Wages of Failure: Executive Compensation at the failed Icelandic Banks

Gudrun Johnsen

University of Iceland / ENS - École Normale Supérieure

November 5th 2018

Forthcoming in

The 2008 Great Financial Crisis in Retrospect, ed. Robert Aliber & Gylfi Zoega, Palgrave Macmillan, New York, 2019

Abstract

One of the most universally accepted culprits of the great financial crisis is incentive pay for bankers. Public investigations have uniformly declared incentive pay as one of the main causes of reckless risk taking, as they offered huge upsides for bankers with limited accountability for the downside. Policy responses to these findings have been mixed. While European legislation has responded without hesitation to lessons derived from the crisis by capping banker‘s variable pay at 50% of total pay, the US has not passed any such legal constraints, despite the Dodd-Frank legislation promises to do so.

This chapter describes the executive compensation arrangements of the failed Icelandic banks and how incentive schemes led to misreporting of profits and equity levels, embezzlement of the funds of publicly owned companies and massive market manipulation, keeping the promises of the incentives schemes alive for themselves, whilst defrauding the investing public and derailing financial supervisors with false market signals.

This chapter draws on the findings of the Icelandic Special Investigation Commission (SIC, 2010) which showed how compensation schemes evolved over time in the failed institutions using proprietary salary and loan book data from 2004-2008, derived from the bankrupt estates. Although the banks‘ chief executives lost significant wealth, which they had accumulated on the job through incentive pay over 2-6 years time, they cashed out significant amounts in salary, bonuses and dividends from stocks that were largely funded by the banks they operated. Intentionally or not, staff were used as a vehicle to falsify equity through both the inappropriate hedging of options via off-balance sheet special purpose vehicles and through excessive lending to purchase own stocks while only pledging the purchased stocks as collateral.

Keywords: Executive Compensation, Incentive Schemes, agency problems, pay for performance, golden goodbyes, camouflage, misreporting, restatement, earning manipulation, incentives, unsustainability

JEL Classifications: D23, G32, G34, G38, J33, J44, K22, M14

I. Introduction

Corporate governance, incentive pay, and securities litigation are widely considered to be the main tools used for disciplining managers of corporations. Talley & Johnsen (2005) show how their mutual relationship and interactions predict that, as share of incentive pay in total salary rises, the likelihood of litigation increases, hence misreporting and manipulation on part of management becomes more likely. These results were confirmed by Peng and Röell (2005)[1]. Establishing how variable salary components evolve as a share of total compensation can therefore be an important early warning sign and aid in the timing of potential executive misbehavior.

It's been forty two years since Jensen & Meckling (1976) pointed out that separation of ownership and control called for optimal contracting aligning the incentives between management and shareholders. Jensen in co-operation with Kevin Murphy published another paper on the topic in 1990, detecting little evidence of the optimal contract being enforced as CEOs' own wealth increased only by 3,25 dollars as they begot wealth for their principals of $1,000. Jensen & Murphy declared that CEOs had been remunerated as bureaucrats, ever since first measured in 1935, calling for a more market oriented approach to compensation. Ever since, there has been a growing and widespread use of incentive pay, combining CEOs' fixed salary with components such as bonuses, stock options, stock grants, and other instruments thought to be linked to firm's own performance.

[1] E. Talley and G. Johnsen, 'Corporate Governance, Executive Compensation and Securities Litigation', USC Law School, Olin Research Paper No. 04-7 2005 and USC CLEO Research Paper No. C04-4 2005, A.A. Röell and L. Peng, 'Executive Pay, Earnings Manipulation and Shareholder Litigation', AFA 2005 Philadelphia Meetings ((August 2006), ssrn.com/abstract=488148.

Despite the widespread use of incentive pay among CEOs in listed firms, the problem of asymmetric information persists between agents and principals. The myriad of papers borne out in this field have not been able to ascertain that shareholders indeed manage to align their own interests with their agents, not least due to the measurement and identification problems that are particularly difficult for researchers to overcome, given the level of confidentiality associated with employment contracts and lack of access to data on compensation of employees below the C-level. Among the hurdles are the endogenous nature of recruitment, differing bargaining positions, the moving target of what constitutes as the performance of the firm, dynamic interplay between market conditions and the CEOs' control over them, the level of competition, possible negative externalities of the firm's production and risk sharing and moral hazard, make it exceptionally hard to pinpoint the shape and form of the optimal contract in practical terms.

Many logical questions arise such as to whom should the contract be optimal, and for how long does it need to last? Can the optimal contract ever be reached when agents have a room to bargain? Even when following shareholder primacy, the principal is still up against the measurement problem, which can lead to inappropriate actions or even value destroying behavior on the part of the agent. This is particularly pertinent in the financial industry, where agents' performance is measured in financial terms, through valuation of assets that vary over time and often, by a judgment call on appropriate yields and discount factors, can dramatically change in value.

As a result, compensation arrangements are associated with a large number of observable and unobservable variables, derived from both firm and employee characteristics. This makes it very difficult to interpret any observed correlation between executive pay and firm outcomes as evidence of a causal relationship.

CEO pay and firm performance may be correlated because compensation affects performance, because firm performance affects pay, or because an unobserved firm or CEO characteristic affects both variables. Hence, the jury is still out on whether and how shareholders can achieve incentive compatibility.

It is therefore invaluable when academics and independent investigators get access to proprietary data, to ascertain whether aspects of theory can be found in the application. Such access was given to the Special Investigation Commission of the Icelandic Parliament official investigation committees after the Great Financial Crisis, tasked to perform a post-mortem on the failed banking sectors. The comment made by the Financial Crisis Inquiry Committee of the US House of Representatives is a representative assessment of the effect of compensation schemes made by all the major official investigations looking into the cause of the crisis[2]:

> "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited"

This chapter builds on the narrative and data published along with the Report of the Parliamentary Special Investigation Commission (2010), looking into the causes and events leading up to the failure of the three Icelandic banks; Glitnir, Landsbanki and Kaupthing. It provides a detailed description of stylized facts regarding compensation in the failed banks in October 2008. Guided by corporate theory of agency cost

[2] Special Investigation Commission (SIC), Pall Hreinsson et. al. (eds.), *The Causes and Events Leading up to the fall of the Icelandic Banks* [*original title*: Rannsóknarnefnd Alþingis, *Aðdragandi og orsakir falls íslensku bankanna og tengdir atburðir*] (Reykjavik, 2010), vol. 7, pp. 222-227; Ministry of Industry, Business and Financial Affairs; 'The Financial Crisis in Denmark – Causes, Consequences and Lessons' in Jesper Rangvid (ed.), Copenhagen (2013) p.32, em.dk/english/publications/2013/13-09-18-financial-crisis; The Financial Crisis Inquiry Commission, P. Angelides et al. (eds.) *The Financial Crisis Inquiry Report* (U.S. Government Printing: Washington, DC, 2011) p. 61; Nyberg Report, *Misjudging Risk: Causes of the Systemic Banking Crisis in Ireland* (2011), p. 31.

predicting misaligned incentives, where ownership diverges from control,[3] evidence of misreporting performance to meet bonus targets was found alongside evidence of large scale market manipulation, which had the effect of bringing incentive pay, in the form of stock and options, in the money. Furthermore, evidence was uncovered of management manipulating key financial strength indicators, such as equity ratios and performance indicators. As time progressed, loan portfolios in the three failed banks were marked by excessive risk taking while evidence of large scale tunneling of funds was found through lending facilities to related parties, including the largest owners of the banks, directly to members of banks‘ management teams and SPV's in ownership of the members of management teams, with little or no collateral-backing, SIC (2010).

This chapter is organized in the following way: Section II describes the data underlying the analysis, Section III shows how wage distributions within the three banks evolved from 2004-2008, Section IV focuses on CEO compensation, Section V describes how incentive schemes contributed to fraudulent behavior and market manipulation, and Section VI contains conclusions. All salary figures are presented in monthly figures in thousands of ISK in figures, graphs and main text. A translation into US dollars monthly and or annual salary figures are provided, intermittently, in the text at the average exchange rate of ISK/USD at 68,14 during the period under investigation from January 2004 - October 2008.

[3] Jensen & Meckling (1976). Under the Jensen & Meckling's definition, agency costs include problems of hidden actions, hidden information, influence costs, and the costs of implementing institutional structures to deal with them.

II. Data

On the grounds of a Parliamentary Special Investigation in Iceland and its legal provisions stipulated act 142/2008 on Special Investigation Commissions (hereafter SIC, 2010) a data warehouse was constructed including data on all salary and incentive pay of all employees working to support the banking operations at the parent companies of Glitnir, Kaupthing and Landsbanki from January 2004-October 2008. The data was collected from payroll officers who handed over the raw databases of their HR payroll systems. Payment records of all staff who worked at the parent companies of the banks during 2004-2008 were delivered to the SIC in June 2009. For the purposes of the investigation, looking into the structure of incentive pay and the effects it had on bankers‘ behavior, the support staff, maintenance, security, physical therapists, chefs and other service staff, which were not directly involved in maintaining the banking operations, were excluded from the dataset. If a job title was not available for an individual during one year, the job title of the year prior or the year after was adopted. Salary distributions are reported as average monthly salary of individuals. To attempt unbiased and comparable monthly observations for all employees, different monthly salary components were summed up and divided by the number of months in the year in which the employee served at the company. Part-time employees where inflated to a full time employee for comparison. The number of compensation components varied between banks, from 77 different components to 271 components. They were therefore simplified and categorized into four main components:

1) Base salary; all fixed monthly salary, all fixed payments such as car benefits, fixed fringe benefits such as telephone expenses, food and clothing benefits and all other cash layouts that were not performance related.

2) Bonus pay: performance related cash payments paid out for performance of the previous year, bonus payments due to employment anniversaries, or other payments geared towards retaining employees.
3) Profit from exercised options, i.e. taxable income from exercised options. If the employee retains the shares, the profit from exercising the option is recorded as income.
4) Pension payments; co-payments of the employer into private and/or mandatory pension fund of the employee.

Data was collected on nominal amounts of options granted at their strike price. Restricted stock grants have not been taken into account here, since that form of compensation was not available, apart from a hybrid type of call options used by Glitnir to retain valuable employees, which had certain characteristics of restricted stock grants. Only realized payments are reported on in time series, i.e. payments that had been delivered to the employees accounts via the payroll of each bank.

TABLE 1

The dataset includes 21,117 observations. Although the banks reported fewer full-time employees in their annual accounts at year end, the data set at hand may include a higher number of employees since it includes all turnover of employees, including summer interns. Number of employees in dataset are provided in Table 1, however number of full-time employees as reported at the consolidated level in the banks as full-time employees at year end in their annual accounts are to be found in Table 2.

TABLE 2

All compensation data is reported in 2008 prices according to Icelandic CPI index of October 2008 unless otherwise indicated. When individual employment contracts are cited, salary numbers are reported in current prices, to correspond with the documents cited.

III. Wage distributions in the three banks 2004-2008

Right after the privatization of the three Icelandic banks in 2003, the wage distributions in Glitnir and Landsbanki were comparatively narrow. The 10% highest earners divided among themselves roughly 30% of total salary outlays of the firms, whereas the same 10% cohort in Kaupthing received 45%. This wide wage distribution of Kaupthing was consistent throughout the period under investigation (2004-2008), as the 10% highest earners received 45-51% of all compensation extended out by the bank. Landsbanki and Glitnir, however, caught up with Kaupthing's trend as time passed. By the year 2007, Landsbanki had 53% of labor cost fall unto the 10% highest earners, but 30% in the year 2004, while Glitnir's 10% highest earners received 43% of the bank's salary payouts in 2007, see figures 1-3.

FIGURES 1-3

Cash bonuses became more prevalent as means of compensation in the top 99th percentile as time passed. Middle management of Kaupthing, those in the 95th-99th percentile, received the largest share of their total salary via cash bonuses in the year 2008, when performance for half the year 2007 and half the year 2008 were being compensated. Operational performance of Kaupthing was relatively the worst performance of the bank, as reported by their annual accounts during the period 2003-2008, see table 3.

TABLE 3

Kaupthing was the most generous of the three banks in its rewards to employees. It was consistently the highest bidder in the labor market, with employees in the 95th percentile being outbid by 11% at times, up to three times that of the rival banks. The same applied to those in the top 99th percentile, who received the biggest salary checks in Kaupthing, apart from 2007, when Landsbanki awarded its highest earners 8.6 million ISK (126 thousand USD) in total compensation, on average a month, annual salary closing in on 1,5 million USD. Kaupthing paid its 1% highest earners 6 million (88 thousand USD) and above on average a month (1,0 million USD annually), while the highest earners of the rival banks received from 2 million to 6 million (350K-1,0 million USD, annual salary) on average during the same period.

Consistently with the largest wage distribution of the three banks, Kaupthing compensated staff in the 99th percentile with wages that were 15 times the median wages in the bank, while Glitnir, which had the narrowest of the wage distributions, compensated its 1% highest earners with 8 to 10 times the salary of the median worker.

Figure 4 shows how incentive pay as a share of total pay, on average, evolved over time among CEOs in all three banks. Landsbanki's CEO, Arnason, was seemingly more exposed to the temptation of adjusting performance figures as incentive pay became over 90% of the total take home pay of the CEOs, which would have reached even to a higher level if the CEO, Mr. Arnason, had exercised his options according to his contract, as further discussed in Section IV. Salary figures, however, do not tell the whole story, as top management in all banks were consistently being allowed to borrow heavily against stocks in the firm, at exclusive terms, as part of their compensation, yet not counted in their salary figures. Kaupthing management received the largest amounts borrowed at the bank to buy shares in Kaupthing, reaching 5.8 billion ISK (88 million USD) for the CEO, Hreidar Mar Sigurdsson and the Chair of the Board, Sigurdur Einarsson, 7.8 billion ISK (114 million USD) and 7.2 Million USD for other investments.

FIGURE 4

IV. CEO Total Compensation

Decision makers in the banks were among the top 1% highest earners, the so-called C-level staff along with occasional traders. Landsbanki lagged behind the other two rivals in terms of total pay, less than 5 million ISK (73 thousand USD) average monthly pay from 2004-2006. Compensating for that, Landsbanki overshot even Kaupthing's top 1% in the year 2007, with average total pay exceeding 25 million ISK a month (4,4 million USD, annually). The components varied also across the three banks – with Kaupthing's staff members consistently getting their largest proportion of total compensation in the form of exercised options, while Glitnir's and Landsbanki's decision makers only cashed out on the stock market success in 2007. This was partly explained by the fact that remuneration committees of both Glitnir and Landsbanki had given its leaders allowance to postpone the exercising of their options indefinitely as in the case of Sigurjon Arnason, who reported to the SIC that he did not intend to cash out on his options until the day he left the job as CEO[4]. Mr. Arnason further reported to the SIC that his decision was heavily influenced by the public outcry over executive pay taking place each year as the Icelandic Business Magazine, Frjals Verslun, reported on the highest earners in Icelandic society each year.[5]

[4] SIC Report, Volume 3, Chapter 10, pp. 39 & 59
[5] SIC Report, Volume 3, Chapter 10, pp. 59

TABLE 4

Hreidar Mar Sigurdsson, Kaupthing's CEO, was the highest salaried bank executive during the period 2004-2008, with total compensation of 2.5 billion ISK (36.68 million USD) for the entire period, while the runner-up, Bjarni Armannsson, CEO of Glitnir, received roughly 1 billion (14.67 million USD), see table 4. After the crash, Mr. Armannsson, voluntarily refunded the bankrupt estate of Glitnir 370 million ISK (5.42 million USD)[6], i.e. the amount he received as a bonus and golden parachute-payment as he left the bank in 2007. Salary figures for the executive chairman of the board of directors at Kaupthing, Mr. Einarsson, are not available. His salary was paid out by a special Kaupthing branch located in the UK. The branch was set up exclusively to pay salary and fringe benefits to the chairman and his assistant. This branch was not subject to any supervision by the Icelandic Financial Supervisory Authorities, and had never been audited specifically by Kaupthing's external or internal auditors. The internal auditor of Kaupthing did not have any knowledge of the branch‘s existence until the SIC asked questions about it during the investigation.[7] The SIC did not receive the requested documents from the branch, in spite of several attempts of the commission and Kaupthing's resolution committee's staff. The total salary cost of the branch is reported in the SIC Report as being 157 million ISK (2.3 million USD) in 2008, 263 million ISK (3.86 million USD) in 2007, 161 million (2.36 milion USD) in 2006, and 177 million (2.6 million USD) for May till December 2005. Sigurdur Einarsson and his personal assistant were the only two employees on payroll in this branch, hence it

[6] Morgunblaðið-news paper, 5. Jan. 2009, on-line article available at: https://www.mbl.is/vidskipti/frettir/2009/01/05/endurgreiddi_370_milljonir/
[7] SIC Report, Volume 3, Chapter 10, pp. 92, testimony of Internal Auditor of Kaupthing, Mrs. Lilja Steinthorsdottir, before the SIC on September 7th 2009, pp. 14.

is fair to assume that Mr. Einarsson received the bulk of the 759,7 million ISK (11.15 million USD) salary cost of that branch during those roughly four years on record.[8]

The UK branch had numerous costs, including household goods for the Chairman's private residence in London for more than 9 million ISK (130 thousand USD).[9]

Short term incentive pay and performance targets

Again, drawing on the work of Talley & Johnsen (2005) and Roell & Peng (2005) who predict that, as share of incentive pay of total compensation increases, so does the likelihood of litigation against the firm; litigation risk increases by 0.3% for each 1% increase in incentive pay as a share of total pay, at the median point. In case of the Icelandic banks, as the proportion of base salary in CEO total compensation reduced, the temptation to manipulate performance indicators became more poignant. In 2004, incentive pay was a relatively modest component of total CEO compensation both in Landsbanki and Kaupthing, 20-36%. Although Glitnir stood out in terms of volatility of this factor, the trend is quite clear; base salary gradually became a less important factor, dropping to a low level of 9% in case of Mr. Arnason, CEO of Landsbanki, in the year 2007, as performance pay reached as high as 80%. Variable pay of each one of the bank executives in the three banks reach 80% as share of total salary at some point during the years in the run up to their collapse. Hence, variable pay dependent on performance became a significant reference point that was hard to ignore in decision making of the CEOs as the banks' operations neared to the edge of the cliff.

Base salary as share of total compensation varied quite a bit between rival banks, but also within banks. In Landsbanki, the two CEOs were compensated in quite a different

[8] SIC Report, Volume 3, Chapter 10, pp. 92
[9] SIC Report, Volume 3, Chapter 10 pp. 91.

manner, and even had different underlying targets for their incentive pay.[10] Halldor J. Kristjansson's, bonus targets rested on a target return on equity of 9% above risk free rate. If the bank yielded 5% above the target return-on-equity pre-tax (ROE), the CEO got a cash bonus equivalent to three months salary, increasing linearly so that reaching 10% above target ROE would yield a bonus of extra 8 months salary. No bonus was to be paid out if ROE was under target and no claw backs were required if the bank suffered a loss. Sigurjon Arnason, the other CEO of Landsbanki, got a 12 month salary in bonus, however, for pre-tax ROE that reached 3% above their target rate which was 6% + the risk free rate. The bonus was a linear function of the pre-tax ROE and could not exceed three years salary, if ROE exceeded 15% above the risk free rate. No claw back was requested if the bank suffered a loss. That way one CEO would receive *36 months salary* in cash bonus if the ROE of the bank exceeded 15% beyond the risk free rate, but the other would receive *10,6 months of his base salary* in bonus, yet both of them were placed at the same level in the company's hierarchy, as Chief Executive Officers; employees of the board of directors.[11]

According to the employment contract of Sigurdur Einarsson, the executive chair of Kaupthing, from 2003, his cash bonus should be 2% of the companies total profit if ROE exceeded 15% but capped at annual salary, or 50% of total compensation. Einarsson's monthly base salary amounted to 3 million ISK. [12]

Hreidar Mar Sigurdsson, CEO of Kaupthing, bonus pay amounted to 2% of the bank‘s profit, if the bank turned a profit of 15% return on equity or more. The bonus payment was capped at the amount of his annual salary.

---

[10] SIC Report, Volume 3, Chapter 10 pp. 52.
[11] SIC Report, Volume 3, Chapter 10 pp. 52.
[12] SIC Report, Volume 3, Chapter 10, pp. 92

Bonus pay for staff members of Kaupthing, according to insights gained at SIC, was decided at the discretion of the CEO, Chairman of the board, and the Managing Director of each division. The SIC failed to find or identify a formal incentive pay system based on predetermined performance metrics and levels. An example of this is provided by the Commission's discovery of an email correspondence between the Chairman of the board of Kaupthing, and the Managing Director of Kaupthing, Luxembourg, where the chairman initiated discussion on the bonus pay for the MD: „Hi Magnus. We haven‘t settled on a bonus figure for last year. I propose 1 million Euros, Rrgds. Se“. The MD‘s answer was short „Thanks More than enough ☺“[13]

At the middle management level in Kaupthing, the largest bonuses during the year in the run up to the collapse of the bank were paid out in the year of the banking failure itself, 2008. Bonuses awarded among staff in middle management increased from 1.3 million ISK on average a month, in 2007, to 2.1 million in 2008, when the bank was battling a liquidity crisis, the stock price was depressed (yet being manipulated at the orders of Kaupthing‘s upper management[14]) and return on reported equity was the lowest. For the CFO, CRO and Chief Executive of the Treasury, bonuses increased from 15 million a month on average in 2007, to 25 million on average for the first six months in 2008, while earnings per share were reported 34.6 króna per share in 2007 but 21.5 per share in 2008.[15]

In Glitnir, bonuses were decided upon three different benchmarks, 1) a so-called, EVA-system[16] (Economic Value Added) induced the incentives of those in corporate

[13] SIC Report, Volume 3, Chapter 10, pp. 86

[14] Supreme Court Ruling: Special Prosecutor vs. Kaupthing management in several cases including nr. 145/2014

[15] SIC Report, Volume 3, Chapter 10, pp. 87

[16] Economic Value Added = R – K * C; R – profit after interest and tax, K – Cost of Equity Capital based on CAPM, C - Total Equity of the Bank.

advisory, proprietary trading, and at the executive level from 2004-2006, when the so-called ROE-system took over (ROE: Return on Equity). The EVA-system was built on benchmarks in absolute krona terms instead of relative numbers such as ROE, decided by the CEO. Upholding the same profit in EVA terms from the year before, would leave the employee with one third of two months base salary, paid out directly. Two thirds of the bonus was delayed by a year and paid out if targeted EVA was upheld the following year. If realized profit went below the EVA target, the delayed bonus pool would be linearly deducted before it would be paid out as deferred bonus. Given the successful delivery of targeted profit net of shareholders opportunity cost, EVA, the bonus payments would grow, linearly, with profit beyond the set target. 2) Framtak-system was set up for support staff, back office, bank's treasury & finance department, 3) Ad-hoc bonus payments were also allowed based on good performance of the staff member, his/her individual performance independent of firm performance, as deemed by the supervisor.

As risk appetite by major shareholders increased, a new incentive scheme was introduced in 2006. Instead of the EVA-benchmark, ROE, return on equity, became the major barometer, demanding significant increase in risk taking and subsequent reward, with much higher levels of bonus pay in the play. Although the bonus targets were set at the department level, and even down to individual level, a full bonus could not be reached unless the overall return on equity of the bank reached 25%, for each percentage below or beyond that the bonus pay changed by 8%, hence no bonus was to be paid if the bank return on equity was below 12.5%.

Mr. Bjarni Armannson, initially followed the EVA bonus program, like other staff members in Glitnir bank. He, however, managed to bargain for ad-hoc bonus payments in addition to bonuses according to the EVA system that were paid into his retirement fund. In 2005, the CEO negotiated additional bonus pay, doubling his bonus from the previous year, whilst shareholders' earnings per share increased by 33%. As Armannsson stepped down, he exercised options that had expired and negotiated a golden handshake of 370 million, being paid out in 2007 and 2008. The financial accounts of 2007 only revealed the 100 million ISK payment due in 2007, but did not disclose the company's contractual commitment to pay him additional 270 million the year after, according to documents revealed by the SIC. [17]

Larus Welding was hired to Glitnir as CEO, in May 2007. The same misreporting took place regarding the company's commitments regarding Welding's employment in the bank's financial accounts. Welding negotiated a signing bonus of 300 million ISK (4.4 million USD) in 2007 for 12 month service, apart from base salary of 5.5 million monthly and arbitrary bonus pay according board resolution. Another 300 million ISK where to be paid to the CEO if he stayed on the job at the company for additional 12 months, from February 2008-February 2009. Glitnir‘s financial accounts for 2007 results did not disclose the firm's contractual commitment in this regard, misreporting its salary cost and liabilities by that amount as well as commitments relating to Mr. Armannsson departure, of 270 million ISK. On top of base salary, bonus payments, sign on bonus and options awards, the CEO, Larus Welding, negotiated an arbitrary payment of 250 million ISK (3.6 million USD), with installments timed according to Mr. Welding‘s needs during the duration of his employment contract. Regular bonus payments based on the decision by the board, were capped at 70 million (roughly 13 months base salary).[18] The 300 million ISK retainer, due in February 2008, was never paid out as salary. Instead, on March 31st 2008, the CEO borrowed 177 million ISK at

[17] SIC Report, Volume 3, Chapter 10, pp. 39
[18] SIC Report, Volume 3, Chapter 10, pp. 42

REIBOR flat (+0 bps) for one year, the 300 million salary payment was postponed by one year and pledged as a collateral against the loan. In addition, Mr. Welding released the bank‘s obligation to honor the roughly 5,1 billion ISK option grant, on the same day, which was exercisable in equal installments over the following five year period. When a staff member inquired whether indeed the CEO was rejecting the payment, the CEO answered: „ it will be paid next year“, the staff member kept on inquiring: „Can we then say that the payment is being postponed by one year?“, the CEO replied: „I need to get this into the accounts that I am presenting tomorrow, is that clear? What are the effects?“ The following day Mr. Welding introduced first quarter results of 2008 to the board, with a slightly improved bottom-line between quarters.[19]

Stock Ownership and leveraged stock purchases of CEOs

Stock ownership among the CEOs of the three banks varied significantly. The CEO of Landsbanki, Sigurjón Þ. Árnason, on record, didn’t own any stock in Landsbanki. However, he had earned a significant amount in unexercised but vested options, which effectively had no predetermined vesting date. That means *de facto* that he owned the shares and not options, yet did not formally hold the voting rights associated with them and did not receive dividends as the options remained unexercised. SIC estimated that Sigurjon owned options to buy 140 million shares in the bank when it failed or 1,25% of outstanding shares in Landsbanki after only 5 year service to the bank. The same applied to the CEO of Glitnir 2007- 2008, Lárus Welding, who had negotiated 150 million shares in options as he got hired to the job. Sigurdur Einarsson, Executive Chairman of the board of directors at Kaupthing, on the other hand, personally owned stocks whose market value reached as high as 6.3 billion ISK (92.5 million USD) at

[19] SIC Report, Volume 3, Chapter 10, pp. 43

year end 2007, but Kaupthing took over the funding of those stocks in 2006. Does this mean that his own skin was in the game by that amount? As it turned out, Mr. Einarsson was personally liable and could not pay these loans back when the bank went under. He declared bankruptcy in Icelandic court in 2016, the largest bankruptcy of any individual in Iceland, with claims amounting to 254 billion ISK (2.5 billion USD in 2016 dollar terms) against his estate. Hreiðar Már Sigurðsson, CEO, on the other hand moved all his stock holdings in Kaupthing over to a Special Investment Vehicle, wholly owned by him, along with all liabilities funding the stock purchases. He was not per forma personally liable and escaped bankruptcy, but was however found guilty of insider trading fraud in a district court for having moved the stocks away from his personal liability over to his own limited liability company at the prevailing market price, which he had helped manipulate, sending a false signal to the market, as he knew the prevailing market price did not reflect the true value of the stock.[20]

TABLE 5

Halldor J. Kristjansson, CEO of Landsbanki, was the only one of the six colleagues, that indeed had placed own capital into the bank where he worked when buying shares. Mr. Kristjansson exercised options and held on to the shares, free and clear, until the bank went under. Table 5 and figures 5-8 show stock ownership of the bank executives of Glitnir, Landsbanki and Kaupthing and the corresponding leverage against them.[21] Although loan agreements provided for margin calls at loan-to-value (LTV) 80%, LTV of Hreidar Mar Sigurdsson‘s[22] and Sigurdur Einarsson‘s positions reached as high as

[20] District Court of Reykjavik, State Prosecutor vs. Hreidar Mar Sigurdsson and Z, nr. S-705/2016

[21] SIC Report, Volume 3, Chapter 10, pp. 86

[22] SIC Report, Volume 3, Chapter 10 pp. 93-94, and Employment Contract Between Kaupthing Bank and Mr. Sigurdsson from 2006

125% and 145% at mid-year 2008. A quick turn-around from the favorable LTV of 77% and 56% six months earlier, or at year end 2007, respectively. The margins were not called upon. Sigurdur Einarsson was personally liable for 10% of the total borrowed amount, in addition to all the shares being pledged as collateral. Staff borrowing to fund stock purchases in Kaupthing was part of the bank's incentive program. The total borrowed amount due to this reached close to 60 billion ISK (880 million USD) in 2008. Twenty five employees borrowed more than 500 million ISK for these purposes from the bank, and their debt grew from 15 billion in 2006, when the stock purchase plan was first implemented, to 30 billion in 2008 (440 million USD). The management team of Kaupthing never meant to attach any personal liability or downside risk with the stock ownership onto the employees, planning to issue put options for all leveraged shares bought by top management under the program. The personal liability was added to the contract after the external auditor pointed the finger to an IFRS accounting standard that clearly states that all put options should be deducted from the equity base.[23] In response to this the management team decided against the put options but added the 10% personal liability to the loan agreement to appease the external auditors. No further collateral or equity was required. The board of Kaupthing issued a board resolution lifting the 10% personal liability pertaining to funding of staff stock purchases on September 25th 2008, only days before the bank went under.[24] This resolution was later deemed illegal and reversed by Kaupthing's resolution committee.

Bjarni Armannsson had virtually no ownership in Glitnir after the year, yet his debt with the bank had not been paid up. No further inquiry was made into which

[23] SIC Report, Volume 3, Chapter 10, pp. 78
[24] SIC Report, Volume 3, Chapter 10, pp. 86

investments of Mr. Armannsson were being funded, after he had sold his shares in Glitnir.

FIGURES 5-8

Despite the fact that a relatively small amount of capital had been wagered by the CEOs towards their holdings in the banks, they did enjoy the fruit of their positions of the full amount, through dividends from the levered stocks, which became part of their net worth, see table 6. Bjarni Armannsson received 153 million ISK (2.25 million USD) during the four years 2004-2007 in the form of dividends. That is a roughly 15% add-on to his one billion ISK (14.67 million USD) total compensation he received on the job (minus 370 million ISK Mr. Armannsson refunded the Glitnir estate in 2009). Hreiðar Már Sigurðsson received 238 million (3.49 million USD) in dividends for the same period, a roughly 10% add-on to his 2.5 billion ISK (36.68 million USD) salary for the same years. Sigurdur Einarsson received, however, roughly 280 million (4.11 million USD) in dividends, see table 6.

TABLE 6

No payments were being made towards the principal of the loans that funded the stock holding positions, nor did the CEOs pay any interest during the lifetime of the loans, hence the dividends ended entirely in the pockets of the bank executives forming their personal wealth, see figures 5-8. Attempts to collect the loans have been made without any success by the resolution committees of the bankrupt estates of Glitnir and Kaupthing, and the dividends were not clawed back. The Supreme Court revoked the board resolution to abolish the 10% personal liability made by the board of directors of Kaupthing on September 25th, 2008.

VI. Falsification of Equity through Incentive Pay

On top of the bonus pay, Glitnir’s management initiated an extensive operation to hold on to valuable employees already in 2003. Various contracts were made with the employees or holding companies in 100% ownership of the employee which borrowed significant amounts of money at favorable rates (sometimes below the risk free rate) from Glitnir to purchase stocks in the bank on the market, only pledging the purchased stocks. Glitnir did not deduct this lending from its equity base as is required by law and IFRS standards. This total amount extended in such credit reached 17% of the bank’s equity base, hence equity ratios were misreported by this amount. [25]

Making only a correction for this, Glitnir would not have met the authorities’ minimum capital adequacy ratio a year before it collapsed. [26] Presumably, enough for administrative actions to be taken against the bank to force restructuring.

With the extensive borrowing programs for the Kaupthing staffer‘s and favored customers who got the same deal, Kaupthing itself, had funded more than 25% of its own equity base, in breach of IFRS standards and article 84, paragraph 5, on financial undertakings nr. 161/2002. Regulatory capital adequacy ratio (CAR) was misreported as 11,18% in the bank‘s half year financial statement, but was in fact 8.13%, only accounting for this misrepresentation of the bank‘s funding structure, close to the legal minimum of 8% CAR. Staff funding of equity at that time, accounted for a third of that

[25] SIC Report, Volume 3, Chapter 10, pp. 34
[26] SIC Report, Volume 3, Chapter 9, pp. 18

misreporting (total of 60 billion ISK, 880 million USD) as the bank failed in October 2008.[27]

Same falsification of equity occurred in Landsbanki – through an option award program. Options were issued in the amount of 13.4% of total outstanding shares during the course of 2001-2008. Instead of issuing new shares when the options vested, management engaged in a complex twist through a perceived need to hedge the firm against the exposure of having to deliver on the options down the road. In the early days, 2001, Landsbanki set up off shore trusts on Guernsey and The Isle of Man. The Bank would issue options awarded to staff, and subsequently the off shore trusts borrowed funds from the bank to buy the equivalent amount of shares and hold the shares until the options vested. Landsbanki set up a forward contracts with the trusts, pledging to buy back the same amount of shares when it had to deliver on the options when vested, at an elevated price to match the lending costs of the trusts. Landsbanki set up at least 8 such trusts, in the British Virgin Islands, Panama and Luxembourg in addition to those in Guernsey. Combined assets of the eight trusts amounted to the second largest shareholder of Landsbanki, but never reported as such, but rather each trust held less than 5% shares in the bank. Going beyond 5% would mean that all trades of those firms in Landsbanki shares would have to be reported on the stock exchange. A shareholder that held more than 10% in the bank needed vetting and approval by the FME - the Financial Supervisory Authority in Iceland. Later the funding of those shares was taken over by the rival banks, but Landsbanki funded their equivalent types of trusts in control of their rival banks (or sister banks such as Straumur Burdaras, a small boutique bank in same controlling ownership as Landsbanki) in return. Irrespectively,

[27] SIC Report, Volume 3, Chapter 9, pp 19-20

the forward contract between Landsbanki pledging to buy back own shares made it so that the risk of the shares never left the balance sheet of Landsbanki, hence should have been deducted from its equity base. Accounting for this breach alone, the bank would have gone below the legal limit of capital adequacy ratio a year before it collapsed.

Intentionally or not, by choosing this arrangement of hedging options via off-shore and off-balance sheet entities, the management and controlling shareholders of Landsbanki avoided dilution of their own control and ownership, which would otherwise have happened as 13.2% of the bank was deemed to be held by the bank's staff. At the outset, the controlling shareholder who bought 45,8% of the shares in the bank during the privatization phase, had gotten an exemption from the authorities from the mandatory takeover rule (at 40%, and later was lowered to 33%). Had the options vested and new shares been issued, this arrangement could have come into question, and the mandatory take-over rule potentially been enforced.[28]

The incentive schemes of the three banks involving funding of own shares in staff ownership, where equity risk of those shares stayed with the banks in question, lead to the banks becoming increasingly more dependent on their own share prices. The CEOs of Glitnir, Landsbanki and Kaupthing, were found to have endangered the funds of the banks by extending credit into investment vehicles to buy shares in the banks, whose operations they were responsible for, with no assets or collateral apart from the pledged shares, by that signaling false demand for the said shares to other investors in the stock market. The Supreme Court declared the market manipulation of Kaupthing's management in the following way: „[T]hese breaches were extensive, carefully organized and committed in collaboration with unambiguous intent. These crimes were

[28] SIC Report, Volume 3, Chapter 10, pp 68

committed against the whole of the Icelandic public and the country‘s financial market at the same time. The direct and indirect damages they inflicted will never be fully assessed. These breaches are among those most serious economic crimes ever to come before Icelandic courts.“[29] Five members of Glitnir management were found guilty for similar breaches in the District Court in Reykjavik in March 2018, for creating false demand for the bank‘s stocks, by extending credit into 14 special purpose vehicles in 100% ownership of staff members within the bank itself without any other assets or collateral pledged apart from the funded shares.[30] Their cases have yet to be heard by the Supreme Court of Iceland.

VII. Conclusions

Considering the threat of value destruction through managerial misreporting, the case of the Icelandic banks adds further insights into the need for policy makers to set limits to banker's incentive pay. Without constraints there will be heightened risk of management engaging in complex economic criminal activities. This is especially prevalent in the financial industry, where executives have means to engage in complex trades whose criminal aspects are both expensive and difficult to prosecute, opening up to impunity on part of bankers that operate under extensive public insurance. If the CEO may find himself/herself not reaching targets set before him/her by incentive pay schemes, the incentive to misreport arises. Incentive pay can therefore not be assigned in isolation. Resources will need to be spent on monitoring the contract, but if resources are limited, chances are that the CEO will manage to shirk, deceit and/or induce litigation against himself/herself or the firm going forward. In the case of the Icelandic bankers, their bet-for-life sentiment led to erosion of the quality of the banks‘ loan

[29] Supreme Court of Iceland case nr. 495/2016
[30] District Court of Reykjavik case nr. S-193/2016

books, fraudulent business practices and breaking of the banks‘ own internal rules. The CEOs of Landsbanki, Glitnir and Kaupthing along with several of their other upper management staff, were found guilty of the most extensive economic crimes whose judgement has ever been passed by the Supreme Court of Iceland. The systemic consequences of banking failure do not allow for policy makers‘ complacency in containing banker's temptations to defraud, which inevitably will rise with the promise of exorbitant wealth of bank executives that otherwise pledge little or no capital of their own to the successful operations of the bank nor bare the cost of the downside.

Tables and graphs.

Table 1

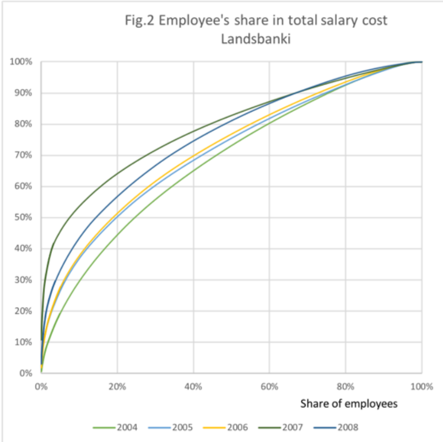
Number of employees in data set

	2004	2005	2006	2007	2008	Total
Glitnir	1179	1243	1250	1619	1530	6821
Landsbankinn	1272	1349	1549	1723	1750	7643
Kaupþing	1220	1270	1334	1502	1387	6713
Total	3671	3862	4133	4844	4667	21177

Table 2

Total number of full time employees of the banks on consolidated basis

	Glitnir	Landsbankinn	Kaupthing	Total
2004	1,126	1,121	1,501	3,748
2005	1,216	1,725	2,318	5,259
2006	1,392	2,117	2,553	6,062
2007	1,976	2,640	3,109	7,725
2008	1,976	2,640	3,256	7,872



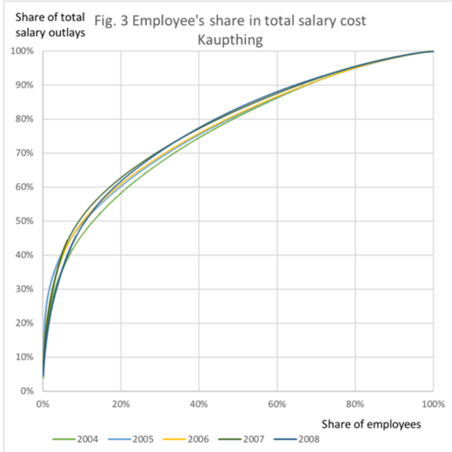


Table 3

Reported Return on Equity (%) for Icelandic and other Nordic Banks

	2003	2004	2005	2006	2007	2008-June [1]
Glitnir	19.83	22.75	22.54	26.16	16.27	6.73
Kaupthing	17.22	12.22	26.29	26.72	20.6	8.02
Landsbanki	13.74	34.33	22.73	27.87	22.19	14.87
Icelandic Mean	**16.93**	**23.1**	**23.85**	**26.92**	**19.69**	**9.87**
Nordea Bank AB	12.24	16.41	17.56	20.64	18.32	8.05
Danske Bank	15.36	13.97	17.22	14.24	14.25	5.54
Skandinaviska Enskilda Banken	11.77	14.28	14.86	18.8	17.83	6.23
Swedbank AB	15.13	22.52	22.8	18.43	17.84	9.29
Svenska Handelsbanken	14.28	16.07	17.31	19.82	20.82	6.86
DnB NOR Bank	12.77	14.36	17.67	18.39	20.49	6.25
Nordic Mean	**13.59**	**16.27**	**17.90**	**18.39**	**18.26**	**7.04**

Source: Flannery, Mark. "Iceland's Failed Banks: A post mortem",
SIC Report, Volume 9, Appendix 3, pp. 94

**Fig. 4. CEO Compensation
Base Salary as share of Total
Compensation**

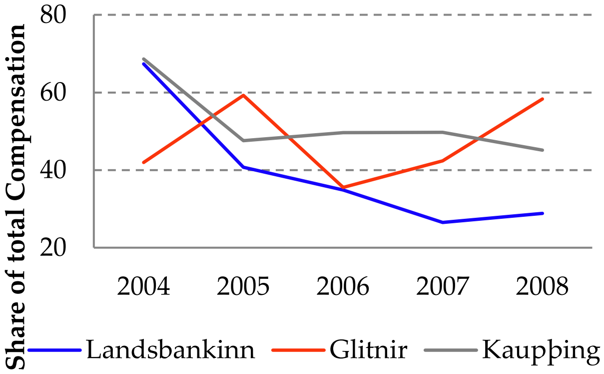


Table 4

CEO Pre-tax total Compensation per annum current prices

Base Salary, Bonuses, Profits from Exercised Options, and Pension Co-pay

Glitnir		Bjarni Ármannsson	Lárus Welding
	2004	80,057,080	
	2005	137,467,312	
	2006	230,881,360	
	2007	570,844,544	387,661,792
	2008	11,149,876	35,823,212
Total		1,030,400,172	423,485,004
Landsbankinn		Halldór J. Kristjánsson	Sigurjón Þ. Árnason
	2004	33,775,376	42,089,283
	2005	262,887,573	112,820,768
	2006	143,907,850	218,169,279
	2007	105,839,025	234,332,638
	2008	133,638,686	355,180,856
Total		680,048,510	962,592,824
Kaupthing		Hreiðar Már Sigurðsson	Sigurður Einarsson*
	2004	141,786,672	not available
	2005	310,321,289	
	2006	822,697,408	
	2007	811,961,856	
	2008	458,917,504	
Total		2,545,684,729	

Source: SIC Report, Volume 8, Appendix 1, pp. 43
Sigurdur Einarsson's salary was paid out of a Kaupthing Branch located in the UK the SIC did not receive detailed salary data from that branch in spite of several attempts. (SIC Report, Volume 3, Chapter 10, pp. 91)

Table 5

Stock Ownership of CEOs at year end*

Personal Assets as well as Assets through Holding Companies in 100% ownership of the CEOs

Glitnir	Bjarni Ármannsson			Lárus Welding		
	No. Shares	% of outstanding shares	Market Value	No. Shares	% of outstandi ng shares	Market Value
2004	176,584,354	1.6%	2,478,812,758	-		-
2005	315,641,330	2.4%	6,861,589,225	-		-
2006	234,050,732	1.7%	5,452,637,266	-		-
2007	573,256	0.004%	12,448,219	-		-
2008	21,560	0.0%	338,492	-		-
Landsbar	**Halldór J. Kristjánsson**			**Sigurjón Þ. Árnason**		
	No. Shares		Market Value	No. Shares		Market Value
2004	1,833,745	0.023%	22,188,315	-		-
2005	10,808,487	0.102%	273,454,721	-		-
2006	10,808,487	0.102%	286,424,906	-		-
2007	10,808,487	0.099%	383,701,289	-		-
2008	11,106,164	0.102%	255,997,080	-		-
Kaupthin	**Hreiðar Már Sigurðsson**			**Sigurður Einarsson**		
	No. Shares		Market Value	No. Shares		Market Value
2004	2,005,091	0.03%	886,250,222	2,511,979	0.04%	1,110,294,718
2005	2,799,239	0.04%	2,088,232,294	3,744,423	0.06%	2,793,339,558
2006	5,423,239	0.07%	4,560,943,999	6,368,423	0.09%	5,355,843,743
2007	6,235,239	0.09%	5,487,010,320	7,180,423	0.10%	6,318,772,240
2008	6,235,239	0.09%	4,676,429,250	7,180,423	0.10%	5,385,317,250

*Ownership in 2008 is marked by mid-year, 30th of June 2008

Source: Bank's Annual Reports, SIC Report, Icelandic Stock Market Registry and ICEX Stock Exchange

Table 6			
Dividend Payments Earned in ISK Due to stock ownership of the CEO			
Glitnir	Bjarni Ármannsson	Lárus Welding	Dividend Payment pr. Share
2004	33,054,721		0.35
2005	31,214,072		0.38
2006	88,729,634		0.38
2007	204,128		0.37
2008	-		-
Total	153,202,554		
Landsbanki	Halldór J. Kristjánsson	Sigurjón Þ. Árnason	
2004	1,833,745		0.2
2005	10,808,487		0.3
2006	10,808,487		0.3
2007	10,808,487		0.4
2008	-		-
Total	34,259,207		-
Kaupthing	Hreiðar Már Sigurðsson	Sigurður Einarsson	
2004	10,025,455	12,559,895	5
2005	27,992,390	37,444,230	10
2006	75,925,346	89,157,922	14
2007	124,704,780	143,608,460	20
2008	-		-
Total	238,647,971	282,770,507	

Source: Annual Reports of Glitnir (Islandsbanki prior to 2006), Landsbankinn & Kaupthing

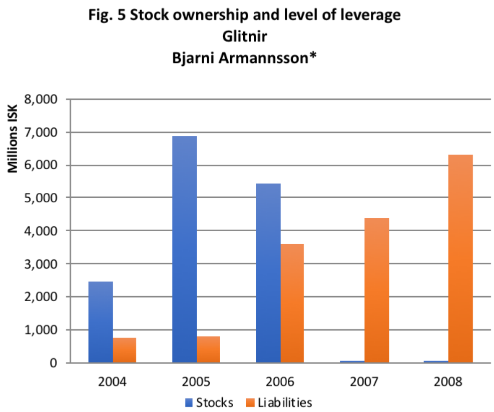


Fig. 5 Stock ownership and level of leverage
Glitnir
Bjarni Armannsson*
Millions ISK
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2004
2005
2006
2007
2008
Stocks
Liabilities

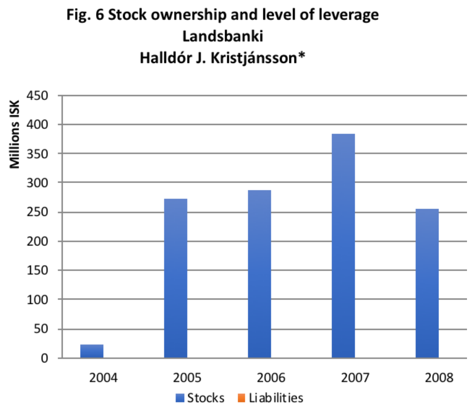


Fig. 6 Stock ownership and level of leverage
Landsbanki
Halldór J. Kristjánsson*
Millions ISK
450
400
350
300
250
200
150
100
50
0
2004
2005
2006
2007
2008
Stocks
Liabilities

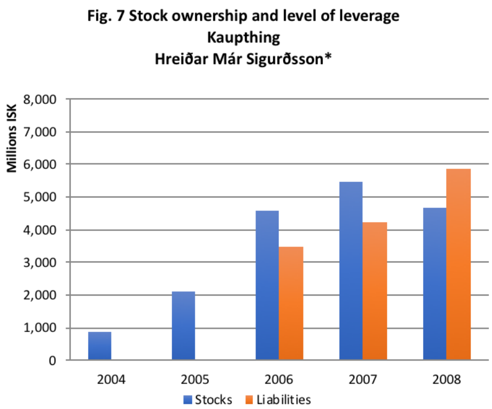


Fig. 7 Stock ownership and level of leverage
Kaupthing
Hreiðar Már Sigurðsson*
Millions ISK
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2004
2005
2006
2007
2008
Stocks
Liabilities

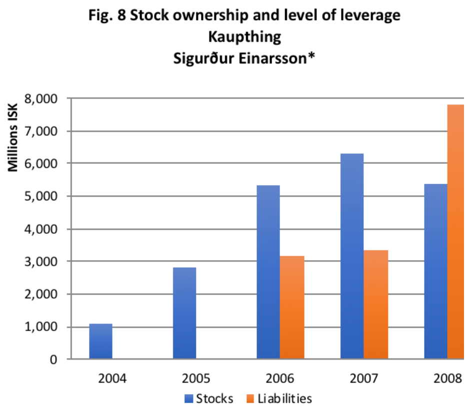


Fig. 8 Stock ownership and level of leverage
Kaupthing
Sigurður Einarsson*
Millions ISK
8,000
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
2004
2005
2006
2007
2008
Stocks
Liabilities