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Icesave: costs and risk

Icesave is one of the key issues impacting the rebuilding of the Icelandic economy. I want to leave aside legal issues surrounding Icesave for the lawyers but analyze the key risks of the Icesave agreement from an economic point of view. The analysis outlined below, is based on a spreadsheet which is available on risk.lse.ac.uk/icesave.

Basic Assumptions

Loan Amount: According to the current arrangement, the government of Iceland guarantees to reimburse the governments of the UK and Netherlands £2,4 billion and EUR 1,3 billion respectively. At current exchange rates this amounts to ISK 732 billion, but this amount fluctuates with the currency.

Interest: Fixed interest rate of 5.55%, calculated from 1 January 2009 but interest payments will not be made until 2016. Until that time interest is added to the principal every year.

Repayments: No repayments of the principal are made during from 2009 to 2016. After that, the repayments are based on quarterly equal payments until 2024.

Repayments and claims The Icelandic government has a priority claim against the Landsbanki (LI) estate for the principal paid because of the Icesave agreement. The claim is defined in krona using the exchange rates as of April 22 last year and amounts to 594 billion. Landsbanki has considerable assets which eventually will be sold and the proceeds paid to creditors, including Iceland. There is some uncertainty regarding the amount that the sale of these assets will bring and when this might happen as discussed further below. It is important to note that Iceland does not have a claim for interest payments made under the Icesave agreement and will have to meet all those payments regardless of the recovery of LI assets.

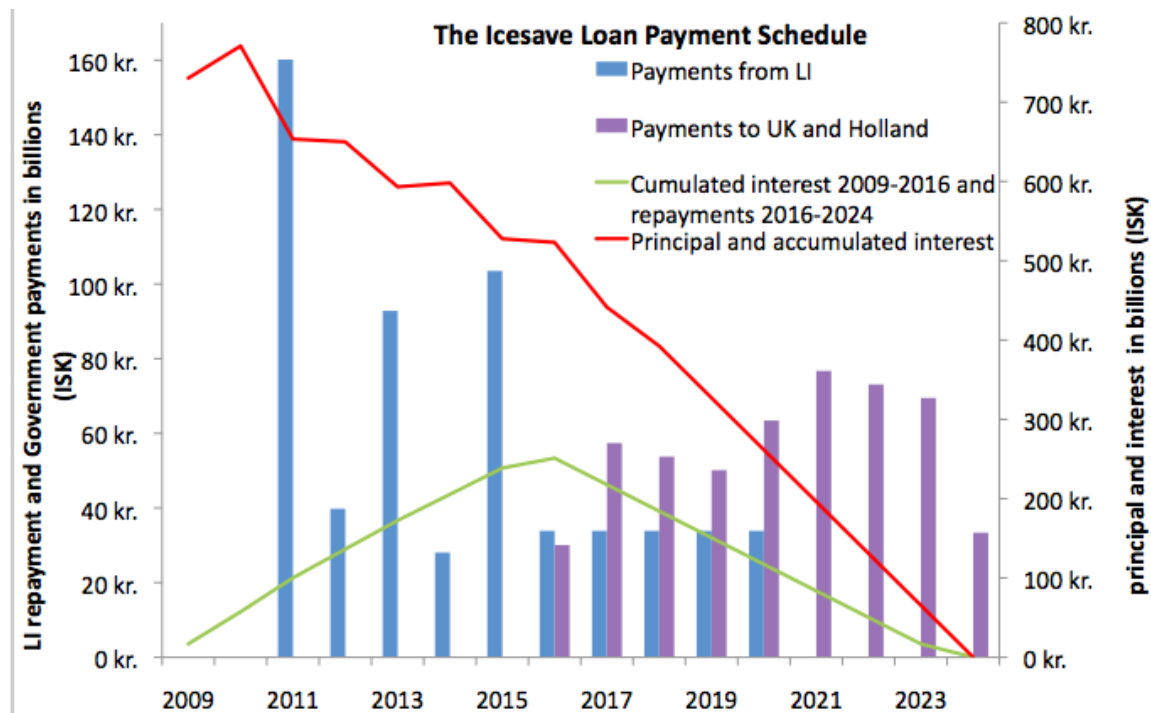
Key risk factors and issues

From an economic point of view there are two key risk factors. First, how much and how quickly we can expect to recover from the sale of LI's assets, and second the evolution of the exchange rate. In turn, future economic growth is fundamentally important in our ability to meet the payments.

Recovery: The recovery committee of LI estimates that 88% of priority claims will be met but payments will be trickling in for quite some years, with 29% coming in 2015 or later. As money comes in, it will be used to reduce the principal of the loans owed to the UK and Netherlands. This in turn reduces the interest payments.

Applying the above has the following impact [insert, same as above, updated to take into account the reduction in the principal]

Given the exchange rate today, and assuming 88% recovery from Landsbanki, the payments would be in billions ISK:



Based on the above, the total cost of Icesave is 507 billion kronas, at the exchange rate yesterday. That means 1.5 million per person in Iceland, and 5.800kr. per person in the UK and Netherlands. To put this into context, this money would be enough to run Landsspítali Islands (main hospital, representing 1/3 of total health expenditures) for 13 years and University of Iceland (17% of total education expenditures) for 45 years.

Of this, 120 billion is repayment of principal, and 387 billion interest.

The worse the economy of Iceland performs, the more we have to pay

Iceland's claim on the estate of LI is defined in Icelandic krona, fixed at the exchange rate of April 22 last year. Already, the krona has depreciated by 8.5%, adding 57 billion to the debt which will be an extra burden on Iceland unless the currency recovers. This is a phenomenon familiar with anybody with currency basket loans.

Ultimately this means that if the economy does well and the exchange rates recovers the debt will be reduced. If however, the economy does poorly, the debt will increase further.

The fact that Iceland's claims are in krona but not in pounds sterling or euros is not a feature of the Icesave agreement but rather a feature of Icelandic bankruptcy law. It might therefore be possible for parliament to eliminate this risk by changing legislation and allowing LI to pay out to claimants in the same currency in which they receive payments from its assets, e.g. recovery in euros will come to the claimants in euros, not krona at the exchange rate from last April.

It is not my intention to forecast exchange rates, and this depends crucially on how the economy recovers, but as a first try if the krona strengthens by 10%, our obligation decreases by 89 billion, and if it weakens by 10% increases by 89 billion. The important point here is that Iceland is taking on this risk with the Icesave agreement.

The Importance of Recovery from LI

It will take many years to sell off all the assets of LI. The recovery rate may prove to be too conservative if the global economy performs well, and the estate can sell off its assets for a better price than expected today. Similarly, if the global economy performs poorly it may take longer for the estate to get a reasonable price for its assets. Iceland's debt burden is therefore very dependent on a global economic recovery. While we wait for it to happen we pay interest on Icesave..

Interest

We are paying 5.55% per year of fixed rate interest. I don't want to pass a judgment on the fairness of this number here, but it seems somewhat above what the

governments of the UK and Netherlands pay for a fixed term loan of the same maturity.

The interest payments are however crucially important. Even if we recover 100% from LI, we still have to pay ISK 732 billion. If it were possible to lower the interest rates or even change it to floating rates, say the international LIBOR 3 month rates,, then our payment would drop to 151 billion.

Conclusion

The Icesave deal imposes substantial costs on the Icelandic economy, but if the economy recovers according to best expectations, we will be able to meet those costs, albeit at considerable costs to living standards.

The real danger is if the economy performs badly. In this case, the burden of Icesave will increase because of the exchange rates, and the high payments will contribute to a downward spiral of the economy.

It must therefore be of the interest of all three governments to reduce this risk, and ensure the viability of the Icelandic economy,