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Iceland Wins Case On Deposit Guarantees

Iceland won a sweeping victory in a court fight over its responsibilities to foreign depositors in Icelandic bank Landsbanki, which failed in 2008.

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The court of the European Free Trade Association on Monday said Iceland didn't breach European Economic Area directives on deposit guarantees by not compensating U.K. and Dutch depositors in Landsbanki's online savings accounts, known as Icesave accounts.

The EFTA Surveillance Authority, which brought the case against Iceland, had claimed Iceland should have made sure U.K. and Dutch savers who lost money on Icesave got repaid from deposit insurance.

U.K. and Dutch authorities compensated their own savers.

The directive, part of EU rules to which Iceland subscribes, "does not lay down an obligation on the State and its authorities to ensure compensation if a deposit-guarantee scheme is unable to cope with its obligations in the event of a systemic crisis," the ruling said.

The ruling of the EFTA Court can't be appealed. The ruling may have ramifications throughout the European Union. Iceland isn't a member of the EU, but it is part of the larger EEA, a group of countries that agree to follow the EU's common-market rules.

The EFTA Court's judgment doesn't bind the EU's highest court, the European Court of Justice, but it does establish a precedent for jurisprudence in the wider EU system.

The EFTA Court sets up a vexing question: If deposit-guarantee programs don't protect everyone, are they really effective?

That issue was raised by the European Commission, the EU's executive arm, which joined the case against Iceland. European deposit-guarantee programs, if they have funds at all, hold a tiny fraction of the insured deposits in the system. Their typical use is providing insurance in case a small number of banks collapse—not to bail out a system's worth of depositors.

In the U.S., the Federal Deposit Insurance Corp. holds just over 1% of insured deposits—but the FDIC is backed by the credit of the U.S. government.

Because its banks opened Internet arms seeking deposits from foreigners, Iceland had an unusually high proportion of foreign depositors in the system. In the euro zone, Cyprus—which is currently negotiating an EU bailout—has plenty as well. Germany has argued in bailout talks that some bank depositors in Cyprus shouldn't get all their money back. Iceland didn't force losses on

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domestic depositors. In the windup of the banks, the authorities put domestic deposits and assets into new "good" banks and left foreign deposits in the insolvent banks. The EFTA Surveillance Authority argued that Iceland violated nondiscrimination rules by treating domestic depositors differently. The court agreed with Iceland that the transfer didn't break the rules.

The EU's common-market rules require that every country establish a deposit-guarantee program that provides a minimum level of compensation to savers in case of a bank failure. Iceland's banking collapse took down all the island's major banks, and its deposit-guarantee fund didn't have nearly enough to pay out insurance.

At the core of the Icesave case is the question of exactly what a country must do in such a total failure. Iceland said its obligation was simply to make sure a reasonable guarantee plan existed. The U.K. said a country is obliged to make sure insured depositors are actually paid.

The Icelandic government expressed "considerable satisfaction" that the country's stance had prevailed in the Icesave case.

By compensating their depositors, the U.K. and the Netherlands received priority claims on the assets of Landsbanki. Iceland's foreign ministry said it expects those assets will be enough to pay all the British and Dutch claims.

U.K. authorities said they were considering their response, while Dutch authorities said they were disappointed by the ruling and would study its consequences.