qviberg is however unapologetic about his relationship with Holmgren: "So far as a decision is businesslike and for the benefit of the shareholders, I would defend nepotism to the end. A person to whom one has a relationship and who is also competent—I cannot see anything wrong with that."⁴⁰ But now the old adage 'Easy come, easy go' seemed to apply. HQ Bank was seen as taking on far too much risk, and in August 2010 the Swedish FSA revoked its licence. It was then acquired by Carnegie Bank which had been recapitalised after temporary difficulties.

7. Help to Local Banks in the Nordic Countries

At the same time as authorities in the Nordic countries refused to provide Icelandic-owned local banks or financial firms with liquidity, they undertook several measures to increase the liquidity of other local banks, with the assistance of the US Federal Reserve Board and the ECB. Norway was not as vulnerable to the international financial crisis as the other Nordic countries because of her vast oil fund and relatively small banking sector. Nevertheless, in the last quarter of 2008, Norges Bank had to provide Norwegian banks with liquidity in foreign currency, \$9.9 billion and €4.8 billion. In the first quarter of 2009, Norges Bank had to provide the banks with \$8 billion.⁴¹ It also increased its liquidity provision to banks in terms of quantity, maturity (extending the loan period) and relaxation of rules on collateral.⁴²

Finland, the only Nordic country using the euro, also felt the credit crunch. In November 2008, Finnish authorities announced a temporary bank liabilities guarantee scheme of up to €50 billion which was extended and amended several times. The European Commission commented: "In particular, the scheme provides for non-discriminatory access as it will be open to all solvent Finnish deposit and mortgage banks, including Finnish subsidiaries of foreign banks."⁴³ By this time, Finnish Glitnir, a subsidiary of a foreign bank, and solvent by all accounts, had of course been sold to staff members for a pittance. The Finnish guarantee scheme turned out to

³⁸ Han er HQ:s nya kung (He is the New King of HQ), *Veckans Affärer* 9 February 2009.

<https://www.va.se/nyheter/2009/02/09/han-ar-hqs-nya-kung/>

³⁹ HQ-bossen om Glitnir förvärvet [HQ Boss on the Glitnir Acquisition], *Affärsvärlden* 17 October 2008. <http://www.affarsvarlden.se/bors-ekonominyheter/hq-bossen-om-glitnir-forvarvet-6660319>

⁴⁰ Lotta Byqvist, *Boken um Q* (Stockholm: Albert Bonniers Förlag, 2015), p. 182.

⁴¹ Statistics Norway, Finanskrisen og finansieringen i Norge (Oslo, Nasjonalregnskap, 9 July 2009). <https://www.ssb.no/nasjonalregnskap-og-konjunkturer/artikler-og-publikasjoner/finanskrisen-og-finansieringen-i-norge>

⁴² *Norges Bank Annual Report 2008* (Oslo: Norges Bank, 2009), p. 88.

⁴³ European Commission, Press Release 14 November 2008. http://europa.eu/rapid/press-release_IP-08-1705_en.htm?locale=en

be insufficient, however, and in May 2009, Finnish authorities announced a capital injection scheme for Finnish banks of up to €4 billion.

Sweden also had to deal with the financial turmoil. At the end of October 2008, Swedish authorities announced a guarantee scheme for Swedish banks of up to €150 billion. In February 2009, Riksbanken announced a recapitalisation scheme for Swedish banks. As already noted, Riksbanken provided direct liquidity assistance to two banks in Sweden, Swedish Kaupthing and Carnegie, practically taking them over and later selling them off. While Riksbanken in October 2008 refused to implement the currency swap deal it had made with the CBI, it made and implemented currency swap deals of SEK 10 billion with the Estonian central bank and of €375 million with the Latvian central bank (of a total €500 million swap deal made between the Swedish and Danish central banks on the one hand and the Latvian central bank on the other hand).⁴⁴ In the international financial crisis of 2007-8, Estonia and Latvia had, by rapid growth sustained partly by heavy borrowing, encountered similar problems as Iceland. Swedish and Danish banks had a significant presence there.

⁴⁴ Riksbanken, Questions and answers on the financial turmoil (27 May 2009).
<http://www.riksbank.se/en/Press-and-published/Notices/2008/Questions-and-answers-on-the-financial-turmoil---updated-on-27-May-2009/>

Chapter Eight

Sale of FIH Bank in Denmark

In Denmark, the most significant Icelandic-owned asset was Kaupthing's FIH Bank. As this Danish bank was used as collateral for an emergency loan from the CBI to Kaupthing during the bank collapse, its value has been an issue of some controversy in Iceland.¹ Therefore a more extensive discussion is required about it than about the other Nordic cases.

1. Kaupthing Buys FIH Bank

In 1958, FIH Bank had been founded as 'Finansieringsinstituttet for Industri og Håndværk A/S.' Its main purpose was to issue medium- and long-term loans to industrial companies with collateral in their machinery. Its founders were the Central Bank of Denmark (Danmarks Nationalbank), the Confederation of Danish Industries and Danish pension funds and insurance companies. In 1988, stocks in FIH Bank were first listed on the Copenhagen Stock Exchange. In 1999, the Swedish bank Svenske Förenings-Sparbanken (Swedbank) became a majority stockholder through the company FI-Holding. Consequently, in 2000, FIH Bank withdrew its listing from the stock exchange. In the spring of 2004, it became clear that Swedbank wanted to sell its shares in FIH bank. The management team of the Icelandic investment bank Kaupthing had not even been alerted to this, but as soon as they heard about the imminent sale, they set their eyes on it. "FIH was a high-quality operation and we saw various possibilities in expanding its business, both by adding new services to the Danish clientele and by using FIH as a platform to consolidate our Nordic operations," Kaupthing's Armann Thorvaldsson explained.² This would however be a very big acquisition for a company like Kaupthing, then quite small.

Morgan Stanley handled the sale process for Swedbank. At the end of April 2004 Kaupthing made an initial bid for DKK 8–8.5 billion (£700–750 million). Many bidders participated in the initial process. The FIH management team was keener on the bid from Iceland than on those from Danish financial institutions which would probably not expand the operations of the bank, but rather merge them with their own operations. In early June 2004 Kaupthing submitted a bid, after due diligence, for 8.3 billion DKK (£730 million). Morgan Stanley contacted the Icelandic negotiation team and told them that Kaupthing could buy FIH Bank for DKK 8.5 billion (£750 million); and the two parties agreed on that price with handshakes at a meeting. But a few days later, Morgan Stanley told the Kaupthing team that they had unexpectedly received a higher bid for the bank. The Kaupthing people soon found out that the new bidder was another Icelandic bank, Landsbanki. Morgan Stanley now offered the shares to Kaupthing for DKK 9.5 billion (£850 million, or €1.4 billion), which was

¹ For example, Stefan Olafsson, *Kaupthingslanid — Svorin sem vantar* [The Kaupthing Loan: The Unanswered Questions]. Blog 23 February 2015.

<http://blog.pressan.is/stefano/2015/02/23/kaupthingslanid-svorin-sem-vantar/>

² Thorvaldsson, *Frozen Assets*, p. 107.

slightly lower than the Landsbanki bid, and the Kaupthing people felt that they had no choice but to accept this offer. It later turned out that the Landsbanki people had had no idea that they had been bidding against Kaupthing.³

The DFSA, Danish Financial Services Authority, set strict ‘ring-fencing’ preconditions for accepting the deal: The operations of FIH Bank would be independent of those of the Icelandic parent company and that it would continue as a mainly Danish bank.⁴ On 14 June 2004 Kaupthing bought FIH Bank from Swedbank for €1.4 billion. (In the deal, minor stockholders were also bought out.)⁵ It was a significant step for Kaupthing. That year, the balance sheet or total lending of FIH Bank amounted to €7,137 million, and its book value of equity was €671 million. Kaupthing therefore bought the company for more than double the book value of equity. Lars Johansen continued as the bank’s director. The bank had in total 165 employees. In the next four years, the bank grew considerably and was profitable. It expanded from its traditional corporate lending into investment banking, establishing two business units, Capital Markets and Corporate Finance. In 2008, its total lending amounted to €9,746 million, and the book value of equity was €1,048 million.⁶ In the beginning of 2008, the bank had in total 335 employees,⁷ many of whom were then laid off as a result of the financial crisis.

2. FIH Bank Provided with Liquidity

After the Icelandic banks started their rapid slide towards collapse in late September 2008, they all asked the CBI for emergency loans in foreign currency. In discussions between Prime Minister Geir H. Haarde and CBI Governor David Oddsson it came out that Oddsson personally thought Landsbanki might be the least bad option in the circumstances. But when Oddsson asked Landsbanki’s Managing Director Sigurjon Th. Arnason how far a large loan in foreign currency to the bank would take it, Arnason admitted that quite soon the bank might need additional liquidity.⁸

Kaupthing, as the largest Icelandic bank, was another, and to some a more plausible, option. It informed the CBI that it urgently needed €500 million, mainly to meet demands by the British FSA for increased liquidity in its UK subsidiary, KSF.⁹ As collateral, it offered its shares in FIH Bank. After the Kaupthing managers told the CBI governors that it was the will of the government to try and save Kaupthing by an emergency loan, Governor Oddsson called Prime Minister Haarde who confirmed that he thought this was worth trying. Oddsson told Haarde that he believed that the

³ Ibid., pp. 107–113.

⁴ Thomas Svaneborg, *Kunsten at tømme en bank og slippe godt fra det* (København: People’s Press, 2016), p. 76.

⁵ Christian Jessen, Dansk storbank solgt for 9,5 mia. kr. [Big Danish Bank Sold for 9.5 Billion], *Børsen* 14 June 2004.

http://borsen.dk/nyheder/generelt/artikel/1/62456/dansk_storbank_solgt_for_95_mia_kr_opd.html

⁶ Numbers for 2004 and 2008 from *Årsrapport 2008* (København: FIH, 2009), p. 4. <http://rse.hi.is/wp-content/uploads/2018/08/a%CC%8Arssrapport-2008.pdf>

⁷ *Årsrapport 2007* (København: FIH, 2008), p. 12. <http://rse.hi.is/wp-content/uploads/2018/08/a%CC%8Arssrapport-2007.pdf>

⁸ Interview with David Oddsson in Reykjavik 6 August 2015.

⁹ CBI, Press Release 27 October 2008, <http://www.sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2008/10/27/Athugasemd-vegna-umm%C3%A6la-Bj%C3%B6rg%C3%B3lfs-Thors-Bj%C3%B6rg%C3%B3lfssonar-um-bei%C3%B0ni-Landsbanka-%C3%8Dslands-um-fyrirgrei%C3%B0slu-Se%C3%B0labanka-%C3%8Dslands-/>

situation was hopeless and that the loan to Kaupthing would never be repaid, but that the CBI would take good collateral against it.¹⁰ Kaupthing's Armann Thorvaldsson writes: "Through pressure from the Prime Minister, the Central Bank agreed on the Monday to lend €500 million against the shares in FIH, our Danish subsidiary."¹¹

Governor Oddsson called his Danish counterpart, Nils Bernstein, and asked him whether FIH Bank would be acceptable as a collateral for a loan of €500 million to its parent company, Kaupthing. Governor Bernstein said that he thought so, but he wanted to check this with the Danish Financial Supervisory Authority (Finanstilsynet), DFSA. Soon thereafter Bernstein called Oddsson back with the message that this was indeed a sound collateral, which should not be surprising, as the FIH Bank book value of equity at that time was more than €1 billion. Oddsson then made sure that the collateral taken by the CBI in FIH Bank was general: This implied that it was a collateral against all legitimate potential claims by the CBI on Kaupthing. The two other CBI governors agreed with him that in the circumstances, and since the government wanted this, Kaupthing should be given a chance. As Oddsson explained on television the day after, Tuesday 7 October, the three governors did not want the largest Icelandic bank to be seen falling for the sole reason that the CBI was being too inflexible.¹²

In the afternoon of Monday 6 October, staff members at Kaupthing and the CBI worked on the deal. Kaupthing's lawyer contacted the Danish Business Registry staff and informed them that FIH had been taken as a general collateral for a loan to Kaupthing. In the CBI, the necessary paperwork for the collateral was finished in the afternoon of Monday 6 October 2008. The loan was for four days, bearing an interest of 9.4%.¹³ Governor Oddsson also asked the officials preparing the Emergency Act then about to be laid before Parliament to insert into the bill a clause about a general permission for the CBI to take over and operate financial firms. While this was not specifically prohibited by law, he thought that it would be advisable to be able to rely on such a clause, if the CBI had to take FIH Bank over. However, there was political resistance to such a general permission for the CBI (most likely rooted in the Social Democrats' antagonism towards Oddsson), and in the draft of the Emergency Act, prepared at the Business Affairs Ministry, there was only a clause that the CBI was permitted to own FIH Bank. Governor Oddsson insisted that this clause should be removed: an individual company like that should not be named specifically in a legal

¹⁰ The conversation was recorded. It was published in 2017, Raeddu orlog bankakerfisins [Discussed the Future of the Banking Sector], *Morgunbladid* 18 November 2017, p. 24. https://www.mbl.is/mogginminn/blad_dagsins/eldra/2017-11-18-all.pdf It is obvious from the conversation that it was only one of many phone calls this day between Haarde and Oddsson, which lends plausibility to Oddsson's contention that it was only by chance that the conversation was recorded: Oddsson happened to take the call from the office of Sturla Palsson, CBI Director of Treasury and Market Operations, who had all his calls recorded. Moreover, Oddsson's choice of words does not suggest that he realised that the call was being recorded.

¹¹ Thorvaldsson, *Frozen Assets*, p. 219. His sources are almost certainly the Kaupthing leadership in Iceland.

¹² Television Interview with David Oddsson on State Television 7 October 2008. <https://www.youtube.com/watch?v=-Lu96mm2EKE>

¹³ When claims were made that the paperwork had not been properly made, the CBI published a press release 17 October 2010, reaffirming that the necessary paperwork for the collateral had indeed been finished in the late afternoon of Monday 6 October 2008. <https://www.sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2014/10/17/Yfirlýsing-Sedlabanka-Islands-vegna-fullyrdinga-fyrirverandi-forstjora-Kaupthings-um-lanveitingu-til-bankans-6-oktober-2008/>

act. But the officials then took out also the general permission for the CBI to own financial firms.¹⁴

Monday 6 October 2008, in the late afternoon, the €500 million emergency loan to Kaupthing was paid out in three transfers from the CBI's account in New York to Kaupthing's account with Deutsche Bank in Frankfurt. At the time, Kaupthing was trying to reach an agreement with the British FSA which had threatened to close down the Kaupthing subsidiary KSF unless more liquidity was provided. When, in the morning of Wednesday 8 October, the FSA closed down KSF and transferred its online accounts to a Dutch competitor, without warning or consultation, Kaupthing decided to use the money to try and maintain operations in other countries. It used €200 million to pay back a loan from the Swedish Central Bank, and the remainder to strengthen the financial position of individual subsidiaries and branches, in Luxembourg, Finland, Norway and elsewhere.¹⁵ As a result of the fall of KSF in London, Thursday 9 October Kaupthing was taken over by the IFSA and could not pay back the €500 million loan to the CBI. Hence, the Kaupthing Resolution Committee took possession of FIH Bank, but in close cooperation with the CBI. FIH Bank was then the fifth largest bank in Denmark in terms of its balance sheet, employing 450 people.¹⁶

3. *The CBI Sells FIH Bank*

It was from the beginning the intention of the CBI to sell the bank at a favourable moment. FIH Bank manager Lars Johansen publicly expressed the hope that the bank could be sold for about the same price that Kaupthing bought it for, €1.4 billion; whereas financial commentators in Denmark expected that it could be sold for its book value of equity, for around €1 billion.¹⁷ The CBI hired JP Morgan to try and start a selling process.¹⁸ But in the circumstances, in the midst of the international financial crisis, FIH Bank did not have a lot of potential buyers, at least not for a reasonable price for the seller. Since 2007, Denmark's biggest pension fund, the Labour Market Supplementary Pension Fund, ATP (Arbejdsmarkedets Tillægspension), had provided the bank with liquidity, a credit line of DKK 15 billion (\$2.6 billion or £1.6 billion), upon which in the present difficulties it had to draw.¹⁹ FIH bank was also included in the rescue packages offered by the Danish government to the banks in the financial crisis. For FIH Bank this meant a capital injection of DKK 1.9 billion (€256 million) in 2009 and a government guarantee of the bank's obligations amounting to about DKK 48 billion (€6.5 billion) at the end of 2010.²⁰ In mid-2009, Lars Johansen who had been at the helm of FIH Bank for eleven years, retired. He was replaced by Henrik Sjøgreen who had worked in the bank since 1992.

¹⁴ SIC Report, Vol. 7, Ch. 20, pp. 124–5.

¹⁵ *Ibid.*, p. 160.

¹⁶ FIH Erhvervsbank, *Børsen* 10 October 2008.

<http://borsen.dk/nyheder/avisen/artikel/12/3071587/artikel.html>

¹⁷ Ursula Rehnagel and Jesper Kongskov, FIH-chef venter hurtigt salg [FIH CEO Expects Quick Sale], *Børsen* 10 October 2008. <http://borsen.dk/nyheder/avisen/artikel/12/3071582/artikel.html>

¹⁸ Jesper Kongskov and Ursula Rehnagel, Lynsalg af FIH sat i gang [Quick Sale of FIH Starts], *Børsen* 27 October 2008. <http://borsen.dk/nyheder/avisen/artikel/12/3073213/artikel.html>

¹⁹ *Årsrapport 2008*, p. 7. <http://rse.hi.is/wp-content/uploads/2018/08/a%CC%8Arssrapport-2008.pdf>

²⁰ Rangvad udvalget [The Rangvad Commission], *Den finansielle krise i Danmark. Årsager, konsekvenser og læring*, pp. 444 and 446. <http://em.dk/publikationer/2013/18-09-13-den-finansielle-krise-i-danmark>

Hans Skov Christensen remained chairman of the board. He played a central role in the Danish business community as managing director of the Confederation of Danish Industries.²¹ Skov Christensen was closely tied to the Conservative National Party (Konservativ Folkeparti), the junior partner in a long-lasting coalition government with the conservative-liberal Left Party (Venstre).²²

Having provided FIH Bank with liquidity, ATP had an interest in gaining control of the bank. The Danish government also wanted to transfer control of the bank from the Kaupthing Resolution Committee and the CBI to Danish companies. ATP informed the government however that if it was to participate in a bid for the bank, the Danish law prohibiting a pension fund from owning more than 50% of a financial company had to be changed. The government duly obliged.²³ In the autumn of 2010, attempts to sell FIH Bank were resumed. The international capital fund Triton, with the participation of five Danish pension funds, expressed interest in FIH Bank which meant that there were at least two potential buyers.²⁴ In Denmark, FIH Bank was widely seen as an attractive investment. The bank had lost money in 2009 because of massive write-offs related to the crisis, but it was expected to make a decent profit in 2010. More importantly, FIH Bank had a book value of equity of almost DKK 8 billion (€1.1 billion) minus the loan from the CBI of half that amount, or DKK 4 billion.²⁵

What complicated the sale process was that the government guarantee to the bank of up to DKK 50 billion was only valid until 30 September 2010, and after that there were fears of a run on the bank, according to the Danish press, as indeed on other Danish banks, if the guarantee would not be extended. The government agency overseeing the bank guarantees, the Financial Stability Company (Finansiel Stabilitet), put pressure on the CBI and the Icelandic government, now led by new people, Governor Mar Gudmundsson at the CBI, Prime Minister Johanna Sigurdardottir and Finance Minister Steingrímur J. Sigfússon. An anonymous source told Danish business newspaper *Børsen*: “The Icelandic government has simply received an ultimatum: FIH has to be sold before the bank guarantee from Bank Package One runs out 30 September this year. The Danish government does not want to participate any longer in a lottery where Danmark takes the risk of a gigantic bill and massive problems if FIH Bank will take a turn to the worse.”²⁶

The deadline for delivering bids on FIH Bank was set to 16 September 2010, with the Danish Financial Stability Company reserving the right to veto any potential buyer,

²¹ Anders Krab-Johansen, Niels Lunde and Thomas Bernt Henriksen, Et liv drevet af tro, pligt og arbejde [A Life Motivated by Faith, Duty and Hard Work], *Børsen* 15 November 2013. <http://borsen.dk/nyheder/avisen/artikel/11/65936/artikel.html>

²² It lasted for ten years, under Anders Fogh Rasmussen in 2001–9 and Lars Løkke Rasmussen in 2009–11.

²³ Morten Jeppesen, Minister ville redde FIH for enhver pris [Minister Wanted to Rescue FIH at Any Price], *Børsen* 1 April 2011. <http://borsen.dk/nyheder/avisen/artikel/11/3839/artikel.html>

²⁴ Jens Nymark, TV2: Budkrig on FIH Erhvervsbank [Bidding War About FIH], *Børsen* 8 September 2010. http://finans.borsen.dk/artikel/1/190690/tv2_budkrig_om_fih_erhvervsbank.html

²⁵ Jens Nymark, Direktør bekræfter budkrig on FIH [Director Confirms Bidding on FIH], *Børsen* 8 September 2010. http://finans.borsen.dk/artikel/1/190698/direktoer_bekraefter_budkrig_om_fih.html

²⁶ Heidi Birgitte Nielsen, Dorthe Bach and Morten Jeppesen, Finansiel Stabilitet bag krav om FIH-salg [Financial Stability Behind Requirement to Sell FIH], *Børsen* 10 September 2010. <http://borsen.dk/nyheder/avisen/artikel/12/3132601/artikel.html>

by refusing to extend government guarantees.²⁷ The CBI, under Mar Gudmundsson, and the Danish authorities decided that the bank should be sold to the consortium led by ATP. According to Danish journalists, the Kaupthing Resolution Committee preferred the other bid, by Triton and its partners, but the CBI overruled it, certainly with the consent of the Danish authorities.²⁸ The deal was apparently concluded at the Copenhagen Airport Hilton in the afternoon of 16 September 2010 and announced on 18 September 2010. The price was nominally DKK 5 billion (€670 million). However, only DKK 1.9 billion (€255 million) was paid out to the Icelandic seller. The rest, up to DKK 3.1 billion (€414 million), was to be determined by the loss which FIH Bank might make on its balance sheet from 30 June 2010 to 31 December 2014. This total loss would be subtracted from the price, whereas a possible profit of FIH from owning Axcel III fund would be added to the price.²⁹ The Triton bid was for a lower total price, but for a higher bonus if FIH Bank would turn out to be profitable in the long run.³⁰ Of the shares, ATP bought about half, the holding company PF I A/S bought the other half, while a tiny fraction of shares was being held by the FIH director. PF I A/S was a holding company for two pension funds, PFA in Denmark and Folksam in Sweden, each with 40% of the shares, and for a Danish venture capitalist, Christian P. Dyvig, with 20%.³¹ JP Morgan advised the CBI on the deal, along with the Danish law firm Kromann Reumert and the Icelandic Lex.

4. The Controversial Strategy of the New Owners

“The buyers used the oldest trick in the book,” former Kaupthing board chairman Sigurdur Einarsson says. “This was a time of uncertainty, but in order to knock down the price, they vastly exaggerated the number of bad assets which the bank possessed and the risks involving in buying it. The CBI people were deceived. It was in essence a sound bank. Dyvig knew what he was doing.”³² The Danish venture capitalist Christian Dyvig who bought 10% of FIH Bank in 2010 was a well-known businessman. Born in 1964, he graduated in law from the University of Copenhagen in 1987. He then was an attorney for Reumert & Partnere (later Kromann Reumert) for a few years, whereupon he studied business administration, graduating from the IMD Business School in Switzerland in 1992. He then worked for Morgan Stanley, first in London as an investment banker, then in mergers and acquisitions in Frankfurt. In 2003, Dyvig moved again to Denmark, becoming manager and partner of Nordic Capital until 2009. Making successful investments in the years preceding

²⁷ Morten Jeppesen and Heidi Birgitte Nielsen, Staten har vetoret ved FIH-salg [Government Has Veto on FIH Sale], *Børsen* 15 September 2010.

http://finans.borsen.dk/artikel/1/191172/staten_har_vetoret_ved_fih-salg.html

²⁸ Heidi Birgitte Nielsen and Dorthe Bach, Island risikerer milliardtab på FIH trods salg [Iceland Risks Losing Billions on FIH Despite Sale], *Børsen* 21 September 2010.

<http://borsen.dk/nyheder/avisen/artikel/12/3133369/artikel.html>

²⁹ CBI, Sala a danska bankanum FIH [The Sale of Danish Bank FIH]. Press Release 19 September 2010. <https://www.sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2010/09/19/Sala-%C3%A1-danska-bankanum-FIH/>

³⁰ FIH solgt til ATP og PFA [FIH Sold to ATP and PFA], *Børsen* 17 September 2010.

<http://borsen.dk/nyheder/avisen/artikel/12/3133157/artikel.html>

³¹ Information from the FIH Danish website, <http://www.fih.dk/> The website has now been removed from the internet.

³² Interview with Sigurdur Einarsson in London 11 December 2013.

the financial crisis, he amassed a personal fortune.³³ Dyvig had from the beginning been interested in FIH Bank. Already in the spring of 2009 he had gone to Iceland and had a secret meeting with acting CBI Governor Svein Harald Øygaard about a possible purchase of the bank. His rival bidders for the bank only learned at the last stage of the sale process about his trip to Iceland, to their surprise and dismay.³⁴

The new owner team took possession of the bank on 6 January 2011. It did not waste any time. The deputy director of ATP, Bjarne Graven Larsen, immediately became co-director of the bank with Henrik Sjøgren. Together, they set about implementing a new strategy for the bank which was to reduce its balance sheet, to liquidate risky engagements and to write off bad loans. Lars Rohde, director of ATP, made the new owners' agenda quite clear publicly. It was to realise all possible credit losses in the bank during the period from 30 June 2010 to 31 December 2014. Therefore, the bank started to liquidate mortgages in the bank. The liquidation process was called "brutal" by the Danish press. Rohde was unrepentant, however: "We act on market terms. We are expected to protect the short-term and long-term interests of pensioners. This is the background for what we do. ATP is not a charity organisation. And the Icelanders have a 'first right of refusal'. This means that they can take the mortgages over if they think we are too tough. So there is no open gap there."³⁵ When Danish journalists asked Finance Minister Steingrímur J. Sigfússon and Steinar Thor Gudgeirsson, chairman of Kaupthing's Resolution Committee, for comments, they had nothing to say.³⁶ It was however the CBI which had most at stake. Not only did it have to try and recover more of its €500 million loan to Kaupthing than the €255 million already paid by the new owners, but its collateral was also a general one, extending to other possible debts owed to it by Kaupthing. However, the CBI had not asked for representation on the FIH Bank board, or for any control over its operations; and now it did not even protest. Many FIH Bank customers were unhappy about their treatment by the bank.³⁷ Some commentators also found it ironic that Rohde should speak about "market terms" in light of the fact that FIH Bank had received strong government support in the form of a government guarantee and a credit line during the financial crisis and a special permission for ATP to own more than 50% in a financial institution.³⁸

In 2011, new kinds of shares in FIH banks were issued specially designed for the two directors, Graven Larsen and Sjøgreen. Essentially, the owners of the new shares would be entitled to all extra dividend after an annual dividend of 8% had been paid out to existing shareholders. Graven Larsen and Sjøgreen each bought shares for DKK 9

³³ Christian Carlsen, Dyvig i ny central FIH-rolle [Dyvig in a New Central Position at FIH], *Børsen* 30 May 2012. <http://borsen.dk/nyheder/avisen/artikel/11/24471/artikel.html> Blå bog, Christian Peter Dyvig [The Blue Book: Christian Peter Dyvig], *Børsen* 22 May 2014.

<http://borsen.dk/nyheder/avisen/artikel/11/83537/artikel.html>

³⁴ Svaneborg, *Kunsten at tømme en bank*, pp. 149 and 153.

³⁵ Morten Jeppesen, Islændinge må betale for FIH's ejendomsudrensning [The Icelanders Must Pay for Cleaning Out Mortgages at FIH], *Børsen* 18 November 2011.

<http://borsen.dk/nyheder/avisen/artikel/12/3187625/artikel.html>

³⁶ Morten Jeppesen, Islændinge tavse om FIH Erhvervsbank [Icelanders Silent on FIH Bank], *Børsen* 18 November 2011. <http://borsen.dk/nyheder/avisen/artikel/11/14128/artikel.html>

³⁷ Jens Theil, Det sladrer finansbosserne om [The Gossip in Financial Circles], *Børsen* 8 January 2014. http://finans.borsen.dk/artikel/1/282378/det_sladrer_finansbosserne_om.html

³⁸ Svaneborg, *Kunsten at tømme en bank*, p. 231.

million.³⁹ The well-known businessman Fritz Schur was also given the opportunity to acquire these kinds of shares, and he did so, buying about 0.5% of the shares, for about DKK ten million.⁴⁰ Very much an insider in Danish society, with ties to the Royal Family, Schur was not only board chairman of Christian Dyvig's investment company, but also of SAS Group, operating the Scandinavian airline, and of Postnord. For a long time, Schur also led a forum of businessmen who supported the Danish conservative-liberal party Venstre financially.⁴¹

5. The Liquidation of FIH Bank Assets

Banks hold many kinds of claims against their debtors, with different risk levels; and risks can depend on time, as different asset prices between booms and bust illustrate. Obviously, if a bank goes aggressively after some of its claims in a short period, it will incur losses which it might have avoided if it had been more patient or accommodating. The new owners of FIH Bank had a clear agenda, as Lars Rohde had explained: It was not to minimise long-term losses, but to clear out all possible losses in the period from 30 June 2010 to 31 December 2014. In 2012, Christian Dyvig became chairman of the FIH Bank board, replacing Hans Skov Christensen and forcefully implementing the new agenda. FIH Bank's main problem if it was to stay liquid was its commercial mortgages. After liquidating as much of them as it could in the first fourteen months of the new ownership, in the spring of 2012 it negotiated a deal with the Danish Financial Stability Company. This involved FIH Bank transferring mortgage portfolios worth about DKK 17.1 billion (€2.3 billion) to the Financial Stability Company, while continuing to manage the portfolios for a fee. The deal which had a complex structure was announced on 2 March 2012. In Denmark it was called "Bank Package Five".

While the European Commission approved the deal temporarily, it decided that it constituted state aid and that it might unduly favour FIH Bank and thus distort competition in the financial sector. Therefore it initiated an investigation procedure against the Danish government. In the next twenty months, FIH Bank responded in many ways. In 2012, it reduced its balance sheet from €11.3 billion to €8.1 billion. In 2013, the bank repaid its capital injection of DKK 1.9 billion from the Danish state and also outstanding government-guaranteed bonds. In December 2013, in order to comply with the reservations of the EU Commissions about the deal, FIH Bank and Danish authorities decided that FIH Bank would pay the Financial Stability Company

³⁹ Aktieklasser blev lavet til FIH-chefer [Special Shares for FIH Bosses], *Børsen* 27 December 2012. <http://borsen.dk/nyheder/avisen/artikel/11/38027/artikel.html>

⁴⁰ Mads Sixhøj, Fritz Schur kan score kassen på FIH-salg [Fritz Schur Can Make a Killing on FIH Sale], *Børsen* 28 December 2012. http://finans.borsen.dk/artikel/1/248690/fritz_schur_kan_score_kassen_paa_fih-salg.html

⁴¹ Niels Sandøe, Hanne Sindbæk and Thomas Svaneborg, *Kammerherrens nye klæder. Fritz Schur. Manden og myterne* (København: Jyllands-Postens Forlag, 2012). See also Ole Troelsø, Prinsgemalen og Fritz Schur finder uslebne diamanter [The Prince Consort and Fritz Schur Find Unpolished Diamonds], *Børsen* 15 December 2014. http://pleasure.borsen.dk/gourmet/artikel/1/296070/prinsgemalen_og_fritz_schur_finder_uslebne_diamanter.html Ulrik Ulriksen and Louise Møller, Jetsettet til fest hos milliardæren Fritz Schur [The Jet Set Attending a Party Given by Billionaire Fritz Schur], *Billedbladet* 7 April 2009. <http://archive.is/kJoMP>

DKK 425 million, 310 million in a cash transfer and the remainder by forgoing administration fees from the Financial Stability Company.⁴²

However, many were taken by surprise on 21 May 2014, when FIH Bank announced that it had sold two thirds of its operations to a bank in Northern Jutland, Spar Nord. The transaction meant that portfolios of about 900 customers, mostly small or medium-size manufacturing companies, were transferred from FIH Bank to Spar Nord, which took in effect over the FIH bank branches in Aarhus, Fredericia and partly in Copenhagen. At the same time, 25 FIH Bank employees were laid off. As a result, the balance sheet of the bank shrunk by about DKK 4 billion. It was also announced that the rest of the bank would be slowly liquidated, with the exception of the Corporate Finance Division which would be maintained.⁴³ On 2 June 2014, FIH Bank announced that it had transferred the portfolios of its 24 biggest customers to a large Copenhagen bank, Nykredit Bank. As a result, the balance sheet of the bank shrunk by another DKK 4 billion. In only eleven days, the bank had reduced its balance sheet to less than half what it had been in 2012.⁴⁴

In these two transactions, the bank did not transfer any of its book value of equity, and it was expected that the remainder of its operations would not include heavy losses. The bank had already paid back the loans which it had received from the Danish government during the financial crisis and written down bad debt. In 2014, also, FIH Bank also benefited from its investment fund Axcel III selling its shares in the cosmetic firm Pandora, realising a profit of about DKK 180 million. In 2014, the FIH Bank's ownership of shares in other companies went down from DKK 813 million to 91 million.⁴⁵

The Danish media noted that these transactions meant that the members of the consortium which had bought FIH Bank in the autumn of 2010 would, in a few years, enjoy a very good return on their investments, as they would probably be able to realise most or all of the book value of equity, DKK 5,739 million (\$870 million, or €769 million) at the end of 2014.⁴⁶ Christian P. Dyvig, having bought 10% of the bank in 2010 for DKK 190 million, could expect to get in return 10% of the book value of equity, or about DKK 570 million, and thus to make a profit of almost DKK 400 million. The two FIH directors, Bjarne Graven Larsen and Henrik Sjøgreen, also could anticipate great benefits. They had each bought shares for about DKK 9

⁴² European Commission final decision, 11 March 2014, State Aid No. SA.34445. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014D0884> See also Simon Kirketerp, Av, for et girokort — FIH skal betale 425 mio til staten [Oh, For a Bank Card: FIH Must Pay State 250 Million], *Børsen* 5 February 2014. http://finans.borsen.dk/artikel/1/276100/av_for_et_girokort_-_fih_skal_betale_425_mio_til_staten.html

⁴³ Ulrik Horn, FIH afvikler banken — sælger kunder for 4 mia til Spar Nord [FIH Dissolves the Bank—Sells 4 Billion in Customer Loans to Spar Nord], *Børsen* 21 May 2014. http://finans.borsen.dk/artikel/1/283313/fih_afvikler_banken_-_saelger_kunder_for_4_mia_til_spar_nord.html

⁴⁴ Ulrik Horn, FIH sælger storkunder til Nykredit: Lån for 4 mia barberet væk [FIH Sells Big Customers to Nykredit: Loans for 4 Billion Shaved Away], *Børsen* 2 June 2014. http://finans.borsen.dk/artikel/1/284095/fih_saelger_storkunder_til_nykredit_laan_for_4_mia_barberet_vaek.html

⁴⁵ *FIH Årsrapport 2014* (København: FIH, 2015), pp. 4 and 7.

⁴⁶ *Ibid.*, p. 3.

million, and could expect to get a return each of about DKK 27 million.⁴⁷ Again, Fritz Schur who had bought the same kind of shares as the two directors for about DKK 10 million would see a handsome net profit, about 20 million Danish *kroner*. The team who bought FIH Bank from the CBI enjoyed an enhanced reputation in Denmark as a result of their success. In 2013, Lars Rohde was appointed Chairman of the Board of Governors in the CBD, the Central Bank of Denmark (Danmarks Nationalbank). In 2015, Christian Dyvig made his first appearance on a list of the 100 richest people in Denmark, owning, according to reporters, DKK 1.1 billion.⁴⁸

The owners of FIH Bank brought a case against the European Commission after the Commission decided in March 2014 that while the 2012 transfer of mortgages from FIH Bank to a Danish government agency had indeed constituted state aid, it was compatible with the internal market in the light of the restructure of FIH Bank and its commitments. After the European Commission decision, FIH Bank wanted back the money it had repaid the Financial Stability Company in 2013.⁴⁹ In September 2016, the FIH owners won the case before the European Court which meant that the Danish state had to return to them DKK 310 million, or €42 million, which they had paid the Financial Stability Company.⁵⁰ The outcome of the whole process was widely criticised in Denmark. Commentators pointed out that the owners had not recapitalised the bank, as they were expected to do. Instead, the Danish state had in effect taken on most of the risk. Little or no mention was made however in Denmark of the fact that the CBI had in October 2008 lent Kaupthing €500 and taken FIH Bank, then with a book value of equity over €1 billion, as a general collateral for this and other potential debts. When FIH bank had been sold in the autumn of 2010, the buyers had only paid €255 million in cash, agreeing to an additional price of €414 million on the condition that there were no hidden losses in the bank. By aggressively liquidating customers, the new owners had more or less reduced this additional price to zero, while maintaining most of the bank's equity. Thus, the team buying FIH Bank had outwitted the representatives of both Danish and Icelandic taxpayers.

6. Help to Danish Banks

In the international financial crisis, Denmark was perhaps the most vulnerable of the four other Nordic countries. Already in July 2008, the CBD had had to provide aid to Roskilde Bank, Denmark's 8th largest bank. Subsequently, in August the bank was liquidated. The cost of the operation for the authorities is estimated to have been €1.4 billion.⁵¹ On 8 October 2008, the Danish government issued a blank guarantee of all

⁴⁷ Jens Theil, Ulrik Horn and Tobias Matthiesen, Kapitalfondskonge står til at score 400 mio på FIH [Investment Fund King to Gain 400 Million on FIH], *Børsen* 22 May 2014. <http://borsen.dk/nyheder/avisen/artikel/11/83492/artikel.html>

⁴⁸ Kapitalfondens-kongen, der gik solo [Investment Fund King Who Went on His Own], *Berlingske Business* 26 September 2015. <http://www.business.dk/business-magasin/kapitalfonds-kongen-der-gik-solo>

⁴⁹ Ulrik Horn, FIH's ankesag til 370 mio trækker ud [FIH 370 Million Appeal Case Delayed], *Børsen* 11 August 2014. [http://finans.borsen.dk/artikel/1/288331/fih ankesag til 370 mio traekker ud.html](http://finans.borsen.dk/artikel/1/288331/fih%20ankesag%20til%20370%20mio%20traekker%20ud.html)

⁵⁰ Judgement of the General Court (Sixth Chamber) 15 September 2016, Fih Holding A/S and Fih Erhvervsbank A/S v European Commission. Fih Holding A/S and Fih Erhvervsbank A/S v European Commission. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62014TJ0386>

⁵¹ Rangvad udvalget [Rangvad Commission], *Den finansielle krise i Danmark—årsager, konsekvenser og læring*, p. 254. The estimated cost was DKK 10.5 billion. <http://em.dk/publikationer/2013/18-09-13-den-finansielle-krise-i-danmark>

financial firms in Denmark, not only for depositors, but also other creditors such as bondholders. Four further bank rescue plans were eventually implemented. Individual banks were also rescued or taken over. In May 2009, Danish authorities provided Fionia Bank with a credit line of €685 million and a capital injection of €134 million. The rescue effort failed, and Fionia Bank was eventually liquidated. In February 2011, Danish authorities took over Amagerbanken and the Faroese Eik Banken and put them into liquidation. In October 2011, they took over Max Bank, a small bank in south Zealand. In April 2012, two banks in Jutland, Vestjysk Bank and Aarhus Lokal Bank, were merged with a €1.2 billion support from the Danish authorities.⁵² As noted earlier, the Danish government provided credit to banks and other financial firms of up to 100 billion Danish *kroner* (€13.5 billion), thereof 24 billion to Danske Bank which was in grave danger of failing.⁵³ In fact, 62 Danish banks, mostly small, went under in the crisis. The total write-downs of financial institutions in 2008–11 amounted to 147 billion Danish *kroner* (€19 billion).⁵⁴

The report of a 2012 investigation commission into the Danish financial crisis reads in some places just like a description of the Icelandic bank crash. “On balance, the pre-crisis years saw a large increase in risk-taking among the Danish financial institutions. Lending rose sharply, also from an international perspective.” The commission pointed out that “the financial sector attributed great importance to the fact that regulation in Denmark was not stricter than abroad (‘level playing field’).” Indeed, the commission complained that the Danish “FSA adopted a relatively ‘mechanical’ approach to its review of the banks’ compliance with the legislation.” As already pointed out, the commission found that the Danish central bank had rather limited powers. “Nationalbanken has no way of effectively controlling the financial institutions’ lending. Consequently, Nationalbanken could not have halted the growth in lending during the years before the crisis even if it had considered there to be a need to do so.” The situation was quite similar in Iceland, even if the SIC, Special Investigation Commission, did not take this much into account. The Danish commission also concluded that the risk created by the rapid growth of Denmark’s largest bank by far, Danske Bank, mostly abroad, had been unacceptable.⁵⁵

Banks in other Nordic countries were rescued or liquidated in an orderly process so they did not have to suffer fire sales, like the Icelandic banks. In six of the seven cases from the Nordic countries discussed here, potential losses from fire sales of Icelandic-owned assets were suffered by the estates of the fallen banks and thus in fact by the banks’ creditors, not least German banks. But in one case, that of FIH Bank, the loss was incurred by the CBI and thus indirectly by the Icelandic taxpayers. It is not easy to estimate the loss. It is clear however that if the CBI had done exactly like the Danish buyers of FIH bank did, wound it down and then seized the remaining book value of equity—since FIH Bank served as a general collateral to all debts by

⁵² Public assistance to financial firms in the EU countries is conveniently summarised in a report by the European Commission, *State Aid: Overview of decisions and on-going in-depth investigations of Financial Institutions in Difficulty* (Brussels: European Commission, 31 December 2016). http://ec.europa.eu/competition/recovery/banking_case_list_public.pdf

⁵³ Skatteyderne mistede milliarder på en nat [Taxpayers Lost Billions Overnight], Sikke en fest [What a Party] DR1 (2012). <http://www.dr.dk/DR1/dr1-dokumentaren/sikke-en-fest/Nyheder/20121126101352.htm>

⁵⁴ Rangvad Commission, *The Financial Crisis in Denmark: Causes, Consequences and Lessons*, pp. 4 og 14. <http://em.dk/english/publications/2013/13-09-18-financial-crisis>

⁵⁵ *Ibid.*, pp. 8–11. <http://em.dk/english/publications/2013/13-09-18-financial-crisis>

Kaupthing to the CBI—it would not have received €225 million as it did, but something approaching at least €769 million, the book value of equity at the end of 2014.

7. Possible Other Scenarios for FIH Bank

In hindsight, it is perhaps surprising that the financially strong Icelandic pension funds, with a lot of foreign assets, did not step in and buy FIH Bank or at least part of it: This would have been the same profit opportunity for them as it was for the Swedish pension fund, Folksam, which participated in the 2010 purchase of FIH Bank. One explanation for this lack of initiative was probably that the bank collapse came as such a shock to most Icelanders that for weeks and even months most political and business leaders in Iceland were almost paralysed.

Other possibilities to recapture at least partly the losses incurred by the CBI from its dealings with Kaupthing would have included a tentative deal explored in mid-October 2008 by former Kaupthing Chairman of the Board Sigurdur Einarsson, on behalf of the Kaupthing Resolution Committee, whereby the SEK, Stockholm Enskilda Banken, would buy all Kaupthing's operations in the other four Nordic countries for about €1 billion. It was clear from talks between Einarsson and Annika Falkengren, the managing director of SEK, that SEK had genuine interest in FIH Bank: They knew as well as Lars Rohde and Christian Dyvig that it was a solid bank.⁵⁶ But when it became known in Iceland that Einarsson was undertaking a task for the Resolution Committee, the Committee immediately disavowed him.

It is also surprising that the CBI seems never to have considered accepting the challenge made by Lars Rohde in his candid interviews with the Danish press: to continue to operate the bank and to provide it with liquidity. Instead of keeping the loans from the IMF dormant, while bearing a high interest, in a New York bank account, the CBI could have cooperated with the Danish authorities and put in some cash. At least the CBI could have tried to monitor the situation more closely, by for example having a representative on the board during the time when the potential buyers owed them almost two thirds of the price for the bank.

The problem with these scenarios about FIH Bank is that the CBI, and perhaps the Icelandic pension funds as well, would probably not have enjoyed the same repeated support from Danish authorities as the well-connected local businessmen, backed by Danish and Swedish pension funds, received. The credit line from the state would not have been extended, the government guarantee would have been revoked, and the Danish Financial Stability Company would not have taken on the riskiest part of FIH Bank's portfolio, the commercial mortgages. It would have taken a strong political initiative from Iceland in 2009 or 2010 to bring about anything like what the new owners did; and this initiative was never made and probably never even contemplated, let alone discussed.

⁵⁶ Interview with Sigurdur Einarsson 11 December 2013; email from Sigurdur Einarsson 18 June 2017.

Chapter Nine

Moral Issues in Fire Sales of Bank Assets

The buyers of Icelandic assets at prices far below their real worth would say, of course, that there is no such thing as real worth, only a certain price in a certain situation and that they were simply doing business. How cogent is that argument?

1. Cases of Insider Trading?

Of the seven cases from the Nordic countries discussed and analysed here only one seems to have been handled professionally, that of Kaupthing Sweden which received liquidity support from the CBS and was subsequently sold for almost half the book value of equity—in the midst of a financial crisis perhaps an acceptable price. Three other cases may possibly have involved unequal treatment by public authorities of Icelandic and local financiers, thus going against at least the spirit, if not the letter, of the EEA Agreement on an internal market governed by the same rules: Norwegian and Finnish Glitnir both being denied liquidity support during the Icelandic bank collapse from their respective central banks, despite being local companies, albeit owned by Icelandic banks, and FIH Bank in Denmark, initially receiving liquidity support, but then being denied it unless sold within a short period of time by the Icelandic owners. At first sight, the three remaining cases may seem to be examples of alert entrepreneurs seizing opportunities at the right time: when Glitnir Securities in Norway was sold to the staff, when Finnish Kaupthing's asset management unit was sold to Aktia and when Swedish Glitnir was sold to HQ Bank. But this may not be altogether a correct description of what happened: In all three cases the staff, with at least some insider knowledge, was involved, while the Glitnir Resolution Committee was well aware of the danger which must have been made clear to it that the staff, if denied the deal, would simply walk out and sell their contacts and special knowledge to Glitnir's competitors.¹ In certain circumstances, an offer can be a threat. Thus, these may have been examples of groups using (or abusing) their temporary strategic advantages to capture assets at bargain prices

Moreover, it is not certain that in more normal situations the financial services authorities of the Nordic countries would, in these three cases, have permitted what looks like insider trading in the traditional sense of the word: A week after the staff of Glitnir Securities bought the firm for NOK 50 million, they sold half of it for the same amount of money to a company with its headquarters in the same building in Oslo; in the course of only one week in October 2008, they made a profit of NOK 50 million. Swedish Glitnir was sold to a company partly owned by the brother-in-law of its CEO; in the last quarter of 2008, the buyer could register a profit of SEK 84 million. The staff of Kaupthing's asset management unit became partners in a unit of Aktia Bank in a deal whose details have never been disclosed. It is an intriguing

¹ Interview with Arni Tomasson by phone 28 May 2017.

question why these deals were permitted and apparently even encouraged by the respective regulators.

This does not imply that something is necessarily wrong with insider trading and that it should be illegal. Milton Friedman and other economists have presented cogent arguments for allowing insider trading. It encourages those with special knowledge to reveal it in market exchanges; for example, those insiders who know that something is wrong in a company sell their stock and thus bring down its price, and vice versa. Insider trading is also hard to detect, not least when it consists in not doing anything about a situation; this makes coherent enforcement of laws against it difficult, or well nigh impossible. Thirdly, insider trading seems to be a victimless crime; nobody is worse off as a result of it because others, lacking the special knowledge which the insiders have, do what they would otherwise have done.² What has been observed here just implies, given the fact that insider trading is illegal in the Nordic countries, that sometimes regulators move against insider trading and sometimes they do not. When insiders in the four other Nordic countries captured assets of the fallen Icelandic banks at very low prices, the regulators did not move.

2. Voluntary and Involuntary Market Transactions

While in six of the seven cases discussed here, the fire sales of Icelandic-owned assets can be attributed to actions or non-actions of public authorities, the general question remains whether there is anything morally wrong with using one's strategic advantage to close a profitable deal. Even if Finn Haugan in Norway and Lars Rohde in Denmark may have been somewhat disingenuous in defending their maneuvers in terms of market forces when they were in fact availing themselves of government support, there is a long tradition in liberal Western countries that outcomes of voluntary exchanges (at least between consenting adults) should be presumed to be morally acceptable. It may therefore be instructive to consider two famous examples of market exchanges under such duress that some might argue that they are not voluntary and therefore unjust.

St. Thomas Aquinas discusses the first example, originally introduced by Stoic philosophers, according to the Roman lawyer Cicero. There has been a famine on Rhodos. A merchant from Alexandria arrives in a ship heavily laden with wheat. He expects more merchants to be on their way to the island as he could see their sails on the distant horizon. The question is whether the merchant has to reveal this to the islanders. It would definitely deprive him of the chance to sell his wheat at a much higher price than would otherwise be the case. In antiquity, opinion on this question was divided. Diogenes from Babylon argued that the merchant was obliged to inform his customers of known defects of the good he was selling, but that he was permitted to try and get the highest price possible for it. Diogenes made a distinction between concealing something about a good from others and not taking the initiative of informing them of something which might change their evaluation of it. The merchant was not forcing the islanders to buy his wheat, Diogenes pointed out. They did so only if they wanted and needed it. Antipater of Tarsus disagreed. The merchant

² The main author of this report had many conversations with Milton Friedman on this issue. Cf. also interview with Milton Friedman on CNBC 12 March 2003; Henry G. Manne, *Insider Trading and the Stockmarket* (New York: The Free Press, 1966).

was a member of the same moral community as the islanders and thus he had an obligation to them not to take advantage of the situation.³

While Cicero himself concurred with Antipater, St. Thomas Aquinas disagreed with both of them:

The defect in a thing makes it of less value now than it seems to be: but in the case cited, the goods are expected to be of less value at a future time, on account of the arrival of other merchants, which was not foreseen by the buyers. Wherefore the seller, since he sells his goods at the price actually offered him, does not seem to act contrary to justice through not stating what is going to happen. If however he were to do so, or if he lowered his price, it would be exceedingly virtuous on his part: although he does not seem to be bound to do this as a debt of justice.⁴

St. Thomas makes a crucial distinction here between justice and generosity. He points out that the merchant is not selling a defective good; he is not cheating his customers, even if he may be lacking in generosity. Although the philosopher-saint does not explicitly make the argument, it seems that he relies on uncertainty about the future: Whereas the merchant has seen the sails of other merchant ships on the horizon, he cannot be sure that they will arrive safely in Rhodos. He is not bound to lower the price others are willing to pay him, on the basis of educated guesswork. Another argument which could strengthen Diogenes' and Aquinas' case is from self-ownership: If people own themselves, then they presumably also own the knowledge which they have acquired without violating any moral or legal rules. It is theirs, and theirs alone, to choose whether or not they reveal it in negotiations with others.

Friedrich A. Hayek and Robert Nozick discuss the second example of market exchanges which may be involuntary and unjust even if no force is used or threatened. In a desert oasis, suddenly all springs but one dry up. The inhabitants who settled there on the assumption that water would be available at a reasonable price, are now totally dependent on the owner of the one remaining spring. Can he charge them whatever he wants or even, out of malice or superstition, withhold 'his' water altogether from them? If he uses the opportunity to charge an extortionary price, then Hayek considers this a clear case of coercion. The exchanges are only voluntary in name because the owner of the sole spring, the extortionist, is a monopolist who has complete control of the other inhabitants' means of existence.⁵

Nozick agrees on the conclusion, but with a different reasoning. His precondition for a justly acquired property right to natural resources such as the spring is the Lockean proviso that other are not made worse off as a consequence of the initial appropriation. It is Nozick's empirical contention that in a system of private property and free trade, because of its enormous creative powers, the Lockean proviso in most cases may be fulfilled: Even if some possibilities to utilise resources are removed from some by others appropriating them, in the process many other possibilities are

³ Marcus Tullius Cicero, *De officiis* [On Duties], tr. Walter Miller (Cambridge, MA: Harvard University Press, 1913), Book III, XII–XIII, pp. 50–57.

⁴ St. Thomas Aquinas, *Summa Theologica*, tr. by Fathers of the English Dominican Province (New York: Benziger Bros., 1947–8), Book II, Part II, Question 77, §3.
<http://dhspritory.org/thomas/summa/SS/SS077.html#SSQ77OUTP1>

⁵ F. A. Hayek, *The Constitution of Liberty*, ed. Ronald Hamowy, *The Collected Works of F. A. Hayek*, Vol. XVII (Chicago: University of Chicago Press, 2011), p. 203.

created, as can be seen from the fact that an immigrant to America in 2017—when almost all natural resources have been appropriated—enjoys many more opportunities to better his conditions than an immigrant in, say, 1617. Nozick argues that the owner of the sole spring is not morally entitled to charge an extortionary price, even if all the other springs have dried up. “This unfortunate circumstance, admittedly no fault of his, brings into operation the Lockean proviso and limits his property rights.”⁶

Although St. Thomas Aquinas holds that property rights are important, he agrees:

Nevertheless, if the need be so manifest and urgent, that it is evident that the present need must be remedied by whatever means be at hand (for instance when a person is in some imminent danger, and there is no other possible remedy), then it is lawful for a man to succor his own need by means of another’s property, by taking it either openly or secretly: nor is this properly speaking theft or robbery.⁷

David Hume, while providing a penetrating analysis of private property rights, also agrees: In a pressing emergency, the rules of justice, including those of private property, are suspended. In this context, Hume mentions a shipwreck and a city besieged.⁸

3. *The Spring Owner or the Alexandrian Merchant?*

Adherents of strict private property rights—who should perhaps be called propertarians rather than libertarians—have however presented cogent arguments against Hayek and Nozick, and, for that matter, against St. Thomas and Hume. If the owner of the sole remaining spring in the oasis significantly raises his price for the water as a result of sudden scarcity, then it can perhaps be regarded as a natural response to a change. It is a signal to the other inhabitants that the oasis has become a less suitable place for them. It tells them that they have to ration their consumption of water. Moreover, it is unclear what constitutes a reasonable price if it is not that which the owner offers and the consumers accept, however grudgingly. Certainly, when water becomes more scarce, its price should go up. But how far could the owner of the sole spring go without abusing his position and becoming an extortionist? People settling in a place may have expectations about future conditions there, but this does not mean that they have legitimate claims on others about satisfying those expectations. This does not apply only to the hypothetical spring in the oasis, but also when a coal mine near a mining village in Wales is exhausted, or when a fish stock disappears after having been harvested by the inhabitants of a fishing village in Iceland over decades: Then, people have to move to more suitable places. They have suffered a *misfortune*, not *injustice*. The implicit assumption in the example of the oasis is that people cannot leave, but this is not necessarily the case (although in Hume’s examples of the shipwreck and the city besieged this premise

⁶ Robert Nozick, *Anarchy, State, and Utopia* (New York: Basic Books, 1974), p. 180.

⁷ St. Thomas Aquinas, *Summa Theologica*, Book II, Part II, Question 66, §7.
<http://dhspriority.org/thomas/summa/SS/SS066.html#SSQ66A7THEP1>

⁸ David Hume, *An Enquiry Concerning the Principles of Morals*, ed. L. A. Selby Bigge (Oxford: Clarendon Press, 1902), Section III, Part 1, p. 186.

may apply). It should also be noted that if the price of water is raised substantially, a motive is created for trying to discover new springs in or near the oasis.⁹

Despite these cogent and relevant arguments, the fact remains that those who take liberty as their moral lodestar regard property as a means rather than an end, so that they will probably agree with Hayek and Nozick (and St. Thomas and Hume) that when there is a clear choice between the two, property has to yield to liberty. There are situations, however rare and unusual, in which people may be abusing their position and coercing others although they are not seemingly using brute force or making threats.¹⁰ The owner of the suddenly sole spring in the oasis using his position to charge extortionary prices is one of those people. The crucial distinction between him and the merchant from Alexandria charging the highest price he can is that the Alexandrian is offering a service, making the effort of sailing all the way to Rhodos with wheat, whereas the owner of the sole spring finds himself in a situation of sudden scarcity and takes advantage of it.

Certainly, those Nordic businessmen who used the situation during the Icelandic bank collapse to capture assets of the fallen banks at bargain prices spoke as if they were following in the footsteps of the merchant from Alexandria. Finn Haugan and Lars Rohde in effect both said: 'We are making you an offer that you can refuse. Take it or leave it. This is just another market exchange.' But in reality, they were more like the owner of the remaining spring in the oasis after all the other springs had dried up. During the financial crisis, all sources of liquidity had dried up for the Icelandic banks. Haugan and Rohde however had access to sources of liquidity, and they took advantage of it to strike a bargain. (For argument's sake, it is left aside here that most of the liquidity they offered was in fact provided by government, which makes their case even less persuasive.) In some of the other examples (Glitnir Securities, Finnish Glitnir, the asset management unit of Finnish Kaupthing), little or no liquidity was provided: The staff simply seized the companies, for a fraction of what they knew they were worth, with the help of local businessmen and the acquiescence of the authorities.

In most of the seven cases discussed here (only excepting the sale of Swedish Kaupthing and possibly the sale of Kaupthing's asset management unit, of which little is known), the buyers may therefore have acted unjustly and therefore immorally. It is true that these were not issues of life and death, like Hume's shipwreck and the city besieged, but they were certainly important for the Icelanders who in the autumn of 2008 seemed to be in a similar situation as the inhabitants of the oasis in the desert. Many thought, with British Prime Minister Gordon Brown, that Iceland was bankrupt. The Icelanders live on the margin of the habitable world, as Julian Huxley once pointed out.¹¹ For a while, the outlook for Iceland as a sustainable country seemed bleak, as can be seen by doubts then frequently expressed

⁹ Ronald Hamowy, Hayek's Concept of Freedom: A Critique, *New Individualist Review* (April 1961), pp. 28–31. Murray Rothbard, *The Ethics of Liberty* (New York: New York University Press, 2002), p. 221.

¹⁰ John R. Lucas, *On Justice* (Oxford: Clarendon Press, 1980), p. 211; Kristjan Kristjansson, *Social Freedom: The Responsibility View* (Cambridge: Cambridge University Press, 1996), pp. 22–4.

¹¹ Apparently, Huxley wrote this in the magazine *Leader* after a visit to Iceland in 1949. Here after John Elkington, The Reykjavik Imperative, *New Scientist*, Vol. 74, No. 1057 (1977), 23 June 1977, p. 702.

about its struggle for independence. There was a nagging fear that Iceland as a whole would be in the situation of a Welsh mining village after the mine had been exhausted, or as a fishing town in the Western Fjords of Iceland after the fish stock traditionally harvested had disappeared. But the treatment of Icelandic-owned assets in the other four Nordic countries perhaps illustrates that Iceland is not the only Nordic country tainted by nepotism and favouritism. The analysis presented here also shows that when push came to shove, Iceland was excluded from the Nordic moral community, just as it was excluded from the talks in 1948 between the three Scandinavian countries about a defence alliance.¹² It did not really belong; it was too far away, too small, expendable. If solidarity is a prevalent virtue in the other four Nordic countries, then it does not seem always to extend to Iceland.

¹² Thor Whitehead, *The Ally Who Came in from the Cold: A Survey of Icelandic Foreign Policy 1946–1956* (Reykjavik: University of Iceland Press, 1998).

Chapter Ten

The Sale of Bank Assets in the UK

The two Icelandic-owned British banks closed down by the British government in October 2008, Heritable and KSF, both turned out to be fully solvent, not least because they were put into an orderly resolution process. It is highly relevant to an investigation of foreign factors in the Icelandic bank collapse to compare the treatment of them to that of Icelandic-owned assets in the Nordic countries.

1. Solvent and Law-Abiding Icelandic-Owned Banks

While the British government may have acted ruthlessly, even brutally, in closing down the subsidiaries and branches of Icelandic banks in the UK, in imposing an Anti-Terrorism Act on Icelandic companies and authorities and in insisting on a reimbursement by the Icelandic government for its outlays concerning the Icesave accounts, after the collapse it, unlike some Nordic authorities, apparently did not actively help local businesses to capture Icelandic-owned assets at bargain prices.

The fact that the two Icelandic-owned banks in the UK, Heritable Bank and KSF, Kaupthing Singer & Friedlander, turned out to have been solvent—with recovery rates of 98 and 87 pence on the pound, respectively—is significant in at least four ways.

First, it suggests that perhaps many of the financial firms owned by Icelandic banks in the Nordic countries also may have been sound. The great losses incurred by them may have been partly because they did not go through a proper resolution process like the financial firms owned by Icelandic banks in the UK.

In the second place, the deposits collected in the UK were mostly invested in the UK: In 2006, for example, of the 100,000 people working for Icelandic-owned companies abroad, 70,000 were based in the UK.¹ In a meeting that year with Icelandic Foreign Minister Geir H. Haarde, UK Foreign Secretary Jack Straw expressed his delight that the Icelanders were investing heavily in the UK: Indeed, then more British residents worked for companies from Iceland than from Switzerland.² After the bank collapse, the London branch of international auditing firm Deloitte was commissioned by Landsbanki's Resolution Committee to investigate how the Icesave money had been used. The conclusion was that it had mostly been used to refinance loan deals by

¹ Kari Jonasson, Efnud til radstefnu eftir stofnun utibus [Held a Conference after Establishing a Branch], *Frettabladid* 10 May 2006, p. 46. http://timarit.is/view_page_init.jsp?pageId=3893025

² Telur Islendinga ekki hafa serstakan hag af ESB-adild [Thinks Iceland Has Little to Gain from EU Membership], *Morgunbladid* 19 January 2006, p. 10. http://timarit.is/view_page_init.jsp?pageId=4120095

Landsbanki and its main customers. It had not been used, as sometimes alleged, for direct loans to the main shareholders in Landsbanki.³

Thirdly, no illegal or abnormal last-minute transfers of money from the UK to Iceland were found despite extensive investigations both in Iceland and the UK. As noted earlier, if the measures undertaken by Icelandic authorities in response to the bank collapse indirectly brought about assets transfers from one group to another in other countries, then they were from German banks to British depositors.

Fourthly, at the same time as solvent Icelandic-owned British banks were closed down with sleight of hand, putting unsecured British deposits and British jobs at risk, all other British banks were rescued, even if some of them turned out to be in much worse condition than British authorities had envisaged.

2. Heritable Bank and Landsbanki's London Branch

Heritable Bank was founded in Glasgow in 1877 and incorporated in Scotland 6 January 1887 as Heritable Investment Bank. From 1945 to 1987 it was known as Heritable and General Trust Ltd, from 1987 to 1989 as Heritable & General Investment Bank Ltd, and from 1989 as The Heritable and General Investment Bank Ltd. In 1950 it moved its headquarters from Glasgow to London, 8 Hill Street, just off Berkeley Square in the West End. In 1956–1983 it was family-owned, after which foreign investors took it over. It specialised in advising on and financing property acquisitions.⁴ At the end of 1999, the total value of Heritable's assets was £55 million, and the profit after tax was £848,000.⁵ The major shareholder at that time was the First Union Bank in the US, later called Wachovia, with 70%, while the management team owned 30%.⁶

On 18 July 2000 it was announced that Landsbanki had bought 70% of the bank, 50% from First Union/Wachovia and 20% from the management team. Landsbanki paid partly in its own shares so First Union/Wachovia became the owner of 4.25% in Landsbanki. With this purchase, Landsbanki intended to provide financial services in the UK to its customers, not least to affluent Icelanders.⁷ John Quitter, a financial expert with ties to the Icelandic business community, had pointed out Heritable Bank to Landsbanki, and he accepted a seat on the new board, whereas Landsbanki director Halldor J. Kristjansson became chairman.⁸ Martin Young remained as bank director.

³ The Deloitte report was not made public, but it was leaked to an Icelandic newspaper, Icesave-fed notad til ad endurfjarmagna lan [Icesave Money used to refinance loan deals], *DV* 25 February 2011, p. 6. http://timarit.is/view_page_init.jsp?pageId=6379049

⁴ David Luck, Scotland's 100-oldest Companies Project. Business Archives of Scotland. May 2011. http://www.gla.ac.uk/media/media_197311_en.pdf Landsbankinn i sokn i London [Landsbankinn Expanding in London], *Morgunbladid* 22 November 2001, p. 12C. http://timarit.is/view_page_init.jsp?pageId=3427461

⁵ Landsbankinn tekur yfir rekstur HGI i London [Landsbanki Takes Over HGI in London], *Morgunbladid* 9 September 2000, p. 20. http://timarit.is/view_page_init.jsp?pageId=1977877

⁶ Landsbankinn i sokn i London [Landsbankinn Expanding in London], *Morgunbladid* 22 November 2001, p. 12C. http://timarit.is/view_page_init.jsp?pageId=3427461

⁷ Landsbankinn tekur yfir rekstur HGI i London [Landsbanki Takes Over HGI in London], *Morgunbladid* 9 September 2000, p. 20. http://timarit.is/view_page_init.jsp?pageId=1977877

⁸ SIC Report, Vol. 8, Online Addenda, No. 1, p. 89. Cf. Landsbankinn tekur yfir rekstur HGI i London [Landsbanki Takes Over HGI in London], *Morgunbladid* 9 September 2000, p. 20. http://timarit.is/view_page_init.jsp?pageId=1977877

While relatively small, with only 32 employees in 2001, Heritable Bank was quite profitable. In February 2002, Landsbanki bought the remaining Wachovia shares in Heritable Bank, as it was now called, and became owner of 95% of its shares. In 2002–2003, Landsbanki bought the 5% which the management team had owned.⁹ In total, Landsbanki paid £25.9 million for Heritable Bank.¹⁰

When Martin Young retired in 2002, after 25 years with Heritable Bank, since 1997 as director, he was replaced by Mark Sismey-Durrant who had been a senior manager at the HSBC in the UK and at Sun Life Financial in Canada and most recently CEO of a mortgage and savings bank in Stevenage, Hertfordshire, Sun Bank Plc (later, after a takeover by Portman Building Society called the Mortgage Works). In the years after Landsbanki took control of Heritable Bank, it gradually expanded into other fields while maintaining its traditional role of advising on and financing property developments, both residential and commercial, in the form of senior and mezzanine debt (all priority debt, secured by collateral). In 2003, Heritable Bank started to accept wholesale deposits where typical customers were local authorities, building societies, corporations and universities. In 2004, Heritable Bank started to accept retail deposits, offering competitive returns on savings accounts. In 2004, also, Heritable Bank entered the mortgage lending business, specialising in buy-to-sell, self-certified and status mortgages where lending is mainly based on the income and creditworthiness of customers. In 2005, Heritable Bank acquired Key Business Finance Corporation, which concentrated on short-term financing to law firms. With this acquisition, Heritable Bank's balance sheet had grown from about £175 million at the time Landsbanki took control, to about £450 million.¹¹ Heritable Bank's total assets at the end of 2004 were evaluated at about £355 million (ISK 43 billion), more than sixfold what it had been five years earlier.¹² In 2006, Heritable Bank launched an Asset Finance business, focused on financing small items such as vehicles and industrial equipment for small and medium sized businesses in the UK. Eventually Heritable Bank's balance sheet amounted to £1.2 billion which was financed by a combination of retail and wholesale deposits, equity and subordinated debt from its parent company, Landsbanki.¹³

In March 2005, Landsbanki also set up a branch in London, located first in Heritable's Mayfair offices and then at Beaufort House at 15 St. Botolph Street, in the City of London. First, the Landsbanki London branch mainly participated in leveraged loan financing, but later it also started to originate leveraged loans. In late 2006, the branch launched an Asset Backed Lending Unit, staffed with a core group of experienced bankers, working with teams in London, Birmingham, Manchester

⁹ Landsbankinn í sokni í London [Landsbankinn Expanding in London], *Morgunblaðið* 22 November 2001, p. 12C. http://timarit.is/view_page_init.jsp?pageId=3427461 Landsbankinn með 95% í Heritable Bank [Landsbanki Owns 95% of Heritable Bank], *Morgunblaðið* 23 February 2002, p. 23. http://timarit.is/view_page_init.jsp?pageId=3433976 4,25% hlutur í Landsbankanum seldur [4.25% Share in Landsbanki Sold], *Morgunblaðið* 26 February 2002, p. 17. http://timarit.is/view_page_init.jsp?pageId=3434146

¹⁰ Kristjánsson and Arnason, *Developments leading up to the Icelandic banking crisis*, p. 7. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

¹¹ *Ibid.*, p. 8.

¹² *Financial Stability*, ed. Tryggvi Pálsson et al. (Reykjavik: CBI, 2005), p. 28. Table 4. https://www.cb.is/library/Skraarsafn---EN/Financial-Stability-Report/en_FS_2005.pdf

¹³ Interview with Mark Sismey-Durrant in London 28 November 2014.

and London. In October 2006, the branch started to collect deposits into online savings accounts, under the brand name 'Icesave'. The idea came from Mark Sismey-Durrant and the Heritable Bank team as a means of enabling Landsbanki to fund its UK lending in a manner similar to Heritable without the alternative dependence on wholesale debt funding for the London branch. The idea was to fund lending in the UK through deposits collected in the same country.¹⁴ This was initially achieved through the purchase by Landsbanki of Cheshire Guernsey from Cheshire Building Society (renamed Landsbanki Guernsey) and then through the launch of Icesave. While the management team of Heritable Bank used their experience to manage the Icesave accounts, back-office operations were outsourced to the Newcastle Building Society. In October 2007, the Landsbanki London branch launched a Capital Markets Products Unit. Its aim was to offer customers advice and financial products. The branch was operated separately from Heritable Bank, except for the administration of the Icesave accounts. An Icelandic banker, Larus Welding, was branch manager in London until 2007 when he moved back to Iceland as CEO of Glitnir. He was succeeded by Baldvin Valtýsson.

3. The Close-Down of Heritable Bank and Landsbanki's London Branch

The London Landsbanki branch was regulated by the Icelandic Financial Supervisory Authority, IFSA, whereas Heritable Bank, being a British bank registered in Scotland, was regulated by the UK Financial Services Authority, FSA. The relationship between Heritable Bank and the FSA was excellent throughout the time of Landsbanki's ownership. However, the start of the credit crunch in late 2007 raised concerns about Landsbanki's liquidity and, consequently, about the instant access Icesave online accounts and the sterling deposits raised through Landsbanki Guernsey. The Icesave accounts were only partly covered by the British deposit insurance scheme in the case of Landsbanki's failure. In Chapter 4 of this report a brief account was given of the inconclusive talks between Landsbanki and the FSA about a possible transfer of the Icesave accounts from the Landsbanki London branch to Heritable Bank: The FSA kept toughening its requirements of Landsbanki to the point where the FSA staff must have known that Landsbanki could not meet them. During the weekend of 4–5 October 2008, the FSA made the final demand that Landsbanki would transfer £53 million to Heritable Bank and £200 million to Landsbanki's London branch before the end of the next working day, Monday 6 October. Otherwise, the FSA would close down both the UK authorised Heritable Bank and Landsbanki's London branch.¹⁵

Monday 6 October 2008, the Landsbanki management team in Iceland told Heritable Bank's Sismey-Durrant that they could not provide Landsbanki Guernsey or Heritable Bank with more cash. For Landsbanki Guernsey this was critical, for Heritable it was not immediately so. The Guernsey regulatory authorities were notified when promised transfers from Landsbanki were not made. Sismey-Durrant was in continuous dialogue with the FSA staff, but it appeared to him that their intentions were unclear, as they seemed to be tied to the situation with the requested transfers to Heritable Bank from Landsbanki. Early in the morning of Tuesday 7

¹⁴ Björgolfsson, *Billions to Bust*, p. 162.

¹⁵ Kristjánsson and Arnason, *Developments leading up to the Icelandic banking crisis*, p. 78.
<http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

October, the UK Board of Heritable Bank were summoned to meet with FSA staff at the London offices of the law firm Slaughter and May and informed that steps had been taken to place the Bank in default. At 9:30 in the morning, the FSA publicly declared Heritable Bank to have been placed into administration. The UK regulatory authorities had used its powers in conjunction with the UK Treasury to effect the transfer of the majority of Heritable Bank's retail depositor accounts to the Dutch-owned bank ING DIRECT.¹⁶ Apparently the Dutch-owned company had been approached by Treasury officials some days earlier to see whether it would be interested in taking on the accounts of its two UK competitors, the Icelandic-owned Heritable Bank and KSF.¹⁷ The balance of accounts thus transferred from Heritable Bank was about £547 million. The transfer was financed by a loan from the Bank of England. In an oversight by the authorities, a small number of depositor accounts administered in-house needed to be covered by the FSCS, Financial Services Compensation Scheme.¹⁸ Apparently, the Dutch-owned bank did not pay anything for the new customers from Heritable Bank.

In Iceland the same Tuesday, in the morning, a resolution committee had taken over Landsbanki. The British authorities did not have the same powers regarding the branch of a foreign bank, now under the control of a Resolution Committee, as they had regarding a subsidiary: The branch was an Icelandic company, the subsidiary a British one. The FSA team that turned up at Landsbanki's branch on Tuesday were therefore somewhat unsure of their role.¹⁹ But on Wednesday 8 October the Treasury issued the freezing order against Landsbanki and certain Icelandic authorities under the Anti-Terrorism Act.²⁰

Since Heritable Bank was registered in Scotland and subject to Scottish law, the Court of Session in Scotland appointed administrators for it. They came from the Glasgow office of the accounting firm Ernst & Young LLP. The administrators immediately started to try and sell off the bank's main assets, such as the Structured Property Finance book and the mortgage books. But they soon concluded that this should be postponed until the market had improved. At the date of administration, Heritable employed 125 staff. More than half of them were made redundant over the next few months. The Director, Mark Sismey-Durrant, and many of his team continued to work with the administrators, Sismey-Durrant until 2011. "The administrators who took over the bank came in expecting to find a lot of problems. They soon discovered that the bank was in much better shape than they had expected, that it was a sound and well-run business and that nothing illegal seemed to have taken place. Their resolution strategy consequently changed," says Sismey Durrant. One of the main challenges initially was to get a functioning payments capability as the UK Direct Debit system had not been updated to reflect the current insolvency law; hence, UK banks suddenly would not process payments for a bank in

¹⁶ Interview with Mark Sismey-Durrant in London 28 November 2014.

¹⁷ Op. cit.

¹⁸ The Heritable Bank plc Transfer of Certain Rights and Liabilities Order 2008. Statutory Instruments, 2008 No. 2644. <http://www.legislation.gov.uk/uksi/2008/2644/sld/made> FSCS starts paying compensation to Heritable Bank customers. Press Release 24 October 2008. https://www.fscs.org.uk/uploaded_files/Publications/press-releases/press_release_24_oct_2008_heritable.pdf

¹⁹ Interview with Lilja B. Einarsdottir in London 3 March 2016.

²⁰ The Landsbanki Freezing Order. Statutory Instruments, 2008 No. 2668. http://www.legislation.gov.uk/uksi/2008/2668/pdfs/uksi_20082668_en.pdf

administration. This took about six months to resolve and was very costly. This also had an impact on immediate liquidity, so the administrators secured a short-term loan facility of £20 million from Austrian bank BAWAG P.S.K. (Bank für Arbeit und Wirtschaft). Because of market conditions, fees and interest rates were exceptionally high. The loan was repaid as soon as possible, in April 2009.²¹

By July 2009, all secured creditors were fully repaid. Assets were recovered in the normal course or slowly sold off and creditors were paid. By August 2015, while Heritable Bank remained in administration, as some issues between it and its former clients were still unresolved, all usual claims and payments had been settled. By then, all non-preferential creditors had been paid. The recovery currently stands at 98 pence in the pound. The total cost of administration and legal fees amounted to £43 million, while a sizeable fund has been kept in reserve for further legal costs and administrative expenses, so that further dividends are likely.²² This is indeed remarkable. It means, in essence, that Heritable Bank assets had been sufficient to cover its liabilities: the bank with net capital resources of €130 million had been solvent in October 2008. It faced a potential liquidity challenge owing to the plight of its parent company Landsbanki, which was ultimately why it was declared to be in default by the FSA. The involvement of the management and staff of the Bank in the continued operations was a significant factor in the high recovery rate.

The UK Treasury, the FSA and the Bank of England seem to have made a huge mistake, or an egregious error, when those authorities closed down Heritable Bank in the manner they employed. Evidently, temporary liquidity support would have ensured its continuing operations while a new home could be found for it. However, its depositors had already been transferred to ING DIRECT before it was declared in default: Its depositors were replaced by the UK Treasury as principal creditor and hence it no longer had a viable future. By law, the FSCS was not supposed to pay claims for compensation unless it was “satisfied that the firm (in this case Heritable Bank) is unable to pay back money it owes to its customers”.²³ In this case, it turned out that the firm was indeed able to pay back money it owed to its customers, even if the cost of resolution was at least £43 million. It therefore seems reasonable to concur with the two Landsbanki managers who claimed that the real value of Heritable Bank as an ongoing operation destroyed by measures undertaken by the British authorities in October 2008 was about £200–250 million.

The assets of Landsbanki’s London branch were formally in the hands of the Landsbanki’s Resolution Committee in Iceland, but they were frozen until the British authorities in June 2009 cancelled the Freezing Order of 8 October 2008. The staff at the branch fully cooperated with the Treasury’s Financial Sanctions Unit which came in after the Freezing Order had been issued. The Treasury staff and accountants that were helping them initially were suspicious, but Manager Baldvin Valtýsson and his

²¹ *First progress report to all known creditors* (London: Ernst & Young, 17 April 2009).

http://www.heritable.co.uk/Uploads/Documents/news/6_Month_Report.pdf

²² *Twentieth progress report to all known creditors* (London: Ernst & Young, 10 March 2016).

https://www.heritable.co.uk/Uploads/Documents/news/Heritable_Bank_PLC_20th_Progress_Report_Signed.pdf Administration cost was £30 million and legal fees £13.4 million.

²³ FSCS starts paying compensation to Heritable Bank customers. Press release 24 October 2008.

https://www.fscs.org.uk/uploaded_files/Publications/press-releases/press_release_24_oct_2008_heritable.pdf

Deputy Lilja B. Einarsdottir explained to them that the assets of the branch could be quite valuable if the resolution of the branch was properly managed. At the time the branch's assets were estimated to be £1.5 billion, but in 2016 this had been adjusted upwards to £2.6 billion.²⁴ The UK Treasury team decided on 12 October to extend a loan of £100 million to the branch in order to avert fire sales and protect the impact on the UK companies being financed by Landsbanki which were themselves at risk without on-going finance. This £100 million facility was repaid in December from cashflow received. After the close-down of the branch, several complicated matters had to be resolved, including the legal liability of its staff who were after all working for a company subject to financial sanctions. Until July 2010, the branch had to a large extent to deposit liquid assets in an account with the Bank of England which bore no interest.²⁵ Gradually the operations of the branch were wound up.

4. *Kaupthing Singer & Friedlander, KSF*

Kaupthing Singer & Friedlander was the other British bank owned by an Icelandic bank. Like Heritable Bank, it had a long history. Julius Singer founded a stockbroking firm in London in 1907. Soon thereafter, Singer was joined by Ernst Friedlander who came from a prominent Berlin family of bankers. During the First World War, however, they were not able to operate on the London stock exchange, because of their German roots, and therefore they turned to banking. In 1920, Singer & Friedlander was incorporated as a partnership. As already mentioned, the well-known investor George Soros started his career in finance at Singer & Friedlander.²⁶ In 1957, the firm was listed on the London stock exchange. In the next three decades, Singer & Friedlander had various owners, and established itself as a merchant bank in the City of London. It set up offices in Birmingham, Bristol and Nottingham, and in 1971 it opened an offshore banking facility. It became an independent bank again in 1987, and for a while, controversial media magnate Robert Maxwell (Jan Ludwig Hoch) owned a share in it.²⁷ In 1994 Singer & Friedlander acquired a majority of shares in the Swedish brokerage Carnegie Group. It sold its shares in 2001–2003, and began to concentrate on its core activities, investment banking and merchant banking operations.²⁸ With the headquarters located at 21 New Street, Bishopsgate, in the City of London, it had in 2003 a balance sheet of almost £3 billion. John Hodson who had been with the bank since 1969 was its director and also board chairman.

In November 2002, Kaupthing had started to operate in London from the small office of a company, Brask & Company, which the bank had acquired. In April 2003, one of Kaupthing's Icelandic managers, Armann Thorvaldsson, moved to London as the manager of Kaupthing's UK operations. He soon came into contact with British investors and entrepreneurs like Robert Tchenguiz and Kevin Stanford, while

²⁴ Interview with Lilja B. Einarsdottir in London 3 March 2016.

²⁵ *Creditors Report 1/2010* (Reykjavik: Landsbanki Islands, Resolution Committee and Winding-Up Board, 2010), p. 34. <https://www.lbi.is/Media/creditor-report-1-03-2010.pdf> *Creditors Report 3/2010* (Reykjavik: Landsbanki Islands, Resolution Committee and Winding-Up Board, 2010), p. 38. <https://www.lbi.is/Media/creditor-report-3-08-2010.pdf>

²⁶ David Litterick, Billionaire who broke the Bank of England, *The Telegraph* 13 September 2002. <https://www.telegraph.co.uk/finance/2773265/Billionaire-who-broke-the-Bank-of-England.html>

²⁷ Maxwell klyfur fjolmidlatroll sitt i tvennt [Maxwell Divides up his Media Empire into Two Parts], *Morgunbladið* 25 August 1991, p. C17. http://timarit.is/view_page_init.jsp?pageId=1749315

²⁸ For a short history: <http://www.fundinguniverse.com/company-histories/singer-friedlander-group-plc-history/>

maintaining a relationship with Icelandic investors such as retail magnate Jon Asgeir Johannesson and the Bakkavor brothers, Lydur and Agust Gudmundsson, producers of various kinds of food. By the end of 2003, Kaupthing had 10 people working in the office, by Christmas 2004 the number had grown to 18, and a year later to 40.²⁹

However, in 2003 Kaupthing began to accumulate shares in Singer & Friedlander, after concluding that they were undervalued. In February 2004, Kaupthing owned 40% of the shares, and in early 2005 it approached Singer & Friedlander with an offer to buy the whole bank. The idea was to merge it with Kaupthing's existing operations in London, under Armann Thorvaldsson. The negotiations were conducted with Tony Presley Shearer who had replaced Hodson as director, and the Singer & Friedlander board. Thorvaldsson recalls:

Tony Shearer, tall and dark haired, was a real character. He had changed his middle name to Presley, to show his devotion to the King, and went to Memphis annually to pay tribute. Tony Shearer had taken over as CEO only a few months before our approach, and I believe he was not particularly happy with the takeover. After I got to know the people at Singer, a few told me that the CEO job had been his dream position. He seemed keen to continue as CEO, but unfortunately we didn't plan to keep him on. His attitude towards us changed very much when we informed him of our plan that I would replace him.³⁰

Later, Tony Presley Shearer was vocal in criticisms of the new owners of Singer & Friedlander. He appeared both before the House of Commons Treasury Committee and in an Icelandic television programme directed by Egill Helgason where he strongly criticised Thorvaldsson.³¹ In neither case, Thorvaldsson was offered the opportunity to respond.

The agreed purchase price for Singer & Friedlander was over £500 million which was about a year's profit for Kaupthing at the time. The agreement was signed 22 April 2005, and Thorvaldsson took over from Tony Presley Shearer as CEO in the beginning of December 2005. In 2005–6 the Kaupthing London branch and Singer & Friedlander were integrated. Some Singer & Friedlander people were made redundant, while new people were hired for the new company. Singer & Friedlander had had many subsidiaries, many of which were dormant, but now the structure of the company was simplified. Information technology was modernised. A new Capital Markets unit was set up. In the summer of 2006 the headquarters were moved from the City to Hanover Street in the West End. In the first six months of 2006, the return to equity was 16% whereas it had been about 6% when Kaupthing took over Singer & Friedlander. KSF was not only successful, it also became quite visible. "Singer had a Private Banking division whose clients included TV actors, film stars, and supermodels. To this Kaupthing added the entrepreneurs. When we merged the two and added a brokerage division, we could service wealthy individuals in many areas. New clients came to us through word of mouth, as well as through social occasions and holidays," Thorvaldsson writes.³² Only one unit was not performing well, New Bond Street Asset Management, jointly owned by Kaupthing and a management team

²⁹ Thorvaldsson, *Frozen Assets*, Ch. 6.

³⁰ *Ibid.*, p. 141.

³¹ Egill Helgason, SFO rannsakur Kaupthing/Silfrid i dag. Blog 13 December 2009.

<http://eyjan.pressan.is/silfuregils/2009/12/13/sfo-rannsakur-kaupthingsilfrid-i-dag/>

³² Thorvaldsson, *Frozen Assets*, p. 161.

led by Zoe Shaw. It invested in some subprime assets and was closed down at the end of 2007.³³

5. The FSA and KSF

The international credit crunch starting in the second half of 2007 affected KSF adversely. Its Icelandic parent company was, like the other two Icelandic banks, subject to much negative media reports and had high CDS (credit default swaps) spreads (which reflected the fact that many investors were taking out insurance against the possible default of the company). One way in which KSF dealt with the sudden liquidity shortage was, in early February 2008, to start taking online deposits under the brand name 'Kaupthing Edge'. Unlike Landsbanki's Icesave accounts, the Edge accounts were based at a Kaupthing subsidiary, KSF, so they were regulated by the FSA and fully covered by the UK deposit insurance scheme. FSA allowed the operation of the Edge accounts provided KSF maintained a 95% liquidity on the deposits. Also, KSF decided in February 2008 to shrink the balance sheet by more than a billion pounds. One banking division was closed and £350 million of loans were wound up, while two other divisions were merged, and the Asset Finance unit was put up for sale. As a consequence, the liquidity position of KSF improved in the first half of 2008.

By now, Kaupthing's management team had decided that it had to move the bank headquarters out of Iceland, as CBI Governor David Oddsson had suggested. One idea explored was that Kaupthing's Danish subsidiary FIH Bank would manage all the Scandinavian operations, while KSF would take over all other international operations, including Luxembourg. On 18 September KSF CEO Armann Thorvaldsson met with FSA staff members to present the plan to move and received a positive response. But at the same time the repercussions of the fall of Lehman Brothers three days earlier were being felt. KSF had sold a part of its Asset Finance unit for £100 million, and was close to selling the remainder for £600 million, but the potential buyer, a subsidiary of RBS, Royal Bank of Scotland, backed out of the deal at the last minute. RBS was then itself in dire straits.

At the same time as Glitnir was seeking assistance from the Icelandic government in late September 2008, scepticism about the other two Icelandic banks, Kaupthing and Landsbanki, increased greatly in the international financial markets, with ratings firms downgrading them. KSF was subject to "haircuts" (demands for more valuable collateral or reduction in loan value) from its traditional customers in the international financial market, and deposits in the Edge accounts started to flow out. Liquidity dropped in a matter of days by a few hundred million pounds. In response, KSF tried to increase liquidity by selling off KSF's leverage finance portfolio and by demanding from the Icelandic and Luxembourg Kaupthing companies increased margins in the securities financing unit. After the Icelandic government announced Monday 29 September that it would take a 75% stake in Glitnir, Thorvaldsson contacted his relationship people at the FSA and told them that KSF was very alert because of the developments in Iceland and their possible effect on KSF. The bank would now operate according to its liquidity contingency plan.

³³ Ibid., p. 240.

From the beginning, KSF had had a good working relationship with the FSA. As the Icelandic bank were collapsing, this was to change. On 1 October, the FSA asked for a meeting with Thorvaldsson and his management team. The meeting took place in the afternoon. The two FSA relationship people attended the meeting where Thorvaldsson presented KSF's emergency plan for increasing liquidity to £1.25 billion in the next ten days. It was the understanding of the KSF management team that the FSA relationship people agreed with the plan. Then the FSA people asked for another meeting which took place in the morning of Thursday 2 October. They were accompanied by liquidity specialists who had worked for the US Securities and Exchange Commission, SEC. The Americans were quite aggressive, even hostile. Indeed, they were so aggressive that after they had left, the British relationship people apologised for their behaviour.³⁴ In the evening, Thorvaldsson and his management team were summoned to the FSA headquarters in Canary Wharf where the FSA staff, led by senior manager Sheila Nicoll, expressed great concern over KSF's deteriorating liquidity and the inability of the Icelandic parent company to assist it.

Thorvaldsson tried to explain to the FSA staff why more than a billion pounds seemed to be missing in liquidity on the Edge accounts. First, in March 2008, Kaupthing and KSF had made a liquidity swap deal according to which Kaupthing lent KSF £1.1 billion for three months, while KSF lent Kaupthing back the same amount of money, £1.1 billion, each day. This enabled KSF to count the £1.1 billion loan from Kaupthing as liquidity in its books. The FSA had from the beginning been fully informed of this liquidity swap deal.³⁵ Thorvaldsson also tried to explain that some of KSF's reduced total liquidity had nothing to do with the Edge online accounts: while the Edge account deposits had increased to £2.8 billion, wholesale deposits in KSF had decreased by £1.5 billion. The outflow from other kinds of deposits should not affect the requirement for a 95% liquidity on the Edge accounts. In the third place, Thorvaldsson pointed out that the £500–600 million which the FSA found wanting in addition to the 1.1 billion from the liquidity swap deal, was because KSF had not aggressively implemented "haircuts" (demanded increased collateral or, alternatively, the repayment of loans) from its parent company, Kaupthing. But to add this to the £1.1 billion involved in the liquidity swap deal to arrive at the staggering sum of £1.6 billion in default constituted, Thorvaldsson argued, some double-counting. If Kaupthing had been able to provide the liquidity, then nothing would be wrong with refraining from the "haircuts".³⁶ Nicoll asked if KSF could draw on the liquidity swap deal with Kaupthing and get £1.1 billion to the UK. Thorvaldsson replied that this was probably out of the question. Possibly, Kaupthing could provide £300–400 million to KSF. "The sudden shift in tone began to ring alarm bells. At the end of the meeting, it was clear that we were at the FSA's mercy," Thorvaldsson recalls.³⁷

6. The FSA Monitoring KSF

Friday 3 October 2008, early in the morning, an FSA team arrived at the KSF headquarters to monitor operations. The same day, FSA imposed on KSF a number of requirements, including the ring-fencing of customer deposits received during 2

³⁴ *Ibid.*, p. 212.

³⁵ SIC Report, Vol. 7, Ch. 20, p. 161.

³⁶ *Ibid.*, pp. 161–2.

³⁷ Thorvaldsson, *Frozen Assets*, p. 212.

October and thereafter, placing them in a segregated trust account with the Bank of England or another UK account provider approved for the purpose.³⁸ During the day, KSF CEO Thorvaldsson was in regular contact with Nicoll at the FSA and with the Kaupthing management team in Iceland. Nicoll made it clear that the FSA would close down KSF if more cash did not arrive from Iceland. Despite its difficulties, Kaupthing transferred £100 million to KSF.

However, now the British authorities were apparently working on the hypothesis that a huge amount of cash had been or was being transferred from the UK to Iceland and that this was the explanation for the much less liquidity found in the KSF books than the FSA staff had expected. As noted earlier, in the early afternoon of Friday 3 October, a little before 14:00, Chancellor Alistair Darling, standing in for Prime Minister Gordon Brown who was in a meeting, called Prime Minister Geir H. Haarde and told him that Kaupthing appeared to have illegally transferred £600 million from its London subsidiary, KSF, to the parent company in Iceland. This money had to be immediately returned to the UK. If not, the FSA would close KSF down that very evening. When Haarde informed the Kaupthing management team of the call, they were surprised and said that this had to be based on some misunderstanding. They called the IFSA and asked it to contact the FSA to provide the relevant information. They also called Thorvaldsson, who was then in a car on his way to a meeting with the FSA.³⁹ Thorvaldsson tried to convince the FSA people that there had been no illegal cash transfer to Iceland and that there could be a way out for KSF, even if KSF's Icelandic parent company was in great trouble and could only provide limited liquidity.

It was the understanding of the KSF management team that in talks on 3 October, and over the weekend, from Saturday 4 to Sunday 5 October, KSF and the FSA reached an agreement that KSF had two weeks to try and increase KSF's liquidity according to a plan, mainly by selling assets. The FSA people examined the plan presented by Thorvaldsson and his team, and Julia Dunn from the FSA accepted it. Senior officials in the Treasury had a different understanding of the talks. They said that the FSA was prepared to allow KSF to stagger (in other words, to implement in an irregular fashion) the payments it needed to receive in order to increase its liquidity, but on condition that KSF started to receive funds from Monday 6 October.

Sunday 5 October 2008, in the late afternoon, Prime Minister Gordon Brown called his Icelandic colleague Geir H. Haarde and told him that according to British authorities KSF had illegally transferred £1.6 billion out of the UK. Haarde replied that he had spoken to the Kaupthing management team, and that they had assured him that they had reached an agreement with the FSA on how to resolve this issue.⁴⁰ It seems that this (extremely serious) allegation was not pursued any further by the British authorities. Monday 6 October, FSA suggested to the KSF and Kaupthing management teams to try and sell KSF or parts of it to Barclays. FSA director Hector Sants sent an email to Kaupthing Director Hreidar M. Sigurdsson, asking him to provide Barclays with all the necessary information. Sigurdsson replied that Kaupthing would stand by its plan, but that he had nothing against Barclays taking a

³⁸ This was not a First Supervisory Notice to Kaupthing, but rather an agreement between the FSA and KSF, or a request by the FSA accepted by KSF. The First Supervisory Notice was issued 8 October.

³⁹ SIC Report, Vol. 7, Ch. 20, p. 83.

⁴⁰ *Ibid.*, p. 164.

look at KSF's British operations. Monday 6 October, in the afternoon, Julia Dunn at the FSA sent an email to KSF's Thorvaldsson, pointing out that KSF should be aware of some formal requirements if the company were to be taken into administration.

Monday 6 October, Thorvaldsson contacted Jon Pain of the FSA and asked him whether KSF could get liquidity from the Bank of England, pointing out that the bank had assets of £3.7 billion which could be used as collateral. Pain immediately rejected this idea (which he must already have been authorised to do). Thorvaldsson spent the evening and into the night talking to people from Barclays. It turned out that they were not interested in the bank itself or in any of its units, but rather in buying assets cheaply. This was no more attractive to the FSA or the Treasury than it was to the Kaupthing people, as it would have left the Edge deposits as liabilities without many assets against them, so the idea of a Barclays takeover of KSF was quickly abandoned.⁴¹

7. The Close-Down of KSF

Despite its difficult liquidity position, Kaupthing transferred £36 million to KSF Tuesday 7 October 2008. But the same day, the close-down of Heritable Bank and the Landsbanki London branch brought about a further outflow from the Kaupthing Edge accounts. At noon, FSA Director Hector Sants sent an email to Hreidar M. Sigurdsson, repeating the demand that KSF had to increase its liquidity if it wanted to continue operating. Sigurdsson replied that Kaupthing and KSF were busy trying to increase KSF's liquidity. They had sold shares in some companies, and in the evening, a team from the international investment firm JC Flowers would come to KSF to look at the books. Hopefully, a deal could be struck with them. Tuesday 7 October, the net outflow from Kaupthing Edge was £95.5 million. In the late afternoon, Jon Pain from the FSA wrote an email to Hreidar M. Sigurdsson where he expressed concern that the outflow from the Edge accounts would continue. "We are therefore of the view that there is a real risk that the subsidiary will not survive and if that looks to be the case, we will have no choice but to put it into Administration." Pain added that the FSA would not make a final decision until the next morning, at 7.30, when it would be clear whether anything had come out of the talks with JC Flowers. A confirmation of such an outcome had to reach the FSA no later than 6.30 in the morning. In the evening, Armann Thorvaldsson met with representatives of JC Flowers. He offered to sell KSF for £50 million which was less than 10% of its book value of equity. However, the JC Flowers people were not ready to make a quick decision, and the deadline was next morning.

After midnight, Thursday 8 October, Hreidar M. Sigurdsson sent Hector Sants an email telling him that the talks with JC Flowers had not led to anything as the company had required more time to make a decision. Kaupthing was however ready to stand by KSF and would provide liquidity in the next few days, by selling assets and other measures. Sants replied the next morning, at 7.11, telling Sigurdsson that KSF's liquidity problem was becoming very serious and that further outflows from the Edge accounts were to be expected. Therefore FSA requested a confirmation before 9 am this same morning that £300 million would be transferred to KSF, with an exact plan as to how Kaupthing would respond to the foreseeable outflows over

⁴¹ *Ibid.*, p. 165. Thorvaldsson, *Frozen Assets*, pp. 217–8.

the next ten days, and how Kaupthing would finance the repayment of £2.8 billion if necessary and how the bank would in that case maintain an acceptable liquidity position. Sants also wanted a confirmation from the CBI that these payments would go through. Shortly before Sants sent his email, at 7 in the morning, the British government announced a huge rescue package for British banks, amounting to £500 billion. Shortly afterwards, Hreidar M. Sigurdsson sent an email to Sants confirming that Kaupthing was working on a plan as Sants had requested. He also asked whether KSF, as a British bank, could participate in the government rescue package. Later in the morning, at 8.19, Sigurdsson sent another email to Sants announcing that Deutsche Bank had a full mandate to handle the sale of KSF and that Kaupthing was working on transferring £300 million to KSF.

Wednesday 8 October 2008, at about 10 in the morning, the headlines of British television channels were about Kaupthing collapsing.⁴² According to the television reports, Chancellor Alistair Darling had transferred the Kaupthing Edge accounts to internet bank ING DIRECT, owned by Dutch bank ING. This came as a complete surprise to KSF's Thorvaldsson who was in his office. He called his contact at the FSA, Julia Dunn, and asked her what was happening. He and other members of the KSF staff were busy working on raising £300 million for increased liquidity and a teleconference with the FSA had been planned later in the day. Dunn was as surprised at the news as Thorvaldsson. She called back after a while, telling Thorvaldsson that if the £300 million were forthcoming, the bank could continue operating. However, at 11:30 in the morning,⁴³ the FSA issued a First Supervisory Notice, requiring KSF to refrain from accepting any deposits from 13:30 that day.⁴⁴ After the FSA had issued its Notice, in effect closing down KSF, the Treasury issued its formal order, transferring KSF accounts to ING DIRECT, at 12.05. The order came into effect on 12.15.⁴⁵ As had been the case with the Heritable Bank accounts, ING did not pay anything for all these new customers.

At noon, KSF's Armann Thorvaldsson and Kaupthing's Hreidar M. Sigurdsson held a teleconference with FSA director Hector Sants. The teleconference started with Sants asking whether the £300 million that had been promised were on their way into the KSF account. Sigurdsson told Sants that he was very disappointed with the behaviour of the FSA. The deposits had been taken from KSF while the KSF and Kaupthing people had been working according to a plan accepted by the FSA on increasing KSF liquidity. Sigurdsson said that under these circumstances it was pointless to transfer £300 million to KSF. He repeated his question to Hector Sants about a possible participation by KSF, a British bank, in the huge recapitalisation

⁴² Kaupthing jatar osigur [Kaupthing Admits Defeat], *Morgunbladid* 9 October 2008, p. 1. http://timarit.is/view_page_init.jsp?pageId=4201358

⁴³ In the summary of the High Court in the case which Kaupthing's Resolution Committee brought against the Treasury, [2009] EWHC 2542 (Admin), it says (§26) that the FSA issued the order at 11.30 in the morning, whereas in the skeleton argument of Kaupthing it says that the FSA decided on the order at 10 in the morning (which was when television channels brought the news of the transfer of deposits from KSF to ING). It is evident that the decisions to close down KSF and to transfer deposits from it to ING preceded the two formal steps taken by the FSA and the Treasury. <http://www.bailii.org/ew/cases/EWHC/Admin/2009/2542.html>

⁴⁴ First Supervisory Notice, FSA 8 October 2008, <https://www.fca.org.uk/publication/supervisory-notices/ksf.pdf>

⁴⁵ The Kaupthing Singer & Friedlander Limited Transfer of Certain Rights and Liabilities Order 2008. Statutory Instruments, 2008, No. 2674, <http://www.legislation.gov.uk/ukSI/2008/2674/sld/made>

scheme which had just been announced by the government. Sants' answer was brief: "Those funds are not for you." He then requested KSF to be taken into administration and asked the board to cooperate during that process. Thorvaldsson and Sigurdsson agreed. They had no choice.⁴⁶

At almost the same time, at 12:33, Chancellor Alistair Darling announced in Parliament that "Kaupthing" had been put into liquidation "within the last hour" and that he had used his powers to transfer most of its deposits to the Dutch bank ING.⁴⁷ Obviously he meant KSF, but as noted earlier, KSF was not in liquidation when Darling spoke in Parliament. The bank went into administration at 14:49 that same day. Furthermore, Sheila Nicoll from the FSA later stated that one of the reasons KSF was taken into administration was that most of its retail deposits had been transferred:

As a result of the events set out above, it is highly likely that there will be a loss of confidence in the Bank; in particular those depositors who remain after the Transfer Order takes effect are likely to wish to withdraw their funds immediately. Accordingly, the Bank would be likely to face rapidly increasing demands for payments of its liabilities, which it would be unable to fund.⁴⁸

So, the Chancellor publicly said that he had transferred deposits from KSF because it was in administration, while the FSA said that KSF was put into administration because deposits had been transferred from it. This was obviously a game KSF could not win.

8. The Court Case Against the Treasury

As a result of KSF's fall, Kaupthing in Iceland could not survive: This event triggered covenants in loan agreements. Kaupthing was therefore taken into resolution in Iceland. Its Resolution Committee decided to bring the British Treasury to court in England, claiming that the Chancellor had with his Transfer Order regarding KSF overstepped the powers given to him in the Banking Act. The Resolution Committee argued, on behalf of Kaupthing, that there had not been "a serious threat to stability" if the order had not been made, as the Banking Act required. Two High Court Judges, in the Administrative Court, Lord Justice Stephen Richards and Justice David Maddison, heard the case. They came to the conclusion that the Chancellor had acted within his powers. The argument made by the Treasury was in their view cogent: KSF was most likely running out of funds and there was a risk of a wider loss of confidence if people could not withdraw their deposits from KSF.⁴⁹

Irrespective of the legal merits of this decision by the High Court, it contained some errors of fact and logic. First, Lord Justice Richards wrote: "On 6 October trading in the shares of Icelandic banks was suspended and the Icelandic Government enacted emergency legislation which included guarantees for depositors in Icelandic branches

⁴⁶ SIC Report, Vol. 7, Ch. 20, pp. 170–1. Thorvaldsson, *Frozen Assets*, p. 226.

⁴⁷ Hansard 8 October 2008, Col. 279.

<https://publications.parliament.uk/pa/cm200708/cmhansrd/cm081008/debtext/81008-0004.htm>

⁴⁸ SIC Report, Vol. 7, Ch. 20, p. 171.

⁴⁹ The Queen (on the application of Kaupthing Bank hf) and H.M. Treasury [2009] EWHC 2542 (Admin), <http://www.bailii.org/ew/cases/EWHC/Admin/2009/2542.html>

of the banks.”⁵⁰ This is not correct. It is a minor error that it was not the government, but the Icelandic Parliament which enacted the Emergency Act. A much more important point is that the Act was about depositors, whether Icelandic or foreign, gaining priority over other bank creditors. This should not be confused with a public announcement made by Icelandic government ministers at the time, similar to that then made in many other European countries, that the government would guarantee deposits in domestic branches of the Icelandic banks. That announcement had no legal validity and could most plausibly be regarded as a reassuring gesture.

In the second place, the Lord Justice stated that the FSA had issued a First Supervisory Notice on KSF 3 October and a Second Supervisory Notice 8 October, whereas the fact was that the First Supervisory Notice was issued 8 October.⁵¹ Prior to that, KSF had fully cooperated with the FSA.

Thirdly, the Lord Justice rejected the witness statement of Gudni N. Adalsteinsson from Kaupthing to the effect that an agreed plan had been in place between Kaupthing and KSF on the one hand and the FSA on the other hand. This was, the judge wrote, disputed by Clive Maxwell, a senior Treasury official. But surely a Treasury official would not necessarily be the person to know, with any certainty, of something that could be interpreted as an agreement between Kaupthing, KSF and the FSA. Again, the judge wrote that Adalsteinsson’s witness statement was “inconsistent” with an email sent from FSA 3 October, where demands for more transfers of money from Iceland to KSF were made. But this is hardly relevant to a plan which took shape and was possibly agreed on Sunday 5 October. The email was also from a FSA senior staff member, Jon Pain, to the director of the IFSA, Jonas Fr. Jonsson. Again, the judge found Adalsteinsson’s witness statement inconsistent with information provided by Sheila Nicoll from the FSA. But that information was only about transfers in and out of the KSF account over a few days and was not in any way a refutation of a possible agreement between KSF and FSA.⁵²

The most important point is however a logical one. Either KSF was systemically important or it was not. If it was systemically important, then the Treasury had the powers to rescue it or to close it down or to undertake other measures by a special order in the interest of “maintaining the stability of the UK financial system in circumstances where the Treasury consider that there would be a serious threat to its stability if the order were not made”, as it was put in the relevant legal statute. If KSF was not systemically important, then the Treasury presumably could not close it down in order to maintain “the stability of the UK financial system”, even if it might perhaps provide other reasons for doing so but they would be reasons irrelevant to the case brought to the court. This point is clear in the answer by Chancellor Alistair Darling to the question asked in preparation of this report why the UK government rescued RBS, but not KSF. He said that it was because KSF was not systemically important like the RBS.⁵³ But if it was not systemically important, then it was not necessary to close it down by a Treasury order. Darling’s answer is inconsistent with the argument accepted by the court that the Treasury was acting within its powers in

⁵⁰ Ibid., §20.

⁵¹ Ibid., §26.

⁵² Ibid., §19.

⁵³ Interview with Alistair Darling in London 11 December 2013.

closing down KSF, because otherwise there was a “serious threat” to the stability of the UK financial system.

9. *The Resolution of KSF*

The fact remains that KSF was closed down and put into administration. The accounting firm Ernst & Young was appointed by the High Court in London to administer it. The immediate task was to ensure a smooth transfer of the Edge accounts to ING. At the date of Administration, there were about 170,000 Edge deposit holders with total deposits of £2.6 billion. Other depositors were about 3,000, holding a total of about £2.3 billion. Those were individuals, charities, corporate customers, local authorities, building societies, banks, fellow KSF Group companies and others. Against those liabilities there were assets, most importantly the KSF loan book which was made up of three distinct portfolios, Private Banking, Property and Corporate. KSF also had a large number of Treasury assets and investments such as listed equities and holdings in investment trusts. Also, KSF owned some subsidiaries and had cash in banks. The administrators maintained some of the staff to keep operations going, but moved the headquarters from Hanover Street in West End to 21 New Street in the City, where Singer & Friedlander had originally been located: the company still rented those premises.

In their first report, the administrators only stated that the recovery rate for unsecured creditors should be a minimum of 50 pence in the pound.⁵⁴ In May 2017, the estimated recovery rate for non-preferential creditors had however become 87 pence on the pound. In the period from 8 October 2008 to 7 April 2017, legal and other professional fees amounted to £55 million and administrators’ fees to £81 million. In the same period of time, distribution to unsecured creditors amounted to £3.8 billion.⁵⁵ It is clear from these figures that KSF was by no means insolvent when the Treasury and the FSA closed it down. It was a sound and profitable company, probably worth about £500 million, as its director, Armann Thorvaldsson, says.⁵⁶ It is interesting that fees to accountants and lawyers which would have been avoided if the company had not been taken into administration, were at least £136 million, or amounting to one fifth of the probable total worth of the company.

10. *Investigations of Kaupthing and KSF Managers*

In the midst of a grave international crisis, unprecedented in recent times, both the British Chancellor of the Exchequer and the Prime Minister had found reason to make phone calls to Prime Minister Geir H. Haarde complaining about illegal transfers from KSF to Kaupthing in Iceland. Then somewhat abruptly, they had gone quiet about this matter, beginning to speak instead about Landsbanki’s Icesave

⁵⁴ *Kaupthing Singer & Friedlander Limited (in Administration)*. Ernst & Young report from 8 October 2008 to 7 April 2009. http://www.kaupthingsingers.co.uk/media/568/ey_ksf_progress_report_-_final.pdf

⁵⁵ *Kaupthing Singer & Friedlander Limited (in Administration)*. Ernst & Young report from 8 October 2016 to 7 April 2017.

http://www.kaupthingsingers.co.uk/media/2174/administrators_progress_report_april_2017_.pdf
Also, *Kaupthing Singer & Friedlander Limited (in Administration)*. Ernst & Young report from 8 October 2016 to 7 April 2018 (London: Ernst & Young, 2018), p. 9.

http://www.kaupthingsingers.co.uk/media/2231/administrators_progress_report_-_april_2018.pdf

⁵⁶ Thorvaldsson, *Frozen Assets*, p. 222.

accounts. Possibly this was because the Treasury and FSA staff quickly realised that they should not have been surprised by the liquidity swap deal in force since February 2008 between KSF and its parent company. It had been declared to the FSA, and there was nothing illegal about it. But the sudden change of subject is yet another indication that Chancellor Darling and Prime Minister Brown were not providing a reason, but rather looking for an excuse, in closing down the Icelandic banks.

After KSF was taken into administration, its director, Armann Thorvaldsson, and his colleagues in Iceland, Sigurdur Einarsson and Hreidar M. Sigurdsson, were subject to thorough investigations both by the FSA and the UK Serious Fraud Office. The FSA concluded its investigation after three and a half years with a “Final Notice” where the only censure they could make was the general one that the KSF management team did not, between 29 September and 2 October 2008, “give proper consideration to or properly monitor a special financing arrangement with its parent company in Iceland under which it could draw up to £1bn at short notice if it needed to”. In the Notice, it is admitted that Thorvaldsson immediately informed the FSA when the financial crisis started in Iceland and that he instigated the special liquidity process in place in KSF. In the Notice, it is also stated that the ultimate insolvency of KSF could not be attributed to what the FSA termed the “failure to monitor promptly and properly” the liquidity swap deal with the parent company. Moreover, it is stated that Thorvaldsson cooperated fully with the FSA.⁵⁷ On the basis of the Notice, the FSA made an agreement with Thorvaldsson, Einarsson and Sigurdsson that they would not hold senior positions in authorised financial firms in the UK for five years, counting from October 2008 which implied that they could do so after eighteen months, in October 2013.

The FSA Final Notice was a remarkable conclusion when it was definitely in the interest of the FSA staff, after what had happened in October 2008, to find something to fault in the management of KSF. A commentator on economic affairs, Paul Murphy of the *Financial Times*, wrote ironically:

This is the final notice from the UK financial regulator after a three and a half year investigation into Kaupthing Singer and Friedlander, the UK subsidiary of toxic Icelandic bank Kaupthing. Essentially, the FSA has found that, between 29 September and 2 October 2008, when the whole financial world looked to be imploding, Singer’s management breached Principle 2 of the FSA’s Principles for Businesses, which requires a firm to conduct its business with due skill, care and diligence. It seems they failed to monitor a special £1bn financing arrangement between the Icelandic parent and the UK sub, and then failed to tell the FSA immediately when it seemed the UK firm might not have access to this funding line. While no regulatory breach has been found, the FSA has naturally gone right ahead and issued an effective ban on two former non-executives at Singer – Sigurdur Einarsson and Hreidar Mar Sigurdsson — along with former chief executive Armann Thorvaldsson. You can almost hear the three men say hvað sem [whatever in Icelandic].⁵⁸

⁵⁷ Financial Services Authority, Final Notice, 18 June 2012.

<http://webarchive.nationalarchives.gov.uk/20121003063618/http://www.fsa.gov.uk/static/pubs/final/kaupthing-singer-friedlander.pdf>

⁵⁸ Paul Murphy, Four days that supposedly sunk Singer and Friedlander. *Financial Times* 26 June 2012. <http://ftalphaville.ft.com/2012/06/26/1059201/four-days-that-supposedly-sunk-singer-and-friedlander/>

The Serious Fraud Office which had 16 December 2009 opened an investigation into suspected offences committed in the UK in relation to Kaupthing before its collapse, discontinued the investigation 15 October 2012, stating that there was “insufficient evidence to justify its continuation”.⁵⁹ The allegations made by two prominent UK government ministers against KSF turned out to be groundless; and the investigations by the FSA and the Serious Fraud Office of KSF did not produce any tangible results. In the process, however, perhaps £500 million—the potential market value of KSF—were lost, and at least £136 million spent on lawyers and accountants.

11. The Irony of the Transfer to ING DIRECT

Ironies abound in the turn of events after the close-down of the two British banks owned by Icelanders. An example is the unilateral transfer, without consultation or compensation, of accounts in Landsbanki’s Heritable Bank and of Kaupthing’s Edge accounts to a competitor, ING DIRECT, owned, like Heritable and KSF, by a foreign bank, Dutch ING. Only two weeks later the Dutch parent company had itself to be bailed out. On 21 October 2008 the Dutch government announced a liquidity guarantee scheme for all financial institutions in the country. ING, Internationale Nederlanden Groep, was by far the most important Dutch bank, with 85 million clients in more than 40 countries, a workforce of 125,000 people and a balance sheet, in 2008, of €1,322 billion. On 22 October ING received a capital injection of €10 billion from the Dutch government. It also received €12 billion of liquidity guarantees under a Dutch liquidity guarantee scheme. This turned out to be insufficient so in January 2009, the Dutch authorities took on a part of ING’s portfolio of subprime loans, amounting to \$28 billion. It was called an “illiquid asset facility”. After some complications, the support for ING was accepted by European authorities, as it was not regarded a distortion of competition.⁶⁰ No mention was made of ING’s two Icelandic competitors in the internal market of the EEA whose online deposits had been transferred to ING DIRECT.

Another irony in choosing ING DIRECT to receive accounts from Heritable Bank owned by Landsbanki—a company put on the UK Treasury’s list of companies and countries subject to economic sanctions, alongside Al-Qaeda, the Talibans and the governments of North Korea and Sudan—was that in 2012 the Dutch parent company ING had to pay a record \$619 million fine to US authorities for violating sanctions against Cuba, Iran, Burma, Sudan and Libya. These violations of US law took place from the 1990s to 2007. It should be emphasised that no Icelandic bank was ever found guilty of similar violations.⁶¹

ING has become a profitable bank again and has repaid the Dutch government. A few years after the Icelandic bank collapse, a former Icelandic banker met a senior ING

⁵⁹ Kaupthing Bank, News Release from Serious Fraud Office 15 October 2012.

<https://www.sfo.gov.uk/2012/10/15/kaupthing-bank/> See also

<https://www.sfo.gov.uk/cases/kaupthing-hf/>

⁶⁰ European Commission, *State Aid: Overview of decisions and on-going in-depth investigations of Financial Institutions in Difficulty*.

http://ec.europa.eu/competition/recovery/banking_case_list_public.pdf

⁶¹ US Treasury. Press Release 12 June 2012. <https://www.treasury.gov/press-center/press-releases/Pages/tg1612.aspx>

manager. They greeted each other affably, as the man from ING had been invited by an Icelandic bank to catch salmon in a river in Iceland. The ING man said to the former banker: “Oh, the trip to Iceland was not the only thing I did not have to pay you guys for. We also got all the deposits from you without having to pay anything for them. We couldn’t believe our own luck.”⁶² It may be problematic to try and estimate the value of deposits alone because they would normally be sold with assets against them, and the assets would sometimes be of uncertain value. But one comparison perhaps might be appropriate: In September 2007, US authorities closed down Georgia-based Netbank and sold its online deposits from 104,000 customers, as well as some loan assets, to ING DIRECT for \$14 million, or 1% of total deposits which then amounted to \$1.4 billion.⁶³ In the UK, total deposits in Heritable Bank transferred to ING DIRECT amounted to £538 million: 1% of that would have been £5 million. Total deposits in KSF’s Edge accounts transferred in the same way amounted to £2.5 billion: 1% of that would have been £25 million. On these lines, the total value of the online deposits in the two Icelandic-owned British banks transferred to their former competitor ING DIRECT, with assets to match (in this case a loan from the UK Treasury with collateral in the assets of the fallen banks), could then be estimated to have been around £30 million, or \$51 million. In one strike, ING DIRECT acquired 160,000 customers from KSF and 22,200 customers from Heritable Bank, and undoubtedly also many former owners of Icesave accounts. This may explain why the ING people said to the former Icelandic banker that they could not believe their own luck.⁶⁴

Besides what amounted to a direct transfer from the two Icelandic-owned British banks to ING DIRECT, these considerations possibly can be used to estimate the total loss from terminating the online accounts of the Icelandic banks. Before the collapse, in Kaupthing’s Edge accounts total deposits amounted to €5.4 billion and in Landsbanki’s Icesave accounts to €5.2 billion (£3.6 billion in the UK and €500 million in the Netherlands).⁶⁵ The total loss, or value destroyed, presumably was 1% of €10.2 billion, or €102 million.

⁶² Interview with Bjorgolfur Gudmundsson in Reykjavik 20 August 2013.

⁶³ ING DIRECT, ING DIRECT Acquires Deposits of Netbank. Press Release 28 September 2007. <https://www.businesswire.com/news/home/20070928005759/en/ING-DIRECT-Acquires-Deposits-NetBank>

⁶⁴ Another comparison might be made with private client funds. For example, in October 2009, Lloyds Banking Group—then 43.5% owned by the British government—sold portfolios of private client funds to investment firm Rathbone Brothers. The price was set at £35.4 million for a total of £1.27 billion of funds under management for 6,000 clients. The portfolios were from of the Bank of Scotland on the one hand and from Lloyds TSB Private Banking on the other hand. Rathbone agreed to pay 2.4% of the total Bank of Scotland assets transferred when clients signed up, and 3.4% of the Lloyds TSB Private Banking assets. Lloyds agrees to sell private client funds portfolio for 35 m to Rathbone Brothers, *The Scotsman* 20 October 2009. <https://www.scotsman.com/business/lloyds-agrees-to-sell-private-client-funds-portfolio-for-163-35m-to-rathbone-brothers-1-779701> Doubtlessly, the price reflects the fact that banks usually find private client funds more desirable than retail deposits, as the risk in selecting corresponding assets is borne mainly by the clients themselves. But it does not seem an unreasonable assumption that if private client funds are bought for 2–3% of their total nominal value, retail deposits, with adequate corresponding assets, would be bought for 1% of their total nominal value.

⁶⁵ SIC Report, Vol. 6, Ch. 18, pp. 3, 4, and 55 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enskali.pdf>

12. No Losses for British Taxpayers

It is a remarkable fact that the two British banks owned by Icelanders, Heritable and KSF, did not cost British taxpayers a penny. The same could not be said about those British banks that were bailed out by the Labour government in 2007–9. In total, British banks had been provided with £133 billion in cash and £1,029 billion—more than one trillion pound sterling—in guarantees and non-cash support. Besides general support for the banking sector, the sums in individual support schemes are staggering: Lloyds received £276 billion, RBS £256 billion, Northern Rock £60 billion and Bradford & Bingley £46 billion. In March 2017 outstanding support for the banks amounted to £58 billion of which 12 billion were guarantee commitments and 46 million were cash outlays. The government then still had to get back £20 billion from RBS, £7 billion from Northern Rock and £30 billion from Bradford & Bingley,⁶⁶ although a month later, in April 2017, it received £11.8 billion from a sale of Bradford & Bingley assets.⁶⁷ While government has recovered its outlays on Lloyds, RBS remains a problem. In 2015, the Treasury started trying to sell its shares in RBS. It then made a loss of £1.1 billion, as shares were sold at a price below that which government had paid for them.⁶⁸ The Chancellor, Philip Hammond, has told British MPs that they should be prepared for more losses: the price of a share was 502p when the bank was bailed out, but in April 2017 the shares were trading at around 224p.⁶⁹ It is not unreasonable to assume that the net loss from the British 2007–9 bailouts will eventually amount to about a half of the £46 billion support yet outstanding, or to £23 billion.

The close-down of the two British banks owned by Icelanders and the subsequent collapse of most of the Icelandic banking sector claimed more immediate victims in the UK and neighbouring countries. For example, in the UK, Landsbanki had in 2005 bought investment company Teather & Greenwood for £42.8 million. The same year, in France Landsbanki had bought Kepler Equities whose worth was then estimated to be €94 million. The same year, in Ireland Landsbanki had bought 50% in Merrion Capital whose worth was then estimated to be €55.3 million, eventually acquiring 84% of the company. In 2007, Landsbanki bought another investment company in the UK, Bridgewell, for £60.3 million, and merged it with Teather & Greenwood under the name Landsbanki Securities.⁷⁰ In the beginning of October 2008, Landsbanki tried to save those assets by selling them to the Icelandic investment bank Straumur for €398 million, but the bank fell before the transaction was completed. Merrion Capital was then sold to management and staff for €30 million, about a third of its

⁶⁶ National Audit Office, Taxpayer support for UK banks: FAQs.

<https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>

⁶⁷ UK Treasury, Bradford & Bingley asset sale to raise £11.8 billion for UK taxpayers. Press Release 31 March 2017. <https://www.gov.uk/government/news/bradford-bingley-asset-sale-to-raise-118-billion-for-uk-taxpayers>

⁶⁸ James Quinn, Tim Wallace and Ashley Armstrong, Chancellor sells stake in RBS at a loss of £1.1bn, *The Telegraph* 4 August 2015.

<http://www.telegraph.co.uk/finance/newsbysector/epic/rbs/11731133/Chancellor-pushes-button-on-2bn-Royal-Bank-of-Scotland-share-sale.html>

⁶⁹ Lucy Burton, Chancellor Philip Hammond admits taxpayer stake in RBS could be sold at a loss, *The Telegraph* 18 April 2017. <http://www.telegraph.co.uk/business/2017/04/18/chancellor-philip-hammond-admits-taxpayer-stake-rbs-could-sold/>

⁷⁰ Kristjansson and Arnason, *Developments leading up to the Icelandic banking crisis*, pp. 9–10. <http://rse.hi.is/wp-content/uploads/2017/11/Report-by-Management-Board-of-Landsbanki-2009-02-26.pdf>

2005 price. Apparently, the buyers could finance the sale from the liquid assets of the company.⁷¹ Kepler was sold to management and staff for €1, and a little less than half of it was subsequently sold for €50 million.⁷² It has since become a well-financed broker in the European market. After the bank collapse, Landsbanki Securities went into administration and changed its name to Teathers. In late October 2008, it was bought for an undisclosed sum by the Icelandic investment bank Straumur which however failed in March 2009. Teathers went into liquidation and was formally dissolved in 2017.⁷³ Thus, a company which originally had been bought for more than £100 million became worthless.

13. A Digression on Rescued Banks

The British banks rescued by the Labour government were no paragons of virtue in comparison with the Icelandic banks. From 2001 under the leadership of Fred Goodwin, RBS grew rapidly. As CEO, Goodwin gained a reputation for ruthlessness in dealing with his staff, fierce determination to expand and, perhaps surprisingly for a known economiser, lavish spending.⁷⁴ RBS had a new £350 million headquarters built at Gogarburn outside Edinburgh; Goodwin had at his disposal a £18 million Dassault Falcon 900 private jet; a permanent suite at the Savoy Hotel in London was kept for him; he and his co-directors used a fleet of 12 chauffeur-driven Mercedes S600 cars, painted in the company's dark blue; and RBS spent hundreds of millions on endorsements from celebrities. Goodwin shared an interest in fast cars with Iceland's best-known businessman Jon Asgeir Johannesson: Against the advice of his co-directors, in 2005 Goodwin decided that RBS should become the major sponsor of the Williams F1 team in motor racing; one other big sponsor was the British company Hamleys, controlled by Johannesson; in early 2008, Johannesson decided personally to buy 10% of WilliamsF1 by the end of the year, even if that deal never became a reality.⁷⁵ Both Goodwin and Johannesson spent huge sums in Monaco at the Grand Prix, the annual motor race in the Mediterranean principality. Enjoying a good relationship with his fellow Scot Gordon Brown, Fred Goodwin was knighted in 2004, and the Queen opened the new headquarters in 2005.⁷⁶ In a few years, Sir Fred Goodwin completed 25 takeovers on both sides of the Atlantic. "He had never seen a deal he did not like and could not bear the prospect of letting one of his rivals' banks steal a perceived prize from under his nose," financial journalist Alex Brummer

⁷¹ Jon A. Bergsveinsson [jab], Fleiri taekifaeri eftir kreppuna [More Opportunities After the Depression], *Frettabladid* 5 May 2010, p. 4. http://timarit.is/view_page_init.jsp?pageId=5075817 Also email to Hannes H. Gissurarson from Sigurjon Th. Arnason 19 June 2017.

⁷² The price in the 2008 purchase, or MBO (management buyout) was confidential, <https://www.lbi.is/news/news/kepler-capital-markets-sold-to-management-and-staff-through-a-management-led-buy-out-mbo> The information on the price and on the subsequent sale of half the company is in an email to Hannes H. Gissurarson from Sigurjon Th. Arnason 19 June 2017.

⁷³ Teathers Ltd, <https://beta.companieshouse.gov.uk/company/03019293/insolvency>

⁷⁴ Matthew Hancock and Nadhim Zahawi, *Masters of Nothing* (London: Backbite, 2011); Ian Martin, *Making It Happen: Fred Goodwin, RBS and the men who blew up the British economy* (London: Simon & Schuster, 2013); Ian Fraser, *Shredded: Inside RBS* (London: Birlinn, 2014).

⁷⁵ In 2006, the major sponsor was RBS, and the 12 companies which were also listed as sponsors were Accenture, Allianz, Battery, Budweiser, Fedex, Hamleys, Mobilecast, Oris, Philips, Qinetiq, Reuters and Tata. François-Michel Grégoire, *Who Works in Formula One* (Who Works Sports Publications, 2006), p. 31.

⁷⁶ On Goodwin's relationship with Brown, Alex Brummer, *Bad Banks: Mistakes, Misselling, Misbehaviour and the Next Global Crisis* (London: Random House Business, 2014), p. 42.

remarked.⁷⁷ The whole edifice collapsed Tuesday 7 October 2008 when the RBS Chairman of the Board called Chancellor Darling telling him that the bank could only keep going for a few hours more.

In a 2011 report, the FSA tried to explain the failure of RBS:

The failure of RBS can be explained by a combination of six key factors: significant weaknesses in RBS's capital position during the Review Period, as a result of management decisions and permitted by an inadequate regulatory capital framework; over-reliance on risky short-term wholesale funding; concerns and uncertainties about RBS's underlying asset quality, which in turn was subject to little fundamental analysis by the FSA; substantial losses in credit trading activities, which eroded market confidence. Both RBS's strategy and the FSA's supervisory approach underestimated how bad losses associated with structured credit might be; the ABN AMRO acquisition, on which RBS proceeded without appropriate heed to the risks involved and with inadequate due diligence; and an overall systemic crisis in which the banks in worse relative positions were extremely vulnerable to failure. RBS was one such bank.⁷⁸

This sounds very much like the criticisms of the Icelandic banks found in the SIC Report. One of the worst blunders of the RBS management was the acquisition of Dutch bank ABN Amro in October 2007. "With the benefit of hindsight it can now be seen as the wrong price, the wrong way to pay, at the wrong time and the wrong deal," Sir Philip Hampton who replaced Sir Tom McKillop as RBS chairman said.⁷⁹ It is worth noting that probably the worst blunder of Kaupthing was also the offer to buy a Dutch bank, NIBC, made at the same time.

In the light of the two facts that Landsbanki was put on a list of organisations subject to economic sanctions at the UK Treasury's website and that in the midst of an international crisis UK government ministers kept calling their Icelandic counterparts to complain about illegal money transfers by Kaupthing (transfers that never took place), it is interesting to take a brief look at RBS which is still mostly owned by the British government. It certainly has had its cases of misconduct both before and after it was rescued by British taxpayers. Indeed, some of them concerned anti-terrorism laws in the UK and the US. In 2002, the FSA fined RBS £750,000 (\$1,1 million) for breaches of its money laundering rules.⁸⁰ In 2010, the US Department of Justice fined RBS \$500 million for the activities of the former ABN Amro Bank. The bank had "facilitated the movement of illegal money through the U.S. financial system by stripping information from transactions and turning a blind eye to its compliance obligations," according to US officials. It had assisted sanctioned countries, including Iran and Sudan.⁸¹ Subsequently, the FSA fined RBS £5.6 million (\$8.7 million) for

⁷⁷ Brummer, *Bad Banks*, p. 43.

⁷⁸ *The Failure of the Royal Bank of Scotland* (London: FSA, December 2011), p. 21.
<https://www.fca.org.uk/publication/corporate/fsa-rbs.pdf>

⁷⁹ *Ibid.*, p. 409.

⁸⁰ FSA fines Royal Bank of Scotland Plc 750,000 for money laundering control failings. Press release 17 December 2002.

<http://www.fsa.gov.uk/library/communication/pr/2002/123.shtml>

⁸¹ US Department of Justice, Former ABN Amro Bank N.V. Agrees to Forfeit \$500 Million in Connection with Conspiracy to Defraud the United States and with Violation of the Bank Secrecy Act. Press Release 10 May 2010. <https://www.justice.gov/opa/pr/former-abn-amro-bank-nv-agrees-forfeit-500-million-connection-conspiracy-defraud-united>

failing to ensure that its customers and their transactions were not involved in terrorism. The bank's negligence "resulted in an unacceptable risk that RBSG [RBS Group] could have facilitated transactions involving sanctions targets, including terrorist financing", according to the FSA.⁸²

The saga continued. In 2012, the FSA fined Coutts & Company, an RBS subsidiary, £8.75 million (\$13.7 million) for failing to establish and maintain effective controls against money laundering by high-risk customers. "The failings at Coutts were serious, systemic and were allowed to persist for almost three years," the FSA concluded after its investigation.⁸³ In 2013, RBS had to pay \$100 million to the New York State Department of Financial Services for failing to comply with rules about transactions with customers from countries subject to sanctions, including Iran and Sudan.⁸⁴ In 2016, the Monetary Authority of Singapore imposed a 2.4 million Singapore dollar (\$1.7 million) fine on Coutts & Company for violations of rules in connection with a Malaysian money-laundering scheme. In 2017, the Swiss Financial Market Supervisory Authority ordered Coutts & Company to pay back 6.5 million Swiss francs (\$6.5 million) in profits from this Malaysian scheme.⁸⁵ In 2017, RBS was facing questions over allegations that in 2010–14 it, and other British banks, helped launder KGB-related funds out of Russia.⁸⁶

RBS and its subsidiaries had not only violated laws against terrorism and money-laundering in the UK, the US and other countries. In 2013, RBS was affected by the LIBOR rate rigging scandal like some other British banks. In the beginning of the year, the bank had to pay a total of \$612 million to settle charges in the case. It paid \$150 million to the US Department of Justice in a plea agreement, admitting its criminal conduct.⁸⁷ The US Commodity Futures Trading Commission, CFTC, fined RBS \$325 million and noted that the misconduct had continued even after RBS traders learning that an investigation had been started.⁸⁸ The FSA fined RBS £87.5

⁸² FSA, FSA fines Royal Bank of Scotland Group £5.6m for UK sanctions controls failings. Press Release 3 August 2010. <http://www.fsa.gov.uk/library/communication/pr/2010/130.shtml>

⁸³ FSA, Final Notice, 23 March 2012. <http://www.fsa.gov.uk/static/pubs/final/coutts-mar12.pdf>

⁸⁴ New York State Department of Financial Services, Cuomo administration announces RBS to pay \$100 million for violations of law involving transactions with Iran, Sudan, other regimes. Press Release 11 December 2013. <http://www.dfs.ny.gov/about/press/pr1312111.htm>

⁸⁵ MAS imposes Penalties on Standard Chartered Bank and Coutts for 1MDB-Related AML Breaches, Press Release 2 December 2016. <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2016/MAS-Imposes-Penalties-on-Standard-Chartered-Bank-and-Coutts-for-1MDB-Related-AML-Breaches.aspx> FINMA sanctions Coutts for 1MDB Breaches, Press Release 2 February 2017. <https://www.finma.ch/en/news/2017/02/20170202-mm-coutts/>

⁸⁶ Luke Harding, Nick Hopkins and Caelainn Barr, British Banks Handled Vast Sums of Laundered Russian Money, *Guardian* 20 March 2017. <https://www.theguardian.com/world/2017/mar/20/british-banks-handled-vast-sums-of-laundered-russian-money>

⁸⁷ US Department of Justice, RBS Securities Japan Limited Agrees to Plead Guilty in Connection with Long-Running Manipulation of Libor Benchmark Interest Rates. Press Release 6 February 2013. <https://www.justice.gov/opa/pr/rbs-securities-japan-limited-agrees-plead-guilty-connection-long-running-manipulation-libor>

⁸⁸ CFTC, CFTC Orders The Royal Bank of Scotland plc and RBS Securities Japan Limited to Pay \$325 Million Penalty to Settle Charges of Manipulation, Attempted Manipulation, and False Reporting of Yen and Swiss Franc LIBOR. Press Release 6 February 2013. <http://www.cftc.gov/PressRoom/PressReleases/pr6510-13>

million (\$136 million) for misconduct relating to the LIBOR.⁸⁹ Then, in December, the European Commission fined RBS the equivalent of \$530 million (€391 million) for similar offences.⁹⁰ In November 2014, the CFTC fined it \$290 million for attempted manipulation of foreign exchange benchmark rates.⁹¹ For similar offences, in the same month the UK FCA—which had now replaced the FSA—fined RBS £217 million (\$344 million).⁹² In 2015, RBS agreed to pay a fine of \$395 million to the US Department of Justice for conspiring with other banks “to fix prices and rig bids for U.S. dollars and euros exchanged in the FX spot market in the United States and elsewhere”. The bank was put on a three-year period of corporate probation. The Federal Reserve System also fined it \$274 million relating to these offences.⁹³ RBS would have been barred from the securities business in the US for these offences, if it had not obtained a special waiver from the SEC, Securities and Exchange Commission.⁹⁴

If anything, the settlement payments and fines became higher. In 2016, RBS had to pay a group of investors £800 million (\$1 billion) for having misled them in its fundraising efforts prior to the 2008 collapse.⁹⁵ In 2017, RBS was negotiating with other investors, trying to avoid a court case.⁹⁶ In 2017, RBS made a deal with US authorities to pay no less than \$5.5 billion to US mortgage lenders Fannie Mae and Freddie Mac for mis-pricing risky mortgages prior to the collapse.⁹⁷ Some less costly scandals also occurred at RBS. In 2011, the FSA fined RBS £2.8 million (\$4.5 million) for multiple failings in the way they handled customers’ complaints.⁹⁸ In 2011, the FSA also fined Coutts & Company, the private banking unit of RBS, £6.3 million (\$10 million) for abuses relating to the marketing of an investment fund.⁹⁹ In 2013— five years after the bailout—the FCA, which as noted earlier had replaced the

⁸⁹ FSA, RBS fined £87.5 million for significant failings in relation to LIBOR. Press Release 6 February 2013. <https://www.fca.org.uk/news/press-releases/rbs-fined-%C2%A3875-million-significant-failings-relation-libor>

⁹⁰ European Commission, Antitrust: Commission fines banks € 1.49 billion for participating in cartels in the interest rate derivatives industry. Press Release 4 December 2013. http://europa.eu/rapid/press-release_IP-13-1208_en.htm

⁹¹ CFTC, CFTC Orders Five Banks to Pay over \$1.4 Billion in Penalties for Attempted Manipulation of Foreign Exchange Benchmark Rates. Press Release 12 November 2014. <http://www.cftc.gov/PressRoom/PressReleases/pr7056-14>

⁹² FCA, FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme. Press Release 12 November 2014. <http://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings>

⁹³ US Department of Justice, Five Major Banks Agree to Parent-Level Guilty Pleas. Press Release 20 May 2015. <https://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas>

⁹⁴ SEC Order. Press Release 20 May 2015. <https://www.sec.gov/rules/other/2015/33-9781.pdf>

⁹⁵ Nasdaq, Royal Bank of Scotland to Pay \$1B Over Right Issue Charges. Press Release 6 December 2016. <http://www.nasdaq.com/article/royal-bank-of-scotland-to-pay-1b-over-right-issue-charges-cm717715>

⁹⁶ Ben Martin, Judge Calls Off High Court Trial into RBS Rights Issue, *The Telegraph* 7 June 2017. <http://www.telegraph.co.uk/business/2017/06/07/judge-calls-high-court-trial-rbs-rights-issue/>

⁹⁷ FHFA. Settlement Agreement, 12 July 2017.

<https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/FHFA-RBS-Settlement-Agreement.pdf>

⁹⁸ FSA, FSA fines RBS and NatWest £2.8m for poor complaint handling. Press Release 11 January 2011. <http://www.fsa.gov.uk/pages/Library/Communication/PR/2011/003.shtml>

⁹⁹ FSA, Coutts fined £6.3m for failings relating to its sale of an AIG fund. Press Release 8 November 2011. <http://www.fsa.gov.uk/library/communication/pr/2011/093.shtml>

FSA, fined RBS £5.6 million (\$8.7 million) for failing properly to report many transactions.¹⁰⁰ This list is by no means exhaustive.

Similar lists could be composed about the three other big British banks, Lloyds, Barclays, and HSBC. It is worth adding, because after the bank collapse Kaupthing managers were charged and convicted for having misled the markets about a purchase by the al-Thani family of Kaupthing stock—a purchase that turned out to be financed almost solely by Kaupthing itself—that Barclays managers have been charged for various misdemeanours in connection with the purchase by the al-Thani family and others of Barclays stock.¹⁰¹ In his memoirs, Gordon Brown—the very man who rescued those banks and brought down at least Kaupthing, if not all three major Icelandic banks—indeed advocates imprisoning “rogue bankers” before they would cause another crash, mentioning Iceland as a model.¹⁰²

To survive in October 2008, probably the two British banks owned by Icelanders—operating in the UK alongside many other banks owned by foreign companies such as Spanish Santander and Dutch ING—would only have needed cash of about £100–200 million and guarantees of about £2 billion, or 0.5% of what other British banks received. And British taxpayers would have been fully repaid, as the results of the resolution processes of the Icelandic-owned banks demonstrate. As British banks, Heritable and KSF, paid taxes in Britain and provided jobs for people who lived in Britain. Chancellor Alistair Darling and Prime Minister Gordon Brown chose to overlook the fact that the Icelanders indeed moved money to Britain instead of taking money out of it. Heritable and KSF were bought with hard cash from Iceland, at market value. And the Icelanders invested in many other British companies, providing services to customers, increasing competition, creating jobs and stimulating growth. During the First World War, the founder of Singer & Friedlander, Julius Singer, was barred from the London exchange because he was of German origin. A hundred years later people were driven out of the British banking sector because they were of Icelandic origin.

¹⁰⁰ FCA, Royal Bank of Scotland fined £5.6m for failing to properly report over a third of transactions. Press Release 24 July 2013. <https://www.fca.org.uk/news/rbs-fined>

¹⁰¹ Ben Martin, Why does Barclays face criminal charges from the SFO? *The Telegraph* 20 June 2017. <http://www.telegraph.co.uk/business/2017/06/20/does-barclays-face-criminal-charges-sfo/>

¹⁰² Brown, *My Life*, *Our Times*, p. 344. Kindle Edition.

Chapter Eleven

The Icesave Dispute, 2008–13

The Icesave dispute is relevant in an investigation of foreign factors in the Icelandic bank collapse, because one of the motives of the British government for its harsh treatment of the Icelanders may have been to improve its bargaining position in this dispute. For a while, the Icesave case also seemed to have become one of the costliest consequences of the collapse for the Icelandic nation.

1. The British and Dutch Demands on Iceland

Since the Icesave accounts were in a branch of Landsbanki, and not in a subsidiary, the UK Treasury did not have legal authority to seize them and transfer them to ING Direct as it did with accounts in Heritable Bank and in KSF. Landsbanki's London branch was strictly speaking not a British, but an Icelandic company. It was under the supervision of IFSA and controlled, after Landsbanki's collapse, by a Resolution Committee appointed by the IFSA on 7 October. This was the alleged reason why the UK Treasury used the legal authority which it had under the Anti-Terrorism Act to freeze all Landsbanki's assets. It was pointed out in Chapters 6 and 7 that this was a pretext and not a reason, because the FSA had already taken steps which made it impossible for Landsbanki to transfer money out of the UK, while authorities in other countries, such as Germany and Sweden, did not take any such drastic actions, even if deposits had been collected there by branches of Icelandic banks rather than by subsidiaries.

What followed was a bitter dispute between Iceland on the one hand and the UK and, to a lesser extent, the Netherlands on the other hand, and a fierce political battle in Iceland for almost four years. Within days of closing down subsidiaries and branches of the Icelandic banks the UK and Dutch governments unilaterally decided to compensate Icesave depositors, then demanding full reimbursement from the Icelandic government for that part of the deposits which should be covered by the IDIGF. It was a hefty bill: £2.35 billion for the UK (€2.7 billion) and €1.3 billion for the Netherlands, around 40% of Iceland's GDP at the time. As noted earlier, the UK and the Netherlands insisted, with the support of the Nordic countries, that it would be a precondition of Iceland's entry into any programme with the IMF that she would recognise such an obligation to the British and Dutch treasuries.

Iceland's beleaguered representatives compromised on 14 November 2008 by accepting the so-called 'Brussels Guidelines', announced two days later.¹ According to them, the European deposit-guarantee scheme was "applicable in Iceland in the same way as it is applicable in the EU Member States". The negotiations ahead should "take into account the unprecedented difficult situation of Iceland and therefore the necessity of finding arrangements that allow Iceland to restore its

¹ In the chaos during the bank collapse, a memo of mutual understanding had been signed by Icelandic officials after talks with their Dutch counterparts, accepting some of the Dutch claims, but it had no legal validity and the Icelandic government made it clear afterwards that it was not bound by it in any way.

financial system and its economy.” The Icelandic government undertook to cover deposits of insured depositors in the Icesave accounts in accordance with EEA law (which the Icelandic and British-Dutch representatives however interpreted differently), while the UK and the Netherlands promised not to hold up Iceland’s request for assistance from the IMF.²

Subsequently, on 19 November 2008 the IMF approved a loan of \$2.1 billion in several instalments to Iceland. It was to be used as a reserve fund, facilitating the resumption of normal currency trade. Talks were held between representatives of Iceland on the one hand and the UK and Netherlands on the other hand about the Icesave issue in The Hague 2–3 December 2008, but further negotiations were then put on hold as the political situation in Iceland became volatile, with protests and even street riots, in late January 2009 finally driving out Haarde’s coalition government of the Independence Party and the Social Democrats, whereupon Johanna Sigurdardottir formed a minority government of her own Social Democrats and the Left Greens, assuming power 1 February 2009.

2. *Icesave I (the Gestsson Deal)*

The new Finance Minister, Steingrímur J. Sigfússon from the Left Greens, turned to an old comrade-in-arms, Ambassador Svavar Gestsson, the former leader of the People’s Alliance, successor to the Icelandic Communist Party and forerunner of the Left Greens.³ The appointment of an Icelandic negotiation committee under Gestsson’s chairmanship was announced on 24 February 2009. Gestsson’s British and Dutch counterparts were both financial experts, Gary Roberts from the UK and Johan Barnard from the Netherlands. The negotiating teams from the three countries met a few times in Copenhagen, where Gestsson resided as Ambassador to Denmark, and in London. Gestsson initially explored the ‘Landsbanki option’ which was essentially to pass the Landsbanki assets overseas on to the British and the Dutch governments to cover their outlays.⁴ His British and Dutch counterparts rejected that option: Their brief was obviously to persuade the Icelandic state to guarantee full repayment of the loans (with interest) that their governments were prepared to issue to the DIGF. But the talks only began seriously after the general elections in Iceland on 25 April 2009 when the Social Democrats and the Left Greens won a landslide victory and formed a majority government.

On 5 June 2009 the three negotiation teams in the Icesave dispute signed an agreement on behalf of their respective governments and subject to ratification by the Icelandic parliament. The agreement contained five main points:

² Prime Minister’s Office, Agreed Guidelines Reached on Deposit Guarantees, 16 November 2008. <http://eng.forsaetisraduneyti.is/news-and-articles/nr/3229>

³ There was one party in between, the Socialist Unity Party. The Communist Party operated from 1930 until 1938 when it dissolved itself and the Socialist Unity Party was founded in cooperation with a splinter group from the Social Democrats; the Socialist Unity Party operated in 1938–1968, but maintained an electoral alliance with some leftwing social democrats from 1956; this alliance, the People’s Alliance, then became a political party in 1968. Gestsson was its leader in 1980–87. On his role in the Party, Hannes H. Gissurarson, *Íslenskir kommúnistar 1918–1998* (Reykjavík: Almenna bókafélagid, 2011), pp. 432 and 525.

⁴ Sigurdur M. Jonsson, *Icesave-samningarnir* (Reykjavík: Almenna bókafélagid, 2011), p. 43; Svavar Gestsson, *Hreint ut sagt. Sjálfsævisaga* [Speaking My Mind: An Autobiography] (Reykjavík: JPV 2012), p. 391.

1. The recognised ultimate debtor was the bankrupt estate of the old Landsbanki. The Landsbanki Resolution Committee issued a bond payable to the Icelandic DIGF with collateral in overseas assets of the old Landsbanki.
2. The DIGF took loans from the British and Dutch treasuries to cover the maximum amounts in the Icesave accounts guaranteed under the European Directive, and already paid out by the British and Dutch treasuries to the depositors (up to €20,887 for each of them). The loans were with a guarantee from the Icelandic state which would thus be liable for any difference between what would be covered by the Landsbanki assets and what had been the total outlays of the British and the Dutch treasuries.
3. The loans were at a maximum of £2,350 million in the UK and €1,329 million in the Netherlands. However, it was assumed that the sale of Landsbanki assets would cover 75% of the value of insured deposits, i.e. 75% of the principal.
4. The loans had a grace period of seven years (when no payments were due) and a maturity of fifteen years.
5. From 1 January 2009, the loans bore a fixed interest rate of 5.55% which was 125 points above the minimum reference rate of the OECD for long-term loans (4.3%).
6. The British authorities undertook to cancel from 15 June 2009 the standing order, under the Anti-Terrorism Act, freezing Landsbanki assets.⁵

Originally, the full text of Gestsson's Icesave agreement was kept secret, but it was soon leaked to the press.

3. Controversy on the Gestsson Deal

From the outset, opinion in Iceland was sharply divided on the Icesave dispute. Some argued for the 'court option', including most prominently former CBI Governor David Oddsson. He argued—as he had done while Governor—that before Iceland underwent financial obligations which could turn out to be immense, it had to be known and certain that there was a legal basis for such obligations.⁶ Therefore this dispute between Iceland and the UK and the Netherlands should be resolved in a court of law. There was a simple way for the British and Dutch governments to enforce their claims against the DIGF or the Icelandic government: It was to go to court in Iceland. Oddsson observed that the Icelandic authorities had in their possession a lot of documents which supported the additional Icelandic argument that the difficult situation in which the country found herself was unprecedented. For

⁵ IDIGF. Settlement Agreement, 5 June 2009. <https://www.island.is/media/eydublod/settlement-agreement.pdf>

⁶ A meeting Oddsson had with Landsbanki's chief managers 31 July 2008 should be recalled. SIC Report, Vol. 5, Ch. 17, pp. 72–3 and 77–8 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli17Enska.pdf> Vol. 6, Ch. 18, pp. 17–18 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

example, a committee under the leadership of Jean-Claude Trichet—now ECB Governor—had concluded that the European deposit-guarantee schemes did not apply in the case of a total bank collapse. Moreover, in discussions with Icelandic authorities officials of the Bank of England, most notably Governor Mervyn King, had taken the position that the Icelandic nation should not pay for the Icesave accounts. These had been business exchanges between depositors and a bank, and they should have been made at their own risk. In these discussions, the Bank of England officials had also recognised that there was no government guarantee behind the Icesave accounts.⁷ Oddsson strongly criticised Prime Minister Sigurdardottir and Finance Minister Sigfusson for helping Iceland’s opponents by accepting an obligation by Iceland to pay for the Icesave accounts.⁸

Others opposed Gestsson’s Icesave deal on practical grounds. Attorney Ragnar H. Hall argued that in effect the Icelandic team had signed away the Landsbanki assets, if their value would turn out to be larger than what the DIGF owed British and Dutch depositors for the maximum coverage under European and Icelandic law, the €20,887 per account.⁹ Economists Jon Danielsson and Kari Sigurdsson observed that even if an obligation to pay was recognised, the British and the Dutch governments had chosen, without consulting Icelandic authorities, to pay out the Icesave deposits in December 2008. Now they were demanding interest from that point in time whereas the normal procedure, according to European and Icelandic law, was that pay-outs to depositors only needed to take place within a year after the failure of a bank.¹⁰ Most critics however simply doubted the ability of the Icelandic state to pay interest, let alone principal, on such a potentially gigantic sum of money. They pointed out that the ‘Brussels Guidelines’ had provided for taking “into account the unprecedented difficult situation of Iceland”, whereas no such considerations were to be found in the Icesave deal negotiated by Gestsson’s team. It was not certain at which points in time the assets of Landsbanki would be sold and if there was a delay, interest would accumulate. Moreover, it was not certain how much of the principal or the interest would be covered by the sale of those assets. Iceland might be mired in debt for generations. These considerations motivated a grassroots movement, called InDefence, which originally was organised to protest against the imposition of the Anti-Terrorism Act on Iceland, but now began actively to campaign against the Icesave deal.¹¹

Some people argued however forcefully for the ‘deal option’ as a necessary evil. Economics Professor Thorolfur Matthiasson said for example:

⁷ Interview with Mervyn King in Petham Oast 14 August 2017. Also, transcript of a phone conversation between King and David Oddsson 4 October 2008 in the possession of the main author of this report.

⁸ Aetla ad daema thjodina til aevarandi fataektar [Want to Impose Perennial Poverty on the Nation], Interview with David Oddsson, *Morgunbladid* 5 July 2009, pp. 12–14. http://timarit.is/view_page_init.jsp?pageId=5256655

⁹ Ragnar A. Hall, Er thetta orugglega rett reiknad? [Are the Calculations Correct?] *Morgunbladid* 10 July 2009, p. 25. http://timarit.is/view_page_init.jsp?pageId=5258794

¹⁰ Jon Danielsson and Kari Sigurdsson, Mistok islensku samninganefndarinnar [Mistakes of the Icelandic Negotiation Team], *Morgunbladid* 11 July 2009, p. 30. http://timarit.is/view_page_init.jsp?pageId=5258855

¹¹ Jonsson, *Icesave-samningarnir*, pp. 50-3.

If Parliament does not agree to a government guarantee of the Icesave loan, we could end up with a war-like situation in the economy, Iceland would nowhere receive any support, there would be massive bankruptcies, and we would occupy the same position in the international community as Cuba and North Korea.¹²

It should perhaps be pointed out that the reason why North Korea was and is internationally isolated and under economic sanctions is that she waged war on South Korea and UN forces in 1950–3, that she has never accepted a peace treaty (there is still only a armistice in force between North Korea and the UN Command), and that she has committed numerous crimes against humanity according to UN reports, such as abducting and murdering foreign citizens and torturing and starving to death her own subjects.¹³ By contrast, Iceland’s only ‘crime’ would have been not to accept a debt which she had never created, and which stemmed from private transactions for profit.

Some people even supported the ‘deal option’ on moral grounds. Economics Professor Thorvaldur Gylfason argued that even if Iceland might not have a legal obligation to pay, she had a moral obligation, because her government had sold a controlling share in Landsbanki to people with contacts in Bulgaria and Russia. “The persistent rumour about Icelandic banks laundering money for Russian oligarchs sounds different now than before.”¹⁴ Those Landsbanki people were friendly with the Independence Party leadership, Gylfason claimed, and the bank had behaved as if it had a state guarantee. Landsbanki’s customers in the UK were in good faith when they thought their deposits were guaranteed by the Icelandic state. “Therefore, the British and other may think that Iceland has a moral obligation to shoulder responsibility for Landsbanki, irrespective of what the law says.”¹⁵ Sociology Professor Stefan Olafsson pointed out that Landsbanki had been an Icelandic bank and regulated in Iceland. “An Icelandic guarantee fund was supposed to guarantee the deposits up to a limit. Icelandic authorities repeatedly have confirmed this guarantee.” Therefore, Iceland had a moral obligation. Olafsson observed that now David Oddsson and other people were supporting the court option. But in an eventual court case, Iceland would have to argue that the deposit-guarantee scheme was only for the Icelandic depositors, not the foreign one. “Does anyone believe that any court would favour Iceland in such a case? Hardly. Much more likely, such an initiative would have exposed our nation as a den of thieves.”¹⁶

¹² Stigur Helgason and Kolbeinn O. Proppe, Oabyrgt ad segja nei [No is Irresponsible], Interview with Thorolfur Matthiasson. *Frettabladid* 26 June 2009, p. 4.

http://timarit.is/view_page_init.jsp?pageId=4276314 Cf. also a television interview with Professor Matthiasson where he predicts a total economic collapse if the Icesave deal would be rejected, <https://www.youtube.com/watch?v=KTcw4RsL4FU>

¹³ Human Rights Council, *Report of the Commission of Inquiry on Human Rights in the Democratic People’s Republic of Korea* (New York: United Nations, 7 February 2014). <https://documents-dds-ny.un.org/doc/UNDOC/GEN/G14/108/71/PDF/G1410871.pdf?OpenElement>

<http://www.ohchr.org/EN/HRBodies/HRC/CoIDPRK/Pages/CommissionInquiryonHRinDPRK.aspx>

¹⁴ Thorvaldur Gylfason, Loglegt? Sidlegt? [Legal? Moral?], *Frettabladid* 25 June 2009, p. 20.

http://timarit.is/view_page_init.jsp?pageId=4276266

¹⁵ Op. cit. Cf. also, Thorvaldur Gylfason, Erum vid oll sek? [Are We All Guilty?], *Frettabladid* 20 August 2009, p. 18. http://timarit.is/view_page_init.jsp?pageId=4292488

¹⁶ Stefan Olafsson, Sidfraedi Icesave-malsins [The Morality of the Icesave Dispute], *Frettabladid* 17 August 2009, p. 12. http://timarit.is/view_page_init.jsp?pageId=4279203

4. Icesave II (The Amended Gestsson Deal)

In the summer of 2009, the Icelandic Parliament debated the bill which Finance Minister Steingrímur J. Sigfússon had introduced to ratify the Icesave deal negotiated by Gestsson (often called Icesave I). Sigfússon and Prime Minister Jóhanna Sigurðardóttir stood firmly by the deal and, according to their critics, did not seem overly enthusiastic about presenting Iceland's position abroad. Perhaps one episode illustrates this. In the beginning of August 2009, Norwegian-French Public Prosecutor Eva Joly, who had been advising a special prosecutor in Iceland in cases relating to the bank collapse, published an article simultaneously in *Morgunblaðið* in Iceland, *Daily Telegraph* in the UK, *Aftenposten* in Norway and *Le Monde* in France. Joly argued that the demands by the British and Dutch governments in the Icesave dispute were unjustified and that Iceland's debt burden was becoming intolerable.¹⁷ The Assistant to Prime Minister Sigurðardóttir, Hrannar B. Arnarsson, commented on Facebook:

Does Eva [Joly] imagine that this article increases trust in Iceland abroad? Does she not know that most of the foreign loans (almost all except Icesave) are taken to strengthen the foreign currency reserves so that there are assets against them? I think she should stick to advising the special prosecutor and leave economic affairs to others.¹⁸

After a public outcry, Arnarsson retracted his comment.

In Parliament, meanwhile, a majority of MPs gradually formed itself, not solely on party lines. This group wanted only to accept the Icesave deal subject to certain preconditions of which five were the most important. First, no assets of the sovereign Icelandic state, including assets of the CBI, should be subject to any legal challenges as a result of the deal; they could neither be frozen nor seized. In the second place, the deal should in no way hinder or limit the full sovereignty of Iceland over its natural resources. Thirdly, the annual payment to the UK should not in 2017–23 exceed more than 4% of the growth of GDP in pound sterling, and to the Netherlands more than 2% of the growth of GDP in euros. Fourthly, Iceland should retain her right to have the legal dispute on state responsibility for bank deposits resolved in a court of law. Fifthly, in the case that the sale of Landsbanki assets would generate more money than would be necessary fully to reimburse the British and the Dutch governments for their outlays to Icesave depositors, this surplus would be disposed of under Icelandic bankruptcy law.¹⁹

While the largest opposition party, the Independence Party, worked with government MPs on the preconditions, it distanced it from the Icesave deal itself. The bill ratifying the Icesave deal was finally passed by Parliament on 28 August 2009 by 34

¹⁷ Eva Joly, *Island: Thad sem laera ma af efnahagshruninu* [Iceland: The Lessons from the Economic Collapse], *Morgunblaðið* 1 August 2009, p. 29. http://timarit.is/view_page_init.jsp?pageId=5260198 English version: <http://www.telegraph.co.uk/finance/comment/5961143/How-could-a-handful-of-men-in-Reykjavik-supervise-a-powerful-City-bank.html>

¹⁸ Hrannar sendir Joly toninn [Hrannar Denigrates Joly], *mbl.is* 2 August 2008 [online edition of *Morgunblaðið*], http://www.mbl.is/frettir/innlent/2009/08/02/hrannar_sendir_joly_toninn/ On the reaction to Arnarsson's comment, Malstadur Islands [Iceland's Case], *Morgunblaðið* 4 August 2009, p. 16. http://timarit.is/view_page_init.jsp?pageId=5260249

¹⁹ Parliament 2009, Case no. 136, Document no. 204. <http://www.althingi.is/altext/137/s/0204.html>

votes to 14, while 14 abstained and one was absent. All government MPs voted for the bill, whereas opposition MPs either voted against it or abstained.²⁰ On 2 September 2009, President Olafur Ragnar Grimsson signed the bill, announcing that he did so with special reference to the preconditions added by Parliament. However, at a meeting in Copenhagen immediately afterwards, the British and the Dutch negotiators categorically rejected the preconditions. Now, Indridi Thorlaksson, the former Director of Iceland's Revenue Service, had taken over from Ambassador Gestsson as Iceland's chief negotiator.²¹ In September, talks continued between the negotiating teams of Iceland, the UK and the Netherlands. While the British government had cancelled the use of the Anti-Terrorism Act against Icelandic institutions and companies after the first deal was signed in June 2009, another way of putting pressure on Iceland remained, through the IMF. The next instalment of the IMF loan to Iceland was delayed, until a new deal had been negotiated. It was also clear that this deal would be similar to the original one. In protest against the whole process, Health Minister Ogmundur Jonasson from the Left Greens resigned 30 September. He had been told that either he would support the bill as a government minister or the Prime Minister would resign.²²

5. *The Campaign Against Icesave II*

A bill to ratify the new Icesave deal (often called Icesave II) was laid before Parliament by Finance Minister Steingrímur J. Sigfússon on 19 October 2009. From the beginning, it was heavily criticised. Attorney Lára Blöndal and Law Professor Stefan Már Stefánsson argued, for example, that the preconditions set by Parliament in August had essentially been removed, leaving Iceland vulnerable in the case of adverse economic developments. Full interest had to be paid on the British and Dutch loans to the DIGF, guaranteed by the Icelandic state, irrespective of economic conditions. The court option was also essentially barred: The deal would not necessarily be invalidated if a court of law came to the conclusion that the Icelandic state had no obligation in the case. Moreover, English law would apply in the case, whereas the idea had been that Icelandic law would apply to the resolution of Landsbanki and the sale of its assets.²³

The highly motivated InDefence group campaigned hard against the new Icesave deal, and 25 November 2009 it started collecting signatures on a petition to President Olafur Ragnar Grimsson not to sign the bill ratifying the deal. Under the Icelandic Constitution, this would mean that a national referendum would be held about the bill. The InDefence initiative was very successful from the beginning: In two days, about 5,000 people had signed the petition. Now Editor of *Morgunblaðið*, former CBI Governor David Oddsson led a campaign in his newspaper against the new deal. Now as before, the bill's supporters did not mince words. Prime Minister Jóhanna Sigurðardóttir said in Parliament: "I think that we would be creating a deep-freeze

²⁰ Two members of the Independence Party voted against the deal (Icesave I) in its modified form, Arní Johnsen and Birgir Armannsson, while other 13 members of the Party abstained and one was absent. All members of the Progressive Party voted against the deal, including the new Chairman Sigmundur David Gunnlaugsson, and so did two members of the Movement, while one member of the Movement abstained. <http://www.althingi.is/thingstorf/thingmalin/atkvaedagreidsla/?nmafak=41243>

²¹ Jonsson, *Icesave-samningarnir*, pp. 147–8.

²² *Ibid.*, p. 154.

²³ Lára Blöndal and Stefan M. Stefánsson, 2009. *Hvad stendur eftir?* [What Is Left?], *Morgunblaðið* 31 October 2009, p. 29. http://timarit.is/view_page_init.jsp?pageId=5265598

winter in the economy this following winter if we are going to do nothing about this.”²⁴ Public Administration Professor Sigurbjorg Sigurgeirsdottir joined her colleagues Stefan Olafsson and Thorvaldur Gylfason in supporting an Icesave deal for moral reasons. She claimed that the Icesave dispute was about democratic responsibility. The Icelanders had to realise their own part in the bank collapse and not simply blame it all on others. Iceland’s international reputation was at stake:

In happier times, the Icelanders used the freedom flowing from the EEA treaty without shouldering the responsibility which is a necessary part of freedom. Now, in the midst of the ruins, they do not seem either to want to shoulder the responsibility implied in the treaty. Therefore Icesave is now an international conflict.

Sigurgeirsdottir added: “Abroad Iceland has many good friends. Iceland’s enemies are closer by.”²⁵

After a heated debate, the bill on the second Icesave deal was passed by Parliament close to midnight on 30 December 2009, by 33 votes against 30. Now all MPs of the opposition parties voted against the bill, and two defectors from the Left Greens. The InDefence collection of signatures on the petition to President Olafur Ragnar Grimsson had gained momentum during the parliamentary debate on the Icesave deal and immediately after it. When Finance Minister Steingrimur J. Sigfusson presented the bill to the President for signing, Grimsson said that he needed time to consider it. On 2 January he received the spokesmen of InDefence who handed over to him the petition signed by 56,089 people. Three days later, on 5 January 2010, Grimsson announced that he would not sign the bill. The reason he gave was not that he preferred the ‘court option’ to the ‘deal option’, but that the people of Iceland should decide on such an important matter.²⁶ Consequently, a national referendum on the bill was scheduled 6 March 2010. Later it was discovered, in leaked documents, that the day after the President’s announcement, on 6 January, the British chief negotiator, Gary Roberts, briefed the economic counsel at the US Embassy in London about the state of the dispute. He said that Iceland had to fulfil her obligations and that the terms of the Icesave deal were generous. Roberts added that “it would be difficult for the UK to support the next IMF review for Iceland if the decision on repayment were still unresolved.”²⁷

The British and the Dutch governments wanted to avoid a referendum. They informally indicated to the Icelanders that they might consider better terms on the loans, while they would continue to demand full payment of principal. They insisted however that new talks would have to be confidential and supported by the opposition as well as by the government parties. Finance Minister Steingrimur J. Sigfusson attended a confidential meeting in The Hague 29 January 2010 with Dutch Finance Minister Wouter Bos and UK Financial Services Secretary Lord Paul Myners, accompanied by the leaders of the two opposition parties, Bjarni Benediktsson from the Independence Party and Sigmundur David Gunnlaugsson from the Progressive

²⁴ Jonsson, *Icesave-samningarnir*, p. 163.

²⁵ Sigurbjorg Sigurgeirsdottir, Eru ovinir Islands her? [Are Iceland’s Enemies Here?], *Frettabladid* 16 December 2009, p. 30. http://timarit.is/view_page_init.jsp?pageId=4438222

²⁶ Declaration by the President of Iceland (official translation), 5 January 2010. http://www.forseti.is/media/PDF/10_01_05_declaration_w_sign.pdf

²⁷ Cable from US London Embassy to State Department, 6 January 2010. <https://wikileaks.org/cable/2010/01/10LONDON21.html>

Party. They decided to try quickly to resolve the issue. Discreetly, US officials were watching.²⁸

On the recommendation of the Icelandic opposition parties, an American expert on sovereign debt resolution, Lee Buchheit, was appointed Iceland's chief negotiator, and new talks were initiated. Buchheit's approach was quite different from that of his predecessors, Gestsson and Thorlaksson. He told his counterparts that he was not there to renegotiate the old Icesave deal, but simply to explore whether new talks could be started on new premises. He and his team stressed that there was no legal obligation by the Icelandic state to guarantee deposit insurance over and above establishing a depositors' guarantee fund. He also told the British and Dutch negotiators that the most important task was to find out how much of the uncontested obligations of the DIGF could be met by the sale of Landsbanki assets, and if there was a shortage, how it could be covered. He advised the Icelandic government ministers and opposition politicians not to hurry too much; it might even be helpful in the bargaining process to let the referendum go ahead.²⁹ It became clear that a mutually satisfactory deal could not be reached in the short time before the referendum which consequently took place on 6 March 2010. The result was, as expected, unequivocal: 62.7% of eligible voters had participated. Of them, 2,599 voted for the bill, 134,392 against it, and 7,240 ballots were blank or void. Of valid votes, 1.9% had said yes, and 98.1% no.³⁰

6. Icesave III (the Buchheit Deal)

The British and the Dutch negotiators tried hard to return to the previous Icesave deals, with little modification, but Lee Buchheit and his team did not accept that. After several meetings in London and Reykjavik, a new Icesave deal, the third one, was signed in London on 8 December 2010. The main differences between the new deal (Icesave III) and the two older ones (Icesave I and Icesave II) were the following:

1. The new deal was more like a treaty between sovereign states to end a dispute than a loan agreement. It provided for the DIGF to reimburse the British and the Dutch governments for their outlays to Icesave depositors and to receive in return the corresponding portion of their claims against the Landsbanki estate. First, the DIGF was to use its existing funds, and then it would make payments as the Landsbanki assets were gradually sold off.
2. The liability of the Icelandic treasury was limited to (a) payment of interest as it accrued until June 2016, and (b) the portion which by then had not been recovered from the bank's estate.
3. The interest rate charged by the British and the Dutch creditors (which were the entities corresponding to the Icelandic DIGF rather than the governments of the two countries) was significantly lowered from previous deals. It was fixed

²⁸ Jonsson, *Icesave-samningarnir*, p. 181; Cable from US Embassy in The Hague to State Department, 19 February 2010. <https://wikileaks.org/cable/2010/02/10THEHAGUE106.html>

²⁹ Jonsson, *Icesave-samningarnir*, pp. 190–5.

³⁰ Results of elections and referenda on the English website of Statistics Iceland, <http://www.statice.is/pages/2465>

until mid-2016. The interest on the Dutch loan was 3.0% and on the UK loan 3.3%. The average interest rate was approximately 3.2%. The interest on any outstanding principal after mid-2016 was the appropriate CIRR, Commercial Interest Reference Rates, without any interest premium. These interest rates were generally the lowest in credit arrangements between public parties.

4. Two provisos about Iceland's economic situation were recognised which placed a ceiling on annual payments from the Icelandic treasury and extended the terms of the loans automatically if the outstanding principal was higher than a specified amount, in proportion to the amount remaining: (a) Annual payments by the Icelandic treasury should not exceed 5% of the treasury's revenue in the preceding year; and if this turned out to be lower than 1.3% of GDP, the maximum repayment should be based on this percentage of GDP. (b) If the outstanding principal of the DIGF obligations amounted to less than the equivalent of ISK 46 billion, then this was to be paid in full within 12 months, in the latter half of 2016 and first half of 2017. If the outstanding obligation turned out to be higher, then the repayment period was lengthened by one year for each ISK 10 billion, although with the limit that the amount outstanding had to be paid by the end of a 30-year repayment period beginning in 2016. Iceland's negotiators added, in their presentations, that it was unlikely that these provisos would be tested.

5. Dispute resolution was transferred from jurisdiction of UK courts to that of the Permanent Court of Arbitration in The Hague. If an issue was referred to the Court, the two parties—Iceland on the one hand and the UK and the Netherlands on the other hand—would each appoint their representatives and the representatives then agree on a third arbitrator.

6. It was clearly stated that the Icelandic state would retain those rights of a state which enjoy protection under the Vienna Convention on Diplomatic Relations, those assets in Iceland which are vital to Iceland as a sovereign state, and CBI assets. The same stipulation applied, as in earlier deals, on Iceland's natural resources.³¹

The opposition parties were quick to point out that the terms of this deal were much more favourable for Iceland than the two previous ones. This implied that the two earlier deals had really been huge blunders despite the great effort by the government to have them accepted and the big words used by scholars in supporting them.

7. The Campaigns For and Against Icesave III

On 15 December 2010, Finance Minister Steingrímur J. Sigfússon introduced the bill ratifying the new Icesave deal (often called Icesave III). The bill was passed by Parliament 16 February 2011 by 44 votes to 16, with 3 abstentions. All MPs from the two government parties voted for the bill, with the exception of two from the Left Greens, both of them later resigning from the Party. Most MPs from the Independence Party voted for the bill, but a few either voted against it or abstained.

³¹ Lee Buchheit et al., Summary of the Negotiating Committee concerning Icesave, 9 December 2010. http://www.ministryoffinance.is/media/Summary_of_the_Negotiating_Committee_concerning_Icesave.pdf

Most MPs from the Progressive Party voted against the bill.³² The strong resistance in the general population to the ‘deal option’ in the Icesave case also remained. Many Icelanders asked why the British and the Dutch governments did not simply go to court to clarify whether there was a legal obligation or not. A new grassroots movement, Let Us Vote (kjosum.is), collected signatures on a petition to President Olafur Ragnar Grimsson to refer the bill ratifying the Icesave deal again to the nation. More than 32,000 people had signed the petition on the day Parliament voted on the bill, 16 February 2011. Grimsson announced 20 February 2011 that he had decided not to sign the bill, stating the same reason as before for his decision, that the nation had to decide on this important matter.³³

Now, there was more vigorous support for the ‘deal option’ than before, both in the business community and amongst academics: A common argument was that Iceland would isolate herself if she was unwilling to resolve this dispute by negotiating. Some continued, also, to support an Icesave deal on moral grounds. Philosophy Professor Vilhjalmur Arnason wrote: “From a moral point of view the Icesave case seems to be simple. The Emergency Act discriminated against Landsbanki’s depositors in such a way that Icelanders were fully compensated, while foreigners received nothing.” Arnason added: “The deal on which now we are now voting distributes the cost fairly between the three nations which hold a stake.”³⁴ Two campaign groups were formed before the referendum, the Advice group against the deal, and the Advance (“Afram” in Icelandic) group for it. On 9 April 2011, the national referendum on Icesave III, the Buchheit deal, was held. Of the 232,460 voters eligible, 175,114 cast their vote, or 75.3%. The No received 103,207 votes, and the Yes 69,462, while blank and void ballots numbered 2,445. This meant that the Icesave deal was defeated by 59.8% against 40.2%.

Subsequently, the British and the Dutch governments gave up further negotiations, joining instead a legal action brought before the EFTA Court by the EFTA Surveillance Authority, ESA. The Authority was of the opinion that by its failure to provide compensation to Icesave depositors, the Icelandic state was in breach of its obligations under European law and directives. ESA had already issued a formal notice in 2010, but the process was halted while negotiations went on. The formal court case started on 15 December 2011. ESA was supported by the EC, the UK and the Netherlands, while Norway and Liechtenstein submitted written observations in favour of the Icelandic position.

8. Arguments before the EFTA Court

Before the EFTA Court, ESA argued that by failing to ensure payments of compensation to Icesave depositors in Landsbanki’s branches in the UK and the Netherlands within set time limits, Iceland had breached her obligations under

³² The Independence Party members voting against the deal were Birgir Armannsson, Petur H. Blondal, Sigurdur K. Kristjansson, and Unnur B. Konradsdottir. The Left Green members voting against it were Asmundur E. Dadason and Lilja Mosesdottir. Independence Party member Gudlaugur Th. Thordarson abstained. So did two Progressive Party members, Guðmundur Steingrímsson and Sív Fríðleifsdóttir. <http://www.althingi.is/thingstorf/thingmalin/atkvaedagreidsla/?nnafnak=44028>

³³ Declaration by the President of Iceland, 20 February 2011 (official translation), http://www.forseti.is/media/PDF/2011_02_20_icesave3_eng.pdf

³⁴ Vilhjalmur Arnason, Nei mun bitna a okkur sjalfum [A No Will Harm Ourselves], *Frettabladid* 9 April 2011, p. 18. http://timarit.is/view_page_init.jsp?pageId=5150899

European Directive 94/19. The Directive imposed an ‘obligation of result’ on EEA states to ensure that a deposit-guarantee scheme was set up capable of guaranteeing that, in the event of deposits being unavailable, deposits were covered up to the minimum set by the Directive, and within a deadline. Iceland had not, ESA argued, fulfilled all her obligations simply by transposing the Directive into national law and setting up a deposit-guarantee scheme. Exceptional circumstances could not alter the obligation to compensate depositors; it could only justify certain payment delays. ESA also submitted that the principle of ‘force majeure’ (when legal obligations are overridden or reduced by extraordinary circumstances) did not apply in the Icesave case and did not, in any event, release Iceland from her obligations under the Directive. ESA added that Iceland was also in breach of the prohibition of discrimination in the Directive, and also in Article 4 of the EEA Agreement. The Icelandic government had moved domestic deposits to new banks and covered them in full. Meanwhile, foreign depositors had not even enjoyed the minimum guarantee laid down in European Directive 94/19. The Icelandic state could not offer any viable justification for this discrimination against foreign depositors.

Iceland responded that Directive 94/19 imposed no ‘obligation of result’ on an EEA member state to guarantee the pay-out of a deposit-guarantee scheme in the event that all else failed. The obligations of the state concerned were limited to ensuring the proper establishment, recognition and supervision of a deposit-guarantee scheme, as Iceland had done. Stipulations in the Directive made clear that the funding for deposit-guarantee schemes would come from the banks. The ESA interpretation of the Directive would convert it from a measure funded by the banks into a measure that could impose huge liabilities on the state, Iceland argued. Only one article of the Directive dealt with the possibility that a deposit-guarantee scheme might be unable to pay duly qualified claims. But the solution there contemplated was an action against the scheme and not against the EEA member state. Iceland submitted further that the fact that the DIGF could not cope with the almost total failure of the Icelandic banks did not show any failure by the Icelandic state to implement the Directive properly. No deposit-guarantee scheme could have coped with such a wide-scale banking failure. Iceland noted that the EC was presently considering reforms of banking supervision in order to strengthen the measures available. Again, even if the Directive were to impose strict obligations upon a state to fund a deposit-guarantee scheme in the event of a banking system collapse, the Icelandic state was prevented from doing so by ‘force majeure’.

Iceland also contended that she was not in breach of the prohibition on discrimination. In the case of a bank failure, an EEA member state might intervene to rescue banks or branches necessary to the functioning of the banking system, even if it was not required to do so. What was regarded by ESA as discrimination was really different consequences flowing from the fact that the domestic branches of Landsbanki were essential to the rescue of the Icelandic financial system. Iceland noted that ESA had never argued that in the Icesave case foreign deposits could have been treated as the domestic ones, by transferring them to a new bank. It was also unclear whether the transfer of domestic deposits to a new bank improved the position of the depositors, as they were subject to stringent capital controls and unable to convert their *krona* into any other currency, whereas the priority claimants in the Landsbanki resolution proceedings stood to be fully reimbursed in a fully convertible currency. Moreover, the DIGF had never treated any depositors

unequally: It was of relevance that deposits in Landsbanki's domestic branches had never become unavailable.

9. The EFTA Court Decision in Favour of Iceland

On 28 January 2013, the EFTA Court delivered its judgement in the Icesave dispute. It rejected the ESA plea that Directive 94/19 implied a specific 'obligation of result' on member states. The Directive had to be interpreted, the Court argued, as it stood at the relevant time, and not as it and other directives had since been amended. Under the Directive, EEA member states had to introduce and supervise a deposit-guarantee scheme. However, it was not envisaged that EEA member states had to ensure the payment of aggregate deposits. A new Directive had since been adopted, in 2009, under which EEA member states were obliged to ensure a certain level of coverage of deposits. But this indeed supported the view, the EFTA Court held, that under the previous arrangement the obligation on EEA member states had been limited to ensuring that national rules requiring a certain coverage level—at least €20,000—were maintained or adopted. In the Directive under consideration in this case, it was provided for the possibility that a deposit-guarantee scheme was unable to pay duly qualified claims. But the obligation on the EEA member states in that case was limited to maintaining or adopting rules that provided for an effective right to file an action against the guarantee scheme. The EFTA Court recognised that EEA member states were obliged to supervise and ensure that deposit-guarantee schemes were, as a rule, not released from the short deadline established in the Directive. "However, an obligation on the State and its national authorities to ensure compensation if a deposit-guarantee scheme is unable to cope with its obligations under exceptional circumstances such as in a systemic crisis cannot be derived from that provision." The EFTA Court also referred to some stipulations in the Directive showing that it dealt, at least primarily, with a failure of individual banks and not with a systemic crisis. The EFTA Court added that how to proceed in a case where the guarantee scheme was unable to cope with its payments obligations remained largely unanswered by the Directive.

The EFTA Court was not persuaded, either, by the ESA plea on discrimination. It pointed out that the facts of the case were that the IFSA had decided on 9 October 2008 to transfer domestic deposits in Landsbanki to a new bank, the New Landsbanki, established between 9 and 22 October 2008. The Icelandic DIGF was not involved in this. On 27 October 2008, the IFSA made a statement which triggered an obligation for the DIGF to make payments as regards foreign deposits in Landsbanki branches. The domestic deposits did not become unavailable. Accordingly, depositor protection under the Directive never applied to depositors in Landsbanki's Icelandic branches. In this case, therefore, difference in treatment was not possible, because the transfer of domestic deposits from the old bank to the new one did not fall within the scope of the non-discrimination principle set out in Directive 94/19.³⁵

The decision of the EFTA Court could be, and was, interpreted as a total victory for those Icelanders who had argued for the 'court option' in the Icesave dispute and

³⁵ Judgement of the EFTA Court, 28 January 2013, http://www.eftacourt.int/uploads/tx_nvcases/16_11_Judgment_EN.pdf

against the ‘deal option’. Only three months away from general elections, the judgement had an immediate political impact. The Progressive Party which had been the only party mostly united against the deal option gained support and handsomely won the elections on 27 April 2013. It had received 14.8% of valid votes in 2009, and now got 24.4%. The Independence Party whose support had been rising in opinion polls during the winter of 2012–13, only moved from its worst ever result in 2009 of 23.7% to a disappointing 26.7% of valid votes. After the election, the leader of the Progressive Party, Sigmundur David Gunnlaugsson—a founding member of the InDefence group before entering politics—formed a new coalition government of the Progressive Party and the Independence Party. The government parties both suffered a debacle. The Social Democrats went from 29.8% to 12.9%, an electoral defeat unparalleled in Icelandic history, and the Left Greens from 21.7% to 10.9%. In a phone poll conducted after the election, 34.6% of those asked said that the Progressive Party had performed well in the Icesave issue, 7% named the Independence party, 4.4% the Left Greens and 4.24% the Social Democrats. According to the same poll, 36.1% said that the Social Democrats had performed very badly in the Icesave issue, 34.8% named the Left Greens, 14% the Independence Party and 7.7 the Progressive Party.³⁶

³⁶ Eva H. Onnudottir, Personal Information (2014), from the unpublished Icelandic Election Research Project.

Chapter Twelve

Moral Issues in the Icesave Dispute

An analysis of the moral issues in the Icesave dispute is relevant for an investigation of foreign factors in the Icelandic bank collapse, because it was a widespread perception in Europe that the Icelanders were in the wrong when refusing to introduce a government guarantee of bank deposits.

1. The Concept of Collective Responsibility

While the legal dispute in the Icesave case was resolved by the EFTA Court in January 2013, and the political impact became clear in the parliamentary elections in April the same year, arguably some moral issues remained. Were Professors Thorvaldur Gylfason and other prominent Icelandic intellectuals perhaps right that after the bank collapse the Icelanders, as a nation, had on moral grounds to take financial responsibility for Landsbanki's Icesave accounts? Does the idea of collective responsibility, or even guilt, make sense in this case? In Icelandic history, there is an interesting parallel with the 1627 'Turkish Raid' when pirates from Ottoman territories in North Africa suddenly appeared in Icelandic waters, plundering and kidnapping people whom they subsequently sold into slavery. This came probably as much as a shock to the tiny nation in a remote corner of the North Atlantic as did the 2008 bank collapse. Intellectuals at the time, mostly clergymen, argued that the 'Turkish Raid' was God's punishment for human sin and that the Icelanders had to learn their lesson from it and become more virtuous.¹ The message in the Icesave case seems to be similar: The Icelanders as a nation have to atone for past excesses.

However, some contemporary philosophers would reject the arguments both of the clergymen four hundred years ago and of Professor Gylfason and his colleagues. They would argue that only individuals can act and that therefore only they can be held responsible for their actions or omissions to act, and not groups of which they may be members.² On that premise, an ordinary Icelander certainly did not bear any responsibility for a business transaction between a foreign investor in pursuit of a high return on his money and an Icelandic bank offering him or her attractive terms. Was it not a private transaction for whom the individuals engaging in it should bear full responsibility, reap the profit or suffer the cost? Even if Canadian philosopher Jan Narveson admits that some forms of collective responsibility may exist, he argues that "it is a dangerous device, generating insoluble problems and entailing the mistreatment of individual people."³

¹ Thorsteinn Helgason, Historical Narrative as Collective Therapy: the Case of the Turkish Raid in Iceland, *Scandinavian Journal of History*, Vol. 22, No. 4 (2008), pp. 286–7.

<https://www.tandfonline.com/doi/abs/10.1080/03468759708579357>

² Karl R. Popper, *The Open Society and Its Enemies*, Vol. I (London: Routledge & Kegan Paul, 1945), Introduction.

³ Jan Narveson, Collective Responsibility, *The Journal of Ethics*, Vol. 6, No. 2 (2002), p. 179.
<https://www.jstor.org/stable/25115724>

Be that as it may, a lively discussion has taken place in contemporary moral philosophy about collective or national responsibility. When an employee of a corporation witnesses it engaging in immoral or illegal activities and keeps silent about it, is he or she not partly responsible for those activities? Are Argentine citizens not responsible for the public debt of their country, created by their democratically elected representatives?⁴ Are people who willingly participate in street riots not to be held responsible for damages and personal injuries suffered by others in such riots even if those participants themselves did not intend the consequences? If Englishmen take pride in the great achievements of the British Empire, should they then not also accept (at least some) blame for the Irish Potato Famine, the operation of concentration camps in the Boer Wars and the Amritsar massacre?⁵ If white South Africans benefited during Apartheid, should they then not contribute to the compensation of its victims, also when they themselves personally did not support Apartheid and even campaigned actively against it? Did the Norwegian government-in-exile during the German occupation of Norway act legally and morally when it retroactively made membership of the fascist party (*Nasjonal Samling*)—a legal political party on Norway before the War—a criminal offence?⁶ Should Stalinist apologists and fellow-travellers in the West be regarded as accomplices in the crimes of their Soviet comrades, thus partly sharing with them the guilt or at any rate some blame for those crimes?⁷ Philosophers have also explored whether the whole of the German nation could be held responsible for Nazi atrocities (as the distinguished German philosopher Karl Jaspers held),⁸ or today's white US citizens for antebellum slavery, or men in general for past repression of women, or inhabitants of affluent Western countries (whose high living standards seem in many cases to depend on luck) for widespread poverty in many other countries.⁹

2. No Responsibility of the Icelandic Nation

Certainly, in some cases collective responsibility has been publicly acknowledged. For example, the Finns, without complaining, paid enormous reparations to the Soviet Union after the 1941–4 Continuation War (which Finland started, unlike the 1939–40 Winter War);¹⁰ since the 1950s, the Federal Republic of Germany has transferred significant resources to Israel in an attempt to make some amends for the

⁴ See, for example, NY judge freezes Argentine assets held by Fed, *Financial Times* 12 January 2010.

⁵ James S. Donnelly, *The Great Irish Potato Famine* (Stroud, Gloucestershire: History Press, 2008); Elizabeth van Heyningen, *The Concentration Camps of the Anglo-Boer War: A Social History* (Johannesburg: Jacana Media, 2013); Nick Lloyd, *The Amritsar Massacre: The Untold Story of One Fateful Day* (London: IB Tauris, 2011).

⁶ *Et rettferdig oppgjør?: rettsoppgjøret i Norge etter 1945* [A Just Reckoning?: The Legal Purge in Norway After 1945], eds. Hans Fredrik Dahl and Øystein Sørensen (Oslo, Pax, 2004).

⁷ Stéphane Courtois et al., *The Black Book of Communism: Crimes, Terror, Repression*, ed. Stéphane Courtois (Cambridge MA: Harvard University Press, 1999); Paul Hollander, *Political Pilgrims: Travels of Western Intellectuals to the Soviet Union, China, and Cuba 1928-1979* (Lanham: University Press of America, 1981); David Caute, *The Fellow-Travellers: Intellectual Friends of Communism* (New Haven NJ: Yale University Press, 1988).

⁸ Karl Jaspers, *Die Schuldfrage* (Heidelberg: Lambert Schneider, 1946).

⁹ David Miller provides a thorough analysis of many such examples in *National Responsibility and Global Justice* (Oxford: Oxford University Press, 2007).

¹⁰ Lennart Jörberg and Olle Krantz, Scandinavia 1914–1970, *Fontana Economic History of Europe: Contemporary Economies*, Vol. 6, Part 2, ed. Carlo M. Cipolla (London: Collins/Fontana, 1976), pp. 430–432.

Nazi Holocaust;¹¹ in 1994, the Swedish government apologised for the extradition of Baltic soldiers to the Soviet Union after Second World War.¹² Some philosophers have found the notion of collective responsibility cogent when the collective in question is cohesive and its members strongly identify with it. An example of such a collective would be a nation, with a shared history and clear identity. Another (partly overlapping) example would be a well-functioning democracy. A relevant consideration in both cases would be the right to dissent and to exit.¹³

Indeed, at first sight the Icelandic nation seems to be eminently qualified to serve as such a collective: She has a long shared history, a common language and a clear identity, besides a well-functioning democracy, with a real right to dissent and to exit. The Icelanders take great pride in the achievements of their forefathers, not least in their rich literary heritage and in the survival of their tiny nation in a harsh environment. Their nationality “infuses citizens with a sense of purposefulness, confidence, and dignity.” Should they not therefore also accept shame for past misdeeds? On the other hand, it should be noted at the outset that, perhaps as a result of their relative isolation and powerlessness, the Icelanders have no legacy of serious misdeeds perpetrated in their name. They have generally not engaged in the pathological variant of nationalism that “revels in macho glory.”¹⁴ Within the country, there are no minorities to oppress (with the exception perhaps of women but their past oppression would however be an international rather than a particularly Icelandic phenomenon). The Icelanders have never invaded other countries or subjected other nations to colonial rule. In the rare dealings with other countries where force has been used (as in the 1627 pirate raids from North Africa or the 1940 British military occupation), the Icelanders have been victims rather than perpetrators.¹⁵

It would seem to be a necessary precondition for assuming national responsibility that at least someone had been harmed or was suffering by the actions or omissions of those acting on behalf of the nation. But in the Icesave case, the depositors suffered no loss: They all got their money back, as Landsbanki’s managers had from the beginning insisted they would. However, from the vantage point of 2009, perhaps the case looked different. It was then estimated that Icesave account holders would get about 75% of their insured deposits back from Landsbanki’s estate.¹⁶ This apparent loss was however in most cases to be suffered by the British and Dutch treasuries (and thus by taxpayers in the two countries) rather than by individual depositors who were almost immediately compensated. The situation in 2009 may however make the position then adopted by Professors Thorvaldur Gylfason, Stefan Olafsson and Sigurbjorg Sigurgeirsdottir more understandable. Their argument apparently was that somehow the Icelandic nation had become an accomplice of Landsbanki, and that

¹¹ Elazar Barkan, *The Guilt of Nations: Restitution and Negotiating Historical Injustices* (Baltimore: The Johns Hopkins University Press, 2000), Ch. 1.

¹² Anders Bojs and Leif Mårtensson, *I Baltutlämningens skugga: internering och utlämning av tyska militärflyktingar via lägren i Rinkaby och Gälltofta 1945-1946* (Kristianstad: Föreningen Gamla Christianstad, 2004), p. 98.

¹³ Narveson, *Journal of Ethics*, p. 181.

¹⁴ John Keane, Nations, Nationalism and European Citizens, *Notions of Nationalism*, ed. Sukumar Periwal (Budapest: Central European University Press, 1995), pp. 186 and 193.

¹⁵ Karlsson, *The History of Iceland*, pp. 143–5 and 314–7.

¹⁶ This was the presumption in the deal which Svavar Gestsson presented to the Parliament in June 2009.

therefore the possible loss suffered by Landsbanki's foreign customers could be blamed on the Icelanders as a whole.

But even if there had been a loss—which, for the depositors, turned out not to be the case—this does not seem a strong argument. 'Caveat emptor:' The buyer beware. Landsbanki's foreign customers should have been expected to look out for themselves. Even if Landsbanki, in its collection of Icesave deposits, arguably traded on the good reputation that Iceland had earned in the 1991–2004 period (as the brand name of the accounts suggests), its customers were never misled by Icelandic authorities about a possible government guarantee of deposits. Publicly, Icelandic politicians and officials said the same as their counterparts in other countries: that the government would do its best to maintain financial stability. It should also be recalled what CBI Governor David Oddsson said at a press conference in May 2008: "It's a new development if banks are supposed to be able to expand at will and take the risk that they choose to take, and then the public, through the central bank, is believed to function as some sort of inexhaustible guarantee fund."¹⁷

3. No Negligence by Icelandic Authorities

A possible counter-argument is that Icelandic authorities were guilty of neglect when they allowed Landsbanki to collect deposits abroad in branches instead of in subsidiaries and when they subsequently did little to facilitate the transfer of the Icesave accounts from branches to subsidiaries, especially in the UK where the FSA had recommended this since March 2008. But such activities took place in other countries as well: In Germany and Sweden, for example, Kaupthing collected deposits in branches rather than subsidiaries. Moreover, Iceland was a member of the EEA, and Icelandic banks could open branches in other countries if they wanted to, provided they fulfilled some conditions—which they did. The CBI at least had no power to stop this, although the CBI governors repeatedly advised Landsbanki's managers to try and transfer the Icesave accounts from branches to subsidiaries.

As previously noted, on many occasions CBI Governor Oddsson forcefully expressed his opinion that such a transfer was crucial to Iceland. At a meeting with IFSA staff members on 7 July 2008, for example, Oddsson observed that the IDIGF would not even be able to handle the failure of a small rural savings association. In his opinion, the collection of deposits abroad should have been stopped by the IFSA.¹⁸ At a meeting with Landsbanki's managers on 14 July, Oddsson expressed great surprise that the Icesave accounts were not already in the process of being transferred from a branch to a subsidiary.¹⁹ At a meeting with staff members from the British FSA visiting Iceland in late July, he expressed his agreement with them on the need to transfer the Icesave accounts to a subsidiary. Afterwards, on 31 July 2008, Oddsson summoned Landsbanki's two managers to a meeting at the CBI, repeating his view that there was no government guarantee of the Icesave accounts: "No guarantee

¹⁷ Board of governors press conference, 8 May 2008.

<http://gamli.sedlabanki.is/?PageID=287&NewsID=1762> See also SIC Report, Vol. 6, Ch. 19, p. 175.

¹⁸ SIC Report, Vol. 6, Ch. 17, p. 70 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli17Enska.pdf>

¹⁹ SIC Report, Vol. 6, Ch. 18, p. 14 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli18Enska1.pdf>

unless stipulated by law.”²⁰ In August 2008, the CBI rejected a request by Landsbanki for a complicated set of measures which were to be kept secret. The objective of those measures was to facilitate the transfer of the Icesave accounts from Landsbanki’s London branch to its British subsidiary, Heritable Bank. In its report, the SIC pointed out that the refusal was reasonable, as this facilitation would have been very risky for the CBI and probably illegal as well.²¹

Formally, the IFSA may have had legal authority to stop deposit collection abroad,²² but in the circumstances it would not have had much political support for such a harsh measure which would almost certainly have brought down the banking sector all at once. In addition, even if it had been true—which it was not—that Icelandic authorities were guilty of neglect by not stopping Landsbanki’s collection of deposits in branches abroad, it does not necessarily follow that the Icelandic nation was responsible for the whole of the potential cost arising from such neglect. If the charge of neglect had been true, then other agents would also have been partly responsible: Landsbanki’s managers and owners, its customers abroad, both bondholders and depositors, and its regulators abroad, such as the FSA in the UK. But the main demand of the British and the Dutch governments in the Icesave dispute—the demand which Professors Thorvaldur Gylfason, Stefan Olafsson and Sigurbjorg Sigurgeirsdottir wanted to accept—was that the Icelandic treasury should guarantee the total cost of Landsbanki’s potential failure to compensate depositors in the UK and Netherlands, not only a part of it.²³

In this purely counterfactual case, where neglect by Icelandic authorities concerning the Icesave accounts would have been accepted, three additional considerations would have been relevant.

First, it has to be stressed that the individual responsibilities of the agents engaging in the transactions, the depositors and the bankers, would have been bypassed and ignored, illustrating yet again that sometimes the assumption of collective responsibility may cancel out individual responsibility, even if obvious and clear in this case.

In the second place, one harm would have been replaced by another: Ordinary Icelandic taxpayers would suddenly have found themselves liable for a huge debt which they had done nothing themselves to create and of which they were almost all unaware until after the bank collapse.

²⁰ SIC Report, Vol. 6, Ch. 17, p. 70 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli17Enska.pdf>

²¹ SIC Report, Vol. 7, Ch. 21, p. 153 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> The measures consisted in the CBI participating in a transfer of the Icesave accounts from Landsbanki’s London branch to Heritable Bank and issuing a £2.5 billion loan to Landsbanki against collateral (which presumably was not considered sufficiently solid at this point in time to be accepted by the British FSA in a direct transfer).

²² It should be recalled, though, that such authority would have been subject to strict requirements, in accordance with the Icelandic legal tradition. Indeed, in 2010, the law on financial companies was amended, giving the IFSA explicit authority to close down foreign branches of such companies. Law No. 75/2010. <https://www.althingi.is/altext/stjt/2010.075.html>

²³ Here, the reference is only to secured depositors: According to EEA stipulations, every depositor in a bank within the area was insured up to €20.887. It would complicate matters in this discussion of the Icesave dispute to introduce unsecured depositors as well.

Thirdly, ought implies can. Certainly the collective duties of a nation should not be beyond its powers, as John Maynard Keynes pointed out in the debate on German reparations after the First World War.²⁴ As the matter stood in 2009, when Landsbanki's assets were expected to cover 75% of the compensation to British and Dutch depositors, the remainder of the estimated total cost, alongside interest for an indefinite period, would have been a punitive 30–35% of Iceland's GDP.²⁵ By comparison, the Finnish war reparations to the Soviet Union, usually considered to be severe, amounted to 10–15% of Finland's GDP.²⁶ Even if originally the reparations exacted from Germany after the First World War were nominally much higher, in the end they amounted to 30–40% of Germany's GDP in 1920.²⁷ It is significant that the British and the Dutch governments in late 2009 rejected amendments by the Icelandic Parliament to the first Icesave deal designed to limit Iceland's liabilities to what would be within her capacity to pay.

4. No Discrimination of Depositors by Icelandic Authorities

In 2011, when it had become clear that Landsbanki's estate would cover all its deposits so that there was no major loss in which to share (except the interest on the outlays of the British and Dutch governments), Professor Vilhjalmur Arnason employed a different argument to that of some of his colleagues at the University of Iceland. Now it was a question of a morally indefensible discrimination: "The Emergency Act discriminated against Landsbanki's depositors in such a way that Icelanders were fully compensated, while foreigners received nothing." Arnason argued that the third and last Icesave deal negotiated by Lee Buchheit in late 2010 distributed "the cost" fairly between the three stakeholders in the matter, the British, Dutch and Icelandic nations, and that therefore it ought to be accepted by Icelandic voters to whom Iceland's President had referred it.²⁸ But the cost of the interest on the compensation which the British and the Dutch governments unilaterally chose to pay to Icesave depositors immediately after the Icelandic bank collapse instead of waiting for Landsbanki's estate to pay out the deposits was not "fairly" distributed between the three nations: This cost, perhaps about 20% of Iceland's GDP—a huge sum on any standard—was supposed to be borne by Iceland alone. Arnason did not explain why the Icelandic treasury should bear the whole cost of outlays by other governments on which it had taken no part in deciding.

More importantly, Professor Arnason is wrong that the 2008 Emergency Act discriminated between Landsbanki's Icelandic and foreign depositors: In fact, the Act gave all of them priority over other bank creditors. This is the reason all depositors

²⁴ John Maynard Keynes, *The Economic Consequence of the Peace* (London: Macmillan, 1920).

²⁵ Depending on the exchange and Iceland's GDP, the total amount of the government guarantee would, in 2008–9, have been 40–60% of GDP, according to Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 88. This means that if the recovery rate from Landsbanki's estate would have been 75%, the real cost, or remaining principal, would have been 10–15% of GDP. In addition, although difficult to calculate, the interest accumulated over time would have amounted to perhaps 20% of GDP. Even Anne Sibert, arguing that the cost was over-estimated by others, agreed in 2010 that the cost would be about 15% of GDP. The Icesave Dispute, VoxEU 13 February 2010.

<http://voxeu.org/article/icesave-dispute>

²⁶ Jörberg and Krantz, *Fontana Economic History of Europe*, pp. 430–432.

²⁷ Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 140.

²⁸ Arnason, *Frettabladid* 9 April 2011.

eventually were paid back in full whereas other creditors, such as bondholders (including the CBI), only recovered a part of their claims on Landsbanki's estate. It is true, but should not be used to confuse the issue, that the means of compensating domestic and foreign depositors were different: In Iceland, deposits were transferred from the old Landsbanki to a new government bank rather than being paid out in full. Depositors simply saw their accounts being smoothly transferred from the old to the new bank and they were able to access them at any time. This was not possible in the UK and Netherlands, because the governments there closed down the old banks, paid out the deposits and then tried to force the Icelandic government into guaranteeing their outlays. In a similar situation with Kaupthing's Edge accounts in Sweden and Germany (operated there from a branch rather than a subsidiary and therefore covered by the Icelandic deposit-guarantee scheme), no demand was made on the Icelandic Treasury, not to mention using an Anti-Terrorism Act against it, or against the CBI or individual Icelandic banks. In Sweden the CBS gave a loan to Kaupthing, with collateral in its assets, enabling it to pay out the depositors almost immediately. In Germany, despite some initial legal complications, the depositors were paid out of Kaupthing's assets in the course of a few months.

It is a relevant question why the British and the Dutch authorities did not pursue the same path as their Swedish and German counterparts. As Iceland argued before the EFTA Court, the different methods of compensating Landsbanki's depositors flowed from different situations in Iceland and other countries, and did not constitute discrimination between domestic and foreign depositors. The EFTA Court conceded that the question of how the Icelandic DIGF would treat individual depositors moreover only became relevant at a point in time when the new domestic banks had already been established. Therefore the DIGF had not really been able to engage in any discrimination between domestic and foreign depositors in the Icelandic banks.

It is quite a different matter, and should not be allowed, either, to confuse the issue, that at the same time as the Emergency Act was passed, on 6 October 2008, Icelandic government ministers publicly announced a full guarantee of all domestic deposits. This was an announcement aimed at averting a domestic bank run, and it was not legally binding, unlike the priority given to all depositors by the Emergency Act. Similar announcements with the same aim were made in many other European countries, in Ireland, Greece and Germany before Iceland, and in Denmark and the UK more or less at the same time.²⁹

Certainly, it can be argued that deposit guarantees such as many governments announced during the financial crisis constitute some kind of discrimination: The government in question issues a guarantee that potential losses from certain kinds of business transactions within its borders will be borne by the taxpayers instead of the agents engaging in the transactions themselves. This is at least discrimination in two senses: First, it is between domestic agents engaged in making and collecting bank deposits (the depositors and the bankers) on the one hand and domestic agents engaged in other kinds of business transactions on the other hand who are left doing this at their own risk (for example customers and owners of restaurants or buyers and sellers of shoes). In the second place, it is discrimination between domestic and

²⁹ SIC Report, Vol. 7, Ch. 17, p. 94 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefKafli17Enska.pdf>

foreign businesses, as further protection is being extended to the domestic ones. But these announcements had a clear and justifiable aim, to maintain financial stability and avert chaos. As economists have observed: “There are two kinds of countries: those that have deposit insurance, and those that don’t yet know that they have it.”³⁰ Moreover, most philosophers would recognise that a government has more extensive duties towards its own citizens—and taxpayers—than to foreigners.³¹ All governments discriminate in many ways between their own citizens and other people. In any case, this kind of discrimination was not what Professor Arnason was criticizing, but that which he mistakenly thought was implicit in the Emergency Act of 6 October 2008.

5. *Discrimination Between Depositors and Bondholders*

Professor Arnason overlooks or ignores the real discrimination implicit in the 2008 Emergency Act. This was the discrimination between all depositors, whether domestic or foreign, on the one hand and other bank creditors, including the CBI and bondholders, domestic and foreign, on the other hand. The impact of giving priority to depositors’ claims was to transfer about €10 billion to them from other creditors.³² Since the largest creditors’ sub-group was German banks, this could to some extent be regarded as an involuntary transfer from German banks to British depositors which made the fierce opposition to it by the British Labour government appear all the more surprising. This discrimination could be, and was, justified by “force majeure”, unforeseeable circumstances that forced the Icelandic legislator to make difficult choices with the aim of ensuring the continuing existence of banking in Iceland and the stability of the economy. If depositors in Iceland would have panicked, then not only the Icelandic banking sector, but the whole economy, might have crashed. Instead, the change from the old to the new banks went surprisingly smoothly and enough confidence in the system was restored for it to survive. But the fact remains that passing the Emergency Act was in some ways tantamount to, or had the same effect as, expropriating without compensation assets belonging to creditors others than depositors, as one Supreme Court Judge, Jon Steinar Gunnlaugsson, wrote in his dissenting opinion when the Supreme Court upheld the Emergency Act. Gunnlaugsson argued that this enforced transfer of assets without compensation was done retroactively, whereas private property rights were explicitly protected in the Icelandic Constitution.³³

In defence of the Emergency Act it might however be responded that its aim was not this transfer of resources, but the crucial stabilisation of the Icelandic economy as well as the fulfillment of Iceland’s international obligations (extending priority to the claims of foreign depositors was probably not necessary to create calm in the Icelandic financial markets, but it was necessary in order not to discriminate between

³⁰ Thomas F. Hellmann, Kevin C. Murdock, and Joseph E. Stiglitz, Liberalization, Moral Hazard in Banking, and Prudential Regulation: Are Capital Requirements Enough? *American Economic Review*, Vol. 90, No. 1 (March, 2000), p. 148. <https://www.jstor.org/stable/117285>

³¹ Miller, *National Responsibility and Global Justice*, p. 124. After all, as Miller points out, “nations are groups whose members recognize special obligations to one another.”

³² Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 184.

³³ *Haestarettardomar* [Supreme Court Judgements], No. 340/2011. Arrowgrass Distressed Opportunities Fund Ltd. et al. v. the UK Financial Services Compensation Scheme Ltd. and Landsbanki. <https://www.haestirettur.is/default.aspx?pageid=347c3bb1-8926-11e5-80c6-005056bc6a40&id=735dadfb-20d8-4147-bba6-63cf07953838>

Icelandic and foreign depositors). Here the old Catholic doctrine of ‘Double Effect’ may apply. St. Thomas Aquinas wrote: “Nothing hinders one act from having two effects, only one of which is intended, while the other is beside the intention.”³⁴ Put bluntly, the Icelandic authorities saw their task as that of saving Iceland, even if it meant, unintentionally but predictably, disregarding the interests of foreign banks and hedge funds. Another example of the Doctrine of Double Effect might have been the extension of the fishing limit in the Icelandic waters from three to 200 miles in a period of only 23 years, from 1952 to 1975. It had the unintended, but predictable, consequence that thousands of people in British fishing towns such as Grimsby and Hull lost their jobs. But many would consider it proper of the Icelandic authorities to give priority to the vital long-term interests of their own nation over the economic interests of people in British fishing towns. What was at stake in the ‘Cod Wars’ was the livelihood, indeed survival, of a tiny nation in a harsh environment. Moreover, to return to the Icesave dispute, the Emergency Act was not strictly speaking retroactive, because it was passed before the banks collapsed and the FSA took them over and appointed resolution committees. On 6 October 2008 there was still some hope that the Icelandic banking sector might be saved. A further consideration is that it may have been in the bondholders’ best long-term interest to avoid the total destruction of the Icelandic economy, and this was precisely the aim of the Emergency Act.

6. *The Responsibility for the Bank Run and the Street Riots*

Considerations of moral obligation, responsibility and liability are certainly relevant to the 2008 Icelandic bank collapse, but perhaps not in the way Professors Thorvaldur Gylfason, Stefan Olafsson, Sigurbjorg Sigurgeirsdottir and Vilhjalmur Arnason envisage. For example, Friday 3 October 2008 Professor Gylfi Magnusson said in a radio interview that the Icelandic banks were “technically bankrupt”.³⁵ Thus he may have prompted the subsequent run by depositors on the banks which was only stopped by the Emergency Act three days later. The CBI was hours from exhausting its supply of notes when the panic receded. Was Magnusson then partly responsible for the collapse even if it would almost certainly have taken place without his public comment?

Another example was the street riots in Reykjavik after the collapse which not only drove out a democratically elected government with a clear mandate until 2011, but also caused considerable damage of property and injuries of policemen, some of them grave.³⁶ In addition, some bankers and politicians had the unpleasant experience, almost unprecedented in Icelandic society, of mobs surrounding their houses at night, throwing stones at windows, spraying walls and scratching cars. Were some of the academics who spoke at protest rallies (which often led to street riots in those heedful days) partly responsible for such ugly incidents, even if they themselves did not throw bricks, strike policemen, spray walls or scratch cars? This may have been an example both of individual and collective responsibility. “Different participants in the

³⁴ St. Thomas Aquinas, *Summa Theologica*, Book II, Part II, Question 64, §7.

<http://dhsprory.org/thomas/summa/SS/SS064.html#SSQ64A7THEP1>

³⁵ Johannesson, *Hrunid*, pp. 86–7. This case is of course in some ways similar to the famous example discussed by philosophers of the man who shouts “Fire!” in a crowded theatre.

³⁶ Stefan G. Sveinsson, *Busahaldabyltingin: sjalfsprottin eda skipulogd?* [The Pots-and-Pans Revolution: Spontaneous or Organised?] (Reykjavik: Almenna bokafelagid, 2013).

mob act in different ways. Some actively attack persons or property; others shout abuse or issue threats; yet others play a more passive role, running alongside the activists, urging them on and contributing generally to the atmosphere of excitement and fear,” British philosopher David Miller writes:

The specific intentions of each participant at the beginning of the riot may have been different: some may have started out meaning to inflict physical damage; others may have wanted to make a political point; and so forth. What matters is that each person took part with the same general attitude—‘teaching them a lesson’, ‘showing them that we mean business’, etc.—and each made some causal contribution to the final outcome, whether this involved engaging directly in destructive acts, or merely in supporting and encouraging those who did.³⁷

In normally peaceful Iceland, certainly some academics encouraged protestors to ‘teach them a lesson’.

For example, Professor Thorvaldur Gylfason spoke at protest rallies in Austurvöllur on two consecutive Saturdays, 18 and 25 October 2008, using harsh words about government ministers and the CBI governors. After the second rally, protestors marched to the Prime Minister’s Residence in Tjarnargata under the slogan ‘End the Silence’.³⁸ Speaking at a nationally televised ‘citizens’ meeting’ in Haskolabio on 24 November, Gylfason demanded the immediate dismissal of the CBI governors. “Listening to him, one got a strong feeling that Iceland was indeed a banana republic,” a journalist wrote in Jon Asgeir Johannesson’s *Frettabladid*, distributed free of charge to every household in Iceland.³⁹ Yet again, Gylfason spoke on 1 December at a protest rally in Arnarholl directly in front of the CBI headquarters: “The government, the CBI and many bank and business managers made such serious blunders that Iceland’s economy is close to a breakdown.”⁴⁰ After the rally, some participants sought to force their way into the CBI headquarters, but they were stopped by police.⁴¹ Was Gylfason partly responsible for this?

At a protest meeting in Austurvöllur 17 January 2009, Professor Gylfi Magnusson did not mince words, either:

The private sector ... has to get rid of holding companies, business “Groups”, book-keeping tricks, hedging, tax havens, cross-ownership and cross-management, political connections and whatever else they call it. This is a part of what has to go to the ashheaps of history. None of this created any value. ... If these people are to be forgiven, their first step must be to stretch out a hand of reconciliation, and that they

³⁷ Miller, *National Responsibility and Global Justice*, pp. 114–5.

³⁸ Thorvaldur Gylfason, speech 18 October 2008. <http://raddirfolksins.info/wp-content/uploads/2008/10/thg181008.pdf> Motmaela threytandi thogn radamanna [Protest Against Deafening Silence of Authorities], *DV* 24 October 2008, p. 18. http://timarit.is/view_page_init.jsp?pageId=6456803

³⁹ Freyr Bjarnason, Kreppan krufin í beinni útsendingu [The Depression Analysed Live], *Frettabladid* 26 November 2008, p. 44. http://timarit.is/view_page_init.jsp?pageId=4011026

⁴⁰ Thorvaldur Gylfason, Speech 1 December 2008. <https://notendur.hi.is/gylfason/Arnarholl.pdf>

⁴¹ Hropudu “David burt” [Shouted, “David Out,”], *Morgunbladid* 2 December 2008, p. 6. http://timarit.is/view_page_init.jsp?pageId=5231440

recognise their responsibility by leaving office. Unfortunately, we have yet seen little of that hand of reconciliation; rather, we have seen a glimpse of the middle finger.⁴²

Here, Magnusson demanded that leading Icelanders should leave office on account of “book-keeping tricks, hedging, tax havens, cross-ownership and cross-management,” holding them responsible for the alleged behaviour of some members of the Icelandic business community. Was Magnusson partly responsible for the subsequent street riots? The riots increased in intensity during January 2009, but they suddenly stopped when a new left-wing minority government was formed on 1 February 2009. Almost two years later, when a protest rally was held in Reykjavik against increased household debts, the main organiser of the 2008–9 riots, folk singer Hordur Torfason, commented: “It is obvious that this protest rally is not organised, unlike the Pots-and-Pans Revolution which was much more directed from behind the scenes.”⁴³ Torfason did not volunteer any information about who directed the Pots-and-Pans Revolution “from behind the scenes” nor about who financed the movement even if one of its chief aims was increased transparency.⁴⁴

7. The Collective Responsibility of the British Nation

While the idea of collective or national responsibility hardly applies to the Icelanders in the Icesave dispute, because the case was really about private transactions and because no harm was done to depositors (and the dispute was about them and not about other creditors of the fallen Icelandic banks), it may apply to the British population. First, the UK has a well-functioning democracy, and even if it is composed of three or four nations (the English, Welsh, Scottish and Northern Irish) and not one, the political mandate of the UK Labour government in the autumn of 2008 was quite clear. Prime Minister Gordon Brown and Chancellor Alistair Darling could be regarded as acting on behalf of the whole population and in accordance with UK law. In the Icesave dispute, the government seemed in the beginning at least to have broad political support even if a few well-known Britons raised dissenting voices about the harsh treatment of a long-time ally, notably Conservative MEP Daniel Hannan, Dr. Eamonn Butler of the Adam Smith Institute, Labour MP Austin Mitchell, and, privately, Governor Mervyn King of the Bank of England, as already noted.⁴⁵

In the second place, when the UK government created and implemented its immense rescue programme during the financial crisis, it discriminated between British banks owned by Icelanders—Heritable and KSF—and all other British banks: At the same

⁴² Gylfi Magnusson, Speech at Austurvöllur 17 January 2009.

https://notendur.hi.is/gylfimag/A_Austurvelli_17-1-09.pdf

⁴³ Omar Fridriksson, Folki er misbodid og bidur eftir einhverju rettleati [People Are Fed Up and Waiting for Justice], *Morgunbladid* 6 October 2010, p. 4.

http://timarit.is/view_page_init.jsp?pageId=5339343

⁴⁴ In 2009, Torfason said that he had no idea about the movement finances. He only knew that the person who took care of the finances of the movement had the first name Eiríkur, but that he had forgotten his family name, and this Eiríkur had since moved abroad. Erla Hlynsdóttir, Motmaelir ekki ut í bláinn [Does Not Protest Out of the Blue], *DV* 8 May 2009, p. 2.

http://timarit.is/view_page_init.jsp?pageId=6367252 Later, however, a financial report appeared on the home page of the movement, http://raddirfolksins.info/?page_id=12 but without any detailed information about the financing of the movement.

⁴⁵ See references in Chapter 6.

time as it brought down the Icelandic-owned banks, it rescued all other banks in the UK, not only systemically important banks like the RBS and HBOS, but also relatively small banks like Bradford & Bingley. Legally, this went against the EEA principle of the internal market, at least in spirit, if not in letter. Morally, this action became even more reprehensible in light of the fact that the two Icelandic-owned banks turned out to be quite sound, whereas the UK government may make huge losses on some other banks that were rescued, such as RBS.

Thirdly, the UK government did Iceland much harm by not only closing down the Icelandic-owned banks, but also by using an Anti-Terrorism Act against Iceland, isolating her internationally and forcing her government to accept responsibility for a debt which should have been (and eventually was) paid by those who incurred it. No other European country took similar measures against Iceland, even if in some of them the Icelandic banks had collected deposits through their branches and not their subsidiaries, thus creating obligations that the Icelandic DIGF would find difficult if not impossible to fulfil. The use of the Anti-Terrorism Act was also quite unnecessary, as already demonstrated. By its Supervisory Notices, the British FSA had effectively eliminated possibilities of illegal transfers from the branches and subsidiaries of the Icelandic banks in the UK (just as the Finnish authorities did for example about possible transfers from Finland). The harm caused by the close-down of the banks and the use of the Anti-Terrorism Act was both financial and social. By closing down KSF in London, the UK Labour government brought down the last remaining Icelandic bank and thus turned an Icelandic crisis into a collapse, although in retrospect it was perhaps a blessing in disguise that Iceland was unable to bail out her banks.

The use of the Anti-Terrorism Act was also an extraordinary attack on a friendly neighbour, a Nordic democracy, a member, with the UK, of the EEA and a founding member, also with the UK, of NATO (unlike Sweden and Switzerland). On the UK Treasury's website, suddenly, the names of Icelandic public institutions such as the CBI and the IFSA were seen on the same list as terrorist organisations Al-Qaeda and the Talibans and governments of rogue countries like North Korea and Iran. Even if Iceland's economy recovered surprisingly quickly, the bank collapse created a lot of social disharmony and suffering in Iceland and turned the lives of many upside down. Mention should also be made of the baseless accusations by Gordon Brown and Alistair Darling against Iceland as the financial crisis was intensifying and how they, in the Icesave dispute, openly used the IMF to try and collect a 'debt' which Iceland did not owe to the UK.

It is also worth noting that the European Commission has the same supervisory role in EU member states as the EFTA Surveillance Authority has in the three EFTA countries that are also members of the EEA, Norway, Iceland and Liechtenstein. The question is why the EFTA Surveillance Authority initiated a process against Iceland for an alleged violation of the rules of the internal market, whereas the European Commission did nothing about the discrimination by the British government between Icelandic-owned banks and other banks or about the use of the Anti-Terrorism Act against not only a private company in Iceland, but also, however briefly, against the Central Bank of Iceland, the Icelandic Financial Supervisory Authority and other Icelandic authorities. The EFTA Surveillance Authority "seeks to protect the rights of individuals and market participants who find their rights infringed by rules or

practices of the EFTA States”.⁴⁶ Accordingly, it has to be assumed that the European Commission would seek to protect the rights of individuals and market participants who find their rights infringed by practices of EU states: Certainly, the two Icelandic banks which had their subsidiaries in the UK closed down may have found their rights infringed by the practices of the UK government. Also, Landsbanki and the Icelandic authorities that were put on a list of terrorist organisations, with immediate consequences, may have found their rights infringed by the practices of the UK government. Be that as it may, the UK government could at least not use “force majeure” as an argument for closing down KSF and Heritable: Its move was not about the stability or even survival of the British economy, contrary to what was the case in Iceland with the Emergency Act.

8. An Apology is Called For

In his analysis of national responsibility, David Miller makes a distinction between two kinds of responsibility groups may have to accept irrespective of the intentions and actions of individual members of the groups: outcome responsibility and remedial responsibility.⁴⁷ There is little doubt in this case about the outcome responsibility, at least partly. The British voters have to assume some responsibility for the activities of their duly elected government regarding the Icelandic banks. But what about remedial responsibility? It is difficult, if not impossible, to estimate how much of the total cost of the Icelandic bank collapse can be ascribed to the actions of the UK government alone. Moreover, more than nine years have passed since the events took place, and Iceland has turned around completely. Again, as some philosophers argue, shame may be a more appropriate moral category in many cases of national responsibility than guilt.⁴⁸ The British Labour leaders certainly did not behave like gentlemen: They were less than truthful about their conversations with Icelandic government ministers (of which the conversation between Alistair Darling and Arni M. Mathiesen Tuesday 7 October is perhaps the most egregious example), and they did not behave properly towards a weak neighbour and old ally. They did not come to the Icelanders “as one cultured nation to another”, as Winston Churchill had put it when giving an address from the balcony of Reykjavik’s Parliament House in August 1941.⁴⁹ A plausible conclusion is therefore that the UK has not only to accept some outcome responsibility for the Icelandic bank collapse, but also some remedial responsibility, but that the remedy should not be financial compensation, but a public apology for the use of the Anti-Terrorism Act, for the unnecessary close-down of two Icelandic-owned British banks and for the abuse of the IMF as an international organisation. Again, the European Commission, by failing to protect the rights of Icelandic participants in the European internal market, and the four Nordic countries, by joining the UK and the Netherlands in forcing Iceland to accept a ‘debt’ which was not hers, unlike Poland and the Faroe Islands which put no such preconditions on their loans to Iceland, have not much of which to be proud in this modern Icelandic saga.

⁴⁶ The EFTA Surveillance Authority at a Glance. <http://www.eftasurv.int/about-the-authority/the-authority-at-a-glance/>

⁴⁷ Miller, *National Responsibility and Global Justice*, pp. 81–2.

⁴⁸ Farid Abdel-Nour, National Responsibility, *Political Theory*, Vol. 31, No. 5 (October 2003), pp. 693–719. <https://www.jstor.org/stable/3595692>

⁴⁹ Winston Churchill, *The Unrelenting Struggle. War Speeches*, compiled by Charles Pile (Boston: Little, Brown, 1942), p. 228.

Conclusions

The main conclusion of this report is that foreign factors were crucial in bringing about the 2008 Icelandic bank collapse. Several lessons can also be learned from the collapse.

1. The Banks Were to Blame, But Also the Financial Framework

In its 2010 Report, the SIC plausibly observes that the Icelandic banks grew too rapidly and far beyond what, in a crisis, the CBI and the Icelandic Treasury could support. But as already noted, while the size of the banks was a *necessary* condition for the collapse of the whole banking sector, it was not a *sufficient* one. The Icelandic banking sector certainly was vulnerable, but something had to happen so that it would fall as a whole. This something was the international financial crisis. More precisely it turned out to be a set of decisions made abroad: hedge fund managers saw Iceland as the weakest country operating on the European internal market; a consensus was formed among European central bankers in spring 2008 that Icelandic banks ought not to be provided with the same assistance as other banks within the EEA; the US, previously Iceland's powerful ally, had lost interest in the country and did nothing to help her in the hour of need, in the summer and autumn of 2008; in October 2008 the British Labour government closed down two British banks owned by Icelandic banks, Heritable and KSF, at the same time as it offered all other British banks a rescue package of £500 billion; as a result loan covenants were triggered so that KSF's parent company Kaupthing fell as the last of the Icelandic banks; adding insult to injury, the Labour government also needlessly used an Anti-Terrorism Act against Iceland—a NATO ally, and not even maintaining her own military—not only against Landsbanki, but also Icelandic authorities.

This report should not be interpreted as an attempt to shift all blame for the collapse from the Icelandic banks, their owners, managers and major clients. Their recklessness and, in some cases, disregard of laws, rules and propriety, is well documented in the SIC report. It is extraordinary, for example, how the business group led by retail tycoon and media magnate Jon Asgeir Johannesson could accumulate debts amounting to €5.5 billion—almost a trillion Icelandic *kronur*—in the Icelandic banks. This created an unacceptable risk for the banks. It is also astonishing how this very group, as soon as it gained control over Glitnir in spring 2007, was able to borrow almost at will and practically empty the bank from the inside, as described in detail in the SIC Report.¹ While other business groups also sometimes acted aggressively and irresponsibly, they did not go nearly as far as Johannesson's group.

The behaviour of Icelandic bankers has however to be put into perspective. They were probably no worse and no better than bankers elsewhere. There is “no evidence

¹ Such behaviour was of course not confined to Iceland: William K. Black, *The Best Way to Rob a Bank is to Own One: How Corporate Executives and Politicians Looted the S & L* (Austin: University of Texas Press, 2014).

that the asset quality of the Icelandic banks—despite some missteps in connected party lending—was any better or worse than for comparable European banks,” finance experts Asgeir Jonsson and Hersir Sigurgeirsson write.² Certainly some banks that could draw on a much longer tradition of banking than the Icelandic ones—for example in Scotland and Switzerland—encountered severe troubles during the financial crisis. It is ironic that some harsh critics of the Icelandic banks worked for other financial institutions—such as Danske Bank, Bear Stearns, RBS, and Merrill Lynch—which did not do any better except that they were rescued with taxpayers’ money, not least with dollars from the US Federal Reserve Board. It is also ironic that the British government put Landsbanki on its online list of organisations under economic sanctions, with the Al-Qaeda, the Talibans and the governments of North Korea and Sudan, while it rescued big banks which since have had to pay hefty fines for money laundering and violations of economic sanctions.

Thorough investigations of the Icelandic banks after the bank collapse have uncovered some questionable and even illegal maneuvers of the bankers. But they have not substantiated any of the allegations made in the autumn of 2008 by British government ministers against the banks. There does not seem to be any causal connection, either, between such isolated misdemeanors and the collapse of the Icelandic banking sector. These misdemeanors mostly consisted in desperate attempts by some bankers and their customers to survive the credit crunch by market manipulation, instead of being about intentional direct private gain, or embezzlement. Moreover, it should be recalled that what happened to other bankers in 2007–8, that suddenly they found themselves deprived of most wholesale funding, had already happened to the Icelandic bankers in 2006–2007. The difference was that the Icelanders survived a year or two longer than the others. Arguably, the Icelandic bankers were quite imaginative and resourceful in 2006–2008, after they had practically been deprived of access to funding, on acceptable terms, in European markets. Knowing of the limited resources of the CBI, they obtained funding in the US for a while, started collecting retail deposits in Europe and issued securities on one another which they then used to obtain credit at the ECB. They have been judged harshly, because they went under, even if they made what could be considered to be a valiant effort to survive. “Success has a hundred fathers, but failure is an orphan.”

Neither should this report be interpreted as an attempt to discredit the members of the SIC. There is little reason to doubt their good faith. They may have had some biases, but such biases were hardly intentional. They would be more a result of the small size and closeness of Icelandic society where it is difficult to distance oneself from one’s past or one’s circle of family, friends and colleagues. In Iceland, there is always a danger to lapse into parochialism, and this is what the SIC may have done. It did only fleetingly treat the 2008 bank collapse as a part of a severe international crisis. Also, the SIC members had limited, if any, first-hand experience of banking or other kinds of business. They did not see the wood for the trees, concentrating on individuals and their activities rather than on the systemic failure of the European banking system of which the Icelandic banking sector was a part: This European system was over-extended, without a plausible lender of last resort for all EEA member states and without a credible common scheme of deposit insurance. In Iceland, as elsewhere, individuals were acting under constraints which were not of their own making, and

² Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, p. 18.

they participated in a chain of events over which none of them had any control. The parochial approach in the Report of the SIC can be contrasted, for example, with the report of the Danish Rangvad Commission and other similar reports which stress the international nature of the crisis without exempting local bankers from blame.³

The Icelandic banking sector collapsed, not necessarily because it was unsustainable in itself (no more than their Swiss or Scottish counterparts), but because nobody came to its rescue in a severe international crisis. In retrospect, however, this was a blessing in disguise: Iceland could scale down her banking sector, whereas some other European countries are saddled with debt created by bank bailouts. It is perhaps foolhardy to try to write hypothetical history. But if the Bank of England, the ECB and the Federal Reserve Board had followed in the footsteps of the three Scandinavian banks and in spring 2008 made currency swap deals with the CBI, as they easily could, and if the British government had treated the two British banks owned by Icelanders like it treated all other British banks, then the CBI might have had the ability to meet the repeated attacks of hedge funds, like the Hong Kong Monetary Authority successfully did in August 1998.⁴ Then the CBI and the Icelandic government perhaps could have implemented the ‘Swedish solution’ of 1992 to financial crises, at least partly: to recapitalise the banking sector; and to nationalise, restructure and then sell off the banks. Then the crisis, even if severe, would not have turned into a collapse.

2. First Lesson: Decisive Leadership is Crucial

If some lessons are to be learned from the 2008 bank collapse, then one would be that decisive leadership at the helm of the CBI was crucial. As already noted, the CBI governors were the first people in authority to realise and warn against the vulnerability of the banks, even if they had very limited maneuvering room. It was the CBI which suggested to the bankers that Kaupthing should move abroad, that Glitnir should sell its Norwegian bank and that Landsbanki should transfer the Icesave accounts from a branch to a subsidiary.⁵ It was the CBI which in February 2008 invited financial expert Andrew Gracie from the Bank of England to visit and evaluate the danger of a bank collapse.⁶ It was the CBI which quietly prepared a plan, in the final stages with the help of a special Liquidity Crisis Task Force, for ring-fencing Iceland, defining four lines of defence in decreasing order of importance: the sovereign, the payment system, depositors and other bank creditors and bank shareholders, as shown in Figure 7.⁷ It was the CBI which in the midst of the crisis

³ Rangvad Commission, *The Financial Crisis in Denmark: Causes, Consequences and Lessons*. <http://em.dk/english/news/2013/18-09-13-the-financial-crisis-in-denmark> A longer version in Danish: *Den finansielle krise i Danmark. Årsager, konsekvenser og læring*. <https://em.dk/arbejdsomraader/finansiel-sektor-og-vaekstkapital/finansiel-stabilitet/finanskrisens-aarsager>

⁴ Paul Krugman, *The North Atlantic Conspiracy*. Blog 31 March 2008.

<https://krugman.blogs.nytimes.com/2008/03/31/the-north-atlantic-conspiracy/>

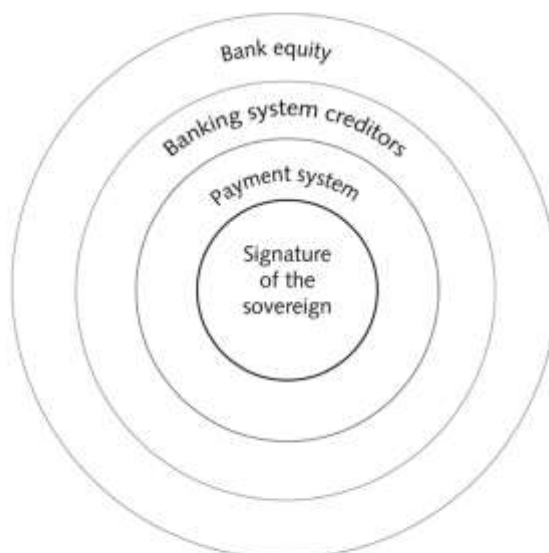
⁵ The evidence is in the SIC Report, Vol. 6, Ch. 19. On a Kaupthing move, pp. 122 and 124; on the transfer of the Icesave accounts, p. 124; on the sale of the Norwegian bank, pp. 256–7.

⁶ SIC Report, Vol. 7, Ch. 21 (in English), p. 138. <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf> SIC Report, Vol. 6, Ch. 19, p. 133.

⁷ SIC Report, Vol. 7, Ch. 21, p. 81 (in English). <http://rse.hi.is/wp-content/uploads/2014/10/RNAvefurKafli21Enska.pdf>

invited financial expert Marc Dobler from the Bank of England to Iceland to help with the plan of dividing up the banks into domestic and foreign parts.⁸

Figure 4: Ring-fencing Iceland



When the Social Democrats on 4 October 2008 categorically rejected a proposal by Prime Minister Geir H. Haarde to appoint a special crisis team led by CBI Governor Oddsson and seemed ready to split the coalition because of it, the CBI did not give up, but sent for financial analysts from JP Morgan. The Independence Party ministers were already convinced that the only way to tackle the imminent collapse was ring-fencing.⁹ But in the early hours of Monday 6 October, the JP Morgan experts managed to convince the ministers from the Social Democrats that it was now inevitable to give up trying to save the banking sector and that instead the authorities should try to ring-fence Iceland.¹⁰ The very same day the Emergency Act was passed by Parliament. It had the intended effects: The sovereign did not default; the domestic depositors did not panic. In the following weeks the staff both of the CBI and the IFSA worked day and night to maintain the payments system, performing what amounted almost to a miracle.

Some might discern contradictions in the remarks above. One contradiction would be between stating the case for the Icelandic bankers on the one hand and praising the CBI governors on the other hand. Were not either the bankers or the CBI governors right, and did not the CBI governors eventually turn out to be right, with their scepticism about the sustainability of the banking sector? But this is a paradox and

⁸ SIC Report, Vol. 7, Ch. 20, pp. 120–122.

⁹ Interviews with Eiríkur Guðnason in Kópavogur 25 October 2011, Geir H. Haarde in Reykjavík 1 October 2013 and Arni M. Mathiesen in Reykjavík 6 August 2015.

¹⁰ *Ibid.*, pp. 103–105. Cf. Sigurdsson, *Stormurinn*, pp. 49–52.

not a contradiction. Both groups were working under conditions of radical uncertainty, a notion which former Bank of England Governor Mervyn King plausibly regards as crucial to understand financial instability.¹¹ Were the banks sustainable, or were they not? A plausible answer is: It depends. Their assets were not worth much if they did not have access to liquidity, whereas they might have survived otherwise, like banks with similar assets in other countries. Under conditions of radical uncertainty, both hypotheses, that they were sustainable and that they were not, might have been plausible at certain points in time.

Financial experts like Professors Frederic Mishkin and Richard Portes claimed that the Icelandic banking sector was essentially sound;¹² other financial experts such as Professors Robert Z. Aliber and Willem H. Buiter regarded it as unsustainable.¹³ But the views of Portes and Mishkin cannot be dismissed simply because things did not turn out the way they expected. After all, neither Aliber nor Buiter foresaw the well-planned attacks of hedge funds on Iceland, the concerted refusal by central banks in Europe and North America to assist the CBI, the close-down of the Icelandic-owned banks in the UK or the use by the British government of an Anti-Terrorism Act against Iceland. Aliber has predicted the exit of Greece from the euro since 2009, but at the time of writing she remains a part of the eurozone, nine years later.¹⁴

3. *Second Lesson: No Disaster to Let Banks Fail*

A second important and general lesson from the Icelandic bank collapse is that it does not necessarily spell disaster to refrain from bailing out banks. Iceland is an example of a country which did not engage in such rescue operations, although it was out of necessity rather than virtue. She recovered quickly and is at present, in the autumn of 2018, flourishing. The main reason has already been noted: The Icelandic economy rests on four strong pillars, profitable fisheries, ample energy resources, accumulated human capital and booming tourism. Financial services are crucial to a well-functioning market economy, but a persuasive case has been made that the financial sector in Europe has grown too large; that it is not always producing anything of value, no more than the alchemists of a bygone age; that it has become an industry trading with itself, talking to itself and judging itself by reference to self-created standards.¹⁵ In Iceland, this sector was radically scaled down as a result of the bank collapse, whereas in the rest of Europe it remains a great potential burden. It may be argued that the ‘Icelandic solution’ is not fully applicable to other countries because in Iceland depositors were mostly Icelandic and the bondholders mostly foreign

¹¹ King, *The End of Alchemy*, pp. 120–55.

¹² Frederic Mishkin and Tryggvi Th. Herbertsson, Financial Stability in Iceland (May 2006), repr. in *Preludes to the Icelandic Financial Crisis*, eds. Aliber and Zoega, pp. 107–159; Portes and Baldursson, The Internationalization of Iceland’s Financial Sector (November 2007), repr. in *Preludes to the Icelandic Financial Crisis*, pp. 160–240.

¹³ Robert Z. Aliber, Monetary Turbulence and the Icelandic Economy (May 2008), repr. in *Preludes to the Icelandic Financial Crisis*, eds. Aliber and Zoega, pp. 302–326; Willem H. Buiter and Anne Sibert, The Icelandic Banking Crisis and What to Do about it: The Lender of Last Resort Theory of Optimal Currency Areas (May 2008), repr. in *Preludes to the Icelandic Financial Crisis*, pp. 241–275.

¹⁴ Shawn Tully, A Great Economist and Euro-fan Turns Negative on the Region, *Fortune* 4 November 2013. <http://fortune.com/2013/11/04/a-great-economist-and-euro-fan-turns-negative-on-the-region/>

¹⁵ King, *The End of Alchemy*; Martin Wolf, *The Shifts and the Shocks: What we’ve learned—and have yet to learn—from the financial crisis* (London: Penguin books, 2014); John Kay, *Other People’s Money: Masters of the Universe or Servants of the People* (London: Profile Books, 2016).

which meant that the measures made under the Emergency Act did not meet significant political resistance.¹⁶ But that is an argument about political, and not economic, feasibility. As has frequently been observed, it is a strange situation where the banks and indirectly their bondholders have such political power that they can in good times pocket the profits, but in bad times pass on the losses to taxpayers. The unethical conduct which was witnessed before during and not least after the financial crisis was “largely a response to perverse incentives imposed by lax government economic policy and strong regulation”.¹⁷

4. Third Lesson: Priority of Depositors' Claims

A third possible general lesson from the Icelandic bank collapse has been widely accepted in Europe. It is to give priority to the claims of depositors over those of other creditors, such as bondholders, as Iceland did by the 2008 Emergency Act. Depositor preference had already been in place in the US since 1993, with the difference that in the US the claims of domestic depositors on the assets of a failed bank were elevated over the claims of foreign depositors and general creditors, whereas the Icelandic Emergency Act had given priority to all depositors, foreign and domestic.¹⁸ Since the 1930s, Switzerland also had given preference to depositors over other bank creditors, but only up to the level now guaranteed, CHF 100,000. Deposits in foreign branches are included. Deposits are guaranteed not by government, but by a scheme based on the self-regulation of Swiss banks.¹⁹ The EU Council (the EU heads of government) agreed 27 June 2013 to draft a directive that would give preference to depositors. It was “aimed at transposing into EU law commitments made at the G20 summit in Washington DC in November 2008, when leaders called for a review of resolution regimes and bankruptcy laws”.²⁰ The EU Bank Recovery and Resolution Directive, BRRD, from 2014, coming into force in the beginning of 2017, ensures that deposits eligible for compensation are treated as preferential debts and that such eligible deposits are given a higher priority within the class of preferential debts than other deposits.²¹ As a member of the EU, the UK has implemented depositor preference, somewhat ironically after having invoked an Anti-Terrorism Act against Iceland for doing the same some years earlier.²²

¹⁶ Jonsson and Sigurgeirsson, *The Icelandic Financial Crisis*, pp. 20–21.

¹⁷ Elaine Sternberg, Ethical Misconduct and the Global Financial Crisis, *Economic Affairs*, Vol. 33, No. 1 (2013), pp. 18–33. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2213135

¹⁸ James A. Marino and Rosalind L. Bennett, The Consequences of National Depositor Preference, *FDIC Banking Review*, Vol. 12 (1999), pp. 19–38.

<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.190.8222&rep=rep1&type=pdf>

¹⁹ *Protection of bank deposits. Fact Sheet* (Bern: Finma, Swiss Financial Market Supervisory Authority, 17 June 2013). <https://www.finma.ch/en/documents> In 2011, only three major countries allowed depositor preference to extend to deposits in foreign branches of banks, Australia, Switzerland and Russia, according to a report by Christopher Bates, *Depositor preference in the G20* (London: Clifford Chance, September 2011).

https://www.cliffordchance.com/briefings/2011/09/depositor_preferenceintheg20-15septembe.html

²⁰ Council agrees position on bank resolution (Brussels: Council of the European Union, 27 June 2013). https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137627.pdf

²¹ Bank Recovery and Resolution Directive 2014/59/EU. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059>

²² The Banks and Building Societies (Depositor Preference and Priorities) Order 2014, in force since 1 January 2015. http://www.legislation.gov.uk/ukxi/2014/3486/pdfs/ukxi_20143486_en.pdf

One general reason for preferential treatment of depositors is political: They are a much larger political constituency than bondholders. A related argument is perhaps theoretically more attractive: Economic and political stability requires that those who save money and keep it in banks can rest assured that they are not taking excessive risks. Some economists also argue that depositor preference—which in turn leads to greater tendency of bank creditors to take solid collateral for their loans—may work to reduce the cost of settling creditor conflicts in the case of resolution or bankruptcy; for operating banks, the two factors eventually may increase the real value of banks and consequently reduce funding costs and thus also the probability of distress.²³

5. Fourth Lesson: No Government Guarantee of Deposits

However, an important additional and related lesson from the Icelandic bank collapse—the fourth lesson found in this report—apparently has not been learned: If depositors are given priority over other creditors in the case of bank failures, then a comprehensive government-guaranteed depositors' compensation scheme for banks does not seem to be necessary. The depositors would be compensated out of the estates of fallen banks, as was the case in Iceland. Depositors' guarantee schemes would not be a potential burden on taxpayers, and instead self-regulating, as in Switzerland. In this matter, the EU has however gone in the other direction after the international financial crisis, establishing explicit government-guaranteed depositors' compensation schemes.²⁴ Generally speaking, the attempt to reduce risk by increased regulation, or by casting all financial institutions in the same mould, may actually increase risk: It is the heterogeneity of financial firms that disperses and thus reduces risk.

6. Fifth Lesson: Discretionary Power Will Be Abused

A fifth general lesson from the 2008 Icelandic bank collapse is about the old truth that discretionary power, once created, is liable to be abused. It was hardly the intention of the legislators passing the 2001 Anti-Terrorism Act in the UK that it could be used, without any obvious or urgent need, for domestic political purposes or to try and starve a small, friendly neighbouring country—so powerless that she does not even maintain a military—into compliance with demands that she should guarantee possible losses from private transactions for profit between some of her citizens and some British citizens. Prime Minister Gordon Brown's and Chancellor Alistair Darling's use of the Anti-Terrorism Act against Iceland was politically motivated, and therefore a blatant abuse of the weapon which had been constructed for them to defend the British realm against real threats. Great Britain has rightfully been held up to the rest of the world as a country based on the venerable traditions of the rule of law and respect for individuals.²⁵ “Herein, indeed, consists the excellence of the English government, that all the parts of it form a mutual check upon each

²³ Daniel D. Hardy, *Bank Resolution Costs, Depositor Preference, and Asset Encumbrance*, IMF Working Paper 13/172 (Washington DC: IMF, 2013).

<https://www.imf.org/external/pubs/ft/wp/2013/wp13172.pdf>

²⁴ For example, the Bank Recovery and Resolution Directive 2014/59/EU, Ch. 4, Section 1, Art. 37, No. 10, says: “In the very extraordinary situation of a systemic crisis, the resolution authority may seek funding from alternative financing sources through the use of government stabilisation tools.”

<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0059>

²⁵ Daniel Hannan, *Inventing Freedom: How the English-Speaking Peoples Made the Modern World* (New York: Broadside Books, 2013).

other,” English legal philosopher William Blackstone wrote.²⁶ In this case, alas, the checks did not work.

7. Sixth Lesson: Iceland is On Her Own

A sixth lesson from the 2008 Icelandic bank collapse is that Iceland is on her own. The Icelanders have to realise that a country has interests rather than friends. Nobody is going to look after and defend Iceland’s interests except herself. In 1994, she had joined the EEA in the belief that she would gain access to the European internal market on equal terms with other member countries. But when push came to shove, her banks and institutions were treated differently from those of other and mightier countries. The Icelandic banks were regarded as intruders, outsiders, trespassers, and Icelandic institutions were not taken seriously. Even if Great Britain is herself a kind of tax haven, and has allowed her dependencies like the Isle of Man, Guernsey and Jersey to attract capital by offering tax advantages, she rejected the idea of Iceland joining that field, as the minutes from meetings of the Bank’s Court of Directors in 2008 reveal.²⁷ The EU took the same position. Well-established banks in Europe disapproved of competition from the aggressive Icelanders, whether for depositors or borrowers. Iceland is a member of NATO which however did nothing when another member state put the Icelandic Ministry of Finance, the CBI and the IFSA on what was essentially a list of terrorist organisations and when this member state tried to starve her to compel her compliance. Within the IMF, in the Icesave dispute the other Nordic nations (unlike the Faroe Islands and Poland) bowed to pressure from the EU, the UK and the Netherlands: Their interests in good relations with these powers overrode any concern for their Icelandic cousins.

What the 2008 bank collapse demonstrated was that Iceland again occupied the position in which she had found herself for more than thousand years: that the powers to be hardly cared about her. The Danish king had at least four times tried to sell this remote and, then, poor island; and the Danish government had as late as 1864 considered exchanging her for Southern Schleswig. Even if Iceland was an ancient Norwegian tributary, the Swedish king had not bothered to ask for Iceland in 1814 when he was given Norway as a compensation for Finland. In 1868, the idea of buying Iceland from Denmark was met with laughter and derision in the US Congress.²⁸ It was only during the ‘American Age’ in Icelandic history, from 1941 to 2006, that Iceland enjoyed the real protection of a major power so that she could lay the foundations for her affluence by extending her fishing limits to the whole of the Icelandic waters.

8. Final Remarks

The considerations above and in preceding chapters hopefully provide answers to the questions originally posed for this report: Why did the US Federal Reserve Board make dollar swap deals with several central banks, including the three Scandinavian

²⁶ William Blackstone, *Commentaries on the Laws of England*, Bk. I (London: John Murray, 1873), p. 25.

²⁷ See Chapter 5 in this Report.

²⁸ Hannes H. Gissurarson, *Proposals to Sell, Annex or Evacuate Iceland, 1518–1868, Rannsóknir i felagsvísindum* [Social Science Research], Vol. XVI (2015).
http://www.academia.edu/17606016/Proposals_to_Sell_Annex_and_Evacuate_Iceland_1518_1868

ones, while refusing to make such a deal with the CBI? Why did British authorities not extend the same liquidity assistance to the two British banks owned by Icelanders as they did to all other British banks in October 2008? Why did the British Labour government invoke an Anti-Terrorist Act against not only Landsbanki, but also the CBI and IFSA? What was the total loss of the Icelandic banks and the Icelandic economy as a whole from the actions or non-actions abroad preceding and perhaps partly causing the bank collapse?

The answer to the first question is straightforward. For the US, Iceland had lost her strategic importance after the end of the Cold War so she did not receive the same special treatment as she did for example when receiving Marshall Aid or concessions for Icelandic companies. US authorities regarded Iceland as a European country, to be dealt with by European authorities. In Washington DC, Iceland was thought of as small and expendable. The main explanation given by the Federal Reserve Board for its refusal to make dollar swap deals with the CBI serves to illustrate this point. It is that because of the relatively large size of the Icelandic banking sector much more liquidity assistance was needed than the Board was ready to provide. But it may be argued that it was precisely because Iceland was not regarded any more as an important ally that the decision was made on this ground. It would barely have been noticed by anyone except the ever-vigilant hedge funds, let alone criticised publicly, if the Federal Reserve Board had made a dollar swap deal of 5–10 billion dollars with the CBI which possibly would have enabled the CBI to control the process in which the size of the banking sector was reduced, for example by implementing a ‘Swedish Model’.

The answers to the second and third questions have their roots in the political situation in the UK. The brutal treatment of Icelandic banks and Icelandic authorities by the British Labour government cannot be explained on any material grounds. There had not been any illegal transfers from the UK to Iceland by the banks prior to the collapse. On the contrary, Icelandic banks and companies had invested heavily in the UK, employing up to 100,000 British residents and taxpayers. The two British banks owned by Icelanders, Heritable and KSF, were solid and in fact much sounder financially than some of the banks which in the crisis received liquidity assistance and new capital from the British authorities, for example RBS and Bradford & Bingley. The different treatment of the two Icelandic-owned British banks and all other British banks went against the spirit, and probably also the letter, of the EEA Agreement. It was also unnecessary to invoke the Anti-Terrorism Act against Landsbanki and Icelandic authorities in order to avoid illegal money transfers out of the UK. Not only is this shown by the fact that other governments did not do anything similar, even if the situation in some countries was the same in that the Icelandic banks collected deposits in their branches rather than their subsidiaries (for example in Germany and Sweden), but also by the crucial Supervisory Notice to Landsbanki issued by the FSA on 3 October 2008 which effectively barred the bank from transferring money out of the UK without written permission of the FSA.²⁹

The most plausible explanation of these measures, and the answer to the second and third questions, is that they were politically motivated. Prime Minister Gordon Brown

²⁹ First Supervisory Notice to Landsbanki, 3 October 2008.
https://www.fca.org.uk/publication/supervisory-notices/landsbanki_3oct08.pdf

and Chancellor Alistair Darling, both from Scotland, were probably trying to divert attention from the fact that their massive rescue of the British financial sector was basically a rescue of two Scottish banks, RBS and HBOS. In the second place, they may have been demonstrating to their Scottish voters the perils of independence. Thirdly, they were seemingly trying to show firmness, at no risk, as their chosen adversary was a tiny, powerless nation. Fourthly, they may have been trying to improve their bargaining position in the following Icesave dispute with Iceland. It is not impossible, fifthly, that partly the brutality they showed to Iceland was a result of the chaos reigning at the time in 10 Downing Street where the Prime Minister was even seriously considering calling out the army. In addition to all this, the record shows that the Bank of England, and probably also the British government, did not look favourably on any attempts by the Icelandic banks to offer financial ‘offshore’ services in competition with banks in some other island countries, most of which happened to be British dependencies or member countries of the British Commonwealth.

A direct answer to the fourth question posed in this report, about the total loss of the Icelandic banks and the Icelandic economy as a whole from the actions or non-actions abroad preceding and perhaps partly causing the bank collapse, is more problematic. Some cases have been investigated here:

1. Sale of Glitnir Bank, Norway: Book value of equity 2008, NOK 3.1 billion. Sold for NOK 300 million, worth NOK 2 billion, Loss, NOK 1.7 billion, or €205 million.
2. Sale of Glitnir Securities, Norway: Book value of equity 2008, NOK 200 million. Sold for NOK 50 million, worth NOK 100 million, Loss, NOK 50 million, or €6 million.
3. Sale of Glitnir Corporation, Finland (FIM): Book value of equity 2008 €108 million. Sold for €3,000, worth 2009 €49.8 million, 2013 €200 million, Loss, €200 million.
4. Resolution of Kaupthing, Finland: Price €85 million (Sofi and Norvestia). Loss, €85 million.
5. eQ Bank, Finland: Book value of equity 2007 €71 million. Sold for €37 million. Loss, €43 million.
6. Kaupthing, Sweden: Price SEK 950 million. Book value of equity 2008 SEK 832 million. Sold for SEK 388 million. Loss SEK 344 million, or €35 million.
7. Glitnir Sverige: Price SEK 425 million. Book value of equity 2008 190 million. Sold for SEK 60 million. Loss, SEK 130 million, or €13 million.
8. FIH Bank, Denmark: Book value of equity 2008 €1,048 million. Sold for (in effect) €255 million, worth 2014 €769 million. Loss €514 million.
9. Heritable: Cost of resolution £43 million. Estimated loss, £200 million, or €253 million.
10. KSF: Cost of resolution £136 million. Estimated loss, £500 million, €632 million.

11. Merrion Capital (Landsbanki in Ireland): Worth €42 million, sold for €30 million. Loss €10 million.

12. Landsbanki Securities (UK Teather & Greenwood, Bridgewell): Price £103.1 million. Liquidated. Loss £103 million, or €130 million.

13. Kepler (France): Worth 2005 €94 million. Sold for €1, worth €100 million. Loss €100 million.

14. Landsbanki, Heritable and KSF: Online accounts worth €102 million as an operation. Transferred without compensation or terminated. Loss €102 million.³⁰

Even if the total loss from these sales or resolution processes may be calculated as €4.3 billion, that number would not make much sense. The cases are vastly different in nature, and the information provided is of different quality. In some of them, such as Heritable and KSF, fire sales did not actually take place whereas the value of the going operations themselves, such as goodwill, certainly was destroyed. The most egregious cases are the fire sales of Glitnir Bank and Glitnir Securities in Norway, of Glitnir Corporation in Finland and of FIH Bank in Denmark, especially because they were encouraged, to say the least, by local authorities. The sale in Denmark is particularly noteworthy because in that case it was the CBI, and in the end the Icelandic nation, that had to bear the loss of €514 million, which far from being destroyed value was captured by well-connected Danish businessmen and their allies in pension funds. In other cases the creditors of the fallen banks, the bondholders, suffered.

Another and a more plausible way of estimating the loss from the bank collapse is to look at numbers at the time of composition, the end of 2015. Total accepted claims against the old banks (excluding their foreign subsidiaries which underwent separate resolutions, being domestic companies) amounted to €65.1 billion where the mean recovery was 48%. The total loss therefore amounted to €33.8 billion. The examples of Heritable and KSF show that probably most of the subsidiaries would have had assets against all their debts. It is possible that the asset bases of their parent companies, the old banks, were not as strong. But if the CBI had received sufficient liquidity assistance from European central banks and the US Federal Reserve Board, then all these companies would have been kept in operation and sold at an advantageous time. Then perhaps there would in the end have been no total loss for the CBI or the Treasury from the necessary reduction of the Icelandic banking sector. If there is a number that can be quoted, it would then be:

€38.1 billion

which would not have been lost (33.8 billion from the banks and €4.3 billion from their subsidiaries). As it turned out, depositors in the banks did not lose anything, only bondholders (including the CBI).

Most would however agree that the greatest loss suffered by the Icelandic nation from the 2008 bank collapse was not financial, but social and moral. For the Icelanders, the

³⁰ Arguably, this implies some double-counting as the value of the Heritable and Edge accounts must have been to some extent reflected in the estimated value of Heritable and KSF.

collapse was a trauma where trust in authorities, respect for traditions and optimism about the future all plummeted. It is only now, a decade later, that perhaps it can be analysed and explained objectively, *sine ira et studio*, as Tacitus put it, without anger and passion.

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