ETUI Policy Brief

European Economic and Employment Policy

Issue 2/2010

Europe needs fair and transparent debt work-out mechanisms: lessons from the Icelandic case

Koos de Bruijn, Jürgen Kaiser, Nick Dearden,
Øygunn Brynildsen and Nuria Molina

The authors all work either for, or with members of, EURODAD, The European network on Debt and Development (www.eurodad.org/).

Policy implications

Debt difficulties currently faced by Iceland and other European countries give rise to new debates among European decision-makers on how to identify causes and responsibilities in the context of sovereign debt crises and how to find efficient solutions to the problems arising. There currently exists no orderly procedure to ensure an efficient and fair solution to sovereign debt difficulties. The lack of such procedure is costly both to the country in question – and most importantly, to the country's most vulnerable social sectors – and to its creditors. An insolvency procedure needs to be set up to deal with sovereign debt disputes. The procedure must be independent, fair and comprehensive, treating all creditors equally. A debt work-out mechanism is needed which assesses the underlying causes of the distressed debt, taking creditors' responsibilities into account. Only by holding creditors, as well as borrowers, to account for irresponsible behaviour could new debt crises be avoided.

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 who received compensation from their respective national governments. 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 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?

etui.

Civil society organisations 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 wellbeing 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, which more often sympathised with lenders. However, the risk of sovereign default is no longer a fantasy for European countries.

Following the global economic downturn, several European countries may be facing an increased risk of default. The debate flourishes on what are the root causes of the difficult economic situation faced by these countries, and what would be the most efficient way of dealing with sovereign debt difficulties. What seem to be missing in the discussions is recognition of the interconnections between the national economies of the European Monetary Union (EMU) Member States and awareness of how institutional weaknesses have contributed to the increased risk of debt distress in several peripheral eurozone countries.

In the context of a possible debt crisis within EMU, interest in the issue of debt workout is spreading and some experts have even suggested the need for a debt work-out mechanism as part of the institutional set-up of a proposed European Monetary Fund (Reinhert 2010).

Interestingly, while Germany has opposed negotiations on restructuring Greek debts, it is also one of the EU Member States that is positive towards establishing a new procedure to deal with sovereign debt restructuring for developing countries. The Netherlands has also shown interest in establishing a global debt work-out mechanism. However, both German and Dutch interest seems to be seriously watered down when debt restructuring is considered in countries where their banks and investors have a high exposure, as shown in the cases of Iceland and Greece.

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 makes specific recommendations for resolving the issue, drawing implications also for sovereign debt more generally.

A slippery slope for Icelandic banking: 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 savers among whom high interest rates attracted hundreds of thousands of customers in a short space of time (Islam 2010). Kaupthing pursued a similar strategy with the brand Kaupthing Edge, operating 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 (Financial Supervisory Authority Iceland 2008).

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 (Times Online 2008). These governments claimed that this would be in violation of EU law to which Iceland is subject as a member of the European Economic Area[1]. EU directive 94/19/EC is designed to provide cover for depositors, wherever deposits are located in the European Community[2]. This means that financial institutions are obliged to set aside funds to cover investors' losses in the case of economic difficulties. However, these regulations do not provide any solution for financial turmoil on the scale that we have seen over the last years. 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

1 European law does not specify how the European Economic Area 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)

2 EU directive 94/19/EC included in the Annex IX of the Agreement on the European Economic Area (EEA) which brings together the 27 EU Members and the three EFTA countries – Iceland, Liechtenstein and Norway – in a single internal market and provides for the inclusion of EU legislation within certain policy areas throughout the 30 EEA States.

a failure of Landsbanki and its UK branch'[3]. However, when the banks went into receivership, the DIGF held only around €68 million which was far from sufficient to cover Dutch and British claims[4].

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 that the relevant EU directive was not designed to cover a systemic failure and does not impose a sovereign guarantee on deposit insurance schemes.

This goes to the heart of the question 'who's to blame' for the Icesave dispute? Without doubt, 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 economics 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. Van Wijnbergen argues that Bos cites guidelines which are not relevant to 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' (van Wijnbergen 2010).

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.'[5] 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'. The Althingi defined that an affordable level of repayment would depend on the level of GPD growth. In the case of no economic growth, Iceland could not afford to spend anything on debt repayment to the UK and the Netherlands. The Alhingi specified that no more than a maximum of 6% of any real increase in GDP (from its level in 2008) should be spent on the repayment of the loans to the UK and the Netherlands.

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

A responsible and just loan?

Civil society organisations and academics have worked for many years to develop 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 frameworks devised to date – for instance Eurodad's *Responsible financing charter* (Eurodad 2008) – 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 (Gerritsen 2008). Dominique Strauss-Kahn, managing director of the IMF, appeared to admit to the presence of 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.'[6]

3 Letter from the Icelandic ministry of Business Affairs to the HM Treasury (5 October 2008).

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

5 HM Treasury notice, 8 October 2008 (http:// www.hm-treasury.gov.uk/fin_sanctions_landsbanki.htm).

6 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).

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 (Hekking 2010). In reaction to the results of the referendum, Dutch Foreign Affairs minister Verhagen said he did not wish to comment: 'we keep our gunpowder dry', leaving all options open, including blocking action in both the EU and IMF (Garschagen 2010).

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.

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. The story of the negotiations to date in the Iceland case is 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 an interest rate 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 upon Germany's First World War reparations, as urged by economists such as John Maynard Keynes, is regarded as a primary course 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[7].

7 Britain defaulted on $4.4 billion in 1934 and this debt remains in limbo (Rohrer 2006).

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[8]. Real disposable income is estimated to have fallen by 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 resolution 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 that the actual existence of the debt is not an issue subject to debate among 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 to this end was exerted upon Iceland by the Netherlands and the UK. This pressure continues. But now that the people of Iceland have rejected the terms of repayment, 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 (EURODAD 2009) we will outline some policy implications for Iceland's overall debt problem, including the Icesave case. **Six principles 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 the IMF and the 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 individual creditors' efforts to secure repayment of specific debts, 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.

8 Iceland had an external debt of 15,015,790 mio ISK in the fourth quarter of 2009 (see website of the Central Bank of Iceland) and a preliminary GDP of 1,500,162 mio ISK (see website of Statistics Iceland, both accessed on 8 June 2010).

4. **Assessment of the indebted country's economic situation by a neutral body.** As 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. Assessment to this end must necessarily be carried out by an independent body.
5. **Public participation.** 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 some of the key decisions on debt repayment to public consultation in a more transparent and participatory way. The Icelandic government would be extremely well advised 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 insolvency procedure needs to be set up to deal with sovereign debt disputes. The current debt crisis within European countries reinforces the need for a transformation of existing debt restructuring mechanisms. Even if countries at risk of insolvency have been granted new loans, it is evident that in the case of no restructuring of distressed debts, countries will be condemned to long recessions with severe social impacts. The government in question, be it Iceland, Greece or any developed or developing country facing high levels of debt, must make the tough choice of balancing creditor repayments versus social spending.

An analogy should be made with corporate and personal bankruptcy law (for instance, Chapter 9 and 11 of the US constitution), which allows a firm or a family to restructure its debts before reaching the point of insolvency. Avoiding insolvency is in the interest of both the firm and its creditors, but also in that of society. For a country, allowing for debt restructuring before reaching the point of detrimental debt distress would ease the cost to both creditors and the people.

Not only would a structured and independent mechanism be more effective than today's time-consuming and costly restructuring procedures, but a mechanism that works according to the Ten Civil Society principles would increase predictability for both lenders and borrowers and 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.

References

EURODAD (2009) *A fair and transparent debt work-out procedure: 10 core civil society principles*, 17 December. http://www.eurodad.org/whatsnew/reports.aspx?id=3946

EURODAD (2008) *Charter on responsible financing*, 6 February. http://www.eurodad.org/whatsnew/reports.aspx?id=2060

Financial Supervisory Authority Iceland (2008) *What actions has the FME taken regarding the situation in the financial markets?* http://www.fme.is/?PageID=864

Garschagen, M. (2010) 'Bevolking IJsland wijst Icesave-akkoord af', *NRC Handelsblad*, 6 March. http://www.nrc.nl/economie/article2498612.ece/Bevolking_IJsland_wijst_Icesave-akkoord_af

Gerritsen, J. (2008) 'IJsland overweegt lening Bos te weigeren', *NRC Handelsblad*, 13 November. http://www.nrc.nl/economie/article2059478.ece/IJsland_overweegt_lening_Bos_te_weigeren

Hekking, H.D. (2010) 'Verzet tegen EU-route IJsland', *Het Financieele Dagblad*, 25 February. www.fd.nl/artikel/14282009/verzet-eu-route-ijsland

Islam, F. (2010) 'As Iceland resists paying our billions, let's not forget just who is to blame', *guardian.co.uk*, 18 February. http://www.guardian.co.uk/commentisfree/2010/feb/18/icelanders-right-furious-wrong-blame

Reinhert, C. (2010) 'European Monetary Fund: one promising feature ', The Economist, 21 February. http://www.economist.com/blogs/freeexchange/2010/02/emf_roundtable_7

Rohrer, F. (2006) 'What's a little debt between friends?', *BBC News Magazine*, 10 May. http://news.bbc.co.uk/2/hi/uk_news/magazine/4757181.stm

Times Online (2008) *Transcript of conversation between Chancellor and Icelandic Finance Minister*, 24 October. http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article5005915.ece

van Wijnbergen, S. (2010) 'Iceland needs international debt management', *NRC Handelsblad*, 12 January. http://www.nrc.nl/international/opinion/article2457326.ece/Iceland_needs_international_debt_management

The views expressed in *ETUI Policy Briefs* are those of the respective author(s) and do not necessarily reflect the views of the ETUI.
For more information about the *ETUI Policy Brief – European Economic and Employment Policy*, please contact the editor, Andrew Watt (awatt@etui.org).
For previous issues, please visit www.etui.org/publications. You may find further information on the ETUI at www.etui.org.

© ETUI aisbl, Brussels 2010
All rights reserved.

ISSN 2031-8782
The ETUI is financially supported by the European Community. The European Community is not responsible for any use made of the information contained in this publication.