Paulson to Taconic Frozen in Iceland Five Years After Failures
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Nov. 14 (Bloomberg) -- When Iceland's banks failed in 2008 under $85 billion of debt, dozens of hedge funds flocked to the island betting they could make money buying up creditor claims. Five years later, they're still waiting.

The firms, including Davidson Kempner Capital Management LLC and Taconic Capital Advisors LP, snapped up the claims on the lenders' assets at prices far below face value. They were wagering, as they did when Lehman Brothers Holdings Inc. went bust, that they'd profit as markets recovered, bank assets were sold off and creditors repaid. Over the years, about 80 firms joined, including Paulson & Co., which had made more than $1 billion betting on Lehman claims.

What the investors, some of them managing more money than Iceland's $14 billion economy, may not have factored in was the backlash in the country of 320,000 people against the speculative Wall Street culture that, in their view, helped cause the failures of Glitnir Bank hf, Kaupthing Bank hf and Landsbanki Islands hf. While Lehman has paid out more than $40 billion to claim holders in the past five years, the hedge funds have yet to get any distributions from the Icelandic banks' estates. The government, elected in April on a platform that included providing mortgage debt relief to Icelanders, has proposed paying the funds only part of their claims and using the difference to finance its campaign promise.

"Obviously they would love to be in the position to expropriate all our assets and pay them into the Treasury but there's no basis for that in Icelandic or international law," said Andrew Jent, president of Dallas, Texas-based Hayman Capital Management LP, which bought Glitnir claims in mid-2012.

Creditor Meeting

Jent said the firm had originally expected that creditors would start getting cash distributions this year and that the process was slowed in part by the elections. He said that creditor representatives have finally been promised a meeting with Iceland's central bank and the committee overseeing the Glitnir estate on Nov. 18 in Reykjavik, yet he doesn't consider it a start to formal negotiations.

Elva Sverrisdottir, a Finance Ministry spokeswoman, and Stefan Johann Stefansson, a central bank spokesman, didn't respond to e-mails seeking comment.

Kaupthing, Glitnir and Landsbanki, Iceland's largest lenders before their failure, collapsed within weeks of each other in October 2008, after they were unable to secure enough short-term funds. The banks had relied on overseas funding to expand their combined balance sheets to 10 times the size of the country's economy, and were crippled when investors fled amid the credit crisis.

Fish, Aluminum

Their failure plunged Iceland into its worst recession since World War II, forcing the government to seek a $4.6 billion bailout from a group led by the International Monetary Fund. The country instituted capital controls to stabilize the currency, after the krona lost about 80 percent of its value against the euro in the offshore market. Those controls, which limit the amount of kronur that can be exchanged into foreign currency, are at the center of the dispute with the hedge funds.

The government, which relies on tourism as well as exports of fish and aluminum to attract foreign currency, is worried that releasing kronur to international investors, who will immediately sell it, will devalue the currency and boost inflation, which has slowed to around 3.6 percent from more than 6 percent last year. The krona is now trading close to 122 to the dollar, compared with a range of 60 to 70 per dollar before the crisis.

The drawn-out process demonstrates the obstacles for distressed investors abroad, where bankruptcy laws aren't always as creditor-friendly as in the U.S. While such funds, which buy the debt of companies in or near bankruptcy and often try to influence debt restructurings, produced an average annual gain of almost 10 percent since stock markets bottomed in March of 2009, legal costs and recovery rates are uncertain.

No Argentina

The hedge funds say the government will eventually have to lift the controls if it wants access to global capital markets and to attract foreign direct investments.

"The government recognizes if they expropriate assets or they put in place some really punitive tax, it's going to be a problem for them," said Hayman's Jent. "They can't possibly want to end up in a similar position to Argentina."

Argentina in 2001 defaulted on a record $95 billion of foreign debt. The country imposed restrictions on imports, banned currency purchases, and nationalized private companies in a bid to keep money from leaving the country. Even so, Argentina's foreign currency reserves plunged to a six-year low of $33 billion this year as the measures deterred foreign investment.

$44 Billion

Jent estimates that about two dozen funds have large enough investments in Iceland to travel there for meetings, and about 80 may be involved in total. Claims on Glitnir and Kaupthing total about $44 billion today, according to Jent.

The two banks had assets of about $14 billion as of June 30 -- $6.5 billion at Kaupthing and $7.5 billion at Glitnir, according to reports from the banks. Glitnir claims trade at about 31 cents on the dollar, up from 28 cents at the beginning of the year, according to Jent.

Landsbanki Islands' general creditors have filed claims against the bank amounting to 1.68 trillion kronur ($13.7 billion). However, since Landsbanki had a really high proportion of priority claimholders, such as depositors, general claimants like bondholders are only expected to get about 5.25 cents to the dollar, according to Keldan.is, a website run by H.F. Securities in Reykjavik. That would bring the total Landsbanki creditors can expect to $717.8 million.

Splitting Banks

The funds, including York Capital Management LP, HBK Capital Management, Claren Road Asset Management LLC and Fir Tree Partners Inc., are betting they can still make 10 percent or more a year for the next several years -- if they can get the government to allow distributions, according to more than half a dozen investors and hedge-fund managers, who asked not to be identified because the funds are private.

After the banking collapse, Iceland split the failed lenders, transferring domestic assets into new banks and leaving foreign assets with the failed banks. The claim holders were given equity stakes in the new banks as well as rights to the assets of the old banks. While most of the assets are denominated in British pounds, euros and dollars, the committees winding up the banks can't make any distributions to the creditors until a decision is made how to deal with the assets denominated in kronur that are subject to the capital controls -- about $3.8 billion across the three banks.

Opening Salvo

Last month, Morgunbladid newspaper, whose editor-in-chief David Oddsson served as prime minister for 13 years and was once the nation's top banker, said the central bank would demand that creditors in Glitnir and Kaupthing should forgo 75 percent of their krona-denominated assets. The central bank later denied planning to force creditors to accept less than they're owed, and said it was still studying the impact a creditor settlement will have on the country's balance of payments.

The central bank, together with the finance minister, can grant exemptions to the capital controls.

Several hedge-fund managers said while there is no economic reason for them to accept less for their krona assets, they expect to take some financial hit. They see the 75 percent haircut as an opening salvo in the negotiations, though no one would say what they expect the final number will be. The creditors are hoping they can get the government to release the assets in foreign currencies first and figure out how to release the krona-denominated assets later.

Mindich Exits

Hedge funds began betting on the Icelandic banks as early as 2008, though many got in more recently, according to investors. Claims trade every day and prices vary based on market participants' views on timing of distributions and capital control issues.

The $10 billion Eton Park Capital Management LP, run by Eric Mindich, was one of the first big funds in the trade, buying the senior unsecured bonds and bank debt of Kaupthing and Glitnir in late 2008, according to investors. It exited much of its position by the beginning of last year.

Jonathan Gasthalter, a spokesman for Eton Park with Sard Verbinnen & Co., declined to comment on the investment and whether it made a profit.

Thomas Kempner's $21 billion Davidson Kempner, based in New York, has one of the bigger positions and has owned claims on Glitnir since 2009, according to investors.

The $8 billion Taconic, run by former Goldman Sachs Group Inc. executives Frank Brosens and Ken Brody, held Icelandic bank clams in their main fund and decided to raise an additional $160 million for a separate, dedicated pool this year after they reached their position limit in the fund. That fund, known as a sidecar, had its second closing on March 1.

Asymmetric Trade

Paulson & Co., the $18 billion firm run by John Paulson, bought $229 million of Glitnir claims in June through its $5.3 billion Credit Opportunities fund. Both firms are based in New York.

Officials from Davidson Kempner, Taconic and Paulson declined to comment on their investments.

The firms and their investors see Iceland as an asymmetric trade, meaning that the probability of a loss is low and the chances of a win are large. In part that's because so much of the banks' assets are in cash.

As of June 30, about 53 percent of Kaupthing's assets were in cash, and only 18 percent of assets were denominated in krona, according to a report released in September. Glitnir's cash position was 56 percent of total assets. About 30 percent of assets were denominated in krona.

'Funny Situation'

April's election resulted in a coalition government run by the Progressive and Independence parties. Prime Minister Sigmundur David Gunnlaugsson, head of the Progressive Party, has suggested creditors should accept less than they're owed so the money can be used to help pay for debt relief to Icelanders. He said last month that creditors in the banks won't get any special treatment as the nation seeks to exit capital controls.

Iceland Finance Minister Bjarni Benediktsson, who is the leader of the Independence Party, has been more conciliatory in his tone toward creditors. He said in an interview in mid-October that the country could exit capital controls in the next six to 12 months.

All political parties in the country agree that exchanging the krona assets for foreign currency and moving the money out of the country would seriously affect households, by driving up consumer prices and mortgages, most which are linked to inflation.

"It's a funny situation," said Hayman's Jent. "There's the prime minister and the finance minister and because it's a coalition government they exist on separate sides of the aisle.
It seems they each want different things out of the negotiation and we've had a difficult time trying to pin down who exactly we're supposed to negotiate with."

'Unscrupulous Dealers'

There is no consensus on when a payoff may happen.
Estimates range from mid-2014 to 2019, according to hedge-fund investors and managers. The length of time it takes to return capital and the haircut will determine how much the funds make.

The funds had originally expected that returns might be higher, based on gains from the Lehman Brothers estate, according to fund managers and investors. Elliott Management Corp., like Paulson, has earned more than $1 billion on its Lehman stakes, according to investors.

While investments that involve politics are always tricky, foreign money managers shoul d have foreseen that their wager on Iceland might not go as smoothly as they hoped.

In March 2008, as the cost of buying insurance against a default of the Icelandic banks was approaching the highest of 81 banks worldwide, Oddsson, then the central ba nk governor, had a warning for speculators.

Attacks on the country's banks "give off an unpleasant odor of unscrupulous dealers who have decided to make a last stab at breaking down the Icelandic financial system," Oddsson said at the central bank's annual meeting. "They will not get away with it."