

ISSUER COMMENT

Iceland's Payment from Hold-Out Creditors Is Credit Positive for Sovereign

From [Credit Outlook](#)

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Last Wednesday, creditors of the failed Kaupthing Bank hf (unrated) agreed to pay \$945 million (ISK120 billion) to [Iceland's](#) (Baa2 stable) Treasury to avoid paying an even larger so-called stability tax on its assets by year-end. In exchange for this payment, Iceland will exempt Kaupthing's creditors from capital controls that since 2008 have prevented them from accessing the bank's high-value foreign assets and transferring their remaining domestic assets abroad. Earlier this month, the creditors of another collapsed bank, Glitnir banki hf (unrated), agreed to pay \$1.6 billion (ISK200 billion) for a similar tax exemption and asset transfer.

The payment is credit positive for the sovereign in two ways. First, the \$945 million improves government finances by increasing funds available for paying down debt. Second, the payment, which will be made by drawing down the creditors' claims on the failed Kaupthing's domestic assets, significantly decreases the total value of domestic assets creditors can withdraw once exempt from capital controls. Decreasing the size of potential outflows significantly reduces a key risk that capital control liberalization poses to Iceland's financial stability. The government expects to remove most capital controls by year-end 2016.

The capital control liberalization strategy, announced 8 June this year, is a three-step process. The first step targets reducing the amount and extending the maturity of the ISK900 billion (\$7 billion) of nonresident net claims on domestic assets held by the failed banks' estates, illustrated by the recently announced agreement.

The second step of the liberalization strategy involves dealing with the principal and interest associated with non-resident-owned ISK-denominated bonds (offshore ISK) that matured after the capital controls were imposed. The main aim of the Icelandic authorities will be to extend the maturity of these liabilities, preventing non-resident creditors from repatriating these assets all at once. Holders of these assets will be offered a choice between three options: long-term treasury bonds denominated in either krónur or euros, a currency auction, or locked non-interest-bearing accounts. Investors who choose the foreign-currency auction to exit will pay a premium to do so.

The third step will involve the gradual lifting of restrictions on Icelandic residents' foreign capital transactions, the timing and sequencing of which has yet to be fully elaborated.

As envisioned, the boon to government finances is concentrated in the first stage. Stabilization contributions from Kaupthing and Glitnir's creditors alone equal roughly 15% of Iceland's 2014 GDP. The government can use these funds in various ways, such as pre-paying existing debt or reducing the funding gap in the pension system.

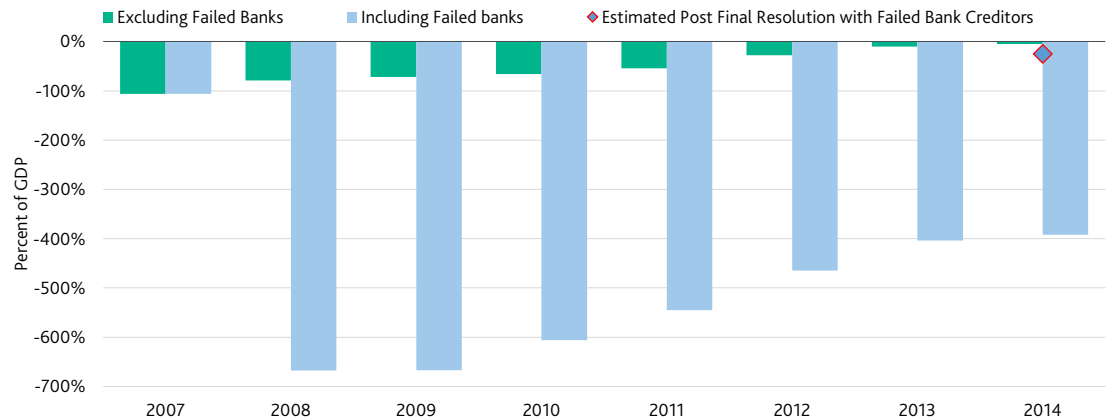
Moreover, with progress on individual bank resolutions underway, which also involves the creditors writing-off a large portion of their external claims on the failed banks, the authorities expect Iceland's net international investment position (NIIP) to decline to negative 25%-20% of GDP over the next year, from the massive negative 397% of GDP (including failed banks' external assets and liabilities) at the end of 2014 (see exhibit)..

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Iceland's Net International Investment Position Including and Excluding Failed Banks

Authorities expect NIIP to improve dramatically once negotiations with banks' creditors are finalized.



Sources: Central Bank of Iceland, Statistics Iceland and Haver Analytics

The fact that two of three banks have finalized stability contribution agreements indicates a thaw in the chilly relationship between international creditors and the Icelandic government following the financial crisis, when capital controls prevented creditors from transferring assets abroad. Improved investor sentiment will help Iceland attract capital and investment, especially once the capital controls are lifted.

The emergence of larger-than-expected asset quality problems in the new banking system and a slower-than-expected move toward liberalization weigh on the positive credit effect of progress to date. However, these stability contributions signify meaningful progress toward reopening Iceland's capital account, reducing the likelihood of a disorderly unwinding of trapped assets, one of the key implementation risks of the liberalization strategy.

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