ICELANDIC ECONOMIC UPDATE

Arion Bank

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The National Treasury refinances

The Icelandic government issued its first EUR denominated bond since 2006 and used the funds to pay down the Nordic loans that remained since the financial collapse in 2008. The refinancing of these loans could save the government about 400 million ISK annually. Iceland is now close to having fully refinanced its post-crisis debt in international financial markets.

IMF post program monitoring – lifting the capital controls

In its fourth post program monitoring discussion the IMF finds that medium-term growth prospects for Iceland are positive. IMF staff believes that gradual lifting of capital controls will begin taking place in 2017, after certain preconditions have been met. However, they conclude that the complete removal of controls extends well beyond their forecast horizon.

The bank tax – a drain on the estates' ISK reserves

The new bank tax of 0.376%, which is imposed in ISK, could cause the bank estates' ISK assets to deteriorate rather quickly. The tax is a major expense item in addition to domestic operating expenses, or approximately 28 bn. ISK per year according to Arion Research calculations.

Advisors to assist in the removal of capital controls

The Ministry of Finance and Economic Affairs has stated that one of the most important tasks the current government faces is the removal of capital controls. A comprehensive solution to the threats facing the Icelandic economy must be found before controls can be lifted so the stability that has been achieved may be maintained. In July the Ministry announced that it had reached an agreement with advisors in the capital account liberalization process.

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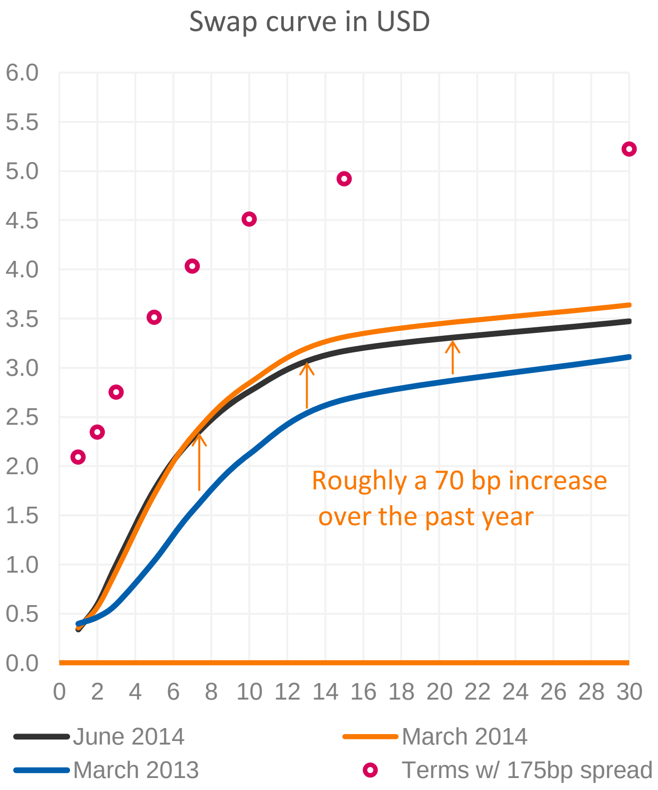
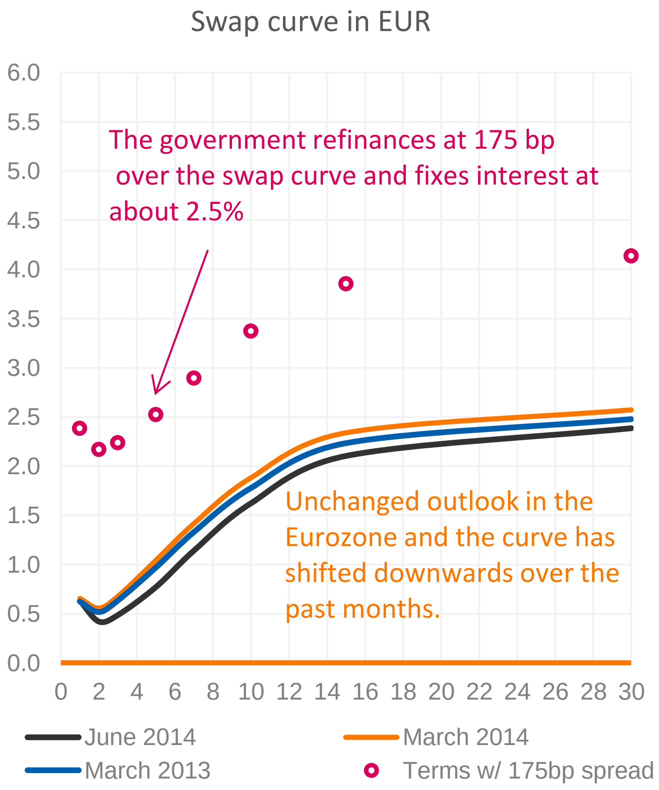
The National Treasury refinances

On July 8th the State Treasury concluded agreements on a bond issuance in the amount of 750 million euros, its first euro bond issuance since 2006. The bond is a 6-year, 2.5% coupon bond with a yield of 2.56% at the time of auction. There was considerable interest in the issue, with total bids amounting to about 2 billion euros, primarily from institutional investors in Europe and the US. Since 2008 the Treasury has had two other foreign issues, both in USD. In June of 2011 a bond with a 5 year maturity and a yield of 4.993% was issued in the amount of 1 bn. dollars while in May of 2012 a bond with a 10 year maturity and a yield of 6.0% was issued, also in the amount of 1 bn. dollars. The issue was in accordance with the government's debt management strategy, which seeks to broaden the investor base and ensure longer-term access to foreign credit markets.

Following the financial collapse in 2008 the Nordic countries provided bilateral loans to Iceland, in relation to the economic recovery program agreed to by the Icelandic government and the IMF, in the amount of 1.775 million Euros. The latest auction was held to facilitate the refinancing of the remaining loans in the amount of 735 million euros. The refinancing had no net effect on the combined debt portfolio of the Treasury and the Central Bank, but the Treasury's debt increased by 1.9% of GDP due to the fact that part of the funds from the bond issuance went towards paying down debt that was on the CBI's books.

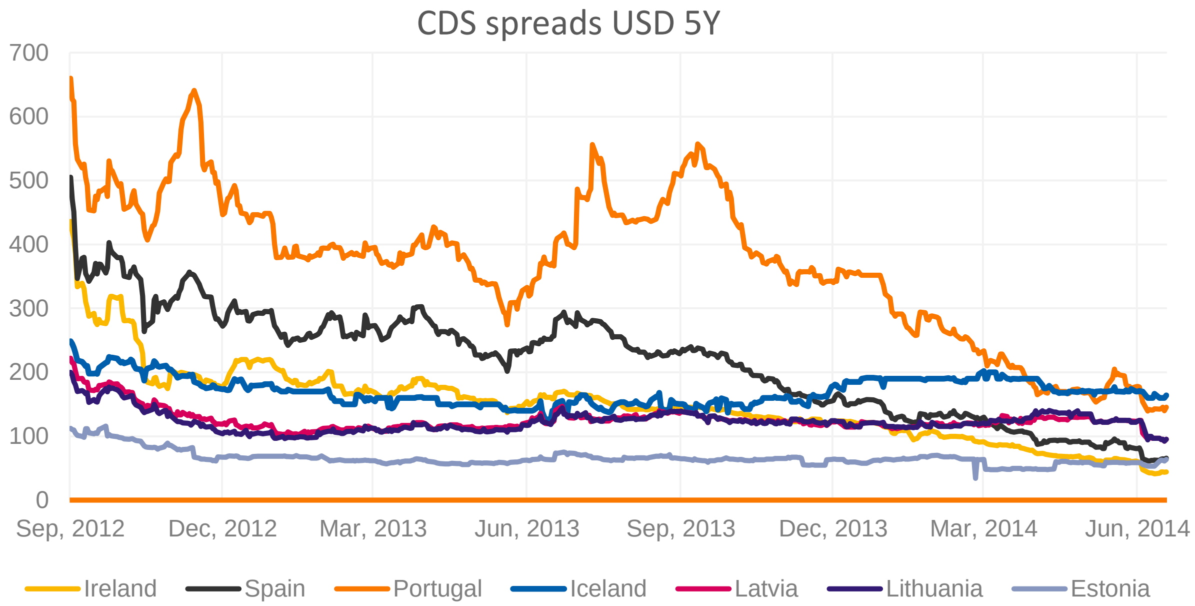
As can be seen in the graphs below the interest terms were 150-175 points above the euro swap curve. Seeing that the yield curves in USD and GBP have shifted upwards by 70-90 points over the past year while the EUR curve has stayed mostly the same, it seems sensible from a debt-management perspective to fix longer term interest rates at favorable terms in euros. Assuming the same risk premium, the Treasury would have been able to get an interest rate of 3.5% in USD and 3.9% in GBP.





Source:Bloomberg

Iceland's sovereign CDS spread stood at about 160 basis points, so a 150-175 premium compared to the swap curve seemed reasonable. When compared to other countries' 5-year USD risk premia at the time of the auction, however, the terms were not necessarily as favorable as one might think (assuming the premium is the same for USD and EUR). If we look at other European countries we had the highest risk premium of the ones listed in the graph below (Ireland, Spain, Portugal and the Baltics). Even Portugal, with all its woes, was down to a spread of 145 bp, while Spain had a spread of 66 bp and Ireland a spread of 44 bp. The Baltic countries Lithuania and Latvia were looking at CDS spreads of about 95 points.



Source:CBI, Bloomberg

It should be noted that in the few weeks since the auction this picture has changed somewhat – the risk premia of all countries has edged up a bit while Iceland's has come down. Portugal's CDS spread now stands at 180 bp, Spain's at 67 bp, Ireland's at 52 bp, Latvia's and Lithuania's at 98 bp and Estonia's at 63 while Iceland's has come down to 150 bp.

Savings could amount to about 400 million ISK annually

Loans outstanding	Outstanding debt (bn. ISK)	Interest expense (bn. ISK)
Foreign bilateral loans		
PLN Wibor+2,75% 30 Sept 2022	7.6	0.4
EUR Euribor+2,75% 30 Des 2021 (DK)	30.7	0.9
EUR Euribor+2,75% 30 Des 2021 (FIN)	20.4	0.6
EUR Euribor+2,75% 30 Des 2021 (SWE)	31.6	0.9
A loan from the Central Bank of Norway	31.5	0.9
Total	**121.8**	**3.7**
After refinancing by bond issuance		
PLN Wibor+2,75% 30 Sept 2022	7.6	0.4
Bond with 2,5% coupon	116	2.9
Total	**123.6**	**3.3**
Difference	**1.8**	**-0.4**

Source: Lanamal rikisins, CBI annual report, Arion Research calculations

The only debt left from the IMF recovery program, besides the Polish loan, is the 91 bn.kr loan from IMF, so Iceland has nearly fully refinanced, in international financial markets, the debt resulting from the financial collapse. The next step will likely be the refinancing of the outstanding USD bond that matures in 2016. It is also quite possible that the government will issue more bonds in the coming quarters in order to pay down its debt owed to the IMF.

IMF post program monitoring – lifting the capital controls

A few weeks ago the IMF published its fourth post program monitoring discussion on Iceland. In it IMF staff notes that the Icelandic economy has exhibited strong growth with tourism related exports being the main driver. Private consumption has also been on the rise while unemployment and debt are trending down. Inflation has been close to target and foreign currency reserve accumulation has been facilitated by a strong trade balance so all thing considered medium-term growth prospects are positive.

The IMF assumes that domestic demand's relative contribution to GDP will surpass that of net exports, despite the króna being undervalued by about 8-16% using standard metrics of the IMF. According to their assumptions the low exchange rate of the króna will not prevent a decreasing trade surplus, although increased imports should lead to increased investment in export related industries.

In an annex to the report IMF staff analyze recent developments regarding the capital account liberalization and the balance of payments and note that BoP prospects as well as macroeconomic developments are key factors when deciding on an orderly lifting of capital controls.

According to the IMF the capital controls must be lifted in an orderly fashion over several years so that exchange rate stabilty, liquidity and financial stability may be preserved. IMF staff estimates that should controls be lifted immediately funds amounting to 80%-105% of GDP could seek to exit the economy, mainly domestic holdings of the old bank estates, the offshore liquid króna overhang and funds due to resident portfolio rebalancing.

Possible ISK pressures should controls be lifted immediately according to the IMF (% of GDP)	
Old bank estates	44%
Liquid offshore ISK holdings of nonresidents	18%
Resident portfolio rebelancing	20-45%
Total pressures according to the IMF	**80-105%**

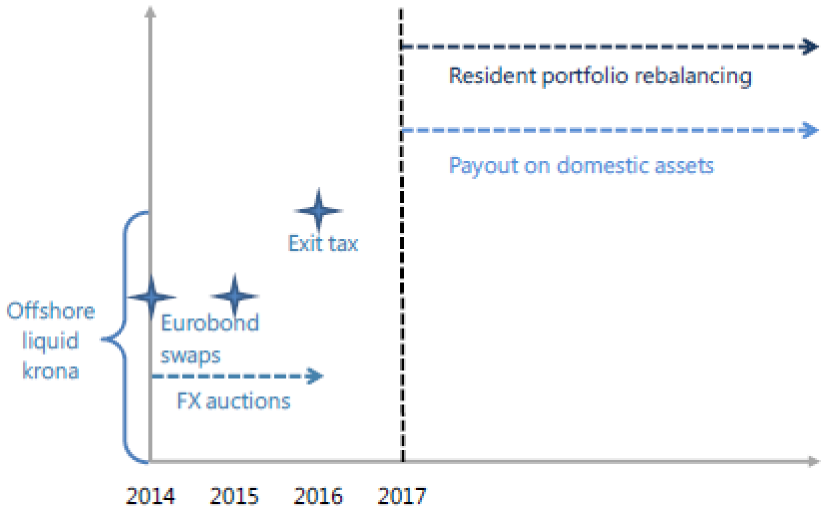
Source:IMF (Iceland, fourth post-program monitoring discussions)

In order to minimize the negative effects of such ouflows on the BoP and economic activity the IMF proposes that certain "speed limits" be imposed.

In the report the IMF lists certain key assumptions, a time frame and possible ways of refinancing.

1. Maturing foreign exchange debt will be rolled over, except for a USD 1 bn. bond maturing in 2016 only half of which will be rolled over.
2. Bonds will be issued to cover the Central Bank's external debt maturing in 2015-2016.
3. Central government entities will have no rollover of debt maturing in 2014, while rolling over 20% of debt in each of the following six years.
4. Local government entities will have no rollover of debt maturing in 2014, while having a 100% rollover thereafter.
5. Municipalities will have no rollover in 2014-2015, while having a 100% rollover thereafter.
6. Banks and other financial institutions will pay down their maturing foreign debt, while other sectors will fully refinance.

By year-end 2016 the IMF believes that all offshore liquid ISK holdings may be released and FX auctions are assumed to remain operational until then. In addition they assume that two long Eurobonds will be issued (in 2014 and 2015), and swapped for ISK assets held by nonresidents. At year-end 2016 the remaining offshore ISK will then be subject to an exit levy. These transactions are assumed to take place at market exchange rates, a conservative assumption given the fact that past FX auction rates have been at a discount of 15-35% to the market rate.



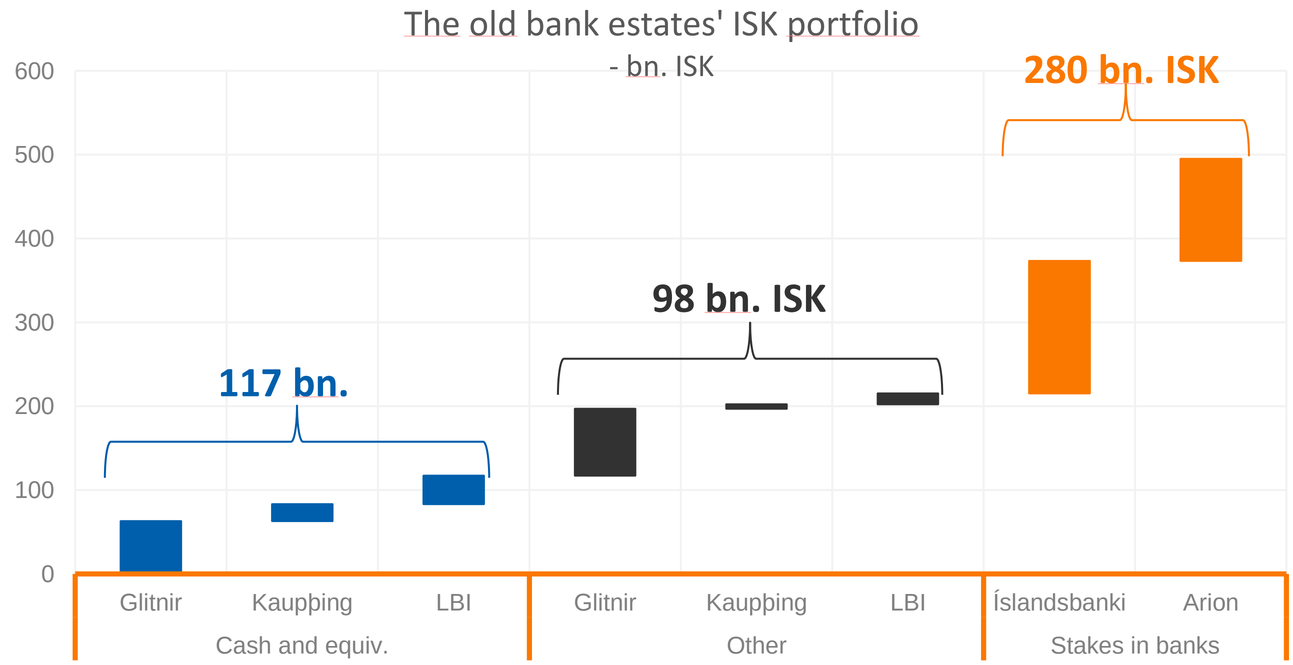
Source: IMF

In 2017 the IMF believes that the gradual lifting of capital controls will begin taking place. Certain conditions will have to be met before then; a substantial decrease in the amount of offshore ISK, sound public finances, access to international financial markets, and a strong financial sector. However, the discussions are concluded with these remarks: “The BOP analysis suggests that a complete removal of controls would extend well beyond our forecast horizon.”

The bank tax – a drain on the estates' ISK reserves

One of the major problems related to the settlement of the old bank estates is that a large part of their assets is in ISK. Since about 94% of the claimholders of the banks are foreigners the general belief is that they would like to exchange these krónur for FX as soon as they are paid out. An outflow of currency of that magnitude through the FX market could potentially cause a sharp depreciation of the ISK.

The largest part of this problem is due to the shares of Glitnir and Kaupthing in Íslandsbanki and Arion bank in the amount of 280 bn. ISK. In addition to those there are about 215 bn. ISK of other holdings – about 117 bn. ISK in cash and cash equivalents and 98 bn. ISK in loans to the old banks' customers, derivatives and other securities.

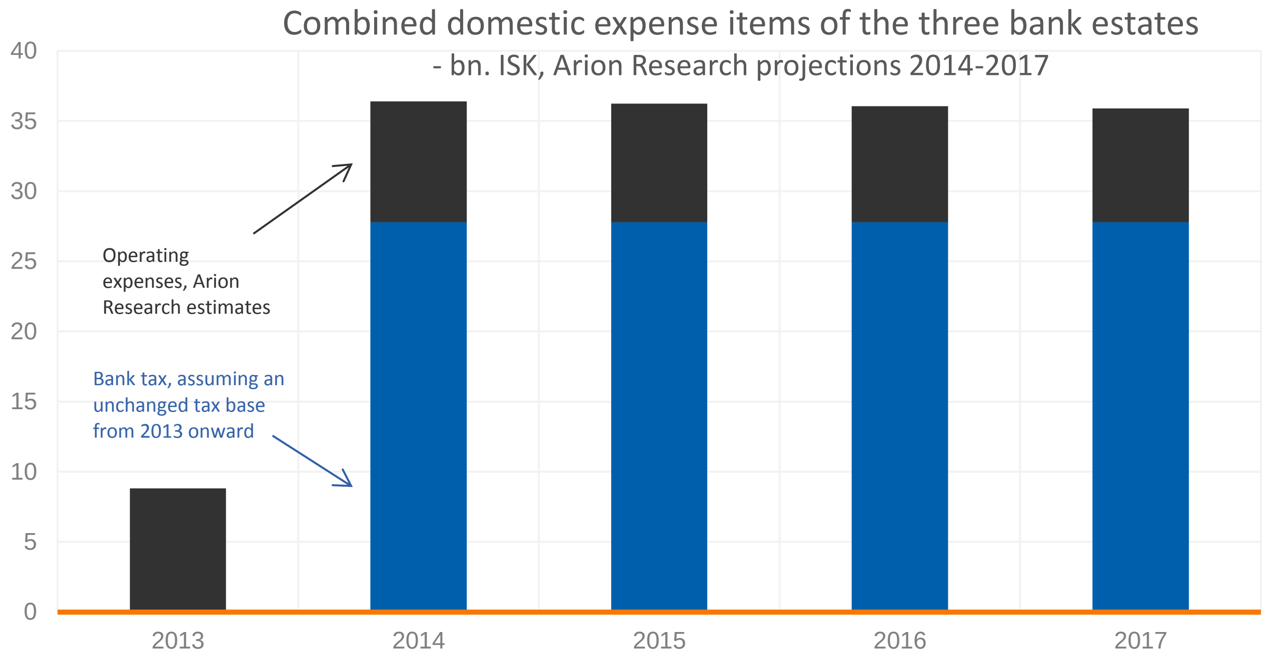


Source: Estates' financial statements, CBI

This risk could be mitigated to a large extent by selling the bank stakes to foreign investors for currency. We were pleased to see that the minister of finance agreed in a recent interview in Kjarninn. Pressure could nevertheless build up when the owners of the banks receive dividend payments, which would, in all likelihood, be exchanged for foreign currency. However, their repatriation would be spread over a longer period, possibly with some restrictions imposed by the government. This could drastically reduce the risk of sudden large outflows and a sharp depreciation of the króna.

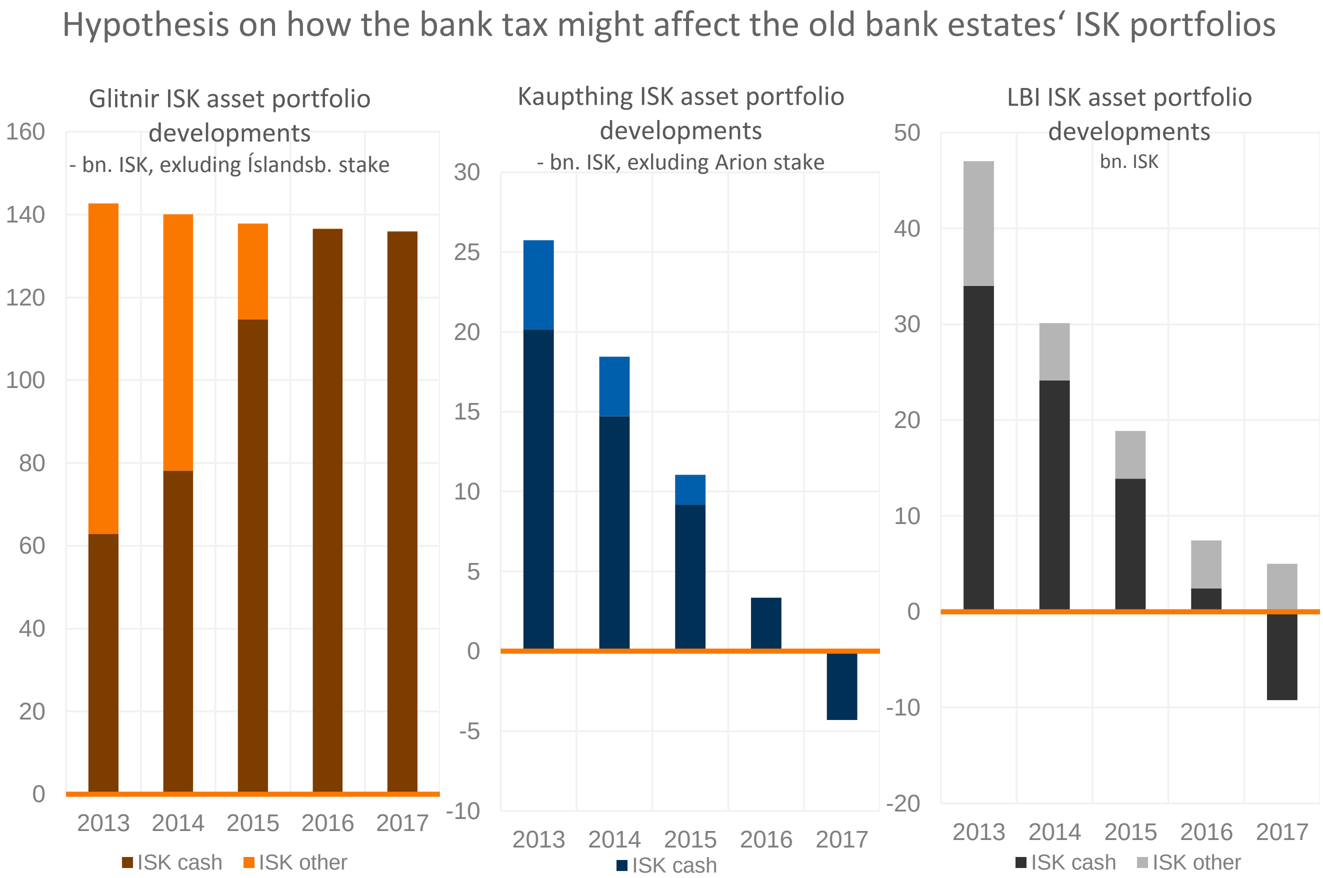
Other króna holdings could still pose some problems. Should shares in the banks be sold for currency the main question would be how these other holdings would be treated. Even though the hope is that the negotiation process will not be dragged out too much it is interesting to see how much of an effect the recent change in the bank tax will have on the old bank estates.

The new tax of 0.376%, which is payable in ISK, could reduce the estates' ISK assets rather quickly. The tax is a major expense item in addition to domestic operating expenses, or approximately 28 bn.ISK per year according to Arion Research calculations.



Source: Arion Research estimates, based on estates' financial statements

In the graphs below we hypothesize about how these expenses will affect the ISK assets of the estates. In order to do so we looked at the business plans of the estates so we could estimate how quickly their domestic ISK assets can be monetized. We also assume that their cash holdings will collect some interest over the period. In addition, we assume that Glitnir and Kaupthing will receive a a similar dividend in 2015-2017, from their shares in Íslandsbanki and Arion banki, as they will likely receive in the current year. According to Arion Research calculations the dividend could amount to close to 12.5 bn. after taxes. Estimating how the ISK assets will be affected if dividend payments are either higher or lower than assumed is straightforward.



It is worth noting that when a column marked "liquid ISK holdings" is negative, it means that the estate is forced to sell foreign currency for krónur in order to make good on their ISK payments. This could turn out to be the case for Kaupthing and LBI as of 2016 if the estates will not have been resolved by that time. Other things equal, the bank tax could wipe out a substantial amount of the estates' ISK holdings over the next four years, absent some solution before that time.

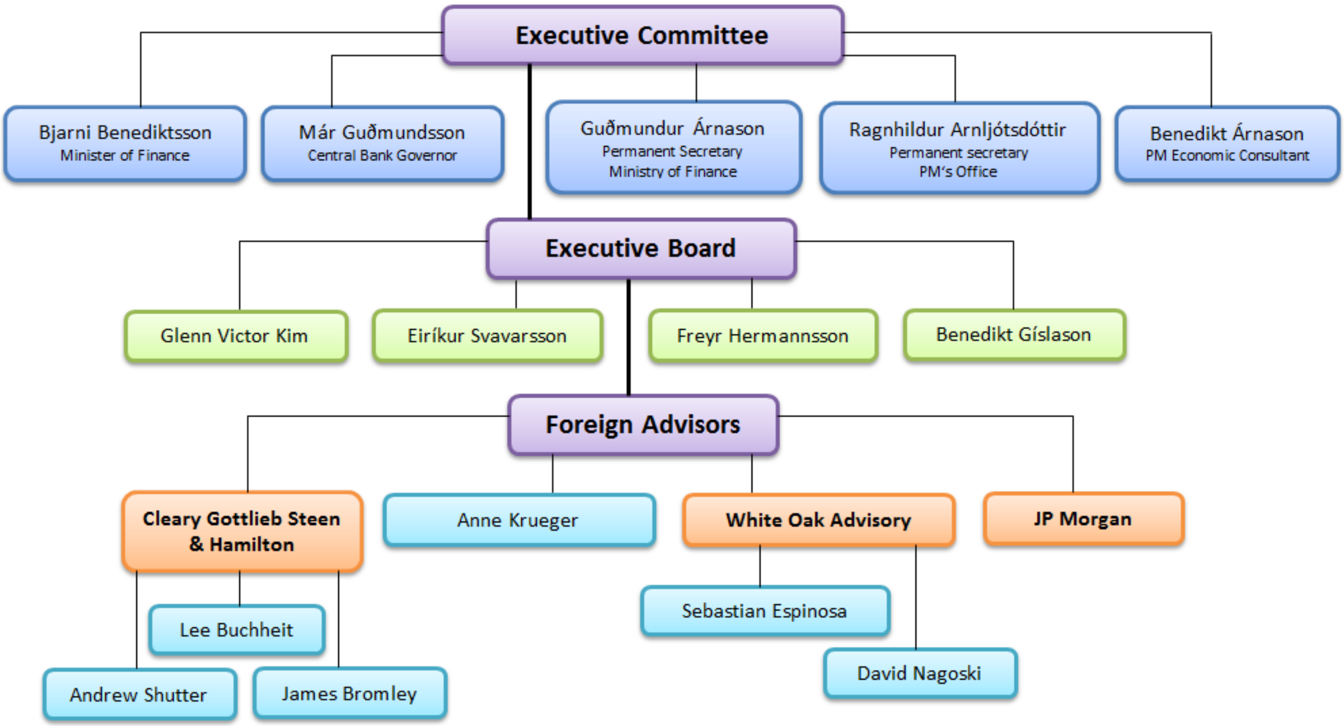
Advisors to assist in the removal of capital controls

The Ministry of Finance and Economic Affairs has stated that one of the most important tasks the current government faces is the removal of capital controls. A comprehensive solution to the threats facing the Icelandic economy must be found before controls can be lifted so the stability that has been achieved may be maintained.

Last fall the government began an effort to update its capital account liberalization strategy. Six consultants were appointed to evaluate the status of the national economy and provide possible solutions to the obstacles on the way to the successful abolition of controls, such as the settlement of the old banks' estates. The CBI, at the behest of the government, also provided a multiple-scenario analysis of the effect on the balance of payments should nonresident króna holders be allowed to repatriate.

On July 9th the Ministry of Finance and Economic Affairs then announced that it had reached an agreement with legal firm Cleary Gottlieb Steen & Hamilton LLP and consultants White Oak Advisory LLP to assist in the capital account liberalization process. Attorney Lee Buchheit of Cleary Gottlieb, a sovereign debt restructuring veteran, will be directing the legal office's work on the project. Additionally, Anne Krueger, former deputy managing director of the IMF, will provide advice regarding the macroeconomic requirements for the removal of controls and JP Morgan will assist in relation to Iceland's sovereign credit rating.

The Minister of Finance has also formed a four-person executive board to work with these advisors. The board members are Benedikt Gíslason, advisor on capital controls to the Minister of Finance, supreme court attorney Eiríkur Svavarsson, Freyr Hermannsson, head of the CBI's treasury section, and Glenn Kim, special advisor and leader of the project.



The findings of the aforementioned consultant group, as well as the CBI's BOP analysis, will reportedly be used as the foundation on which the newly hired advisers base their liberalisation strategy advice. One of the first tasks in this project is the preparation of a list of conditions that must be met, in order to preserve macroeconomic stability, when applying for an exemption from the capital controls. White Oak Advisory and Anne Krueger will lead that effort.

Should the winding-up boards of the old banks' estates fail to propose timely (within three months) solutions consistent with these macroeconomic conditions it should be clear that all attempts to negotiate the resolution of estates have failed, in which case other routes will be explored, according to Morgunblaðið's source. One possible route could be to isolate the estates using legal means. James Bromley at Cleary Gottlieb, who specializes in global restructuring and cross-border insolvency, will reportedly be advising the government on how that can be achieved while avoiding litigation risk.