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I. Introduction: The wider world

Mr Chairman, distinguished guest, ladies and gentlemen, good morning.

Well, what a difference a year makes. One year ago at this conference, the talk was of Iceland's international banking system as a cornerstone of its modern economy. But the financial tsunami that hit Iceland's shores in October 2008 finally laid bare the serious issues and imbalances in the Icelandic financial sector and the broader economy.

As you can see from the slide behind me (glæra 2), the systemic crisis in Iceland is second to none, ranking no. 1 in terms of collapsing equity value (on the left side you see the severity of the contraction and on the right the duration in years from collapse to recovery). And this slide (glæra 3) shows the severity of the crisis as measured by other different yardsticks.

Of course, the events that wrought devastation in the land last October did not happen in a bubble. In the words of Warren Buffet, „In the business world, the rearview mirror is always clearer than the windshield“. So keeping that sentiment in mind, I would like to briefly review the global and local causes of the national turmoil we are now living through.

The backdrop to Iceland’s great financial expansion was a massive expansion of credit world-wide. Taking its cue from the Greenspan Fed, the developed world expanded provision of credit early in the decade and precipitated price bubbles in any sector that would benefit from leverage. Among these were private equity, corporate debt, hedge funds, and of course, mortgage loans of all kinds, including subprime. At the same time, the financial sector continued a rapid globalization that had gotten underway the century before. New interconnections meant new kinds of cross-border exposures: German banks bought

pieces of home loans in California and Nevada, and financiers from Europe, Asia, and North America extended credit to growing banks in Iceland.

All these interconnections can be summed up in the words of John F. Kennedy: „When the tide comes in, every boat rises“. Conversely, when the tide went out every boat beached at once. A drying up of liquidity that started in American subprime markets in the first months of 2007 spread throughout that year to affect nearly every sector, first in America and then outwards in the world, eventually even to once-distant Iceland and the wholesale funding on which Icelandic banks had come to rely.

In a world newly awash with debt, credit ratings took on a vastly expanded importance. But the poor quality of these ratings belied their importance. Just as elsewhere the credit rating agencies completely

failed to accurately assess the financial situation in Iceland. They continued to post rosy credit ratings for Icelandic financial firms on the assumption that the Central Bank could step in and bail out these institutions if need be. However, that possibility was gone years ago, probably as early as 2005. If these agencies had been consistent with their own practices, they would have lowered Icelandic credit ratings earlier, and continued to lower them as the situation in Iceland deteriorated through 2006 and 2007. Instead, one agency rated all three large Icelandic banks as Aa3 as recently as January 2008, nearly a full year after the global credit crisis kicked off in the United States. This rating placed the Icelandic banks just one notch below the very highest quality investment-grade bonds, even as their own ability to roll over their wholesale debt was being called into question by the CDS market. Consistent, steady downgrades of the Icelandic banks by the credit rating agencies alone could have put the brakes on the Icelandic financial sector. Instead, just as with structured bonds built around

subprime mortgages, by the time the Icelandic banks' ratings caught up to the reality, it was too little, too late.

II. The Icelandic model

With the global picture in mind, I would like to look more closely at the last decade in Iceland, as in my view the unfolding of this crisis stretches far back in time. This one began long before 2008. A financial crash of this magnitude does not happen out of the blue one sunny October morning: it takes years to build.

I will argue that considerably less was going on in the Icelandic economy during the last six years than often presented – and generally believed. Certainly, there were very substantial foreign investments in the form of a massive power-station and aluminium-smelter project in Eastern Iceland, but apart from that, progress in other sectors of the

economy was rather modest in an overall context and does not explain the „boom“ in recent years. In fact, as everybody must have realized by now, the recent boom years were in the main the result of the influx of the availability of credit – and the interest rate differential between Iceland and other countries. In a wider world awash in cheap credit, carry traders borrowed low and bought high, flooding the small and newly open Icelandic economy with an oversupply of cash. These „massive currency inflows effectively became a part of the local money supply“, making the Central Bank’s job all the harder, to quote Jón Daníelsson and Gylfi Zoega, both professors of economics and authors of a report on the collapse of the Icelandic financial sector. And these large capital flows all but guaranteed the formation of a bubble economy in Iceland.

This monetary bubble got under way concurrently with the privatization of Iceland’s 2 staid, state-run banks, sold to handpicked

parties on the basis of a political decision. This act started off a cycle of bad decisions and bad banking that would plague the country for the decade to come.

The „Icelandic business model“ that was much-heralded in the middle of this decade was inherently flawed. Foremost among the flaws was a world-conquering ambition that was all out of proportion with the abilities and resources of the banks and other businesses in the economy. This was an ambition that was always two steps ahead of capability, but nonetheless celebrated in both the business press and the wider society. Peer pressure and a desire to conform ensured that once one financial institution in Iceland embraced a business idea, the others quickly piled in behind, regardless of the wisdom of doing so. And any criticism of the „Icelandic model“, especially from outside of the country, was quickly diffused by labeling it as „envious“ or „misguided“: „These outsiders don’t understand our special economy

and are merely envious of our great success“ was often heard. One well-intentioned critic said: „You must be careful, otherwise the land of hot springs will become known as the country of hot air“. I believe those words, or words to that very effect were spoken at this conference in 2005 - but no one listened. And where was the media? It failed complete to provide the discipline expected of it in a modern democratic society, printing press release without a critical thought or comment.

Icelandic financial institutions took excessive risks. To quote professors Daníelsson and Zoega again, „There is little evidence that either the government or the private sector had a sufficient understanding of the necessary risk management processes and banking supervision needed when a banking sector becomes such a large part of the economy.“ And just like their larger peers elsewhere in Europe and the United States, these institutions relied on problematic models, such as value-

at-risk, to score and evaluate their exposures. As we have now experienced, in a pervasive bear market, these models stop working: the movement of nearly all asset prices becomes correlated as assets lose value in lock-step.

General George S. Patton, speaking of risk-taking said, „Take calculated risks. That is quite different from being rash.“ Unfortunately, „rash“ might be the best word to describe the spirit of excessive risk-taking that took over the Icelandic economy as a whole. Fishing-industry firms became currency speculators. Real estate investment companies sprouted overnight and ran off to exotic locales in search of development projects. Pension funds began demanding geared investments: the more leverage, the more return. And average Icelanders with domestic salaries took big bets of their own by taking on foreign-currency debt to buy cars and homes.

There was a very real liquidity risk in most Icelandic financial institutions. The basic business model of banking has an inherent liquidity risk: that is borrowing short and lending long. Most banks do this by taking short-term deposits and making longer term loans on the back of those deposits. Banks then use a variety of techniques to match the term of these assets and liabilities, but they rarely match perfectly. Here in Iceland this inherent liquidity risk was aggravated by the use of wholesale funding from foreign banks: the Icelandic banks borrowed short at one-to-several years maturity and lent that money out on longer time periods. The risk was always that funding would fail to roll over, something we saw all too well in 2008 – and the consequences, as we know, were cataclysmic.

The „Icelandic model“ also suffered from a lack of clear objectives. Running a business organisation without clear objectives is like playing chess without a strategy and drifting from one move to the next one –

which is a sure formula for losing the game. Without clear objectives, „bigger is better“ became the mantra, and balance sheets and jeep tires grew to match. In the case of the banks, these balance sheets were routinely overstated: filled with overpriced assets and vulnerable loans that were carried with insufficient default provisions. The annualized growth rate in assets of one of Iceland’s prominent financial institutions was 97% on the 8-year period from the beginning of 2000 to the end of 2007. That means that the balance sheet of this entity almost doubled in size every year for most of the decade. „Bigger is better“, until it isn’t. For the FME, as regulator, supervising entities growing at this rate is impossible. Not nearly impossible – just plain impossible. By the time a study of such an institution is finalized, it is a totally different organisation – and the report irrelevant and obsolete.

Iceland has long done well in international surveys of corruption, most recently coming in as the 7th "cleanest" out of 180 countries in the

world in a popular index. The methodology of this index, which, by the way, is a perception index, focuses specifically on the act of paying or soliciting bribes, something that is thankfully quite rare in Iceland.

What is quite common, however, is a more subtle form of bribe: the favor. Favors are part of daily life and business life in Iceland, and by including mutual back-scratching in such an index the country might appear quite corrupt. This high incidence of favors also goes by another name: cronyism. The handing out of deals to cronies certainly played a large part in the high number of bad business decisions taken over this past decade. By the middle of 2008, four large Icelandic financial entities had 373 billion ISK of exposure to parties related to those institutions: directors, managers, large shareholders, and their families and related companies.

During the boom years, Icelandic businessmen trumpeted their ability to get deals done fast. In his article *Wall Street on the Tundra*, Michael

Lewis quotes Vilhjálmur Bjarnason: “We were always told that the Icelandic businessmen were so clever. They were very quick. And when they bought something they did it very quickly. Why was that? That is usually because the seller is very satisfied with the price.” Doing many deals fast meant that Icelandic businesses often overpaid: bad decisions, made faster.

Combined with bad business was plain and simple bad management. Somewhere along the line, management lost the ability or the desire to just say “no”. Consequently Icelandic financial institutions became buying machines, hoovering up questionable assets in an era of inflated asset prices. To paraphrase Hermod Skånland, the Governor of the Norwegian Central Bank during Norway’s crisis: Bad business, bad banking, bad management, and not a little bad luck.

III. FME: where we stand today

So where does the FME stand today (glæra 4)? Currently FME employs 66, up almost twofold from earlier in the decade. But as our workforce grew linearly, assets of the firms under supervision grew exponentially, or at least until last October. FME has been accused of having been too accomodating during the „boom“ years and ahving been part of the cheer-leading team or even part of the wrong team. I can't comment on everything that transpired at FME in years past, but I submit that FME was overwhelmed by the fast pace of the growth of the banking industry and the financial sector as a whole. And employee turnover was in double digit numbers from 2005 on as banks hired FME staff, offering much higher salaries than FME could hope to offer. Of course, FME also lacked legal authority to take more forceful regulatory actions if such had been contemplated.

In 2008 and 2009 to date (glæra 5), FME has conducted 50 formal on-site inspections of monitored entities, which today number 119. During the heart of the crisis, FME employees' hours increased considerably. The number of hours logged directly to FME tasks in October was over 13 thousand, or 125% higher than at the beginning of the year.

Many FME employees logged over 2000 task hours in 2008, 600 hours more than in an average year. Immediate work focused on gathering information pertinent to the banking crisis and any potential illegal activities surrounding the last months of the banks, and we have recently hired additional specialists to assist with the additional workload.

In the fall of 2008 (glæra 6), the FME advised the resolution committees of the banks to hire independent specialists to assist with the investigation of aspects of the operations of the banks prior to state takeover. Areas of particular interest included unusual transfer of

funds between countries, changes in terms of loan agreements, securities and derivative transactions, transfers of assets of investment funds, and transfers of other operating assets. The FME received extensive reports covering these types of transactions for each of the three big Icelandic banks earlier this year, and expects similar reports mid-year regarding three additional financial institutions. The content of these reports has to date provided the bulk of the material for follow-up investigation by teams at the FME.

The goal of these investigations (glæra 7) is to turn cases of potential material wrongdoing over to the Special Prosecutor. Ten such matters have already been handed over. Five more are in the pipeline for handover in the near future and many more are under continuing investigation.

The new banks presented their business plans in January and the FME has reviewed these in order to assess the future operations and viability of the new banks. Additionally, we have retained international experts from both Deloitte and Oliver Wyman to evaluate the assets of the failed banks with an eye to establishing fair valuations for these assets. In the near term, our goal is to give a „certificate of health“ to the three „new“ banks that were created in the wake of last October’s takeover. Our target for this confirmation of banking licenses is next month.

IV. **Moving forward** (glærur 8 & 9)

Going forward, the FME will continue to use this crisis as an opportunity to hone its skills and add new skills, such as forensic accounting, to its toolkit. The FME also looks forward to continuing input in strengthened legislation, better regulations, and clear corporate governance policies for the financial sector.

In the medium to long term, we will undertake the process of rebuilding this shattered industry in a form that better matches the size and capability of the national economy. We must keep open the possibility of consolidation here at home, and also be open to offers from competent international buyers. In rebuilding the banking system, we might have as a goal the model of Canada: a system of stable commercial banks that provide the services of basic banking to the Icelandic nation, leaving ancillary activities like proprietary trading, brokerage, corporate advisory, and asset and pension management to specialized firms. This is the model that former Fed chairman Paul Volcker praised in a recent speech in Toronto. He said that the purpose of a banking system ought first and foremost to be a „fiduciary responsibility to service consumers, individuals, businesses, and governments by providing outlets for their money and by providing credit.” In other words banks should get back to the basics of banking:

the days of banks being entrepreneurs are over. As he put it, “These institutions that have arisen in the United States and the UK [and Iceland] that combine hedge funds, equity funds, [and] large proprietary trading with commercial banks, have enormous conflicts of interest. And [...] the conflicts of interest contribute to their instability. So I would say let’s get rid of that. Let’s have big and small commercial banks and protect them – it’s the service part of the financial system.”

A financial system oriented to serving customers rather than owners should serve as the model for Iceland, as well.

In the future, we might also advise our aspiring businessmen with the words of Emilio Botin, the chairman of Spain’s Banco Santander, the bank named best in the world in 2008 by Euromoney Magazine. When asked how his bank stayed out of the subprime mess, he responded: "If you don't fully understand an instrument, don't buy it. If you will not buy for yourself a specific product, don't try to sell it. If you don't know

very well your customers, don't lend them any money. If you do all these three things, you will be a better banker, my son."

As we rebuild our financial system, we embark on rebuilding our credibility abroad with foreign governments, financial institutions, and rating agencies. Credibility is something that is built over a long time, and for a small country like ours it can be lost in a weekend. The process of rebuilding our good name has already begun and will continue. At the FME it means increased transparency and strengthened cooperation with our counterparts abroad through organizations like CESR, CEBS, and CEIOPS. More broadly, we want „Iceland“ to once more conjure up images of a green, prosperous, and democratic land with a stable and ethical business environment and a sound financial system. The bubble and subsequent undoing of the Icelandic economy has been a painful experience for the nation and the financial wisdom of the Icelandic nation has been questioned, but no-

one can question the resolve and resilience of the Icelandic people.

The events of recent times create an opportunity to rebuild a better financial system, a better economy, and a richer society, if we apply the lessons we have learned. We will get through this.

Thank you.