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AN EXAMINATION OF 'INSTITUTIONAL ASCRIPTION': CAPTURE OF THE GATEKEEPERS OF ACCOUNTING VERACITY

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Abstract

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This paper aims to apply the theory of gatekeeping — institutional ascription — using the financial crisis of 2008–2009 in Iceland as a case. An investigation of the theory was conducted (Gabbioneta et al., 2014). The research question tested is whether the auditors, regulators, rating agencies, and analysts failed in the duty of stewardship to assess the scale and scope of accounting scandals and fraud perpetrated by executives of financial institutions. The paper shows that unless legal cases are prosecuted, where a complete presentation of evidence is presented, the theory has explanatory power but little predictive power, as all information must be in the public domain. The data applied in this paper is enriched by several unique elements of the situation described: a Special Investigation Commission (SIC, 2010), a report by a well-known regulator, the Office of a Special Prosecutor, (Jännäri, 2009) the role of the Supreme Court in reviewing all cases emanating from the crash, and a Report on Financial Stability (Central Bank of Iceland, 2010). Because of the extensive database provided by a combination of disinfectant and sunlight, this paper permits a richness of data across all financial institutions and an investigation of the theory of institutional ascription. The paper teaches authorities the need for more active use of the criminal system to prosecute wrongdoing.

Keywords: Financial Regulation, Trust, Malfeasance, Reputational Capital, Compliance, Critical Accounting Information

Authors' individual contribution: Conceptualization — M.B. and T.O.S.; Methodology — M.B.; Validation — T.O.S.; Formal Analysis — M.B. and T.O.S.; Investigation — T.O.S. and M.B.; Writing — M.B.

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1. INTRODUCTION

Auditors, regulators, rating agencies, short sellers, and analysts have a role to play in assessing the veracity of financial statements. Regardless of a specific country or institutional framework, each ensures that the corporation and its management provide accurate information to outside parties. Those gatekeepers' duty is stewardship, even fiduciary duty, within the institutional set of norms

and practices specific to the mix of accounting rules. These legal and other structures are operative in that domain. Each network "member/s" has an important and vital role in ensuring information transparency and veracity. Institutional ascription, where institutional processes essentially dull vigilance by auditors, analysts, regulators, and rating agencies, fail in their duty of independent, objective, and fair accounts of the financial statements (Gabbioneta et al., 2013). We suggest that the actions

taken in Iceland, although unique to the degree of transparency, provide a lesson for other jurisdictions, as well as show how institutional ascription may be applied.

The objective of this paper is to investigate and apply the theory of gatekeeping — institutional ascription — as advanced by Gabbioneta and her colleagues in two separate but related papers (Gabbioneta et al., 2013; Gabbioneta et al., 2014) where they examined the long-standing fraud that existed in an Italian-based, global firm, Parmalat, in the 1990s. The company borrowed in international debt markets and attracted debt ratings by major rating agencies, two international audit firms over its fraudulent history, an Italian regulator — Consob, was an index firm, and its outcome was bankruptcy.

The fraud lasted from initiation until bankruptcy years later. Because of the sustained fraud, criminal fraud cases resulted in directors and auditors being imprisoned for criminal behavior. The second audit firm was admonished for audit negligence.

The investigation of the theory was conducted in Iceland, where in four days, from October 6 to 9, 2008, the entire financial system of the country collapsed — the third largest bankruptcy ever. The three commercial banks had grown dramatically in the period from 2000–2008, grew 20-fold, such that the liabilities were 11× gross domestic product (GDP) of the smallest stand-alone currency area in the world — some 319,000 people (Benediktssdóttir et al., 2017).

The research addresses the question of *whether the auditors, regulators, rating agencies, and analysts failed in the duty of stewardship to assess the scale and scope of the accounting scandals and fraud perpetrated by executives of financial institutions*. Although some of these actors are private they serve as necessary adjuncts to “pure” market forces. As they are independent the question of stewardship implies that they have a duty of due care in their judgments and assessments. It is noteworthy that to adequately investigate the theory, there needs to be a full explication of what happened after the event. Both an investigation and multiple criminal trials occurred in Iceland. The findings presented in this paper show that unless criminal trials are conducted where a complete presentation of evidence is presented giving sunlight, the theory may have explanatory power but little predictive power as all information needs to be in the public domain. In the case of Parmalat, the data analysis was achieved similarly to this paper — via media and court records. However, in this paper, the data was enriched by several unique elements of the Icelandic situation: a Special Investigation Commission (SIC, 2010) report, a report by an international regulator, the Office of the Special Prosecutor (Jännäri, 2009), the role of the Supreme Court of Iceland in reviewing all cases emanating from the crash, and the Report on Financial Stability (Central Bank of Iceland, 2010).

The second question addressed *what set of circumstances, processes, failure of rules, and behavior allowed the gatekeepers to fail in their duty of care and stewardship*. What makes this investigation of the theory so comprehensive is the public airing of the facts and circumstances of that failure.

As other jurisdictions, Germany, the Netherlands, the US, and the UK (all of whom bailed out the banks) chose not to prosecute fraud and malfeasance after the 2008 crash criminally; the paper is somewhat unique, given the criminal prosecutions in Iceland. It indicates to authorities the need for active use of the criminal system to prosecute wrongdoing (Coffee, 2020; Rakoff, 2020).

The remainder of the paper is organized as follows. The next Section 2 presents an overview of applicable literature and prior research on financial regulation, malfeasance, reputational capital, compliance, and accounting information. Section 3 describes the methodology employed to address the research questions. The analysis in Section 4 summarizes the findings and contributions. The paper ends with a discussion and conclusion sections (Sections 5 and 6), including the study's limitations and potential future research avenues.

2. LITERATURE REVIEW

Gabbioneta et al. (2013) and Gabbioneta et al. (2014) outlined the theory of institutional ascription whereby a network of gatekeepers operates in a manner such they rely too extensively on others in a manner so that a “group think” becomes the modus operandi. Such group thinking is exacerbated by the existence of a “corporate star” whereby everyone becomes infected with telling the favorable tale until it is too late. The theory of institutional ascription can be distinguished from regulatory capture as stated by Stigler (1971) and extended by Dal Bó (2006).

The research thrust of accounting scandals is explored by Cooper et al. (2013) in their editorial on accounting scandals, which brought together a wide range of perspectives on accounting fraud and scandals. Soltani (2014) extends the work on accounting scandals, providing the context for scandals, but does not appreciate how the various actors interact as a network.

Ball (2009) suggests that the US system is a mixed one comprised of regulation and market forces. Market forces are represented by a network of independent actors who work to ensure veracity, together with regulators to ensure veracity of financial statements. Auditors are partly a consequence of statute and market forces as they act in a commercial manner along with professional standards to support the public good of their work. Rating agencies are part of the network, as they operate to ensure the reliability of debt agreements and risk assessments. Short sellers play a role in ensuring accountability by taking positions where they consider shares to be overvalued. The network is thus complex and subject as Ball (2009) indicates to regulation/political forces along with market forces.

Regulation and the capabilities of regulators have been explored by Metzenbaum and Vasisht (2015), “good regulators need to be comfortable with taking bold, (yet informed) action in the face of harsh criticism, can identify non-compliance patterns, and survive in a world of often harsh criticism” (p. 1). Regulators act on behalf of the public as they are funded largely by public money. In contrast, other actors who are present in a melange of regulation and market forces are often

profit-seeking enterprises — rating agencies, short sellers, and analysts. Auditors in their role of attesting to the veracity of financial statements, play a statutory role (quasi-regulatory), a public interest, and a commercial role (Anginer et al., 2020). It is noteworthy that as Bin Haron et al. (2013) point out how difficult it is to criminally prosecute auditors for failure in most jurisdictions.

Gunnarsson and Stefánsson (2020) provide a summary of the cases against bankers for market manipulation and the rationale (ignoring ethical issues) of why they performed such actions.

Claassen (2015) explored the philosophy of bank bailouts. Each jurisdiction after the Global Financial Crisis (GFC) did it differently; in some instances, the state took ownership (the Netherlands and the UK), support for the banking sector and other sectors (Germany), and in the US, a combination of preference shares, loan guarantees, incentives for existing firms to take over troubled enterprises, and required capital injection. In contrast, Iceland did not bail out its banks. However, it gave preference in claims to Icelandic citizens and the setting up of “a bank for overseas assets and liabilities” and a bank for domestic assets and liabilities where the creditors of the overseas bank had a claim against the “local” Icelandic banks and forced the local banks to substantially write down local assets, implying that foreigners took a “haircut” on domestic assets as well — another instance of Iceland preferring its citizens versus international debt holders.

Lagner and Knyphausen-Aufseß (2012) examined the research conducted on the actions of rating agencies and essentially concluded in their extensive literature search that although such agencies have a significant advantage in analyzing corporations and the market, due to economies of scale of the three global agencies it remains *caveat emptor*. This assertion, after the myriad failings of the agencies in 2008, stands in direct contrast to White (2019), who suggests that the agencies failed through a combination of not understanding the mortgage-backed-securities market and their accompanying risk, as well as not appreciating the fat tail risk of the distribution of housing mortgages, when the housing market in the US could collapse, due to a combination of aggressive selling of mortgages to clients without necessary risk evaluation (Coulmont et al., 2020; Dyck et al., 2023).

The tale of Iceland and its rapid growth in its financial system after the deregulation, due in considerable measure to Iceland joining the European Economic Area (EEA), and its intended and unintended consequences, is the subject of several books and articles (Sigurjonsson, 2010). Baldursson and Portes (2013) describe the massive growth and assert that whether the financial system failure was due to regulatory failure or dishonest bankers is probably a combination of both elements. They carefully analyze the drivers leading to bank failure and the lack of system transparency. Johnsen (2014) examines the combination of dishonesty, related party loans (notably directed to bank owners and executives), collusion between the banks, the rapid growth of debt and lending, and international expansion to suggest that no one wanted it to stop once the party started. Jónsson and Sigurgeirsson (2016) reach similar conclusions

but tend to focus on crony capitalism and the political support by the government, together with negligence by the Central Bank of Iceland (CBI) when analyzing the failure of the financial system.

3. METHOD

Qualitative methodology is the research approach adopted, to explore and understand a complex phenomenon. The focus is on the subjective experiences and meanings that society attributes to those phenomena. Unlike quantitative research, which relies on numerical data and statistical analysis, qualitative research emphasizes rich, detailed, context-dependent descriptions and interpretations.

Case studies employing documents have the advantage of unobtrusiveness, but complete evidence is not possible (i.e., those instances where the regulators and justice system chose not to pursue) (Yin, 2018). This is like much of legal research employing settled cases, legal research requires a concerted search and depth of analysis by the researchers to identify commonalities, differences, and nuances of the specific instances analyzed. This method is beneficial for the study to uncover trends in thinking about the topic. The descriptive method relies on data from regulators, analysts, rating agencies, public sources on governance, and financial markets. Collecting different data sources helped to gain an in-depth understanding of the subject while allowing data triangulation. Hence, the sampling was purposeful and of a snowball type sampling. Sampling continued until data saturation was reached.

4. FINDINGS

4.1. The rise, fall, and new beginnings

The growth of the Icelandic banks and its associated service economy is summarized in this section. The rise was a direct consequence of deregulation, liberalization, and privatization. The three factors were the intended result of joining the EEA in 1994 (Sigurjonsson, 2010). The changes were profound, as Iceland was now open to the flow of capital and people and mainly subject to European rules and regulatory processes. The question, of course, was, were they ready? Events proved probably not.

Beginning in 2000, there was a rapid rise in debt held by Icelanders. Further, the banks expanded substantially abroad, mainly through the acquisition of financial institutions, and so too did many of their clients, the so-called Vikings (Lewis, 2012). There was easy access to credit by the Vikings and Icelanders as interest rates were low. The growth in loan portfolios reached 11 times GDP, the bank activities, and at least half of their revenues were outside Iceland.

The bank assets for much of the 2000s were achieved by the banks borrowing in the international debt market and some European central banks, peaking in 2006 with debt issues of €14 billion, and when that dried up, the banks resorted to widespread use of high-yield internet-based savings accounts, to shore up their financing to allow loan consolidation. Loan portfolios were risky but were not treated as such by the banks. The loan risks

were several: currency risks, an inflated property market in Reykjavik, aggressive expansions, and likely overpayments for overseas assets.

4.2. Legislative framework and responses to systemic failure of the financial system

Like most European countries, Iceland has a civil law system. In such a system, in contrast to the Anglo-Saxon common law, there are specific codes based upon a written constitution, and there exists little scope for judge-made law in civil, criminal, and commercial courts. This is notwithstanding that judges tend to follow previous judicial decisions. Icelandic law, though, is subject, to consistency with the jurisprudence of the European Free Trade Association Court (EFTA). The principle is the quasi-primacy of the state, Iceland, within the legal system of the European Union and the EEA. EFTA operates its laws consistently with the EU through the European Court of Justice (Méndez-Pinedor & Hannesson, 2012).

The EFTA court was tested by the governments of the Netherlands and the UK in early 2013 regarding deposit guarantees for depositors for Dutch and UK depositors with the collapse of Icesaver deposits with Landsbanki and Edge with Kaupthing. The EFTA court upheld the Icelandic legislation as the court indicated that deposit guarantees did not envisage a bail-out in the event of a system-wide failure.

Claassen (2015) makes a case that the state, by underpinning its banking system or an individual institution through direct grants or taking ownership or guarantees, is consistent with the state's role in ensuring an adequate standard of living for all citizens. Left unstated by Claassen (2015), when a financial institution or the financial system fails (Iceland) or the US with the Troubled Asset Relief Program, is that bank failure may also be a failure by regulators in monitoring the banks.

Claassen (2015) raises the ethical issue: do banks — essentially bank leadership — have an equal moral obligation to avoid being in a position of needing a bailout by the government? Stated in this manner, bank executives are in an insurance relationship between the bank as an entity and the government. If this is the case, then there is a risk of moral hazard for bank executives — knowing that they are insured, they may take on additional risk.

The lack of criminal prosecutions for wrongdoers in the GFC has raised concerns by many, notably Rakoff (2020) in reviewing Coffee (2020), where Coffee cites the extreme reluctance to prosecute white collar criminals not just for financial malfeasance but also environmental, safety concerns and the like. Instead, regulators and prosecutors in the US, the UK, avoid criminal prosecution of individual wrongdoers.

Gunnarsson and Stefánsson (2020) outlined the cases against the bankers. The bankers were not charged with reckless lending, even though that was a critical element; rather, they were charged and convicted of criminal breach of trust. They were guilty of market manipulation, as bankers extended credit to individuals, including themselves, to purchase bank shares, and the “security” was those same shares. Just as importantly, when the market

went sour, those executives doubled substantially down to try and beat the market to avoid taking losses.

In all, some 36 bankers received 96 years of imprisonment convictions, as some were convicted in several separate criminal cases. What is also noteworthy is that the cases were initially tried in District Court and then were reheard in the Supreme Court. In some instances, cases adjudged in the lower court as not guilty were overturned by the superior court, or sentences were increased.

Because of the case against an auditor, we could not assess whether institutional attribution was proven, as the case was dismissed. In contrast, the second exemplar against three auditors, with one auditor dismissed, is more consistent, although not totally in accord with the theory.

The case involved the audit of a set of consolidated statements. What stands out in the Supreme Court records of the case is the complexity and intercompany transfers that were part of the company's operations. From statements made in the case about the location of some of the subsidiaries mentioned — Seychelles, Jersey, British Virgin Islands, domiciles that at first blush appear to be selected due to significant tax avoidance behavior by the company. Note, too, that the tax advisors of the same audit firm designed the suggestion of setting up these organizational arrangements. It is this action alone that is highly consistent with the theory.

The case, though, did not analyze in any depth the organizational design considerations at all. In contrast, it rested upon two brothers buying out their sister's share of the company using misappropriated company funds. It is noteworthy that all six defendants, three from the company and the three auditors, had been found not guilty by the District Court, but the Supreme Court, in reviewing the case and setting the sentence, found the three company representatives guilty and two of the auditors guilty.

The details of the audit case are as follows: they audited the company, and there was a loan agreement between M Ltd. and M Export Import Ltd., dated December 30, 2006. The audit report stated that the existence of assets and ownership had been checked in the balance sheet of the 2006 financial statements (Gunnarsson & Stefánsson, 2020). However, what stands is that the loan was not reflected in the accounts presented in the balance sheet of December 31, 2006.

To the authors, this represents negligence. The issue of related party loans and transfers between organizational entities lies at the heart of the findings of the SIC, as it was never clear who was behind the shell companies and the transfers. Bankers did not look behind the veil to assess all the funds flows; the question is left unanswered whether they had no incentive or were the wily smart bankers doing what they did as referred to by Baldursson and Portes (2013).

Only after the SIC (2010) report was the nature and extent of these flows established. Perhaps the Supreme Court, in recognizing the negligence of the two auditors in this instance, was cognizant of that fact, in saying that the two auditors were held guilty of a breach of fiduciary duty and thus given

significant imprisonment sentences (3.5 years and 2 years, respectively).

The theory has been tested in this instance, but the results are mixed. The courts established that the two auditors breached a fiduciary duty of care by failing to ensure that the December 30, 2006 loan was included in the December 31, 2006, balance sheet. To the authors, this implies a failure to follow due audit processes according to recognized audit standards. It indicates a lack of adequate review of year-end work. On the other hand, given the complexities described in the fraud as documented by the Supreme Court case and the multiplicity of transactions, was this oversight (even though the amount was significant) or negligence of an order consistent with the theory? On balance, we find some evidence of institutional attribution but it is insufficient. However, we see the conflict of interest inherent in a highly complex, suspect organizational structure as set up by the tax practice of an audit firm. The audit practice was conflicted, attempting to serve multiple masters, we consider that there is some evidence supportive of the theory of institutional attribution.

4.3. The regulatory regime 2000–2007

The regulatory regime during this period was somewhat complex and likely lacked clear accountability. The players included the CBI, with representatives on the board of the Financial Supervisory Authority of Iceland (hereafter, FSA), the Ministry of Economic Affairs, and the Ministry of Finance. Our analysis in this section will concentrate on the primary regulatory regime, the FSA, and its role in the bank growth scenario and the crisis. It is based almost totally upon the annual reports of the FSA (2000–2007) that highlight the issues and their responses over this period. The analysis has also benefited from hindsight from several sources, notably the Special Investigation Commission report (SIC, 2010).

A warning is well summarized by Baldursson and Portes (2013), who stated when examining the build-up of the banks and the aftermath, “The story can be read as a consequence of the bankers’ dishonesty or the authorities’ ignorance. We stress the importance of information, transparency, and disclosure — but it may be that no regulation and supervision seeking to enforce transparency can succeed against a determined strategy of concealment by very clever bankers. The great complexity of the story admits either interpretation, most likely both” (p. 6). What Baldursson and Portes (2013) perhaps fail to highlight is not only the apparent information asymmetry between the FSA and the respective banks but also the former’s responsibility with not just regulating commercial banks but also savings banks, investment banks, insurance companies, insurance brokers, securities firms, pension funds, and the Icelandic Stock Exchange, with on average over the period roughly 35 staff. In 2001, the International Monetary Fund’s Financial System Stability Assessment (IMF, 2001) commented on the capability of the overstretched staff but also made other areas of dramatic improvements necessary for the FSA. The assessment was followed up in 2003, the FSA had diligently put in place the remedies

requested by the Financial System Stability Assessment (IMF, 2001).

In its initial FSA annual report for the period January 1, 1999, to June 30, 2000, it set out its philosophy in the following terms, “the policy of the FME [FSA] is based upon a constructive relationship with parties that are subject to supervision, while at the same time showing firmness if necessary [...] parties subject to supervision are in accordance with laws, regulations, and [...] proper business practices” (FSA, 2000, p. 8).

In the annual report 2000 (FSA, 2000), the FSA highlighted the increased lending (the beginning of a lending boom that seems to presage a crash), as well as foreign borrowing by the banks, an increase of 150% since 1998, plus a dramatic rise in securities held by the banks, a 13-fold increase. They were concerned about capital adequacy ratios (CAR). A highlight of warning signals that were ignored is that “foreign borrowing is primarily balanced out by foreign currency linked loans to domestic customers, some of whom do not have their income in the corresponding currency. Furthermore, the assets of financial institutions are increasingly tied up in marketable securities, which are susceptible to market fluctuations” (FSA, 2000, p. 20).

The annual report 2001 (FSA, 2001) warns strongly about CAR and the widespread use of subordinated debt to bolster CAR as part of tier II capital. The report raises an interesting but largely unanswered question, “Growing activities of Icelandic credit institutions abroad call for changes in surveillance. The FME [FSA] has increased its overview of these activities through increased information disclosure by the credit institutions” (FSA, 2001, p. 3). Note that the tier I equity of the banks by the owners was all borrowed from other banks, so real at-risk equity was non-existent.

In the annual report 2001, the FSA comments on the IMF’s Financial System Stability Assessment report (IMF, 2001), where the IMF focused on rapid increases in foreign and domestic debt, external imbalances, inflation, and the depreciation of the local currency. “The implementation problems are in no small part related to the overall size of the supervisory authority, Fjármálaeftirlitid (FME), which is understaffed” (IMF, 2001, p. 6). A follow-up report two years later states that additional staffing and resources had been added, along with an enhanced legal framework. What was not stated was that in 2001, the full-time-equivalent supervisory staff was 26, with a high turnover ratio from regulator to regulate, so experience was an issue. Our conclusion is thus clear: given the broad mandate of supervisory activities, the FSA was under-resourced; given the growth in foreign assets and liabilities of 18% year over year, “the bank’s growing foreign debt has resulted in their increasing dependence on the supply of foreign credit for refinancing” (FSA, 2003, p. 12). They go on to raise the issue of liquidity, but nothing substantively about the debt boom, or the risks to the country with significant dependence on foreign debt.

A bank’s profitability is also dependent upon the assessment of loan loss provisions, and although the banks had dramatically grown, were the loan loss provisions adequate given new customers or

extensions of existing credit lines to extant customers? The FSA suggests that the commercial banks had grown by significantly entering the mortgage loan business, albeit ignoring the housing bubble that had emanated as the commercial banks entered into housing loans, and the accompanying rise in overall consumer debt. Foreign lending also rose from 7% of total lending so by 2005, it was 20%. The FSA was aware of the risks by 2005, “This rapid lending increase is a cause for concern, since it is one of the risk factors which experience has shown may indicate upcoming difficulties in the financial system” (FSA, 2005, p. 10). They go on to suggest that net debt in 2004 has doubled while the gross debt has more than quadrupled, “this comprises a substantial refinancing risk” (FSA, 2005, p. 11). The report emphasizes enhanced risk management by the banks, but there are seemingly no warnings for the country’s risk and potential stresses on the CBI.

The risks posed by dramatic expansion outside Iceland gave rise to a new role for the FSA, “The role of the FME [FSA] has changed from being a supervisory body for financial undertakings in Iceland to carrying out the responsibility for supervision of multinational financial enterprises on a consolidated basis” (FSA, 2005, p. 24). There is no mention of loan concentration of borrowers, or related party loans, which the FSA partly recognized in their 2006 annual report (FSA, 2006) where they called for auditors to provide details of related party loans and loan concentration — which did not effectively occur, given the lack of transparency.

What is evident with hindsight is that the FSA were aware and likely cognizant of the emerging risks that the financial system posed for Iceland, even as far back as 2001, but were understaffed nor adequately provided with the tools to do more than highlight concerns. The CBI did not respond, neither did the two government supervisory ministries and perhaps all were just going along with the party until the music stopped. The culture, at first blush, appears to disclose the problem but does not investigate too profoundly or go after evidence of malfeasance.

The annual report 2007 (FSA, 2007) states that a priority was a survey of the credit risks of the most significant financial undertakings. Notable was no mention of the related party of the interrelationship between the Savings Banks and Kaupthing Bank through the “financial holding company” vehicle of Exista (Mixa et al., 2016). In our discussion in the section on the SIC in this paper (earlier section), we discuss the very complicated legal structures enacted and the funds flow between the three major banks and their lenders and borrowers. We would also note that the complex legal structures to obfuscate accountability and loan exposure, as well as tax “minimization”, appear in our section on auditor accountability and responsibility and the two major cases that we outline in that section.

The description and analysis of the FSA over the period 2000 to 2007 (note we ignore the crash of October 2008 as no results are available for this period), we find the implications as outlined.

The banks’ growth and accompanying decreased asset quality (and hence loan loss provisions were inadequate), and borrowing risks

were understood. What is less clear is why the FSA, after highlighting issues, did not push the arguments and implications regarding both systemic risk as well as country risk to responsible authorities. This may be as in Baldursson and Portes (2013) that there was a breakdown of trust between two ministers and their respective ministries in government — a small country with many close personal and professional relationships.

The related party loan issue is hinted at by the request for audit reports from 2006, but why was this concern not raised earlier? In a small economy conflicts of interest are always present, and strong regulatory regimes not only rely upon transparency and information flows but ensure that the spirit and letter of the law are followed — so-called crony capitalism.

4.4. Bond ratings and the Iceland situation

White (2019) in commenting upon the role of credit rating agencies (CRAs) before the criticism leveled at them after the GFC, “The major credit rating agencies... were part of the infrastructure of the financial system: part of the “plumbing”. They attracted little attention because they appeared to be functioning reasonably well — “doing their job”” (p. 2). He further suggests that the crisis was a watershed moment for CRAs. CRAs gather information about borrowers and form opinions about their creditworthiness. CRAs have been extensively studied, largely in the finance literature (Lagner & Knyphausen-Aufseß, 2012), concluded in contrast to White (2019) that the models employed for credit ratings were not the problem but the blind trust that investors placed in the ratings (p. 181). The experience of Iceland, employing retrospective sense-making by examining the ratings and statements by Moody’s concerning Iceland, is more consistent with the views of White (2019), as we shall demonstrate in the following paragraphs. The rationale for focusing on Moody’s is that they appeared to be more active in assessing the Icelandic banks.

Several exemplars from Moody’s reports are discussed (e.g., Moody’s Investors Service, 2004) upgraded the long-term deposits of Kaupthing to A1 from A2 “reflects the bank’s leading position in its domestic market in Iceland, the fact that it is one of the country’s largest institutions, and its healthy financial fundamentals” (Johnsen, 2014, p. 55). Note that this explanation is consistent with Gabbioneta et al. (2014) concerning “star quality”. There is no recognition that the growth of Kaupthing had been recent due to an acquisition of a domestic commercial bank (Bundarbanki in 2003) by what had been formerly a small investment bank and multiple acquisitions outside Iceland in 2004 (Denmark, Norway, and Finland, plus setting up an asset management company in the UK).

A cautionary note was provided by Moody’s on April 4, 2006 (Moody’s Investors Service, 2006), in that the rating agency put the banks’ financial strength rating (BFSR) for Kaupthing at C+ (outlook negative from stable the same C+) rating and Landsbanki C. The report goes on to suggest challenging operating conditions for all three banks. However, caution is offered, “Nonetheless, the deposit and debt ratings have been affirmed at

their present levels due to Moody's belief that the importance of the major banks to the Icelandic markets makes government support likely in the event of difficulties or a major systemic shock. The rating of the government of Iceland is Aaa, reflecting the country's high-income level" (Johnsen, 2014, p. 55).

In early April 2007, Moody's applied a newer methodology to its ratings, all three Icelandic banks, along with 42 other banks worldwide, were placed on a review list indicating that they would be subject to further analysis — an orange rather than a red flag in other words, notable given the later problems in Wall Street — Bear Stearns and Lehman Brothers were not highlighted in the banks of concern (Moody's Investors Service, 2007).

A week after the announcement of the review, all three Icelandic banks were downgraded from Aaa to Aa3, followed in August of that year by a possible downgrade of Kaupthing due to the announcement that Kaupthing was to acquire NIBC, a Dutch bank. However, the report found positive signs: a strong domestic franchise and business, geographic diversity, high profitability, and good asset quality. Again, there is no mention of the role of loan concentration, related party loans, and refinancing of critical customers whose credit lines were reduced elsewhere.

In essence, the theory advanced by Gabbioneta et al. (2014) is somewhat confirmed by examining the history of Moody's bond ratings from 2004 to 2007, the star quality and apparent performance of the three Icelandic banks and their ability to grow so dramatically over this period, both domestically and internationally. Growth for a financial institution requires funding, and although the three banks essentially met Capital Asset Ratios for this period, the funding needs were immense. Secondly, the tail rating (an exogenous shock) is highlighted but ignored based upon the supposition that in the event of an exogenous shock, the government would adopt what governments in other domiciles — Germany, the Netherlands, the UK, and the US, did, bail the banks. However, the assumption with hindsight was erroneous because it depends upon intent, and would a coalition government notwithstanding its internationally strong fiscal position and its commitment to international protocols take the risk as they did in not guaranteeing international depositors and lenders? Moody's were basing their ratings to a great extent on the governmental bailout of a troubled bank, should the need arise, but ignored the possibility of systemic failure.

Øygard (2020) mentioned, "In retrospect, the excesses were glaring. In 2005, Glitnir, Kaupthing, and Landsbanki got hold of €14 billion by tapping European debt securities markets... the banks knew exactly who to call to get money" (p. 23). The rating agencies proved to be as less capable in evaluating a newcomer on the international financial scene as they were in evaluating the new challenges raised by subprime mortgages in the US. Yet, the rating agencies were not adept at seeing those new realities. However, likely too they focused upon the apparent success of the Icelandic banking system, further evidence of star quality — support for institutional ascription.

4.5. Summary of analysis and key findings

As indicated in the literature review, Gabbioneta et al. (2013) indicate in the institutional ascription theory that the network of gatekeepers become mutually over-confident and rely on each other such that independent assessments are comprised. In the longitudinal study from 2000 to 2015 covering the rise, the fall, the crash, and subsequent investigations and prosecutions in Iceland, we find partial support for the theory of institutional ascription.

However, we find an additional or another plausible explanation. The weak business culture indicated by cronyism and the personal and business relationships that extend to politicians and the community at large also played a significant role in permitting not just the risky practices of the financial institutions but also the manipulation of information to allow such malfeasance. It is also notable that the rapidity of liberalisation of the economy as Iceland joined the EEA played a part; new operations occurred, but the regulatory network and the necessary transparency were not ready.

Like most financial system crashes, the country was awash in debt, as the banks grew locally and internationally. The ease of debt was accompanied by a widespread euphoria: the world's smallest currency area was making substantial inroads into Europe — notably the Nordic countries and the UK — and growing wealth in Iceland. The inroads into Europe, both by acquisitions of financial institutions and retail and other enterprises, were a source of pride.

What was ignored was the credit squeeze that was happening globally that resulted in a tightening of credit, and many of the Vikings and other major borrowers of the banks were forced to reduce credit lines outside of Iceland and were refinanced in Iceland. Thus, the financial system's credit risks grew, yet no provision was made for higher loan loss provisions.

The FSA, from 2000 to 2008 as the regulator, produced evidence of the increasing debt, liquidity issues, concern about tier I capital, and the possibility of extensive related party loans. They knew what was happening, but a culture of risk aversion and losing in litigation meant they failed due to fear of losing.

The rating agencies identified, independently, the risks of the substantial — exponential growth of the banks, but due to the low level of debt of the Icelandic government and the importance of the financial system to the country, considered that the risk of systemic and even individual bank failure was low as the government would become a lender of last resort. With the analysis of some years later, we identify that the rating agencies, individually and collectively, were guilty of ignoring the fat tail risk of asset prices. The consequence is that proof by Gabbioneta et al. (2013) that the network relied too much on each other. We do not see this fully in evidence; bad modeling and a "heroic" assumption are the cause. The regulators failed to act effectively with the three major banks, perhaps evidence of the star quality?

What stands out in our longitudinal study are the in-depth efforts to identify what went wrong and the transparency of those efforts in the public

domain. The SIC, who had previously been unknown and not found in other investigations, had access to information and questioning of individuals. So too truth-telling, the resources available to the SIC — Joly (money laundering and anti-corruption), legal and financial experts, ethicists, and philosophers meant that they were committed to truth-telling. The reconfiguring of the FSA and its conscious felt need to change the culture to show prosecutorial zeal and set a new culture and strategy for the future is noteworthy.

We find the theory of institutional ascription, although providing a partial framework for our analysis, is unproven. Perhaps this is due to its inability as a predictive theory, but we believe otherwise. There is clear evidence of network failure in Iceland, but only partly due to reliance on others and a star culture. In contrast, similarly to the Greek tragedy of Icarus, we see a widespread inability to see what was there and, more importantly, act. Is this an Icelandic phenomenon? We believe not, but it requires all those who are regulators to act with a combination of humility, based upon reason and evidence, but above all, act with a solid mission-based focus — auditors to ensure accounting veracity — including fraud, rating agencies to think about their models and the reality of the information that they collect and having a deep inquiring mindset, and regulators acting with strength not just identifying compliance problems but working to ensure that the system stability is ensured along with consumer interests.

5. DISCUSSION

The difficulty of proving or confirming institutional ascription is frequently a result of the lack of fulsome evidence in the face of malfeasance and wrongdoing. Such lack of evidence is the unwillingness of regulatory authorities to use the criminal remedies available to them and instead rely too willingly on negotiated settlements through consent decrees. Coffee (2020) provides some suggestions in his thoughtful book on the reform of legislation; we see significant opportunities to explore the implications of his recommendations for corporate governance. What does governance have to look like to be fully accountable for the stakeholders of the modern corporation that too often appears to be focused upon short-term earnings and less on substantial wealth creation and made worse by executive compensation arrangements that reward attendance, not action?

We strongly suggest a plea that prosecutor authorities employ the criminal remedies that are available, notwithstanding the budgetary and win/loss challenges that they face; only in this way can we reduce malfeasance, accounting scandals, and executives who feel that they have little to lose, but in so doing capitalism loses.

6. CONCLUSION

The paper concludes that Iceland was unique in several ways as to the manner in which they dealt with the financial crisis: Icelanders' claims were treated in preference to all other claims; the banks were not bailed out by the government; and a new regulatory regime was established. The GFC was for

Iceland, largely self-inflicted. The banks grew too quickly, crony capitalism was pervasive, the owners of the banks were the largest creditors, debt became pervasive and the regulatory regime was not fit for purpose.

Unlike elsewhere the Icelandic parliament instituted widespread ways to find out what happened and punish those who the courts found were guilty of market manipulation. The auditors as well as the regulators failed to appreciate that the equity of the banks was based upon borrowed money, from the other Icelandic banks, and consequently, the whole edifice was built on sand. Bankers took the liberty of handsomely rewarding their owners and themselves and the results were inevitable.

The theory of institutional ascription relies upon a network of independent market actors to act in ways to ensure that financial statements are fair but represent the economic substance of the financial condition and results. The rating agencies saw the growth but felt that the government would bail out the banks — a heroic assumption given the scale of the debts of the banks. The regulatory agencies were remiss in not looking at substance but relying on form. The CBI was a lender of last resort but failed to appreciate the scale of the problem.

The country fell for the perceived benefits of liberalisation, deregulation, and globalisation without having the infrastructure or systems in place to ensure that pure greed was managed in a manner that would ensure trust in institutions. Being part of Europe meant that the country was ill-prepared for the growth that would follow. It is easy in hindsight to blame bankers and regulatory failure but in essence, most Icelanders were proud of the growth from 2000 to 2006 but did not appreciate that the growth was illusory.

Institutional ascription as a theory to explain the crisis was partly supported — by reliance on others, e.g., the rating agencies; audit quality was suspect due to the pervasiveness of related party loans that were not closely examined, and taxation records were not examined with sufficient diligence due to complex off-shore organizational structures. However, due to the transparency of legal cases, the SIC, with outside experts, the fulsome explication of what happened, similar to Parmalat, means that no one was left wondering why and how.

Although conceptually appealing, the theory is found somewhat wanting, as it is viewed as a means to describe *ex post* what occurred, but does not provide predictive power, a necessary test of a strong theory.

Future research should examine how regulation can be strengthened so that markets can operate fairly and transparent. Market failures are partly due to failures of regulatory processes and institutions, but these are subject to political processes, so what is needed is more research on how regulatory processes can become more effective and less subject to political whim.

The research limitations are attributable to the methodology selected, we do not know about those instances not highlighted in reports or cases before the Supreme Court. In no way does this detract from the significant findings presented.

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