Kaarlo Jannari, May 14,2008

Speech at the Annual General meeting of the Icelandic Financial Services Association: Reflections on the present financial crisis in general and in Iceland in particular

Mr. Chairman, Honorable guests, Ladies and gentlemen,

I feel very honored to be standing here today to address the Annual General Meeting of the Icelandic Financial Services Association, Samtök fjarmalafyrirtækja. I reckon that the reason for inviting me to speak this morning is that I wrote a report on Banking Regulation and Supervision in Iceland at the request of your government as part of your stand-by arrangement with the International Monetary Fund (IMF). The report was published at the end of March this year. The report seems to have been rather well received or at least it has been received with some interest as otherwise you would not have invited me here today. I also know that your government has initiated work on the possible implementation of some of my recommendations.

I do not aim to dwell in any detail on my report. Rather I shall try to look into the future and discuss the global financial crisis with special emphasis on developments and challenges within the European Single Financial Market of which Iceland is a part of through your membership in the European Economic Area (EEA). Towards the end of my speech I will make a few comments on the situation in Iceland.
I shall start, however, with briefly recalling my report and some of its conclusions. The financial economic catastrophe that hit Iceland in early October 2008 did not come without warning from the blue. It was built up gradually basically by your own actions which were made possible by the laxity in the global economy and the international financial markets. All that I try to describe in my report. In retrospect it is easy to say that your crisis is the result of a dangerous cocktail of bad banking and bad policies. There is also an ingredient of bad luck, but honestly I believe that your banking system would have ended up in deep crisis even if Lehman Brothers had not been allowed to go bankrupt in the United States. With better luck you could have perhaps come out of the crisis with less damage, but obviously there was no chance that your banks could have gone on living in their risky ways for much longer. I am sure many books, by insiders, investigating journalists, economists and real authors will be

written about the crisis and about the effect it has had and will have on the people. Some have already come out, I have been told, and many more will follow. But only many years from now an objective overall analysis of the calamity will be possible. Now it is still too early. There is too much emotion, suffering and pain still around and still will be for some time to come.

Now you, Icelanders, have to do all you can so that it can never happen again in your country. The crisis is, however, now global and it is up to the major economies (including the EU) and their leaders and the international organizations like the IMF, WTO and the World Bank Group to develop and improve on our global market economy system.

As to my recommendations to you I understand that the proposal to concentrate financial sector legislation and matters to one ministry is largely being adopted. I hope the same applies to my proposal to bring Seðlabanki and Fjármálaeftirlitið (FME) closer together or even to merge them. Both of them should also be allotted sufficient resources to fulfill their duties.

I am also proposing setting up a National Credit Registry (NCR). All loan from banks (perhaps above a certain threshold) would be registered and accounted for by the NCR which could be run by the FME. Banks could have access to the Registry to check whether a loan applicant already has loans outstanding in other banks. That would help to assess the creditworthiness of the client and the potential credit risk. The permission of the loan applicant should, of course, be needed for an inquiry to the Registry in order to safeguard the privacy and confidentiality of the client information. If the client were to refuse such a check that would obviously reflect negatively on his or her chances to get a loan.

The Supervisory Authorities on the other hand could use the Registry to assess large exposures and connected lending on the macro or national level and also by economic sectors. This could be useful to detect developments that might pose systemic risks in the economy.

The information on the Registry should, of course, be strictly protected and be used only for supervisory and credit risk assessment purposes. Banking Secrecy is an important cornerstone of good banking practice in the Western World. People and firms have to be able to to trust that their financial matters with the banks remain confidential. Therefore access to this kind of information should be strictly limited to the purposes I have described above. Quite another thing is that in serious criminal investigations the police and the public prosecutor could have access to some information, but only on strong grounds. Nice to know is never enough of a reason to have access to information protected by banking secrecy regulations.

In some ways, I think my most important recommendation is to give the Supervisory Authorities more discretionary powers. I do not mean that the FME or Seðlabanki should be given dictatorial powers to intervene in the business of banks at will. On the contrary we have to be cautious of not forgetting that the owners and the management of a bank are responsible for the strategy and the day to day operations and decision making in their bank. The Supervisory Authorities' discretionary powers should be limited to matters and circumstances where the public interest and systemic stability or depositors funds are in jeopardy. Such powers should be defined in rather broad terms in the legislation. A difficult, but not an impossible task. The other side of the coin is that the Supervisory Authorities have to be strictly accountable for their actions while at the same time making sure that they can act independently and free of political or financial pressure or influence. How to do this in the Icelandic set of circumstances and in your legal tradition I leave for your experts and decision makers to solve. But you as well as other countries have to find a way to do it in a balanced way that leaves room for business innovation and competition without endangering stability and public interest.

Now let me turn to the international scene. The Icelandic crisis was only possible because the global financial development during this decade made it possible to expand seemingly without limits. The global glut of liquidity and the imbalances in the trade flows was also due to bad policies and bad banking. The Icelanders were not alone in overextending themselves to market risks.

The sub-prime mortgage bubble's bursting in the US was a prelude to the global crisis. It turned out to be just the tip of the iceberg. The events that have followed are known to you all so I shall not bother you with recounting them all. Suffice it to say that the outlook for the world economy has not been this bad since the 1930's. Governments and central banks have taken extraordinary measures to bring back confidence and trust into the financial markets. The key words are confidence and trust. The market economy is based on therm. If you do not trust anybody and have confidence in nothing, the economy will come to a halt and we degenerate back to barter economy or medieval ways of business.

Governments have been recapitalizing banks, bought their bad assets, bailed them out and taken them over. Governments have introduced massive stimulus packages to bolster their economies. Central banks have been lowering interest rates close to zero and have doled out liquidity into the market in enormous amounts. Most recently they have reverted to so called “unconventional measures” which is or at least is close to a euphemism for printing money. And yet, or perhaps because of all this, confidence and trust have not returned. What is wrong? The people and the markets do not seem to believe all that the so called toxic assets have been disclosed and fear that things will still get much worse before any improvement is in sight.

The US has undertaken stress tests for 19 of its biggest banks. The results were published last week and met with mixed reactions. Pessimists maintain that the tests were rather soft and underestimate the risks inherent in the balances of the banks. One may recall here that in Iceland stress tests were undertaken for the major banks’ liquidity positions using the most up-to-date methodologies as late as the Spring of 2008, but the real life scenarios turned out to be much harder than the testers could have anticipated.

The situation in Europe is even more precarious than in the US. The IMF came out on Tuesday this week with a report on Europe. It is very critical, at least if one is to believe what The Financial Times wrote about it yesterday. Europe is facing “economic storm of the lifetime” IMF says. It goes on to say that bolder and more forceful policy action is needed for economic recovery and to restore market trust and confidence. It calls for coordinated stress tests in Europe and considers regulatory and supervisory action to have been “unhelpfully diverse” and that full public disclosure is needed to restore confidence in financial institutions. It urges Europe to identify, quantify and ring fence toxic assets and to recapitalize through the private sector, “but with public support if needed”.

I find this straight talk by the IMF very refreshing and down to the point. The EU and its member countries have not been standing idle, however. A lot of things have been done or are in the pipeline, but much more needs to be done. The Committee of the European Banking Supervisors, CEBS, where also Iceland through the FME is present, is working on parameters for stress testing in the EU. Tests would be done on national basis country by country and individual banks would not be tested and results of the tests would not be fully disclosed. No wonder then that some people feel disappointed about lack of transparency.

Obviously the Regulatory and Supervisory Structures globally and in the EU (and thereby in the EEA) need strengthening. The G-20 meetings have come up with some positive statements to this effect ranging from tougher regulation on Credit Rating Agencies to revisions in the Capital Adequacy Accord. Within the EU the Commission set up the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière. The report of the group was published at the end of February and has been out for comments. Also Iceland has commented on the groups' proposals individually and together with its EEA partners Norway and Liechtenstein. Iceland rightly underlines the importance of improving on deposit guarantee regulations and home and host country cooperation and wants more clarity on burden sharing in times of crisis.

Without going into details of the de Larosière report I find it as a positive step into the right direction. It does not, however, go far enough into unifying supervisory structures in Europe. While admitting that the EU regulatory and supervisory framework remains strongly fragmented, the proposed changes do not bring about an efficient and credible European System of Financial Supervision. Nevertheless the proposals are ambitious and as such perhaps the best that that can be considered politically achievable. The Commission is supposed to come out tomorrow with its preliminary opinion on the proposals, to be followed by more detailed assessment in a few weeks time. Rumors go that there are strong disagreements among the member countries on some of the proposals. That makes me fear that the outcome will be a watered down version of the group's proposals.

Building a robust European Regulatory and Supervisory Framework is painfully slow and I hope that we do not need an even worse crisis than what we already have to force the national governments to relinquish some of their nationalistic attitudes. The outlook for Europe can be rather grim if measures to be adopted are considered to be too little and too late.

Problems abound and not only in UK, Spain, Ireland and Eastern Europe. The German banking system has been crying for overhaul for years. The time for action is now and now Germany has announced that it aims to establish a "Bad Bank" for the toxic assets of its banks. The Landesbank and other structural problems remain, however.

Let me now, before closing, turn back to Iceland again. After the recent early parliamentary elections you now have a new majority government. So the stage is set for grappling the huge economic and financial problems that face your nation. It seems that you have chosen to to stay in the mainstream of European style of market economy system and are not to try to go the "Argentine" way as has been suggested by at least some rather dubious professors that I have seen interviewed on your TV.

I strongly believe that the least painful of the painful ways for Iceland to get out of its present situation is to speed up the process of restructuring the banking system. That requires, among many other things, a determined but cooperative attitude towards your foreign creditors. You have to find equitable and fair solutions also to their grievances. I have been told that some of your foreign counterparties have been less than happy with the way that things have developed. You need urgently to reestablish good name for Iceland in the international financial markets. It takes ever more time to do that if you do not speedily come up with solutions that can be acceptable to your major creditors and other counterparties. I think that also the Icelandic Financial Services Association could play an important part in this work of conciliation by offering a forum for exchange of views and cooperation for the different parties.

I am personally a great believer in the EU and the euro. I have seen from close quarters how positive membership in the EU and the adoption of the Euro has been for Finland. Iceland is not Finland, of course, but still I believe that also Iceland would benefit from being a member of the Union and in adapting the euro as its currency. These are topical issues in your country right now. These are not simple matters and negotiations about membership would not be easy.

Membership application and negotiations would, however, be a major step to bolster your international standing in the international financial markets. Obviously it is of outmost importance that fishing sector issues have to be solved in a way that protects your vital national interests. But also other issues shall arise that will play into the hands of those in Iceland who oppose membership. I would assume that such issues would be for instance seal hunting and products and whaling. Issues that do not have huge economic importance, but are important as part of your traditions.

Consequently, do not expect the membership negotiations to be easy and plain sailing. On the contrary, the EU may appear cordial and friendly towards potential members, but in true, serious negotiations the Commission will be tougher than most of you can imagine and you should not be led to believe that results would be forthcoming very quickly.

Still, and now closing, I believe that the future of Iceland lies in Europe not in Argentina or Zimbabwe (see my note of 100 trillion Zimbabwe dollars). The choice is yours. And as always in the difficult times of your history you will ultimately come out as winners even if it will take some years.

Thank you for your attention. Now there might be some time for questions from the audience if the chairman so wishes.