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SPECIAL COMMENT

Iceland: Outcome of Referendum on Icesave Likely to Impact Sovereign Ratings

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Moody's sovereign bond ratings for Iceland (Baa3, negative outlook) will be affected by the outcome of the country's forthcoming referendum on the revised agreement to resolve the dispute over the Icesave offshore bank deposit scheme. In the event that the agreement is approved by Iceland's electorate, we would likely change the outlook on the government's current Baa3 ratings to stable from negative. If the agreement is rejected, we would likely downgrade Iceland's ratings to Ba1 or below, given the negative repercussions that would follow for the country's economic and financial normalisation.

Last week, Iceland's parliament approved a revised agreement to repay the governments of the UK and the Netherlands for the costs they incurred in covering their citizens' Icesave deposits. The new agreement is considerably more favourable to Iceland. However, over the weekend, the president of Iceland decided to put the agreement to a popular referendum after 40,000 citizens (around 20% of the electorate) signed a petition against it. The referendum is expected to take place in mid-April.

When a referendum on an earlier, more expensive version of the agreement was held in March 2010, it was rejected by 93.2% of the voters who took part. However, a first poll taken this week indicates good support for the latest deal, with 58% of respondents in favour. Moody's notes that even members of the opposition Independence Party supported the agreement in parliament. We also expect an active political campaign in favour of the agreement, unlike last March.

In contrast to the last referendum, a renegotiation of the revised agreement does not seem to be an option this time. In case of a renewed rejection of the agreement, the Icesave dispute would eventually have to be resolved in court with uncertain timing and potentially higher costs to the Icelandic government.

The lack of an agreement over Icesave has been an important negative factor for Iceland's credit ratings so far because it has impeded progress towards normalisation of the country's international economic relations in general, not just with the UK and the Netherlands.

Approval Of The New Icesave Agreement Would Be Credit-Positive

A final and positive resolution would remove a key uncertainty that currently weighs on Iceland's rating. In the event that the agreement is approved, Moody's would likely change the outlook on the government's current Baa3/P-3 ratings to stable from negative.

This decision would be based on Moody's view that the terms of the new Icesave agreement contains several clauses that will reduce the cost to Iceland. Specifically, the new agreement stipulates lower interest rates on the obligation (with an average interest rate of 3.2% vs. 5.5% in the previous agreement) as well as an interest holiday of nine months. The repayment of the liability will start in 2011. The government is only expected to cover the interest cost of the liability, while principal is to be paid mostly with the recovered out of recoveries of assets from the Landsbanki estate.

The revised Icesave terms would result in a material improvement in Iceland's debt and debt service metrics. According to the IMF, the net present value (NPV) of the liability would be around 3.5% of GDP in 2011, declining to 1.3% of GDP by 2015. This compares with earlier estimates that had assumed the NPV of the liability to be around 15% of GDP. Moody's cautions that these calculations are based on several assumptions that might turn out to be optimistic, in particular in terms of the exchange rate and the recovery rate from the sale of Landsbanki assets by the administrators (86% according to the latest estimates). Under these assumptions, the gross public sector debt ratio would peak at around 100% of GDP this year (compared to 115% earlier) and decline to around 72% by 2015. This assumes continued fiscal consolidation beyond the expiry of the current IMF program in August 2011. The Icesave agreement would also positively impact Iceland's very high external debt ratios. External debt is forecast to decline from 267% of GDP in 2011 to 182% by 2015.

Resolving the Icesave dispute would also be positive in that it would (1) allow Iceland to regain market access; and (2) remove a key obstacle for relaxing the strict capital controls. Constraints on access to external financing are an impediment for a more robust economic recovery. At the same time, there clearly is a need to proceed carefully with the liberalisation of capital controls given the high uncertainty over the reaction of foreign investors trapped in ISK-denominated bonds and the impact of any outflow on the exchange rate. The authorities intend to present a revised strategy for capital account liberalisation by the end of February.

However, the Icesave issue is not the only factor that drives Iceland's rating. Other significant uncertainties and risks for the rating remain, including the following:

» Legal challenges to emergency legislation enacted after the banks failed and potentially also to private-sector debt restructuring. Adverse court rulings in these cases may impact the government's and the banks' balance sheets negatively.

» The government's strategy on capital control liberalisation will become more relevant in terms of the potential impact on the exchange rate, government funding conditions and the economy at large.

» Moody's will be assessing the outlook for fiscal consolidation beyond the current IMF program, taking into account the outlook for municipalities and government-related corporations.

» Lastly, the health of the new banking sector and the potential impact of private sector debt restructuring continue to constitute a risk.

A Rejection Of The Icesave Agreement In The Referendum Would Most Likely Lead To A Negative Rating Action

In the event that the agreement is rejected by Iceland's electorate, Moody's would likely downgrade the government's ratings to Ba1 or below, given the negative repercussions that would follow for the country's economic and financial normalisation. Moody's believes that a failure to approve the new agreement might lead to a cut-off in the remaining US$1.1 billion committed by the other Nordic countries and probably also to delays in Iceland's IMF program. It would almost certainly prolong the need to maintain capital controls in order to conserve foreign exchange.

The extent of any downward move in the rating would then depend on the outlook for the economy's health as well as the prospects for continued fiscal and external consolidation under different assumptions of foreign financial support and the prolongation of capital controls.

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