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From Rule-Based to Principle-Based Supervision: The Case of the Icelandic Financial Supervisory Authority (FME)

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Ladies and Gentlemen.

The international financial crisis, which started in 2007, has affected financial institutions, states, companies and individuals worldwide – and continues to do so. As you know, Iceland has been hard hit by the crisis. In the autumn of 2008 the country's three major banks went insolvent following difficulties in refinancing their debt. The value of Iceland's currency, the krona, fell sharply, companies went bankrupt, unemployment soared and enormous pressure was put on public finances.

In the years preceding the crisis the Icelandic banking system grew enormously. Total liabilities of the system were more than 100 billion US dollars at the time of its collapse. Mind you that there are only about 320 thousand people living in the country and the GDP is only around 14 billion US dollars. Relative to the size of its economy, Iceland's banking collapse is the largest suffered by any country in world history.

At the time of the Icelandic collapse many people feared that the country was only “the canary in the coal mine”. Unfortunately this metaphore has proven to be, at least in part, a true description of reality. Since the autumn of 2008 other countries have encountered severe problems with their banking sector which, in some cases, have seriously affected their fiscal health.

Late in the year 2008 the Icelandic parliament, Althingi, established a Special Investigation Commission to investigate and analyse the processes leading to the country’s bank collapse. The Commission delivered its more than two thousand page long report in April 2010. Its main conclusion was that the rapid high-risk expansion of the Icelandic banks was mainly to blame for their downfall. The balance sheets of the banks and their lending portfolios left them highly exposed to sudden changes in the economic environment and market conditions.

After the bust of the US sub-prime mortgages bubble in the summer of 2007 the Icelandic banks encounterd growing difficulties in refinancing their debt. As the world’s financial markets slowly shut down on them they were forced to seek other ways to stay afloat. One was to start offering deposit accounts to European savers with high interest rates. But this did not prevent their collapse. And in addition to all the difficulties that the collapse has caused for the Icelandic state and the general public it has regrettably also resulted in a legal dispute between Iceland and two of its European neighbors on the issue of deposit guarantees.

The principal premise for the banks’ growth was their easy access to international financial markets. One of the reasons for this was the banks’ good credit rating which was partly inhereted from the Icelandic treasury. When the banking system had become far too big relative to the size of the Icelandic economy, the government should have acted and tried to reduce the size of the banks.

But it did not.

In addition, the Commission's report concludes that the regulators; the Central Bank and the Financial Supervisory Authority, were too lenient and acquiescent in their attitude towards the banks.

According to Icelandic law, the main role of the Financial Supervisory Authority, which I will henceforth refer to as the FME, is to ensure that regulated entities comply with the legislation that covers their business activities and otherwise organise their business in accordance with sound and normal business practices.

The Special Investigation Commission's report concludes that apart from being understaffed the FME did not use all the powers at its disposal to contain and restrict the bank's activities. In the words of the report the FME's staff was (quote) "not firm and assertive enough when carrying out their monitoring duties as regards the resolution and follow-up of cases." (unquote)

The FME did thus not always apply appropriate legal measures to deal with cases of non-compliance of the banks with regulations, f.ex. on connected lending and large exposures. This meant among other things that the banks got away with entering large exposures into their books in violation of law.

A separate working group of the Special Investigation Commission examined whether the collapse could to some degree be ascribed to morality and work practices within the financial and other sectors of society. It concluded that a part of the blame for what happened can be ascribed to a narrow interpretation of laws by the regulators. The prevailing view within these bodies was that as long as the banks fulfilled the formal requirements of laws and other legally binding rules the authorities could not demand any action of them. This formalistic interpretation looks more to the *letter* of the law instead of the *purpose* behind it. An economist working for the Icelandic Central Bank is quoted in the working group's report as saying (quote): "I think there was a basic misunderstanding in Iceland concerning what the supervision of financial markets really is all about. ... So you are watching a

whole banking system falling off a cliff but since it is doing it legally then it's just fine." (unquote)

Shortly after the bank collapse in the autumn of 2008 the government of Iceland decided to hire Mr. Kaarlo Jännäri, a former head of the Finnish Financial Supervisory Authority, to assess the laws on the financial market and propose improvements. In his report Mr. Jännäri concludes that in the prelude to the collapse the powers of FME were too limited and (quote) "the Nordic tradition of jurisprudence did not allow much leeway into discretion. The tycoons of the financial system could circumvent the underlying purpose of the regulations by sticking to the letter of the law with the help of diligent lawyers and complicated corporate structures. The supervisors were too timid and lacked legal authority in their efforts to intervene in these developments, ..." (unquote).

To improve financial market supervision and prevent future shocks Mr. Jännäri proposed several significant changes to the legal framework. In his opinion the FME should be given more discretionary powers and encouraged it to use its powers more forcefully. Also, tougher rules should be laid down and strict practices applied on large exposures, connected lending and quality of owners, using discretionary best judgement when necessary.

Last year the Icelandic parliament, Althingi, passed a new law on financial institutions where stock is taken of Mr. Jännäri's recommendations. In short the FME has been given more powers and more leeway to make discretionary decisions with the aim of securing sound and normal business practices. The new law has resulted in changed working practices of the FME. For example, the authority has established special processes to evaluate the professional fitness of board members of financial institutions. In general it is fair to say that the FME is now looking more to the purpose behind laws and regulations than it did before.

Ladies and Gentlemen.

The discussion paper, prepared by the SAIs of the Netherlands and Slovenia, seeks to explain trends in governance in the EUROSAI region using the theoretical model of competing values. In my opinion the case of the Icelandic Financial Supervisory Authority and the recent changes in its legal basis shows a drift away from an emphasis on formal rules towards a more goal-oriented supervision. Instead of rigid legal formulations the FME has been given more leeway to independently evaluate behavior and circumstances and act with the aim of securing sound and normal business practices. In terms of the model, the case of the FME represents a move from the bottom-left box to the bottom-right box. I cannot say whether this is the general trend in the Icelandic state administration. The Icelandic National Audit Office has not done extensive studies on this subject – not yet at least. But this is certainly a very interesting question which I'm sure we will take notice of in our future work.

I would like to end this short presentation by sharing the following thought with you, Ladies and Gentlemen:

The drift away from rule-based governance towards a more dynamic goal-oriented governance places special demands on public managers. Is the public administration in our countries really up to the task? Is the educational background and experience of public managers such that they can be trusted to make independent decisions based on principles or rational goals?

I would very much like to hear your reflections on this.

Thank you very much.