

The saga of Icesave

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The President of Iceland has refused to sign a parliamentary bill agreeing to compensate the governments of the UK and Netherlands for deposit insurance payouts because of Icesave. This does not mean a rejection of the country's obligations, nor any form of default. On the contrary, the decision by the president stems from the fact that over 70% of Icelanders find the terms of the current deal unreasonable.

Origin of the problem

Iceland has traditionally had limited experience with international banking (Butler and Sibert 2008). The financial system was highly regulated and politicised, with the bulk of the system in government hands and insulated from the outside world with capital controls until 1994. This all changed with the deregulation and privatisation of the financial system. Iceland adopted a new regulatory structure, in line with EU regulations, because of its European Economic Area membership. Importantly, this meant that Icelandic banks could operate in the EU with the so called "one passport".

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Unfortunately, both the banks and government were woefully ill-prepared for this. There was no institutional experience in how to regulate and run an international and free banking system, as can be found in other, more established, banking centres. The banks passed into the hands of highly leveraged holding companies that became the biggest debtors of the banks and invested alongside them. Significant parts of the economy were controlled by a handful of investment groups running financial institutions, non-financials and media, with close connections to main political parties.

Deregulated and privatised, the banks proceeded to gear up, using borrowed funds to acquire assets across the world. Favourable ratings did help here, for example a Moody's report in December 2006 which lists the strengths of the Icelandic banking system as:

- Strong likelihood of state support in the event of systemic shock
- Good financial fundamentals
- Good efficiency levels
- Diversification of income
- Capable credit risk management and good quality loan portfolios
- Adequate capitalisation
- Prudent liquidity management

This coincided with one of the biggest asset bubbles the world has ever seen, where anybody taking a highly leveraged bet was assured outsized profits. Eventually, the balance sheet of the banks swelled to 10 times the GDP of Iceland. (See Danielsson and Zoega 2009).

So what is Icesave?

The Iceland banks started experiencing increasing problems raising funds in international capital markets in 2006. To avoid deleveraging and continuing expanding, the banks hit on the idea of establishing internet banks in Europe, collecting high interest deposits. This was easy to do is because of the European financial passport. Moreover, it was a favoured move by the rating agencies (Moody's 2006).

There are essentially two ways a bank can do this, by a branch or subsidiary. Landsbanki opted to set up branches, under the name of Icesave, supervised and insured from Iceland. They offered above market interest rates, starting in October 2006, eventually amassing £4.5 billion in the UK. In 2008, the FSA was concerned and applied increasing pressure on Landsbanki to limit deposits. The response was to start raising deposits in the Netherlands, starting in May 2008 and eventually collecting €1.7 billion from the region.

What about risk?

Landsbanki, along with many other financial institutions, was affected by the global crisis of 2007 and started experiencing serious funding difficulties in 2008. Capital markets viewed Landsbanki, along with the other Icelandic banks, as more risky than most, if not all, banks in Europe. Thanks to Icesave, Landsbanki was often considered the safest of the three main

Icelandic banks, the idea being that deposits are a stable source of funding. Subsequent events have proven this belief to be wrong.

International capital markets increasingly seem to have viewed the Icelandic banks and the government of Iceland as a single joint entity from a risk point of view. The country risk became the same as the bank risk, where high risk activity by one bank directly affected the other banks and the government. The Icelandic authorities and the banks would have been well aware of this externality, but this awareness does not appear to have translated into any concrete actions to reduce the risk. On the contrary, both the banks government seem to have gambled for resurrection.

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The CDS spreads of Landsbanki started rising sharply in 2008, see Figure 1, reaching 865 March 31 when they started taking deposits in the Netherlands, after which they dropped to 291 May 23, before reaching 715 by early August.

Singh and Spackman (2009) calculate the implied probability of default for March 31 2008 as 22% using an assumption of 40% recovery, and 77% if using stochastic recovery and probability, a methodology they recommend.

The reason Landsbanki put so much emphasis on Icesave seems to be because it is much cheaper to pay

a couple of percentage points above prevailing deposit rates in the UK, than paying much more in international capital markets. This may have been done with the encouragement of the UK FSA, being worried about the funding position of Landsbanki.

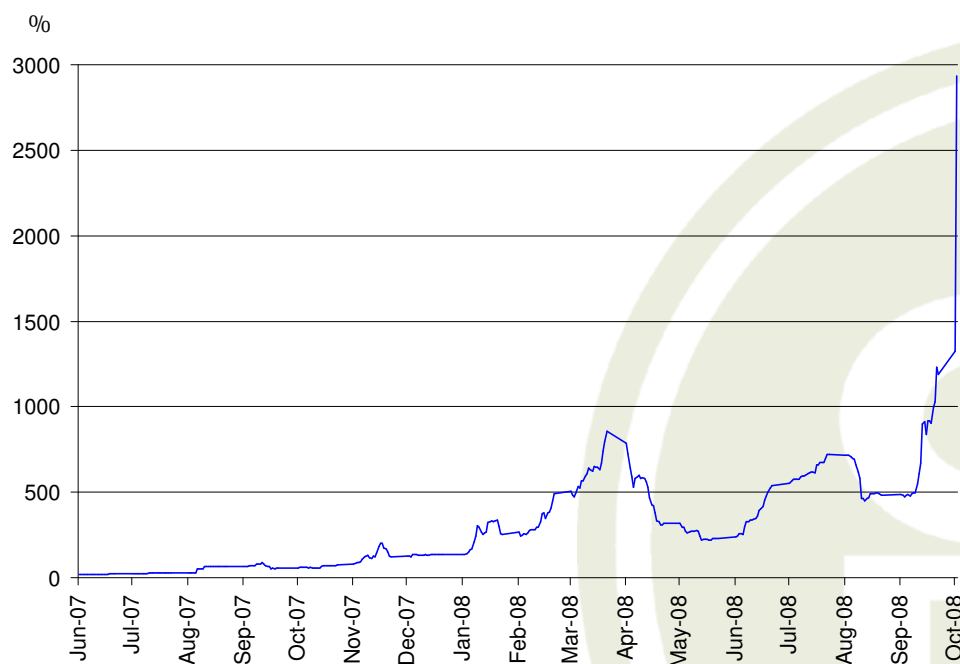
The question remains why the rating agencies did not seem to understand the risk created by Icesave, and to what extent the Icelandic and UK authorities understood this risk.

Both depositors and governments were exposed. The first €21,000 of deposits was insured by the Icelandic deposit insurance fund (more on this later). The Netherlands eventually provided insurance for up to €100,000 in retail deposits and the UK eventually provided unlimited insurance for retail deposits. Wholesale depositors such as local government and charities invested with Landsbanki, but not as a part of Icesave, and thus did not enjoy this protection.

There were therefore five different entities with direct exposure to Landsbanki: the Icelandic, British and Dutch deposit insurance funds, retail depositors in the Netherlands with excess of €100,000, and all wholesale depositors.

The Audit Commission in the UK (2009) investigated the investments of public authorities into the Icelandic banks and concludes that some authorities "have been less cautious by following ratings [not credit but interest paid] exclusively and perhaps striving to achieve a high yield without due regard to the risk involved. And a small group of authorities has been negligent in their stewardship of public funds." This last group put £33 million into the Icelandic banks in October 2008, when one Icelandic bank had already failed, and the bankruptcy of the rest was imminent. One council invested £1.5 million on the day the CDS spread on Landsbanki exceeded 3,000.

Figure 1 CDS spreads on Landsbanki, 2007–2008



Who knew?

The risk was out there for everybody to see. As far back as 2005 the financial press in Scandinavia was saying that the Icelandic financial system was a gigantic hedge fund, naming its activities "pyramid schemes" and claiming Icelandic entities were buying assets in Scandinavia at far too high prices, which would eventually bankrupt them. The Icelandic response at the time was to label this as simply malice and envy. Two reports were commissioned in Iceland, Herbertsson and Miskhin (2006) and Baldursson and Portes (2007), both painting the Icelandic economy and its banking system in favourable terms.

By 2008 anybody with access to Bloomberg could see that the CDS spreads on Landsbanki were amongst the highest in the Europe for banks.

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The risk was widely discussed in media. *This is Money* in the UK had an article on March 16 2008 called 'Iceland's banks top "riskiness league"' where in discussing the Icelandic banks state "These banks are now seen as the most unsafe in the developed world." MoneyWeek in the UK on March 19, 2008, had a similar story stating "Landsbanki (owner of the popular Icesave internet banking business) has to pay the credit markets 6.0% more than risk-free rates and 4.2% more than ING does, for funds. Given that Icesave pays 6.05% on their easy access internet savings account and ING pays 6.0%, perhaps shopping around for the highest savings rate right now is not actually the best thing to do. Perhaps, just perhaps, we should pay more attention to the risk side of the equation too."

The relevant authorities were also aware of the precarious state of the Icelandic banks. For example, Gunnarsson (2009) notes that in April 2008, Trichet called the governor of Bank of Iceland angrily complaining that the Icelandic banks were conducting abnormal fake transactions with the ECB via Luxembourg. Apparently, the Icelandic banks had obtained €4 billion from the ECB by selling each other bonds with the explicit purpose of exploiting opportunities with the ECB. Gunnarsson (2009) in his discussion makes it clear that the relevant authorities in Europe were monitoring the situation closely and that they applied increasing pressure on Landsbanki to limit deposits. Furthermore, he states that the Dutch Central Bank demanded in July that Landsbanki stop collecting deposits, to which Landsbanki responded by offering to place all deposits above a certain amount on account with the Dutch Central Bank, an offer that was rejected.

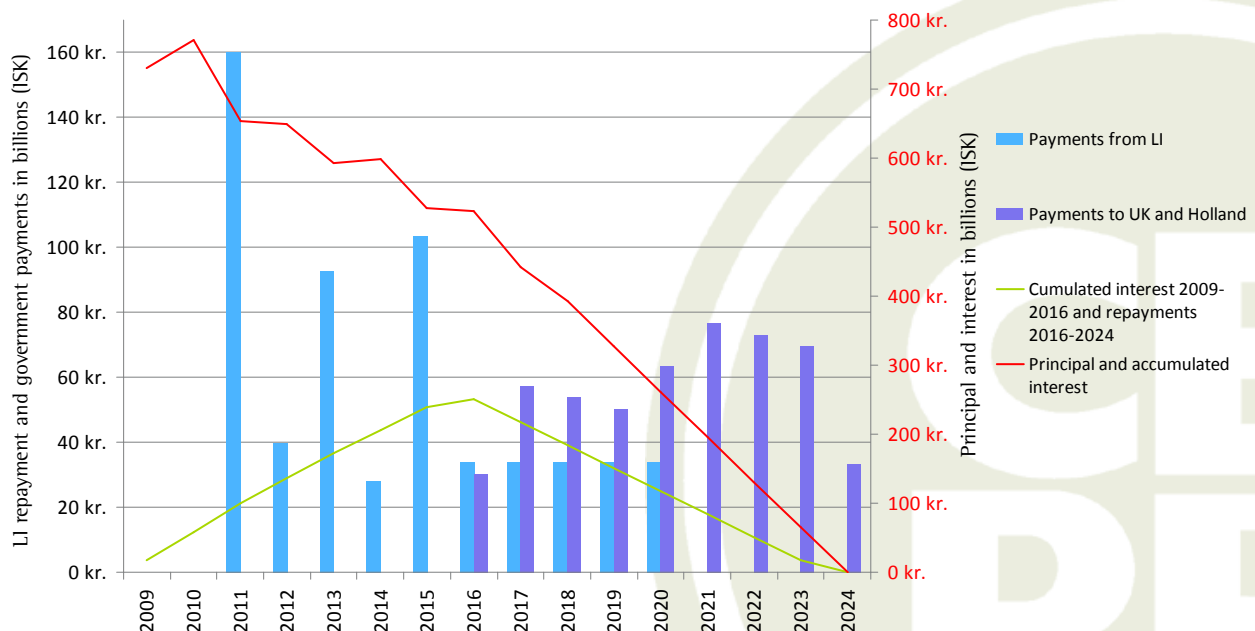
Bankruptcy and responsibility

Landsbanki eventually collapsed in October 2008 along with the rest of the Icelandic financial system. While the specific timing may have had something to do with the failure of Lehmans, it is clear that the global financial community viewed the bankruptcy of Landsbanki as imminent by September 2008 judging by the CDS spreads.

After the failure of Landsbanki, the government of the UK fully compensated all retail depositors, while the government of the Netherlands compensated retail depositors up to €100,000. The first €21,000 however fell onto the Icelandic deposit insurance fund, which only contained a fraction of the needed amount.

Under EU law, if the deposit insurance fund is not sufficient, it falls on the other banks in the country to make up the shortfall. But the law is unclear on what happens if all of the banks fail, and there seems to be

Figure 2 The Icesave loan payment schedule



no obligation for the government to make up the shortfall. The uncertainty on this issue is reflected in a letter from HM Treasury (2008) to the Ministry of Business Affairs in Iceland.

The consistent position of the Icelandic government has been that it does not have the obligation to top up the deposit insurance fund, while the equally consistent position of the EU is that it does. The independent legal advice indicates that the law is unclear. (See for example the Mishcon de Reya Solicitors report 2009).

It is this uncertainty which is the foundation of Iceland's reluctance to compensate the UK and Netherlands. Responsibility for allowing Icesave to operate falls onto the shoulders of the home supervisor (Iceland) and it had the legal remedies to prevent it.

If the Icesave repayments become too burdensome they may trigger a sovereign default meaning that the UK and Dutch taxpayers would be unlikely to get reimbursed at all.

The host supervisors of the UK and Netherlands, however, also have a duty to protect depositors in their countries. The Dutch authorities have repeatedly stated that there was little they could do. (The UK authorities have kept quiet.) Both countries did provide deposit insurance above and beyond the legal minimum. But if the authorities do not have the legal remedies to protect their depositors and tax payers, it signals a fault in European financial regulations.

The Icelanders have not rejected their obligation, but claim that because of the legal uncertainty, the UK, Netherlands, and EU share a part of the responsibility. It is the terms under which Iceland compensates the UK and Netherlands that is at the heart of the dispute.

What is the issue?

The overall amount involved might not seem excessive, around €3.9 billion, but only around 315,000 people live in Iceland, so that equates to about €13,000 per person. According to the current deal, Iceland is to pay 5.55% interest per year, or €217 million, and replay the money between 2016 and 2024.

Adjusting for population size the overall deal implies that the UK would have to pay over €800 billion, with €43 billion per year in interest. For the Netherlands it is as if it had to pay €202 billion, with €11 billion in interest per year. I suspect neither country would be inclined to agree to such an agreement if their private banks had incurred similar obligations abroad.

The recovery rate for Landsbanki is expected to be 88.2%, but payout will not start until next year earliest, and probably last beyond 2020. Meanwhile Iceland pays interest. I calculated the debt profile here in Danielsson (2010), with the specific calculations available online [here](#). At current exchange rates, Iceland can be expected to pay €2.82 billion, of which €2.16 billion is accumulated interest. This is just under the government expenditures in 2010.

The claim on the estate of Landsbanki is fixed in Icelandic krona at an exchange rate from April last year, while the obligation is in pounds and euros. Iceland is therefore assuming a considerable currency risk. Already the debt has increased by 6%. If the economy performs badly, it will have to pay more because of the exchange rate.

Iceland is already just about the most indebted country in the world as a consequence of the crisis, with government debt to GDP perhaps around 140%, the bulk of which is in foreign currency (considerable uncertainty exists about the exact debt position of the Icelandic government, especially foreign debt). By contrast, before the crisis government debt was quite low. The economy is in dire straits, but stabilising. If the Icesave repayments become too burdensome they may trigger a sovereign default meaning that the UK and Dutch taxpayers would be unlikely to get reimbursed at all.

Two forms of pressure

In order to press their case, the EU has applied considerable pressure on Iceland, primarily using two different methods.

- First, the EU has used its influence to hold up approval of IMF aid, further weakening the Icelandic economy. This would seem counterproductive, since it increases the eventual cost of the rescue package. Furthermore, such a use of the IMF as a collection agency in bilateral disputes between governments is questionable.
- Secondly, Iceland has applied to join the the EU, see Danielsson (2009), and its application appears to be conditional on settlement. However, since the majority of Icelandic voters have consistently opposed EU membership, this pressure is currently not all that effective. Ironically, as well as cementing opposition to Icesave, repeated public threats by Dutch politicians against Iceland have served as to solidify Icelandic voters against EU membership.

Conclusion

The responsibility for Icesave falls jointly on Iceland, UK and the Netherlands. It is in the best interests of all three governments, as well as the IMF and the EU, to come to a reasonable agreement, enabling Iceland to make good on its obligations, without tipping the economy into the abyss.

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