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SIC Report Chapter 2: Summary of the Report's Main Conclusions

Rannsoknarnefndir Althing

Chapter 2

Summary of the Report's Main Conclusions

■ Explanations for the collapse of Glitnir Bank hf., Kaupthing Bank hf. and Landsbanki Íslands hf. are first and foremost to be found in their rapid expansion and their subsequent size when they tumbled in October 2008. Their balance sheets and lending portfolios expanded beyond the capacity of their own infrastructure. Management and supervision did not keep up with the rapid expansion of lending. Growth in lending by the banks' parent companies averaged nearly 50% from the beginning of 2004 until their collapse. Lending to holding companies grew at the fastest and steadiest pace, on the one hand, and to foreign parties on the other hand.[1] Growth in lending to foreign parties was significantly more rapid. The growth was especially rapid during the latter part of 2007. The banks' rapid lending growth had the effect that their asset portfolios became fraught with high risk. Numerous examples in the report corroborate that conclusion.

■ In general, such large-scale and high-risk growth is not compatible with the long-term interests of solid banks. On the other hand, there were strong incentives for growth within the banks. These incentives included the banks' incentive schemes, as well as the high leverage of the major owners. It should have been clear to the supervisory authorities that such incentives existed and that there was reason for concern over this rapid growth. However, it is evident that the Financial Supervisory Authority FME, the institution that bore the main responsibility for monitoring the activities of the banks, did not grow in the same proportion as the banks, and its practices did not keep up with the rapid changes in the banks' practices.

■ Access to international financial markets was, for the banks, the principal premise for their big growth. This was especially the case in the years 2004 to 2006. These years saw the banks' biggest growth. There were mainly two reasons why international financial markets opened their doors to the banks, firstly, because of their good credit rating. This was to some extent inherited from the Treasury. Secondly, they had access to European markets, on the basis of the EEA Agreement. In 2005, Glitnir, Kaupthing Bank and Landsbanki got hold of around EUR 14 billion in foreign debt securities markets. This amount was slightly higher than Iceland's gross domestic product

1. The Central Bank of Iceland defines "foreign parties" as parties (natural persons or legal entities) domiciled abroad. Such parties are not necessarily unrelated to Iceland. For example, if an Icelandic-owned company that is registered in Luxembourg takes out a loan in an Icelandic bank, that loan, according to this definition, is made out to a "foreign party".

in that year and doubles the amount in debt securities issued the previous year. The terms for these debt securities were very favourable, only about 20 points over the benchmark interest rate. When funding in the European debt securities markets became more difficult, the debt securities market in the US opened up. That opening was largely due to collateralised debt obligations (CDOs). Icelandic bank securities were packaged into these CDOs because of the high credit rating of the Icelandic financial undertakings. At the same time, they paid, as a rule, high interest rates, considering their credit rating. Thus, the Icelandic banks were the "cheapest" in light of their credit rating from the rating agencies. Therefore, they were ideal for raising the average rating of a collateralised debt obligation. It is clear that the Icelandic banks acted with far too much haste when issuing debt securities in international markets. It was evident that sooner or later interest rates would go up and that credit markets would tighten again.

■ When the banking system had become far too big, relative to the size of the Icelandic economy, the governmental authorities needed to respond. No later that 2006 it would have been necessary to take action, if there was to be any chance of preventing the collapse of the banks, without severely impacting upon the value of their assets. Neither that year nor the next did the authorities try, in a decisive way, to have the banks reduce the size of their balance sheets. Furthermore, the authorities did not exert themselves in order to have one or more of the three big banks move their headquarters abroad. On the contrary, it was the policy of the coalition of the Independence Party and the Social Democratic Alliance, according to their coalition agreement of 23 May 2007, to ensure that financial activities could continue to grow domestically and expand into new fields of competition with other market areas. It was also the policy of the government that the domestic multinational corporations would see it to their advantage to have their headquarters remain in Iceland.

■ The largest owners of all the big banks had abnormally easy access to credit at the banks they owned, apparently in their capacity as owners. The examination conducted by the SIC of the largest exposures at Glitnir, Kaupthing Bank, Landsbanki and Straumur-Burðarás revealed that in all of the banks, their principal owners were among the largest borrowers.

■ At Glitnir Bank hf. the largest borrowers were Baugur Group hf. and companies affiliated to Baugur. The accelerated pace of Glitnir's growth in lending to this group just after mid-year 2007 is of particular interest. At that time, a new Board of Directors had been elected for Glitnir since parties affiliated with Baugur and FL Group had significantly increased their stake in the bank. When the bank collapsed, its outstanding loans to Baugur and affiliated companies amounted to over ISK 250 billion (a little less than EUR 2 billion). This amount was equal to 70% of the bank's equity base.

■ The largest shareholder of Kaupthing Bank, Exista hf., was also the bank's second largest debtor. The largest debtor was Robert Tchenguiz, a shareholder and board member of Exista. When the bank collapsed, Exista's outstanding debt to Kaupthing Bank amounted to well over ISK 200 billion.

■ When Landsbanki collapsed, Björgólfur Thor Björgólfsson and companies affiliated to him were the bank's largest debtors. Björgólfur Guðmundsson was the bank's third largest debtor. In total, their obligations to the bank amounted to well over ISK 200 billion. This amount was higher than Landsbanki Group's equity.

■ Mr. Thor Björgólfsson was also the largest shareholder of Straumur-Burðarás and chairman of the Board of Directors of that bank. Mr. Björgólfur Thor Björgólfsson and Mr. Björgólfur Guðmundsson were both, along with affiliated parties, among the largest debtors of the bank and together they constituted the bank's largest group of borrowers.

■ The owners of the banks received substantial facilities through the banks' subsidiaries that operated money market funds. An investigation into the investments of money market funds under the aegis of the management companies of the big banks revealed that the funds invested a great deal in securities connected to the owners of the banks. It is difficult to see how chance alone could have been the reason behind those investment decisions.

■ During a hearing, an owner of one of the banks, who also had been a board member of the bank, said he believed that the bank "had been very happy to have [him] as a borrower".[2] Generally speaking, bank employees are not in a good position to assess objectively whether the bank's owner is a good borrower or not.

■ Towards the end of 2007 and in 2008 the banks started to face constraints in their operations. It seems that the boundaries between the interests of the banks and the interests of their largest shareholders were often fuzzy and that the banks put more emphasis on backing up their owners, thus going beyond normal practices. The operations of the Icelandic banks were, in many ways, characterised by their maximising the interests of the larger shareholders, who managed the banks, rather than running solid banks with the interests of all shareholders in mind, where due responsibility was demonstrated towards their creditors.

■ The concentrated risk of the Icelandic banks had already become dangerously high, well before their collapse. This applies both to lending to certain groups within each bank, as well as how the same groups also constituted high risk exposures in more than one bank. 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. Other groups had substantial outstanding liabilities to more than one bank: Exista, Mr. Björgólfur Thor Björgólfsson, Mr. Björgólfur Guðmundsson and Mr. Ólafur Ólafsson. The risks stemming from these parties were somewhat less than that from Baugur and affiliated companies.

2. Statement by Mr. Björgólfur Guðmundsson before the SIC on 10 January 2010, p. 41.

■ The capital ratio of Glitnir, Kaupthing Bank and Landsbanki was, in their annual reports, always slightly above the statutory minimum. However, these capital ratios did not reflect the real strength of the banks and the financial system as a whole or the capacity to withstand shock. This was due to considerable risk exposure stemming from the banks' own shares, both through primary collaterals and forward contracts on their own shares. If equity no longer provides a cushion for protecting depositors and creditors it is not equity in the economic sense. Under such circumstances it is no longer possible to take the capital ratio into account when evaluating the strength of a financial institution, as the risk of loss stemming from the institution's own shares lies with itself.

■ The banks had invested their funds in their own shares. Share capital, financed by the company itself, is not the protection against loss it is intended to be. Here this is referred to as "weak equity". Weak equity in the three banks amounted to about ISK 300 billion by mid year 2008. At the same time, the capital base of the banks was about ISK 1,186 billion in total. Weak equity, therefore, represented more than 25% of the banks' capital base. If only the core component of the capital base is examined, i.e. shareholders' equity, according to the annual accounts, less intangible assets, the weak equity of the three banks amounted to more than 50% of the core component in mid year 2008.

■ In addition to the risk that the banks carried on account of their own shares, the SIC assessed how much risk they carried from each other's shares. Here this is referred to as "cross-financing". Around mid year 2008, direct financing by the banks of their own shares, as well as cross-financing of the other banks' shares, amounted to about ISK 400 billion. If only the core component of the capital base is examined this amounted to about 70% of the core component in 2008.

■ The SIC is of the opinion that the financing of owners' equity in the Icelandic banking system had been based, to such a great extent, on borrowing from the system itself that its stability was threatened. The shares owned by the biggest shareholders of the banks were especially leveraged. This resulted in the banks and their biggest owners being very sensitive to losses and the lowering of share prices.

■ Overstatement of a bank's equity increases its growth potential. However, the bank's ability to deal with setbacks decreases at the same time. The risk of bankruptcy is thereby increased. Under these circumstances, the loss to depositors and other creditors becomes greater than it would otherwise have been. If the bank in question is systemically important, as was the case with all of these three banks in Iceland, the costs to society will also be significant, as has been the case.

■ The SIC investigation into the Icelandic banks' operations indicates that, as a consequence wider authorisation for the operations of financial institutions in the last few years, their operational risk increased significantly. It is especially noteworthy that the freedom of credit institutions to engage in riskier investments was significantly increased in this period. They were i.a. authorised to engage in investment banking in conjunction with the traditional activities of a commercial bank, although this scope for increased risk-taking did not go hand in hand with satisfactory restraints and increased equity requirements. The FME had the power to require increased equity of financial institutions, i.a. in case of increased operational risk. This power, however, was never exercised.

■ In the last decade, the economic policy of the Icelandic authorities hasaimed at maintaining maximum long-term economic growth. It is the opinion of the SIC that neither the state's budget policy nor its monetary policy adequately addressed economic fluctuations, overexpansion and grow-■g imbalance in the economy. Unfortunately, it seems to be unavoidable to conclude that the state's budget policy increased in fact the imbalance. The policy of the CBI was not sufficiently restrictive and its actions too limited to render the desired results in the fight against increased leverage and underlying inflation.

■ The authorities decided to lower taxes during an economic expansion period. This was done despite expert advice and even against the better judgement of policy makers who made the decision. This decision was highly reproachable. The changes made to the lending guidelines at the Housing Financing Fund in 2004 also fuelled expansion. The changes in the lending guidelines were one of the biggest mistakes in monetary and fiscal management made in the period leading up to the banks' collapse. That mistake was made with full knowledge of the likely consequences. The repercussions were quick to emerge and the consequences were even greater under the global low interest rate environment at the time. These decisions in fiscal and monetary management and others named in the report exacerbated the imbalance in the economy. They were a factor in forcing an adjustment of the imbalances, which ended with a very hard landing.

■ It was mostly left to the Central Bank of Iceland (CBI) to counteract the effects of the expansion and for this reason the bank began to raise interest rates in the spring of 2004. The bank was, however, unhurried in its decisions to lift rates. While considering the steps towards monetary tightening it continually seems to have been expecting budget restraint measures by the government. Time and again, the bank called for such measures. However, no such decisions were made. In the latter half of 2005, it had become evident that the CBI interest rates were too low.

■ Within the CBI, opinions frequently diverged on what should be the desirable level for the policy rate. The Board of Governors of the CBI was more often in favour of less restraint than the chief economist of the Bank had proposed. Minutes of meetings by the Board of Governors of the CBI do not shed a light on whether, and if so, how, i.e. on what data or information, the bank's board based its decisions, when deciding on a policy which differed from that suggested by the chief economist.

■ The CBI attempted to curb domestic demand by lifting the policy rate. Meanwhile, the CBI expanded its liquidity provision to financial institutions significantly. From the autumn of 2005 to the beginning of October 2008, the stock of loans against collateral from the CBI increased from ISK 30 billion to ISK 500 billion. At the beginning of October 2008, loans from the CBI to financial institutions against collateral in securities and letters of credit in the three large banks amounted to ISK 300 billion. The CBI authorisation to provide credit institutions with loans by buying securities according to Article 7 of Act No. 36/2001 falls under the condition that these are granted against collateral that the bank considers eligible. Although the CBI was aware of the weaknesses of the banks it nonetheless provided volumes of loans against collateral in the banks' securities. This knowledge can barely be seen as compatible with what the aforementioned legal provision on valid collateral stipulates.

■ At the beginning of 2006, the Icelandic krona was much stronger than was sustainable in the long-term. The current account deficit was over 16% of GDP. The national balance sheet appeared weak, as liabilities in foreign currencies in excess of assets nearly amounted to the GDP of the country. At that time, all the prerequisites for a financial crisis were in place. The research department of Danske Bank drew attention to the economic imbalances in Iceland. In its view, there were signs that the current account deficit would reach 20% in 2006. It was pointed out that the unemployment rate was 1% and wage growth had been 7% annually. As a result the krona depreciated rapidly in March 2006. CDS spreads on Iceland and the banks rose. The situation calmed down in the middle of 2006. However, imbalances in the economy continued to grow more rapidly than before. All developments increased the likelihood of a serious financial crisis significantly.

■ The summer of 2007 saw the onset of an international financial crisis. It hit in the wake of unusually low real interests, easy access to loans, little fluctuation of economic indicators, and widespread increase in asset values. These circumstances led to growing weaknesses in the international financial system, which emerged following extensive amortisation precipitated by a sharp fall in the value of CDOs containing U.S. sub-prime mortgages in 2007. The major financial markets were rendered virtually inoperable. This proved especially difficult for the Icelandic banks. They had become increasingly dependent on funding through international financial markets. The Icelandic banks were faced with either raising further deposits or seeking other ways of funding themselves. In the latter half of 2007, securities for over EUR 2 billion would fall due. A further EUR 3 billion would fall due in 2008.

■ Despite the success of the Landsbanki Icesave accounts and the Kaupthing Edge accounts, the total deposits in the banks decreased kept shrinking from the autumn of 2007 until their collapse. So-called wholesale deposits were flowing out of all the banks. The outflow of wholesale deposits from the Landsbanki branches in the UK and the Netherlands in the year before the collapse of the banks exceeded the inflow of retail deposits into the bank's Icesave accounts.

■ Collateralised loans increased substantially in all three banks as the liquidity crisis became more widespread. In the autumn of 2007, the banks' collateralised loans were some EUR 2 billion, mostly from the CBI. When the banks collapsed they had grown to roughly EUR 9 billion and nearly half that sum was from the European Central Bank Collateralised loans were chosen rather than financing through the issue of medium term bonds with maturity of three to five years. They were mostly granted for a period of a few weeks, although individual loans were granted for a period up to six months. For the banks, this increased financing through short-term collateralised loans escalated their financial risk substantially. Like deposits, collateralised loans are sensitive to changes in market conditions. This is especially true if the collateralised loans are provided by others than central banks. The creditors can, for example, reject their renewal or extension on maturity, or decide on increased haircut discount.

■ When the liquidity crisis intensified in the international financial markets there was a substantial increase in foreign lending by the three big banks. In the second half of 2007 lending to foreign parties grew by EUR 11.4 billion. Lending by the banks' parent companies to foreign parties increased by more than 120% in just six months. The increase was so substantial that it can be assumed that many of these new clients had turned to the Icelandic banks after other banks were beginning to slow their lending, and that these clients had thus been rejected by other banks.

■ In addition to borrowing in Iceland, the largest Icelandic investment companies had been doing business with foreign banks and borrowed from them as well. Several of these loans were secured with domestic securities as collateral. As the winter of 2007-2008 progressed share prices fell. By then the quality of collateral declined for the Icelandic investment companies. Foreign creditors made margin calls. Glitnir, Kaupthing Bank and Landsbanki responded by taking over the financing so that loans in foreign banks could be repaid. The Icelandic banks thus lent substantial amounts while experiencing considerable liquidity problems at the same time.

■ Loans from foreign banks to Icelandic investors increased the Icelandic banks' risk because in fact they often acted as "lenders of last resort" to these investors. There were a number of reasons for this. First, the Icelandic banks had loaned these parties such amounts that for the banks it was a matter of vital importance that their debtors would manage to bounce back. Second, these parties had, in their capacity as owners and stakeholders, had an abnormally easy access to credit at the banks. Thirdly, it was a significant factor that loans to these parties was to a large extent to fund stock purchases in the banks themselves. They were thus part of the banks' attempts to maintain the share prices. Finally, the banks considered that the damaging impact of bad publicity would be substantial if there were repeated instances of large investment companies landing in trouble, such as happened with Gnúpur.

■ As stated before, the banks held a lot of their own shares as collateral for their lending. With share prices declining, the quality of their loan portfolio declined. This could in turn affect the banks' performance and, consequently, the price of their stock. Additionally, the employees of the banks in many cases owned significant shares in their own bank, sometimes even financed by the bank itself. The banks already had put themselves in a difficult position when share prices started to fall in late 2007, collateral coverage of their stock loans decreased, and their clients' positions deteriorated.

■ All the banks purchased their own shares on a large scale in automatically matched trades in the Stock Exchange.[3] This was particularly the case after the prices of shares started to drop. In 2008 the banks were buyers on average in 45% of cases of automatically matched trades in their own shares. In comparison they were sellers in less than 2% of cases of automatically matched trades during the same period. This cannot be considered to be normal market making on the part of the three large banks. It must be assumed that all the banks in this manner attempted to elicit abnormal demand for their own shares. For that purpose they used the leeway that could be created by the trading conducted by the proprietary trading desks.

■ Lending for the purchase of shares in the banks that took place in late 2007 and all of 2008 were in many cases likely to increase the leeway of the proprietary trading desks to buy more shares. In some cases care was not taken to prevent situations where the bank would still bear all the risk of fluctuations in the price of shares.

■ In light of the prevailing market situation since the autumn of 2007, the banks found it hard to unwind the risks that had developed within the system. It is appropriate to keep in mind that the banks took those risks in their operations when the market situation was more favourable. A risk is developed when it is taken, not when prices start dropping. A large part of the problem that the banks attempted to respond to in the period leading up to their collapse was due to risks that were already in place within the system when the liquidity crisis occurred in the autumn of 2007. Increased lending to the owners of the banks, acquisitions of foreign financing, losses due to buying and selling of their own shares and comparable conduct of the banks, to the degree described in the report, can hardly be considered as justifiable responses to such a crisis or to be in line with healthy and normal business practices.

■ From November 2007 onwards the Board of Governors of the CBI became increasingly concerned about the situation that was developing in the operational environment of the banks. The Board of Governors described these concerns either directly to the Prime Minister and a small group of ministers, or within the platform of the government consultative group. In spite of these concerns there is no evidence that the Board of Governors of the CBI made available to the government formal propositions for necessary measures. Insofar as the CBI considered that it lacked the necessary lawful means to react on its own to the problem at hand, it would have been appro-

3. Automatically matched trades take place when trading members of the Stock Exchange put in their offers and trades occur when offers are matched, that is as soon as the matching takes place. It is also possible to negotiate the terms of trades outside the Stock Exchange and announce the trade subsequently. Such trades are called manual trades.

priate for the Board of Governors to notify the government thereof in a formal manner. Therefore, the bank's assessment of the severity of the situation and the logical course of action and proposals, based on that assessment, did not go hand in hand.

■ The Prime Minister, the Minister for Foreign Affairs and the Minister of Finance met with the Board of Governors of the CBI on 7 February 2008. During the meeting, the Chairman of the Board of Governors painted a very bleak picture of the state and future prospects of the Icelandic banks. The information indicated an imminent danger for the Icelandic economy. The Board of Governors also met with the Prime Minister and the Minister for Foreign Affairs on 1 April 2008. In that meeting, the Board informed the ministers that GBP 193 million had been withdrawn from the Icesave accounts in London during the previous weekend. The Board also said that Landsbanki could withstand such an outflow for six days. Neither the Prime Minister nor other ministers of the government who were informed about this reacted by resorting to active and credible measures.

■ It is clear from the events during the year leading up to the collapse of the banks that a certain degree of mistrust and cooperation problems existed between Mr. Oddsson, Chairman of the Board of Governors of the CBI, and most of the ministers of the Social Democratic Alliance. It is also clear that the previous cooperation in the political arena between the Chairman of the Board of Governors of the CBI and the Prime Minister, as well as their long standing friendship, had an influence, as described by the latter, on the way in which people construed the exchange of information between government leaders and the Chairman of the Board of Governors of the CBI. In the period leading up to the collapse of the Icelandic banks, Mr. Davíð Oddsson's previous political career thus had an influence, according to the description given by the ministers of the government that took office in May 2007, on how ministers responded to the information which he provided to them in the course of his duties as Chairman of the Board of Governors of the CBI.

■ During the meetings of the Board of Governors of the CBI with ministers, the bank would not be in the habit of handing out documents with summarised information, along with the bank's review of that information and proposals for actions, where applicable. This is cause for wonder. During some of these meetings very alarming news were heard. The discharge of official duties by the Board of Governors of the CBI was, in this regard, not as thorough as might have been expected. Due to this fact, the ministers no doubt had difficulties assessing the right course of action, not in the least in view of the difficult relations between the ministers of the Social Democratic Alliance and the Chairman of the Board of Governors of the CBI. On the other hand, the ministers apparently did not call for such proposals and documents from the CBI, once important information had been verbally conveyed to them. They had, however, ample reason to do so. Furthermore, ministers were not generally in the habit of recording minutes of their meetings with the Board of Governors, even though there was every reason to do so, in light of the important information often communicated there.

■ It has been established that until just before the collapse of the banks there was little discussion within the Icelandic government of the bank's standing and of the liquidity crisis which began towards the end of summer 2007. Nothing suggests, either from the government's minutes or the accounts of those who reported to the SIC, that the ministers of the Icelandic government responsible for economic affairs (the Prime Minister), banking affairs (the Minister of Business Affairs) or the state's finances (the Minister of Finance) submitted to the government a specific report on the problems of the banks or its possible impact on the state's economy and finance when the banks started to face constraints in their operations and until the banking system collapsed in October 2008.

■ In 2008 the Prime Minister had quite a few meetings with the Chairman of the CBI Board of Governors and the CEOs of the banks. During the period from February until May 2008 Board of Governors had at least five meetings with the Prime Minister, Minister of Finance and the Minister for Foreign Affairs. Banking affairs came under the domain of the ministry of Mr. Björgvin G. Sigurðsson, Minister for Business Affairs. He was not summoned to attend any of these meetings, in spite of the fact that the problems the banks were facing and the liquidity crisis were being discussed there. In addition, the Minister of Business Affairs was apparently neither informed of the meetings, nor was he informed of what took place during the meetings, with one exception, since he was informed of a meeting that took place on 7 February 2008 in a Social Democratic Alliance parliamentary group meeting on 11 February 2008. As the leader of the government, the Prime Minister had the responsibility to inform the Minister of Business Affairs of the aforementioned meetings so that he could attend to his duties.

■ It is the assessment of the SIC that the government's actions concerning matters relating to the banks were unfocused when the situation became more dire in the beginning of 2008. The ministers focused too much on the image crisis facing the financial institutions rather than the obvious problem, that the Icelandic financial system was far too large in relation to the Icelandic economy. When the ministers intended to improve the image of the banking system by partaking in public discussions, mainly abroad, it was done without any assessment of the financial capability of the state to come to the banks' assistance and without information being available on the cost of a possible financial shock.

■ The consultative group of the Prime Minister's Office, the Ministry of Finance, the Ministry of Business Affairs, the FME and the CBI on financial stability and contingency planning was established by a written agreement on 21 February 2006. The group was a platform for exchange of information and dialogue. Its role should be consultative and it would not make decisions on measures. In the agreement establishing the consultative group, composing a joint contingency plan for the government was not specified as one if its tasks. However it seems clear that both the CBI and the FME looked to the consultative group concerning initiative towards a joint contingency plan and coordinated actions, not least when it came to actions which demanded political policy. Thus it seems that the consultative group had in fact gained more value as regards to a plan of action than the terms of the agreement from 21 February 2006 stated. At least it is clear that nowhere else in the administrative body the work of composing a joint contingency plan was being carried out The uncertainty regarding the powers and responsibilities of the consultative group seems to have lead to lack of clarity, as to who was in charge, who coordinated and was responsible for contingency preparations on behalf of the Icelandic state in the event of a financial shock. In statements by ministers and representatives of the governmental institutions before the SIC, each pointed a finger at the other concerning positive obligation and no one assumed responsibility.

■ Proposals and documents regarding the necessity of a contingency plan which were introduced to the consultative group by individual institutions, neither received formal resolution there, nor by ministers with representatives in the group. Therefore it seems that the group was considerably lacking in targeted administration, both by the group itself and the ministers. In this context the SIC especially wishes to mention that when the banks collapsed there was no joint governmental contingency plan available. At that point, it was sorely needed.

■ The consultative group does not seem to have been successful either in synchronising its actions regarding projects, which obviously could have come under the authority of several government bodies. At least three ministers, along with two governmental institutions, the CBI and the FME, were involved as regards problems related to the Landsbanki Icesave accounts in its foreign branches. Despite this there have been no indications that the Icelandic authorities did, at that time, synchronise the group's actions and formally request that Landsbanki transfer the Icesave accounts to a subsidiary. There is also no indication that the authorities ever called for a schedule for such a transfer from the bank if the authorities assumed the bank was preparing the transfer. Regardless of Landsbanki's legal authorisation to operate a branch in London, it was clear that progress in the transfer of the Icesave accounts to a subsidiary could be of significant importance when it came to the reaction and actions of the Icelandic authorities over the coming months, e.g. because of the Depositors' and Investors' Guarantee Fund and in relations with foreign regulatory bodies and central banks. At this point, it would at least have been reasonable and in accordance with the principles of good governance for the authorities competent in regard to these matters to request confirmed plans concerning the timing of the transfer of the accounts to a subsidiary. This would also have been part of being able to monitor and follow up on whether the bank's plans were being carried out.

■ The increased aggregation of deposits by the Icelandic banks in their foreign branches resulted in considerable increase of the obligations of the Depositors and Investors Guarantee Fund (TIF). The biggest influence was the introduction of the Icesave accounts which Landsbanki opened in the UK in October 2006. In 2007 the share of foreign parties in deposits rose to over 50%. The development regarding TIF's obligations demanded that the fund's Board of Directors and the government should consider more thoroughly how able it was to meet liabilities that might arise. It was clear that the fund's assets were insufficient to fulfil the liabilities it would have to meet if larger financial institutions became insolvent. Thus, one of the challenges that needed to be addressed in the government's contingency plan was how to fulfil the liabilities the TIF would have to meet in case of a financial shock. Work on this had not been finished when the banks collapsed in October 2008. Among the consequences was the uncertainty that occurred at the time of the collapse, and later regarding the fund's issues on account of deposits in the foreign branches of the Icelandic banks, which were not covered by the Icelandic government's guarantee on deposits in Iceland.

■ During the time leading up to the collapse of the banks there were divergent views within the Icelandic administration on the obligations of the EEA member states, in case a guarantee scheme, established in accordance with de deposit guarantee directive of the EU, could not meet its payment obligations. Despite this, the Icelandic authorities did not conduct an enquiry into the available legal sources for the interpretation of such obligations. The examination by the Investigation Commission does not indicate that contemporary sources on this issue provide definitive answers to the aforementioned matters. Nevertheless, it was important that such an enquiry be conducted, at the latest following queries by foreign governments in July-August of 2008 about whether the Icelandic state would guarantee the Icelandic Guarantee Fund's ability to pay, if its payment obligation would become operative. These were significant financial interests. Therefore, it was important that ministers, and others within the administration involved in decision making and communicating with foreign governments on the matter, had the means to obtain a clear picture of the legal issues put to the test in this context, and thus able to considered them in their decisions and their replies to questions and demands by foreign governments.

■ On 15 April 2008 Mr. David Oddsson sent a formal request for a currency swap agreement to the Bank of England. Mervyn King, Governor of the Bank of England, replied to Mr. Oddsson's letter on 23 April and rejected the request by the CBI. However, he declared that foreign central banks could help Iceland find an effective way to reduce the size of its banking system. In his opinion, this was the only practical solution to the problem. In closing, King said that he offered all the help he could provide to tackle the issue at hand. The CBI did not accept this offer. Instead, a reply was sent to the Bank of England, kindly asking it to revise its position regarding the said swap agreement. There was no reply to that letter.

After the G10 Summit of central bank governors in Basel on 4 May 2008, it became clear that neither a currency swap agreement with the Bank of England nor with other central banks, with the exception of the Danish, Norwegian and Swedish ones, was on offer to the CBI. In a letter to the Investigation Commission, Stefan Ingves, Governor of the Central Bank of Sweden, makes it clear that unclear ownership, along with the banks' rapid balance sheet growth had led to a dangerous situation and that the Icelandic government did neither seem to fully grasp nor understand how to deal with it.

■ In the spring of 2008, only the Danish, Norwegian and Swedish central banks were willing to enter into currency swap agreements with the CBI, though not without insistence. As a precondition for such agreements, they insisted that the prime minister pledged to put pressure on the Icelandic banks to reduce the size of their balance sheets, in view of the proposals made by the IMF. The facilities from the Nordic central banks were conditional on the Icelandic government taking action to have the CBI and the FME take certain political measures and actions. The ministers signed the declaration in 15 May 2008, along with the Board of Governors of the CBI. The declaration was not made public, nor was it presented at a government meeting. The aforementioned promises by the government in the summer of 2008 were not kept. That did not improve the reputation of the Icelandic authorities with foreign central banks. At this time, the Icelandic authorities had become very isolated in the international community. Therefore, they had few to turn to when the Icelandic banks collapsed in October 2008.

■ In 2008, Glitnir had difficulties in funding itself. At the beginning of the year it thought of issuing debt securities in the international financial market but had to renounce because of lukewarm reception by investors. Glitnir, on the other hand, did well in developing the so-called asset-backed debt securities. They were later useful for taking collateralised loans from the European Central Bank. Glitnir's debt securities had large maturity dates in October 2008. Around mid-September 2008, it became definitively clear that the sale of assets by a subsidiary of Glitnir in Norway would not go through. At about that time, the Bayerische Landesbank refused to extend two loans of the bank, at a total of EUR 150 million. Finally, market conditions deteriorated rapidly after the collapse of Lehman Brothers.

■ On 25 September 2008, Mr. Þorsteinn Már Baldvinsson, Chairman of the Board of Glitnir, spoke with the CBI's Board of Governors. There were indications that Glitnir would have difficulties paying back loans due around the middle of October of the same year. Mr. Baldvinsson requested a collateralised loan to the amount of EUR 600 million. After the meeting events developed quickly. A few days later, on Monday 29 September 2008, it was publicly announced that the Icelandic government would supply Glitnir with EUR 600 million in exchange for a 75% share in the bank. The SIC is of the opinion that it must be strongly criticised how the CBI's Board of Governors conducted the examination and processing of Glitnir's request. The Glitnir request was not processed on sufficient grounds. For the same reason, the CBI's Board of Governors did not have the necessary information to be able to estimate in an adequate manner whether the action proposed by the CBI to the government was rational.

■ In the end, the actions proposed to the minister concerning Glitnir on Sunday 28 September 2008, were not credible. First of all, the amount in question was nearly a quarter of the CBI's foreign currency reserves. Secondly, Glitnir had encountered difficulties concerning financing in foreign markets for about a year. At the same time, the bank was aware that liabilities amounting to EUR 1.4 billion would fall due in the coming six months. This was public information. Thirdly, the CBI had not managed to strengthen its foreign currency reserves in any significant manner despite its declarations of intending to do so. To foreign investors and credit-rating agencies it must have seemed evident that the Icelandic state did not have access to financing markets either.

■ The credit rating of Glitnir was lowered on 1 October 2008. Subsequently, the difficulties of the bank increased. On the basis of loan terms contingent on credit rating, the DZ Bank and the Sumitomo Bank made due two loans amounting to a total of EUR 425 million. A credit line for EUR 1 billion with Deutsche Bank was also contingent on credit rating. The reduced value of the collateral used by Glitnir against loans resulted in high margin calls on the bank. The sum total of margin calls on the bank at this time amounted to EUR 1,100 million. Included therein was a EUR 640 million margin call from the European Central Bank. That margin call was received on Friday 3 October 2008. That action was actually postponed temporarily on Sunday 5 October 2008. In October, over EUR 500 million in collateralised loans, acquired by Glitnir from other parties than central banks, had reached their maturity date. After the collapse of Lehman Brothers, the government's takeover of Glitnir and the lowering of Glitnir's credit rating, it was very unlikely that these collateralised loans would be refinanced. It was absolutely impossible for the Icelandic state to meet payments on the aforementioned claims. The government was not able to secure loans in the international finance markets. In the evening of 7 October 2008, the FME decided, on the basis of Emergency Act (Act No. 125/2008), that a special resolution committee take control of Glitnir.

■ After it became clear that the government's measures in the Glitnir affair had been unsuccessful, a certain chaos seems to have ensued as regards contingency planning on behalf of the state. The CBI and the government did not act in harmony and overall leadership was lacking. No decision was taken with regard to what course to take. By summoning a group of specialists on the morning of 4 October 2008, the Prime Minister finally made a decision and a certain course was set for the issue. This was the third group in a short period of time tasked with contingency preparations. The government consultative group had discussed contingency plans between 21 February 2006 and 3 October 2008. A group summoned by the CBI worked on contingency planning between 30 September and 3 October 2008. The new group of experts on behalf of the Prime Minister worked on contingency plans from 4 October 2008. In the beginning, this group was not given access to all the material from the other two groups. As an example of how scant the preparations were for this work, the first task of the group was to print out the annual accounts of the large financial corporations from the office of one member of the group at the University of Reykjavík. The aforementioned procedures by the authorities with regard to contingency plans for protecting the financial system of the country, and other fundamental interests of state and the nation, were unacceptable. These methods were not in keeping with the manner in which nations with developed financial markets and administration operate in general.

■ Broadly speaking, when it came to drafting the so-called Emergency Act, i.e. Act No. 125/2008, the only thing emerging from the work of the consultative group of the Icelandic authorities that proved demonstrably useful was the draft provision which became Article 100a of Act No. 161/2002 on Financial Undertakings. Other provisions of the Emergency Act were mostly drafted on 4-6 October 2008 under enormous time constraints. Many of those provisions were extremely complex and wide-ranging in scope. Those who drew them up were not assisted by experts in fields bound to feature extensively in the formulation of the bill, e.g. in the field of insolvency law. The Emergency Act was adopted by Althingi late on 6 October 2008.

■ Work on state contingency preparations was far from being organised and thorough. However, it should be noted that the SIC does not find it possible to claim that the Icelandic banks could have been saved from collapse even if work on contingency preparations during 2008 had been more thorough. Such actions should have been launched much earlier. On the other hand, thorough preparations would have contributed to greatly lessening the damage caused by the collapse of the banks. The Icelandic government would then also have been able to formulate policies sooner on many of the issues that needed to be decided upon, and would thus have been better equipped to react and reply to questions from foreign governments on urgent issues, i.e. in particular the UK and Dutch authorities in late summer 2008.

■ After the proposed nationalisation of a 75% share of Glitnir was announced, significant outflows of deposits started at Landsbanki and Kaupthing Bank. The banks also had to contend with margin calls. The European Central Bank issued a EUR 400 million margin call to Landsbanki on Friday 3 October 2008. On the evening of Sunday 5 October 2008, the ECB withdrew the margin call shortly before the bank was supposed to open on Monday 6 October 2008. That day, the CEOs of Landsbanki wrote a letter to the CBI disclosing that a significant outflow had taken place from the Icesave accounts in London over the previous weekend. The outflow was said to total GBP 318 million. For this reason, the FSA had demanded that Landsbanki transfer GBP 200 million in cash to the UK in addition to providing GBP 53 million to the bank's subsidiary. Landsbanki requested a loan from the CBI to the amount of EUR 500 million. As collateral, the bank offered a selection of debt securities to the amount of EUR 2.8 billion. The CBI turned down the request. The bank did not believe it had sufficient funds, since a large part of the bank's foreign currency reserves had been loaned to Kaupthing Bank. In the evening of 6 October 2008, the London branch of Landsbanki was closed down. The following day a special resolution committee assumed control of the bank in accordance with a decision by the FME on the basis of the Emergency Act.

■ On 3 October, 2008, the FSA demanded that Kaupthing Bank would transfer GBP 1,600 million to Kaupthing Singer & Friedlander (KSF) before the closing of business on Monday 6 October, as KSF had violated rules on liquidity in Britain. The above-mentioned amount was broken down, on the one hand, into GBP 1,100 million because of deposits with Kaupthing Bank, and, on the other hand, GBP 500 million because of margin calls by KSF to

Kaupthing Bank. In the following days, Kaupthing Bank sold assets in order to raise funds. On 6 October, the bank obtained, inter alia, a loan of EUR 500 million from the CBI against collateral in the Danish bank FIH. On the morning of 8 October, the FSA demanded that a total of GBP 300 million be transferred to KSF in London. Kaupthing Bank did not make this payment. On the basis of a special legal authorisation, the UK Treasury decided to transfer the deposits in the KSF Edge Accounts to the Dutch bank ING Direct N.V. The transfer took place at 10:00 a.m. on 8 October 2008. Later that same day, KSF was placed under cessation of payments. This led to the parent company Kaupthing Bank hf. being put into moratorium. On the eve of 9 October 2008, a special resolution committee took control of the bank in accordance with a decision by the FME on the basis of the Emergency Act.

■ Shortly after the collapse of the banks in November 2008, an appraisal was carried out of the value of their assets. The results of the asset valuation showed 40% of the booked value at the time when the banks collapsed. The difference amounts to over ISK 7,000 billion.

■ The FME was not well enough equipped to sufficiently monitor the financial institutions when they collapsed in the autumn of 2008. Considering the operating expenses of the FME and its budget up to 2006, it is clear that the growth of the Authority did not keep pace with the rapid growth of the Icelandic financial system, more complicated ownership links within the financial market, and increased activity of regulated entities abroad, and it was not consistent with the growing and increasingly complicated tasks entrusted to it pursuant to law during the preceding years. The FME's tasks demand vast expert knowledge on the operations of banks, economics, accounting, and legislation on financial markets. It is clear, that the increase in the FME's budgetary resources came about too late for it to be able to keep pace with the developments in the operations of the financial institutions, and to carry out its statutory supervisory tasks.

■ However, not all of the FME's difficulties can be attributed to insufficient financial appropriations. Thus, the FME did not sufficiently concern itself with some basic questions, such as the size of the banking system, and the Authority's necessary reactions in regard to its much too rapid growth.

■ Part of the FME's difficulties was also wrong prioritisation. Although the FME has been in the process of improving and structuring its IT systems since 2006, much greater emphasis should have been placed on installing advanced IT systems. Continuous financial monitoring is carried out by collecting data from regulated entities, data processing, and expert evaluation of the collected data. Such monitoring can not be fully utilised unless the Authority has at its disposal both advanced IT systems and experts to process the data. The FME severely lacked the technical expertise and the equipment necessary to produce high quality comprehensive surveys of the position and development of individual financial institutions from its databases. Therefore, the Authority did not really have the necessary overview of the activities of the financial institutions which was so urgently needed. The difficulties the FME was faced with in processing data from its systems undoubtedly greatly reduced its ability to carry out its duties in monitoring and keeping in check the financial institutions which collapsed in the autumn of 2008.

■ In its supervisory duties the FME was lacking in firmness and assertiveness, as regards the resolution of and the follow-up of cases. The Authority did not sufficiently ensure that formal procedures were followed in cases where it had been discovered that regulated entities did not comply with the laws and regulations applicable to their operations. According to the clear instructions of Article 10(1) of Act No. 87/1998 on Official Supervision of Financial Activities, the FME shall demand that a remedy is made within a reasonable time. If a regulated entity does not comply within the allotted time limit, the FME can respond, among other things, through coercive instruments. There are examples of cases of this kind where the only action taken, in response to a violation of law, was the submission of written comments to the relevant financial corporation, without putting the matter through proper legal channels as well. Such shortcomings in the way in which the FME conducted its operations with regard to the financial corporations, meant that insufficient force was applied to ensure that the financial corporations would comply with the law in a targeted and predictable manner commensurate with the budget of the FME.

■ Nor did the auditors perform their duties adequately when auditing the financial statements of the financial corporations for 2007 and the semi-annual statements for 2008. This is true in particular of their investigation and assessment of the value of loans to the corporations' biggest clients, the treatment of staff-owned shares, and the facilities the financial corporations provided for the purpose of buying their own shares. With regard to this, it should be pointed out that at the time in question matters had evolved in such a way that there was particular reason to pay attention to these factors.

■ The powerlessness of the government and the authorities, when it came to reducing the size of the financial system in time before a financial shock hit, is evident when looking at the history related in Chapters 19 and 20. In this context, it should be kept in mind that when a bank provides a company with a low loan, the bank is in a position to set the terms that shall apply if the company defaults on payments. On the other hand, if a bank provides a company with such a high loan that the bank may anticipate substantial losses if the company defaults on payments, it is in effect the company that has established such a grip on the bank that it can have an abnormal impact on the progress of its transactions with the bank. It is also clear that when the size of the financial system of a country is, for instance, threefold its gross domestic product, the competent authorities of the country have, in general, the potential to set rules for the financial system to comply with and to ensure compliance with such rules. However, when the size of the financial system of a country is nine times its gross domestic product the roles are reversed. This was the case in Iceland. It appears that both the parliament and the government lacked both the power and the courage to set reasonable limits to the financial system. All the energy seems to have been directed at keeping the financial system going. It had grown so large, that it was impossible to risk that even one part of it would collapse.

■ In replies made by administrators of governmental institutions who reported to the SIC, the statement was frequently encountered that it did not fall under the functional area of the person concerned, or his institution, to address or take responsibility for the project in question. It was also repeatedly stated, that other institutions or officials were responsible for such issues or tasks. Based on these answers, it may be assumed that the representatives and administrators of those governmental institutions, that had the role of monitoring operations in the financial markets and the effects of those operations on state economics were, in various cases, unaware of who was meant to carry out and take responsibility for certain aspects of these affairs in the government's daily activities. It is imperative to look carefully to how the obligations of individual institutions and officials may be better defined and delineated, in this respect.

■ The SIC's assessment, pursuant to Article 1(1) of Act no. 142/2008, was mainly aimed at the activities of public bodies and those who might be responsible for mistakes or negligence within the meaning of those terms, as defined in the Act. Although the SIC was entrusted with investigating whether weaknesses in the operations of the banks and their policies had played a part in their collapse, the Commission was not expected to address possible criminal conduct of the directors of the banks in their operations. On the basis of events and viewpoints that are described in more detail in individual chapters of this report, the SIC is of the opinion that Mr. Geir H. Haarde, then Prime Minister, Mr. Árni M. Mathiesen, then Minister of Finance, and Mr. Björgvin G. Sigurðsson, then Minister of Business Affairs, showed negligence, within the meaning of Article 1(1) of Act No 142/2008, 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 is also of the opinion that Mr. Jónas Fr. Jónsson, then Director General of the FME, and Mr. Davíð Oddsson, Mr. Eiríkur Guðnason and Mr. Ingimundur Friðriksson, then Governors of the CBI, showed negligence, within the meaning of Article 1(1) of Act No 142/2008, in the course of particular work during the administration of laws and rules on financial activities, and monitoring thereof. The Commission's conclusions regarding this subject are more closely described in Chapter 21. Apart from instances and situations, which the SIC considers to constitute negligence in this sense, its more detailed criticisms and rebukes regarding the government's efforts during the time leading up to the collapse of the banks, may be found in the conclusions at the end of individual chapters.