



# Who should pay for Iceland's debt?

## How a fair and transparent debt work-out mechanism could help settle the Icelandic case

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### The debt crisis in Iceland: where developing and developed countries meet

On 6 March 2010 the people of Iceland voted on whether and how Icelandic citizens should have to pay back debts claimed by the Netherlands and the UK. The claimed debts relate to the collapse of the Icelandic bank Landsbanki, and its Icesave branch, which held €6.7 billion in deposits from Dutch and British savers. More than 90% of Icelandic voters rejected the repayment plan.

The referendum has been widely portrayed in the European press as a populist move by the President of Iceland to buy time and scale up pressure on the Dutch and British authorities which are pushing for swift repayment. It has also unveiled disagreements within Iceland over the extent to which Icelandic citizens should foot the bill for their financial sector's reckless behaviour. But most importantly, it has brought to the forefront of public debate in Europe some key questions that anti-poverty activists have been raising for more than a decade:

- Who should be responsible for sovereign debts and how can they be held accountable? Is it only the

borrower? Or does the creditor bear some sort of responsibility? How does this relate to Iceland's 'debt'?

- How should a country's financial situation affect the terms of repayment of a debt? Should the lender's claims take priority over the borrower's chances to rebuild their economy? What power should the holding of debt assign to creditor over debtor?
- Who should decide on disputed debt claims and terms of repayment? Is there a fair, independent and transparent institutional mechanism which all parties involved regard as legitimate enough to be able to arbitrate?

The lack of a straightforward answer to these crucial questions exposes the fact that despite the fact that such crises continue to happen as part and parcel of the global economic system. Civil society and academics have long denounced the vulnerable situation in which this gap in the global economic system leaves developing countries. Facing debt crisis, countries currently have two options: either they default on their debts and risk excommunication from the international

community, or they submit to the will of their creditors at the expense of their own economic well-being and the needs of their citizens.

This dilemma is not faced by individuals, companies or local municipalities. The US and most European countries are equipped with laws which protect companies and individuals in the event of bankruptcy. These laws prevent creditors from swooping in to claim money ahead of one another, and ahead of the company or municipality fulfilling more important duties – for instance to their staff.

Until recently, sovereign debt default seemed to be the exclusive concern of developing countries, and thus the issue did not gain much traction among developed countries, who more often sympathised with lenders. However, now that the risk of sovereign default is no longer a fantasy for European countries, interest in the issue is spreading and some experts have even suggested the need for a debt-workout mechanism as part of the institutional set up of a proposed European Monetary Fund.<sup>1</sup>

Some EU member states, such as the Netherlands and Germany, have also shown interest in establishing global debt work-out mechanisms. The current crisis should be turned into an opportunity to discuss what mechanisms should be put into place at a global level to address external debt problems in a fair, transparent and independent fashion.

This policy brief outlines the course of events in Iceland since the end of 2008, and addresses key questions including:

- a) How was the loan contracted?
- b) What are the responsibilities of different authorities and governments involved?

- c) What mechanisms are being used to settle disagreements over repayment; and
- d) How could a fair, independent and transparent debt work-out mechanism help in settling the Icelandic case?

#### **A slippery slope for Icelandic banking:**

**..The international community is not equipped to provide fair and legitimate solutions to debt crises...**

#### **Autumn 2008**

From 2007, many in the international banking community believed Iceland's banks to be unstable, overexposed to a few sectors of the global economy which were themselves over-valued. As such these banks found borrowing difficult.

Two banks particularly – Landsbanki and Kaupthing - decided to increase their investments by attracting depositors overseas. In particular Landsbanki's Icesave brand targeted British and Dutch customers where high interest rates attracted hundreds of thousands of customers in a short space of time.<sup>2</sup> Kaupthing pursued a similar strategy with the brand Kaupthing Edge, and operated in Germany, Austria and other European countries.

In October 2008 both Landsbanki (7 October) and Kaupthing (9 October) were placed under receivership by the Icelandic Financial Supervisory Authority (FME) as rumours of the banks' solvency problems spread and the institutions became unable to meet their obligations. The FME took over the board activities and management of

Landsbanki, Glitnir and Kaupthing to ensure continued commercial bank operations in Iceland. This was made possible under new legislation adopted by the Althingi (the Icelandic Parliament) on 6 October 2008 to deal with the special circumstances created by the economic crisis.<sup>3</sup>

On 7 October it also became clear that Iceland would not guarantee deposits in branches outside Iceland, creating fears in other European countries that their investors would lose a proportion of their savings.<sup>4</sup> These governments claimed that this would be in violation of EU law.<sup>5</sup> EU directive 94/19/EC is intended to provide cover for depositors, wherever deposits are located in the European Community. To this end, Iceland created the Depositors' and Investors' Guarantee Fund (DIGF), and promised to raise money "so that the Fund would be able to meet the minimum compensation limits in the event of a failure of Landsbanki and its UK branch".<sup>6</sup> However, when the banks went into receivership, the DIGF only held around €68 million which was far from sufficient to cover Dutch and British claims.<sup>7</sup>

In the view of both the Netherlands and the UK the Icelandic state should have become the guarantor of last resort in this situation. The Icelandic government, however, stated the relevant EU directive was not designed to cover a systemic failure and it does not impose a sovereign guarantee on deposit insurance schemes.

This question goes to the heart of the question 'who's to blame' for the Icesave dispute? Without question, the regulation of the Icelandic banks was insufficient. But poor regulation in the UK and the Netherlands means these countries must also share some responsibility for the losses. As one example, Dutch economic professor and former top civil servant, Sweder van Wijnbergen, says that both premier Brown

and minister Bos – failed to check whether, legally, Iceland was really obliged to reimburse Dutch savers:

"Bos alleges Iceland infringed EU regulations, but those he cites actually say nothing on the subject. The then-applicable guidelines state only that a deposit-guarantee system must be in place with 'sufficient resources' to cover deposits. It doesn't say what must take place if a calamity wipes out the fund. And it also says nothing about who must pay for the central bank's top-up, only that states must agree on that via a bilateral treaty. The Netherlands has no such agreement with Iceland. Thus the parliamentarian who called for legal steps to be taken to enforce repayment just displays his own ignorance, since there is no legal basis for that claim. Bos glibly said on television that it would take too much time; he knows, of course, that he doesn't have a leg to stand on."<sup>8</sup>

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Regardless, the British and Dutch governments were determined that their depositors would not lose their investment in the Icelandic banks. On 8 October, the British Chancellor froze Landsbanki's UK assets under the Landsbanki Freezing Order 2008, using anti-terrorism legislation "because the Treasury believed that action to the detriment of the UK's economy (or part of it) had been or was likely to be taken by certain persons who are the government of or resident of a country or territory outside the UK."<sup>9</sup> The act of using anti-terror legislation rubbed salt into the wound of many in Iceland, and has presented a major obstacle to negotiations ever since.

In order to be able to pay out guaranteed deposits, Iceland finally borrowed €2,6bn and €1,3bn from the UK and the Netherlands respectively in November 2008. However, when the Althingi discussed the terms of repayment of these loans in August 2009, they rejected them. They did not question repayment, but set clear terms, against the wishes of the Icelandic government, which stated that Iceland would only repay the debts at a rate that it could 'afford'. They defined this as spending no more than 4% growth in GDP to repay UK debts and 2% for Dutch debts. If the economy failed to grow – for instance because of excessive austerity measures - Iceland would pay nothing.

The British and Dutch governments did not accept these terms, and the dispute has continued until the current day, with the recent referendum only confirming the depth of feeling in Iceland on the matter.

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### A responsible and just loan?

Civil society and academics have worked for many years on developing a framework for responsible and just lending. The impetus behind this is to avoid repetition of the 'Third World Debt Crisis' of the 1980s and 90s which saw enormous amounts of irresponsible, reckless and detrimental finance flood into developing countries and create a debt overhang which continues to distort the development of many countries to this day. A responsible and just lending framework is designed to ensure that all lending benefits the recipient, is open and transparent, and ensures that both lender and borrower share risk and responsibility for lending.

Under framework's devised to date – for instance Eurodad's [Responsible Financing Charter](#) – the Icelandic government's loan from the UK and the Netherlands cannot be regarded as 'responsible'. The UK and Dutch governments were led entirely by domestic considerations. Both governments knew that the Icelandic DIGF would not have been able to refund their depositors in the short-term. While the liquidation of Landsbanki might well have enabled a substantial bail-out, the process could have taken years. Any short-term bail-out of UK and Dutch investors would require intervention, hence the need for strong pressure to convince Iceland to take the loan.

In order to ensure repayment on their own terms, the Dutch and British governments have used all levers of power open to them – including anti-terrorism legislation (cited above) and continued threats to cut Iceland off from the international community.

It is reported that both countries worked to ensure that the approval of the IMF loan for Iceland (€1.7 billion) was conditioned on Iceland's commitment to compensate Icesave savers.<sup>10</sup> Dominique Strauss-Kahn, managing director of the IMF, appeared to admit to international pressure when he said: "Contrary to what has been said by many, for us the solution of this banking question is not a condition for the IMF to help the country. But we are an institution led by the international community.... If a lot of members think that we have to hold on, we have to hold on."<sup>11</sup>

In addition, Iceland has requested accession to the European Union, but Dutch MEPs have requested the Dutch minister of Foreign Affairs to refuse to start negotiations with Iceland as long as the Icesave dispute remains outstanding.<sup>12</sup> In reaction to the results of the referendum, Dutch Foreign Affairs minister Verhagen said he did not want to comment: "we keep our gunpowder dry", leaving all options open, including blocking action in both EU and IMF.<sup>13</sup> Hence, the involvement of the Icelandic parliament and people in the negotiation of the loan has been seen mainly as a hindrance rather than a central element of the loan contraction.

Finally, the Dutch and UK governments have refused to accept the need to limit repayments to ensure the government of Iceland can continue to meet its primary obligations to its citizens. We will turn to this issue in more detail below.

All of this is in plain contradiction with the [Responsible Financing Charter](#) which states:

- a loan document should spell out whether the lender faces a conflict of interest

- a loan must be based on consent, including parliamentary and citizen participation
- the assumptions on which the repayment terms are calculated must be made public
- the loan must accept that the borrower might not be able to meet repayment terms and stipulate how this matter will be resolved and should provide for arbitration in the event of a dispute.

### **Will repayment terms let Iceland swim or sink?**

The terms of repayment of the loan, then, are now the main subject of debate. It is difficult to balance a country's obligation to honour its foreign contracts with the obligation to provide appropriate living conditions, and indeed fulfil the human rights, of its citizens. However, insolvency procedures can help us to find a solution. Chapter 9 of the US Insolvency Code regulates insolvencies of municipalities, i.e. entities with governmental powers. Therefore it comes closest to the kind of rules-based approach that might be applicable to sovereigns like Iceland. Chapter 9 stipulates that bankrupt municipalities must not be forced to raise taxes nor to cut essential services, in order to honour their commitments to external creditors. First and foremost, those entities have a responsibility to their service users.

The level of sacrifice that is acceptable to a country is something that the people of that country should have a primary voice in deciding, hence the need for their full involvement in loan contraction. But it is also something that requires a court of arbitration to adjudicate on, especially when the lenders are necessarily self-interested in the repayment of the loan.

The story of the negotiations to date are proof of the difficulty of agreeing on such an important matter without an agreed arbitration system. In the negotiations preceding Iceland's March referendum, Iceland had offered to pay on the basis of 'what it can afford', while lenders were insisting on a repayment rate which is fixed in advance (for instance the 5.5% rate currently 'in effect') or a rate linked to international standards (for instance the Euribor-rate plus a risk fee of 2.75% offered more recently). Iceland fears that the latter offers would lead to Dutch and UK governments making a profit out of repayments.

In fact, previous crises have demonstrated the importance of limiting repayment terms to those compatible with economic recovery. The failure of European powers to set a limit to Germany's First World War reparations, as urged by economists such as John Maynard Keynes, is counted as a primary cause of economic collapse and the rise of fascism in Germany. For similar reasons the British government defaulted on the debts it owed to the US after the First World War, despite much lower rates of interest than those currently being offered to Iceland.<sup>14</sup>

The consequences of Iceland taking on the scale of debts proposed by the UK and Dutch governments would be enormous. At end of 2009 Iceland's total external debt was 10 times GDP, at a time when GDP is falling sharply.<sup>15</sup> Real disposable income is estimated to have fallen 17.6% in 2009. Unemployment has increased from 0.8% in March 2008 to a peak of 9.3% in Sept 2009. Loan repayments – which will mean new taxes or borrowing or cuts in spending in Iceland – will be felt strongly on the rest of Iceland's economy. It is exactly this trap of debt, austerity and economic stagnation which has impacted on many developing

world countries in the last 30 years. Clearly the current debt system does not work.

### **How a fair, transparent and independent debt-work out mechanism could help settle the Icelandic case: policy implications**

In this policy brief we have outlined the circumstances that led to the Icelandic case. We have seen the existence of the debt itself is not debated by the three governments involved. However, the circumstances under which the loan was provided cannot be regarded as truly responsible. Though there was no obligation for Iceland to accept a loan, pressure was put upon Iceland by the Netherlands and the UK to do so. This pressure continues. But now the people of Iceland have rejected repayment terms, submitting the case to a Court of Arbitration would seem an obvious way of overcoming the impasse and determining whether the loan was contracted legally and what the repayment terms should be taking into account Iceland's current economic situation.

Using the [Civil Society Principles on a Sovereign Debt Work-Out Procedure](#)<sup>16</sup> we will outline some policy implications for Iceland's overall debt problem, including the Icesave case. **There are 6 principles that are salient:**

#### **1. Creation of a decision making body which is independent of creditors.**

The sovereign debt work-out procedure must be independent of any creditor institution or body. This is clearly not currently the case for Iceland. Instead the Netherlands and the UK use their power in both IMF and EU to put pressure on Iceland. In principle, all creditors, including the Dutch and British claimants, should submit their claims to an independent institution or body.

2. **A comprehensive process.** While the present Dutch/British initiatives are the expression of privileged creditors trying to secure their part of the cake, the restoration of Iceland's economic viability needs a comprehensive approach, unimpaired by piecemeal and individual creditor interests.
  3. **Legitimacy.** Beyond issues of debt sustainability, an independent arbitration panel needs to verify the validity of each individual claim, which is clearly not (yet) proven in the Icesave dispute.
  4. **Assessment of the indebted country's economic situation by a neutral body.** Like in a (US) Chapter 9 proceeding, the essential functions of the Icelandic state need to be secured when its payment capacities towards its external creditors are considered. This must necessarily be done by an independent body.
  5. **Transparency.** The referendum is an impressive act of taking the issue of a country's fiscal and external viability out of the negotiation rooms of treasuries, central banks and private lenders, and submitting it to a transparent democratic process. For the Icelandic government it would be highly advisable to continue to subject any proposed agreement with external creditors to public scrutiny.
  6. **Enforceability.** All parties must respect the decision of the independent arbitrators.
- Anti-poverty campaigners have argued for many years that an arbitration procedure needs to be set up to deal with sovereign debt disputes. Such a mechanism could transform international financing, by ensuring that debt is both responsible and payable. It would transform relations between lender and borrower, creating a basis on which debts could be seen as truly a matter of joint responsibility.

<sup>1</sup> Reinhert, Carmen: "European Monetary Fund: one promising feature", *The Economist*, 21<sup>st</sup> February 2010. Available at: [http://www.economist.com/blogs/freeexchange/2010/02/emf\\_roundtable\\_7](http://www.economist.com/blogs/freeexchange/2010/02/emf_roundtable_7).

<sup>2</sup> Faisal Islam, 'As Iceland resists paying our billions, let's not forget just who is to blame', *guardian.co.uk*, 18 February 2010.

<sup>3</sup> What actions has the FME taken regarding the situation in the financial markets? (<http://www.fme.is/?PageID=864>).

<sup>4</sup> "Transcript of conversation between Chancellor and Icelandic Finance Minister". London: Times Online. 24 October 2008 ([http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article5005915.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece)).

<sup>5</sup> European law does not specify how the Member States have to provide the cover, although most operate some sort of fund to which credit institutions contribute, as in Iceland (European Court of Justice: [Case C-222/02 Peter Paul and Others v Bundesrepublik Deutschland](#) (Reference for a preliminary ruling from the Bundesgerichtshof). [2004] ECR I-09425). The Icelandic scheme was both pre-funded and post-funded if needed, as is the general setup across Europe (The Financial Supervisory Authority Iceland (FME): *The Icelandic Depositors and Investors Guarantee Fund* (<http://www.fme.is/?PageID=206>)).

<sup>6</sup> Letter (5 October 2008) of the Icelandic ministry of Business Affairs to the HM Treasury.

<sup>7</sup> The minimum deposit guarantee in Iceland equals EUR 20,887 (The Depositors' and Investors' Guarantee Fund: *Payments* (<http://www.tryggingarsjodur.is/Payments>)).

<sup>8</sup> 'Iceland needs international debt management' in NRC Handelsblad (12 January 2010).

<sup>9</sup> HM Treasury notice, 8 October 2011, [www.hm-treasury.gov.uk/fin\\_sanctions\\_landsbanki.htm](http://www.hm-treasury.gov.uk/fin_sanctions_landsbanki.htm).

<sup>10</sup> 'Iceland overweegt lening Bos te weigeren' in NRC Handelsblad of 13 November 2008.

<sup>11</sup> Transcript of a Press Conference by IMF-managing director Dominique Strauss-Kahn on 14 January 2010

(<http://www.imf.org/external/np/tr/2010/tr101410.htm>).

<sup>12</sup> 'Verzet tegen EU-route IJsland' in *Financieele Dagblad* of 25 February 2010.

<sup>13</sup> 'Bevolking IJsland wijst Icesave-akkoord af' in NRC Handelsblad (website, 6 March 2010)

<sup>14</sup> Britain defaulted on \$4.4billion in 1934 and this debt remains in limbo. BBC, 'What's a little debt between friends', 10 May 2006.

<sup>15</sup> Iceland had an external debt of 15,015,790 mio ISK in the fourth quarter of 2009 (<http://www.sedlabanki.is/?pageid=552&itemid=55be3a0-9943-484e-a8de-46d23f17ba25&nextday=26&nextmonth=11>) and a preliminary GDP of 1,500,162 mio ISK (<http://www.statice.is/?PageID=1267&src=/temp/en/Dialog/varval.asp?ma=THJ01102%26ti=Gross+domestic+product+and+Gross+national+income+1980-2009%26path=../Database/thjodhagsreikningar/landsframeidsla/%26lang=1%26units=Million%20ISK>).

<sup>16</sup> *A fair and transparent debt work-out procedure: 10 core civil society principles*, EURODAD, December 2009 (<http://www.eurodad.org/whatsnew/reports.aspx?id=3946>).

