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Iceland's Financial Crisis – *Quo Vadis* International Law

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I. Introduction

In October 2008, Iceland's banking system collapsed. Within a week, the three major banks comprising ninety percent of the Icelandic banking system had failed. It was one of the fastest and most comprehensive banking crises in history. This collapse occurred at the height of the global credit crunch and followed the bankruptcy of Lehman Brothers in the United States.

The crisis has shaken up the tiny nation in the North Atlantic and has transformed its political landscape. Following months of protests over the handling of the financial crisis, Prime Minister Haarde of the Independence Party resigned in January 2009. His coalition government with the Social Democratic Alliance collapsed. He was succeeded by Jóhanna Sigurðardóttir (Social Democratic Alliance) who formed a coalition government with the Left-Green Movement. Iceland had never seriously considered EU membership for fear of losing control over fisheries. However, the crisis tipped the scales in favor of EU membership. The financial stability benefits of the EU and the Euro in particular seemed suddenly much more attractive.

A long-running dispute on who ought to pay for the deposits in failed Icelandic banks has poisoned relations between Iceland, the United Kingdom, as well as the Netherlands. In total, Iceland could be obliged to pay more than 4.5 billion dollars (U.S.) to the U.K. and the Netherlands. The perceived passivity of the EU in this dispute fuelled a backlash against EU membership in Iceland. Curiously, the parties decided to treat the collapse of the Icelandic banks essentially as a commercial event and concluded a series of agreements governed by English law. They appeared reluctant to resolve the dispute at the inter-state level. As a result, international and European law and international dispute settlement have played virtually no role in resolving the Icesave dispute.

For Iceland, the stakes are undoubtedly high. Its International Monetary Fund program, potential EU membership, sustained economic recovery, and its solvency hang in the balance.[1] But the implications of this dispute

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extend far beyond Iceland. Iceland is an early example of the widespread shift of debt from private to public balance sheets that has taken place in many parts of the developed world. It provides a glimpse into the limitations of our current framework for dealing with the cross-border spillovers of systemic banking crises and sovereign debt crises. The case of Iceland demonstrates that we urgently need to upgrade our toolbox to deal with a potential wave of sovereign defaults in many parts of the world.

II. A severe Banking Crisis Weighs on the Public Purse

Iceland's financial crisis is unusual in several respects. The island has a population of just over 300,000 people. Pre-crisis gross domestic product (GDP) amounted to about $16.5 billion, with a GDP per capita of $42,000. In 2008, Iceland ranked first in the United Nations Human Development Index.[2] The country has a mature democratic system and bountiful natural resources. These features distinguish Iceland from the traditional suspects for debt crises: developing countries with fragile political institutions and a heavy reliance on external finance.

In early October 2008, Iceland's three major banks with large international operations—Landsbanki, Kaupthing, and Glitnir—lost the ability to refinance their liabilities in international capital markets. When the banks collapsed, their liabilities exceeded sixty billion dollars (US). A rapid loss of confidence, centered on the banks' refinancing difficulties and a chronic current account deficit exceeding twelve percent of GDP, triggered a run on the Icelandic currency. The classic scenario of a currency run materialized. Iceland's currency, the krona, lost more than fifty percent of its value against a basket of currencies.[3] Iceland's central bank lost most of its reserves in a vain attempt to prevent the currency's collapse.

The Icelandic central bank was unable to fulfill the function as a lender of last resort because the bank's liabilities were denominated in foreign currency and exceeded eight times Icelandic GDP. The government for its part lacked the resources to simultaneously guarantee the foreign currency liabilities of the three largest banks as they were simply too large given the size of Iceland's economy. Even if the government had formally given such a guarantee, it would have likely lacked credibility in the eyes of international financial markets.

In response to the banking crisis, Iceland adopted emergency legislation authorizing the take-over of banks experiencing payment difficulties.[4] The government decided to split off three new domestic banks that would take over the Icelandic assets and liabilities of the old banks. The rationale behind the emergency legislation was to preserve Iceland's banking system and the safety of deposits by transferring some assets of the old banks into new banks. Most liabilities and derivatives were left in the old bank to be wound up. The government also modified the priority ranking of creditor claims, giving preference to domestic depositors over general unsecured creditors, such as the banks' bondholders.

The case of Iceland illustrates that contingent liabilities from private sector debt might add substantially to a country's debt burden in a crisis. Before the crisis, Icelandic sovereign debt was less than ten percent of GDP. It is projected to exceed 150 percent of GDP by the end of 2010—a spectacular increase within just over a year. Notwithstanding the financial difficulties of its banks, Iceland so far has remained current on its sovereign debt. References to the bankruptcy of Iceland, as a country, gloss over this crucial fact. But they illustrate that in practice the distinction between sovereign and private sector liabilities is no longer clearcut. Alarmed at the rapid rise in Iceland's public debt, some went so far as drawing parallels between Iceland's liabilities and German war reparations under the Versailles Treaty.[5]

III. The Icesave Dispute

Since October 2008, Iceland, the Netherlands, and the United Kingdom have negotiated on sharing the burden of compensating retail depositors in Icesave, the Internet unit of Landsbanki bank. With its high interest rates, the failed online bank had attracted a large and diverse group of savers from across Europe, especially from the U.K. and the Netherlands. The Dutch and U.K. deposit insurance schemes paid out the claims to the depositors at the height of the crisis without consulting Iceland, and now seek reimbursement from the Icelandic Deposit Insurance Fund.

At the heart of the dispute is the EC Directive on deposit-guarantee schemes, which harmonized requirements for deposit guarantees applicable to branches throughout the single market for financial services.[6] Depositors and other creditors may also have non-discrimination claims under the European Economic Area (EEA) Agreement.[7] As a member of the EEA, Iceland is bound by the Directive.[8] As a general rule, a credit institution may only accept deposits if it is a member of such scheme. The Icelandic supervisor is responsible for the branches of its banks throughout the EU and the EEA. The Icelandic crisis exposed significant shortcomings in the regulatory and supervisory framework of the European single market in financial services. Banks have been able to open branches based on the license of their home country, which exercises supervision and guarantees deposits. Significant changes to this liberal regime are already under way, and more reform is to be expected.

There is some uncertainty whether Iceland is obliged to refund the compensation that the U.K. and the Netherlands paid out to depositors. The U.K. and the Netherlands maintain that Iceland is obligated to pay 20,887 Euros ($30,000) per depositor under the EEA Agreement and the Directive. A Joint Legal Opinion by four experts under the auspices of the Economic and Financial Affairs Council (ECOFIN) reached the preliminary conclusion that Iceland is under an obligation to ensure that its deposit-guarantee scheme has adequate means and is in a position to indemnify depositors. But whether this amounts to an obligation to achieve that result in all circumstances, or refers to an obligation to set up and operate an effective deposit insurance scheme with adequate capitalization, is disputed. There are also questions as to the interpretation of these obligations in a severe banking crisis. The Joint Legal Opinion underscored that it is for the European Free Trade Association (EFTA) Surveillance Authority to assess the compatibility of the Icelandic legislation with the EEA Agreement.[9]

The British government alleged that Iceland appeared ready to flout its international obligations under the Directive at the height of the credit crunch. The U.K. invoked provisions of the Anti-terrorism, Crime and Security Act 2001 to freeze the assets of Icelandic banks in the U.K. with the stated aim of preventing harm to the U.K. economy.[10] The move caused uproar in Iceland, raised eyebrows from advocates of civil liberties, and complicated the resolution of the Icesave dispute.[11]

The Icelandic position is that the asset freeze played an important role in the collapse of Kaupthing bank. Moreover, it is alleged that no consultations were held, despite a Memorandum of Understanding to the contrary.[12] Iceland maintains that it always stood by its international obligations. It briefly considered seeking judicial review of the asset freeze in English courts and also bringing a claim before the International Court of Justice, the European Court of Human Rights or the European Court of Justice. It ultimately decided against that course of action and focused its energy on negotiations with the U.K. and the Netherlands.[13]

In November 2008, Agreed Guidelines concluded in Brussels under EU auspices stipulated that the Deposit Insurance Directives applies to Iceland like an EU member state. Iceland accepted its obligations under the EEA agreement in principle. The Guidelines also contain an undertaking to take Iceland's difficult economic situation into account in resolving the dispute and to work towards the restoration of its financial system and economy. However, the three governments continued to disagree on Iceland's legal obligations with respect to Icesave.

After months of negotiations, in June 2009, the three governments agreed on two loan agreements.[14] The Icelandic-U.K. agreement was for 2.35 billion pounds with a seven-year grace period. It is repayable in thirty-two quarterly installments between 2016 and 2024, with interest at 5.55 percent. The Dutch loan is for 1.33 billion Euros and the same payment terms. A condition precedent for their entry into force is a state guarantee by the Icelandic Parliament that is satisfactory to the lenders, under which Iceland guarantees all the Guarantee Funds' obligations from June 2016 onwards. The agreements also contain a clause guaranteeing equal creditor treatment and a vague undertaking to treat Landsbanki's creditors in accordance with "accepted international or European principles of creditor in an international winding up."

Faced with widespread concerns in Iceland that the loan imposes an impossible burden on future generations, the Icelandic Parliament added a series of conditions to the bill authorizing the sovereign guarantee.[15] These conditions include a ceiling as a percentage of GDP on the guarantee; a bar to attachments of assets deemed critical for Iceland's sovereign functions; a revision clause should the competent adjudicator subsequently find that Iceland was not obligated to pay under the EEA Agreement; the allocation of the Landsbanki bankruptcy estate according to Icelandic law; and parliamentary oversight over the loan agreements.

On October 19, 2009, the U.K. and the Netherlands accepted some of the conditions, including the cap on payments at a maximum six percent of cumulative GDP growth.[16] However, the lenders insisted on an unconditional guarantee. The Icelandic government therefore submitted a bill authorizing such guarantee to Parliament. On December 30, 2009, the Parliament approved the guarantee, this time without any conditions attached. Yet on January 4, 2010, the President of Iceland referred the bill to a referendum under Article 26 of the Icelandic Constitution. That referendum will be held on March 6, 2010 and will determine the fate of the sovereign guarantee and the loan agreements.

IV. Outlook

Pollsters predict a negative outcome in the referendum, which could cause a constitutional crisis in Iceland. The Icelandic government also fears that such outcome would return the Icesave dispute to square one. The British and Dutch governments share these concerns. Both sides appear eager to avoid the need for a referendum. However, the collapse of the Dutch government on February 20 is likely to delay negotiations. Since January 2010, Iceland has sought new negotiations. To that end, Iceland appointed Lee Buchheit– a New York lawyer with extensive experience in sovereign debt restructurings – to lead its delegation in a new round of negotiations.

In February, the U.K. appeared to have softened its stance.[17] A face-saving compromise seemed possible. Various compromise solutions were explored, ranging from more direct support from the Nordic countries, to a lower interest rate and an interest payment holiday. The last U.K. and Dutch offer was for a floating interest rate of 2.75 percentage points above the London interbank rate and a two-year interest holiday. Iceland responded that the British and Dutch government should on-lend at their own cost of borrowing. Unable to agree on the revised terms, the latest round of talks collapsed on February 25.[18] A rejection of the loan agreement now seems almost inevitable.

Iceland is seeking to enlist U.S. help to ensure that the IMF program and the Icesave dispute are decoupled.[19] The United States has so far remained neutral on the Icesave dispute. Such neutrality appears increasingly difficult to maintain. Iceland's attempt to multilateralize the dispute brings back memories of the Cod Wars between Iceland and the U.K. in the 1970s. When Iceland threatened to close the NATO air base at Keflavik if the conflict over fishing rights continued, NATO and the United States intervened. The United States offered to mediate and encouraged an intercession by the NATO Secretary General, which led to a compromise that was acceptable to both parties.

Rumor has it that the U.K. and the Netherlands have used the IMF program as a negotiation chip by delaying disbursements until the Icesave dispute is resolved. Iceland is trying to put its program on the agenda of the IMF Executive Board, irrespective of the progress in the Icesave negotiations. On February 24, the EU Commission recommended accession negotiations with Iceland. But all EU member states, including the U.K. and the Netherlands, will need to approve. The Icesave dispute is likely to hang like a Damocles sword over Iceland's bid to join the EU. Iceland's high public debt could turn out to be a stumbling block for eventual membership in the Eurozone.

The Icesave negotiations that have unfolded over the last eighteen months resemble a high-stakes power game, the last chapter of which remains to be written. The parties need to be willing to compromise on the amount that Iceland is obliged to pay. Ultimately, a sustainable solution will involve recognition of the dispute's inter-state character, reasonable payment terms, and a robust international mechanism for settling disputes under the agreement.

About the Author

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Endnotes

[1] The key terms of the International Monetary Fund Agreement are set out in the Letters of Intent by Iceland to the IMF. *See* Iceland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding (Oct. 20, 2009), *available at* http://www.imf.org/external/np/loi/2009/isl/102009.pdf; and Iceland: Letter of Intent and Technical Memorandum of Understanding (Nov. 15, 2008), *available at* http://www.imf.org/external/np/loi/2008/isl/111508.pdf.

[2] U.N. Dev. Programme [UNDP], *Human Development Report, Overcoming Barriers: Human Mobility and Development* (2009), *available at* http://hdr.undp.org/en/reports/global/hdr2009/. In the 2009 Report, Iceland is still ranked as number three in the world.

[3] At the beginning of 2008, one Euro was equivalent to 85 Krona (ISK). By November 2008, 165 ISK were needed to buy one Euro.

[4] Act on Authorisation for Treasury Disbursements due to Unusual Financial Market Circumstances [Emergency Act] No. 125/2008 [Iceland] (Oct. 6, 2008), *available at* http://eng.forsaetisraduneyti.is/media/English/unusual_financial_market_circumstances.pdf.

[5] Thrain Eggertsson, *Long Term Consequences May be Ruinous for Iceland*, FIN. TIMES, Oct. 27, 2008 (predicting that the "unrealistic debt" burden will most likely lead to "extremely high inflation, economic decline, mass emigration and political disorder. I am reminded of the situation facing Germany in 1919 following the Versailles Peace Treaty").

[6] Council Directive 94/19/EC, O.J. (L 135) 5, *amended by* Council Directive 2005/1/EC, O.J. (L 79) 9.

[7] Agreement on the European Economic Area, Mar. 17, 1993, 1994 O.J. (L 1) 3, *available at* http://www.efta.int/~/media/Documents/legal-texts/eea/the-eea-agreement/Main%20Text%20of%20the%20Agreement/EEAagreement.ashx [hereinafter EEA Agreement]. The EEA Agreement extends the Internal Market of the EU to the European Free Trade Agreement (EFTA) member states, with the exception of Switzerland, Iceland, Liechtenstein, and Norway. Community legislation is dynamically incorporated into the Agreement.

[8] Decision of the European Economic Joint Area Committee No. 18/94 amending Annex IX (Financial Services) to the EEA Agreement incorporated the Directive into the Agreement on the European Economic Area of which Island is a member.

[9] Opinion on the Obligations of Iceland under the Deposit Guarantee Directive 94/19/EC (Nov. 7, 2009), *available at* http://www.island.is/media/frettir/31.pdf. The EFTA Surveillance Authority has received a number of claims relating to Iceland's financial crisis: one from an EU member state regarding depositors; one from a group of Dutch depositors; one from a group of depositors of Landsbanki Guernsey; one from thirty-nine financial institutions that were general creditors of the collapsed Icelandic banks; and seven complaints by bondholders of Icelandic banks. None of these cases have been decided.

[10] Landsbanki Freezing Order 2008, 2008, S.I. 2668 (U.K.) (done under Sections 4 and 14 of and Schedule 3 of the Anti-terrorism, Crime and Security Act 2001); *see also* De Nederlandsche Bank N.V./Landsbanki Islands HF, Rechtbank Amsterdam [Amsterdam District Court], 13 October 2008, HA-RK 08.668 (Neth.), *available at* http://www.island.is/media/frettir/13.pdf (Dutch emergency regulations declared applicable to Landsbanki Amsterdam).

[11] More than one third of Icelanders signed an online petition ("Icelanders are not terrorists"). The petition is *avaliable at* http://lisa.indefence.is/Petition.

[12] Memorandum of Understanding between the Financial Compensation Scheme and the Icelandic Deposit Insurance Fund (Oct. 31, 2006).

[13] In a Memorandum of Understanding between the two deposit insurance funds, the Icelandic Fund accepted the obligation to compensate Dutch depositors in Landbanki Amsterdam up to 20,887 Euros. *See* Memorandum of Understanding between the Depositor's and Investors' Guarantee Fund (Oct. 11, 2008), *available at* http://www.island.is/media/frettir/11.pdf.

[14] Loan Agreements between the Depositors' and Investors' Guarantee Fund of Iceland, Iceland and the Commissioner's of Her Majesty's Government/The State of the Netherlands (June 5, 2009), *available at* http://mbl.is/media/47/1547.pdf; and Settlement Agreement and Finance Agreement between Financial Services Compensation Scheme Limited and the Depositors' and Investors' Guarantee Fund of Iceland (June 5, 2009), *available at* http://www.island.is/media/eydublod/settlement-agreement.pdf.

[15] Proposals for Amendment, Parliamentary Doc. No. 204, 137th Legislative Sess. (2009). The Iceland Parliament approved Act 96-2009 on August 28, 2009. It received the President's approval on September 2.

[16] Acceptance and Amendment Agreement Relating to a Loan Agreement dated 5 June 2009 between the Depositors' and Investors' Guarantee Fund of Iceland, Iceland, and the Commissioners of Her Majesty's Treasury (Oct. 19, 2009), *available at* http://www.island.is/media/icesave-19.10.2009/01-AAA-UK.pdf.

[17] Alex Barker & Andrew Ward, *Iceland Wins Softer Repayment Terms*,

FIN. TIMES, Feb. 17, 2010.

[18] Alex Barker & Andrew Ward, *Icesave Repayment Talks Collapse*, FIN. TIMES, Feb. 25, 2010.

[19] David Jolly, *Iceland Asks U.S. to Help Ensure International Loans*, N.Y. TIMES, Feb. 23, 2010.