

Icesave

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Prior to the privatization the Icelandic state owned banks had been under heavy political influence. In fact, the entire financial system was closely regulated. Currency controls were in effect until 1992. However, with Iceland's entry into the European Economic Area (EEA) with the EU in 1994, major changes occurred. The agreement made free flow of capital possible and Icelandic banks were able to open banks or branches of within the EEA. However, Iceland was not at all capable to deal with these major changes in regulation. Neither education nor experience existed within the country to participate in international banking let alone monitor international financial business. This applied equally to the financial community and government officials. Therefore it was of the utmost importance to tread very carefully when taking the first steps on the international banking scene.

1. Privatization.

When the Icelandic banks were privatized Landsbankinn, the largest bank in Iceland, was sold to individuals who had no experience in banking. Nonetheless, free movement of capital and high availability of credit from global financial markets and large foreign banks made it possible for Landsbankinn to expand. However, by 2006 it became increasingly difficult to get credit, and as a response to this problem Landsbankinn decided to offer internet banking and savings accounts in England in October 2006. These accounts were called Icesave. At that time the international rating agencies gave Iceland and the Icelandic banks top ratings: Landsbankinn was seen as being a trustworthy and able bank, a fact the new owners fully exploited.

The operations of Landsbankinn in England were made possible by the EEA agreement, and the bank operated according to EEA regulations. The Internet accounts- Icesave- soon became very popular because of the high interest rates they carried, and by the end deposits had reached 4,5 billion pounds sterling. Then in May, 2008, Landsbankinn opened internet accounts in the Netherlands, similarly under EEA regulations. These collected deposits of additional 1.7 billion Euros.

The regulations of the European Union and EEA had been eased considerably when it came to banking and financial activities, and restrictions on establishing banks or opening branches had been reduced significantly within the EU and EEA. The EU directive on deposits had virtually promised that all deposits were insured up to 20.000 Euros. The law on deposit insurance states explicitly that if a deposit insurance fund which insures deposits is established a explicit government guarantee does not apply to deposits.

Such a fund had been created in Reykjavík, Iceland, and according to both Icelandic law and the EEA regulations it was this fund, not the Icelandic state, which guaranteed the deposits of Icelandic banks. At no point, between the creation of this system and the fall of 2008 when the Icelandic banks fell, there were no comments made, neither the EU nor any European regulatory agency. Because of that, it can be said with all certainty that Iceland had fulfilled its obligations to the Icesave depositors under EU or EEA regulations.

However, when we consider the expectations of the depositors that there was a reliable deposit insurance system within the EU, it is most likely that the EU regulation is flawed. According to regulations, Icesave account holders affected by the collapse of Landsbankinn in October 2008, were supposed to send a written request to the Icelandic insurance fund within two months, requesting the insurance on their deposits. However, fearing a run on their banking systems, the British and Dutch insurance deposit funds rushed in and paid the depositors the insured amount. As a result, Britain and the Netherlands demanded reimbursement from the Icelandic insurance deposit fund. And since the fund did not have the resources to meet those demands, the governments in question demanded the Icelandic treasury cover the shortfall.

At first glance it appears that Britain and the Netherlands jumped the gun. To begin with, they interfered in the normal course of events. The Icelandic deposit insurance fund had not had the opportunity to assess any reimbursement demands when the two countries paid out the deposits. Because Iceland had indeed implemented an insurance fund under EU regulation, and since regulators had never made any comments on the arrangement, Iceland had not been in violation of regulations regarding the deposit insurance funds.

After the Icelandic insurance fund had been drained and was bankrupt, there really was no alternative recourse for those who had deposited funds into Icesave accounts. According to EU regulations, the treasury of any given country is not allowed to guarantee deposits because of market discrimination. Who would not prefer to do business with a bank under German government guarantee rather than a Icelandic government guarantee?

When the matter is looked at with greater scrutiny it becomes apparent that the British and the Dutch did not jump the gun. Landsbankinn was in business both in England and the Netherlands with the permission of the countries in question. A bank operating in those countries, whether it is a branch or not, must abide and operate under the laws and regulations that apply there. Therefore Landsbankinn had to operate under those laws, and therefore Landsbankinn acquired insurance from the British and Dutch insurance funds. Otherwise, there would have been discrimination in the market. A bank operating with only cheap insurance from Iceland would get a head start in the English and Dutch financial markets.

As Landsbankinn had bought insurance coverage in both the Netherlands and the UK, it is obvious that the British and the Dutch were obligated to pay and therefore did pay out the deposits that Landsbankinn had taken out insurance for.

Judging from the facts mentioned above it is clear that there is no legal basis for Icelandic taxpayers to be held responsible for the banking operations of Landsbankinn in the UK and the Netherlands. This has been the view of most Icelanders since the beginning of the Icesave dispute. Iceland immediately requested the case being settled in court, but both the UK and the Dutch prevented that course of action. If the Governments of those countries now intend to take the matter before courts we are most pleased with that decision. But we believe that this is not at all likely to happen, and that the governments of the two countries will instead continue to try to force Iceland to pay.

The problem the EU faces is that the legislation on deposit insurance creates an expectation that depositors will be fully compensated if a bank becomes insolvent. The EU legislation assumes that up to one in fifty banks can become insolvent, and under these assumptions it is practical to rely on the system in question. In Iceland, however, 90% of the banking system went into bankruptcy, and because of the enormity of the crash the insurance deposit fund could not be expected under any

reasonable assumptions to fulfill the expectations the legislation had promised to depositors. The EU could become liable because the legislation on deposits promised, and continues to promise more than it could deliver. The EU is fully aware of this, and is therefore keen to keep the faults of its legislation hidden from the public.

It is of the utmost importance to the banks and financial system that the public has faith in the banking system, and that the public keeps providing them with use of their savings by depositing them in their savings accounts. It is actually a prerequisite that government institutions ensure in one way or the other public deposits in order for the banks to continue to do business. To reflect on this raises pressing questions: Why can a private company not vouch for its own activities, without the government getting involved?

The explanation is that through this arrangement the public gets the sense that their deposits are safe, that they belong to them and that they are entitled to recover them at any time. Here, however, we have a fundamental misunderstanding, a misconception which is required to keep the banking system working. When an individual deposits his or her money into a bank they are in fact lending the money to the bank which then uses the money to do whatever it pleases with the money. It is not a new truth that full recovery is not always possible. Having a government guarantee on private lending of this sort is wrong because little if any restrictions are placed on how the bank in question can use the funds it gains access through government insured deposits, knowing that it will be bailed out using the depositors tax money to cover any damages.

Had the foreign deposits been included in the emergency measures passed in Iceland when the banks failed it would simply have meant that the banks would simply have entered bankruptcy again. Instead only deposits in bank branches located in Iceland were included in the legislation. There was therefore no discrimination based on nationality, but a discrimination based on residence. British or Dutch depositors who resided in Iceland were insured under the emergency legislation.

2. Discrimination

Another issue regarding the Icesave dispute is the question of possible discrimination on account of residence or nationality. If courts find that to be the case Iceland might be held liable for the Icesave deposits. In the fall of 2008 when the banks collapsed the Icelandic government judged it to be the right course of action to take over the three major banks. They were then divided into two parts: the Icelandic operations and foreign operations were split apart. All foreign assets and liabilities were left in the old banks, which then entered receivership, while all the domestic assets and liabilities were transferred to new banks which were also given sizable capital injections by the government. The old banks, which are now in receivership own significant portions of the new banks.

This was done in order to ensure that there would continue to be a functioning banking system in Iceland, and to avoid the prospect of having to reintroduce barter. Because of that all businesses and individuals doing business, working or living in Iceland were included under the legislation, since they were believed to have a common interest in maintaining a functioning banking system in Iceland. Since virtually the entire banking system, and large sections of the financial system, had collapsed, the parliament judged that in order to avoid a mass panic and run on the newly resurrected banks all deposits had to be insured with no maximum amount. A mass run on the financial system was actually taking place: as companies and the public hoarded cash the Central Bank was running out of bank notes - worn notes that had been marked for destruction were even reintroduced. The authorities feared the worst.

Here we are dealing with the fundamental question of whether a sovereign nation has a right, under extreme circumstances, to rescue the foundations of its economy and society or not: Do the rules and regulations of the European Union have greater importance than the foundation of the nation states? It is of the utmost importance to have this question settled before the appropriate courts. It is also obvious that it is not in the interest of the European Union that the interests of the nation state be deemed more important than the union.

3. Conclusion:

Judging from the facts mentioned above it is clear that deposits of individuals and businesses to the Icesave accounts of Landsbankinn were guaranteed by Icelandic, British and Dutch deposit funds. As the Icelandic, British and Dutch authorities had fulfilled their obligations towards EU regulations on deposits insurance by setting up deposit insurance funds none of the countries had any further government obligations to fulfill.

If the funds could not meet the minimum deposit guarantee, there really was no other option available.

The old Landsbankinn owns significant assets. Those who have overseen its liquidation believe that these assets will suffice to pay out the minimum insured amount on all the deposits in the Icesave accounts. It will, however, take a few years to sell of all the assets of Landsbankinn.

EU legislation on deposit insurance is clearly aimed at creating the perception that banks are a safe place to deposit money into. Bearing in mind that that economic crises keep plaguing the world, such guarantees are clearly needed. The enthusiasm of the EU to hide the shortcomings of the deposit insurance system are understandable, but to aid the banks in their image control campaigns so willingly puts the European Union firmly on the side of the banks and not the common citizens of Europe.

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