

SPECIAL COMMENT

Iceland: Rejection of Icesave Agreement Has No Immediate Rating Impact

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On 20 April 2011, Moody's affirmed Iceland's local and foreign currency government bond ratings at Baa3 and maintained its negative outlook on the rating further to the rejection of the revised Icesave agreement by the Icelandic electorate on 9 April 2011.

Moody's had previously stated¹ that a rejection would most likely result in a negative rating action. However, today's affirmation of the rating recognizes several developments that led Moody's to reach a more benign assessment of the potential impact of the referendum outcome than it had previously assumed.

- » Despite the rejection of the revised agreement to resolve the dispute over the Icesave offshore bank deposit scheme, the British and Dutch deposit insurance funds are expected to receive initial payments from the Landsbanki estate soon for the costs they incurred in covering their citizens' Icesave deposits. In addition, the Landsbanki estate now expects to be able to make significantly higher payments to priority claimants as asset recoveries have been much higher than expected earlier. The outstanding Icesave obligation and potential liability to the government might therefore be reduced significantly in the coming months regardless of the referendum outcome.
- » The programme with the International Monetary Fund (IMF) is expected to remain on track. The fifth review was scheduled for late April, and there will certainly be a delay while the Fund assesses the implications of the referendum outcome. However, it seems unlikely that there will be a significant delay or blockage of the programme as occurred in 2009.
- » Public statements from the Nordic governments after the referendum indicate that they are likely to continue to provide funding to the Icelandic authorities under their loan agreements. Apart from the IMF, the Nordic governments' financing has been an essential external funding source for the Icelandic authorities.

The outlook on the Baa3 rating remains negative, reflecting Moody's view that there are still substantial uncertainties that weigh on the rating. Moody's understands that the underlying issue of whether the Icelandic government has a liability under the EU directive on deposit-guarantee schemes will now most likely be resolved through the court of the European Free Trade Association (EFTA).² This legal process may take at least a year. There are also uncertainties regarding the timetable for the relaxation of capital controls and the economic outlook, in particular related to investment.

¹ See Moody's Special Comment entitled "[Iceland: Outcome of Referendum on Icesave Likely to Impact Sovereign Ratings](#)", published on 11 February 2011.

² In May 2010, the EFTA Surveillance Authority (ESA, equivalent to EU Commission for EFTA countries) initiated infringement proceedings against Iceland, claiming that Iceland is obliged to ensure that each depositor receives the minimum deposit insurance, and issued a letter of formal notice to the Icelandic government. The government will now reply by mid-May. Unless ESA changes its mind following the government's response, the next formal step would be to send Iceland a final warning, a Reasoned Opinion. This final warning will give Iceland two months to rectify its breach of the EEA Agreement. If Iceland remains in breach of the agreement, the case will be sent to the EFTA Court.

Potential government obligation related to Icesave probably more limited than previously expected

Finding a solution to the Icesave dispute has long been considered an important pre-requisite for normalizing Iceland's relations with the international investor community. As such, the prospect of further legal proceedings before the issue is finally resolved is negative. At current exchange rates, the nominal outstanding value of the disputed amount is close to €4 billion or ISK650 billion (approximately 44% of GDP).

However, Moody's recognizes that the size and importance of the liability will likely decline substantially in the coming months and years. The Landsbanki Resolution Committee now estimates that asset recoveries will ultimately amount to approximately 90% of priority deposit claims, which is significantly higher than earlier estimates. Clearly, not all assets are currently liquid and the recovery process will take several years. Also, the ultimate recovery is subject to uncertainties and depends on exchange rate movements. But the estate now expects to start paying out to priority claimants (such as the UK and Dutch deposit insurance funds) after the summer. According to information from the Landsbanki Resolution Committee³, the estate has accumulated substantial cash reserves of ISK361 billion (as of 31/12/2010) that could presumably be used for a first payment. The outstanding Icesave obligation and potential liability to the government (if found liable) could more than halve by the time the legal process has run its course.

External funding from IMF and Nordic governments likely to remain in place

The second driver underlying the rating affirmation is Moody's expectation that the programme with the IMF will remain on track, despite a short delay while the IMF re-assesses its macroeconomic framework. Moody's considers the IMF programme to be a crucial anchor for Iceland's economic and financial recovery, especially in terms of the ongoing fiscal consolidation. A related third driver is the rating agency's expectation that the Nordic governments will also continue to provide funding to Iceland under their loan agreements (€888 million of a total loan amount of €1,775 million is still available). The deadline for draw-downs has recently been extended to December 2011 from December 2010 originally.⁴

These drivers address Moody's previous concerns that a possible rejection of the Icesave agreement might put the external funding from the Nordics (and consequently the IMF) at risk, thereby undermining Iceland's economic recovery, fiscal sustainability and the ability of the Icelandic authorities to relax the strict capital controls that are in place.

Additionally, Moody's notes that the government recently announced a buyback offer at par for all holders of the two Eurobonds maturing in December 2011 and April 2012. The government has already bought back a significant amount of these bonds but approximately €800 million worth remain outstanding. The auction on 5 May will provide a good indication of the sentiment of non-resident investors towards Iceland and will probably influence the timing of the first steps towards relaxing capital controls.

³ See www.lbj.is for the Committee's website

⁴ In Sweden, parliamentary approval for the extension is still required.

Ongoing uncertainties warrant maintaining a negative outlook

Moody's is maintaining its negative outlook on Iceland's Baa3 rating as there are still considerable uncertainties.

Firstly, while the size of the Icesave liability will shrink, the government could still be found liable for accrued interest and any uncovered portion of the principal, the amount of which is unclear at this point in time. Litigation risks relating to the Emergency Act and the priority status of deposit claims are another source of legal uncertainty. Moody's understands that these lawsuits are expected to be resolved in the coming months.

Secondly, the risks to Iceland's economic recovery are significant. In particular, Moody's believes that the economy might be negatively affected due to lower investment because of possible delays to the liberalization of the strict capital controls that are currently in place. This year, Moody's expects the country to record positive GDP growth – for the first time since 2008 – of around 2% (after declines in real GDP of 3.5% in 2010 and 6.8% in 2009). Most of the growth is expected to be driven by investment but this may no longer materialize if foreign investors delay investment decisions, pending a full resolution of the Icesave issue. The Central Bank of Iceland forecasts real GDP growth of 2.3% for 2011, compared to earlier forecasts of 2.8%.

It remains to be seen whether the Icesave rejection will have more fundamental implications for the outlook for foreign direct investment (FDI) and the attractiveness of Iceland as a place of doing business. Given the small size of the economy, one or two large FDI projects could make a big difference for the growth outlook. There is significant potential to further develop Iceland's vast hydro and geothermal energy sources which are key to the country's medium-term growth outlook. Due to the very low cost of energy, Iceland will probably continue to be a favoured destination for energy-intensive industries like aluminium producers. However, at the same time, there is vocal opposition to foreign ownership of the country's natural resources as well as to further investments by multinational corporations in the aluminium industry.

Credit triggers for a future rating action

Moody's would downgrade Iceland's rating if the above-mentioned legal risks related to the priority status of deposits were to materialize. This would result in a much higher potential liability for the government because of lower payouts from the Landsbanki estate to the British and Dutch deposit insurance funds. The rating would also come under downward pressure if the Nordic funding was disrupted against our expectations or the economic recovery turns out to be slower than Moody's is expecting, possibly due to delays to important investment projects or slower-than-expected corporate and household debt restructuring.

Indications of a declining commitment to fiscal consolidation would also be negative for the rating. The Icelandic government has so far shown strong commitment to fiscal consolidation under the IMF programme and has managed a significant reduction in the very large deficit (also in comparison to other Nordic countries after their banking and economic crisis in the earlier 1990s). The 2011 budget is targeting a primary surplus of just under 1% of GDP this year, increasing rapidly in the coming years (overall budget deficit of 4.5% of GDP in 2011 compared to a deficit of 8.9% of GDP in 2009). However, Moody's notes that the current IMF programme will come to an end in August 2011. A continued anchor for fiscal policy would therefore give additional confidence.

Going forward, the speed and sequencing of capital account liberalization will become a more important rating driver, and Moody's will closely monitor the impact of the steps the Icelandic government will take on the exchange rate. On the one hand, the lifting of the capital controls and renewed access to external funding are crucial elements for a sustained recovery in Iceland. On the other, a too rapid relaxation of capital controls risks creating excessive exchange rate weakness. Foreign investors – trapped in the country when the capital controls were introduced in late 2008 – hold an estimated ISK465 billion (approx. 30% of GDP) in assets in the country. Most, if not all, will want to exit as soon as possible, with significant implications for the exchange rate, if their exit is not properly sequenced and controlled.

Conversely, the rating outlook could be returned to stable and the ratings eventually upgraded if the economy were to recover much faster than is currently expected and if the foreign exchange rate were to remain stable following the gradual relaxation of capital controls.

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