

### **Icesave: A farewell to uncertainty**

- The EFTA court pronounced its judgment on the Icesave case yesterday. The court dismissed all pleas brought by the EFTA Surveillance Authority, and the ruling represented an outright victory for Iceland. Of the thirteen court cases brought by ESA against Iceland on behalf of EFTA through 2011, this is the first time that Iceland has emerged victorious. This eliminates all uncertainty associated with the resolution of the Icesave dispute in the last few years, which has, as we will see below, been damaging to the Icelandic economy. We expect the judgment to have a positive effect on the domestic economy.

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This was a declaratory judgment in which the court ruled on the following points:

1) The violation of the EEA agreement by the Icelandic deposit guarantee fund. The court was of the opinion that the Icelandic authorities did not contravene the deposit guarantee directive by not ensuring that Icesave depositors were paid from the depositors' and investors' guarantee fund (TIF) no later than 2009.

2) Discrimination. Icelandic deposits were placed in the new operational Landsbanki while foreign depositors were left with a claim on the estate of the old bank. The court was of the opinion that the Icelandic authorities did not discriminate on the basis of nationality.

In the opinion of the EFTA court, unusual conditions prevailed in Iceland following the banking collapse and therefore the Icelandic authorities were under no duty to fulfill the obligations outlined above. The court also affirmed that as a general rule, governments were not obligated to finance deposit guarantee funds under the directive in place when the old Landsbanki went bust.

### Landsbanki estate has more than enough to cover priority claims

The assets of the old Landsbanki estate are valued at ISK 1,517 billion according to a statement issued by Landsbanki's winding-up committee last November. Priority claims total ISK 1,318 bn. so it appears that it will be possible to pay all priority claims, with a further ISK 200 bn. being available to pay general claims. General claims are valued at ISK 1,600 bn., and therefore it seems that the estate will be able to pay around 12% of general claims.

The estate has already paid ISK 660 bn. to meet priority claims (or approximately half of all priority claims), and of this total ISK 585 bn. has gone to pay claims relating to Icesave (or approximately half of all Icesave deposits which are currently estimated to be ISK 1,166 bn.). It is therefore clear that the estate's assets are more than sufficient to foot the entire Icesave bill.

### Possible implications for Iceland's credit rating

Although it is impossible to put a figure on the damage caused by the Icesave business, it is clear that it has been detrimental to Iceland. For example, the case delayed the introduction of loan facilities from the International Monetary Fund. In addition, it has fuelled uncertainty over Iceland's government debt; for example the IMF estimated in November 2012 that a negative judgment by the EFTA court could cost the Icelandic government ISK 95-320 billion.

Consequently the Icesave business has affected Iceland's credit rating, which is currently, and has been since the crisis began, a whisker away from being rated as junk.

- At **Moody's** the outlook has been negative since July 2010. The agency has noted that the high ratio of public debt limits the authorities' ability to cope with shocks, and it underlined in this context the possible impact of a negative judgment in the Icesave case.
- At **S&P** the outlook was negative from March 2010 until November 2011. One of the reasons the outlook was negative was the risk of a ratings downgrade if an agreement over Icesave was not reached.
- At **Fitch** Iceland's credit rating was put on a watch list in January 2010 following the rejection of the Icesave agreement. The outlook was upgraded to stable in May 2011.

## Comments by rating agencies

All the rating agencies have now responded to yesterday's judgment, one way or another. They agree that the outcome is definitely positive as it removes uncertainty regarding the state of government debt, although the agencies have not responded to the judgment by upgrading their outlook for the Icelandic sovereign.

- **Moody's** said that the court decision was a most favorable outcome, and that Icesave had been figured into assessment of "high" event risk. Iceland's public debt is high, although the debt ratio is on a declining trend.
- An **S&P's** analyst was quoted as saying that the agency had already discounted Icesave as a major risk factor, since the Landsbanki estate was going to be able to cover the majority of the claims either way, so the judgment was apparently not a catalyst for Iceland's sovereign credit rating.
- **Fitch** notes that although the ruling marks a step towards normalising relations with external creditors, and that debt appears to be on a downward trajectory, capital controls remain a major stumbling block.

Although the lukewarm reactions of the rating agencies don't spark hopes of major changes to Iceland's credit rating in the near term due to the judgment (although it will definitely help more than hurt in the longer term), we wouldn't be surprised if sooner or later, Moody's responded by upgrading its outlook from negative to stable.

The Republic of Iceland's sovereign credit rating is as follows:

	<i>Affirmed</i>	Foreign Currency		Domestic Currency		<i>Outlook</i>
		Long-term	Short-term	Long-term	Short-term	
<b>Moody's</b>	<i>Jul. '10</i>	Baa3	P-3	Baa3	P-3	<i>Negative</i>
<b>S&amp;P</b>	<i>Nov. '11</i>	BBB-	A-3	BBB-	A-3	<i>Stable</i>
<b>Fitch</b>	<i>Feb. '12</i>	BBB-	F3	BBB+		<i>Stable</i>

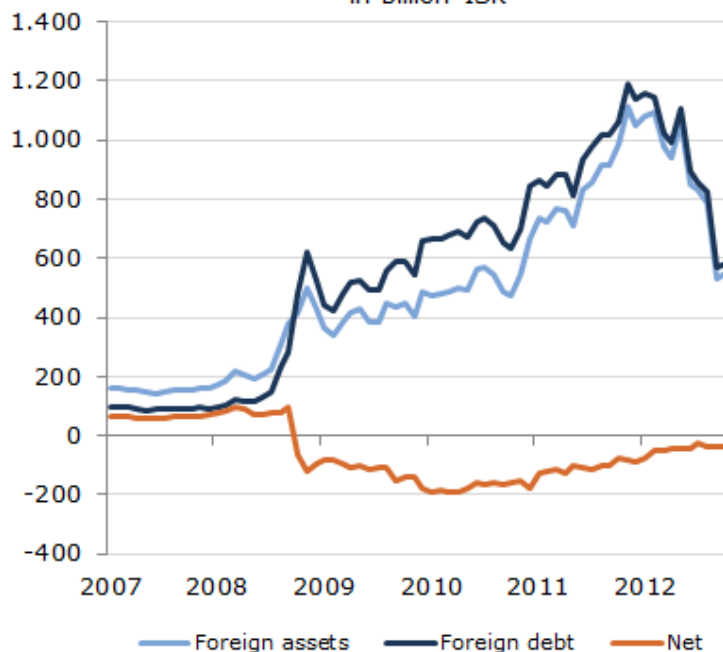
Source: Central bank of Iceland

## What does it all mean for the Icelandic economy?

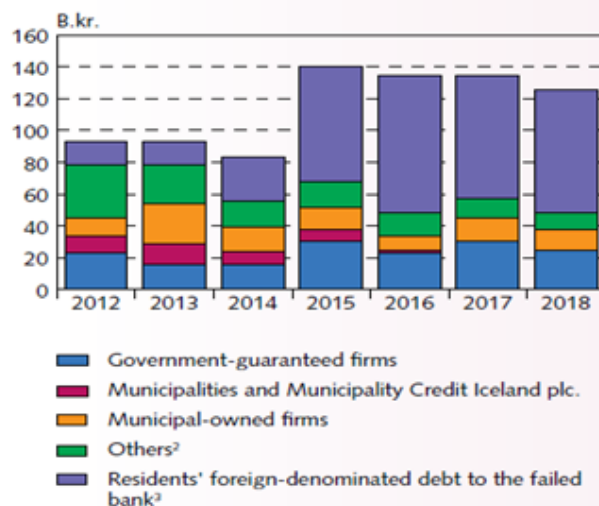
Any uncertainty is bound to slow down economic recovery and yesterday's judgment eliminated a significant amount of ambiguity about the state of Iceland's finances. It is likely that this judgment will facilitate the government's efforts to raise funds abroad, not least since the government held two international bond offerings in 2011-2012 despite the uncertainty over the Icesave business, totalling ISK 240 billion. We wonder what effect the uncertainty over Icesave had on Iceland's credit terms in those issues, and whether yesterday's judgment may improve Iceland's credit terms and even make it easier for Icelandic companies to raise funding in international markets in the coming quarters.

The Central Bank of Iceland's entire currency reserve is borrowed money. Arion Research has previously pointed out the importance of amassing a non-borrowed currency reserve as the interest costs on the reserve total ISK 23 billion a year. It is possible that there will now be less pressure to maintain such a large borrowed reserve, particularly if it becomes easier for Icelandic companies and other borrowers who need to make foreign loan repayments in the near future to seek refinancing.

**Net foreign position of central bank**  
- in billion ISK



**Chart 4**  
Estimated instalments on non-Treasury foreign loans<sup>1</sup>



1. All figures in b.kr. based on 31.12.2011 exchange rates. 2. Excluding DMBs in winding-up proceedings and Actavis. 3. Debt service on around 20% of the portfolio is unknown and therefore estimated.  
Sources: Municipality Credit Iceland plc. annual financial statements, Central Bank of Iceland.

### One step closer to abolishing capital controls

Yesterday's judgment is very good news for the Icelandic economy, the treasury and for investors. An unresolved Icesave case and the possibility that the government would need to assume huge debts in foreign currency has had a significant effect on Iceland's rating and the value of Icelandic assets. All forecasts on Iceland's foreign debt have contained provisos on Icesave.

By removing the Icesave-variable from the equation, plans to reduce Iceland's foreign debt can be made on more solid ground. It is therefore more likely that Icelandic and foreign long-term investors will be confident enough invest in the Icelandic economy, and they will require a lower premium on their investment.

This all means we are a step closer to lifting the capital controls. The reaction from the bond market yesterday shows that investors already rate government debt to be a better investment option than it was before; the yield on longer treasury notes had fallen 10-20 bps at the closing bell yesterday. The fact that the amount of government bonds available to investors will be lower than it otherwise would have been, since no new debt will have to be issued to cover the British and Dutch claims, is also a factor in this respect. The judgment also implies that the Central Bank will not be forced to hike interest rates as much to attract and retain foreign capital in Iceland.

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