

Iceland's Banking Meltdown: Analyzing The Portents Of A Financial Storm

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Abstract

While no country has fully escaped the impact of the 2008 economic crisis, few have experienced as significant an impact by it as Iceland. After experiencing remarkable growth in its financial sector over the past years, in the fall of 2008 Iceland's three largest commercial banks all collapsed in a matter of days leaving the Icelandic government and ultimately the Icelandic citizens responsible for unwinding institutions unable to be deemed too big to fail. This paper attempts to perform an autopsy of these failed institutions aiming to uncover what portents or early warning signs there were of the crisis and conjecturing what steps these institutions might have taken to avoid collapse.

To understand these financial institutions in context, the firms' performance are analyzed by relevant financial ratios. Using time series analysis, the recent growth of these financial institutions is examined and special attention is paid to the impact of significant changes in focus and strategy had on underlying bank performance. Cross-sectional analysis is used to compare these financial institutions to one another and benchmarking is used to compare these banks to similar institutions outside of Iceland that were able to weather the crisis. The shortcomings in the Icelandic financial institutions identified in this ratio analysis make up the basis for evaluating their risk management strategies.

Risk management is an important aspect of business in the 21st century not the least for financial institutions. Regulators require a bare minimum of risk management while modern financial tools such as derivatives enable risks to be transferred from risk adverse parties to those with greater risk tolerance. This paper examines the risk management strategies (or lack thereof) employed by the Icelandic banks and evaluates what worked and what didn't work. Furthermore, additional tools are briefly discussed that could be used to address shortcomings in the risk management strategies of these financial institutions.

While impossible to know what might have been in the past, a thorough analysis of what happened to the financial institutions of Iceland in the time leading up to their failure will identify both the strengths and weaknesses of those institutions and the regulatory frameworks of Iceland. In the aftermath of a financial crisis it is easy to cast blame and call for greater government oversight however indiscriminate it may be. Yet, unreflective action not supported by sober analysis of what actually happened often leads to unintended consequences. Therefore, thorough analysis of this or any post-crisis situation is both warranted and of great importance. With the knowledge gained from such an analysis the leaders of business and government can be better prepared to better manage the risks of financial institutions through more appropriate risk management and well directed government regulation.

Key words: Commercial Banking, Risk Management, Government Policy and Regulation