



Outline Argument for the Setting up of a Fully Independent Public Inquiry into the Placing into Administration of Landsbanki Guernsey Ltd.

Made on behalf of the Landsbanki Guernsey Depositors' Action Group.

Submitted to States of Guernsey Deputies for consideration:

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Landsbanki Guernsey
Depositors Action Group

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Remit of the Public Inquiry:

The remit of the inquiry addressed in this submission is as follows

1. The cause of the collapse of Landsbanki Guernsey Limited (LGL);
2. The role of the Guernsey Financial Services Commission (GFSC) in ensuring the proper management of Landsbanki Guernsey Limited to protect depositors' funds;
3. The role of the UK's FSA in contributing to the failure of Landsbanki Guernsey Limited;
4. The role of the respective Governments of Guernsey, UK and Iceland in the failure of Landsbanki Guernsey Limited.

The Landsbanki Guernsey Depositors Action Group (LGDAG):

LGDAG is a not-for-profit association registered under the Companies Act of England and Wales and representing many of the 1600 retail depositors in Landsbanki Guernsey who currently stand to lose a large part of their savings due to the placing into administration of Landsbanki Guernsey Ltd.

Introduction:

Landsbanki Guernsey Limited (LGL) collapsed primarily because it was prevented from accessing funds in its sister bank, Heritable UK (HB), following UK Government intervention by means of FSA and UK Treasury management of Heritable transfers in the days prior to Heritable Bank being placed under administration. Heritable was unable to access an established line of credit from its parent Landsbanki Islands HF (LIhf). Deprived of liquidity, LGL's senior management were forced to apply to the Royal Court of Guernsey to place the bank into administration.

LGL transferred funds and assets to HB during Quarter 2, 2008 following agreement with the GFSC. The decision to transfer such a large percentage of its asset and funds base to HB and the management of funds transferred to one financial entity raise major issues about the risk management skills of LGL's management and the role of the GFSC in not completing an internationally recognised level of due diligence prior to permitting the upstreaming of funds to HB.

The percentage of the funds transferred from LGL to HB was considerably in excess of international guidelines¹, which recommend that a minimum of 2 banks should be used. The percentage of funds transferred is also considerably higher than recommended guidelines laid out in the Banking Supervision (Bailiwick of Guernsey) Law 1994². The actions of the GFSC in allowing LGL to continue with such a high level of its capital base in a sister company with a common Icelandic parent when there was ample evidence of the instability of the Icelandic Banking system must also be called into question.

Transfer was authorised as the GFSC took at face value intimations from the FSA concerning the ability of Heritable to stand alone in the event of LIhf failure; this despite many publicly available reports stating otherwise³.

LGL's position was worsened by the UK Government, HM Treasury and the Financial Services Authority (FSA) failing to communicate their views and actions in advance to the GFSC or act in accordance with previous norms and established practices between the parties. Full disclosure of the communications between the GFSC and FSA has not been made and is urgently required. The extent of the FSA involvement is demonstrated by their decision as early as 3rd October to treat HB effectively as a failing bank and restrict transfers from it to LGL when these transfers were requested.

The inability of LGL to withstand this situation was exacerbated by the absence of a lender of last resort within Guernsey or any reserve fund from the Guernsey financial industry. The Guernsey Government failed to follow the best practice of most international Governments including the UK, Ireland, Iceland, Antigua and the USA during this crisis, in guaranteeing 100% of all retail deposits. Intervention by the Guernsey Government may not have prevented the collapse of LGL but it would have ensured that 1600 retail depositors would have been fully protected. *It has been reported that in the days after LG failure, GFSC placed more onerous regulatory licence conditions on the remaining financial institutions in Guernsey which may have prevented those interested institutions from continuing negotiations with the administrator which may have resulted in LGL being taken over as a going concern.*

¹Basel Accord 2 and BIPRU

² Banking Supervision Law (Bailiwick of Guernsey) 1994: Section 24. (1) &(2)

³ See amongst others Landsbanki Islands hf Annual Report 2007; Heritable Bank Annual Report 2007; Fitch Ratings Report: Heritable Bank Ltd. 26-Sept-2007

Retail depositors in The Cheshire Building Society (Guernsey), which had previously been sold to Landsbanki Islands hf, would have been fully protected by the UK Government, had the sale not taken place and Cheshire Building Society collapsed

The proposed inquiry should address the issue of why Landsbanki Islands hf was allowed to acquire this existing banking institution without like for like protection for existing depositors. Many depositors were effectively trapped in fixed term accounts and were not adequately informed of the change in their protection.

The cause of the systemic failure of the Icelandic banking system is being investigated in a number of other jurisdictions, including but not limited to Iceland and the UK. The Guernsey Government should ensure that those responsible for these regulatory failures and any fraudulent acts are held responsible for these actions and seek compensation directly.

For clarity, a list of the questions (not exhaustive) that LGDAG believe this inquiry should answer is included at Appendix 2. A further list of actions for the Guernsey, UK and Iceland Governments is included at Appendix 3. Appendix 4 is a list of issues and questions that we believe this inquiry should address as part of its remit.

The events leading to the collapse of Landsbanki Guernsey Limited:

Icelandic Banking System Failure:

The events leading up to the failure of the Icelandic banking system are well documented elsewhere. In this submission we summarise the major milestones as part of Appendix 1.

These events were well publicised and should have been high priority stimuli for robust GFSC and FSA intervention and action. The Lex column of the 'Financial Times' on 16th October 2008 summed it up well:

'.. The next bogeyman is the UK's Financial Services Authority. When Icelandic Banks could not fund themselves by borrowing money on the wholesale market at 15% it was absurd that the FSA allowed them to suck up £4.5 bn of UK deposits [and by extension the GFSC and funds upstreamed to the UK from Guernsey] by offering 6.5% instead.....'

However, while these events clearly contributed to the failure of the Landsbanki Group, LGDAG submits that the reason LGL failed was not systemic. Simply put, too large a percentage of its assets were held in HB and LIhf on an unsecured basis. LGDAG propose that the Public Inquiry concentrates on the:

- Roles of the Directors, their advisers and the GFSC in allowing these funds to be held in HB and LIhf
- The actions/inactions of the FSA in failing to communicate with the GFSC and
- The failure of both the Guernsey and UK Governments (in the UK's case via the FSA) to protect retail depositors in line with the international practice during this financial crisis.

FSA Action to close down Heritable Bank:

On 3rd October 2008 the FSA took the unprecedented action of issuing Heritable Bank with a First Supervisory Notice (FSN). This required HB to hold in a Bank of England account deposits equal to the value of all deposits it received from 3rd October 2008 onwards. The FSA supervisory notice of 7th October further required FSA authorisation for any payments greater than £250,000 and also prevented HB from accepting any deposits into existing accounts or new accounts and also from making transfers of any value whatsoever to/or on behalf of any Landsbanki Group company.

This action effectively created a blanket ban which looks to have been put in place to suit likely future creditors of Heritable Bank (in administration), to the detriment of LGL. (See subsequent actions of FSA in transferring retail depositors' accounts to ING whilst interbank and commercial deposits remained under the administration⁴).

The rationale given for these actions was the belief of the FSA that:

- HB was failing or likely to fail the Threshold Condition 4 (adequate resources)
- It was desirable to exercise the variation of permission in order to protect the interests of consumers or potential consumers.

It is therefore clear that as early as 3rd of October the FSA had taken the decision that HB was failing and effectively cut off its ability to operate, thereby ensuring it's almost certain failure. This decision is contrary to sworn affidavits by the directors of Heritable Bank lodged at Companies House stating that prior to the FSA action that the bank was a going concern⁵. As a result of the close interrelationship between HB and LGL the collapse of LGL was equally assured by this FSA order. This FSA order included a confidentiality clause preventing communication and publication by the parties and was only made public at a later date.

FSA - GFSC MOU and Break-Down of Communication:

Notwithstanding a Memorandum of Understanding (MOU) between the FSA and the GFSC dated July 2003, which provided for the sharing of information and cooperation between the FSA and the GFSC, no prior warning of the seizure of HB and its consequent effect on LGL was given by the FSA. As a direct result of the significant percentage of LGL assets held in HB on an unsecured basis, the Guernsey authorities had no option but to withdraw LGL's banking license and put the bank into administration.

⁴ Transfer of Certain Rights and Liabilities Order 2008 and the Transfer of Rights and Liabilities to ING Order 2008

⁵ Companies House - Heritable Bank Statement of Affairs.

In order to determine the full validity of the MOU both legally and morally a full disclosure of all communications that took place in the lead up to the collapse of LGL is required. Both the FSA and the GFSC have declined to do this. The FSA has used exceptions to the Freedom of Information Act in refusing to disclose all detailed communication that took place at this time.

The GFSC and Guernsey Government should not similarly fail to make a full disclosure of all related documents and communications⁶.

A more detailed examination of the failures of the GFSC and FSA and their roles in the collapse is addressed later in this document.

LGL unable to independently survive:

Despite the reported state of the Icelandic banking system, directors of both Landsbanki Guernsey and Heritable Bank have stated that there was no run taking place and that business continued as normal with new deposits being accepted. The directors of LGL noted that they expected further withdrawals to occur in the week commencing 6th October 2008 due to intense press coverage and had requested further funds from LIHF to cover this eventuality. At the time of being placed into administration LGL showed an apparently unimpaired loan book, significant cash and overall a healthy balance sheet, with assets valued at £143,361M and liabilities of £121,181M. However realisable value was less than this because, during 2008, significant cash holdings were deposited by LGL in HB and LIhf totalling £49,097M.⁷ As a percentage of the bank's assets this was far in excess of the Basel Accord 2 or BIPRU guidelines.

Moreover, LGDAG understands that, part of these cash holdings of LGL were moved from being on deposit with the parent Landsbanki Islands hf to being on deposit with its sister company HB because the GFSC had serious concerns about risks in the Icelandic banking system and believed that Heritable Bank had sufficient ring fenced funds to survive in the event of a parent bank collapse.

This action leads to one major question which the inquiry needs to answer:

- Why did the GFSC, given its concerns about risks in the Icelandic banking system, allow such a significant deposit to be made on an unsecured basis in a sister company directly controlled by Landsbanki Islands hf?

Placing of Heritable Bank into Administration:

When HB was placed in administration the LGL cash holdings placed on deposit with HB were frozen. The issue of why HB was placed in administration is one that is central to the LGL collapse and as such extremely important to depositors. LGDAG would encourage this inquiry to investigate both the processes and rationale used by the UK Government in placing HB into administration.

No Lender of Last Resort or Host Government Backing

The international best practice (UK, USA, Antigua, Spain, Germany, Iceland etc.) during the financial crisis of 2007-9 of fully protecting retail depositors by direct intervention into the banking system was not followed by the Guernsey Government. Several of these bank interventions have already shown a market-to-market profit for the respective Governments without taking into consideration any additional benefits that their actions had had on general stability of their financial sectors.

In the absence of funds to support such an intervention it is noted that no support was sought from the UK Government who could have been requested to step in and act as this lender of last resort. The lack of any specific fund to draw down on or a clear mechanism for raising such funds leaves Guernsey vulnerable to a similar event such as that faced by LGL. Further this leaves Guernsey as one of the few Governments during this financial crisis to fail to guarantee 100% of retail depositors accounts. Smaller and less robust economies such as Antigua and even Iceland itself have guaranteed deposits. The LGDAG believe that this has put Guernsey at a relative competitive disadvantage to other financial centres.

⁶ Provision for full disclosure is legislated for in the Banking Supervision Law (Bailiwick of Guernsey) 1994: Section 44 (a), (c), (e).

⁷ Deloitte & Touche LLP: 'Summary Preliminary Statement of affairs as at 6 October 2008

The Role of The Guernsey Financial Services Commission in ensuring proper management of Landsbanki Guernsey Ltd to Protect depositors' funds: GFSC – FSA Memorandum of understanding: Failure of Communication?

Warning signals as to the health of the Icelandic banking system had been widely broadcast in the mainstream UK press during the previous eighteen months leading up to the collapse. Please see Appendix 1 for a timeline.

According to evidence presented by Mr Peter Neville, Director General of the Guernsey Financial Services Commission, to the House of Commons Treasury Select Committee⁸, The GFSC had concerns that the FSA believed that *'it could not and should not have passed us more information than it did in terms of the changed liquidity situation, the dependence on the parent and on the action it was planning to take'*. The concern for Mr Neville was therefore that *"there was limited information given to us ... and they did not tell us they were limiting information'*.

The GFSC requested that the board of directors of LGL assess the level of upstreaming to Lihf in February 2008. This was revisited in March 2008 when a number of requirements were placed on the bank to be completed by April 2008 which included amongst others.

- Revisions to existing counterparty liquidity and interest rate risk policies of the bank if parental funding was withdrawn;
- An alternative lending strategy to parental funding;
- An assessment of how to manage the possible impact on market sentiment should significant sums be withdrawn from the parent.

The proposed Public Inquiry must ask why the GFSC and directors of LGL looked no further than HB, LGL's sister bank in London under the direct control of the Icelandic parent, rather than spreading the funds more widely among non-Icelandic banks with stronger credit ratings. Given these concerns about Icelandic risk there is also the question of why these funds were not secured.

However at no time did the GFSC follow the example of the FSC in the Isle of Man which decided, in March 2008, that there could be no exposure of KSFIOM funds to Iceland.

The FSA presented no opposition to placing more than 35% of LGL's assets in Heritable UK and Landsbanki Islands hf, despite their inter-dependency and offered the GFSC no indication of the action it was intending to take.

This is an example of the FSA's failure to comply both in spirit and deed with the Memorandum of Understanding. This inquiry must demand to know what information and assurances, if any, were provided by the FSA to the GFSC.

Letters were sent by the GFSC to the FSA asking for information on the liquidity regime and the ability of Heritable Bank to repay the money in the event of a parental failure (ie standalone). The FSA replied, providing the information requested, but it did not appear to answer the question that was posed:

- Was it safe to place the money in Heritable Bank?

Given the response by the FSA, and the interpretation of the GFSC, questions need to be asked as to what procedures and due diligence were followed in reaching these critical decisions within both the GFSC and LGL.

Hector Sants of the FSA has stated that the purpose of the letter was to confirm the liquidity regime, but the question of whether or not it [the letter] provided sufficient enough assurance to the GFSC was a matter for them to decide. He also stated that, as the GFSC was the host regulator, it was not for the FSA to make judgments on the information provided but just to provide it.

In summary the GFSC and Landsbanki Guernsey Directors appear to have made an enormous error of judgment and failed in their duty of care to depositors. They claim that their actions in moving these assets from Iceland to the UK were to protect the bank from Icelandic influence, however rather than moving money to a totally independent entity which would therefore spread risk, they decided to transfer the funds into a sister company largely dependent on the common parent letter of credit for its liquidity rating.

⁸ House of Commons Treasury Committee: 'Banking Crisis: the Impact of the failure of the Icelandic banks'.

Regulatory Failure by the FSA:

In documents leaked on the Internet⁹ recently, it emerged that loans, totalling more than €6.4bn (£5.45bn), had been given to companies connected to just six Kaupthing HF clients, four of whom were major shareholders in the company. These loans were granted with partial or no collateral, the largest of which was given to Exista, its biggest shareholder with a 22% stake. The bank was also lending millions of pounds to individuals and holding companies so that they could buy shares in Kaupthing itself, effectively propping up its own share price. Whilst this information pertains to Kaupthing further forensic auditing is underway for the other failed Icelandic banks, Glitnir and Landsbanki Islands hf. It is widely recognised that many of the largest shareholders of all three banks had interconnected holdings, and many had links with UK businesses.

Eva Joly, MEP and fraud expert and now working with the UK Serious Fraud Office, believes it will be *'the largest investigation in history of an economic and banking bank collapse'*.

With regard to Landsbanki Islands hf, information is now beginning to enter the public domain. The Icelandic special prosecutor has interrogated the former Landsbanki CEO Sigurjón Árnason with regard to transactions between Landsbanki and Imon, a holding company owned by Magnús Ármann. Ármann, it has been claimed, was technically bankrupt when it was alleged some of the biggest players in the economic collapse used his name to transfer money and buy companies to hide their identity.

Imon bought shares in Landsbanki three days before it went bankrupt for just over five billion ISK. This was alleged to be insider trading. It is alleged that Magnús Ármann allowed his name to be used because he owed so much already, and being technically bankrupt, that he would never be able to pay. So increasing his level of indebtedness would not make a great deal of difference. In return for a hefty fee he therefore used his name and company to transfer the assets of the Landsbanki elite to offshore accounts. According to newspaper reports Sigurjón Árnason took the decision to lend Ármann the money for the shares, when the only collateral for the loan was the shares themselves.¹⁰

The Serious Fraud Office is now investigating the three failed banks in collaboration with Icelandic authorities to determine levels of fraud or indications of criminal intent.¹¹

Joly is also critical of the UK and Dutch regulators who took no action until it was far too late for depositors in spite of the doubts that were emerging. *'The UK in my opinion has a responsibility for not controlling Icelandic banks, like Icesave, that were operating here,' she said. 'They were given some warnings about the banks and they did not do anything. This to my mind has been very harmful.'*

Regulatory Failure by the GFSC:

- Did the GFSC have its finger on the pulse of the financial markets?
- Did any of the regulators have sufficient risk analysis skills and protocols to deal with an obviously burgeoning Icelandic economic problem?

The LGDAG would suggest that they did not and were highly remiss in that area.

The GFSC permitted a bank within its jurisdiction (LGL) to place 35% of its assets with a single entity. Not only did it allow the assets to be placed with a single entity but the entity (HB) was part of the same group over which the GFSC had concerns. It was also part of the same group that the GFSC were aware of being monitored by the FSA, and concerns about the health of Icelandic banks as a whole was known to them.

If they didn't know then one has to seriously question their right to be regulators, and furthermore their professional competence could be called into question.

It is self evident that at the time of the asset transfer, the GFSC must have been aware that should HB fail (as subsequently happened) then LGL would be pulled down along with its sister bank and that the transferred money would then be under the jurisdiction of UK courts under the Insolvency Acts. The transfer of funds to Heritable was made after consultation by the GFSC with the FSA although the recollection by the GFSC of that consultation seems to differ from that of the FSA. Either way, one has to be very critical of an organisation that cannot see the broader view that all Icelandic banks were in potential trouble and yet still authorised the

⁹ Daily Telegraph, 04 Aug 2009

¹⁰ Independent Iceland News, 15 July 2009

¹¹ Rowena Mason: Daily Telegraph, 11 Sep 2009

transfer of a major percentage of assets to a single bank, over which it had no control, and in doing so appeared to break international banking guidelines.

Irrespective of the GFSC's understanding of the conversations it held with the FSA, it is beyond comprehension how even cursory risk management assessment would sanction a transfer with such high risks being attached to them. It begs the question why did the GFSC allow, indeed encourage, these actions? Why not simply place the funds on deposit among a number of fellow Guernsey banks with stronger credit ratings or in other areas?

The recommendations of the GFSC's own 2008 consultation paper states: '*a subsidiary has its own board and capital of its own, and the potential to be ring-fenced so that the failure of its parent need not affect the ability of the Guernsey bank's depositors to be repaid*' (LGL was a subsidiary of LIHf) and: '*in order to ensure diversification on the asset side, the assets not placed with the group must be invested in liquid, high quality assets*'?¹²

Why were assets not ring fenced and further investment diversified from the 'Landsbanki group? The GFSC also failed to put in place any procedures to ensure that the risk was monitored on an ongoing basis.

- This inquiry needs to answer why?

The GFSC has indicated that assets were placed with HB following in depth discussions with the FSA and stated at the Treasury Select Committee Hearing: '*The information provided to us by the FSA in April and July 2008 was a key determinant in our permitting funds to be placed with Heritable, as explicitly stated in Dr Quick's letter of 21 April 2008*'.

- There appears to be no evidence that the GFSC carried out any due diligence on the information provided by the FSA. Was this all taken at face value?
- Why did the GFSC rely so heavily on the Memorandum of Understanding it had entered into with the FSA?
- As the situation deteriorated, why was there no attempt to rectify the situation?

The FSA and indeed Her Majesty's Government have made it clear that the regulation of the banking sector in Guernsey is the sole responsibility of the Guernsey authorities and regulator by stating as follows:

*'oversight of Landsbanki Guernsey Limited is the responsibility of the Guernsey Financial Supervision Commission and therefore arrangements for depositors in Landsbanki Guernsey is a matter for the Government of Guernsey.'*¹³

Why was Landsbanki allowed to enter and operate in Guernsey?

The vetting of Landsbanki and also its takeover of the Cheshire Building Society showed a failure of regulation, particularly when the States of Jersey, for example indicated that Landsbanki would not have been granted an operating licence¹⁴. The takeover of the Cheshire at a time when serious question marks about the viability of the Icelandic Banking system were being raised similarly showed a failure by the GFSC regulator in ensuring that depositor protection was not diminished by the change of ownership.

In actual fact Landsbanki Guernsey was administrated by contract staff supplied by Butterfield Bank, a small private bank largely operating in offshore jurisdictions.

This inquiry should ask to what extent was the GFSC made aware of the potential risks and at the following times when it should have reviewed the change in depositor protection:

- The takeover of the Cheshire in 2006?
- At the time of the first indications of Icelandic bank failure in Q1 2008?
- In the days immediately before the FSA actions of placing Heritable Bank into administration?

The very existence of the Parent Company Letter of Comfort that the GFSC insisted upon demonstrates it had concerns regarding Landsbanki Islands Hf.

- Why did the GFSC insist on this being put in place?
- What procedures were followed in reviewing the draft content of the letter of comfort to ensure it met Guernsey's legislative requirements and how were they to be implemented?
- If there was the perceived need for a letter of comfort why did the GFSC not insist on LGL placing a bond as insurance against failure, particularly when concerns over the state of the Icelandic banking system had been aired as early as August 2006?
- What memos or documents exist analysing these risks and the robustness of the letter of comfort which at best can be described as poorly drafted and lacking substance?

¹² Consultation on Parental Upstreaming and the introduction of Depositor Protection and Ombudsman Schemes. Aug 2008

¹³ Correspondence: Paul Myners 23 January 2009

¹⁴ Senator Philip Ozouf, Economic Development Minister, October 2008

With hindsight the letter of comfort was clearly unacceptable in ensuring depositor protection in the event of parent company failure and should have been supplemented with a more robust mechanism of protecting depositors.

Appendix1: Timeline to the Landsbanki Islands hf collapse:

The timeline below outlines the events leading to the collapse of Landsbanki Islands hf and the Icelandic banking system. The sources are not taken from specialist journals or reports but from mainstream media. This demonstrates that financial professionals including regulators should have been aware and had plenty of time to fully prepare.

Mar 2006¹⁵

'Iceland's banks were pumelled yesterday as the Nordic economy lurched into its third week of crisis, flashing an ominous early-warning signal for markets worldwide.'

Mar 2006¹⁶

'The island's big three banks - Kaupthing, Landsbanki, and Glitnir fiercely denied suggestions they may not be able to roll over \$17.8bn (£10bn) in debt by the end of 2007, protesting that they are in better shape than British banks.'

Sep 2007¹⁷

'Heritable Bank Limited's Long and short-term IDR's and Support rating are based on a guarantee of materially all its obligations from its parent Landsbanki Islands (LB) of Iceland.'

'To support liquidity Heritable holds a committed credit line of GBPE200M from Landsbanki, which has been extended to December 2008. This is needed as the level of liquid assets on the balance sheet is low. . .'

Nov 2007¹⁸

'The Island's central bank unexpectedly raised its key interest rate to a record 13.75pc as inflation stayed above its target.'

Dec 2007¹⁹

'Fashion chain's profit warning comes as estimated £100m wiped off Baugur's retail portfolio in the past year.'

Feb 2008²⁰

'By early 2008 the credit crunch was showing its teeth. Markets feared a Northern Rock-style crisis was threatening Iceland's entire banking system. If the financial system that bankrolled the island's billionaire entrepreneurs collapsed, the knock on effects would soon be far-reaching, especially in Iceland-owned companies in Britain.'

¹⁵ Ambrose Evans-Pritchard: Daily Telegraph, 14 Mar 2006

¹⁶ Ambrose Evans-Pritchard: Daily Telegraph, 21 March 2006

¹⁷ Fitch Ratings Report, 'Heritable Bank Ltd' 26 September 2007

¹⁸ Daily Telegraph, 2 Nov 2007

¹⁹ Daily Telegraph, 6 December 2007

²⁰ Ian Dey: Daily Telegraph, 3 February 2008

Feb 2008²¹

'based on prices quoted in the credit markets, international investors reckon Kaupthing, Iceland's biggest bank, is about seven times more likely to default than the typical European bank. Moody's, the credit rating agency, last week placed the entire Icelandic banking sector on review for a possible downgrade. Standard & Poor's has warned that the major institutions - Kaupthing, Glitnir and Landsbanki - are facing tough times.....analysts reckon that, thanks to a series of cross-shareholdings across the Icelandic economy, it would not take much for the whole country's financial system to go into meltdown'.

'The Icelandic banking sector is a classic example of plucky ambition or unrestraint, depending on one's attitude to risk,' said a research note from the consultancy Markit last week. 'The credit markets have certainly taken the latter view in recent months'.

Feb 2008

Moody's Investors Service cut its ratings on all the major Icelandic banks. Landsbanki's long-term rating was downgraded *'in light of the weaker credit environment'.*

Mar 2008²²

'As Iceland goes, so go the Baltics, the Balkans, Hungary, Turkey, and perhaps South Africa. All are living far beyond their means, plugging the gaping holes in their accounts with fickle flows of foreign finance. All have let credit grow far above the safe "speed limit", some exceeding 50pc a year'.

Mar 2008²³

Iceland, which has boomed on the back of exponential growth in its banking sector, scrambles to prevent a meltdown of its economy as the credit crunch tightens its grip'.

May 2008²⁴

'Given the size of the Icelandic banks relative to GDP (900%) and the lack of foreign parents with deep pockets, it is hard to imagine that the authorities could distance themselves from a systemic crisis, particularly because of banks' huge net external liabilities (200% of GDP)'.

May 2008

Fitch, cut the ratings of Glitnir Bank and Kaupthing Bank. Standard & Poors said it had only rated one Icelandic bank, Glitnir, and had cut its rating from A- to BBB+ in April.

Martin Winn, a spokesman for the agency said:

'We have been highlighting a growing risk about the Icelandic banking system since February 2007. The rating BBB+ is very high risk for a Western European bank'.

Those warnings were passed on to many financial managers, prompting some to stop investing in Iceland.

²¹ Daily Telegraph, 3 Feb 2008

²² Ambrose Evans-Pritchard: Daily Telegraph, 27 Mar 2008

²³ Louise Armitstead: Daily Telegraph, March 2008

²⁴ Fitch Ratings: 'Iceland Special Report', 22 May 2008

Jul 2008²⁵

Robert White, professor of Political economy at the London School of Economics (and winner of the Leontief Prize in Economics, 2008) said:

'The size of the (Iceland) accumulated macroeconomic imbalances beggars' belief. The external deficit was 25 per cent of GDP in 2006 and 17 per cent in 2007. Gross short-term foreign debt amounted to 15 times the value of the central bank's foreign exchange reserves at the end of 2007, or roughly 200 per cent of GDP. Gross long-term foreign debt amounted to another 350 per cent of GDP. Bank assets swelled to 10 times GDP by the end of 2007. These imbalances are the other side of the Icelandic purchases of companies in Britain, Denmark and elsewhere.'

Sept 2008²⁶

'The impact of the global financial crisis on the Icelandic economy threatens to cause chaos for some of Britain's leading retailers and savings institutions'.

Whilst the above should have rung alarm bells to individual investors, the GFSC should have had klaxons ringing and acted in a responsible manner; not to curtail the business plan of the banks but to ensure that the banks had provided sufficient depositors' protection in the event of an Icelandic banking collapse.

As was concluded in the Treasury Select Committee hearing: *'it is important to note that the majority of those affected are not sophisticated investors of high net worth who are somehow insulated from the losses they have incurred'*. As such it was the responsibility of the GFSC to ensure that depositors were suitably protected and that the GFSC had ample time to devise a strategy whereby Landsbanki Guernsey Limited could continue to operate and protect its depositors at the same time. The LGDAG believe that the GFSC failed to do so.

²⁵ Financial Times, 1 Jul 2008

²⁶ Harry Wallop and James Hall: Daily Telegraph, 29 Sep 2008

Appendix 2: Questions for this Public Inquiry to answer:

- Why was Landsbanki Islands hf permitted to buy The Cheshire Building Society (Guernsey)?
- Why were Cheshire depositors' changed levels of protection not adequately disclosed?
- Why were Cheshire depositors in bonds and deposits of fixed duration, given their reduced level of protection, not allowed to withdraw their funds?
- What legal due diligence was carried out by the GFSC in accepting the Landsbanki Islands hf Parental Letter of Comfort?
- What information and assurances, if any, were provided by the FSA to the GFSC regarding the deposit by LGL in HB?
- How and why did the GFSC interpret FSA correspondence as a "*go ahead*" for transferring money to the UK?
- Why did the GFSC and the Directors of LGL allow such a large amount of money to be placed on an unsecured basis in a sister company, which was a subsidiary of the same parent?
- Why did the GFSC and LGL directors ignore the UK and EU guidelines concerning the maximum percentage of capital resources that should be held in any one place, i.e. 25%?
- Why did the GFSC rely so heavily on the Memorandum of Understanding it had entered into with the FSA rather than complete its own due diligence?
- As the situation deteriorated, why was there no attempt to rectify the situation rather than allow upstreaming to a sister company rather than directly to the parent?
- Did the regulators have sufficient risk analysis skills and protocols to deal with an obviously burgeoning Icelandic economic problem?
- What risk analysis skills and protocols were the GFSC using? How have these been revised in light of these failures?
- Irrespective of the GFSC's understanding of the conversations it held with the FSA, how could any, even cursory, risk management assessment sanction a transfer with such high risks being attached to them?
- Why did so many people both inside the GFSC and the Guernsey Government believe that the transferred money was protected/ring-fenced and that Heritable Bank was standalone in its ability to survive a parental collapse even when documentation available showed this not to be true?
- Did the GFSC indeed implement a change in regulatory licence conditions on remaining Guernsey financial institutions which may have prevented them from continuing negotiations to buy LG as a going concern?
- Why was there such a breakdown of communication between the GFSC and the UK authorities from October 3rd until January 2009?

Appendix 3: Government level actions required:

Actions for the Guernsey Government:

- Ensure that Guernsey, on behalf of depositors within its jurisdiction, is represented directly or indirectly in all discussion regarding overseas regulatory failures.
- Release all communication between the FSA and GFSC and UK and Guernsey Government agencies leading up to the transfer of LGL assets to HB and following the decision by the FSA to disregard its MOU with the GFSC.
- Establish a Reserve Fund/Lender of last resort or other insurance which protects depositors in the event of future bank failures.
- GFSC to ensure in the event of any future transfers of bank ownership, depositors are protected including fixed-term as well as bond holders. All account holders are given the right to close their account in the event of such a change.
- Regulator to ensure that cash reserves are held in secured and sufficiently dissipated locations.

Actions for the UK Government:

- Ensure UK nationals can hold bank accounts - both Sterling and foreign currency - in accounts within the UK's jurisdiction on an equal status with UK residents.
- Ensure all transfers of deposits that enjoy UK protection have sufficient safeguards in place before any transfer is authorised.

Actions for the Icelandic Government:

- Ensure that depositors in LGL receive the same guarantees as Icelandic depositors in Landsbanki Islands hf.
- Undertake to stand behind the obligation of the Landsbanki Islands hf parent company letter of comfort to LGL.

Appendix 4: Issues to be considered as part of the remit of this Public Inquiry:

- The decision to allow the UK Government to lead negotiations with Iceland.
- The UK Ministry of Justice's decision to pass its responsibility for these negotiations to the Treasury.
- The failure of the Guernsey Government to act as lender of last resort.
- The failure of the Guernsey Government to seek a loan from the UK in the case of insufficient funds being available to act as lender of last resort.
- The damage caused by LGL's failure to Guernsey's reputation as a financial centre.
- The failure of the Guernsey Government to implement a meaningful depositor's compensation scheme which will protect in full depositors within the islands' banks.
- The failure of the Guernsey Government to interact with the Icelandic authorities in a meaningful manner immediately after the failure of Landsbanki Guernsey.
- The failure of the Guernsey Regulator to act in a manner which would protect the interests of LG savers by ensuring that the business plan of LGL was such as to mitigate risk.
- The failure of the GFSC to recognise the inherent risks in allowing LG to upstream funds to Heritable Bank rather than a number of non-associated banks.
- The failure of the GFSC to reduce LGL upstreaming to a level in line with international recommendations.
- The modification of the banking operating conditions immediately after the failure of Landsbanki Guernsey which may have precluded further negotiations between the administrator and banks to take over Landsbanki Guernsey as a going concern.