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Framework for Financial Stability in Iceland

Recommendations of the Group of Three to the Minister of Industries and Innovation and the Minister of Finance and Economic Affairs

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Gavin Bingham · Jón Sigurðsson · Kaarlo Jännäri

to the Minister of Industries and Innovation
and the Minister of Finance
and Economic Affairs

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Recommendations of the Group of Three – Gavin Bingham, Jón Sigurðsson and Kaarlo Jännäri – to the Minister of Industries and Innovation and the Minister of Finance and Economic Affairs

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Acronyms and abbreviations

BIS: Bank of International Settlements
CAD: Capital Adequacy Ratio
CBI: Central Bank of Iceland
CEO: Chief Executive Officer
CRD: Capital Requirements Directive
CRR: Capital Requirements Regulation
DG: Director General
ECB: European Central Bank
EEA: European Economic Area
ESRB: European Systemic Risk Board
EU: European Union
FFSA: Finnish Financial Supervisory Authority
FME: The Financial Supervisory Authority, (Icel. Fjármálaeftirlitið)
FSB: Financial Stability Board
FSC: Financial Stability Council
FSIFS: Future Structure of the Icelandic Financial System, Report of the Minister of Economic Affairs to Althingi, March 2012
FX: Foreign exchange
G3: Group of Three
GDP: Gross domestic product
HFF: Housing Financing Fund, (Icel. Íbúðalánasjóður)
ISK: Icelandic Krona
IT: Information technology
MFE: Ministry of Finance and Economic Affairs
MII: Ministry of Industries and Innovation
MPC: Monetary Policy Committee
NIB: Nordic Investment Bank
NCR: National credit registry
RAS: Risk Assessment System
ROA: Return on assets
ROE: Return on equity
SIC: Special Investigation Commission of Althingi, Iceland's parliament
SME: Small and medium enterprises
TBTF: Too big to fail
TOC: Technical and Operational Committee

Key Recommendations

After a thorough examination of conditions in Iceland and international experience, and after extensive consultations encompassing a wide spectrum of interests, the Group proposes:

a) Establishing an overarching statutory framework for the financial system by enacting financial stability framework legislation (a Systemic Stability Act) to enhance and preserve the stability of an efficient and effective financial system for Iceland as a public good.
b) Creating the necessary institutional framework for the 'third pillar of macro-economic policy' by establishing a Financial Stability Council (FSC) and providing a common platform for the operations of the central bank (CBI) and the financial supervisory authority (FME), with the aim of bringing them within three years under the roof of a single institution that will serve as Iceland's integrated monetary and financial stability authority.
c) Bringing all financial sector legislation as well as the CBI and the FME under a single ministry in order to strengthen governance of this important policy area and to clarify the lines of accountability and responsibility for financial stability.
d) Addressing the structural problems of concentration, complexity, lax competition and distorted incentives in the Icelandic financial system by:
    - making all financial undertakings subject to a common core set of rules for comparable activities;
    - correcting distortions that lead to excessive leverage and divert the focus of financial institutions from intermediation of finance between ultimate borrowers and savers and provision of financial services to households and companies;
    - replacing the blanket state guarantee of deposits in Icelandic banks, in force since October 2008, with a deposit guarantee scheme in line with the forthcoming EU/EEA directive and giving permanent priority to covered deposits in resolution;
    - requiring that all financial undertakings be structured and operated so that they can be wound down easily, quickly and without causing contagion or triggering a crisis;
    - making different critical functions such as investment banking and commercial banking separable in resolution, and consider requiring legal separation of certain particularly risky financial activities from deposit-taking operations of banks if such activities amount to a significant share of a bank's business;
    - using regulatory powers and control rights that arise from public ownership to address distorted incentives, for example, by requiring variable compensation of key staff and management to be paid in the form of non-voting equity or non-negotiable junior subordinated instruments;
    - placing the relevant parts of the temporary emergency legislation of 2008 on a permanent footing in a manner which gives the FME the

power to resolve any financial undertaking in a manner that assures the continued performance of critical functions and the stability of the financial system;
- encouraging foreign ownership/entry in the financial market, subject to conditions that underpin financial stability.

The executive summary provides greater detail on the Group's key recommendations. The analysis underlying them is contained in the report.

Preface

On 23 March 2012 the Minister of Economic Affairs, Steingrímur J. Sigfússon, appointed the authors of this report, Gavin Bingham, Partner, the Systemic Policy Partnership and former Secretary General of the Central Bank Governance Forum of the Bank for International Settlements (BIS) in Basel, Jón Sigurðsson, former President and CEO of the Nordic Investment Bank (NIB) in Helsinki, and Kaarlo Jännäri, former Director General of the Finnish Financial Supervisory Authority, to form a working group (Group of Three, G3 or Group) to prepare proposals for a comprehensive legal and regulatory framework for Iceland's financial system. The background to this appointment was that Sigfússon's predecessor as Minister of Economic Affairs, Árni Páll Árnason, had taken the initiative in the autumn of 2011 of having a comprehensive report prepared on the financial system and its future development, to be submitted to the Icelandic parliament, *Althingi*. The purpose of this report was to enable informed discussion within and outside Parliament on the prospects for the financial system against the background of the ongoing financial crisis that has revealed various flaws and deficiencies in it. The Minister's report, *Future Structure of the Icelandic Financial System (FSIFS)*, was published on 23 March 2012.[1] A subsequent process of consultation on the Minister´s report, with a wide spectrum of interested parties, was undertaken. The consultation responses have been available to the Group and have been of great help in its work.[2] In its terms of reference the G3 is requested to consider carefully the FSIFS report and opinions and comments expressed in subsequent parliamentary discussion of it and in an extensive consultation process involving stakeholders and academia. Based upon this and other relevant domestic and international information – the G3 is expected to:

1. Examine the changes made to the regulatory framework and supervisory practices for the financial market in Iceland in response to the financial collapse of 2008.
2. Analyze remaining weaknesses in the regulatory framework of the financial and related markets, supervisory practices and implementation and make proposals on improvements.
3. Propose changes, based on relevant research and assessment of the relevance of alternative arrangements, for an improved distribution of functions between participants in the financial market and the strengthening of the institutional structure of financial supervision at both the micro-prudential and macro-prudential levels.
4. Present proposals on how best to organize a comprehensive and consistent regulatory framework for the financial market as a whole.

The G3 is requested to make proposals on the general orientation of desirable changes

[1] Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs) (2012), Future Structure of the Icelandic Financial System.

[2] The consultation responses can be found on the website http://www.althingi.is/dba-bin/erindi.pl?ltg=140&mnr=778

in the legal framework for the financial system and in particular concerning the responsibilities of the Central Bank of Iceland (CBI) and the Financial Supervisory Authority of Iceland (FME).

This report addresses the above issues with particular emphasis on the importance of:

- Financial stability, establishing an overarching statutory framework for the financial system and a systemic stability policy framework.
- Addressing concentration, oligopoly and competition issues in the financial sector.
- Addressing asymmetry of gains and losses in the financial system and the 'too-big-to-fail' (TBTF) syndrome.
- Correcting distorted incentives that lead to excessive leveraging and risk taking.
- Clarifying the respective roles and responsibilities of the CBI and the FME.
- Enacting a permanent resolution, recovery and crisis management regime.
- Ensuring good corporate governance and clear lines of accountability.
- Simplifying the financial system and its regulation and supervision.

The Group has benefitted greatly from discussions with government ministers, members of parliament, the Governor of the CBI and the Director General of the FME and the staff of these institutions, as well as with members of the financial community in Reykjavik, and from the many useful comments expressed in the consultation process referred to above.

In our work we were ably assisted by members of the staff of the Ministry of Economic Affairs and the Ministry of Industries and Innovation, in particular by Kjartan Gunnarsson, Deputy Permanent Secretary. We are grateful for their contribution.

The Group had the opportunity to meet with the Governor of the Bank of Finland, the Chairman of the Board and the Director General of the Finnish Financial Supervisory Authority and her Deputy in the course of preparing its report, which was of great value for its work. The report of Sir Andrew Large of May 2012 on financial stability and systemic oversight prepared for the Central Bank of Iceland provided valuable input for the Group's work.

We hope this report will form a useful basis for the deliberations of the Icelandic authorities on how to proceed to improve Iceland's financial system and prepare it for future challenges.

Gavin Bingham • Jón Sigurðsson • Kaarlo Jännäri

1

Executive Summary

The weaknesses in Iceland's regulatory system that need to be addressed are essentially of three kinds: First, supervision of the financial system as a whole (systemic or 'macroprudential' supervision) is inadequate. Second, insufficient attention is paid to the pervasive conflicts of interest and distorted incentives in the financial sector that are rooted in asymmetry of information and asymmetry of gains and losses, with gains being privatised but losses socialised. Third, Icelandic financial undertakings are not regulated in a manner that would facilitate the resolution of ailing or failing firms or the elimination of the types of behaviour that caused the crisis.

To address these weaknesses, we propose the following reforms that rest on the conviction that greater simplicity in Iceland's financial system and in its regulatory architecture will foster stability and efficiency:

I. *Overarching framework*

Establish an overarching statutory framework for the financial system by:

- Enacting financial stability framework legislation (Systemic Stability Act) to enhance and preserve the stability of an efficient and effective financial system for Iceland as a public good of major significance for the economy and society as a whole.
- Structuring and regulating the financial system so profitable business is based on controlled risk-taking and long-term business relationships aimed at serving the needs of the Icelandic economy.
- Making all financial undertakings subject to a common core set of rules for comparable activities.
- Making all providers of publicly offered financial services subject to financial licensing.

II. *New Regulatory Architecture*

Create a Financial Stability Council, based in statute, in the proposed financial stability act:

- The FSC would have the overall responsibility for financial stability policy spanning crisis prevention, management and resolution. It would have an explicit mandate to address the structural features that lead to complexity, obscurity and distorted incentives. It would be structured to have political legitimacy as well as impartial and professional analytical and technical capabilities. The FSC would replace the present Committee on Financial Stability of senior officials of the involved Ministries, the CBI and the FME.

Integrate the central bank (CBI) and the supervisory authority (FME) into a single Icelandic monetary and financial authority in a two-stage process.

- The first step is to provide a common platform for the operations of the CBI and FME. This is a matter of urgency and should be undertaken immediately. The common platform should provide for joint information acquisition and data compilation, common data bases, integrated information technology systems and other administrative arrangements.
- The second part involves bringing the CBI and the FME together in a unified monetary and financial stability authority.

Policy preparation, decision making and implementation in the two primary areas of policy responsibility would be separated but subject to common oversight. More stringent and effective governance and more clearly structured accountability to parliament would be needed for the new institution. The second stage should be completed within three years.

III. *Alternative Regulatory Architecture*

Notwithstanding the recent re-allocation of ministerial responsibilities, the Group recommends that financial stability policy, all financial sector legislation and responsibility for the CBI and the FME, and eventually the prospective new monetary and financial stability authority, be brought together in one Ministry to ensure an integrated approach to financial stability policy and to strengthen governance of this important policy area. Because of the current ownership of bank shares by the government, public control rights need to be exercised at arm's length from the political process. Public agencies or companies having such rights should be given an explicit mandate to use them impartially and in the interest of systemic stability, and be subject to rigorous and regular oversight of their performance in this regard.

- The structure of the FSC will depend on whether the other reforms recommended by the Group are implemented.
- If the proposals to create an integrated monetary and financial stability authority and to allocate the responsibility for financial stability to a single ministry are adopted, the FSC should consist of three persons: the Minister responsible for financial stability policy (Chair), the head of the integrated monetary and financial stability authority and an independent external expert. In the event of a financial crisis the Prime Minister would automatically join the FSC and assume the Chair. The integrated monetary and financial stability authority would provide the necessary analytical and technical support both in normal times and in times of crisis.
- In the absence of other institutional reforms, the structure of the FSC would consist of the Minister of Finance and Economic Affairs (as Chair), the Minister of Industries and Innovation (as Vice-Chair), the Governor of the CBI and the Director General of the FME. All four would be *ex officio* members of the Council. There would be no right of substitution. Analytical and technical support would be provided by a Technical and Operational Committee (TOC) that would perform any functions assigned to it by the FSC. The TOC would consist of two members from the CBI and two members from the FME. The Deputy Governor of the CBI would act *ex officio* as Chair of the TOC and the Deputy Director General of the FME in the same way as Vice-Chair. The other two members of the TOC from the CBI and the FME would be appointed by the Governor of the CBI and the Director General of the FME respectively. Two senior officials, one from each of the Ministries of Finance and Economic Affairs and of Industries and Innovation, would have permanent observer status at meetings of the TOC.
- The FSC (and its support unit, the TOC,) should strive for unanimity in their decisions. In case it cannot be achieved, decisions will be made my simple majority vote, with the Chair having the deciding vote in the case of a tie.
- The Systemic Stability Act, cf. sections I and II above, should give the FSC a broad mandate for financial stability policy and well-defined responsibilities and powers, including:

- Identifying emerging macro-economic disequilibria and structural distortions likely to lead to financial instability; determining the action that needs to be taken to address them, taking action when the sources of instability can be addressed with the powers available to the council and its members; recommending concrete action by others under a 'comply-or-explain' provision if the power to act is beyond the scope of the council and its members.
- Managing actions during a financial crisis. The FSC, with the Prime Minister in the Chair, will coordinate measures to deal with financial crises. The CBI will be responsible for liquidity support and the Government for solvency support, but the guiding principle will be to keep use of public funds to an absolute minimum, relying on effective resolution methods instead of using public money. Resolution authority to deal with ailing and failing financial undertakings will be in the hands of the supervisory arm of the integrated monetary financial stability authority and, until its creation, with the FME.
- Proposing the creation of tools needed to address risks to the stability of the financial system and authorising or requiring the discretionary use of tools that need prior approval. The Systemic Stability Act should include authority for the relevant minister(s) to establish rules and standards on the basis of proposals from the FSC. The standards established by the FSC and the tools authorised by it shall apply to all financial undertakings.
- The FSC and its member institutions shall have the right and obligation to comment on proposed changes in legislation, rules or regulations in their field of competence and to propose changes when they deem them necessary.

In the course of establishing a common platform for the CBI and FME and creating an integrated monetary and financial authority, it will be necessary to clarify the respective roles of the FSC, CBI and FME and to allocate the following responsibilities: systemic stability, financial regulation, prudential supervision, market efficiency and continuity, financial infrastructure, financial crime and consumer protection and resolution. The allocation of responsibility to the CBI and the FME needs be made with an eye to the role and operation of the central banking and prudential arms of the integrated authority that will be created. This will require:

- Defining in statute clear financial stability objectives for both the CBI and the FME and subsequently for the integrated authority.
- Giving the CBI and the FME severally and jointly responsibility for identifying structural factors leading, or likely to lead, to financial instability.
- Allocating specific regulatory and supervisory tasks to the CBI (liquidity, foreign exchange exposures, integrity of short-term repo markets, etc.) with the FME entrusted with oversight of all institutional risk. The FME should be given sole responsibility for resolution, including the responsibility for ensuring that institutions are structured and operated so that they can be resolved easily and without disruption to the financial system and so that distortions incentives are reduced.
- Retaining licensing authority for financial undertakings with the FME but requiring it to consult the CBI on the authorization of banks.

These changes in the regulatory architecture will create more powerful institutions. It is therefore essential to establish clear and compatible governance arrangements, in-

cluding rigorous appointment procedures, suitable checks and balances and effective oversight. Among the first duties of the FSC will be to establish rules of procedure and by-laws that will assure due process and accountability. Audits of the use of resources and work procedures of both CBI and FME should be performed on behalf of their boards by outside experts. The proposed integrated monetary and financial stability authority (and before its creation the CBI and FME) must, as an independent supervisory authority, be accountable by law to the Althingi.

IV. *Structure of the financial system: Ownership and control*

Address concentration, oligopoly and competition issues in the financial sector by:

- Putting all financial institutions on the same footing through umbrella legislation to promote financial stability, address concentration and promote competition.
- Making it easier and less costly for customers to switch between financial service providers to foster competition, for instance by making transfers of demand deposits from one credit institution to another free of any transfer charges or any other administrative obstacles; allowing transfer of loans between banks free of stamp duty.
- Imposing incremental capital requirements – including bail-in-able debt in resolution – on financial institutions exceeding a certain relative size threshold or classified as systemically important institutions.
- Considering regulating interbank transactions in order to reduce systemic leverage.
- Reforming the Housing Financing Fund (HFF, *Icel. Íbúðalánasjóður*), to create a level playing field in the mortgage credit market, separating its social policy function from its lending operations. Making the direct lending of HFF to individual customers subject to the same regulation and supervision as that of the banks as regards capital adequacy and provisioning, as well as taxation. Shifting ministerial oversight of the HFF to either the Ministry of Finance and Economic Affairs or Ministry of Industries and Innovation, or preferably, to the single ministry responsible for financial stability.
- Making direct lending of the pension funds to the private sector, including lending to fund members, subject to the same rulebook as the lending operations of the banks.
- Ensuring that financial undertakings are structured and operated so that any critical functions such as investment banking and commercial banking are separable in resolution.

Use – at arm's length from the political process – control rights that arise from public ownership or holdings of controlling interests in financial undertakings, to foster financial stability and address conflicts of interest.

Accept and even encourage foreign ownership/entry in the financial market, subject to prudential requirements that underpin financial stability, such as sufficient simplicity in structure, a clear business model, adequate capital and liquidity guarantees, conservative and effective risk management and strong oversight by the home authority.

Address the conflicts of interest and distorted incentives that arise from connected lending, board and management compensation packages, bonus schemes and leveraging by increasing the liability of managers, directors and shareholders both to other shareholders and with respect to the public interest. The changes already made in regulation since

2008 should be reviewed to reinforce supervision of connected lending and decision makers' pay in order to encourage prudent behaviour:

- Structure decision makers' compensation so that any variable remuneration is vested in a manner that takes long-term performance into account.
- Make vested managerial compensation first in line for absorbing losses with no control rights arising from the conversion of such claims.
- Ensure that managers of institutions placed in resolution are subject to rigorous fit-and-proper vetting for future financial sector employment.

Replace the blanket state guarantee for deposits in Icelandic banks in force since October 2008 with a deposit guarantee scheme in line with the forthcoming EU/EEA directive and a permanent priority for deposits covered by a deposit guarantee scheme.

Ensure the national credit registry (NCR) is structured to provide full information on the exposures of the counterparties of financial undertakings even when they have complex and changing legal structures or when the credits are low in value.

Correct distortions that lead to excessive leverage and risk taking, such as the differential treatment of interest and dividends in taxation. Consider introducing limits on gross leverage, along the lines proposed in CRD IV and on loan-to-value ratios. Revise the accounting treatment of unrealized capital gains and losses in the income account with a view to financial stability. The external auditors of financial firms should disclose these effects clearly in the interest of prudent behaviour:

- Shift focus from return on equity (ROE) (which encourages leveraging) to return on assets (ROA) (which focuses on total return). Encourage the use of ROA in the presentation of financial statements of financial firms, in particular firms where the state holds a controlling share. Consider strengthening the requirements placed on external auditors to disclose not only the ROE but also ROA in their reporting.
- Seek to eliminate or at least to reduce the too-big-to-fail (TBTF) syndrome by addressing the financial risks and the risks of regulatory capture associated with firm size, by making essential financial functions separable in resolution, and by making resolution prompt, orderly and effective.

V. *Resolution regime*

Establish a permanent resolution regime administered by the FME with the following key features:

- Preserves critical functions.
- Leads to a change in the business models, strategy and behaviour that caused the distress in the first place.
- Applies to all financial undertakings.
- Is closely aligned with the regulatory regime to ensure that institutions are structured and operated so that they can be wound down easily, quickly and without triggering a crisis. Critical functions need to be separable in resolution to ensure that vital financial services continue; to accomplish this, licensing of financial firms should be structured so that permission to conduct particular types of business can be revoked or transferred to other firms even if other activities need to be terminated.
- Gives the FME the powers needed for a national resolution authority. Many of these powers are provided for in the Icelandic emergency legislation of October 2008, which is still in force. This legislation should be reviewed in the light

of international developments such as those mentioned above, and the resolution powers of FME should be made permanent rather than temporary in order to make the behaviour of firms, their boards and management more prudent.
- Provides priority in resolution for covered deposits and for the claims of the deposit guarantee scheme.
- Ensures that investment banking and commercial banking and other important banking functions are separable in resolution of financial undertakings. It should be considered to assign banks´ proprietary trading and other significant trading activities to a separate legal entity if the activities to be separated amount to a significant share of a bank´s business (as proposed in the recent report of the Liikanen-group to the EU Commission.)

VI. *Governance and accountability*

Good governance, transparency and accountability are essential for confidence in the regulatory and supervisory system. To secure this, it is necessary to:

- Determine the extent and nature of enabling legislation, and those areas where different authorities have discretion and the extent of their discretion; the greater the discretion, the greater the accountability will need to be.
- Clarify who is responsible for which decisions and how they are made (singly, jointly; consensus, voting; disclosure of votes/views). Placing all financial sector matters under a single ministry and creating an integrated monetary and financial stability authority would call for the strengthening of accountability of the independent supervisory authority because of the concentration of power this implies.
- Ensure open, transparent and merit-based appointment processes for key officials responsible for financial stability. Increase regular reporting to Parliament on financial stability and prudential supervision matters, building on the practices used for monetary and fiscal policy. Such reporting will, of course, be subject to strict confidentiality requirements.
- The FSC and its participating institutions will need to develop suitable procedures and channels of communication for disclosure of systemic stability policy decisions, the reasons for them and how they were reached.

2

Current state of the financial system

2.1 Key features[3]

The Icelandic financial system is characterized by the dominance of three banks, Arion Bank, Íslandsbanki and Landsbankinn, all established by the authorities as part of emergency measures to secure continued financial services for the public and domestic business following the bank collapse of 2008. The state currently holds 81% of Landsbankinn, 13% of Arion Bank and 5% of Íslandsbanki. The three new banks are focused mainly on the domestic market in contrast to the three large internationally active banks, Glitnir, Kaupthing and Landsbanki, they replaced. By far the largest proportion of the balance sheets of these three 'old' banks that failed in 2008 derived from foreign exchange denominated and international operations. These international activities formed the basis for the extremely fast growth of their balance sheets from the turn of the century until their collapse in 2008. It is important to note that Iceland's modern history has been characterised by financial instability and currency difficulties that have had extensive adverse macroeconomic consequences.

Another key feature of Iceland's financial system is the fact that the state-owned Housing Financing Fund is by far the biggest financier of residential housing and that the pension funds (membership of which is compulsory by law) have a dominant role on the supply side of the capital market. The pension funds are furthermore active as retail lenders to their individual members, and even in some cases to business firms.

The financial market situation has changed radically since 2008. The assets of the financial system as a whole are less than half (49% according to CBI statistics) of what they were at the height of the banking boom in the first half of 2008. The number of financial undertakings has decreased in recent years as many savings banks and specialized lenders have ceased their operations. This has increased concentration in the financial market and further consolidation can be expected in the years ahead. The combined market share of the three biggest banks in total deposits is at present around 95%. However, measured as a share of deposits, concentration was very high even before the crisis. The picture is somewhat different if concentration is measured in terms of market share in total direct lending, because of the importance of retail lending by the state-owned Housing Financing Fund (HFF) and the pension funds, which taken together account for some 36% of direct lending to households and business firms.[4] For this reason the market share of the three biggest banks in total lending at the end of 2011 amounted to around 62%. Neither the HFF nor the pension funds are obliged to comply fully with the same rules as other financial undertakings e.g. regarding provisioning, financial security and internal control. This is clearly an impediment to fair competition. The funded pension system, which is one of the strengths of the Icelandic economy, ought to emphasize long-term

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3 Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs) (2012), chapters 5 and 6.

4 Excluding purchases of listed securities (marketable bonds).

investment rather than retail lending to individual households or companies. The role of the HFF as a retail lender in the housing mortgage market could similarly be taken care of by retail banks. The role of a state-owned institution for housing finance needs to be carefully defined and limited, on the one hand to providing a wholesale supply of funds for retail banks serving the individual home owner, and on the other hand – in a separate capacity – providing subsidized financing for social housing for low-income families.

The high degree of concentration in the financial market makes it crucial to find ways to counteract the market dominance of the major actors in this oligopolistic setting. On the one hand there is a need to prevent further concentration in banking in Iceland, because it is such a small market easily dominated by big firms, while on the other hand the very smallness of the market makes it impractical, uneconomic and inefficient to have many banks serving this small economy. A balance needs to be struck. Merger of two of the three major banks has often been discussed in Iceland. It seems doubtful, however, that Iceland would be better served with a banking duopoly instead of the present oligopoly. One consequence of oligopoly (with tendencies for collusive behaviour), together with the absence of foreign competition in the financial market, has been high interest rate margins – and in general high intermediation margins – in Iceland.

The following measures would promote competition on equal terms and reduce the harmful effects of market concentration in the financial sector:

- Put all financial institutions on the same footing through umbrella legislation to address concentration and promote competition.
- Make it easier and less costly for customers to switch between financial service providers to foster competition, for instance, by making transfers of demand deposits from one bank to another free of any transfer charges or any other administrative obstacles; also allowing transfers of loans between banks free of stamp duty.
- Reform the HFF to create a level playing field in the mortgage market. Make HFF's retail lending to households and building companies subject to the same regulation and supervision as the banks as regards capital adequacy and provisioning as well as taxation. Shift ministerial oversight of lending and financial market activities of the HFF to the Ministry of Finance and Economic Affairs or the Ministry of Industries and Innovation or, preferably, to a single ministry responsible for financial stability.
- Make pension funds' retail lending subject to the same rulebook as the lending operations of the banks.
- Encourage foreign ownership in the financial market, subject to conditions that underpin financial stability, such as sufficient simplicity in structure, clear business models, adequate capital and liquidity guarantees, conservative and effective risk management and strong oversight by the home authority. The prime concern should be to seek financially fit and proper investors with the capacity to preserve the stability of the financial system and instil confidence in it.
- Ensure Iceland's continuing membership in the European internal market in financial services and restore free movement of capital. Both these features of Iceland's EEA membership are important for competition as they preserve market access for foreign banks in Iceland and access by Icelandic companies to international financial markets and banking services.

As a consequence of the financial collapse in 2008 the state has become a significant owner of financial undertakings. This role needs to be managed with great care with the aim of promoting systemic stability and responsible governance of financial firms. The following recommendations can be made in this connection:

- Exert – at arm's length from the political process – controlling rights that arise from public ownership or holdings of significant or controlling interests to foster financial stability and address conflicts of interest. Public agencies or publicly owned companies having such rights should be given an explicit mandate to do this and be subject to rigorous and regular evaluation in achieving it. This could for instance mean that these public agents would be required to focus on ROA and not solely on ROE, to evaluate the respective business models to see whether they are consistent with financial stability and to review their management performance in implementing this policy, to ensure that compensation rewards prudent behaviour, that risk management is effective and that sufficient earnings are retained to augment capital when needed.
- Keep a majority stake in Landsbankinn in Government hands for the time being. It may also be prudent for the state to retain its minority share holdings in Arion bank and Íslandsbanki until greater clarity emerges regarding the market value of the shares, the ownership structure and whether holders of a qualifying interest meet fit and proper standards. The Government may well end up being a significant shareholder in these banks – and possibly the single largest shareholder – after the conclusion of the winding up of the old banks' estates. The time to divest these holdings will come when the three banks are financially fit for public offering, when the stock market is ready to receive such a quantity of shares – or when there is interest by foreign investors and it is no longer essential to use public control rights to foster stability and competition.

The above recommendations all aim at promoting more competition in the financial market in the belief that competition and stability can coexist in the financial sector. "In fact, more competitive market structures can promote stability by reducing the number of banks that are 'too big to fail'. Policy goals for the financial sector include promoting both competition and stability."[5]

2.2 Changes in regulation and supervision since 2008

In the years preceding the events of October 2008, Icelandic legislation and derived rules and regulations had been brought more or less into line with EU directives and regulations, as is required by Iceland's membership of the EEA. The enforcement and supervision of these rules were not sufficiently developed and the rules themselves were deficient in many respects, as their subsequent reform demonstrates. The banking system had outgrown the ability of the authorities, mainly the FME and the CBI, to supervise and monitor the financial system with the resources available to them. These developments and the then existing legal and regulatory framework were described in the March 2009 report by Kaarlo Jännäri titled *"Report on Banking Regulation and Supervision in Iceland: past, present, future"*.[6] The

[5] OECD (2006) and Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs) (2012).

[6] Jännäri (2009).

report made a number of recommendations on improvements in the regulatory and supervisory framework. Reports by Pierre-Yves Thoraval (April 2011)[7] and Mats Josefsson (November 2011)[8] are also worth mentioning in this context.

One of the central observations and recommendations of the Jännäri-Report was that the supervisory authorities should have more discretionary powers and should use them more boldly. The Icelandic legal tradition (as in other Nordic countries) limits strongly the leeway for discretion by authorities. To be binding, rules should be stated explicitly in the provisions of the relevant statute (Act of Parliament), and lower level regulations and recommendations have often been challenged by the supervised entities with reference to the lack of explicit statutory provisions – even if such challenges do not now take place as frequently as before the crisis. To some extent, the corporate culture within the financial sector still views the supervisors mainly as an unwelcome additional and unnecessary cost, and a nuisance rather than as an essential aid for financial undertakings to develop and apply sound risk management systems and governance, which would impart credibility to their operations. The Jännäri-Report also made recommendations on tighter rules and supervision of connected lending, large exposures, liquidity and foreign exchange positions and 'fit and proper' assessment of major owners and management. It suggested more frequent on-site examinations to verify the accuracy of reports from the supervised entities. The report also made recommendations on a merger of – or at least much closer cooperation between – the FME and the CBI and suggested the establishment of a National Credit Registry. These are discussed elsewhere in this report.

The Emergency Act of 6 October 2008 is the most significant change in the legal framework of the financial sector since the outbreak of the crisis. This Act gives extraordinary powers to the authorities and, together with the introduction of controls on international capital movements, has provided an opportunity to design a permanently more robust financial system for Iceland. The Emergency Act and the capital controls are intended to be temporary; it is therefore important to design the future structure of Icelandic financial regulation and supervision before key provisions of the Emergency Act and the capital controls are revoked.

The Emergency Act gives the FME wide powers to intervene in the affairs of a failing institution and put it into resolution. In future permanent resolution legislation, the FME should retain the right to intervene within the provisions of the resolution regime.

Since 2008 a considerable number of regulatory and legislative amendments have been introduced and implemented in order to improve the framework. The Ministry of Economic Affairs, the FME and the CBI have taken the initiative to numerous amendments or new laws, regulations, rules and guidelines that have been adopted. The major ones are described in the FSIFS report in chapter 4.3., pp. 34–37 and in chapter 7.4., pp. 67–73.[9] Some of these changes make the regime in Iceland more stringent than in the EU/EEA in general (such as stricter rules on remuneration of bank boards and management and the possibility for FME to restrict certain activities of financial institutions without taking away their operating licence as a whole). Iceland also applies a 16% risk-weighted capital adequacy requirement on banks, which is higher than the norm in the EU/EEA countries. Such high capital ratios are socio-economically beneficial and should be retained. Also important are more strin-

[7] Thoraval (2011).

[8] Josefsson (2011).

[9] Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs) (2012)

gent rules on connected lending and large exposures. The FME has work in progress on a number of new rules and guidelines. One of these is a more comprehensive set of rules for large exposures. New tighter rules on insider information/trading and rules on proper and sound business practices and behaviour are also in the pipeline. Iceland also has special taxes on the banking industry that may be higher than in most other European countries. The taxation of the financial sector should be reviewed in the context of the reforms of financial legislation to ensure that the Icelandic banks are not facing an unfair competitive disadvantage in comparison with foreign banks. In this regard developments in the EU should be monitored closely.

Pierre-Yves Thoraval's assessment of Iceland's compliance with the Basic Principles of Banking Supervision, issued by the Basel Banking Supervision Committee, finds Iceland materially non-compliant with 12 of the 25 basic principles.[10] The FME has initiated a major project to rectify these and other deficiencies. The number of FME employees has increased markedly, but additional training and experience is called for. The FME has restructured itself and the new organization took effect in early 2012.

The old organization was based on sectoral departments while the new one tries to capture the risks and challenges in a more comprehensive way without too much segregation between sectors. The three new departments, on-site, oversight and off-site, work closely together to maintain an overall, and as up-to-date as possible, view of the risks of individual supervised entities. The FME's project of reforms for 2011–2014 is a work in progress. It is the intention of the authorities that this project will strengthen the supervisory system and make the FME compliant with the Basel recommendations. In addition, the FME is taking the opportunity to use technical assistance and funds available through Iceland's application for membership to the European Union[11] to train and help increase the professional skills of its staff. FME is also in the process of establishing a 'twinning' agreement with the Finnish Financial Supervisory Authority and of building a Risk Assessment System (RAS). One major area in need of improvement is the IT-system for processing and analysing the supervisory information received from the supervised entities. Close cooperation with the CBI is hoped for in the IT-projects.

It remains to be seen whether the reforms under way or in the pipeline will bring the supervisory standards in Iceland to the highest international level. There is, however, a risk of loss of momentum in the renewal process. Therefore extra vigilance is called for to keep the process on track.

The CBI bears responsibility, partly shared with the FME, for liquidity and foreign exchange supervision. The capital controls have for the time being limited the exposure of financial undertakings to foreign exchange risks. The government's declared policy is to abolish the capital controls in the next few years. This is, indeed, written into the foreign exchange legislation. Before capital controls are abolished, regulations on liquidity and foreign exchange and their supervision will need to be revised to meet the challenges of free capital movements. The CBI is currently working on these regulations and has recently published a report on this topic.[12]

When the new banks succeeding the banks that collapsed in 2008 were given operating licences in 2009, the FME imposed upon them strict temporary capital requirements (16% CAD) as well as more demanding

[10] Thoraval (2011).

[11] Taiex and IPA support, see http://ec.europa.eu/enlargement/taiex/what-is-taiex/index_en.htm

[12] Seðlabanki Íslands (CBI) (2012).

liquidity rules than had been issued by the CBI before the banking crisis. These temporary rules will be in force until the end of 2012. For this reason there has since then been a certain overlap in the regulatory and supervisory activities of the CBI and FME as regards liquidity. It is important that these more demanding capital adequacy and liquidity requirements can be retained if this is warranted by the circumstances in the opinion of the financial stability authorities. There is a need to clarify and define the responsibilities of the two institutions (CBI and FME) in this area in order to avoid burdening the supervised entities with two sets of regulations and twofold reporting duties. The CBI and the FME are currently working together on new regulations on liquidity in line with Basel III and CRD IV requirements, which will replace the temporary rules of 2009. At present the CBI is not by law entitled to make on-site examinations to verify the accuracy of reports from the banks on liquidity and foreign exchange risk. In the course of developing common reporting and inspection procedures to be used by both institutions, it should be given that possibility either directly or – to simplify matters for the supervised entities – through FME's on-site function.

The overall relationship and cooperation arrangements between the CBI and the FME are very important. The Cooperation Agreement between the FME and the CBI from 2006 has been replaced by a new agreement of January 2011.[13] The new agreement has improved sharing of information and widened and deepened the cooperation of the two institutions on financial stability issues. There are still, however, some perceived legal obstacles to sharing information received directly from the banks. All such obstacles should be removed. The new agreement has also increased cooperation between macro- and micro-supervision. It seems, however that there is still some ambiguity as to responsibility for possible contingency actions in relation to systemic risk. The biannual meetings of the Governor of the CBI and the Director General of the FME have proven to be useful. The four working groups under the agreement, on foreign exchange risk, liquidity risk, payment and settlement risk and micro-macro risks, meet regularly between the meetings of the Governor and the DG. Their work provides important input for the meetings of the Governor and the DG. And the conclusions of these meetings provide focus for coordinated work between the two institutions in the interim. A brief summary of these biannual meetings is submitted to the high-level Financial Stability Committee. The ministerial committee on Economic Policy also receives briefings presented by the Governor and the DG of the FME from the biannual meetings.

The Financial Stability Committee mentioned above was appointed in July 2010 and replaced the Cooperative Group, established in 2006 with broadly speaking the same institutional representatives. The Agreement on the Appointment of a Financial Stability Committee is annexed to the FSIFS report.[14] The Committee is chaired by the representative of the Ministry of Economic Affairs; soon to be replaced by the representative of the Ministry of Finance and Economy (MFE). The other members come from the Prime Minister's Office, the Ministry of Industries and Innovation (MII), the FME and the CBI. The committee meets at least six times a year. The Financial Stability Council proposed in this report would i.a. replace this committee.

The legal and regulatory changes described above have brought major improve-

[13] Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs (2012))

[14] Efnahags- og viðskiptaráðuneytið (Ministry of Economic Affairs) 2012.

ments. However, much work still needs to be done, in particular, to have the appropriate regulatory rules in place when the remaining provisions of the Emergency Act and the capital controls are abolished or replaced. International developments in these areas, in particular in the EU/EEA, need to be monitored closely. In supervisory practices the FME reforms seem to be heading in the right direction, but momentum must not be lost. The respective roles and the institutional relationship between the CBI and the FME need to be clarified and their co-operation deepened through the establishment of a common administrative and operational platform and the institutionalisation of complementary policy making. This would permit common reporting and inspection procedures to be used to collect all supervisory information used either by the CBI or the FME or both. The CBI and FME need to have integrated information technology systems with common databases, human resource policies and some common administrative arrangements for reasons of effectiveness and efficiency.

To summarize in the simplest possible way, the changes in regulation and supervision made since 2008 have resulted in much stricter rules than were in force before the crisis — in some instances even stricter than the norm in other EEA countries. More demanding capital adequacy and liquidity requirements have been placed on the banks than before. In spite of these improvements, weaknesses in financial regulation and supervision remain in Iceland that need to be addressed. This is the subject of the next section.

2.3 Remaining weaknesses in financial regulation and supervision

The financial crisis that hit Iceland so severely in 2008 had complex roots – both domestic and international. Even though this financial crisis was unique in its severity, the modern history of Iceland is characterised by "financial instability and FX difficulties".[15]

At the root of the collapse were serious flaws in the business models of the banks, as well as in their governance and risk management. Extensive cross-ownership, connected lending, overly large exposures, extravagant risk-inducing bonus systems and reckless leveraging are examples of these faults. Financial sector operations were characterised by distorted incentives and pervasive conflicts of interest, as well as complex financial products that misled markets. Lurking in the background were severe imbalances that had been building up in the Icelandic economy over a number of years. Defective macro-economic policies led to an unsustainable boom and large-scale accumulation of financial risks. A case in point is the combination of interest rate policy focused exclusively on achieving and maintaining a low rate of inflation and a floating exchange rate that was driven up by high interest rates. Together these gave rise to a very extensive, speculative cross-border 'carry trade' in securities denominated in ISK. These problems were exacerbated by an ample supply of cheap credit in the global capital market that showed scant regard for risk. Financial regulation and supervision proved ineffective in dealing with this multi-faceted problem, focusing too much on the financial details of individual financial undertakings and not enough on the financial system as a whole. Regulation was lagging behind evolving practices in the institutions being regulated. It was in fact conducted in a spirit of 'light touch regulation' and an unspoken belief in the self-correcting properties of financial markets producing the most efficient outcomes. This was a recipe for disaster.

[15] Ásgeir Jónsson (2010).

As described in the preceding section of this report (section 2.2 of the main text) many amendments have been made to the regulatory framework and supervisory practices in the aftermath of the bank collapse in 2008. Most of these changes concern supervision of individual financial undertakings and have addressed several of the shortcomings of the micro-prudential regulatory framework as it was before the crisis. One interesting and important addition to the database used for financial supervision deserves special mention, namely the establishment of a national credit registry, which can be used for both micro- and macro-supervisory purposes.

The remaining weaknesses in the regulatory system are essentially of three kinds: Firstly, insufficient supervision of the financial system as a whole, i.e. macroprudential (or systemic) supervision. Secondly, insufficient attention to the pervasive conflicts of interest and distorted incentives in the financial sector that are rooted in particular in asymmetry of information and asymmetry with respect to gains and losses, with gains being privatised but losses socialised. Thirdly, Icelandic financial undertakings are not regulated in a manner that would facilitate the resolution of ailing or failing firms, or the elimination of the types of behaviour that caused the crisis, or would secure the continued performance of critical functions when an institution fails. Brief comments on each of these three areas of weakness in the present regulatory system follow.

2.3.1 The need for a macro-prudential policy framework

There is wide acceptance that insufficient regulation and supervision of the financial system as a whole was a very serious shortcoming of public financial policy prior to the financial crisis – not only in Iceland but also in most countries of the world. The regulators did not see the forest for the trees. The most important change needed in the regulatory system is to fill the gap previously left unfilled between a central bank too exclusively focused on inflation targeting and a financial regulator/supervisor too exclusively focused on individual institutions. Neither of the two supervisory authorities (FME and CBI) has a sufficiently explicit mandate and responsibility for financial stability or the necessary instruments to pursue it. There is widespread recognition that it is essential to have a body – an authority – monitoring the entire financial system, spotting vulnerabilities and systemic risks that are not apparent when attention is concentrated on individual financial institutions. It is recognised that cyclical credit growth and asset price developments can create financial instability and cause economic harm even when inflation is low and economic growth appears steady. It is also recognised that vulnerabilities can accumulate in the financial system through the network of linkages between individual institutions even when each of the undertakings that make up the system is prudently managed and sound. The regulatory changes made after 2008 addressed some of these challenges but this is an area where additional work must be done in Iceland and elsewhere. The network of linkages in the financial system needs to be kept under constant surveillance. Recognition of these systemic risks is without doubt one of the most important lessons from the financial crisis that continues to plague Western Europe and North America.

Most of the arguments put forward for new macro-prudential policies focus on new tools to constrain future credit booms – i.e. taking away the punchbowl before the party gets out of hand.[16] Macro-prudential policy needs

[16] Turner (2010), Large (2010), Bank for International Settlements (BIS) (2011).

to be formulated in the overall context of general macro-economic policies. It should be seen as the third pillar of macro-economic management alongside fiscal and monetary policy. It should consequently take account of the amount of credit supplied to the real economy, which is important for macro-economic stability. This may entail judgements about the relative merits of different uses of the banks' lending capacity, including the extent to which it is used for intra financial sector activity versus providing financial services to ultimate savers and borrowers.[17]

The share of financial sector transactions with other financial institutions made up the vast majority of all financial transactions at the height of the banking boom preceding the collapse in 2008. Intra financial sector transactions have social value; they encourage the transmission of savings to their most productive uses; they help create liquidity and to price and reallocate risk, but such transactions are only useful if they serve the financial system's real function of supporting the economic activity of ultimate savers and borrowers. The extensive use of banks' balance sheets to support inter-bank position-taking was among the causes of the crisis, the poisoned chalice of the bank boom that preceded the crash. In the future it may be necessary to rely on new prudential tools that seek to limit the unwarranted proliferation of inter-bank/intra-finance-sector complexity.

2.3.2 The need to counteract conflicts of interest and correct distorted incentives

Pervasive conflicts of interest and distorted incentives were root causes of the credit boom that led to the financial crisis of 2008. However, they have long plagued the financial sector and can only be properly addressed by fairly fundamental reforms. The conflicts of interest and distorted incentives can be found at both the macro and the micro level.

At the macro level, perhaps the most important distortion of incentives arises from the moral hazard created by the perception that certain important banks are 'too big to fail'. This moral hazard gives rise to serious incentive problems, encouraging costly risk-taking in the belief that the banks will always be bailed out in the end. It is difficult to break the cycle of booms followed by busts and bailouts based on an implicit tax-payer subsidy, encouraging individual financial institutions – and the financial sector as a whole – to become bigger and bigger.[18] Government declarations of a firm commitment to a no-bailout policy are not credible if the costs to society of adhering to that commitment are too great. A size cap on the largest banks either in absolute terms or relative to GDP would be a robust but blunt macro-prudential instrument to deal with this. It might be difficult to garner sufficient political support for this kind of policy. One way to deal with systemic risk of this nature would be to impose higher capital requirements on financial institutions that exceed a certain relative size threshold or are classified as systemically important for the whole financial system. This approach is presently being proposed and developed in the EU/EEA context and should be considered for Iceland.[19] It can be seen as a macro-prudential instrument but also as a measure that corrects distortions in competition arising from being — or being perceived to be — 'too big to fail'.

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[17] Turner (2011).

[18] Sveriges Riksbank (2011).

[19] Higher capital requirements for systemically important financial institutions are being considered in the development of the EU's new banking legislation (CRD IV and CRR).

Another route to deal with moral hazard distortion of incentives would be to enact a strict resolution regime enabling an institution in distress to be wound down without the use of public money and without triggering contagion. One way to achieve this, which is under active consideration in the international community, is to institute bail-in provisions for failing banks.[20] Such an arrangement would imply that different creditor classes of the bank, starting with junior unsecured bondholders, would fund the resolution – not taxpayers. This is needed to make the financial system in its entirety safer when single entities in it have serious problems. However, it may not suffice if all or most of a country's financial institutions are in distress.[21]

In addition to the 'too-big-to-fail' syndrome, there are other sources of moral hazard that can contribute to rapid growth of credit and gross leverage. Whenever a creditor thinks it may get bailed out, i.e. protected from loss by a third party, it becomes more willing to lend cheaply, sometimes without checking the borrower's creditworthiness adequately. This can encourage a build-up of risky debt with consequent losses for the third party – often the general public. The regulatory system needs to provide for monitoring of such risks and prevent them from growing.

In this context the following recommendations can be made:

- Correct distortions that lead to excessive leverage and risk taking, such as the differential tax treatment of interest and dividends.[22]
- Review the accounting treatment of unrealized capital gains and losses in the income account with an eye to increasing financial stability. Require the external auditors of financial firms to disclose these effects clearly in the interest of prudent behaviour.
- Shift focus from ROE (which encourages leverage) to ROA (which focuses on total return). Encourage the use of ROA in the presentation of financial statements of financial firms, in particular firms where the Government holds a controlling stake. Consider strengthening the requirements placed on external auditors to disclose not only ROE but also ROA in their reporting.
- Seek to eliminate or at least to reduce the 'too-big-to-fail' syndrome by addressing the financial risks and the risks of regulatory capture associated with firm size, by making essential financial functions separable in resolution and by making resolution swift, orderly and effective.

At the micro level – the level of the individual firm – the highly leveraged balance sheets and the often-complex corporate structure of limited liability financial firms creates perverse incentives for both shareholders and management to invest the bank's resources in risky business ventures. Owners/shareholders and management then have relatively little at stake personally, but reap potentially large gains if the risky venture is successful. These incentives are seldom defused by the vigilance of the bank's creditors – especially depositors – who rightly believe that they enjoy explicit or implicit taxpayer protection. These perverse incentives encourage carelessness or even recklessness in risk-taking and lending that can have catastrophic results.

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[20] See for example European Commission (2012d)

[21] The increased use of collateralized borrowing by banks needs to be monitored as it may hamper the development of such a framework.

[22] One suggestion that has been made to reduce the incentive to take on excessive leverage is to eliminate the deductability of interest expenses once leverage exceeds a particular threshold, such as five times capital.

The Icelandic Government's declaration, given on 6 October 2008 and reiterated several times since, that deposits in domestic commercial and savings banks and their branches in Iceland will be fully guaranteed by the state – often referred to as the blanket guarantee – creates moral hazard, with incentives to place one-sided bets against the state.

The blanket state guarantee should be abolished as soon as a new deposit guarantee scheme has been securely put in place. To make the abolition less likely to cause a sudden outflow from bank deposits, it would be advisable to emphasize at the same time that deposits (enjoying deposit guarantees by law, or the guarantees pertaining to such deposits) will continue to have priority in an eventual winding-up of financial undertakings.

How can the distorted incentives in the financial system be corrected? Higher capital requirements would obviously help; greater equity capital would reduce the asymmetry of shareholder incentives since the owners of the firm would have more to lose in the event of failure. But this is unlikely to suffice. Another approach would be to alter the structure of banks radically by demanding much higher equity and also limiting their operations to simple banking services – i.e. narrow or limited purpose banking. Although this would obviously make banks less risk-prone it would entail other problems, including the need to ensure sufficient maturity transformation and financial intermediation for the economy. For this reason such structural changes are not likely to occur. But the need to somehow align the incentives of bank management with wider public interests remains. Bonuses calculated on the basis of short-term performance have been extraordinarily generous in recent years, not least in the run-up to the financial crisis. The amounts involved have in many cases been significant relative to the capital base of the institutions. New Icelandic regulations on performance-related pay for bank management are a significant step toward proper regulation of bankers' variable pay and bonuses. It is important to motivate management to protect the bank's balance sheet as a whole and not just to align their interests with those of the shareholders. Maximizing expected shareholder returns – often within a relatively short-term time horizon – may leave huge tail risks with the taxpayers. Regulators should insist on changing the structure of incentives to discourage executives responsible for lending and capital investment decisions from making one-sided bets against the creditors, and in effect against the state.

The most effective way to correct the distorted incentives of management would be to make managers personally liable in the event of insolvency or state rescue of the bank. This could be achieved by requiring a substantial part of management's performance related remuneration to be held back for a number of years – even as long as five to ten years – and to be forfeited in the event of failure. If provisions of this sort were enforced, management of failed institutions would lose much of their accumulated wealth. Under such rules all variable pay of key decision makers in financial undertakings would be subject to claw-back in light of subsequent performance. Making key decision makers in financial firms personally liable in a substantial way in the event of failure of the business under their control would align their interests not only with those of shareholders but also with those of depositors and creditors, including the state as the creditor of last resort. A move in this direction is in evidence in FME's Rules No. 700/2011 of 30 June 2011, on remuneration policy for financial undertakings, and in the similar Rules No. 299/2012 of 12 April 2012, on remuneration policy for insurance companies. They constitute a first step in

establishing the principle of personal liability of decision makers in financial firms.

The question remains, how can such rules be strengthened and successfully applied? Such reforms would be much more effective if they were applied across borders; international agreement – as a minimum on first principles of such rules – is needed. The FSB has made a first step in this direction, but more is needed to align the incentives of managements with those of creditors, taxpayers and society at large. An EU directive on remuneration for the financial sector has been in the making for a number of years but seems to be advancing at a snail's pace.[23] It may prove necessary for individual countries to go their own way in regulating pay in the financial sector, since they have a vital national interest in ensuring the safety of their financial systems. Given the severity of Iceland's financial crisis, it would not be inappropriate for it to take the lead.

A related measure to address management's perverse incentives would be to require variable compensation of key decision makers not only to be vested but to be paid in the form of instruments, such as non-voting equity or junior subordinated instruments, so that managers would suffer losses before other unsecured creditors such as bond holders, collateralised debt holders and shareholders. Such instruments would not provide company-wide decision or control rights over the resolved entity; indeed owners of such instruments could be forbidden to serve as employees of the resolved entity.

There are, however, problems to be addressed in this connection. One is that bank managers could find innovative contractual means of altering their exposures. A second problem is that distorted incentives arising from the structure of management compensation are not confined to the financial sector; they can also be found, although not as blatant, throughout the corporate world. In this context the following recommendations can be made:

- Address conflicts of interest and distorted incentives arising from connected lending, board and management compensation packages, bonus schemes, leverage and limitations on liability of managers, directors and shareholders. The changes already made to better regulate connected lending and decision makers' pay with an eye to encouraging prudent behaviour need to be regularly reviewed.
- Consider introducing limits on gross leverage as well as on loan-to-value ratios and find ways to make both shareholders and management more legally liable than at present in order to reduce risk-seeking behaviour. Follow closely proposals on these matters being developed by the FSB and within the EU/EEA, in particular on the debt write-down tool, i.e. bail-in-able debt, to deal with financial firms in distress.
- Structure decision makers' compensation so that any variable remuneration is vested in a manner that takes long-term performance into account. Consider whether the length of time that variable remuneration of decision makers is to be held in escrow accounts should be extended.[24]

2.3.3
The need to expedite orderly resolution

While it is essential to correct the failures in regulatory design that contributed to the crisis, it would be folly to think that improved regulation, even if it radically altered the nature of the Icelandic financial system

23 The European Parliament's proposal for the CRD IV / CRR package includes provisions on remuneration, see European Parliament (2012a) and European Parliament (2012b).

24 Wooley (2010) and Wolf (2010).

and adequately addressed the profound perverse incentives present in Iceland's and other countries' financial systems, would suffice to prevent all future crisis. Draconian regulation that suppressed virtually all financial intermediation might achieve this, but the costs would exceed the benefits. A degree of creative destruction is necessary for a vibrant economy.

Regulatory and resolution arrangements should therefore be designed so that financial failure does not constitute a catastrophe but is a part of an on-going evolutionary process of winnowing the weak and permitting the efficient and strong to survive in a manner that makes the overall financial system and economy more dynamic. Regulation and resolution therefore must go hand in hand. Financial institutions must be structured and made to operate in a manner that they can be wound down in an orderly fashion in case of failure. This kind of regulation is even more important in small, concentrated financial systems, with a limited number of players.

The emergency legislation that was enacted in October 2008 gave the authorities important and useful powers for resolving financial institutions in distress. This legislation needs to be put on a permanent footing, taking into account developments in other jurisdictions as well as in the EU/EEA[25]and at international level (FSB)[26]. In doing so, it is important not to focus solely on resolution arrangements but also to ensure that the regulators have the mandate, powers and capacity to ensure that financial institutions are structured and operated so that they can be wound down quickly, easily and without causing disruption to the provision of essential financial services.

The Group recognizes that work on resolution frameworks and the structure of the financial industry is on-going. It is therefore important to follow carefully developments in this regard in the EU/EEA, including the work of the Liikanen-group[27] that submitted its report on the structure of the European banking industry in the beginning of October 2012 to the EU Commission.[28] Nonetheless, it is possible to identify the broad framework of a regulatory and resolution regime suitable for Iceland. In chapter 7 of this report we present our recommendations on the key elements of a resolution regime for Iceland.

In its report the Liikanen-group concludes "that it is necessary to require legal separation of certain particularly risky financial activities from deposit-taking banks within the banking group. The activities to be separated would include proprietary trading of securities and derivatives, and certain other activities closely related with securities and derivatives markets …" This legal separation would only be required if these activities amount to a significant share of a bank´s business. This proposal should be carefully considered in Iceland.

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25 European Commission (2012d).
26 Financial Stability Board (October 2011).
27 European Commission (2012a).
28 European Commision (2012e).

3

Prospective future financial system

3.1 Strengthening the regulatory and supervisory framework

In the preceding sections a number of recommendations have been made for improvements in the regulation of the financial sector with the aim of establishing a regulatory framework for a solid and efficient financial system, serving the needs of the Icelandic public and industries and promoting profitable business based on controlled risk-taking and long-term business relationships. This view of the future of the financial sector in Iceland would not aim at developing Iceland as an off-shore financial centre, but primarily at providing reliable financial services for key existing industries – and for new economic activities arising through innovation – not least by promoting SMEs in new knowledge-based technical sectors. The financial sector also needs to provide Iceland with an efficient and stable payments system, a safe repository for savings and inter-temporal shifting of consumption over the life cycle. There needs to be a strong emphasis on well considered risk management across the whole financial system. The possibilities for mergers of Icelandic banks with foreign institutions or the entry into Iceland of foreign banks need to be explored carefully, as the advent of a reputable foreign financial institution could help bring the most modern and efficient risk management and banking practices to the Icelandic market, in addition to making the isolated Icelandic financial sector more competitive.

It is necessary to take a close look at how the institutional structure of financial regulation and supervision in Iceland can best be strengthened.

3.2 The institutional structure

The current Icelandic regulatory architecture consists of a single integrated regulatory and supervisory authority, the FME, that serves as the main micro-prudential authority, and the central bank, the CBI, with responsibility for price stability, for specific micro-prudential matters, such as liquidity and foreign exchange exposure of banks, as well as presumptive responsibility for systemic stability – i.e. systemic stability oversight. The cooperation agreement between the two institutions signed in January 2011 makes it clear that both FME and CBI regard overseeing financial stability as a joint responsibility, but both lack explicit statutory mandates enabling them to serve as efficient micro- and macro-prudential overseers.

The FME is at present the main authority responsible for the supervision of banks, insurance and other finance sector companies, pension funds, investment firms, assetmanagement companies and the stock exchange. As emphasized in the FSIFS report, the more general objectives of official supervision should be spelled out in statute. It is important to reinforce FME's systematic supervision of all financial undertakings at the level of individual business units and to clarify its role as the comprehensive micro-prudential supervisor of all financial activity. In addition, given the current institutional

set-up, the FME and the CBI should be seen to be jointly and severally responsible for systemic stability.

The Act on the Finnish Financial Supervisory Authority (FFSA) is an example of legislation that provides the supervisory authority with an explicit systemic stability objective.[29] The FFSA operates administratively in connection with the Bank of Finland, but is by law an independent institution with its own objectives, its own board and with independent decision-making powers.

It is interesting to note that the Board of Directors of the FFSA has been given the responsibility to act as the national, macro-prudential authority for Finland to comply with the recommendations of the European Systemic Risk Board (ESRB).

The ESRB recommended that the member states of the EU "designate in the national legislation an authority entrusted with the conduct of macro-prudential policy". In light of an interim report on this matter and the need to designate an authority to carry out macro-prudential responsibilities according to the forthcoming EU/EEA banking legislation (CRD IV) most European authorities have been developing macro-prudential frameworks.

The Norwegian Government has decided that the Ministry of Finance, which is responsible for overall financial stability, should be invested with the powers to decide the counter-cyclical capital buffer according to the CRD IV proposal. This framework shall be in place at least until experience is gained on the implementation of this buffer. The buffer will be established following a recommendation from the Norwegian central bank.

Overall macro-prudential policy in Denmark will be vested in a special risk-council. The council has, however, only advisory tasks while the various authorities (central bank, financial supervisor and ministries) will retain their operational tools. The council will be chaired by a representative of the central bank, with one additional member from each of the financial supervisor and the three ministries dealing with economic and financial issues.

Sweden has not formally responded to ESRB´S recommendations but a committee is currently working on these issues and is expected to present its results by the end of 2012.

In the Icelandic system, macro-prudential analysis has been presumed to be the responsibility of the CBI, while the FME is responsible for institution-level micro-prudential analysis. The aim of macro-prudential analysis is, of course, to identify, as early as possible, systemic risks threatening the stability of the financial system as a whole. It involves combining macro- and micro-prudential analysis to assess the resilience of financial companies, financial markets and financial market infrastructures to various endogenous and exogenous shocks. Safeguarding the stability of the financial system in its entirety should clearly be seen as a shared responsibility of the FME and the CBI. This needs to be spelled out clearly in statute and constitutes one of the arguments in favour of bringing them together in an integrated monetary and financial stability authority.

An arrangement similar to the Finnish system warrants consideration in Iceland. But even without formal institutional changes there needs to be clear and consistent emphasis on systemic stability with well defined objectives and responsibilities. This

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[29] The first section of the Act on FFSA states:

> *The activities of the Financial Supervisory Authority are aimed at ensuring financial stability and the necessary smooth operation of credit, insurance and pension institutions, and other supervised entities, so as to safeguard the interests of the insured and maintain confidence in the financial markets.*

See Laws of Finland (2008)

would imply that the statutory objectives of both institutions be amended, adding new general provisions on their functions in relation to the proposed Act on Systemic Stability, cf. the following chapter. The Financial Stability Council (FSC) proposed in this report would be the ultimate forum for macro-prudential policy, accountable to parliament and the general public for such policy. The cooperation agreement between the FME and CBI is an important element in constructing a macro-prudential framework and should be carefully implemented and the cooperation of the two institutions further developed.

Drawing on Andrew Large's presentation in his report of May 2012 for the CBI entitled *Financial Stability: The Role of the Central Bank of Iceland*[30] the proposal to establish the FSC through a Systemic Stability Act would i. a.:

- replace the Committee on Financial Stability agreed upon by ministers and supervisors on 2 April 2012;
- provide a mandate for the Technical and Operational Committee (TOC);
- reflect and decide on recommendations from the TOC;
- consider and resolve eventual policy conflicts in its area of competence;
- provide continuity of authority for the conduct of systemic stability policies across the central elements of such policies including:
  - Reviewing and assessing the systemic conjuncture and resilience of the financial system; identifying incipient or actual threats to financial stability, or system-wide vulnerabilities and applying the available policy instruments to address these threats.
  - Identifying specific vulnerabilities or threats affecting individual (or a group of) financial undertakings or markets, together with the regulatory/supervisory measures to address them.
  - Providing crisis handling and resolution preparedness by developing an efficient crisis management mechanism, including determining the 'triggering device' to authorize the use of exceptional powers and to reconstitute itself in crisis management mode under the chairmanship of the Prime Minister.

When these elements have been clearly defined and articulated and tasks allotted accordingly to relevant institutions, the financial system would be better prepared to face unexpected challenges and shocks.

30 Large (2012), Davis and Green (2010), in particular chapter 3.

4

Overarching framework for the financial system

4.1 Financial Stability as a public good

Financial stability is a public good of major significance for the economy and society as a whole. The experience of the past four years has clearly illustrated how important it is to establish an overarching framework for financial stability policy in order to be able to deliver this public good. Although the root causes of the crisis go much deeper, the absence of a comprehensive and coherent legal basis for Iceland's financial system and the lack of clarity as to the responsibilities and powers of the various authorities concerned contributed to the build-up of the crisis of 2008 and complicated its management, as was highlighted by the Special Investigation Commission (SIC) in its report to the Althing in April 2010.[31] This lack of clarity as to accountability and ultimate responsibility was highlighted further in the court proceedings in the case against the former Prime Minister before *Landsdómur* (a special court of impeachment) in 2011 and 2012.

In a crisis, reliance on traditional or presumptive powers is inadequate. This speaks strongly in favour of a separate statutory framework for systemic stability policy. Such a framework should provide a uniform legislative basis for all financial activity undertaken in Iceland as well as a regulatory architecture that provides the authorities with an explicit mandate to foster financial stability together with the necessary powers to do so.

Systemic policy touches upon a number of distinct though related policy areas and can be implemented through a wide array of instruments. Systemic policy is, therefore, difficult to fit into the 'one-objective-one-instrument-one-authority' model that has been used with some success in other economic policy areas, for instance, in monetary policy-making for inflation targeting. Moreover, some elements of systemic financial stability policy may involve trade-offs between competing objectives.

For example, there may be a trade-off between the soundness of the financial system and short-term economic growth. A regulatory regime requiring very high levels of capital for financial undertakings may ensure financial stability, but may at the same time be seen as inhibiting economic growth. On the other hand – as evidenced by recent experience – it is clear that rapid economic growth driven by an excessive and conjunctively dangerous expansion of credit, leverage and debt may well lead to financial instability. The conflict between systemic stability and growth may be more imaginary than real, and is certainly so in the long run, where the objectives of systemic stability and sustainable growth will tend to converge. There might also be a trade-off between efficiency and stability – for instance, a limited purpose banking system might be

[31] Rannsóknarnefnd Alþingis (Special Investigation Commission of Althingi) (SIC) (2010).

stable but it could prove less efficient in providing long-term finance for commerce and industry than universal banking.

Many of the trade-offs are – and may always be – politically contentious. For this reason the decisions on them cannot be delegated completely to a technocratic executive agency, even though impartial and professional analysis of the trade-offs will always be essential for such decision-making.

Since a number of different financial authorities, with differing degrees of political authority and technocratic capacity, are likely to take an interest in systemic stability, it is important to specify clearly what the responsibilities of each authority are and determine the manner in which they interact and are held to account. This involves determining what matters each authority can decide upon singly and what matters they need to decide on jointly. There should also be an explicit obligation to cooperate, including the obligation to share information, to inform other authorities of developments or actions relevant for their particular sphere of responsibility and to take action without delay when a crisis looms. The establishment of a specific authority to organise coordination and cooperation among the various public authorities dealing with the financial sector and to take the lead as the national macro-prudential authority entrusted with responsibility for systemic stability policy is essential.

After reviewing a wide range of literature on financial stability in different jurisdictions, and taking due note of the experience of Iceland and other countries in the period leading up to and during the financial crisis, we have come to the conclusion that policy aiming at financial stability should be seen as the third pillar of economic management alongside monetary and fiscal policy.[32] To permit such a policy to be implemented it is necessary to create a coherent and independent financial stability framework. Such frameworks are currently being put in place in a number of countries, but their nature varies considerably. In some cases, the focus is on crisis prevention through macro-prudential policies that place a systemic overlay on micro-prudential policies intended to secure sound and prudent behaviour by individual institutions. In other countries, the framework is broader and encompasses actions to address flaws in the way the financial system operates and is regulated.

Consistent with the analysis in the foregoing section, we are of the view that an effective framework must be broader and address the root causes of systemic instability that lie in macroeconomic disequilibria, distorted incentives, excessive complexity and structural weaknesses in the financial sector. As such the framework should encompass crisis prevention, but it is naive to think that this alone will suffice. It is important to have in place effective crisis management and crisis resolution arrangements. The framework should provide for monitoring and identifying systemic risks and initiating action in response. It should specify crisis management responsibilities and procedures and it should provide powers to resolve both financial institutions in distress and systemic crisis involving more than one institution. An explicit statutory framework for this purpose should be introduced in Iceland, sooner rather than later, while memories from the crisis are still fresh in peoples' minds.

[32] Clark and Large (2011), Turner (2010) ,Turner (2011), Large (2010) Davis and Green (2010), Davis and Green (2008/reprint 2011) and Bank for International Settlement (2011).

4.2 Systemic Stability Act

The most effective way to focus attention on financial stability policy as an important aspect of economic management is to codify its objectives in law and establish in a single act a systemic stability authority with responsibility for oversight of systemic risk and for coordinated and resolute responses to threats to financial stability. The same law would also provide for common standards and harmonized prudential rules applicable to all financial undertakings and their activities. Umbrella legislation of this kind to harmonize prudential requirements and standards for all financial activities is important for financial stability, not least to close loopholes for unregulated or less regulated activities that might if unchecked grow out of control and create systemic risks through the rise of so-called shadow banking.

The act would also provide for a new, two-tier architecture for financial stability policy with varying but clearly specified responsibilities for crisis prevention, crisis management and resolution. Recognizing that some decisions relevant for financial stability are inherently political, the first tier would be designed to secure political legitimacy for them. At the same time, great technical expertise is needed to prepare and implement the decisions. Moreover, some decisions – most particularly those related to monetary policy – should be kept out of day-to-day politics. Accordingly a second, technocratic tier would be responsible for developing systemic policy proposals and for making decisions in areas that should be shielded from the vagaries of politics.

The cleanest and simplest architecture would be for the first tier to consist of three persons. Assuming that all finance sector matters were to fall under the same ministry and the CBI and FME were to be brought together in an integrated monetary and financial authority, the three persons would be: the minister responsible for financial stability (Minister of Finance and Economic Affairs), the head of the integrated monetary and financial stability authority and an impartial, independent professional member. The second tier would be located in the integrated monetary and financial stability authority and consist of senior officials with extensive supervisory and central banking experience.

The Group is, however, mindful of recent decisions regarding the allocation of ministerial responsibilities, which make the CBI and the FME responsible to two respective ministries and that there could be institutional inertia to an outright merger of CBI and FME. In the following we take note of the allocation of responsibilities between the Ministry of Finance and Economic Affairs and the Ministry of Industries and Innovation as of 1 September 2012 and propose that the CBI and FME be given a common operational platform as soon as possible, but retain their separate identities until it is determined how they can best be integrated into a single unified monetary and financial stability authority for Iceland.

Recognizing that monetary and prudential policy need to be separated, both the central banking and supervisory activities would be separated organizationally despite having a common operational platform, as is the case in most countries where monetary and supervisory responsibilities are integrated (e.g. Finland) and where they soon will be (United Kingdom and the Eurozone).[33] Estab-

[33] In its Proposal of 12 September 2012 for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions, European Commission (2012b), the Commission states that: "Monetary policy tasks will be strictly separated from supervisory tasks to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision. To implement the necessary separation between both tasks and en-

lishing separate but integrated policy making and governance structures should take place within three years.

The new institution responsible for both monetary and financial stability policy would clearly require more stringent and effective governance, stronger checks and balances and more clearly structured accountability to parliament than is presently the case for its potential constituent parts.

Because the institutions responsible for the 'third pillar of macroeconomic policy' will have important public responsibilities and significant powers that affect public welfare, it is critical that they be subject to the highest standards of good governance. Such responsibilities and powers require clear specification of objectives and of the actions that the authority can take; requiring clarity about who has the authority to act and how decisions to act are made; requiring a set of incentives to prompt the decision makers to act in a manner consistent with the achievement of the objectives; requiring that there be an array of checks and balances in place to deter any potential abuse of authority; and ensuring that there are effective means to hold those who wield the powers to account.

One challenge in designing effective governance arrangements for the financial stability area is the lack of clarity about the actions that are needed. As sufficient understanding of how different measures affect the resilience of the financial system is lacking, it is advisable to build some flexibility into the system.

Good governance, transparency and accountability are essential for confidence in the regulatory and supervisory system. To secure this it is necessary to:

- Determine the extent and nature of enabling legislation granting discretionary powers to the FSC or its implementing and supporting agencies and the extent of these discretionary powers; the greater the powers, the greater the accountability.
- Clarify who is responsible for which decisions and how they are made (singly or jointly; by consensus; by voting; disclosure of votes/views expressed).
- Ensure open, transparent and merit-based appointment processes for key officials responsible for financial stability.
- Ensure there is continuity and renewal in policy-making bodies by instituting fixed but staggered terms for their members.
- Introduce checks and balances and 'double key' decision making arrangements to ensure effective checks and balances in areas where they are needed. In double key decision-making, two separate parties are involved in making decisions. They are commonly used to avoid the abuse of power.
- Increase regular reporting to parliament on financial stability and prudential supervision matters, building on the practices developed for monetary and fiscal policy. Such reporting will of course be subject to strict confidentiality requirements.

Components of the act on financial stability

The act on financial stability (Systemic Stability Act) would have the following main components:

I. Its objective of delivering systemic financial stability as a public good of major significance for the economy and society as a whole should be clearly stated.

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sure appropriate attention to supervisory tasks, the ECB will ensure that all preparatory and executing activities within the ECB will be carried out by bodies and administrative divisions separated from those responsible for monetary policy. To this end a supervisory board will be set up that will prepare decisions on supervisory matters."

II. Umbrella provisions should lay down common standards and harmonized prudential rules for all financial institutions and their activities, respecting and referring to existing legislation on the financial sector.
III. A statutory mandate should be established for the systemic stability authority – the Financial Stability Council (FSC) responsible for policy decisions – and for its support unit, the Technical and Operational Committee (TOC), which should be provided by the integrated monetary and financial stability authority, if and when created, and by the CBI and MFE until then.
IV. Statutory authority needs to be given to the FSC to deploy systemic stability instruments and to instruct or invite its implementing agencies to use them.
V. Provisions should be made for supporting the work of and implementing the decisions of the FSC.
VI. Decision making procedures should be laid down for the FSC and the TOC, including provisions on transparency and the accountability of the FSC and the TOC for their decisions.
VII. Provisions should specify entry into force and related matters.

A brief comment on each of these components follows:

I. The purpose of this legislation is to enhance and preserve financial stability as a public good of major significance for the economy and society as a whole. The definition of financial stability needs to be very carefully considered when a specific public authority is entrusted by law with the responsibility of supervising systemic stability and taking actions to promote it in the economy as a whole. To focus attention on the importance of this goal of economic policy, a definition of financial stability should be placed in the statute along the following lines, attempting to balance clarity with flexibility:

> *Financial stability is a state in which there are no substantial discontinuities in the functioning of the financial system and in which it is able to withstand shocks without giving way to cumulative processes that may impair the allocation of savings to investment, the inter-temporal shifting of consumption, effective price discovery (of financial and real claims), prudent management of financial risk or the operation of the payments system of the economy.*

The financial system as referred to in this context would encompass the entire banking system and all other undertakings whose activities are financial in nature, including the Housing Financing Fund (HFF), the pension fund sector and all other financial institutions and – very importantly – the payments and settlement system, involving both domestic and international payments.

II. Umbrella provisions on common standards and harmonized prudential rules for all financial institutions and financial activities should be proposed as part of the law on financial stability, to ensure that comparable duties and obligations, as well as rights that are conferred by statute, are placed on all firms active in the financial markets. This can be done with reference to existing special legislation for the bulk of financial business and by extending the application of such legal provisions where and when appropriate to firms which are unregulated or less regulated than, for example, banks, securities firms or insurance companies. This part of the proposed financial stability law is important both in order to deal with existing differences in treatment under the present legal framework and to prevent or discourage 'shadow-banking' which could potenti-

ally grow out of control, giving rise to systemic risks.[34]

III. Coordination for systemic policy needs to rely on extensive cooperation between the lead systemic stability authority and other authorities concerned with systemic stability. In Iceland this would include the Ministry of Finance and Economic Affairs (MFE), the Ministry of Industries and Innovation (MII), the Central Bank of Iceland (CBI) and the Financial Supervisory Authority (FME). For successful systemic policy implementation close and effective engagement is needed among the authorities involved. Many developed countries seek to achieve this through some kind of formal, high-level, coordinating authority – a board or a council for financial stability – preferably with a statutory objective for proactive decision making.[35]

This approach would seem to be called for in Iceland. It is, therefore, proposed that the financial stability law should provide for the creation of the Financial Stability Council which should be tasked with the responsibilities to review and assess the systemic conjuncture and resilience of the financial system; to identify incipient or actual threats to financial stability on the basis of analysis by its Technical and Operational Committee (TOC) and to apply the policy instruments available directly to the Council, or to invite its implementing agencies to apply policy instruments under their control; to address these threats or, when responsibility for relevant instruments lies elsewhere, to recommend policy actions to be taken by other authorities.

The responsibilities of the FSC would also include

- specifying a systemic stability mandate for the CBI and the FME within the statutory framework setting out the objectives for financial stability policy;
- evaluating trade-offs between financial stability and other public policy objectives (growth, employment, efficiency, competition);
- identifying and designating institutions, infrastructure providers or market practices as systemically significant and therefore subject to special powers given to the FSC, FME and CBI;
- empowering or requiring the CBI and the FME to implement different types of systemic stability measures (e.g. to reduce intra-system leverage and/or maturity transformation; to change the structure of financial institutions so that they can be resolved easily without impairing the performance of critical functions, etc.);
- proposing legislation needed to enhance systemic stability;
- determining, using well defined triggers, when crisis management protocols should apply; and
- determining, when acting in crisis mode, whether public money should be used to deal with a systemic crisis.

Ideally the FSC would be composed of the single minister responsible for financial stability (Chair), the head of the integrated monetary and financial stability authority and an independent expert. In the absence of the necessary reforms, the FSC should be comprised of the Minister of Finance and Economic Affairs (in the Chair), the Minister of Industries and Innovation (Vice-Chair), the Governor of the CBI and the Director General of the FME. In carrying out its mandate as outlined above the FSC should have regard to competitive conditions in the financial sector in consultation with the Competition Authority. Furthermore, the FSC would also be responsible for triggering

[34] European Commission (2012c), Financial Stability Board (April 2012).

[35] Clark and Large (2011), Davis and Green (2010) and Bank for International Settlements (2011).

the transition from 'business as usual-mode' to 'crisis mode' for the financial system and take overall charge if financial crisis situations arise, requiring intervention or recovery and resolution action to be taken, such as actions to deal with ailing or failing financial undertakings. If a financial crisis is declared by the FSC, the Prime Minister would join the FSC as a full member and assume the chairmanship.

The FSC should meet every quarter or as often as may be required.

The TOC should be composed of two members from the CBI, and two members from the FME. The TOC would be chaired by the Deputy Governor of CBI with the Deputy Director General of the FME as Vice-Chair, both being active members of the TOC. Two senior officials, one from each of the Ministry of Finance and Economic Affairs and the Ministry of Industries and Innovation, should have permanent observer status at meetings of the TOC. The duties of the TOC are to provide the FSC with analysis of the systemic conjuncture and resilience of the financial system, to identify incipient or actual threats to financial stability and to propose to the FSC suitable policy actions in response to such threats. In this task its members can draw on the expertise and resources of the institutions they represent. Consideration needs to be given to the nature of the proposals made by the TOC — whether a decision can be made by the FSC without a proposal from the TOC, whether the FSC can modify a proposal from the TOC, whether the TOC has the sole right of proposal or whether proposals can be made by the institutions providing its members or by FSC members or by third parties.

It is clear that the analytical underpinnings for assessing systemic risks in the financial system are in their infancy and need to be developed. The same is true of the proposed policy instruments to contain systemic risk. Furthermore, the TOC will take decisions on technical and operational matters on the basis of a mandate given to it by the FSC.

The TOC should meet regularly at least every month, or as often as is required, and have its secretariat at the CBI.

The FSC and the TOC will need to monitor not only conjunctural indicators that may warn of a build-up of systemic risk in the financial system, but also structural indicators of change, such as on the emergence of new financial instruments and new forms of business activity as well as measures of inter-linkages in the system, which may indicate potential sources of risk. Even if many of the macro-prudential instruments proposed in the literature have been used for micro-prudential (and even on occasion for macro-economic) purposes in the past there is only limited experience of their use for macro-prudential objectives. Consequently, caution is called for in the use of macro-prudential policy measures for both theoretical and empirical reasons. Numerous studies are underway on this topic in many countries and internationally. The FSC and the TOC need to follow these studies carefully in their work. The FSC should be given the responsibility to propose new instruments of macro-prudential policy to be deployed by the implementing agencies.

The FSC should be accountable to parliament and should present annual reports to the appropriate parliamentary committee, and such other reports as may be required.

IV. A statutory mandate should be established in the proposed Systemic Stability Act for the systemic stability authority (FSC). The FSC should be empowered to use systemic stability instruments or to invite its implementing agencies to do so. Given the potential diversity of instruments that might be used for systemic stability purposes, the lead systemic stability authority needs to have correspondingly flexible powers. The list of instruments presented for use as

macro-prudential instruments, e.g. in chapter 8 of the FSIFS-report, shows clearly that there need to be distinctions in the powers over such instruments given to the FSC. The FSC might be given the power to administer some policy tools directly through its implementing agencies; for others it could be given the power of recommendation, where the recipient authority is required to comply or explain; and in yet other instances it might simply have the responsibility to make public recommendations to 'take note' of the need for certain policy actions, without necessarily providing a formal response.

V. The FSC's supporting (and implementing) agencies are the CBI and the FME (or the prospective integrated monetary and financial stability authority). These institutions should be given statutory obligation to support the FSC in its operations and to implement its decisions in accordance with their legal remit. Provisions should be made for supporting arrangements for the FSC, first through the TOC and then by the proposed integrated monetary and financial stability authority when it has been established.

VI. Preparing proposals on the policy tools relevant for the conduct of systemic stability policy and their application should be among the first duties of the FSC. The Systemic Stability Act should include authority for the relevant minister(s) to establish such rules on the basis of proposals from the FSC.

VII. The overarching objective of financial stability legislation, as described in first paragraph of this chapter, should be the guiding light for all decisions of both the FSC and the TOC. In all cases these bodies should aim at consensus when making decisions on policy action. In case consensus cannot be achieved, decisions will be made by simple majority voting. In both bodies the chair shall cast the deciding vote in the event of a tie. Insofar as systemic stability policy decisions may involve overriding or modifying actions taken by other financial authorities, it is necessary that the framework for decision-making should be clear and consistent. It is important that all actions taken by the systemic stability authority to ensure financial stability be well founded and documented. Care must be taken to develop suitable procedures and information channels for public disclosure of decisions taken and their analytical underpinnings. Untimely transparency can, however, undermine the intended purpose of policy action taken to instil confidence in the financial system. The timing of disclosure should, therefore, be chosen with care and disclosure should not take place until such time has come that any risk of upsetting the financial markets is minimal. It is a greater challenge to disclose information on systemic stability policy than, for instance, monetary policy because financial stability is more complicated than price stability. Consequently it is more difficult to define the objectives and success or failure of actions taken in the area of systemic stability policy than is the case for monetary policy aiming at price stability. This challenge has to be met, because transparency and disclosure of the grounds for important policy decisions is the only way to ensure informed public scrutiny of the decisions taken and the accountability of the responsible authorities. It may inevitably take some time to develop suitable procedures and channels of communication for disclosure of systemic stability policy decisions. This should be a priority task for the FSC and its TOC.

VIII. Other provisions of the Systemic Stability Act will need to address such issues as entry into force, transitional arrangements and the relationship with other laws that bear

upon the financial system. It will also need to ensure that the FSC and its supporting and implementing agencies are able to obtain all data needed for systemic stability analysis, both within and outside the regulatory perimeter. In addition it will need to give the relevant minister(s) authority to issue rules and regulations on the basis of the Act's provisions.

5

Corporate structure, ownership and control rights

5.1 Complex corporate structures

The process of consolidation that has characterized the development of the financial sector in most countries in recent decades has not only led to concentration. It has also created large and complex financial institutions with both cross-sector and cross-border characteristics. Complex corporate structures can be a source of systemic risk. Cross-ownership among financial undertakings complicates matters still further. The basic question is, how should financial firms be structured so that they are stable, efficient and perform clearly defined fiduciary responsibilities? These aspects should be carefully considered when authorizations are issued to financial firms and followed up in regular supervision of their operations.

Another structural aspect concerns how firms are structured to address the problem of divided loyalties. Is the firm serving buy side or sell side interests? How can synergies between lending to companies and institutions and securities issuance and trading on behalf of clients be exploited to lower the cost of operations without distorting incentives and consequently the functioning of the market? The problem is twofold: On the one hand the risk of illegal use of insider information and on the other the agency problem. Whose interests are being served? The seller's, the buyer's or the agent's?

To address the insider trading problem, secure Chinese walls are needed in all financial undertakings, and they need to be thoroughly scrutinized by supervisors on a regular basis.

The logical way to deal with the problem of divided loyalties and asymmetry of information is to ensure that the different functions of financial firms are carried out separately. This has the added advantage that the functions are separable in the event of distress. The synergies of universal banking can then be exploited to lower costs and concerns about investment banking and commercial banking can be addressed. This can be facilitated by careful structuring of banking licences and by the provisions of the resolution and regulatory regimes.

5.2 Correction of distorted incentives

In section (2.3.2.) above the need to counteract conflicts of interest and to correct distorted incentives is discussed. In the present section this is followed up with further reflections on this important matter and a number of measures are proposed to deal with these problems. Conflicts of interest and distorted incentives arising from connected lending, board and management compensation packages, bonus schemes, leverage and limitations on liability of managers, directors and shareholders need to be resolutely dealt with. The following list indicates several measures to this end:

- Review changes already made in the legal framework to better regulate connected lending and decision makers' pay with an eye to encouraging prudent behaviour.
- Consider introducing limits on gross leverage and loan-to-value ratios and find ways to make the legal liability of both shareholders and management more extensive than at present to deter risk-seeking behaviour. Follow closely proposals on these matters being developed by the FSB and within the EU/EEA.
- Structure decision makers' compensation so that any variable remuneration is vested in a manner that takes long-term performance into account. Consider whether the length of time that variable remuneration of decision makers is to be held in escrow accounts should be extended.
- Make vested managerial compensation first in line for absorbing losses, with no control rights arising from the conversion of such compensation into claims.
- Ensure that managers of institutions that go into resolution are subject to rigorous fit and proper vetting for future financial sector employment.
- Ensure that the national credit registry (NCR) is structured to provide full information on the exposures of the counterparties of financial undertakings even when they have complex and changing legal structures. Extend the NCR's coverage to smaller credits to enable comprehensive use of the registry for credit risk evaluation by the banks and the authorities.
- The accounting treatment of unrealized capital gains and losses in the income account may be in need of a review from the point of view of financial stability. The external auditors of financial firms should disclose these effects clearly in the interest of prudent behaviour.
- Shift focus from ROE (which encourages leverage) to ROA (which focuses on total return). Encourage the use of ROA in the presentation of financial statements of financial firms, in particular firms where the Government holds a controlling share. Consider strengthening the requirements placed on external auditors to disclose not only ROE but also ROA in their reporting.
- Seek to eliminate or at least to reduce the 'too-big-to-fail' syndrome by 1) addressing the financial risks and risks of regulatory capture associated with firm size, 2) by making essential financial functions separable in resolution and 3) by making resolution effective and orderly as well as timely.

6

Resolution regime

The financial crisis has highlighted that public authorities – as well as the banking industry itself – are ill equipped to deal with ailing banks, particularly when they are large, complex and internationally active. In order to maintain essential financial services for the economy governments have in recent years been forced to inject public money into banks and provide government guarantees for banking operations. The measures undertaken in Iceland under the Emergency Act of October 2008 are an example of this kind of government action. To ensure that in the future authorities will have the means to intervene decisively, both before problems occur and early on once they do, new statutory powers may be needed. Furthermore, if the financial situation of a financial undertaking deteriorates beyond repair contingency plans are needed to ensure that its critical functions can continue without imposing costs on taxpayers or society. These costs should be borne by the undertaking's owners and creditors. This is the aim of the frameworks for recovery and resolution of ailing or failing financial undertakings drawn up both by the FSB and the EU Commission and presently under intensive development.[36]

In Iceland the Emergency Act of 2008 put in place a provisional resolution regime for financial institutions. The provisions of the Emergency Act have been transferred to the Act on Financial Undertakings; some of them as interim provisions authorising the FME to intervene into the operations of ailing undertakings. These provisions should now be replaced by a permanent and comprehensive framework for recovery and resolution, should Iceland be hit by another financial crisis in the future. In doing so account should be taken of the EU Commission's recent proposals on recovery and resolution[37] and the Financial Stability Board's Key Attributes.[38]

In section (2.3.2) the need to establish a permanent resolution regime is discussed. We recommend that such a resolution regime be established to replace the current, partly temporary, provisions in the Act on Financial Undertakings on these matters. It is important to establish this regime to allow orderly resolution of financial firms in distress and thereby minimize the systemic disturbance that a failure of a financial undertaking can otherwise have for the whole economy. The new regime modelled on the recommendations of the FSB's and the EU Commission's proposals on this matter should designate FME as the resolution authority for all financial undertakings as defined under revised umbrella legislation proposed in this report.

The legislation relating to resolution should prescribe the same ranking of claimants as in bankruptcy, except that

I. deposits covered by an approved deposit guarantee scheme, up to the guaranteed amount shall rank ahead of other unsecured claims and, as a consequence, the claims of the deposit guarantee authority on the institution arising from the payment of deposit guarantee shall have the same ranking;

[36] European Commission (2012c) and FSB (October 2011).

[37] European Commission (2012d)

[38] Financial Stability Board (October 2011).

II. instruments issued to provide variable compensation to employees of the financial undertaking shall take the form of equity without voting rights or subordinated instruments that rank immediately above shareholders' equity claims and below all other junior subordinated instruments;
III. FME should have flexibility to depart from the equal (pari passu) treatment of creditors of the same class if necessary to contain the systemic impact of failure and maximize value for the benefit of all creditors as a whole, subject to the condition that all creditors receive amounts in line with what they would have received in liquidation.

The FME should have the power

- to require that any financial undertaking subject to its resolution authority be 'resolvable', i.e., structured and operated in a manner that permits rapid and orderly resolution, with a minimum risk of contagion. Such powers relate to the legal and corporate structure of the group, to the way a firm conducts its business (accounting practices, use of intra-group guarantees, segregation of client assets and monies, etc.) and organizes functions such as IT, back office, liquidity management, risk management, etc.;
- to require financial undertakings, in particular those deemed to be of systemic importance, to prepare recovery and resolution plans ('living wills') accepted by the authority;
- to require financial undertakings to maintain management information systems that are able to produce information relevant for resolution on a timely basis (e.g., single customer view to facilitate deposit pay-outs, location of assets, booking of claims in legal entities, etc.);
- to alter licences granted to a financial undertaking in the event that periodic review of operations and business models reveals that a change in the scope and nature of the financial undertaking's operations is needed to promote systemic stability. In addition, the FME should have the power to require that financial undertakings are structured and operated so that functions such as investment banking and commercial banking or any other function that is deemed essential are separable in resolution;
- to require changes in funding and asset allocation structures (maturity, leverage, type of counterparty, financial instruments, borrowed vs. own funds, senior vs. junior debt, etc.) for a financial group and/or its constituent parts in the interest of the financial stability of the undertaking and the financial system. Such powers would extend only to the nature and overall size of classes of assets and liabilities and transactions related to them. They would not permit the FME to instruct the financial undertaking to engage in particular transactions, except in the case of resolution where such powers could be exercised;
- to require variable compensation to be vested for as long as the recipient is employed by the financial undertaking and be provided in the form of non-negotiable instruments that can be converted into shares in the event of a resolution but that, when converted, do not provide the holder with voting rights;
- to remove management and directors, who then automatically become subject to heightened fit and proper scrutiny for any future employment in a financial undertaking. According to interim provision No. VI of the Act on Financial Undertakings, the FME already has these powers; they should be retained;
- to designate any other key employee of a financial institution in resolution as sub-

ject to heightened fit and proper scrutiny;
- to appoint an administrator to take control of the financial undertaking in place of the board of directors and shareholders, whose powers then become null and void. The FME has these powers under current legislation; they should be retained.
- to apply any of its resolution powers to specific parts of a financial undertaking's business (e.g. investment banking, trading, insurance, retail banking, etc.). The FME has these powers under current legislation, they should be retained;
- to terminate, assign or transfer existing contracts, buy, sell or transfer assets and liabilities, legal rights and obligations, including deposit liabilities and ownership in shares, notwithstanding requirements for consent or novation. This provision is part of the current legislation and should be strengthened;
- to write down, in a manner consistent with the statutory ranking of claims in bankruptcy, equity or other instruments of ownership and unsecured claims to the extent necessary to absorb losses. This is in line with current legislation and should be retained;
- to impose a moratorium on payments and a stay on creditor actions (except for payments and property transfers to financial market infrastructures). This provision is currently in place and should be retained;
- to stay temporarily the exercise of early termination rights or netting provisions to permit the orderly transfer of operations to another entity (subject to adequate safeguards)[39];
- to establish legal entities to take over and continue operating any critical functions and viable operations or to manage and run down non-performing or other impaired assets. The FME has these powers under current legislation. They should be retained;
- to effect the closure and orderly wind-down (liquidation) of the whole or part of the failing financial undertaking. The FME has these powers under current legislation. They should be retained.

Judicial review of resolution measures should not constrain the implementation of, or result in a reversal of, measures taken by the FME. Instead it should provide for redress by awarding compensation, if justified. Appeals against resolution actions should not have the effect of suspending the implementation of the measures.

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[39] See FSB (October 2011) and International Institute for the Unification of Private Law (2012).

7

Institutional architecture and policy making processes

In a small country like Iceland the need to organise regulation and supervision of the financial sector in an efficient manner is felt even more strongly than in bigger countries. The institutional architecture for these important functions needs to be both effective and economic, utilizing existing institutions in the best possible manner as building blocks for an improved system. The task at hand is to determine how the following seven different functions can best be performed — as the sole, joint or shared responsibility of different authorities and institutions:

- Establishing suitable laws, regulations and rules for a stable and efficient financial system.
- Addressing systemic risk arising from cyclical and structural distortions or from network effects.
- Supervising the behaviour of financial institutions.
- Ensuring the continuity, depth and liquidity of key markets.
- Guaranteeing that the financial market infrastructure (clearing, settlement, payments) functions.
- Protecting the unsophisticated consumer, prosecuting financial crime, deterring money laundering.
- Resolving financial institutions in distress.

In all the areas outlined above, form should always follow function.

A few reflections on the allocation of responsibilities for these seven functions are in place.

The law-making function and the authority to issue legally binding rules and regulations belong, of course, ultimately to parliament and the relevant ministries. But the views of the authorities and institutions vested with responsibility for financial stability should always be sought on changes in the legal framework of the financial sector. This right and obligation should be made explicit in statute.

To address systemic risk in the financial sector properly, a comprehensive systemic policy framework is needed. As argued in chapter 4 of this report, a tripartite structure is necessary for effective systemic policy, bringing together the financial regulators/supervisors, the monetary authority and the fiscal authority, and securing at the same time political legitimacy for the systemic policy authority. The establishment of the FSC as proposed in this report would accomplish this.

The supervision of the behaviour of financial institutions and their compliance with laws and regulations in force regarding their operations should primarily be the responsibility of the FME at the level of the individual firm. But this important function is shared with the CBI as regards liquidity and foreign exchange matters because of the close connections between these areas of business and the CBI's activities. It is important to avoid unnecessary duplication of supervisory effort both to minimise costs for the public purse and to avoid burdening the supervised entities with unnecessary bureaucracy.

The CBI is involved in the key financial markets and should bear responsibility for oversight of their proper functioning. The FME has responsibility for supervising the conduct of the actors in the financial markets as regards fair trading and proper conduct vis-à-vis the customers of financial institutions.

The CBI is responsible for the oversight of the payment system and provides important infrastructure services for the payments system. These activities need to be subject to effective oversight.

Consumer protection in the financial market as well as deterring financial crime, money laundering and other illegal financial activities are within the remit of the FME. These functions warrant a specialized department within the FME. Money laundering and financial crime cases require close cooperation between the FME, the police and the public prosecutor.

The most natural location for the resolution function is with the FME, where it indeed is located at present. But changes are needed to give it greater and clearer authority and financial capacity to deal with recovery and resolution matters in cooperation with the fiscal authorities.[40]

7.1 Allocation of tasks

There are a number of tasks to be allocated among the financial, monetary and, in some cases, judicial authorities. The list includes:

licensing; deposit guarantees; resolution; consumer protection; liquidity; continuity and depth of markets; capital; firm structure; risk management; forensics' enforcement; fraud and financial crime; money laundering; consumer protection; market maker of last resort; lender of last resort; owner of last resort; provision and regulation of financial activities by non-financial institutions.

It is necessary to clarify the respective roles and responsibilities of the CBI and the FME and streamline their operations. The following recommendations are made in this respect:

- Specify clearly statutory financial stability objectives for both the CBI and FME.
- Allocate specific regulatory and supervisory tasks to the CBI, with the FME having oversight of all institutional risk and sole responsibility for resolution.
- CBI should share liquidity and foreign exchange balance supervision with the FME. This close cooperation would of necessity imply unobstructed flow of information on these matters between the two institutions in both directions. The CBI should be responsible for stable, continuous and deep markets in financial instruments relevant for liquidity (repos, etc.) and should have the necessary regulatory powers to perform this task. In addition, it should have the power to obtain relevant information regarding these matters from any Icelandic entity and from supervisory authorities abroad.
- The FME would continue to be the licensing authority and be required to consult the CBI on licensing of banks. The FME should have the power to tailor the licences and be obliged to review the appropriateness of the scope of the licences periodically.
- The CBI and the FME should have jointly and severally responsibility for identifying structural factors that are leading to, or are likely to lead to, financial instability.

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[40] According to the EU Commission's proposal there would be a need to ensure that "there is a seperation between the resolution function and the supervisory functions" within the FME. European Commission (2012d).

7.2 Operational arrangements

Practical, operational arrangements of FME and CBI need to be strengthened. The following recommendations are made:

- Create a common administrative and support infrastructure for the CBI and FME (including, integrated or at least compatible information technology systems with common databases, human resource policies, accounting and budgeting arrangements, facilities management, legal, and other administrative services).
- Separate treatment of retail consumer complaints and of financial crime, money laundering and related matters from prudential supervision and assign them to one or more separate units operating within the FME. Close collaboration with the police and the public prosecutor is needed in dealing with financial crime and money laundering issues.
- Lay down common reporting and inspection standards and procedures to be used to collect all supervisory information used either by the CBI or the FME or both.
- Establish clear and compatible governance arrangements for both institutions, including rigorous professional and impartial appointment procedures and effective oversight for areas of shared responsibility.
- Audits of the use or resources and procedures of both the CBI and FME should be performed on behalf of their boards by outside experts.
- Make the CBI and FME (and the prospective integrated monetary and financial stability authority) accountable by law to Parliament. At present the Monetary Policy Committee (MPC) of the CBI is by law accountable to parliament in a formal manner, and is required to report to the relevant parliamentary committee at least twice a year. The amendment of the procedural law for the Althingi enacted in 2011 establishes and widens its authority to summon representatives of public institutions, such as the CBI and the FME, to appear before parliamentary committees to report publicly on their activities. This parliamentary authority has already been put to use with regard to both the CBI and FME following the entry into force last year of the new amendment. The possibility should be considered of making such reporting duties, on a regular basis, directly and explicitly a statutory requirement for both institutions and for the proposed new integrated authority.

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