ISSN 1011-8888

INSTITUTE OF ECONOMIC STUDIES

WORKING PAPER SERIES

W04:10 September 2004

Property by ultimatum:

The case of the Reykjavik Savings Bank

Friðrik Már Baldursson

Address: Friðrik Már Baldursson
University of Iceland
Faculty of Economics and Business Administration
101 Reykjavik
Iceland

Email: fmbald@hi.is

Property by ultimatum: The case of the Reykjavik Savings Bank

By

Fridrik Mar Baldursson
Department of Economics
University of Iceland

September 2004

Abstract

The paper is a case study of the planned takeover of the Reykjavik Savings Bank by a larger commercial bank. When the takeover deal was announced, the Icelandic Parliament quickly and unanimously passed a law which blocked the deal by creating a hold-up situation for the bank board: if it converts the bank to a corporation – as is necessary prior to takeover – an outside board will replace the present board. In this, the government re-fragmented property rights it had recently reassembled, leading to inefficient underuse of resources; it recreated an anticommons. It is argued that the strong support for the law is somewhat of a puzzle from the perspective of theories of pressure groups, regulatory threat and privatization. However, the paper claims that this may be explained by positive analysis of justice: the board played an ultimatum game against the general public and made what was perceived as an unfair proposal. The proposal was soundly rejected by the public, as usually happens when unfair offers are made in ultimatum games.

Keywords: Rent-seeking, Pressure groups, Regulatory threat, Positive Justice, Equity

JEL classification codes: D78, D72, K11

Address:
Professor Fridrik M. Baldursson
Department of Economics
University of Iceland
101 Reykjavik
ICELAND

fmbald@hi.is
www.hi.is/~fmbald
Tel. +354 525 5273
Fax + 354 552 68

1. **Introduction**

This paper tells a story of a savings bank in Iceland. The story has several facets that are interesting from an economic point of view. It tells us something about the damage ill defined property rights can do and about the power of pressure groups. More importantly, it also shows that if rent-seeking interest groups are too bold in their efforts, public perceptions of equity and justice may lead to their defeat.

Savings banks in Iceland operate after a special chapter of the law on financial undertakings. Historically, these are small financial institutions, that usually operate in a single local community and were originally created for the purpose of providing loans to individuals and small businesses in these communities. The savings banks form has come under pressure in recent years. The banks have become too small relative to commercial banks to be competitive in the capital market and to adequately serve the needs of some of their larger customers. In 2001 changes were made to the law that allowed savings banks to convert themselves into corporations. This would *inter alia* allow them to raise new equity by ordinary means or merge with other banks.

The equity of the savings banks was initially created by so called 'guarantee capital certificates' which are owned by 'guarantee capital owners'. According to the law, ownership of guarantee capital should only give rights to a 'normal' return on the invested capital and does not give the owner a share in profits of the savings banks. The certificates may not be freely sold –the bank can buy them at its discretion at a price that corresponds to the normal return and the board of the bank will then find a new owner in some way. Of course the board could (and probably did) select new certificate owners carefully in order to build up a power base – a club – in support of itself. Traditionally, however, ownership of such capital was argued to be a social duty – a contribution to the local community – rather than an ordinary investment. Recently, all that has changed.

The background for the change is the rapid development of the financial sector in Iceland in recent years. In the last few years the commercial bank sector has been transformed from a bunch of mostly state owned, heavily regulated and inefficient banks to a group of dynamic private firms that have begun to stretch the confines of the small Icelandic economy and have extended their operations to other countries. Against this backdrop the small savings banks are looking increasingly anachronistic with a substantial amount of capital tied up that could probably be put to better use and inefficient operations, in part due to their small size.

If savings banks were ordinary corporations then they would probably have been acquired by the commercial banks already. Indeed, such acquisitions have been expected for a while. The problem has been that nobody really knows who owns the savings banks. The guarantee capital certificates cannot be sold freely and the substantial amount of equity in excess of guarantee capital that e.g. the Reykjavik Savings Bank has accumulated over its over seventy years of operation – 93% of total equity – is effectively without an owner.[1] Yet, even with complete uncertainty about how this problem would be solved, ownership of guarantee capital certificates became sought after, especially in the years leading up to the events to be described in this paper. The reason was probably simple: the certificates represented an option on a payment whose outcome was uncertain, but was at least not worse than expected return on government bonds and might be a lot better if the excess equity of the Reykjavik Savings Bank were to be distributed – at least in part – among certificate owners. It may be guessed that owners of guarantee capital gradually came to think of the guarantee capital like shares and that they had a moral, if not yet legal, right to the return on these shares. At least it seemed possible that at least a part of the excess equity would be distributed in some way among the guarantee capital owners.

Indeed, the law on savings banks was changed in 2001 such that the savings banks can now be converted into corporations. However, guarantee capital owners were not to get a share of the excess equity. Rather, the law now states that they are to get shares in the corporation in proportion to the share of guarantee capital in the assessed market value of the savings bank. The 'equity without owner' is to be converted into shares held by a self governing foundation. Often, and in particular at the Reykjavik Savings Bank, these shares are in majority and the foundation will therefore control the savings bank. Until recently, the law stated that the board of directors of the

[1] Reykjavik is the capital of Iceland. With surrounding municipalities it is by far the largest urban area in Iceland with over half the population residing in the area. The Reykjavik Savings Bank is also the largest savings bank in Iceland.

foundation was to be elected by the original capital share owners. Guarantee capital owners, through their elected representatives, were therefore to be in full control of the bank after its conversion to a corporation.

In December 2003 the board of the Reykjavik Savings Bank (RSB) announced a deal where the RSB was to be taken over by Iceland's largest commercial bank. By the device of selling shares of guarantee capital owners and the associated foundation at different prices the 7% share of guarantee capital owners was to be raised to 33%. There ensued a hot popular debate about these plans which ended with an almost unanimous decision by the Icelandic parliament to block the deal. The device used was that of changing articles of the law regarding rules for composition of the board of the self governing foundation. Rather than having the guarantee capital owners elect the board it was now to be elected by politicians and the Association of Savings Banks (whose majority was against the merger).

When the popular discussion of this case is examined it is striking how strong the opposition for the takeover agreement was.[2] Support naturally came from those who were to gain from the deal, but these were few in number in relation to those who stood to lose from it: for example the savings bank workers, who expected rationalization and layoffs and small communities, who would lose local jobs and probably get a lower level of service. Most importantly, the general public was against the deal; without this general opposition a reasonable guess is that the deal would have been allowed to go forward. This opposition was then transmitted to the parliament.

The aim of this paper is to consider these events from the perspective of economics, specifically literature on special interest groups, property rights and justice. We begin by giving some background in Section 2. Section 3 describes the takeover deal in some detail. In Section 4 we try to give a rough estimate of welfare effects and Section 5 gives a taxonomy of the interest groups involved. Economic theory and evidence from positive analysis of justice is brought to bear on the case in Section 6.

[2] There was a lively public debate about the issue. For example, scores of articles, contributed by readers, were published in one of the main newspapers in Iceland, *Morgunblaðið*.

A discussion of the case in light of economic literature is offered in Section 7. Section 8 concludes.

2. Background

History

Savings banks are a product of the enlightenment and date back to the late 1700's. The accepted wisdom is that the banks were initially founded for philanthropic reasons to encourage self-help and thrift by the poorer classes of society.[3] Established banks of the time did not cater to the needs of ordinary people. For example, in Scotland a substantial amount of money for an ordinary labourer, £10, was needed to open an account. This appears to have amounted to at least 1-2 years of earnings of an agricultural labourer.[4] At the parish bank of Ruthwell, Scotland, the first UK savings bank founded by the Rev. Henry Duncan in 1810, an account could be opened with a sixpence deposit – approximately a day's earnings. Clearly, savings banks provided a valuable service in placing financial services of the time within reach of the working classes. Savings banks spread quickly throughout the UK, Europe and the United States. Deposits grew rapidly: total savings in the first year of the Ruthwell parish bank were £151 whereas ten years later deposits in UK savings banks amounted to over three million pounds.[5]

In Iceland, the first savings bank was founded in 1868 and savings banks were soon established throughout the country. Now, there are 25 savings banks in Iceland. Most of them are very small, the average bank had assets of about 85 million euro (M€) at the end of 2003. The largest, the Reykjavik Savings Bank (RSB), had assets of 590 M€. This is places the bank in the mid-range of European savings banks in terms of size (Williams, 2003). The RSB is, however, small compared to commercial banks in

[3] The ideology and rhetoric surrounding savings banks is a topic worth a study of its own. They are said to be run with the benefit of owners of savings and the public in mind, but not with a view of maximizing profits of guarantee capital owners; see e.g. Chapter 2 of Williams (2001) and the documentation with the Icelandic bill of 2001. When the mode of governance of savings banks is examined it is difficult to be anything other than sceptical about the realism of this rhethoric. From the point of view of economics one would generally assume that the agents involved maximize their own utility which does not necessarily imply maximizing benefits of the customers or the owners of savings.

[4] An agricultural labourer might expect to earn fivepence a day and work was seasonal and casual. http://www.rampantscotland.com/famous/blfamduncan.htm as accessed on June 22 2004.

[5] http://www.savingsbanksmuseum.co.uk/savings_banks_history.html as accessed on June 22 2004. It seems an open question whether and then how much this institutional change contributed to economic growth in this period.

Iceland: the assets of the largest Icelandic bank, KB Bank, were 6.3 billion € at the end of 2003 or over 10 times those of the RSB; equity ratios are similar. [6]

Development of the Icelandic banking sector

The banking sector in Iceland has been radically reformed in recent years. Until a few years ago most commercial banks and so-called investment funds were state owned. [7] While one of the largest sectors of lending, housing loans, is still in the hands of the state which operates a special housing loan fund, all other commercial banks and investment funds – which have been merged with the banks – are now privately owned. They have all been listed on the Icelandic stock exchange and have used the stock market to raise new equity as needed. The growth of the banking sector has been quite spectacular, many fear excessively so: assets have tripled in five years, which translates into annual growth of 25% on average each year over 1999-2003. All the commercial banks now operate internationally to some degree. The largest bank in Iceland, the aforementioned KB Bank, is, when its subsidiaries in ten other countries are counted, now the ninth largest Nordic bank and is growing fast, doubling its size in a recent acquisition of a Danish bank. This is in spite of Iceland being on the order of 1% of the size of the Nordic countries as a whole.

Savings banks have followed suit, although not to quite the same degree as the commercial banks. Savings banks doubled their assets over the period 1999-2003, corresponding to annual growth of 15% on average. The RSB did a little more than this, growing by 140% over the period. It is of interest to note that in the period 1999-2000, right before the first of several recent changes in law on savings banks in 2001, the two subsectors grew at about the same rate, or approximately 55% over the two years. However, if the addition of investment funds (converted to an investment bank in 1998 and subsequently merged with a commercial bank) to the asset base of commercial banks are taken as net growth – which is probably how the savings bank

[6] All figures used in this paper come from the 2003 report of the Icelandic Financial Surveillance Authority. However, developments in the banking sector in Iceland are so fast that these figures have become obsolete. For example, the KB Bank more than doubled its size in its recent acquisition of the Danish FIH Group. Icelandic business now only amounts to 20% of the operations of the bank. The scale of magnitude is still right, however.

[7] There were specialized investment funds for fisheries, manufacturing etc. that were all consolidated into one investment bank which was subsequently privatized and then merged with one of the commercial banks.

saw it – and not included in the year end 1998 figures, growth over 1999-2000 was substantially faster at commercial banks, or 87%. Savings banks were excluded from using ordinary devices of financial markets to grow, e.g. taking over other banks in exchange for their own shares, and this probably led to their push for being allowed to convert themselves into corporations. This, in turn, brought about the change in law in 2001 which opened up this possibility.

It is likely that what some politicans wanted to achieve with the changes in the law on financial undertakings was that the savings banks would grow on their own and possibly merge with one another, rather than with the savings banks. The hope was probably that this would strengthen the savings banks and create a new force and more competition in the Icelandic banking sector. However, there was nothing in the law that indicated that savings banks could not merge with commercial banks and indeed it seems a little naive – with a degree of hindsight – to think that this was a likely scenario for the savings banks. They were obvious takeover targets for the much larger commercial banks and given the latter group's financial strength, the most likely fate of a savings bank in a commercially interesting area like Reykjavik was to be taken over by a commercial bank.

Guarantee capital

Rules governing guarantee capital certificates in savings banks were traditionally very restrictive in terms of what the owner could do. These assets could not be sold except with the permission of the board and they could not be used to guarantee loans. Neither could the owner demand that the savings bank buy back his certificates. He was effectively stuck with the certificates and at the mercy of the bank board. It was only under extreme circumstances such as bankruptcy, death or divorce that the bank was required by law to buy back the guarantee capital certificates and then providing only so-called 'normal' return. On the face of it, these rules, which were relaxed somewhat in 2001, ordinarily would not have been expected to make the certificates a very attractive investment. Yet, in the years leading up to the relaxation of rules some savings banks managed to sell a considerable amount of certificates. It is difficult to believe that these purchases were philanthropic as they ostensibly were two hundred years earlier. It appears likelier that the people that purchased guarantee capital certificates considered them as investments with little downside risk but considerable upside potential. There had been discussion for a number of years that, even if it was uncertain how or when, the savings banks were bound to be converted into corporations and then the guarantee capital owners – at least in their own eyes – were the obvious claimants to the residual equity in excess of guarantee capital; the owners by the definition of Grossman and Hart (1986).

The relaxation of rules regarding guarantee capital certificates in 2001 was supposed to make them a more attractive investment. Now the savings banks were *allowed* – not obligated – to buy back guarantee capital when the owner wished to sell. The savings bank is the sole buyer of the guarantee capital certificates as before. The price is determined as before, yielding normal or fair return. However, rules regarding payments of dividends were also relaxed making it possible for well run savings banks to increase return on guarantee capital.[8] It is still rather difficult to understand, in particular from historical dividend policy, why anyone should buy or hold these strongly delimited assets on their own merits rather than government bonds, say, which would be expected to give a similar return but are vastly superior in all other respects and can, *inter alia*, be freely bought and sold in a well functioning and liquid market. This change in the law was therefore seen as unlikely to change very much in the market environment of savings banks.

The major change in the law in 2001 was that now savings banks can be converted into corporations. If a savings bank wants to convert itself into a corporation, and this has to be approved by a meeting of guarantee capital owners by a two-third majority, then first an 'independent' party must assess the value of the savings bank. Guarantee capital owners are then supposed to receive shares such that their holding in the bank amount to the same ratio as the ratio of guarantee capital was in the assessed market value of the savings bank. The residual equity is to be held by a self governing foundation. The board of the foundation was to be elected from the group of guarantee capital owners at the time when the savings bank was converted into a corporation. The aim of the foundation, according to the law, is to support culture and charities in the operating area of the savings bank. Clearly, the foundation has a lot of flexibility

[8] The change was that up to 10% of profits with a maximum of 5% of guarantee capital could be paid out as dividends. In practice this means an additional 5% in returns for RSB guarantee capital owners. This was meant to alleviate the situation of smaller savings banks (or their management) that did not see corporatization as a viable option.

in how it spends its money and how it invests its assets. A seat on the board of the foundation would therefore seem to embody considerable power and prestige.

The committee that wrote the bill for changes in the articles in the law on financial institutions dealing with savings banks was composed of representatives of the Ministry of Commerce and the Financial Surveillance Authority as well as the managing director of the RSB and the managing director of the Association of Savings Banks.

3. The takeover deal

After the law of 2001 was passed, pressure immediately built up to convert the Reykjavik Savings Bank into a corporation and in 2002 a group of investors attempted to rally the guarantee capital owners around its plan to effectively take over the bank and sell it to a commercial bank. The board of the bank – which had built up a loyal base of guarantee certificate owners and had already made plans of its own for conversion, which it must have wanted to have full control over – managed to hold the fort this time. Subsequently some changes were made to the law which were intended to strengthen takeover defences of savings banks. There was also an easing of the rules on valuation of guarantee capital. Now they were to be revalued as follows: "In evaluating the proportion of guarantee capital, regard shall be had for the dividend to be expected from the guarantee capital holding in accordance with [rules on dividend payments], on the one hand, and the dividend to be expected from and risk of shares in the savings bank, on the other."[9] It later became evident that the board interpreted this as allowing a substantial increase in the share of guarantee capital in the market value of the RSB.

Early in the year 2004, however, the board – now with a new member from the earlier takeover group – solicited bids for the RSB from commercial banks. The highest bid came from the KB Bank. Apparently, the majority of guarantee capital owners supported this move.[10] The Reykjavik Savings Bank was to be converted into a corporation with the structure outlined above. The proceeds of the sale of the shares

[9] Law on Financial Undertakings, Article 74.

[10] The purchase price of the Reykjavik Savings Bank constituted about 8,4% of the market value of the KB Bank at the time the deal was made, whereas the equity of the Reykjavik Savings Bank was 10% of the equity of the KB Bank.

of the self governing foundation were to be put into a charity fund controlled by the board members of the savings bank. Receipts from the sale were not, however, to follow the original 7:93 division of equity. Rather, the board planned to divide 34% of the income among guarantee capital owners and 66% were to go to the foundation (see Table 1). They justified this in two ways. First, prior to corporatization, a revaluation was to be made where the guarantee capital was to be revalued by a factor of 2.6. This was based on a present value calculation used predicted future dividends to estimate what was a legitimate share of guarantee capital.[11] This brought the share of guarantee capital up to 19%. Second, the shares of guarantee capital owners were to be sold to KB Bank at a price of 2.13 per share while foundation shares were to be priced at 1. In total, this maneuver led to a rate of 5.54 for unit of nominal guarantee capital equity and a price of 0.87 for a unit of the foundation's equity.[12]

[Table 1 about here]

The Government of Iceland evidently did not like the deal made and responded very swiftly. The Minister of Commerce put a bill before the Parliament which made it into an act – almost unanimously – in a matter of days.[13] The new law effectively removes the control of Icelandic savings banks from the guarantee capital owners if they decide on conversion to a corporation by changing the rules for appointment to the board of directors of the self governing foundation, which would usually hold the majority of shares in savings banks when they are converted into corporations. The new law states that the Minister of Commerce should appoint two board members, the municipality where the bank is located appoints two members, and the Association of Savings Banks one member. If there was a notion that the savings banks were effectively owned by the guarantee capital owners then their property has now been more or less expropriated by the state. After the new law was passed, the conversion of savings banks into corporations implies that the boards – representatives of the guarantee capital owners – lose all control of the savings banks. Control then passes into the hands of a board of directors which represents the interests of everyone

[11] Had the deal gone forward, the Financial Surveillance Authority would have had to approve the revaluation.
[12] These are implied valuations based on round figures from newspaper articles.
[13] There was one vote against: that of an MP which was also on the board of the RSB and the leader of the group which made the first takeover attempt.

except the guarantee capital owners, in particular political interests related to regional policy, local political interests – which are usually concerned with protecting local jobs – and interests of smaller rural savings banks or perhaps rather the interests of their management. It should not come as a surprise that mergers and rationalization of this part of the financial sector has been halted – at least for a while. With the new law the government created a holdup situation where the *status quo* is clearly a more favorable position for the guarantee capital owners and the present board to be in.

4. Welfare effects

One way of estimating aggregate welfare effects of the acquisition of the RSB by the KB Bank is simply to look at the difference between the offered purchase price of ISK 9 billion (€ 102 million) and the estimated 'standalone' market value ISK 7.3 billion (€ 83 million). This difference, ISK 1.7 billion (€ 19 million) can be taken to be a lower bound for the efficiency gains the KB Bank was expecting to achieve.[14] It was argued by some that competition in the banking sector would decrease as a result of the takeover and some of this surplus may be expected monopoly rents. It is, however, unlikely that monopoly profits would have increased substantially by a takeover of the RSB by the much larger KB Bank whose competitors are other commercial banks in Iceland. We therefore disregard this component of potential costs. It is difficult to see any other welfare costs of the merger – there is very little unemployment in Iceland in general and Reykjavik in particular so disruption costs are minimal. The exceptions – which are likely to consist of some management and staff – are so few that they could easily be compensated, e.g. by sufficiently generous severance packages.[15] Hence, € 19 million is likely to be a cautious estimate of the efficiency gains. This is not a huge sum in terms of the larger economy, in per capita terms it is about € 67 or 0.2% of GDP.[16]

It must however, be kept in mind that the RSB case was widely regarded as the beginning of a takeover wave of savings banks in general. The RSB constitutes about 30% of the savings bank sector as a whole. However, it is much better run than other savings banks with a return on equity of 17.5% in 2003 compared to 11.5% on

[14] Presumably, KB Bank intended to reap some gains from the deal as well.
[15] A promise was made on behalf of KB Bank that there would be no layoffs of RSB employees. This was taken moderately seriously by the latter.
[16] GDP per capita is approximately € 30.000.

average at other savings banks.[17] Potential efficiency gains from a restructuring of the sector as a whole are therefore proportionally higher than at the RSB. A guess of efficiency gains at other savings banks based on the above figures could be in the range ISK 6-9 billion or € 70-100 million, corresponding to 0.8-1.2% of GDP. There would, however, be transitional costs, especially in rural areas. Rural MPs and their constituents would place a high weight on such costs.

5. Interested parties

To place the RSB story into theoretical perspective it is essential to understand who the interested parties are and how their interests may be expected to be perceived. Such a classification of course involves some simplification, but keeping that in mind, the relevant groups may be considered to be the following:

1. Guarantee capital owners
2. Board of Directors of the RSB
3. The Savings Bank Association
4. Savings bank workers
5. Municipalities where savings banks are located
6. Customers: savers and debtors
7. The general public
8. Politicians
9. Bureaucrats

We now go through this list and indicate what the probable interests of the different groups are and how they are likely to view the proposed merger of the RSB with KB Bank.

[17] Return on equity was in fact similar at the RSB and the KB Bank. These are of course figures for just one year, which may be affected by irregular terms in the operations accounts, and should be taken with due caution. It is ironic that a large part of the profits of savings banks – including the RSB – in recent years comes from their investment a few years ago in Kaupthing, a precursor of KB Bank.

Guarantee capital owners

The guarantee capital owners are a mixed group, probably mostly from Reykjavik. Information on the composition of this group is not publicly available.[18] However, it is known that the board had invited selected people to invest in guarantee capital for a long time. It is therefore likely that a substantial portion of guarantee capital owners were in some sense loyal to the board. A number of employees of the bank are also guarantee capital owners. The interests are therefore likely to be a mixture of earning a return on the investment, supporting 'friends' (the board) and protecting one's own job. Initially, it seems that many guarantee capital owners were rather hostile to the takeover plan, which was then opposed by the board. In the second round, however, it appears that the majority – probably with the exception of those who also are employees or the RSB – were positive towards the merger, which was then also supported by the board.

Board of Directors

The majority (three) of the board of directors was elected by capital owners while local politicians would typically elect the remainder. After the first takeover attempt, one of the persons behind the attempt was elected to the board He also happened to be a Member of Parliament, belonging to the larger party of the governing coalition. Subsequently he also became the chairman of the permanent parliamentary committee on economic and commercial affairs.

The majority of the board would be expected to consider two things: The pecuniary return on selling the guarantee capital and the possibility of a seat on the board of the self-governing foundation. Selling the RSB to KB Bank would clearly affect both positively.

Savings Bank Association

The Savings Bank Association is dominated by CEOs of small savings banks. This group will probably see it in their interests to maintain the status quo, i.e. to prevent savings banks being bought up by commercial banks. In that way the members protect

[18] Keeping this information secret was an important part of the defense strategy of the Board of Directors during the "hostile" takeover attempt of the RSB in 2002. It was only after a court ruling that the group attempting the takeover were allowed to see the list (they were not allowed to make a copy).

their jobs which are likely to offer higher salaries and greater power and prestige in their local communities than what they could get after a merger with a larger bank.

Savings bank workers

The majority of employees of savings banks – in particular employees of the Reykjavik Savings Bank – appears to see it as in their interests to prevent mergers with larger banks. This group is likely to look mostly towards protecting their own jobs, although employees of the Reykjavik Savings Bank have a much better chance than rural bank employees of finding other comparable jobs.

Municipalities

The municipalities – i.e. local politicians – where savings banks are located are likely to see it in their interests to prevent savings banks being taken over by commerical banks. A merger with a commercial bank will lead to lost local jobs (bad news for politicians, especially in rural communities) and also less influence, both direct (through board membership) and indirect (through personal contact with local board members).

Customers: savers and debtors

These were not heard much from in the debate surrounding the proposed merger. Individuals and firms in smaller communities might with some reason think their access to capital would be worse with the disappearance of their local savings banks. Customers in Reykjavik would not have much to worry about were the RSB to merge with KB Bank.

The general public

At first sight it appears that the proposed merger should not matter much to the general public. The argument that efficiency gains from changes such as this benefit everyone, generally carry little weight with the public. Furthermore, business activity is lively in Iceland and the financial sector has been very active in mergers and acquisitions over the last few years. There seems no reason for 'the man on the street' to have much to say for or against this particular merger. Neverthe less, polls showed that most people were against the merger. Some people polled were worried by less competition in the bank sector after the merger of RSB with the KB Bank.

Politicians

Local politicians were dealt with under ‘Municipalities’. Members of Parliament are of course a mixed group with different constituencies. The present majority coalition is composed of two parties. The larger partner is a conservative party, usually considered pro-business and pro-efficiency, and what was traditionally a rural farmers’ party. The Minister of Trade and Commerce, whose portfolio includes banking affairs, was firmly against the merger. Her constituency is rural and therefore the issue of ‘protecting’ jobs in savings banks (although not particularly at the RSB) is likely to be important to her. The same applies to many other rural MPs in the ruling parties. It should, however, be kept in mind that the law of 2002 allowed for the conversion of savings banks into corporations. Mergers with commercial banks were widely expected to follow. Most MPs of the conservative party should, based on their ideological background and the general views of their constituency, have positively welcomed this development on efficiency grounds. Furthermore, the new law, with its effective expropriation of guarantee capital owners, should in principle have been odious to conservative MPs. The opposition of voters in general to the merger must therefore have influenced MPs of all parties and they must have seen it as politically costly to be against the new law, whether they liked it or not. Conservative MPs, especially from Reykjavik, must have seen a tradeoff between efficiency in the banking sector and political costs of opposing the bill for the proposed change.

Bureaucrats

Ministerial bureaucrats do not normally participate in public debates on issues they are concerned with in their work. Therefore their voice was not heard in the public debate on the RSB issue. To the extent that bureaucrats had particular interests, they would be expected to align mostly with those of the general public. However, the new law states that the board of the self-governing foundation is nominated by the Minister of Commerce and Trade, the Minister of Finance and local politicians. The position of bureaucrats is therefore strengthened somewhat with this change which they are likely to see as positive. In sum, bureaucrats are likely to oppose the merger and support the new law. However, it is doubtful that these interests were very strong.

Summary

Apart from (parliamentary) politicians, who must be defined as part of the government along with the executive branch (i.e. the Minister of Commerce) most other interested parties fall into the category of what Becker (1983) called ‘pressure groups’. When the payoffs of the guarantee capital owners had been raised from the first (unsuccessful) attempt at merging the RSB with KB Bank, some new members had been elected to the board of directors and the board itself was in control of the process, the guarantee capital owners and the board stood to profit enough from the merger so that they were prepared to support it and put pressure on politicians to not interfere. So was the management of the RSB which was omitted in the above analysis, but appears to have gone hand-in-hand with the board. All others, including the Savings Bank Association, the union of savings bank workers, municipalities where savings banks are located, government bureaucrats as well as the general public were against it and put pressure, in varying degrees, on politicians to block the merger in some way.

With some risk of oversimplification we can therefore divide the interested parties between two pressure groups: those who stood to profit from the deal and were for it – the board and guarantee capital owners – and those who stood to lose from it – basically all other interest groups.

6. The RSB case in light of economic theory

The RSB case is about potential deregulation which is meant to realize efficiency gains manifested in pecuniary surplus. The board attempted to capture the surplus on behalf of the guarantee capital owners. This reads like a simple case of rent-seeking. However, upon closer examination it becomes clear that there are several theories in the economics literature that are also potentially relevant for understanding the case of the Reykjavik Savings Bank. These include the economic theory of regulation as set forth by Stigler (1971) and Pelzman (1976) and further developed by Glazer and McMillan (1992); Becker’s (1983) theory of pressure groups; and theories of privatization, see e.g. Boycko, Shleifer and Vishny (1996). The reaction of the government to the takeover plan can be placed in context of the recent theory of the anticommons and the fragmentation of property (Heller, 1998; Buchanan and Yoon, 2000; Parisi, 2002; Schulz, Parisi and Depoorter, 2002; Parisi, Schulz and Depoorter, 2004). The real puzzle of the case – the virtually unanimous support for the change in law which blocked the takeover deal – is, however, not explained by any of these theories. We shall argue that in large part this must be explained by appealing to positive theories of justice (Konow, 2003). We now briefly summarize these theories and indicate in what way they can throw a light on the RSB story.

Economic theories of regulation

It is impossible to consider economic aspects of regulation, which is one view of the RSB case, without mentioning Stigler's seminal 1971 article and Peltzman's (1976) subsequent formalization and extension of Stigler's ideas. The basic hypothesis of the 'economic theory of regulation' was that regulation (and then implicitly deregulation as well) is supplied by politicians in response to demand from interest groups, regulation being one way of redistributing wealth from one group to another. The price of the good supplied – regulation – is the political support of the interest group. It follows from these hypotheses that the groups most likely to be successful in the competition for advantageous regulation are small (due to free-rider problems of larger groups), well-organized groups whose members have individually a lot to gain from favorable regulation. In terms of price regulation, Peltzman's model is based on the hypothesis that political support is primarily a function of two variables: industry profits and price. It follows that the industries most likely to be regulated were predicted to be those that are very competitive, so strong pressure for entry restrictions in order to raise prices are expected from the industry, or monopolistic, so pressure for some form of price intervention would be likely to come from consumer groups or downstream industries.

Becker (1983) built conceptually on the work of Stigler and Peltzman, but focussed on the competition between pressure groups. Little attention was given to politicians, political parties, and voters who were assumed "mainly to transmit the pressure of active groups". In Becker's reduced model there is a fixed total 'pie' of transfers and interest groups compete for shares of this pie. The net amount of transfers a pressure group succeeds in obtaining is given by an influence function. The influence of a given interest group depends on the effective pressure that the group and its competitors manage to put on politicians. Pressure, however, does not come free; the interest group must invest in it and different groups may be more or less efficient in producing pressure. One factor which would be expected to play a role in determining the relative efficiency of interest groups is personal connections of group members to political parties and politicians. The transfer process is also costly due to deadweight losses of regulation. This implies that policies that raise efficiency have an advantage over those that are lower efficiency. Like Stigler and Peltzman, Becker also showed that groups that are successful in obtaining subsidies tend to be small relative to those that are taxed to pay the subsidies.

It appears that economic theories of regulation have something to say about the RSB case. The board of directors and guarantee capital owners of the RSB is certainly a small and well-organized group and each individual had a considerable amount to gain from the merger. Furthermore, given the composition of the group, it should have been quite effective at lobbying. Its unofficial leader was an MP of the larger party of the governing coalition and also the chairman of the permanent parliamentary committee on economic and commercial affairs. Each individual in the opposition had much less at stake. Possible exceptions are the employees and also rural interests that felt that the deal threatened savings banks in their areas. Such interests, however, have not had much impact in recent years. For example, the privatization program of the government, which in many ways may be expected to have similar consequences, at least on impact, has not met effective opposition. The surprise is therefore that the lobbying effort of the board failed so drastically.

Some degree of self-restraint due to the threat of government intervention might have been expected in the RSB case. A conceptually similar setting was studied by Glazer and McMillan (1992) in their study of pricing by a monopolist firm threatened with profit regulation. In this model the probability of regulation is increasing in the price set and once regulated, profits are fixed forever. The firm is assumed to be rational and maximize the present value of expected profits, taking the threat of regulation into account. The result is that the monopolist engages in a form of limit pricing to forestall the imposition of regulation which implies lower prices than would prevail in unregulated monopoly. Rather than setting price in monopoly, the RSB board had to decide how high a share they, on behalf of the guarantee capital owners, were going to take in the proportion of the sales price of the bank that was due to the self-governing foundation. With no threat of intervention a profit maximizing board should rationally have taken all or almost all that was in excess of the equity of the foundation for itself. By analogy with the Glazer-McMillan theory, threat of intervention should lower this share.

It seems unlikely that much attention was paid to a possible intervention in the RSB case. The board attempted raise its share from 7.4% to 34.4%. A more cautious strategy would have been to use the allowance in the law to revalue equity to the utmost, raising the share to about 19%, but then using the same price for all shares in the final sale. On the other hand the board could have tried to stretch this even further; in the limit it could have sold the foundation share for a negligible amount and appropriated most of the receipts for itself. If, however, one assumes that a share price of 1 for foundation shares was a lower limit on the price that the foundation would get, then the board went as far as it possibly could. This seems the most reasonable conclusion and the board then seemingly discounted the probability of intervention completely. We shall return to the question, what bearing the Glazer-McMillan theory has on the RSB case, below.

Theories of privatization

Theories of privatization may also be relevant here; see e.g. Boycko, Shleifer and Vishny (1996). In this theory there are two types of politicians: those whose constituency benefits from maintaining inefficient public enterprises and therefore stand to lose votes upon privatization; and ‘reformers’, whose supporters want to see lower taxes and public spending and therefore stand to gain from privatization. Privatization raises the cost to politicians of influencing public enterprises. In particular, the privatized firm has to be subsidized to maintain inefficient operations and this carries more political costs than the hidden, but implicit subsidies of foregone profits in state enterprises. Keeping the traditional role of savings banks in mind (c.f. earlier discussion in Section 2) the takeover of the RSB by a commercial bank resembles privatization in that efficiency and profit motives may be expected to have a higher priority with management after the merger than before it. When a savings bank is merged with a larger commercial bank, politicians, especially local ones, no longer have the possibility to pressure banks to delay layoffs or lend to local firms on terms more favorable than commercial banks would do, if they would lend at all. Subsidies to maintain jobs in savings banks are more or less out of the question. There is a regional fund that could conceivably lend more to rural areas instead of savings banks, but such lending has been decreasing in recent years.

As in most countries, Icelandic politicians are a mixture of those who get their support from beneficiaries of public munificence and of 'reformers', in the sense of Boycko, Shleifer and Vishny, who support privatization and a more efficient public and private sector. Furthermore, as in many other countries, the privatization wave that was initiated in the UK by Mrs. Thatcher in the 1980s has had a strong impact in Iceland with, *inter alia*, all the state banks privatized in the last few years.[19] The balance sheet of the government is greatly improved and taxes have been lowered. Large privatizations still lie ahead, e.g. in telecommunications and energy. The conservative party has driven this policy for the most part and has been rewarded by being the dominating partner in two-party governments since 1991. With this in mind, it would seem that conservative politicians generally should have supported the sale of the RSB. Some MPs probably saw the sale as the beginning of the demise of savings banks in general with consequences for rural jobs and opposed it on those grounds. This, however, does not explain the opposition of conservative MPs in the metropolitan Reykjavik area.

Property rights

The 'tragedy of the anticommons' was discussed by Heller (1998) and subsequently formalized by Buchanan and Yoon (2000) and later in a general form by Schulz, Parisi and Depoorter (2002) and Parisi, Schulz and Depoorter (2004). 'Commons' and 'anticommons' may be regarded as legally symmetric concepts. In the standard formulation of the 'tragedy of the commons' a common resource is *overutilized* due to the presence of many users who have the right to utilize the resource. The tragedy of the commons is due to the absence of a crucial component of property rights: the right to exclude others from using the resource.[20] Due to this absence, users do not take the negative effects of their exploitation of the resource into account when making decisions on how much effort they should exert.

[19] Before privatization there was only one private commercial bank in Iceland.
[20] There are of course many well known exceptions to the tragedy of the commons where users have managed to strike a Coasian bargain on access rights. A case close to this author's home is that of Icelandic farmers who set up rules in the early middle ages on how many sheep could graze in common pastures, see Eggertsson (1992).

In the tragedy of the anticommons a resource is *underutilized* due to fragmentation of property rights. In Michael Heller's definition, anticommons is "a property regime in which multiple owners hold effective rights of exclusion in a scarce resource" (Heller, 1998, p. 668). In such a regime the rights to use the resource are split into two or more components and each user has the right to use, and exclude others from using, his particular component. This is likely to reduce, or even preclude use of the resource. For example, in a former sale of land to an orchard farmer a sheep farmer might have retained the right to let his sheep graze on the land.[21] After this deal has been made there are mutual rights of exclusion in use of the land: the orchard farmer can exclude the sheep farmer from use other than letting his sheep graze whereas the sheep farmer can exclude the orchard farmer from any use of the land which interferes with the sheep grazing. At a later stage the land may be sought after for other and more valuable uses, for example for recreation for city folk. The orchard farmer may want to convert the land to a recreational area, but the sheep farmer can block such use by virtue of the contract he holds.

Heller discussed the puzzle that in post-communist Moscow many storefronts were empty while "flimsy metal kiosks, stocked full of goods, mushroomed on on Moscow streets" (Heller, 1998, p. 623). Heller explained this and many other instances of under- or non-use of valuable resources by the fragmentation of rights to use the properties in question. Various components of property rights for the storefronts, such as the right to sell a property, the right to receive sale revenue, the right to lease, the right to occupy, etc. were held by different parties (most components by several agents) which apparently could not negotiate a division of the rents involved and therefore the properties were not used. This concept may also be applied to the granting of patents. Heller and Eisenberg (1999) argue that granting too many patent rights in biomedical research may delay the discovery and production of life-saving products.[22]

[21] This example is taken from Schulz, Parisi and Depoorter (2002).
[22] All this begs the question why Coasian bargains are not struck in such situations where it seems that the parties to a case must be sufficiently few to overcome transactions costs.

Parisi (2002) gives a fascinating account of how property has tended to become more fragmented over time and claims that there is an inherent tendency towards increasing fragmentation of property rights. If contracts can be freely made, there are often some short-term profits that can be made by splitting up components of property. In a world without transactions cost where Coasian bargains may be freely and costlessly struck this would not be a problem since then parties would negiotiate unification of property components if that is more profitable than leaving them fragmented. However, both Heller (1998) and Parisi point out what might be termed a 'Humpty Dumpty problem': It is more costly and difficult to reunite property rights than splitting them up. The financial and legal effort it takes to reunite split property rights creates a form of irreversibility that prevents unification. On a normative note, Parisi argues that legal rules should be designed so as to combat the trend towards increased property fragmentation.[23]

Like the empty storefronts in Moscow that caught Heller's attention, the Reykjavik Savings Bank is a case of underutilized resources. The board followed up deregulatory change in law by a deal that would have realized a tidy surplus which, incidentally, they planned to appropriate for themselves and other guarantee capital owners. The opportunity for this deal was created by the government which had removed restrictions on savings banks and allowed them to convert themselves into corporations. In this the government essentially converted the very imperfect property of guarantee capital with its severe restrictions on transfer – in itself an example of fragmented property rights – into ordinary shares in a corporation which enjoyed all the usual components of property including free transfer.[24]

The government's response to the takeover contract, however, was a change in law which implied that, upon conversion of the savings bank into a corporation, the board would effectively be replaced with a new board, representing interests of just about everyone except the owners of guarantee capital. This created a type of hold-up situation, a special case of the anticommons theory. It is obviously against the

[23] The title of Parisi's paper is 'Entropy in property' – a reference to the Second Law of Thermodynamics: "the entropy of an isolated system always increases as a result of a spontaneous process" (Encyclopedia Brittanica, web edition as accessed on August 26, 2004). This is an apt analogue to the process he describes.
[24] Actually there are certain restrictions on holding of shares in commercial banks which make them less transferable than shares in other corporations.

interests of the present board and guarantee capital owners to hand complete power over the bank to a new and hostile board which has every reason to maintain the status quo and – given the composition – even spend more on unnecessary employment and bad loans. Therefore the board will not convert the savings bank into a corporation under this law.

The government in this case went directly against Parisi's policy advice: rather than combating fragmentation of property rights it employed fragmentation of property rights as a tool. By transferring control of a corporatized savings bank to an outside board it made the possibility of profiting from a sale of shares highly unlikely and removed the control of dividend policy from guarantee capital owners as well. Thereby, the right to transfer the shares was effectively removed According to law the board may buy back guarantee capital certificates. However, given the present situation, it is difficult to see why the board should want to act as a market maker and buy the certificates. The guarantee capital owners are therefore locked into their investment, retaining only the right to receive a dividend on their capital. Of course it should be kept in mind that it was on those terms that they originally made their investment.

It is obligatory to point out that the parties to the case should have been able to strike a Coasian bargain (Coase, 1960; Stigler, 1965). Why didn't the board of the RSB react quickly to threatening signals from the government and offer to reduce the guarantee capital owners' share of the pie at least down to the 19% equity share?[25] This would of course have been quite expensive: Instead of the average owner receiving € 32,000 for his certificates he or she would have gotten € 14,000 or a little less than half the original sum. In business negotiations parties would have found a middle ground. It is, however, probable, that negotiations were very difficult at this stage. This was not a question of business-as-usual, it was a political deal as well and it would probably have been politically costly to negotiate with the board when things had come so far; the transactions costs had become too high for a bargain to be made.

[25] Before the bill for the change in law was put forward, the Minister of Commerce wrote a rather terse letter to the board asking for explanations of the contract drawn up with KB Bank. The letter referred repeatedly to the law on self governing foundations which contains articles forbidding board members of the foundation to be involved in decisions that are likely to involve a conflict of interest of the board member and the self governing foundation.

As some recent literature on the Political Coase Theorem (Acemoglu, 2003) indicates, it may also be difficult or impossible for politicians to strike such bargains due to commitment problems.

Positive theories of justice

As argued above, theories of economic regulation can explain some aspects of the RSB case. When the interest groups and the composition of Parliament is examined one would have expected a political conflict over the outcome of the RSB case according to the interests of constituents and how effective the various interest groups were at applying pressure to politicians. This is just politics as usual and offers no big surprises. Structurally similar issues, such as privatization of state enterprises, which in many cases have similar consequences as the RSB deal, have usually been approved without much ado by the Parliament. Hence, the real puzzle here is why the vote in Parliament for the new law was almost unanimous – the vote against was that of a Member of Parliament who was also a board member of the RSB and one of the original instigators of the merger. A possible explanation lies in social norms; people's perception of what is just, equitable or fair.

Theories of justice have a bearing here. Konow (2003) surveys a large literature on normative and positive theories of justice and empirical research into what people deem fair or just behavior. On basis of the empirical evidence, Konow proposes a synthesis of several theories of justice, a multi-criterion positive justice theory where efficiency, equity and needs are "interpreted, weighted and applied in a manner that depends on the context" (p. 1235). "Equity" is here used in the sense that people receive payoffs in proportion to the inputs they control; circumstances outside of a person's control such as birth or (brute) luck should not have a bearing on allocations, whereas effort and choices that influence the contribution of an individual should affect allocations.

Needs are hardly relevant in the RSB case and as argued earlier the RSB deal was surely efficient. The remaining key question in the RSB case is therefore whether the payoffs resulting from the deal with KB Bank were equitable: did the guarantee capital owners deserve – in the perception of the general public – to profit as much as they stood to do?

If the RSB had been an ordinary corporation and the guarantee capital owners had bought shares rather than certificates, then they would have made a calculated bet, a good, but *ex ante* risky, investment which yielded a handsome return. One can infer from Konow's discussion that most people judge payoffs from such investments to be equitable. The people involved, the board of the RSB, would probably argue that this – making a calculated bet – is more or less what they did when they bought their guarantee capital certificates. However, there is no doubt that these were not the terms of their original investment. Indeed, the law was rather clear as to the intended share of the guarantee capital owners. However, they managed to circumvent the law by differentiating prices by owner of shares-to-be. This well publicized fact was probably what turned the table against them.

A type of laboratory experiments that seems particularly relevant in this case is the so-called ultimatum game where a 'proposer' offers a division of a sum of money which the 'responder' can either accept or reject; rejection implies that both players receive no payment.[26] By standard economic theory, where only absolute payoffs matter, the responder should accept any proposal that gives him/her a positive amount of money. However, it is a robust result in the laboratory that responders will reject low offers, but usually accept a 50% or even a slightly lower share. This seems to be almost universally expected by the proposers and the most common proposals are in fact for a 40-50% share of the responder.[27] Positive amounts are even proposed in so called dictator games, where the responder has no choice except to accept the offer made.

There are several theories that attempt to explain such behavior. Bolton and Ockenfels' (2003) ERC theory (**E**quity, **R**eciprocity, and **C**ompetition) appears to be the most successful such theory in that it manages to encompass both experiments of the ultimatum type, where behavior inconsistent with standard theory is observed, and market exchange experiments, where the textbook theory is in fact upheld and the expected equilibria usually emerge. Bolton and Ockenfels deviate from standard

[26] For recent evidence, see e.g. Falk et al. (2003).
[27] An outlier in the large collection of studies of ultimatum games in various countries and cultures is a study where the subjects were the Machiguenga, a people of the Peruvian Amazon. With them the modal (mean) offer was a 15% (20%) share for the responder and this was almost always accepted. Konow (2003, p. 1227) expresses some scepticism of these results, especially with regard to how the experiment was explained to the Machiguenga.

theory in allowing not only absolute payoffs in the ‘motivation’ function of subjects (a form of expected utility), but also relative shares in the pie to be split. This theory, however, does not take equity, in the sense that Konow defines it, into account. Thus, utility (motivation) in the ERC theory is lowered by a low relative payoff, *ceteris paribus*, regardless of the reasons for the higher payoff of others. The evidence Konow draws together, however, appears to support the hypothesis that people find unequal payoffs fair, given that those who get the high payoffs have exerted some form of effort to earn them and that the payoffs are in some reasonable proportion to the amount of effort. This conjecture seems to be supported by experiments where the ultimatum game is modified such that some subjects come to be perceived to be entitled to higher payoffs (Hoffman and Spitzer, 1982, 1985; Hoffman, McCabe, Shachat and Smith, 1994). In these experiments results are much closer to the predicted non-cooperative Nash equilibria than in standard ultimatum games where people make proposals with a clean slate.

The RSB case may be regarded as an ultimatum game with the board as the proposer and the general public as the responder. On behalf of the guarantee capital owners, the board had access to a substantial amount of money which it could have shared with the general public through a charity. It chose to appropriate all the money for the owners. The public rejected the offer and clearly thought it inequitable and unfair.[28]

7. Discussion

The RSB case should be seen against a backdrop of increasing ‘propertization’ in Iceland in the last couple of decades. A large share of the country’s resources has been moved into private hands over this period, there is more belief in and use of private incentives and the range of private property rights has been extended. A continuing Demsetzian transformation has been taking place. This process has not only occured through privatization, but also through many other policy changes. One of the biggest such changes was the creation of the individual, transferable quota (ITQ) system used to manage Iceland’s fisheries. It is outside the scope of this paper to give a detailed account of the Icelandic ITQ system (see e.g. Arnason, 1997).

[28] This is a positive test of justice in the RSB case. Normative tests can be done by considering the deal in light of theories such as the entitlement theory of Nozick (1974), Buchanan’s contractarian theory (1986) or Rawls’ (1971) difference principle. The reader is invited to conduct such tests on his own.

Suffice it to say that in the eyes of its admirers, this system has worked wonders for Iceland's fisheries, solving the commons problem that plagued the fisheries prior to its implementation with considerable gains for most Icelanders. For critics, whose voice has rung loud over the last decade or so, the system has undeservedly moved vast sums of money into the hands of people who happened to own fishing boats in the period used in determining the inital, grandfathered allocations and also disrupted a way of life in the smaller fishing villages around the coast of Iceland. The defence that the ITQ system is in the first instance probably a Pareto improvement and secondly grandfathering is nothing more than a formalization of previously existing, indirect property rights carries little weight with the general public.

When the government changed the law on savings banks in 2001 it was careful to try and make sure that previous rules regarding guarantee capital would be upheld. The owners of guarantee capital certificates were to get normal return on their investment in accordance with the terms of investment, nothing more. It is likely that the previous debate on the ITQ system and the strong aversion to what were perceived as undeserved gains for individuals created by the state that manifested itself in that debate were important in this regard. The residual value of a savings bank converted into a corporation was to be held by a self governing foundation which was to be altruistically managed by representatives of guarantee capital owners. This turned out to be naive; the temptation turned out to be too strong for the owners. By the expedient device of different prices for the shares of the foundation and those of the owners they planned to appropriate the surplus for themselves.

In some ways the attempt at taking the surplus is understandable. The board had in many ways acted like a board in a regular commercial bank and the RSB was (and is) reasonably well run. The general trend has been away from common property arrangements and there are frequent news of individuals in similar positions in ordinary corporations collecting large sums of money when selling their shares to banks or larger firms. The market value of the RSB has been built up by the business acumen of the board as representatives of the guarantee capital owners. It must have been tempting to think it only fair that they were the natural 'residual claimants' (Grossman and Hart, 1986) – the just owners of the savings bank.

Above, I have claimed that the puzzle here is why the vote in Parliament for the new law was almost unanimous. The solution to this puzzle is that the vote was most likely driven by public opinion. The takeover deal may have been just in the opinion of guarantee capital owners and the board, but in the eyes of most others, this deal – while having the merit of making Iceland's financial sector more efficient – amounted to an 'expropriation' of the savings bank by the guarantee capital owners. They were trying to get as much as they dared of the money that was up for grabs for themselves and the board was to get the prestige and power of controlling by far the largest charity in Iceland. This was the opinion that won out in the debate. The reason for the general opposition to the takeover of the RSB is probably that people saw a group (guarantee capital owners) where each individual stood to profit substantially without having done much to deserve this. Guarantee capital owners had not taken risks, nor exerted any effort in the eyes of the general public and hence their profit was judged inequitable and unfair by the public opinion. Arguments that all will be better off with a more efficient banking sector matter little in this regard (as they indeed also do, *mutatis mutandis*, in the fishing quota debate).

The state reacted by blocking the deal with the device of a holdup, effectively expropriating the newly created property rights of guarantee capital owners.[29] The problem was of course that the property rights involved were badly defined so use of the term 'expropriation' for the actions of the state is perhaps not quite justified. Over the course of many decades a substantial amount of money was accumulated in the savings banks which was controlled by their executives and board members, but this capital had no clear owner even if it was managed by the board. It was the residual after the normal return on guarantee capital had been subtracted from the profits of the banks and no one knew (or knows) precisely what to do with it.

8. Conclusion

The policy advice of economists is usually – and quite reasonably – based on standard economic theory. In particular, a policy that leads to Pareto improvements is something that most economists will support. An action (or non-action) such as allowing takeover of the Reykjavik Savings Bank by a commercial bank is something

[29] It is interesting that the relevant articles in the law of 2002 were not simply abolished.

that would be expected to lead to non-negative payoffs for virtually everyone in Iceland. Yet, there was a strong, negative public reaction to what were perceived as unfair gains or, put simply, the greed of guarantee capital owners, especially the board of directors. This reaction appears to have put such pressure on politicians that there was virtually unanimous agreement to block the merger with the act of 2004. The framers of the takeover proposal would probably have done well to play some ultimatum games in the laboratory before forging their deal!

It is hard to reconcile Becker's (1983) original model of special interest groups fully with the RSB case. The case indicates that interest groups that are too aggressive and greedy may find out that their fortunes are reversed. Modifying Becker's modelwith due attention given to equity appe ars to be a promising avenue to follow in future research. In some sense the Glazer-McMillan (1992) theory of regulatory threat is better suited to study cases like the RSB case: the more inequitable the actions of a rent-seeking group are perceived to be the, the likelier it is that countervailing action will be taken by the state.

On a more practical note, one may wonder whether the RSB case is closed. This seems rather unlikely. Inefficient policies are likely to lose out in the long run – in Becker's words to be "incomplete and temporary" (Becker, 1983). Yet, the thorny problem of who is to get the surplus value of the bank remains. T he board still has the option to try to fight the new law on constitutional grounds and/or try to extract available surplus by other means, for example, through the provisions in the law regarding payment of dividends in part independently of profits. There are certain restrictions on how much can be paid out, but there is still considerable room for providing an excellent return on guarantee capital certificates, perhaps a real return of some 10-15% annually. By exploiting the room for dividend payments to the utmost, the board can in principle drain the RSB slowly but surely of its excess equity. This allows at least some of the excess equity to be taken out more covertly than with a public sale, reducing the risk of adverse public opinion and subsequent state intervention. This, however, is risky. The general banking regulation would force lending to be reduced at the same time as equity is reduced This would run the risk of destroying the bank altogether 'prematurely' and could also cause a clash with management and other interested parties which could put up difficult resistance to such a strategy. Furthermore, if this strategy were to be exposed as well as the planned sale it could lead to a similar public reaction as before and creating similar political costs for the government, which has shown quite credibly, that it may react quite quickly to such pressure.

The RSB case shows that relying on altruism and moral restraint of bank boards is not a realistic way of converting savings banks into corporations in an equitable way. One way of allocating the surplus equity of savings banks that are converted to corporations would be to distribute shares equally among citizens in the municipality in question in each case. The savings banks were originally created with the idealistic purpose of working for the greater good of these communities. Distribution by vouchers would be in that spirit and should, in the rather small and well informed communities of Iceland, not be subject to problems similar to those that occurred in many Eastern European countries that applied this method in privatization of state owned enterprises. If a deal is made for takeover of a savings bank prior to conversion to a corporation, such as in the case of the Reykjavik Savings Bank, then the sales value in excess of what is deemed to be a fair return for the guarantee capital owners could be distributed through reduction in local taxes. This obviously requires cleancut expropriation of the ownerless share, but this is clearly better than the present holdup situation with the risk of slow drainage of the RSB and possibly other savings banks.

References

Acemoglu, D (2003). Why not a political Coase theorem? Social conflict, commitment, and politics, Journal of Comparative Economics 31, 620-52.

Arnason, R (1997). The Icelandic Individual Transferable Quota System: Motivation, Structure and Performance. In E.K. Pikitch, D.D. Huppert and Michael P. Sissenwine (editors) Global Trends: Fisheries Management. American Fisheries Society, pp. 225-36.

Becker, G (1983). A theory of competition among pressure groups for political influence, Quarterly Journal of Economics 98, 371-400.

Bolton, G and A Ockenfels (2000). ERC: A theory of equity, reciprocity and competition, American Economic Review 90, 166-93.

Boyce JR (2000). Interest group competition over policy outcomes: dynamics, strategic behavior, and social costs, Public Choice 102, 313-39.

Boycko, M, A Shleifer and RW Vishny (1996). A theory of privatisation, Economic Journal 106, 309-19.

Buchanan, JM (1974). Liberty, Market and State: Political Economy in the 1980's. NY: NYU Press, Columbia University Press.

Buchanan, JM and YJ Yoon (2000). Symmetric tragedies: commons and anticommons, Journal of Law and Economics 43, 1-13.

Coase, R (1960). The problem of social cost, Journal of Law and Economics 3, 1-44.

Dagan, H and MA Heller (2004). Conflicts in Property, ssrn.com/abstract=556261.

Demsetz, H (1967). Toward a theory of property rights, American Economic Review 57, 347-59.

Eggertsson, T (1992). Analyzing institutional successes and failures: a millennium of common mountain pastures in Iceland, International Review of Law and Economics 12(4), 423-37.

Falk, A, E Fehr and U Fischbacher (2003). On the nature of fair behavior, Economic Inquiry 41, 20-26.

Glazer, A. and H McMillan (1992). Pricing by the firm under regulatory threat, Quarterly Journal of Economics 107, 1089-99.

Grossman, SJ and OD Hart (1986). The costs and benefits: a theory of vertical and lateral integration, Journal of Political Economy, 94, 691-719.

Heller MA (1998). The tragedy of the anticommons: property in the transition from Marx to markets, Harvard Law Review 111, 621-687.

Heller, M. & Eisenberg, R. (1998). "Can Patents Deter Innovation? The Anticommons in Biomedical Research," 280 Science,excerpted as 'Upstream Patents =Downstream Bottlenecks' in Law Quadrangle Notes. 4.13, 93–97.

Hermalin, BE and NE Wallace (1994). The determinants of efficiency and solvency in savings and loans, RAND Journal of Economics 25, 361-81.

Hoffman, E, K McCabe, K Shachat and VL Smith (1994). Preferences, property Rights and anonymity in bargaining games. Games and Economic Behavior, 7, 346–380.

Hoffman, E, and M Spitzer (1982). The Coase Theorem: some experimental tests. Journal of Law and Economics, 25, 73–98.

Hoffman, E, and M Spitzer (1985). Entitlement, rights and fairness: an experimental examination of subjects' concepts of distributive justice. Journal of Legal Studies, 14, 259–279.

Konow J (2003). Which is the fairest one of all? A positive analysis of justice theories, Journal of Economic Literature, 41(4), 1188-1239.

Krueger, A (1974). The political economy of the rent-seeking society, American Economic Review 64, 291-303.

Nozick, R (1971). Anarchy, State and Utopia, NY: Basic Books.

Parisi, F (2002). Entropy in property, American Journal of Comparative Law 50, 701-38.

Parisi, F (2003). Political Coase theorem, Public Choice 115, 1-36.

Parisi, F N Schultz and B Depoorter (2004). Simultaneous and sequential anticommons, European Journal of Law and Economics 17, 175-90.

Peltzman, S. (1976). Toward a more general theory of regulation, Journal of Law and Economics 19, 211-40.

Rawls, J (1971). A Theory of Justice, Cambridge: Belknap Press of Harvard University Press.

Schulz, N, F Parisi and B Depoorter (2002). Fragmentation in property: towards a general model, Journal of Institutional and Theoretical Economics 158, 594-613.

Stigler, GJ (1966). The Theory of Price, Macmillan, New York, NY.

Stigler, GJ 1971. The theory of economic regulation, Bell Journal of Economics and Management Science 2, 3-21.

Williams, J (2003): Are European Savings Banks too Small? A Comparison of Scale Economies and Scale Efficiency, mimeo. University of Wales UK.

Table 1. Equity and market value of the Reykjavik Savings Bank, end of 2003

Figures are in millions unless otherwise stated

	ISK	Euros	
Guarantee capital certificates	539	6	
Other equity	4,059	46	
Total nominal equity	4,598	52	
Assessed market value	7,300	83	100.0%
Share of guarantee capital owners, without revaluation	539	6	7.4%
Share of self governing foundation, without revaluation	6,761	77	92.6%
Assessed market value	7,300	83	100.0%
Share of guarantee capital owners, with revaluation	1,400	16	19.2%
Share of self governing foundation, stage 2, with revaluation	5,900	67	80.8%
Sales value of RSB	9,000	102	100.0%
Planned share of guarantee capital owners	3,100	35	34.4%
Planned share of self governing foundation	5,900	67	65.6%
Average nomial guarantee capital per owner ('000)			
Without revaluation	490	6	
With revaluation	1,273	14	
Sales receipts per owner ('000)	2,818	32	

Source: Financial Surveillance Authority and various articles in *Morgunblaðið*

INSTITUTE OF ECONOMIC STUDIES WORKING PAPERS 1987-2004
Formerly Iceland Economic Papers Series

Editor Tryggvi Thor Herbertsson

A complete list of IoES Working Papers and Reprints can be accessed on our World Wide Web site at http://www.ioes.hi.is

W04:10 Friðrik Már Baldursson: Property by ultimatum: The case of the Reykjavik Savings Bank

W04:09 Ingólfur Arnarson: Analyzing Behavior of Agents of Economic Processes in Time

W04:08 Otto Biering Ottosson and Thorolfur Matthiasson: Subsidizing the Icelandic Fisheries

W04:07 Niels Vestergaard and Ragnar Arnason: On the Relationship between Greenland's Gross Domestic Product and her Fish Exports: Empirical Estimates

W04:06 Ingolfur Arnarson: Modelling Fishery Management Schemes with an Olympic System Application

W04:05 Ingolfur Arnarson and Pall Jensson: Adding the Sales Markets Dimension to Bio-Economic Models. The Case of Fishery Management

W04:04 Edmund S. Phelps: Changing Prospects, Speculative Swings: Structuralist Links through Real Asset Prices and Exchange Rates

W04:03 Ingolfur Arnarson: Analysing Behavior of Agents of Economic Processes in Time

W04:02 Ron Smith and Gylfi Zoega: Global Shocks and Unemployment Adjustment

W04:01 Fridrik M. Baldursson and Nils-Henrik M von der Fehr: Prices vs. quantities: public finance and the choice of regulatory instruments

W03:06 Thorolfur Matthiasson: Paying paper by paper, the wage system of Icelandic University teachers explained

W03:05 Gur Ofur and Ilana Grau: Bringing the Government hospitals into line: The next step of reform in the healthcare sector

W03:04 Ingolfur Arnarson and Pall Jensson: The Impact of the Cost of the Time Resource on the Efficiency of Economic Processes

W03:03 Torben M. Andersen and Tryggvi Thor Herbertsson: Measuring Globalization

W03:02 Tryggvi Thor Herbertsson and J. Michael Orszag: The Early Retirement Burden: Assessing the Costs of the Continued Prevalence of Early Retirement in OECD Countries

W03:01 Eirik S. Amundsen, Fridrik M. Baldursson and Jørgen Birk Mortensen: Price Volatility and Banking in Green Certificate Markets

W02:10 Tryggvi Thor Herbertsson and Gylfi Zoega: A Microstate with Scale Economies: The Case of Iceland

W02:09 Alison, L. Booth and Gylfi Zoega: Is Wage Compression a Necessary Condition for Firm-Financed General Training

W02:08 Asgeir Jonsson: Exchange rate interventions in centralized labor markets

W02:07 Alison, L. Booth, Marco Francesconi and Gylfi Zoega: Oligopsony, Institutions and the Efficiency of General Training

W02:06 Alison L. Booth and Gylfi Zoega: If you’re so smart, why aren’t you rich? Wage inequality with heterogeneous workers

W02:05 Gudmundur Magnusson and Saso Andonov: Basel Capital Adequacy Ratio and the Icelandic Banking Sector: Quantitative Impact, Structural Changes and Optimality Considerations

W02:04 Tor Einarsson: Small Open Economy Model with Domestic Resource Shocks: Monetary Union vs. Floating Exchange Rate

W02:03 Thorvaldur Gylfason: The Real Exchange Rate Always Floats

W02:02 Fridrik M. Baldursson and Nils-Henrik M von der Fehr: Prices vs. Quantities: The Case of Risk Averse Agents

W02:01 Tor Einarsson and Milton H. Marquis: Banks, Bonds, and the Liquidity Effect

W01:11 Tor Einarsson: Small Open Economy Model with Domestic Resource Shocks: Monetary Union vs. Floating Exchange Rate

W01:10 Tryggvi Thor Herbertsson: Shrinking Labour Forces and Early Retirement

W01:09 Tryggvi Thor Herbertsson, Edmund Phelps, and Gylfi Zoega: Demographics and Unemployment

W01:08 Tor Einarsson and Milton H. Marquis: Bank Intermediation and Persistent Liquidity Effects in the Presence of a Frictionless Bond Market

W01:07 Tor Einarsson and Milton H. Marquis: Bank Intermediation over the Business Cycle

W01:06 Thorvaldur Gylfason: Lessons from the Dutch Disease: Causes, Treatment and Cures

W01:05 Tryggvi Thor Herbertsson and Gylfi Zoega: The Modigliani “Puzzle”

W01:04 Gylfi Zoega and Yu-Fu Chen: Exchange Rate Volatility as Employment Protection

W01:03 Asta Herdis Hall and Solveig Frida Johannsdóttir: Generational Equality in Iceland

W01:02 Tryggvi Thor Herbertsson and J. Michael Orszag: The Costs of Early Retirement in the OECD

W01:01 Tryggvi Thor Herbertsson: The Economics of Early Retirement

W00:20 Helgi Tomasson: Monitoring the trading intensity of a stock market under infrequent trading

W00:19 Helgi Tomasson: Computations of Bayesian Estimators in ARMA Models

W00:18 Helgi Tomasson: Estimation of Correlations in Financial Markets when Trading is Infrequent

W00:17 Ragnar Arnason, Gylfi Magnusson and Sveinn Agnarsson: The Norwegian Spring Spawning Herring Fishery: A Stylised Game Model

W00:16 Jon Danielsson, Bjorn N. Jorgensen and Casper G. de Vries: Risk Management and Regulation in Incomplete Markets

W00:15 Sveinn Agnarsson: Development of Efficiency in Icelandic Fish Processing Firms: A DEA Approach

W00:14 Sveinn Agnarsson: Productivity in Icelandic Fish Processing Industry 1985 – 1995: A Comparison of Methods