

ISSUER COMMENT

Iceland: EFTA Court Decision Frees Iceland from Failed Landsbanki Liabilities, a Credit Positive

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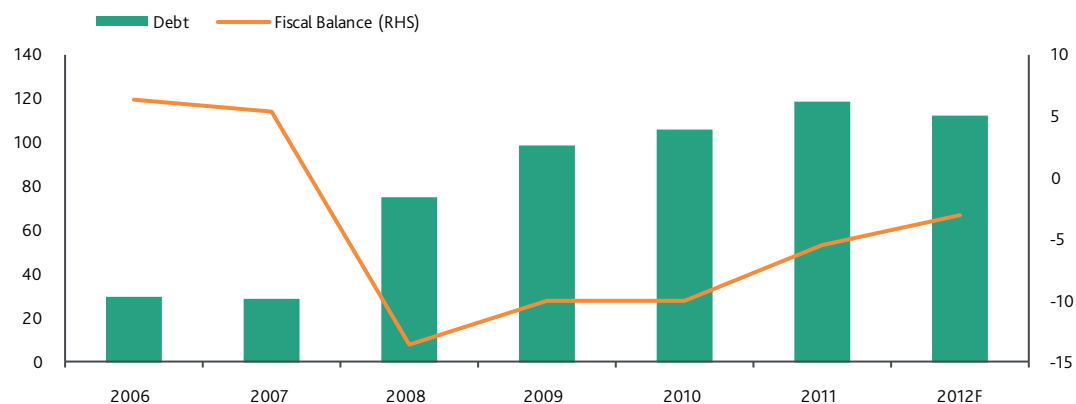
On Monday, the European Free Trade Association (EFTA) Court dismissed the EFTA Surveillance Authority (ESA) case against Iceland (Baa3 negative) for an alleged violation of its obligation under the European Union's Deposit Guarantee Directive. The court's decision, which is final and cannot be appealed, frees the Icelandic government from potentially large costs related to the obligation to compensate depositors in Landsbanki's British and Dutch "Icesave" online savings accounts and is credit positive for the sovereign. Liability for Icesave claims will instead remain fully and exclusively with the estate of the failed Landbanki.

The EFTA Court decision in the Icesave dispute is the most favourable possible outcome for Iceland, ending significant legal and financial uncertainty for the government. An earlier agreement with the British and Dutch governments, which was rejected by Icelandic voters in a referendum in April 2011 and led to the ESA's legal case, would have resulted in significant payments due from the Icelandic state. The International Monetary Fund (IMF) estimated the potential cost at around 6%-9% of Icelandic GDP under most scenarios, but at up to 20% of GDP in a worst-case scenario.

We did not include potential Icesave payments in our calculations of Iceland's public debt and deficit given the legal uncertainties of the case, but the potentially large contingent liabilities presented a key risk to the government's generally improving fiscal position and figured into our assessment of "high" event risk in Iceland.

Iceland's public finances have improved significantly since the depth of its banking and financial crisis. We estimate the 2012 budget deficit at around 3% of GDP, compared to a peak deficit of 13.5% of GDP in 2008. Public debt is high, but in contrast to similarly rated EU peers, Iceland's debt ratio is on a clearly declining trend, as shown below.

FIGURE 1
General Government Debt and Financial Balance (% of GDP) [1]



[1] Debt includes the loans from Norway and the IMF
 Source: IMF, Central Bank of Iceland, Statistics Iceland, Moody's

So far, Landsbanki's Winding-Up Board has paid out around 50% of its total Icesave obligation ((ISK 1,167 billion or 67% of 2012 estimated GDP) and it expects to be able to repay the full Icesave claims over the coming years.

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