Special Comment

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Iceland's amendment to Icesave agreement supports fiscal sustainability

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Executive Summary

In June 2009, the Icelandic government came to an agreement with the UK and the Netherlands to cover the re-payment of their residents' deposits in a failed Icelandic bank, Landsbanki. The agreement, which meant a significant increase in the country's government debt, was met with popular and political resistance in Iceland.

The Icelandic parliament is now in the final stages of amending the agreement. The amendment will place a limit on the government's debt service on an annual basis, as well as providing some insurance if the size of the debt is significantly more than expected. The amendment also formalises a mechanism for renegotiating the agreement if the economic recovery is weaker than forecast.

Moody's considers the amendments to be mildly positive for the government's Baa1 rating. The debt service limits should support fiscal sustainability, although some outstanding challenges mean the negative outlook remains.

Moody's Investors Service

Background: Icesave

Until its collapse in October 2008, former Icelandic bank Landsbanki provided an internet banking service, Icesave, in the UK and the Netherlands. Landsbanki operated this service as a branch under European passport rules, which meant that the responsibility to insure Icesave deposit accounts fell to the Icelandic deposit insurance scheme. When Landsbanki collapsed, it left the Icelandic deposit insurance scheme with a bill for around €4 billion, or 40-50% of GDP[1]. The scheme had net assets of only around €50 million.

The British and Dutch authorities made the initial payments to Icesave depositors in October, but demanded that the Icelandic government guarantee re-payment at a later date. They argued that the Icelandic government, which had guaranteed the deposits of Icelandic depositors when Landsbanki failed, should provide equal treatment to British and Dutch depositors under European law. The Icelandic government, in desperate need of international financial support at the time, felt that it had no choice but to accede.

Public reaction

The formal Icesave agreement between the Icelandic, British and Dutch governments was signed on 5 June 2009. As expected, the agreement states that the Icelandic deposit insurance scheme is liable for the funds paid out to British and Dutch depositors in 2008. The deposit insurance scheme will use assets recovered from the liquidation of the former Landsbanki – estimated at around 75% of the Icesave debt – to re-pay as much as possible. The loan carries an interest rate of 5.55% per annum with a 15-year term and a seven-year grace period. The Icelandic government will guarantee the entire debt, effectively taking responsibility for the difference between the value of the debt and the value of the recovered assets[2].

The public's reaction to the agreement was tepid at first, but gradually came to the boil over the following ten weeks, as it was debated by a legislative committee. There was a keen awareness that Iceland was both agreeing to pay a significant sum and assuming some risk that the recovered assets were substantially below the estimated amount. There was also a related risk that the deposit insurance scheme's priority claim on the former Landsbanki's assets (enacted hastily in September 2008) would be successfully challenged in court.

The amendment

In reaction to escalating public opposition, the Icelandic parliament has decided to add an amendment to the Icesave agreement. The Prime Minister of Iceland, Johanna Sigurdardottir, has stated that the British and Dutch authorities have been kept informed of the amendment. Hence, Moody's assumes that the two governments will not object to the amendment and the agreement will soon be finalised.

The amendment has several aspects, including confirmation of the sovereignty of the Icelandic government over Iceland's natural resources, and its right to re-negotiate the agreement if there is a legal ruling in the future that says European governments are not liable for cross-border deposit insurance claims. However, from Moody's perspective, the three most important aspects are as follows:

1. Affirmation that the British and Dutch governments will comply with a substantiated and reasonable request by Iceland to revise the agreement. This would allow Iceland to re-negotiate the agreement if its economy remains weak for longer than expected, and/or if the recovery rate of Landsbanki's assets is significantly lower than currently assumed.

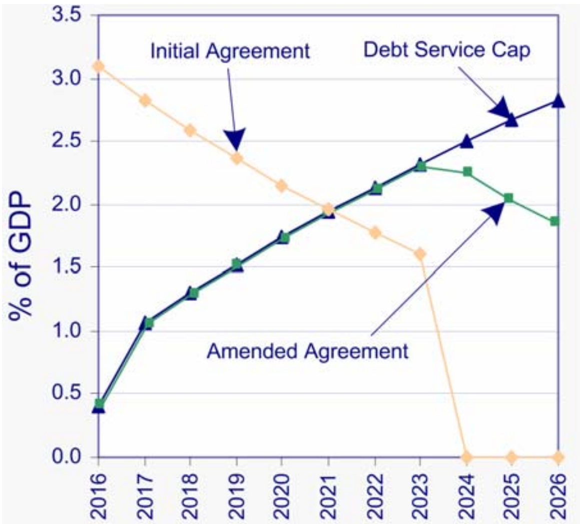
2. Affirmation that the agreement is conditional upon legal confirmation of the deposit insurance scheme's priority claim over the former Landsbanki's assets. This is an insurance clause in case the Icelandic government is unsuccessful in defending the deposit insurance scheme's priority claim on the former Landsbanki's assets in court. Moody's understands that numerous aggrieved creditors of the former Landsbanki are mounting legal challenges against the Icelandic government. The clause stipulates that

[1] Depending on the exchange rate and GDP assumptions used.
[2] Assuming a 75% recovery ratio for the Landsbanki assets, the net present value of the government's portion of the loan is around €1.3 billion, or 17% of 2009 GDP, according to the central bank.

the Icesave agreement would be re-negotiated if the priority claim was lost and the assets available to cover the debt were significantly reduced.

3. Limits on the size of the debt repayments. Debt service will be capped at 4% (for the UK) and 2% (Netherlands) of GDP growth in foreign currency terms between 2008 and the year of repayment. This clause effectively extends the amortisation period of the Icesave loan by several years. By Moody's calculations, such limits are likely to force the parties to extend the term of the loan by around two years, until 2026. The result is that debt payments would gradually rise, and then fall, as opposed to following the "front-loaded" form of the initial agreement.

Exhibit 1: Estimated cost of ICESAVE agreement for Iceland



Source: Moody's and Central Bank of Iceland

The chart above shows Moody's estimation of how the debt service profile could be altered by the amendment. According to the initial agreement, payments would be nearly 3.1% of full-year GDP in 2016, gradually declining to 1.6% in 2023, when the loan would be fully re-paid. Under the amended agreement, the debt service limits would be binding until about 2023, when debt service would likely peak. Debt re-payments would then decline over the next two years, by which time the loan would be fully re-paid[3].

Mildly positive for rating

Moody's views the Icesave amendments as mildly positive for the government's rating. By flattening the debt payment profile, the government will gain more time to repair its financial position. There is also less risk of a shock jeopardising the government's creditworthiness in the earlier stages of re-payment. Although the absolute value of the debt re-payments will be higher under the amended agreement, the net present value of the two payment profiles is approximately the same.

The first and second clauses (highlighted above) formalise what we assume was already an implicit understanding between the three negotiating parties. Debt between sovereign governments is typically different from market debt, in that it is often restructured or forgiven for political and/or economic reasons. Moody's always assumed that the Icesave debt would be treated similarly – that is, that it would be renegotiated if the Icelandic economy did not enjoy a robust recovery, or if the size of the debt became materially larger. Arguably, however, the inclusion of such clauses in the agreement slightly strengthens the Icelandic government's bargaining power if such an event was to occur.

[3] As we are analysing a period in the very distant future, it is important to note that these forecasts, while based on reasonable assumptions, are largely speculative.

Passage of the Icesave bill is also likely to finally lead to a completion of the IMF's first review of the stand-by arrangement. The review has been delayed by a large number of factors, including the requirement for Iceland to gain access to additional financing from third parties. While the Nordic governments have agreed to a €1.7 loan in principle, it seems that completion of the loan is somehow tied to finalization of the IMF review and resolution of the Icesave matter. Moody's now expects Iceland's IMF review to progress to the executive board in September, which means the next tranche of financing could be disbursed soon after. The funds from the Nordic countries and the IMF are essential components in the authorities' plan to shore up confidence in the currency before removing capital controls.

Negative outlook remains

Moody's still has a negative outlook on the Icelandic government's rating. Although the passage of the Icesave agreement is mildly positive for the rating, there are a number of problematic issues outstanding. Moody's continues to be especially concerned about the trajectory of the currency, which has been gradually depreciating despite the country's tight monetary policy and rigid capital controls. As private sector debt is relatively high in Iceland, failure to stabilise the currency could severely hinder an economic recovery, if it prevents a reduction in interest rates.

More positively, some coincident economic indicators, such as unemployment and government tax receipts, appear to have stabilised. The government has also made noticeable progress over the past few months in terms of its economic objectives, such as a social pact on wages, fiscal consolidation and banking restructuring. Moody's will continue to monitor the progress on key policy issues to assess how they affect the economy and the government's creditworthiness.

Moody's Related Research

Iceland Analyses:

- Iceland Credit Analysis, January 2009 (114141)
- Banking System Outlook: Iceland June 2009 (118212)

Statistical Handbook:

- Moody's Country Credit Statistical Handbook, May 2009 (117471)

Sovereign Analytics:

- What does it mean to be a Triple-A Sovereign?, May 2008 (109129)

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- Rating Sovereigns during a Global "Sudden Stop" in International Funding, November 2008 (112231)
- Banking Crisis: European Governments take calculated Risks with Public Finances – But no Rating Impact except for Iceland, October 2008 (111874)
- Anchors in the Storm: Aaa Governments and Bank Bail-Outs, March 2008 (108164)

Rating Methodology:

- Sovereign Bond Ratings, September 2008 (109490)

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Iceland

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