ICELANDIC ECONOMIC UPDATE

Arion Bank

Arion Research | August 2014

The CBI's net FX reserves are close to being in positive territory

The Central Bank of Iceland is close to being in positive territory when it comes to its net foreign assets. Some might argue that we are already there when taking claims on failed financial institutions into account. Although this bodes well for the economy, as we examine in our analysis the accumulation of FX reserves is not completely free of charge.

Government Accounts for 2013 much better than anticipated

The Icelandic government appears to be on the right track as far as Government Accounts go, especially when excluding irregular items. It would in fact have delivered positive results without these irregular items in 2013. The year 2014 is getting off to a good start with the first half of the year showing a surplus of about 13 bn.ISK on a cash basis.

EFTA Court publishes its Advisory Opinion on price indexed loans

The EFTA Court has determined that price indexed loan contracts do not go against EEA regulations, which Icelandic laws must be in accordance with. The opinion, which was requested by Icelandic authorities, is an input in pending cases regarding price-indexed contracts and their specific terms. Should Icelandic courts find the loans illegal the results could be catastrophic. However, we believe such a result to be highly unlikely.

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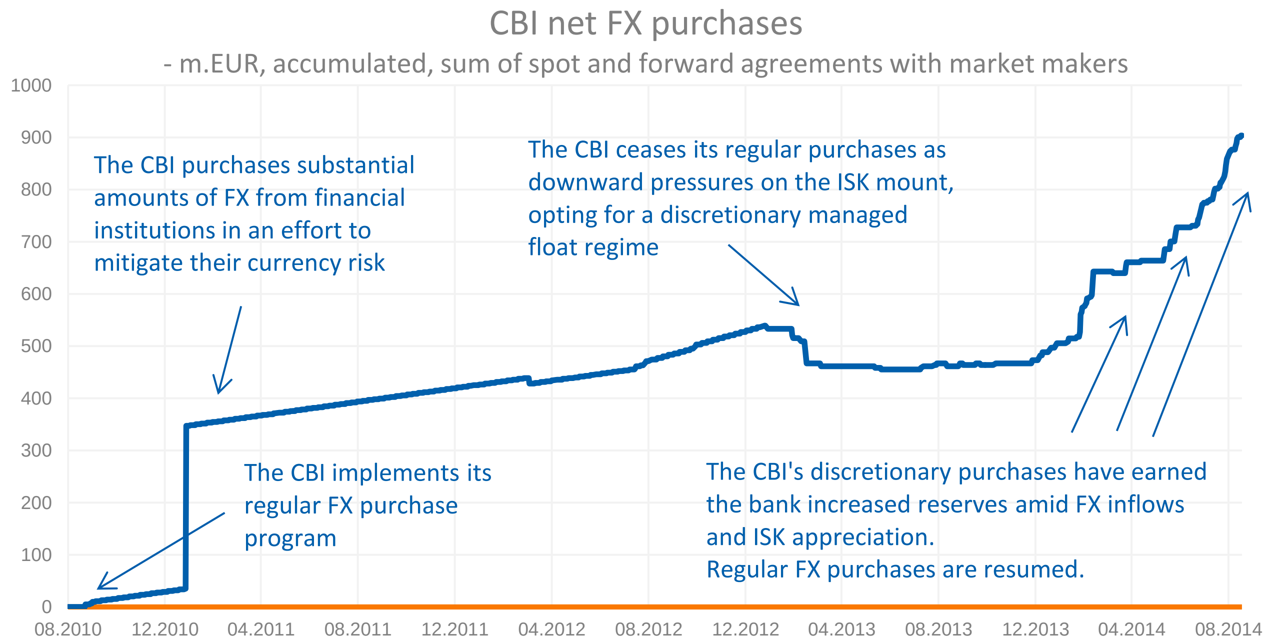
The CBI's net FX reserves are close to being in positive territory

In the wake of the financial crisis in 2008-2009 the Central Bank of Iceland's foreign debt outgrew its foreign assets. Both the CBI and the State Treasury assumed substantial foreign debt to strengthen the Bank's FX reserves in accordance with the IMF's economic program. Around the same time, the Bank spent some of its reserves in order to intervene in the FX market and prop up the króna.

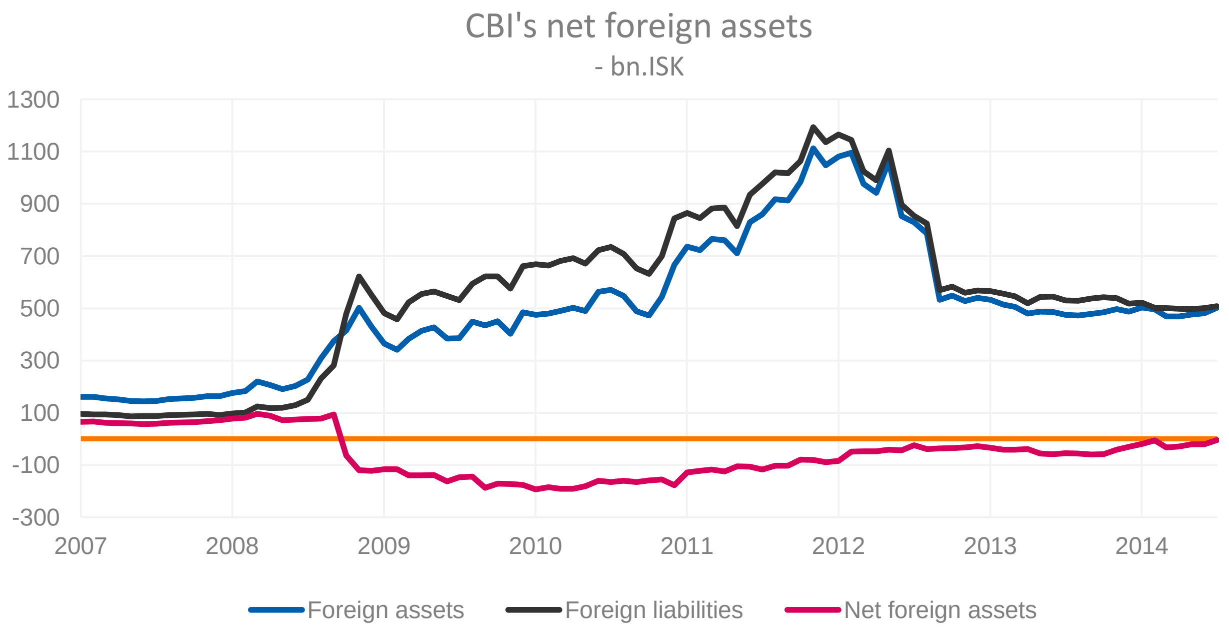
In the fall of 2010 the CBI began deleveraging its reserves using regular FX purchases in the interbank market. The Bank's intervention policy has since changed somewhat – it ceased regular purchases, assumed a managed float policy based on irregular, discretionary purchases and has now resumed regular purchases in addition to its discretionary intervention.

Using these methods the CBI has managed to purchase approximately 900 million euros in the interbank market over the last four years with close to half of that being over the last 12 months.



Sources: CBI, Arion Research calculations and observations

In the graph below we compare the foreign assets on the CBI's balance sheet with the sum of all debt that is either foreign or in foreign currency (including foreign deposits of domestic financial institutions and the Treasury with the CBI) in order to get some sense of how leveraged the CBI's FX reserves are. The Bank's interventions have been successful when it comes to deleveraging its reserves as its net foreign assets are approaching zero after having been in negative territory since the collapse.



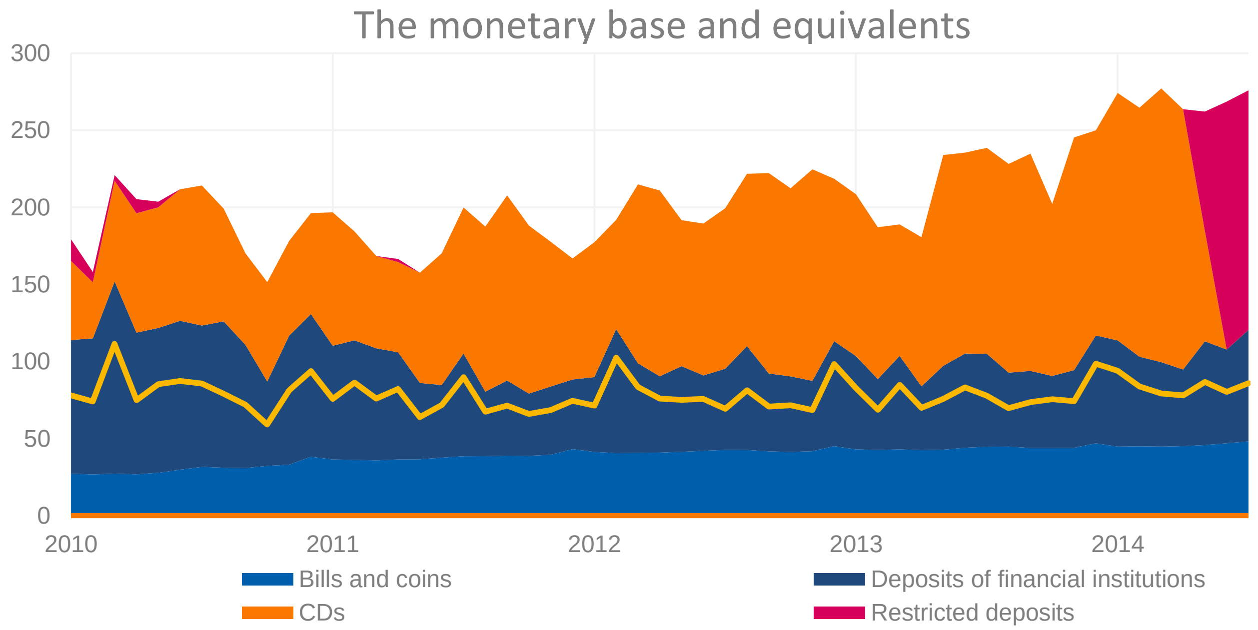
Sources: CBI, Arion Research calculations

At its peak in 2009 the net foreign debt of the bank amounted to over 190 bn.ISK. At the end of July 2014 the CBI held foreign debt in excess of foreign assets in the amount of approximately 5 bn.ISK. In addition, substantial assets on the CBI's balance sheet, (e.g. multicurrency loans in relation to the new banks' takeover of collateralized loans as well as claims on insolvent financial institutions in the CBI's Holding Company (ESÍ)), will most likely be resolved in foreign currency. However, these assets are not counted as foreign assets on the Bank's balance sheet so one could argue that the CBI has already reached the milestone of having accumulated unleveraged reserves.

Holding reserves is not completely free of charge

In general, adequate reserves increase trust in the economy the most when market participants believe that the Central Bank will intervene when need be, and in turn increased trust in the economy reduces the need for such intervention. It is therefore good news that the Bank has managed to accumulate reserves, especially if liberalization of the capital account is on the government's agenda in the coming months. However, even though the level of reserves is rather high, its degree of leverage decreases its usefulness. The CBI is hardly willing to deplete its reserves to defend the currency if such operations result in a mountain of foreign debt.

Although the accumulation of reserves is definitely a positive step, it is not completely free of charge. The Bank must purchase its FX in the interbank market by increasing its debt to the financial system in ISK. The Bank's FX purchases therefore increase the monetary base (or its equivalent) even though the effects are mitigated to some extent by restricting a large part of the cash for up to a month. Additionally, the CBI has sold about 30 bn.ISK worth of its Holding Company's (ESÍ) assets. The plan is to securitize about 103 bn.ISK worth of ESÍ's assets and sell about 20 bn.ISK worth each year over the coming five years, thereby mopping up some of the excess liquidity.



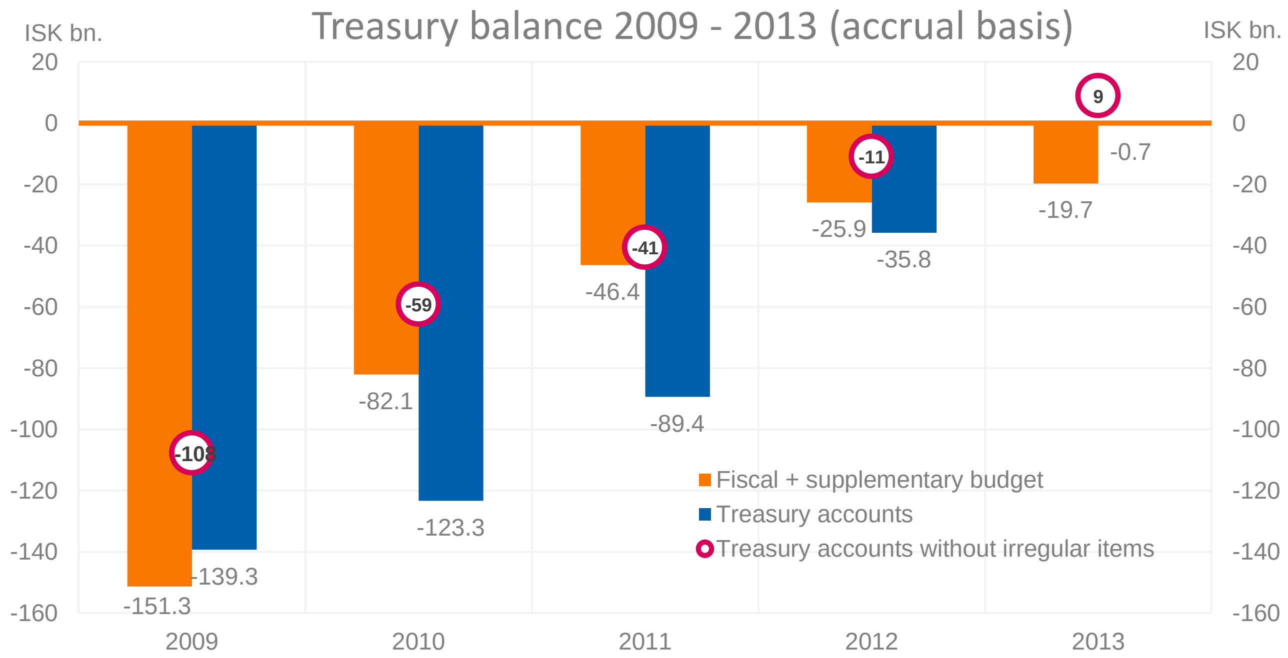
Source: CBI

According to the CBI governor, Már Guðmundsson, in a recent Q&A session there is little cause for concern over excess cash in the system. He claims that the CBI has managed to completely neutralize the FX intervention, pointing out that otherwise we would have seen the effects of excess cash in interest rates. However, we would like to point out that the restricted deposits he is referring to are only restricted for 30 days, so the effects are not completely neutralized if you look at a longer time horizon. Már added that the CBI cannot affect the real exchange rate, except in the short term (potentially up to two to three years). If there is downward pressure on nominal rates we would end up with higher inflation, which is something the CBI needs to be very aware of. According to Már the CBI has struck a balance in this regard.

Government Accounts for 2013 much better than anticipated

Government accounts for 2013 were published in mid-August and the results were considerably better than previously expected. The 2013 supplementary budget had assumed a deficit of 19.7 bn.ISK, while the deficit ended up being about 19 bn.ISK smaller, or 732 m.ISK. For comparison the results for 2012 were a deficit of 35.8 bn.ISK. The deviation from expectations can largely be explained by irregular items, mainly due to a 24.9 bn.ISK increase in the value of the Treasury's holding in Landsbankinn hf. as a result of a final settlement between the old and the new Landsbanki.

The effect of irregular items on government accounts in recent years has been quite large so even though we have seen sizeable deficits as a result of one-off expenses government finances look like they are heading in the right direction.

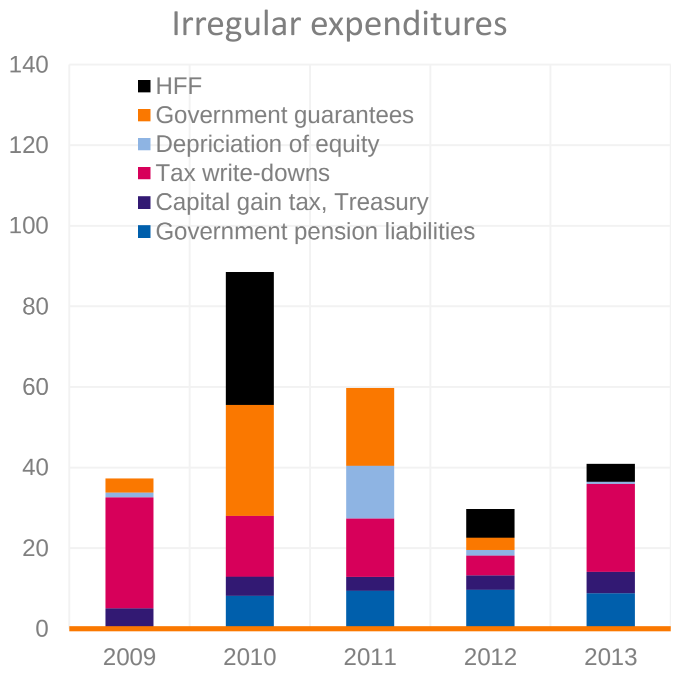


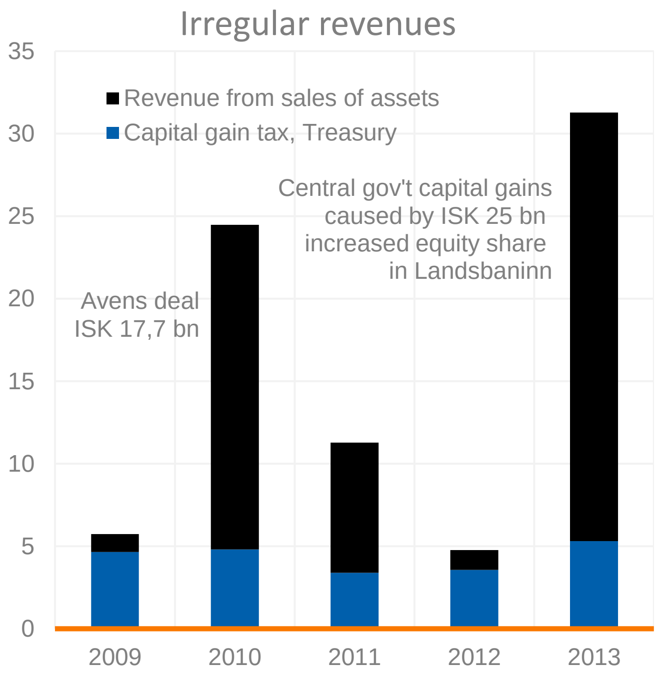
Sources: The Financial Management Authority, Ministry of Finance and Economic Affairs

A positive underlying trend when excluding irregular items

In order to get a good sense of the underlying management of the Treasury it can be useful to look past these irregular items and examine how the outcome has been developing. In the graph above the circles demonstrate how the Treasury's balance over the last five years has developed when irregular items are excluded and should, therefore, show how the underlying performance of the Treasury management. From that point of view the Treasury had a surplus of 9 bn.ISK in 2013, which is an improvement of 20 bn.ISK from the previous year. If we look back to 2009 we can see that management of the Treasury has been improving every year with the latest account showing a 117 bn.ISK improvement from 2009.

The graphs below attempt to clarify what falls under "irregular items" and list which items have been subtracted on the income- and expense side when evaluating the underlying management of the Treasury. On the expense side we can see that written-off equity contributions to the Housing Financing Fund weigh heavily on the results and account for about 45 bn.ISK over the last 5 years. Additionally, accrued government guarantees in 2010 and 2011 account for approximately 47 bn.ISK, mainly due to the old Landsbanki and the merger of SpKef and Landsbankinn.



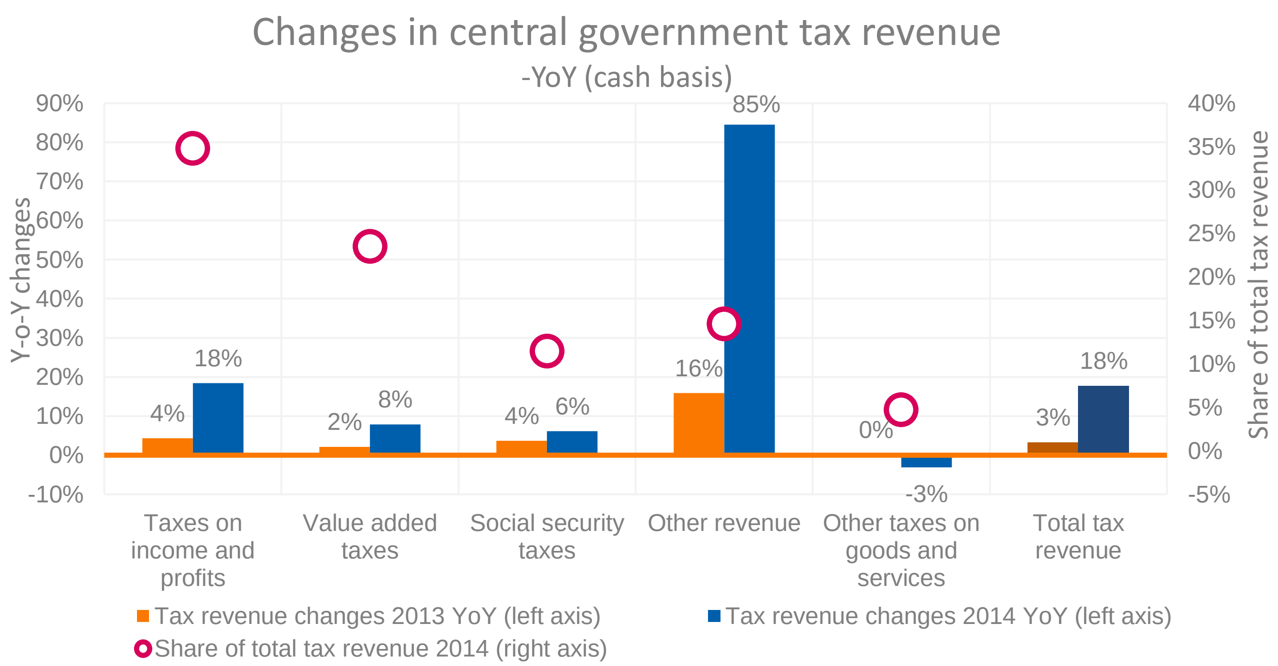


Sources: The Financial Management Authority, Ministry of Finance and Economic Affairs

Other expense items are for example write-downs of equity stakes, write-offs of tax claims, pension obligations and the capital gains tax of the Treasury. The largest irregular income item is the sale of tangible assets and income from liquid assets. The largest items in that category are the Avens agreement, which resulted in income of 18 bn.ISK for the Treasury, and the recent increase in the Treasury's share in Landsbankinn.

First half of 2014 shows positive results

In the first 6 months of this year the Treasury is being run with a surplus of about 13 bn.ISK on a cash basis. Part of the reason for good results in the first half of 2014 is that all main sources of income are above projections. Irregular items have a sizeable effect as well, with a dividend payment from Landsbankinn accounting for the bulk of the deviation.



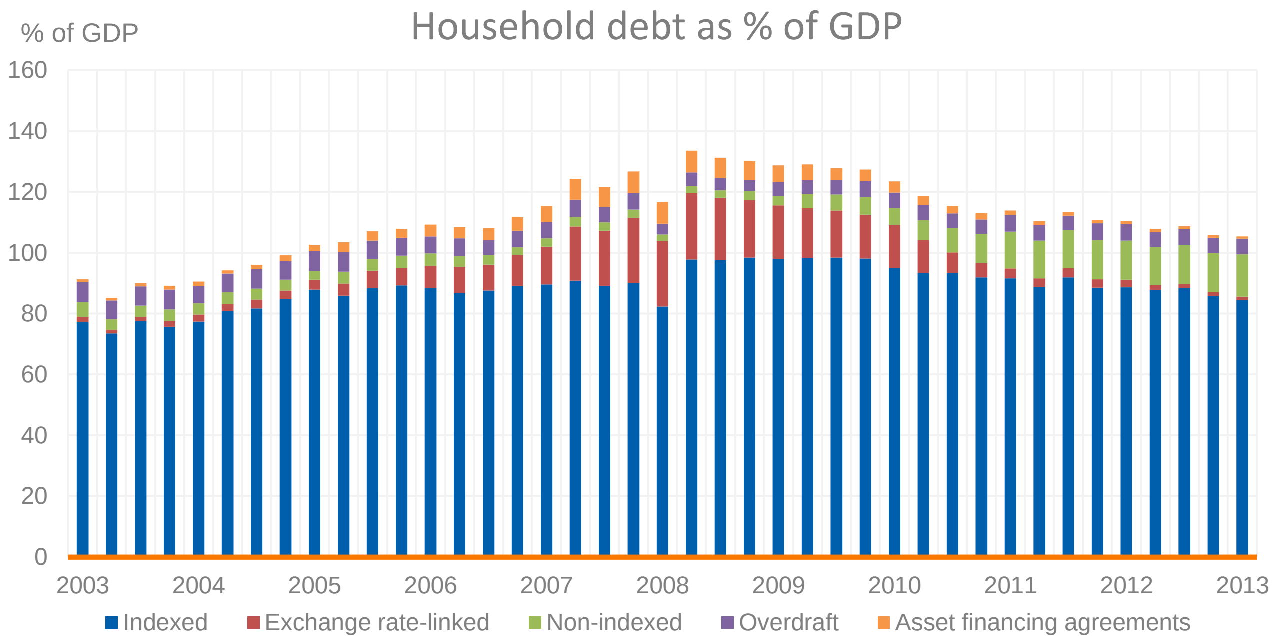
Source: Ministry of Finance and Economic Affairs

Looking past irregular items the Treasury is close to being run with a zero balance in the first half of the year. Whether we take the dividend payments into account or not the results are beating expectations since the budget assumed a deficit of 10.5 bn.ISK in the period on a cash basis.[1] The settlement of accounts for the first half of the year is therefore a good indicator for a positive result in 2014.

[1] It should be noted that the budget for 2014 assumed a 500 m.ISK surplus on an accrual basis and a 10.5 bn.ISK deficit on a cash basis. These are two different accounting methods and in order to compare the settlement of the Treasury's accounts for the first 6 months of the year to numbers in the budget we must look at the cash basis.

EFTA Court deems price indexed loans in accordance with EEA regulations

In late 2013 Icelandic courts requested an Advisory Opinion of the EFTA court regarding the indexation of mortgage loans in Iceland and whether the terms of such loans should be viewed as “unfair“. Given the fact that Icelandic courts have never ignored the opinion of the EFTA court this result had the possibility of having a large impact on all pending and possible future cases regarding such loans, which were and remain very common in Iceland. As can be seen in the picture below, price indexed loans comprise the majority of all loan agreements in Iceland, currently accounting for over 80% of GDP.



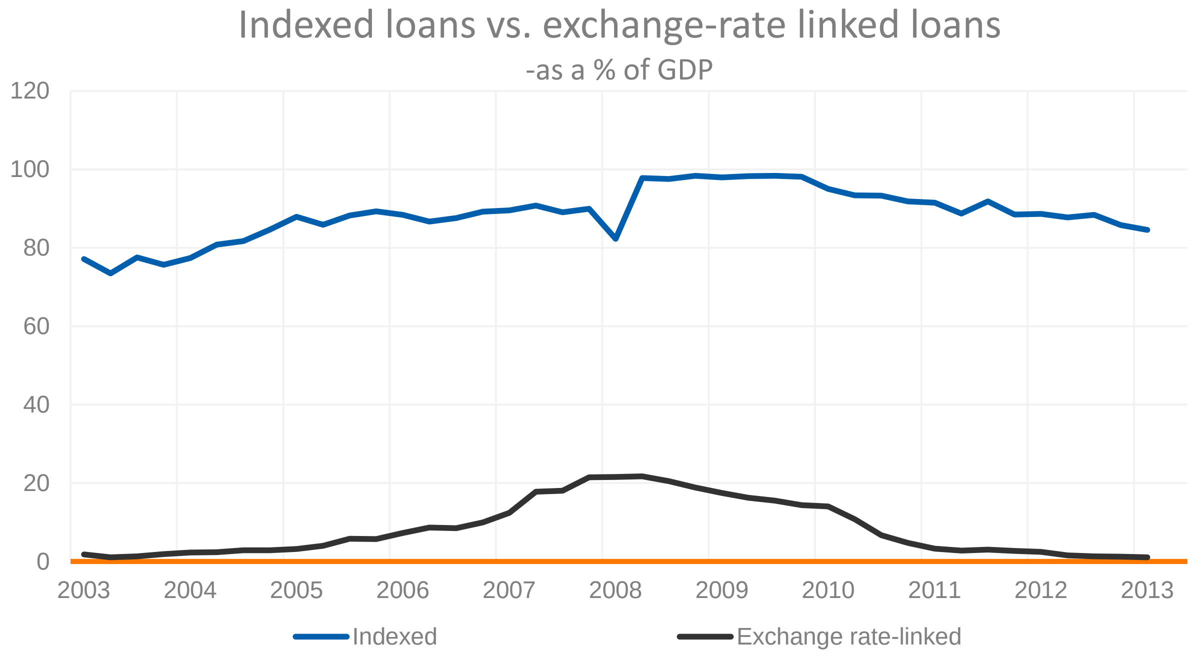
Sources: Statistics Iceland, CBI

In the case currently pending in Icelandic courts, Gunnar V. Engilbertsson v. Íslandsbanki hf., the plaintiff argues that the financial risks of the indexation mechanism and high inflation had been very difficult to understand given the terms of the agreement. According to him, the payment schedule described in the contract did not reflect a realistic scenario of how the principal and instalments could develop.

In relation to this case, the Reykjavík District Court posed five questions for the EFTA court in October of 2013, to which they have now provided answers. In short, the EFTA court does not view price indexation as prohibited per se (which is what was largely expected by our legal experts) and also concludes that national courts must decide on the legality of the specific terms of the indexed agreements. The case will now resume in Icelandic courts, but a final verdict is not expected until sometime in the fall of 2015.

Another case, which is more likely to cause a stir, is pending before the EFTA court. In addition to the five questions already posed in the previous case, an additional question is asked regarding the legality of using a 0% inflation rate as a benchmark when presenting the cost of credit to the consumer. Although the court has not published the date of the ruling results are expected in October of this year.

Should Icelandic courts find that price indexation was an illegal contract form or that a 0% interest rate should not have been used as a benchmark we might see a process similar to when exchange-rate linked loans were deemed illegal. Although the specifics of the recalculation of those loans remain contested to this day the general rule was that anything charged beyond the interest rate on the loan was recalculated to reduce the principal of the loan up to the ruling in 2010. After that the CBI rate applies to all the loans throughout the remainder of the loan period, which should be shortened due to the accelerated reduction in principal.



Source: Statistics Iceland, CBI

At its peak, exchange rate-linked loans amounted to about 20% of GDP while indexed loans have been in the range of 80-100% of GDP over the past decade. Given the scope of the price indexed agreements, compared to the exchange-rate linked ones, and their variability and complexity we could expect a flood of court cases over the next years if Icelandic courts find that the contract form or even specific terms were not in accordance with Icelandic laws. It is safe to say that the cost to the Icelandic economy related to such a ruling would be gigantic. Given the EFTA Court's recent Advisory Opinion the likelihood of such a ruling has been drastically reduced.