

The Distorted System: Iceland's Lessons Yet To Be Learned

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Background

"The truth is incontrovertible. Panic may resent it, ignorance may deride it, malice may distort it, but, there it is." Winston Churchill

In October 2008, 97% of the Icelandic banking sector collapsed in a matter of three days. The triggering event was the fall of Lehman Brothers, with the subsequent collapse of interbank lending, the fall in asset prices, and the evaporation of trust among financial market participants. Focusing on this trigger is convenient for the culprits of the collapse in Iceland, who have every incentive to push the blame on to someone else. Policymakers elsewhere also prefer to create the impression that the crisis was akin to a natural disaster, diverting attention from their own failures prior to the crisis.

The fall of Lehman, however, was not the true cause of the collapse of the Icelandic banking sector, a point reinforced by the fact that only massive action by governments and central banks to bail out and support weak or insolvent banks prevented the collapse of the global financial system in fall 2008. The subsequent great recession is still causing significant pain for many millions of people around the world. Yet there has been no comprehensive, in-depth analysis to identify the major weaknesses, build a foundation for the future, and reconstruct a sustainable banking system. In fact, Iceland is the only country in the world that has dared to look inside the Pandora's box and allow researchers complete access to the financial system's data in order to carry out a comprehensive post mortem and figure out the true causes of the collapse.

Findings of the Icelandic Special Investigation Commission

The findings published in the report of the Special Investigation Commission set up by Iceland's Parliament in 2008 and published in 2010 reveal malpractice on the part of the bankers, complete lack of oversight on the part of public servants, incompetence in financial surveillance, and, as a consequence, helplessness among top government elected officials in steering clear of the financial abyss which awaited every single Icelandic citizen as their banking system collapsed in early October 2008.

The collapse has had a lasting impact on the Icelandic people. Almost six years after the calamity hit, the nation is still deeply entangled in the complexities of resolving the banking crisis and a lengthy foreign dispute over deposit guarantees. Capital controls are still in force, investments are at a historic low for the sixth year running, and real wages—which were cut in half—are a long way from being restored to their pre-crisis levels. The debt burden of the Icelandic state and the austerity policies adopted by the government after the crash have undermined other societal infrastructures, including the education system and the health care system. Although the social security system has been safeguarded, it is under heavy strain. The country also faces the looming threat of a brain drain, including a shortage of medical doctors.

The Commission's report also revealed an incestuous web of ownership between listed and nonlisted firms, as well as massive manipulation of stock market prices and of financial results and leverage. The banks' loan portfolios were marked by excessive risk, with the majority of loans extended in the form of zero coupons to related parties up to concentrations that were well above the legal threshold of large exposures of banks.

This structure of interconnected conglomerates and special-purpose vehicles, which was designed to circumvent legal constraints in credit allocation, gave rise to a massive build-up of systemic risk. The resulting vulnerability of the system was what brought it down, with supervisors unable to detect the interconnectedness and correlation between assets of the banks in a timely manner. In addition, the equity cushions of the firms that received credit from the banks were extremely thin, leaving virtually no room for a drop in asset prices.

The banks therefore became wholly dependent on the well-being of relatively few customers. With the size of the banking sector growing to 10 times Iceland's GDP, the government's well-being and that of the country's citizens was at risk. Not only did the banks distort financial markets in Iceland, they distorted the entire Icelandic economy—with an inevitable effect on the Icelandic krona, the smallest floating currency in the

world. Unfortunately, no policymaker had the competence or the courage to recognize that the emperor was naked and avoid the collapse that ensued.

The Icelandic banks were able to grow as much as they did because they were able to piggyback on the stellar credit rating of the almost-debt-free Icelandic state. Although at times the banks were willing to pay interest rates similar to those paid by emerging market institutions with much lower credit ratings, their growth was spurred by implicit government guarantees that lowered their interest rates and enabled them to continue to borrow.

Aftermath: Have the Lessons Been Learned?

Iceland was a classic, albeit an extreme, case of a credit boom and bust. Although the scale of the problems had a dramatic effect on this small country, the key elements of the problems that played out in Iceland—excessive leverage, opacity, interconnectedness, and ineffective regulation—were evident throughout the financial system. Despite the obvious harm and disruption they have caused to millions of people around the world, these issues have not been properly addressed, and they continue to make the global financial system fragile and prone to inefficiencies and potential crisis.

The trends in banking since 2008 have been alarming. The largest, so-called global systemically important financial institutions (G-SIFIs) have become larger, and by a number of measures (such as their exposure to each other through derivatives) they have become even more interconnected and dangerous.

Moreover, their continued “too big to fail” status enables these institutions to be ever more reckless, pursue continued growth, and take excessive risks. Through these actions they are further endangering the global economy—distorting it further and exacerbating the inefficiencies associated with the fragility of the system. Even if banks have, by some measures, reduced their leverage, the levels that regulators tolerate remain dangerously high and the regulations remain insufficient and flawed. More than six years after the United States provided government backing to the sale of Bear Stearns to JPMorgan Chase, and despite much rhetoric and debate, it is remarkable how little has changed.

To promote recovery, the US Federal Reserve and other central banks embarked on a policy of low interest rates and unusual measures, such as massive purchases of government bonds and other assets. These policies have helped many banks to become more profitable, but lending and economic growth have been slower to recover.

Both the slow recovery and the failure to deliver meaningful regulatory reforms can, at least partly, be explained by policymakers’ failure to diagnose the key flaws in the banking system and what regulation is meant to address. The issues—illustrated clearly in the case of Iceland—are also obvious elsewhere and have barely changed despite the flurry of action by policymakers. Iceland, in fact, appears to be ahead of many other nations in addressing the fundamentals.

As a result of the magnitude of the Icelandic banking collapse and the subsequent autopsy, the structure of the Icelandic banking system has changed profoundly. The resurrected Icelandic banks are now less than one-fifth of their former size relative to GDP, and they now use significantly more equity funding—much more than is required even in nations with relatively tough capital requirements. Incentive pay has only recently been reintroduced into banking, but it cannot exceed 25% of total pay. Banks’ compensation practices are now subject to the approval of Iceland’s Financial Supervisory Authority, the FME, which has tripled its number of employees since the 2008 collapse.

The key distortions in banking are due to poor governance and lack of accountability among the many participants, including bankers, auditors, regulators, and politicians. Bankers and others are able to directly benefit from taking risk while leaving it to others to pick up the pieces if things go wrong. If they are paid to gamble and suffer few if any consequences for misbehavior, they will respond to their incentives. Institutional investors who might benefit from the upside lack incentives to control risk, and creditors have little incentive to instill “discipline” if they believe that they will most likely be repaid by the government if banks default. It therefore falls on policymakers to counter the incentives and protect the public and the economy.

Iceland may also be the only country where a policymaker was actually put on trial for negligence. Elsewhere, no policymaker has suffered significant consequences for failing to protect the public. With the public largely confused by the many narratives and rhetoric about tough reforms, and with specious threats

from bankers and others, policymakers continue to fail to take sufficient action. They might have reasons to avoid challenging bankers, or be biased against regulation. They might be scared to make significant changes, or have other objectives, such as encouraging favorite investments, which they might see as more important than having a safer system. Whatever is the reason, not only do policymakers tolerate recklessness in banking, they continue to encourage and subsidize it.

Making It Happen

There is plenty of scope for improving the financial system, and steps should be taken immediately. The top priorities include:

recognizing and winding down nonviable banks rather than allowing them to persist or even supporting them; at the same time, viable institutions must be strengthened further by obliging them to retain their earnings and raise more equity;

reducing opacity by requiring better disclosure, restricting banks' ability to trade in opaque over-the-counter markets, and forcing most derivatives trading on to public exchanges;

addressing the serious corporate governance problems in banking by introducing, into the legal code, language stating that the purpose of a financial institution is to serve its customers, shareholders, and society at large, obliging banks' directors to avert collateral damage as they control the institution's risk-taking.

Conclusion

Mark Carney, the governor of the Bank of England, has provocatively predicted that the size of the UK banking sector could reach nine times the country's GDP in the foreseeable future. Iceland's banking sector was 10 times the size of the country's GDP in the year before it collapsed. Will policymakers in the United Kingdom and elsewhere have the courage and the competence to address the evident weaknesses of their banking systems and regulations before allowing such growth? Or will it take a crisis of the magnitude suffered by Iceland to generate the political will that is needed for genuine reform?

More Info

Books:

Admati, Anat, and Martin Hellwig. *The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*. Princeton, NJ: Princeton University Press, 2013. Makes the case for stronger and more effective capital regulation. Chapter 11 provides an outline for both immediate steps to take and improved capital regulations. (For more discussion at a policy level, see Admati et al., 2013.) Online: <http://bankersnewclothes.com>

Johnsen, Gudrun. *Bringing Down the Banking System: Lessons from Iceland*. New York: Palgrave Macmillan, 2014. A detailed account of the findings of Iceland's parliamentary Special Investigation Commission on the causes and events leading up to the collapse of the country's banks in 2008. Online: <http://bringingdownthebankingsystem.com>

Articles:

Admati, Anat R., Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer. "Fallacies, irrelevant facts, and myths in the discussion of capital regulation: Why bank equity is not socially expensive." Revised October 22, 2013. Online: www.gsb.stanford.edu/news/research/admati.etal.html

Carney, Mark. "The UK at the heart of a renewed globalisation." Speech given at an event to celebrate the 125th anniversary of the *Financial Times* on October 24, 2013. Online: www.bankofengland.co.uk/publications/Documents/speeches/2013/speech690.pdf

Rannsóknarnefndir Alþingis. "Report of the Special Investigation Commission." April 12, 2010. Icelandic Parliament page with links to selected parts of the report in English. Online: <http://tinyurl.com/mzevwrz>

Websites:

The Bankers' New Clothes: What's Wrong With Banking and What to do About It <http://bankersnewclothes.com>

World Bank – banks' capital-to-assets ratios, by country <http://data.worldbank.org/indicator/FB.BNK.CAPA.ZS>

See Also

Viewpoints

- [Forecasting the Credit Crunch and Future Market Prospects](#)
- [Lessons from the Credit Crisis: Governing Financial Institutions](#)

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