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IE Fund Forum Geneva, 13 March 2012

$44.4bn Private equity fundraising total for 2011, down from $140.8bn in 2008

Iceland has definitely turned a financial corner as its 'real' economy improves. But as Jonathan Boyd finds out, policies put in place to solve its financial crisis are now hampering allocation to and within the country

The allocation conundrum

Fund and asset allocators working in Iceland face a set of challenges, particularly in the institutional investor and pension fund space.

On the one hand, the young demographic and recovery in the 'real' economy since the country's financial system tipped into chaos in 2008 means that monthly inflows into both mandatory and voluntary savings schemes (pension funds) are actually relatively strong, while assets under management are growing.

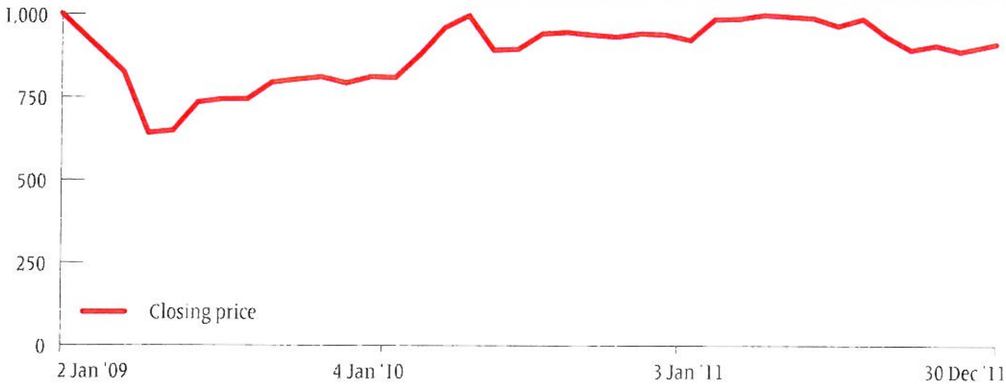
In addition, the younger average age of those working means liabilities are much further into the future than in any of the struggling peripheral eurozone members, and the system is still accumulating rather than paying pension incomes.

But on the other hand, capital controls in the form of foreign exchange restrictions introduced in the wake of the country's financial crisis mean that those charged with selecting buckets into which to put the accumulating cash are finding their choices restricted.

One asset manager working on behalf of one of the top five domestic pension funds says that the capital controls present by far the biggest challenge as it stops all additional allocation to foreign assets. Existing overseas assets can be re-allocated overseas. But if the money is repatriated, it cannot find a way out again.

Besides leading to difficult allocation questions, the build-up of cash within Iceland's long-term savings market threatens to create a local asset price bubble because the accumulation is set to keep growing until 2020, when net inflow to the system is projected to ease.

OMX ICELAND 6 INDEX – EQUITY RETURNS OVER THREE YEARS



Source NasdaqOMX

In practical terms, what allocators can do is put the cash coming into the system into three main buckets, the manager says: government bonds, cash, and domestic listed and unlisted equities. A fourth bucket that has not been used in any significant way is municipal bonds.

YIELDING PROBLEMS

Changes in yields from the three main asset classes will determine which is preferred, but there is little else that can be done to boost returns.

Activities such as currency hedging, overlays, swaps or other related activities are either not possible or made very difficult to execute due to the capital controls.

The benchmark real return that is required from the perspective of those allocating assets on behalf of pension savers is 3.5% per annum.

Sounds reasonable, but analysts fear there is simply too much money chasing the key available domestic asset – government bonds – which means real returns are being made much more difficult.

"PRIOR TO THE CRASH, THE INVESTMENT CULTURE SIMILAR TO SWEDEN'S. IT WAS MORE EQUITY-BASED"

Flóki Halldórsson, Stefnir Asset Management

Hrafn Árnason, executive director of discretionary management at Íslandsbanki's wealth management division VÍB, sums up his view thus. "The government got rid of the asset allocation problem for us – everything is restricted to Iceland."

He also notes the problems this has led to in terms of yields. "At some point, the yield will stop getting lower. But the thing is we have a shortage of government bonds.

"The state of government finances is quite good. They don't have to issue that much – only about ISK25bn to ISK30bn (€158m to €188m). And, if you look at the net inflow into the pension system just from contributions, it is about ISK100bn (€625m) per annum. So [government securities] covers, perhaps, 25%.

"There is also ISK11bn (€69bn) of return from government securities alone that needs to be reinvested – equivalent to about half of the new [government] debt [to be issued in 2012]."

The focus in the Icelandic market on pension funds and institutional investors reflects the balance of the market away from retail since the 2008 crisis.

Margrét Sveinsdóttir, managing director of asset management at Arion banki, says that Iceland is not too dissimilar to other European markets in that respect.

The key difference remains the focus on government fixed income securities, particularly index-linked ones. That said, there is also the issue of a lack of industry data to support conclusions on specific trends – there is no central pool of asset management data available.

"We have information on the fund management companies, but not on the totals of AUM," she says. "We have been trying to gather that from annual reports or other sources, and tried to estimate the asset management market. By that estimate, I believe we have about a 45% market share, although this is not a figure we have had verified."

RISING MARKET SHARE

Arion banki and Stefnir Asset Management – owned by Arion with about ISK300bn (€1.89bn) under management – estimate the biggest single pot of assets under management is the pension system, at about ISK2trn (€12.5bn), or 1.3x GDP.

This figure includes an estimated ISK300bn (€1.9bn – as of 4 January) that is being saved through additional voluntary contributions that typically would be invested in addition to any mandatory scheme.

Regarding the ongoing accumulation, Sveinsdóttir and Flóki Halldórsson, managing director of Stefnir AM, note a mismatch between supply and demand for assets. Net inflows may dip in the near future due to a law allowing some withdrawal of pension savings intended to stimulate domestic consumption, but the overall trend remains.

"Because of the mandatory system and relatively young population, the pension system is growing well," says Halldórsson. "We estimate the money that needs to be invested or reinvested in this closed environment is about ISK120 to ISK150bn (€750m to €938m) annually."

Sveinsdóttir adds: "High net-worth and retail individuals have been deleveraging, using savings to pay off debts, or investing in other types of assets such as real estate.

"However, we have still enjoyed inflows and increased assets under management – some from the inflow, but also from returns."

Asset and fund selectors are also kept busy catering to the offshore assets of the industry, despite the capital controls, as assets held abroad before the restrictions can be reinvested abroad.

Halldórsson says: "We can sell to clients in Luxembourg. Foreign holdings of Icelandic pension funds are about ISK400bn (€2.5bn). So, there is a large pool of international equities and private equity there that we can cater to. They can shuffle around their holdings and change managers.

"We have increased our market share with our international equity funds, among pension funds, to about 6% of pension fund holdings."

Domestically, there are signs of improvement in the area of equities. Since spring 2009, Stefnir and Arion banki have seen a 12-fold increase in Icelandic equities' AUM, largely as a result of the local stock exchange recovering from its collapse. Halldórsson describes liquidity as being less than it used to be but still "fairly good for running liquid funds".

Overall, the former popularity of equities is yet to return, especially at the private investor level.

Halldórsson says: "Prior to the crash, the investment culture was similar to Sweden's. It was more equity-based. After the crash, people got very risk-averse and so many moved into inflation-linked bonds.

"We have also had to compete with deposits from the banks because after the crash, deposits were made a priority claim.

"The government also said it guaranteed all deposits. With people being sceptical about everything, including mutual funds, many went into deposits and have not returned." Icelandic equity funds have typically been non-Ucits.

"Although Icelandic law allows for both Ucits and non-Ucits, the latter has allowed investments with fewer restrictions, which suits the fact that there are relatively few listed Icelandic companies."

Similarly, the environment has made it hard to invest in domestic equities through exchange traded funds, adds Halldórsson.

"We were managing the only ETF for the Icelandic equity market – ICEQ – before the collapse. It was quite successful, but since the crash liquidity was hit by the low number of listed companies.

"It is not feasible for the time being, but we have been in contact with the Icelandic stock exchange on viability for reviving the product.

"We have looked at producing an ETF on the government bond side, but it was also a question of probably

"THE MARKET IS DIFFERENT FROM 2007, IN TERMS OF THE COLLAPSE OF THE EQUITY AND CORPORATE BOND MARKETS"

Margrét Sveinsdóttir, MD asset management, Arion banki

"CAPITAL CONTROLS WILL PROBABLY BE LIFTED SLOWLY BECAUSE THE CURRENCY RESERVES ARE ON LOAN FROM THE IMF. WE DO NOT OWN THEM"

Hrafn Árnason, VÍB

7.9% ETFs' share of European equity funds, worth €132.8bn

ICESAVE SAGA ROLLS ON

As recently as December 2011 Michel Barnier, the EU's Internal Market and Services commissioner, lent his support to the decision by the EFTA Surveillance Authority to refer Iceland to the EFTA Court over its position on British and Dutch depositors in the bankrupt bank Landsbanki's business Icesave.

This support was based on the suggestion that Iceland was not implementing minimum compensation to depositors, in line with the Directive on Deposit Guarantee Schemes.

According to the Directive, Icelandic bank Landsbanki – and its UK and Dutch branches under the Icesave brand – was supposed to pay at least €20,000 per depositor, after Landsbanki went bankrupt in 2008.

If the EFTA Court rules against Iceland, it will be required to pay the money immediately. Iceland is responsible under the Directive because Landsbanki's presence in the UK and Netherlands was through branches not subsidiaries. That puts the regulatory onus on the home country, in this case Iceland, to ensure that depositors receive the minimum compensation due.

Locally, the issue has been noticed in other ways. Icelandic media reported recently that the country's president Ólafur Ragnar Grímsson apparently did not get a Christmas card from UK prime minister David Cameron. His predecessor Gordon Brown infamously used anti-terror laws to seize assets of stricken Icelandic financial institutions.

too few securities. We have postponed any plans to launch that."

Private equity investments have been on the increase over the past year. This may involve refinancing of Icelandic companies that ended up being owned by banks following the financial crisis.

"The market has changed," says Sveinsdóttir. "It is very different from 2007, both in terms of currency restrictions and the collapse of the equity and corporate bond markets.

"But we are back to 2007 levels in terms of assets under management. The pool of investment opportunities has shrunk so much – and the fact that investors need to invest within Iceland – that this has led to the creation of private equity funds and the launch of the first real estate fund for pension funds.

"The third novelty is institutional investor funds that issue asset-backed securities. The funds are then able to finance properties or other assets with strong cash flow. One example is a real estate company that has long-term lease contracts with government departments."

Iceland's capital controls are an extreme measure in response to an extreme financial situation, which at the time threatened not only this country but also depositors in other European countries through debacles such as Icesave (see above).

Introducing the controls was intended to limit capital flight. This not only hit domestic allocators, but also foreign ones whose assets in Iceland effectively were locked in. The key question for both sets of investors is when might the controls be lifted.

"THE GOVERNMENT GOT RID OF THE ASSET ALLOCATION PROBLEM FOR US – EVERYTHING IS RESTRICTED TO ICELAND"
Hrafn Árnason, VÍB

LIFTING CONTROLS

The view from those working within Icelandic financial institutions is that this remains an unknown factor, despite certain ongoing official references to 2013 being the year when this could happen.

Árnason says "Capital controls will probably be lifted slowly because the currency reserves are on loan from the IMF. We do not own them.

"It is more like a credit line – we do not want to use this, but just have it there. If restrictions were lifted too quickly, the concern is that the currency reserves would run out, and so much money would pour out of the country that it won't be possible to price the currency before it dried up. Then we would be in real trouble.

"The currency crisis was paused by implementing currency restrictions. That did not really fix it. There is about ISK400bn to ISK1trn (€2.5bn to €6.2bn) waiting to get out of the country – depending on what counting method is used – that is basically in foreign ownership."

In terms of dates, the official view of the Icelandic central bank up to the end of 2011 was for controls to be relaxed by 2013. However, it is reported that the central bank has also been sounding out foreign investors about access to a vehicle that effectively guarantees an exit in euros, but not before 2016.

These mixed signals are not only of concern to foreign investors. As the existing currency reserve is just short of ISK1trn, against the ISK2trn (€12bn) in the pension system, the question arises what would happen if the controls are relaxed and those allocating on behalf of the pension system also wanted to diversify half their assets overseas.

The feeling is that there simply is not enough in the currency reserve to enable this. According to one asset manager working in the pension system, the practical implications are that totally freeing up the currency by 2013 may not be possible, unless, say, certain restrictions were placed on domestic pension funds.

He fears it may take five to ten years before they are totally unfettered by capital controls – unless the government can bring about a massive injection of foreign direct investment, which would bring with it growth in foreign currency reserves.

The irony in all of this, he adds, is that rules restricting pension funds to 50% foreign exposure meant the funds were harder hit by the domestic financial crisis in the first instance than if they had been allowed higher ratios of foreign assets – because the value of those foreign assets did not fall as much. ■