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A tale of wilful malfeasance 2003–2008 – followed by recovery and resurrection in Iceland

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Abstract: The collapse of the Icelandic financial system in October 2008, was unprecedented in both scale and scope, 97% of the financial system collapsed, inflation was rampant, the currency disintegrated, and unemployment was both a social and political issue. This paper endeavours to show, using documentary evidence from 2003–2008, whether the system of monitoring of the banks and economy failed – applying evidence of institutional ascription. The contribution of the paper is to document that both institutional ascriptions, along with corruption and greed, were endemic from 2003–2008. The resurrection and recovery followed a transparent process, based upon objectives of wealth equality along with fairness – inclusive capitalism, to address what went wrong, address the overhang of debt and the rebuild of trust in all institutions, including government itself.

Keywords: institutional ascription; inclusive capitalism; corruption; malfeasance; financial system collapse.

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1 Introduction and preamble

The rapid growth of the three major Icelandic banks from their privatisation in 2003 until complete failure in October 2008, has been documented, (e.g., Baldursson and Portes 2013; Benediktsdottir et al., 2017; Bergmann, 2014; Buiter and Sibert, 2011; Johnsen, 2014; Ingimundarson et al., 2016; Jonsson and Sigurgeirsson, 2016), but what is not totally clear to these observers, in most instances, is that failure was inevitable. We suggest that a strong parallel exists between the failure of Parmalat in 2003 as documented by Gabbioneta et al. (2013, p.485) and the description that they make in the following way,

> "Our study shows how institutional processes open opportunity structures for sustained concealment. Organizational conformity with prevailing expectations of appropriate corporate behaviour leads to endorsement by field-level actors, which can enable and discourage organizations to slip into illegality. Having done so, organizations take advantage of regulatory loopholes to conceal those behaviours. But more interestingly, we show how processes of 'institutional ascription' dull the vigilance of audit firms, analysts and rating agencies that supposedly construct independent, objective, true and fair accountants of corporate affairs."

Their study examined legal case transcripts, largely, wwhereas our paper employed multiple sources including government and agency documents, legal cases, interviews, articles, and reports. It is using this framework – institutional ascription that we approached our study, but only partially, rather the issue of corruption as advanced by Plato, centuries ago also hold sway – the systemic collapse of moral capacity and an inability (until after 2010) to restore justice for the common good (Plato, 1987).[1]

The paper outlines the fraud and malfeasance that took place between privatisation and failure outlining the roles played by the regulatory systems in place. It also highlights not just the fraud that took place but the importance of collusion between the competing banks, the looting of the banks by their owners, the widespread use of 'love notes' between the banks to secure loans from the Central Bank of Iceland (CBI) [in Iceland Krona (ISK)], the European Central Bank (ECB) and the Central Bank of Luxembourg (CBL) (both in euros). In addition, the Iceland Business Vikings liberally employed complex and obscure ownership structures (Johnsen, 2014; Mixa et al., 2016). The use of interlocked and related enterprises (mostly offshore) meant that although technically they were not regarded as 'related party loans', the extent of which was only partially revealed by the Special Investigation Commission reporting to Parliament in 2010. Such complex organisational structures were facilitated both by international accounting, and international legal firms. We suggest in the paper, again something that few others have detailed, is the widespread corruption, not only in a strict legal sense, where laws were broken, as they were in Iceland. But more importantly a moral compass was broken, consistent with Plato, and as outlined by Sigmundsdottir (2013), sort of 'they are us and we are them'. Therefore, we extend the weak business culture as advanced by Vaiman et al. (2011) that as Iceland had been relatively a closed society, the unfettering of regulation, without strong and well-established regulatory processes in place meant that market controls were non-existent and certain inevitability of collapse. Again, the parallels to Parmalat in Italy are powerful, from their 2003 failure to a systemic collapse in Iceland just five years later.

The question that could be asked is why is Iceland relevant not just to the Global Financial Crisis? We suggest that the implications and explanations to what happened both before the crisis and afterwards have lessons and parallels beyond Iceland. Mele et al. (2017) set out their thoughts, echoing and extending the thoughts of the managing firector of the IMF, "Recently (…) capitalism has been characterized by 'excess' – in risk taking, leverage opacity, complexity and compensation … [inclusive capitalism] the attributes of which are 'trust, opportunity, rewards for all within a market economy – allowing everyone's talent to flourish'"; "We could add that such 'excess' erodes both the common good and connected with this public trust." Mele et al. (2017) were addressing the Global Financial Crisis in their editorial, but what stands out in Iceland is that not only did the elite go along with the excess but so too did the masses. Therefore, this paper is not just a revisiting of the causes of system failure in Iceland, but the lengths taken to rebuild public trust, over some eight years.

2 Methodological approach

The research methodology is cross-disciplinary. Primary source material was an examination of Annual Reports of the CBI from 2000–2012, Annual Reports of the Financial Supervisory Authority of Iceland (2001–2007), Annual Reports of Glitnir, Kaupthing, and Landsbanki (2000–2007), Report of the Special Investigation Commission to the Althingi (2010), Reports Commissioned by the Iceland Chamber of Commerce after the Geyser Crisis of 2006, Mischkin and Herbertsson (2011) and Portes et al. (2007), IMF Reports on financial stability both prior and after the crash – 2001, 2003, and 2011, Jännäri (2009), Icelandic Supreme Court, along with Gunnarsson and Stefánsson (2020) – that documented the corruption and fraud cases against Icelandic bankers subsequent to 2008, and Baudino et al. (2020). Such sources were supplemented by interviews with several executives (10) of one of the banks reflecting on their experiences pre- and post-crisis, a researcher from the SIC, along with a former chair of the Financial Supervisory Authority. Secondary sources are the various accounts from academics (including a member of the SIC), and other published materials.

Materials since 2008 were gathered from legislation initiatives along with IMF Reports and the EFTA court case on Icesave (the internet savings account of Landsbanki and subject to litigation between Iceland versus the governments of the Netherlands and the UK) (Mendez-Pinedo, 2017), along with the Bergmann (2014), Benediktsdottir et al. (2017) and Nichols and Gylfason (2018). Noteworthy is that the material is also described by Oygard (2020) where he employs personal knowledge in his capacity as temporary CBI governor after the crash, as well as extensive interviews that he conducted with key players involved. The actions of the Supreme Court of Iceland are also important in their role in rebuilding trust by the citizens as all successful prosecutions of wrong doers were approved by that court. Interestingly, although the SIC, correctly is highly critical of the actions taken by the Icelandic Business Vikings who earlier were hailed as heroes by Icelanders none were not prosecuted. After the crash the Icelandic Business Vikings, but notably the bankers and the banks themselves, were widely excoriated by their fellow citizens, and some bankers moved offshore until their court appearances (Loftsdottir, 2015).

3 The regulatory regime in Iceland 2003–2008

3.1 Financial Supervisory Authority

Figure 1 outlines the key elements of the regulatory regime in Iceland 2003–2008. The Financial Supervisory Authority [Fjármálaeftirlitið (FME)] was the primary regulator of all financial institutions in Iceland from 2000–2008. Their mandate was quite extensive covering: banks (the three large banks operated locally and internationally as both commercial, investment banks, and asset managers), savings and loan institutions (24), private pension funds (49), insurance companies, asset managers, securities firms and brokerage firms, and their mandate was both licensing and regulation. What is amazing in hindsight is the lack of resources for most of this growth period 2003–2008, staff count at the FSA in 2005 was in the low thirties, few IT specialists, lawyers (8) business people (14), and as Oygard (2020) and Benediktsdottir et al. (2017), was characterised by a lack of on-site visits and just more importantly a lack of prosecutory zeal, e.g., Oygard states, "If you don't investigate, you ask for a chaos of criminality, it isn't just the cases that brought forward matter." The former chief economist of the CBI stated it even more strongly in his appearance before the SIC, "I think there is fundamental misunderstanding of what financial supervision is all about in Iceland, …, they thought the role of these institutions was to follow up on whether the letter of the law was met by those under supervision. So long as you are watching the entire financial system falling off a cliff, and you follow the law you're fine" [Report of the Special Investigation Commission to the Althingi, (2010), p.186].

The conclusions of the CBI chief economist were echoed by Bergmann (2014), "Unlike the supervision authorities in many European countries, who understood their function as to holistically monitor the financial system in both practical and legal terms, the FSA followed an ultra-legalistic approach, claiming it had no authority to intervene to prevent the collapse and the banks followed the letter of the law." What stands out from the foregoing is that either the FSA totally misunderstood its role or were negligent –

given that the leadership of the FSA attended regular conferences of regulators, perhaps the latter explanation is more plausible.

Figure 1 Regulatory regime in Iceland 2003–2008

Financial Services Authority
- Under-resourced for rapid growth
- Look at form of the banks (failed to look at the substance of transactions)
- Few, if any, site visits
- Failed to appreciate the risks of international growth

Banks
- Glitnir
- Kaupthing
- Landsbanki

Borrowed heavily to finance growth

Bank owners (Vikings), largest borrowers via complex, web of companies avoiding related party disclosure

Grew rapidly via subsidiaries and acquisitions in Europe through debt financing

- Role of Exista in funding of Kaupthing
- Borrowed via medium-term bonds in Europe and N-America
- Love notes between the banks to secure funding from CBI, CBL and ECB

Central Bank of Iceland
- Focused on inflation only
- As the ISK value grew, inflation reduced, but the country and the economy became a haven for internet-based savings accounts that were unstable
- Money supply quadrupled in four years
- Auditors failed to appreciate the role of related party loans and their risks
- growth

Role of Government
- Two departments supervised the banks, little accountability
- Saw the growth of the banks as a cause of pride

Role of Rating Agencies
- Moody's rated the country risk as Aa3 and Aaa- from 1991-2008 and similarly the Icelandic banks

In 2007, the FSA for the first time seemed to be cognizant of the importance of related party loans and required the auditors of the three banks to review related party loans whether they were consistent with similar transactions with other bank customers. The auditors then sent a report to the FSA on the extent of related party loans. Whether, the auditors did a thorough examination or were negligent is a matter of conjecture. The challenge they faced, really only disclosed and even then not fully disclosed by the Report of the Special Investigation Commission to the Althingi (2010), was their inability to penetrate the corporate veil of the complex organisation structures adopted by the bank owners and their offshore investments. A clue is that the spouse of an owner of Glitnir according to tax records was the largest single dividend recipient in Iceland (so-called pseudo-persons abroad) (Johnsen, 2014).

During the meteoric growth of the banks, through a combination of opening of new international branches and subsidiaries, along with a strong appetite for acquisitions – notably by Kaupthing, the FSA reported in 2005 the following, "The financial market in Iceland has undergone revolutionary changes in two years Icelandic financial undertakings have considerably increased their operations abroad, …, the contribution of financial services exceeds that of the fishing sector." The report goes on to state, "The activities of foreign subsidaries are subject to supervision of the states where they are established." What is interesting is that the EU Passport system was employed but no agreements were in place to ensure accountability of such supervision – partial evidence of institutional ascription as there was no substantial follow-up whether those regulatory authorities abroad are following with diligence as to best practice. Notably as well in the Annual Report of the FSA (2005/2006), is a new strategy premised on the balanced scorecard, but no attention is given to on site investigations or prosecuting wrongdoing – in fact on site investigations decreased in 2005/2006.

Again the parallels to Parmalat with respect to regulators are quite strong as documented by Gabbioneta et al. (2013) where the regulator, Consob, relied on the work of others. However, a further distinction is necessary, the FSA in Iceland experienced a significant staff turnover during this period, commented on as staff moved from the regulator to the banks (Benediktsdottir et al., 2017; Gylfason et al., 2010) on the one way move from regulator to regulatee with accompanying motive not to rock the boat and to ensure a possible sinecure at the banks.

To summarise the FSA was not fit for purpose, too much reliance was placed on outside regulators, understaffed, and more importantly lacking a culture of investigation and prosecutory zeal. In addition, the FSA did not have strong political support (two ministries were responsible) along with government relying on market forces to control the growth of the banks in particular, such that essentially the regulator acted not as a regulator, but rather as a means to describe what was happening in contrast to acting with investigatory and prosecutory zeal.

3.2 Central Bank of Iceland

The CBI, as an independent agency, was charged with a regulatory role for the Icelandic economy. However, the chair of CBI, was a prime initiator of the deregulation in his former role as Prime Minister (in addition, his formal education was in law, not economics or finance). The sole emphasis of the CBI was focused on inflation. The implication of such an emphasis was that as the financial system embraced overseas expansion, inflation was controlled as earnings were made in foreign currencies, essentially strengthening the ISK against other currencies. But no efforts aere made to assess financial stability nor to actively manage the rampant financial system expansion and accompanying growth in the money supply, nor the currency and trade balances (17% of GDP in 2005).

As CBI raised short term interest rates, the effect was to increase the value of the ISK. Unique to Iceland, due in large measure to the fact that mortgages were indexed to inflation, but instead of the inflation adjustment being paid by borrowers, it was added to the principal owing. Borrowers in Iceland were sensitive to long term interest rates but did not adjust their behaviour to short term interest rate adjustments. The Report of the Special Investigation Commission to the Althingi (2010) highlighted the importance of the carry trade and the behaviours of Icelanders due to the mortgage terms were delighted as the ISK rose, yet implicitly CBI was not addressing the financial stability of the country, this was exacerbated when in early 2008 CBI abandoned reserve requirements on deposits in foreign subsidaries and when the crisis of October 2008 arrived the entire system was short of foreign exchange [Bergmann, (2014), p.79]. Johnsen (2014) confirms pseudo persons abroad received US$200 million each year – tracking of such payments could have been accomplished by FSA with the right kind of both will and expertise.

In 2006, the Geyser Crisis, after several analysts, beginning with Fitch in February, “The credit boom in Iceland gives most cause for concern … banks will suffer a deterioration in loan quality." This was followed in March by JP Morgan and Merrill Lynch, the consequence of which was that the cost of credit default swaps doubled between late 2005 and April 2006. The report in March 2006, by Danske Bank (Denmark) was salutary, "The banks funding squeeze will probably force them to reduce lending to domestic players and could force a sell off of external assets."[2] Followed also by two rating agencies – Moody's and Standard and Poor's, who downgraded the ratings for each of the three banks, thereby forcing a new challenge for the banks in raising medium term funds. This issue is discussed in more detail in a succeeding discussion on rating agencies. The banks diversified by issuing bonds in Japan, Canada, Mexico and the USA. The diversification instead of causing the CBI to examine its controls, considered that the risks had been reduced. Concurrently Landsbanki introduced high-yield, internet-based deposits (Icesave), that meant an inflow of foreign currency that also strengthened the ISK against foreign currencies, and reduced inflation. High-yield internet-based savings accounts, edge were also introduced by Kaupthing, soon after Icesave.

Neither the FSA nor the CBI appreciated the risks and implications of the escalating commitment (Jonsson and Sigurgeirsson, 2016; Sleesman et al., 2018). Furthermore, the annual reports of all three banks reduced their loan loss provisions, notwithstanding that their risk exposure had dramatically increased – the portfolio of loans had dramatically altered. The Annual Report of Landsbanki (2006), a significant lender to their owners stated it in this manner, under the heading of strength through adversity, "Due to the perceived risk in the Icelandic economy, market sentiment surrounding the Icelandic commercial banks in the international bond markets deteriorated temporarily [see e.g., Brogi and Lagasio (2019), on ownership structure of banks and its effect on governance]. Landsbanki kept its balance as the waves grew, took steps promptly to address those concerns which were justified and rejected those that were not." Notably though advances to customers grew by 46%, and the commentary on loan loss provisions is optimistic at best, "Management uses estimates based upon historical risk experience for assets with credit risk characteristics to objective evidence of impairment." Yet circumstances had clearly altered, given the rise in rates for CDS, and thus extrapolation from the past may be misguided, notwithstanding 20:20 hindsight, but also recognition – that was ignored, global credit markets had dramatically altered.

Almost simultaneously with the mini-crisis – Geyser Crisis, CBI, along with the ECB and the CBL, became the funders of bonds issued by one bank for unsecured bonds to a second bank. The latter bank then received funds in either ISK or euros from the central banks. The total amount of claims on banks by the CBI collateralised with these love letters was close to 3 billion euros and almost the same amount with the European central banks. It was not until July 2008 that the CBI stopped funding these love notes (Johnsen, 2014; Jonsson and Sigurgeirsson, 2016). In so doing the three commercial banks had essentially taken over the money supply, such that in a few short years it increased by 400%! Not the CBI, whose function was to manage the financial stability.

The implication of the evidence provided is the CBI was at best negligent in its key role of managing/controlling the economy and had become subservient to the banks, in contrast to its protection of the economy. The law outlined a dual responsibility for the CBI, price stability and financial stability. Given the rapid growth of the banks from 2003–2007, and after the Geyser Crisis, the former took almost sole precedence over the latter. What is amazing is that the tools that were available to CBI were not employed: failure to monitor liquid assets of the banks abroad, failure to tighten collateral rules, failure to examine closely the mismatch of assets and liabilities (particularly important as the banks reported upcoming liability commitments but failed to examine the overly optimistic estimates that indicated their ability to meet those commitments), failure to stress test the assumptions by the banks on their notices of funding needs in the short-term and medium-term, and failure to act to manage growth (Baldursson and Portes, 2013). The latter is very important as it was apparent that they either misread their mandate or alternatively were reluctant to act (Report of the Special Investigation Commission to the Althingi, 2010). The implication is that CBI was inadequate in their actions essentially from privatisation until failure. This is notwithstanding that from 2007 regular meetings were held between the ministries, the Prime Minister's Office the FSA and the CBI but actions taken from the sharing of information were quite remiss.

3.3 Role of government

The government prior to joining the EEA had strongly committed to a neoliberal philosophy led in large measure by Oddsson (Prime Minister from 1991–2004) along with a key academic Gissuararsson, who led what has been termed the Locomotive Group (Olafsson, 2016). They invited key leaders of the neoliberalist philosophy to come to Iceland and share their ideas. Moving from essentially a statistic to a neoliberal experiment took at least a decade but the effects were profound – pension reform, liberalising the economy, taxation burdens were shifted to encourage entrepreneurial efforts, selling off public enterprises, that were consistent with Thatcher in the UK, and Reagan in the USA.

Market deregulation as indicated by Loundsbury and Hirsch (2010) assumes that the market can manage itself. Perhaps the country was ill-equipped for the massive changes, but what made the conditions more acute is government became a promoter for the banks, coupled with a lack of clarity of who was actually responsible.

The privatisation of the banks was a case in point. Although there was an independent agency charged with privatisation, the chair of that body resigned in protest about the process. Notably the 'rules' for privatisation were broken to a great extent, such that two of the banks were essentially a creation of the two political parties in government (Aliber and Zoega, 2011; Bergmann, 2014), commented that privatisation was in essence crony capitalism. Furthermore, there existed a dual ministry accountability for the banks, meaning that reliance on others was inevitable and again supports the institutional ascription framework.

3.4 Auditors of the commercial banks

All three banks were audited by local affiliates of large international auditing firms, Glitnir and Landsbanki by PwC and Kaupthing by KPMG. It is not clear whether the auditors appreciated the significance of the love notes, the massive transfer of funds between the banks (Johnsen, 2014), the fact that the owners' equity was borrowed at privatisation, the importance – even prior to 2007 of related party transactions, and the self-dealing in their own shares from initiation (market manipulation). No auditors were sanctioned in any way, although an audit case for negligence with respect to accuracy of year-end financial statements was successfully prosecuted (Supreme Court of Iceland, 2015; Gunnarsson and Stefánsson, 2020).

3.5 Bank owners, largest borrowers

Benediktsdottir et al. (2017) point at the conflict between owners as borrowers, and show the extent of the capture of the banks by their owners, and just as importantly the myriad cross-transfers that occurred between owners and not just their bank but also the other two banks. Coupled with the related party loans, indicated earlier, the lack of accountability, fraud, and misstatement is not just indicative of institutional ascription but aided by the lack of media attention, notable as an owner of Glitnir also owned the largest media outlet apart from the government TV channel. Coupled with the status accorded to these Vikings there was little comment, until after the crash, by academics or others who were negligent (Durrenberger and Palsson, 2015).

3.6 Bank executives prosecuted

Gunnarsson and Stefánsson (2020), outline in their thorough explanation of the cases prosecuted (some cases directly related to 2008) and employing largely EU law to categorise the criminal breaches as, "Insider fraud, market manipulation, and criminal breach of trust." Market manipulation was premised on transactions giving false signals, such as each bank continuously and consistently over many years traded their own shares to provide false signals to the market about share values. Reckless lending such as lending based solely on shares submitted as surety could be classified as criminal breach of trust. Some 36 bankers received a total of 96 years of imprisonment (some were convicted in separate criminal cases). All cases were reviewed by the Supreme Court of Iceland. What should be emphasised is that additional resources were devoted to the investigators, the FSA and to the judicial system to ensure, transparency, fairness of process as cases were dealt with quite quickly, and that instead of finding fault with low level individuals focus was on the key decision makers at each of the banks.

3.7 Icelandic Business Vikings

Loftsdottir (2015) the owners of the banks as they expanded and the bank executives expanded their global reach were initially hailed as heroes, but latter were cast as villains. It seems clear (Benediktsdottir et al., 2017; Johnsen, 2014; Jonsson and Sigurgeirsson, 2016) the banks were systematically looted by their owners. There is not much that is new here [Black (2005) – a former bank regulator explaining the savings and loan crisis in the US, and Marsavelski and Braithwaite (2018)]. All assert that the best way to rob a bank is to own it. Wade and Sigurgeirsdottir (2012) stated the role of the Icelandic Business Vikings in the following manner,

> "Iceland's success, …, was based on a mechanism whereby a small group of financiers backed by the state borrowed colossal sums from international capital markets, bought foreign assets, restructured the assets and redistributed profits back to tiny Iceland booming the economy. The Icelandic elite and masses cheered them on, as much as populations at home in Norway and Denmark had cheered on the old Vikings."

Noteworthy to reemphasise that the initial privatisation of the banks was: restricted to Icelanders only, political favours were strongly in evidence, a bankrupt (who was ineligible to own a bank was able to do so), none of the new owners had banking experience, the executives of the banks were very young and had built relationships in business administration at the University of Iceland, and politicians were largely recipients of what could be termed 'sweetheart loans'.

In essence, the owners were the largest borrowers, they borrowed their equity capital, expanded rapidly internationally (even though some of their investments in hindsight were sound) used the banks for expansion and luxury goods acquisitions.

3.8 Rating agencies

White (2019) suggests that until Enron and the Global Financial Crisis, credit rating agencies (CRAs) such as Fitch's, Moody's and Standard and Poor's, "Were part of the infrastructure of the financial system: part of the ‚plumbing'. They attracted little attention because they appeared to be functioning reasonable well – 'doing their job'." Perhaps until 2006 the CRAs with respect Iceland, notwithstanding the exponential growth of the banks were subject to a mistaken belief, in the event of bank failure the government of the state would bail out the banks and thus sovereign debt ratings and bank debt ratings were almost equal.

The Icelandic government in 2003 had little foreign debt. The banks were essentially local banks that expanded rapidly internationally. The banks rapidly expanded their borrowings in the European bond markets and until the warning signals of the Geyser Crisis of 2006, were rated with a high investment grade by the rating agencies: Moody's, and Fitch and it was only when Oddsson in his role as Governor of CBI met with the analysts in February 2006 that there was a real risk that Iceland would be closed off from European funding due to the increased credit. Borrowing by the banks faced a rise in retail funding and significant premiums required [Johnsen, (2014), p.79].

It was only when the CDSs in 2007, became highly actively traded and the premium was significant, did the full reality become patently obvious to the CRAs. The case could easily be made that the efforts of both the government (criticising Danske Bank in particular as not understanding Iceland) and the efforts of the banks through the offices of the Chamber of Commerce in commissioning two reports – Mischkin and Herbertsson (2011) and Portes et al. (2007) – were successful in allaying some concerns about the Icelandic banking system but only delayed the inevitable. Thus, it was only in 2007 that CDS spreads became intolerable and the banks raised money in international bond markets between February 2006 and mid-2007.

In essence, the foregoing sections on the regulatory regime in Iceland from 2003–2008, was not fit for purpose. Groupthink by regulators, politicians as well as the Icelandic elite and masses were acting as if the party would never cease. In any small country talent is going to be a problem and the pull of the banks to hire former regulators was strong and staff turnover, notably at the FSA, was quite significant. Coupled with a legal not a regulatory mindset by the FSA and the CBI, it meant that the bankers and their owners were left alone. Not only was institutional ascription prevalent so too was an environment of wrongdoing what Plato centuries earlier referred to as a lack of virtue, that largely corrupted the entire nation.

4 Events post 2008–2014

Three successive governments post 2008, realised that institutions needed to be radically changed, external assistance would be necessary, a full and transparent disclosure of what happened would be essential, the legal system would be needed both internally to prosecute those citizens who had acted with wilful malfeasance. In addition, international courts, the European Free Trade Agreement Court, would be required to tackle who ultimately paid the claims of depositors in Landsbanki's internet-deposit scheme – the governments of the Netherlands and the UK (their taxpayers) or the government of Iceland (their taxpayers).

Contrary to popular misconceptions, that state money was not used to address collapse, the state did refinance CBI and provide some equity funding for the new banks. Unlike other jurisdictions, e.g., Germany, UK, and USA, what stands out in the case of Iceland is the myriad efforts by successive governments to relieve the debt overhang by households – reducing principal to no more than 110% of market value, ensuring the banks worked collaboratively with borrowers, allowing withdrawals from pension funds, and substantive efforts to move borrowers away from indexed mortgages – including interest relief, taxation relief and the like.

The emergency legislation was creative in that it enabled not just a restructuring of the banks (including savings banks) but more importantly it created incentives to keep the banks operational. The so-called international banks whose assets went to restructuring committees and the liabilities were mostly acquired by hedge funds at significant discounts. To avoid a currency crisis when the resolution committees had completed their work, and the funds were largely in ISK, capital controls were kept in place for a significant period (Baldursson et al., 2017) but when removed a special exit tax was paid, with not only remunerative benefits to the government of Iceland but to rebuild trust by the citizenry.

The Office of the Special Prosecutor that addressed wrongdoing was setup to ensure that the most responsible were charged and were prosecuted and a key task of the FSA after the crisis was a dual and challenging responsibility. The challenge was to rebuild a new regulatory culture, while simultaneously prepare files for prosecution. Unlike other countries the SIC did thoroughly investigate what went wrong. Their report was followed by setting up the Special Prosecutor and then cases prosecuted, and all prosecutions were approved by the Supreme Court.

It appears that rebuilding of institutions is easier than rebuilding trust. The SIC and the government, and the restructured CBI were willing to accept outside assistance and again provided some enabling of rebuilding of trust. Legislative changes were amended when either circumstances changed or new information regarding efficacy of changes was available.

Figure 2, Financial System in Iceland 2008–2014 outlines the regulatory changes and the restructuring of the banks, that unlike other bank reconstructions was done quite differently. Local deposits were transferred to the new, local banks (Arion, Islandsbanki, and Landsbanki) and domestic loans, after a significant write-off, were transferred to the new banks and even then, due in large measure to currency issues and indexed loans proved unworkable and were written down again, sometimes more than once. In the case of corporate loans, the London Approach was employed to make loans manageable avoiding bankruptcy if the future position of the company was cash flow positive (Bank of England, 1993).

Figure 2 Financial system in Iceland 2008–2014

Financial Services Authority

- New leadership
- New culture
- Investigate for prosecution
- Enhanced capabilities: IT. Regulatory. Enhanced resources
- Clear accountabilities
- Later merged with CBI

Central Bank of Iceland

- New leadership
- An active role. particularly after refinancing by government and the support of IMF and other countries

Office of the Special Prosecutor

- Based on evidence from FME. successful prosecutions of bank executives

Banks

- Nationalization 2008
- (government owned and
- later partly sold)
- Arion (formerly Kaupthing)
- Islandsbank (formerly Glitnir)
- Landsbanki

Local banks only

Role of Government

Government 2009

- IMF
- Restructured the banks
- Householders' Relief

Government 2009 – 2013

- Household Relief
- Repayment of loans
- Corporate restructuring and debt relief through London protocol

Government 2013 – 2014

- Move towards non-indexed loans
- Household Financing Authority restructured

5 Discussion

This research' goal is to examine the set of conditions precedent that characterised the regulatory framework and political conditions in Iceland from the initiation of neoliberal restructuring that were in existence from 1994 until financial collapse in October 2008. We follow this collapse and its immediate aftermath with the many processes and outcomes that Iceland took in the period 2008 until 2014, to formulate new cultures and institutions in a dedicated effort to rebuild trust by its citizens in its institutions, along with reducing the large debt overhang by households and corporations that was a consequence of the exuberance of the early 2000's. Perhaps it could even be argued, although only partially, such changes were a move towards a sort of inclusive capitalism, (Lagarde, 2014), even though Iceland began their journey almost immediately after the crisis of October 2008.

A key part of the history of Iceland is the sagas, stories of: mayhem, rivalries, breaking of trust and the like and in some senses the story of Iceland 2000 to 2008, has elements of the sagas. The country became driven by greed and the feeling was sustained because both the elites and the masses supported the exuberance of the Iceland Business Vikings as they acquired Europe. Enhanced living standards for most Icelanders, the banks sustained growth abroad through a combination of leverage, lack of transparent reporting and malfeasance. Were the bankers the only responsible individuals in this story of excess? The paper indicates that was not the case, but they were adjudged guilty.

Senior bankers were correctly adjudged as guilty because they were enablers, through EU legislation, and Icelandic criminal law; of market manipulation; insider dealing; and criminal breach of trust. The facts were shown to the people of Iceland by the SIC in 2010, and thus justice needed to be meted out to those responsible. But as the paper notes it was not just the Iceland Business Vikings as owners of the banks who looted the banks that were responsible, but also the regulatory agencies charged with control who failed, and government too facilitated the exuberance.

What is remarkable is that after the crash of October 2008, the government, driven by the citizens of Iceland needed radical action to restore trust. This was accomplished even though some of the actions initially taken were not quite radical enough and was adjusted as new information became available, but it took until 2014 before all the initiatives really came to an end. A new constitution was written by citizens and enacted by parliament to rebuild that trust.

The lessons of Iceland are important because it was part of the Global Financial Crisis, but its circumstances were both broader and deeper than elsewhere. The effects on the smallest currency system of the world, had spin off effects due to leveraging of loans in ISK, linked to foreign currencies and the inflationary effects were dramatic. It is for this reason that radical change was not only necessary but in a small country, without the direct regulatory strictures of say Ireland with the EU, could be affected quite easily. An important lesson is that the welfare state, was preserved and enhanced and became, along with capital controls, new tool kits employed by the IMF.

The contribution of the paper demonstrates the wilful malfeasance from bank privatisation until collapse and then how political leadership took a strong stance to quickly rebuild institutions, understand what happened and based upon evidence prosecute wrongdoing and address the concerns of all citizens by ensuring that debt overhang was manageable. The malfeasance is consistent with a combination of institutional ascription and greed, the rebuilding is driven by attempts to rebuild trust and is consistent with a combination of sound public policy and inclusive capitalism.

6 Future research

The theme of inclusive capitalism was brought to public attention in a conference in London 2014. The objective was to encourage efforts to increase the social and economic benefits of all areas of economic activity. But what has happened since that conference has been increases in wealth and income inequality. The question that underlies the paper is the Nordic countries, and notably Iceland providing frameworks and tools to address that inequality, and can their lessons be adopted outside the Nordic area?

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Notes

1 As shown in the translation by Lee [Plato, (1987), pp.421–422].

2 Paradoxically the banks increased their lending, largely to their owners, as such borrowers had credit reduced abroad, and the banks doubled down, by refinancing them in ISK, essentially increasing financial as well as customer risk, with security issued based on their shares (Report of the Special Investigation Commission to the Althingi, 2010). It is for this reason that Baldursson and Portes (2013) refer to gambling for resurrection, but the gambling began at privatisation.