Progress of the Plan for Removal of Capital Controls

A report as provided for in Act No. 16/2013 of the Althingi.

This report is published by the Minister of Finance and Economic Affairs as provided for in Act No. 16/2013 of the Althingi:

> [The Minister shall publish a report on the progress of the plan for removal of restrictions on cross-border capital movements and foreign currency transactions at six-month intervals until such restrictions are finally removed. The report referred to in the first sentence shall be published for the first time within six months of the entry into force of this Act.]

The first of the reports provided for in the Act was published on the website of the Ministry of Finance and Economic Affairs on 17 September 2013.[1] Reference is made to the report for a general discussion of the background of the capital controls, their purpose and the main aspects of the plan for their removal.

Scope of the problem

The balance of payments problem faced by the Icelandic economy, which is the reason for the existence of capital controls, concerns possible outflows due to: 1) ISK assets of non-residents, referred to as "offshore ISK"; 2) winding-up of the failed banks; 3) an outflow of ISK assets of domestic parties (e.g. pension funds) following the relaxing of controls; 4) contractual instalments by domestic parties on obligations to foreign parties. Should capital controls be removed in an uncontrolled manner the interplay of the above-mentioned factors could create instability and undermine economic and financial stability.

The plan for removing capital controls which has been followed since March 2011 has been primarily aimed at reducing risk in connection with offshore ISK. In recent quarters, however, the authorities have to an increasing extent focused on the difficulties arising from the settlements of failed financial undertakings. Achieving these settlements without substantial negative impact on the nation's balance of payments is a prerequisite for removing capital controls without undesirable effect on economic and financial stability.

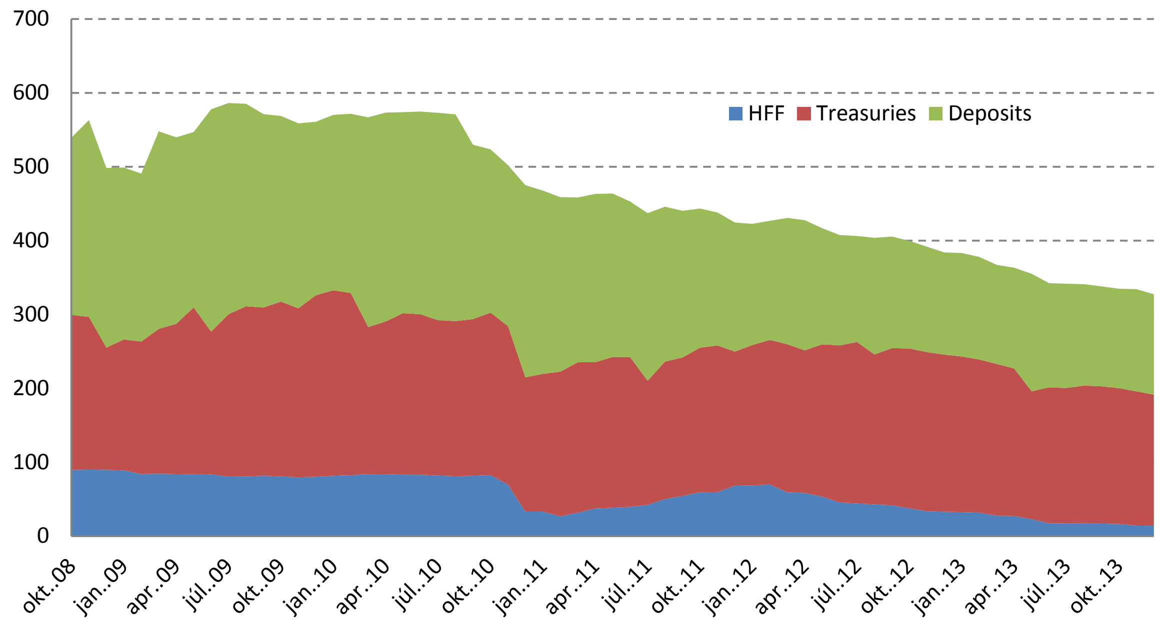
Offshore ISK

As of year-end 2013, offshore ISK amounted to ISK 327 billion, compared to ISK 565 billion following the collapse of the financial system in 2008. The Central Bank has reduced the stock of offshore ISK, both through special transactions and auctions (see below) in accordance with the plan for removal of controls of March 2011. Through the Central Bank's auctions, foreign short-term ISK investors have been effectively allowed to exit, thereby reducing the portion of offshore ISK owned by parties wishing to redeem their investment practically regardless of the exchange rate. In tandem with this reduction the composition of these assets has undergone a considerable change. The majority of the reduction has been in deposits, while non-residents have also increased the duration of their assets in Treasury paper. At year-end 2013, ISK 177 billion of offshore ISK were in Treasury securities, ISK

[1] http://www.fjarmalaraduneyti.is/frettir/2013/09/17/nr/17190

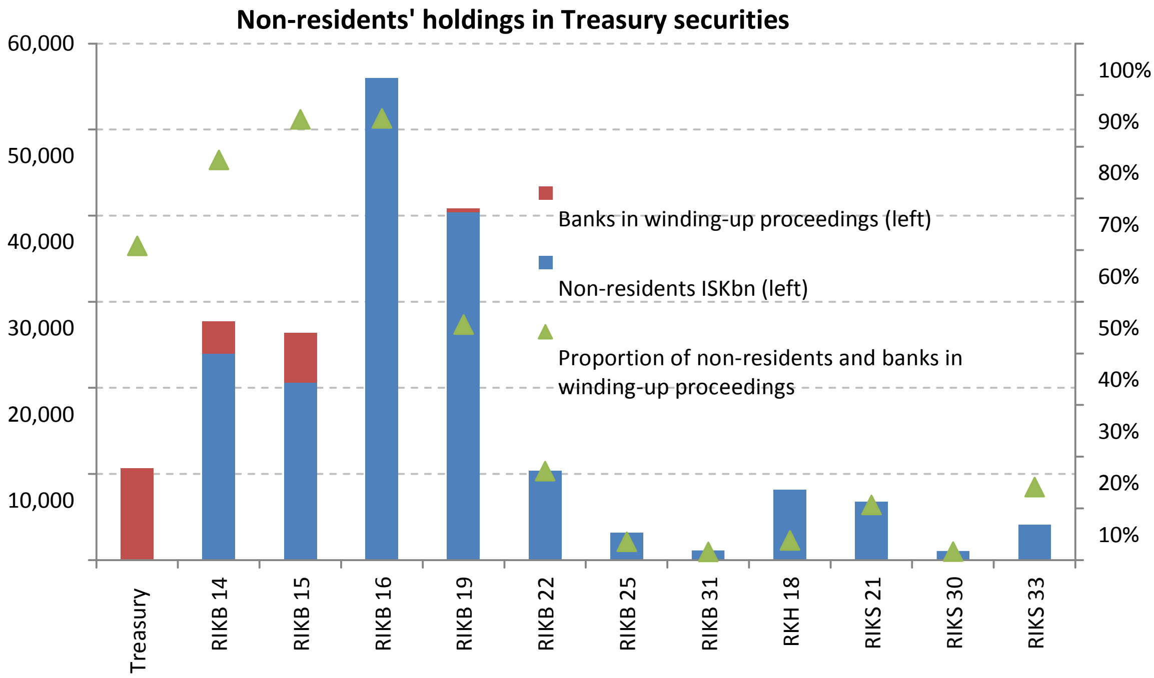
136 billion in deposits and ISK 14 billion in bonds of the Housing Financing Fund (HFF). The amount of offshore ISK held as deposits has not changed substantially since mid-2013, while investments in Treasuries have decreased somewhat. This is something of a change from earlier developments.

Non-residents' ISK assets (off-shore assets)

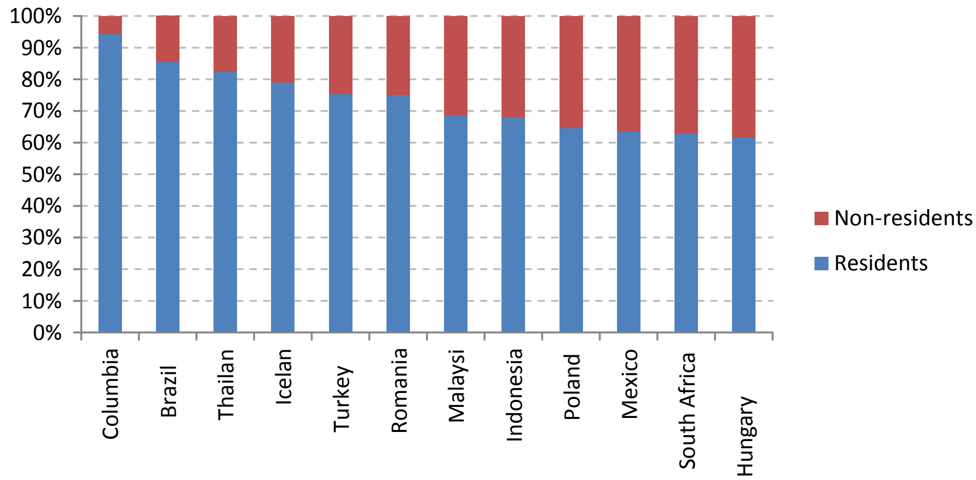


It is difficult to assess how volatile the remaining ISK assets are. Investors' interest in selling their investments is determined primarily by the exchange rate they are offered in each instance and could rise significantly if the offshore rate decreases. It is unlikely that all offshore ISK will be rapidly converted to foreign currency; more likely some of the investors will keep their investments after removal of controls, but it is difficult to predict such developments.

At the end of February 2014, non-residents held 22% of Treasury notes and bonds issued in ISK, but no Treasury bills. Non-residents owned 21% of the total outstanding stock of Treasury notes, bonds and bills. They hold a fairly high proportion of the shortest-term notes, but only a small portion of those with longer duration. The estates of the failed banks also own some amount of the shortest Treasury notes, as the chart below shows. In total, non-residents and the estates hold around 24% of Treasury paper issued in ISK.



In estimating the probable outflow of offshore ISK, it is worth pointing out that in many emerging market economies non-residents' holdings of Treasury paper in domestic currency have been somewhat higher than in Iceland. In view of this, non-residents can be expected to continue to purchase Treasury ISK issues after the controls are removed.



The failed banks

The winding-up proceedings of the failed banks will have a considerable impact on the development of Iceland's net IIP in the coming years. The difficulty in connection with the banks' winding-up is actual twofold. On the one hand, there is the bond issued by the new Landsbankinn to the old bank, LBI, and on the other hand there are the settlements of the estates of Kaupthing and Glitnir. A considerable amount of the estates' assets are in ISK, while almost 95% of their creditors are non-residents. In addition, some ISK funds will accrue to foreign creditors of other estates.

The bond issued to LBI by Landsbankinn was recognised in the latter's accounts at ISK 238 billion as of year-end 2013. The bond is to be paid in equal instalments from 2014 to 2018. There is evidently a considerable mismatch between the bond and Landsbankinn's possible foreign currency income in these years. Therefore changes to the bond's terms need to be negotiated to ensure that the repayment profile will not be too steep for Iceland's balance of payments, with a resulting negative impact on the ISK exchange rate or foreign currency reserves. For some time now the Winding-up Board of LBI and Landsbankinn have been discussing possible changes to the terms of the bond.

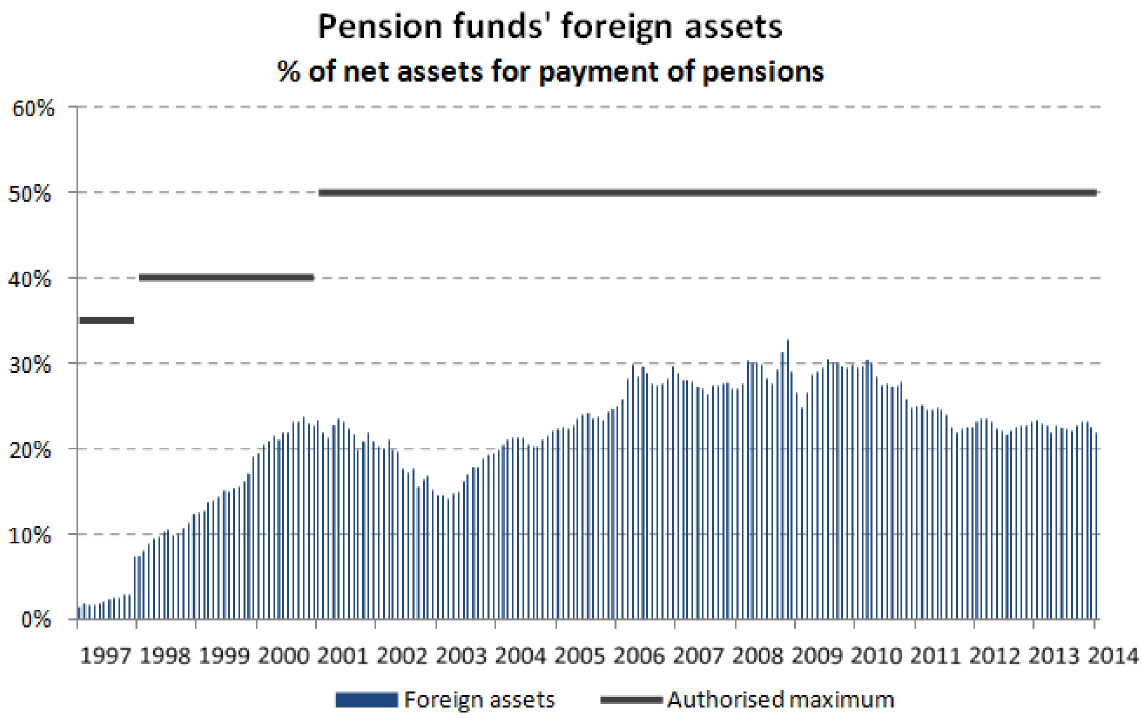
The balance of payment problems connected to the settlements of Kaupthing and Glitnir involve some ISK 500 billion of assets which are, firstly, liquid assets expected to be recovered over a period of several years and, secondly, the estates' holdings of approximately ISK 285 billion (book value) in the two new banks, Arion Bank and Íslandsbanki.

Sale of these holdings could exert pressure on the ISK exchange rate if new (domestic) investors wanted to buy foreign currency to pay for the holdings or if payment were made to creditors in ISK used by the investors to pay for the holdings. Sale of the holdings for foreign currency to non-residents who intend to hold these assets for a longer term would avoid such negative effects, although there might be pressure over a longer period when the banks paid dividends to their foreign owners.

In view of the large amounts concerned, compositions reached by the fallen banks which do not take their possible negative consequences on the balance of payments into consideration could cause more damage to Iceland than some prolonging of capital controls. It is therefore important that the compositions contribute to stability and support the objective of removing capital controls. Under Icelandic law, the estates will have to be liquidated if compositions cannot be achieved.

Domestic parties

Upon the removal of capital controls domestic parties can be expected to seek to invest abroad once more and thereby transfer funds out of the country. A large portion of household savings are tied up in the pension fund system and pension funds definitely will seek once more to increase the share of foreign assets in their portfolios to ensure diversification of risk. Confidence in the Icelandic economy will be a major factor in determining the amount of domestic funds seeking to exit upon the removal of capital controls.



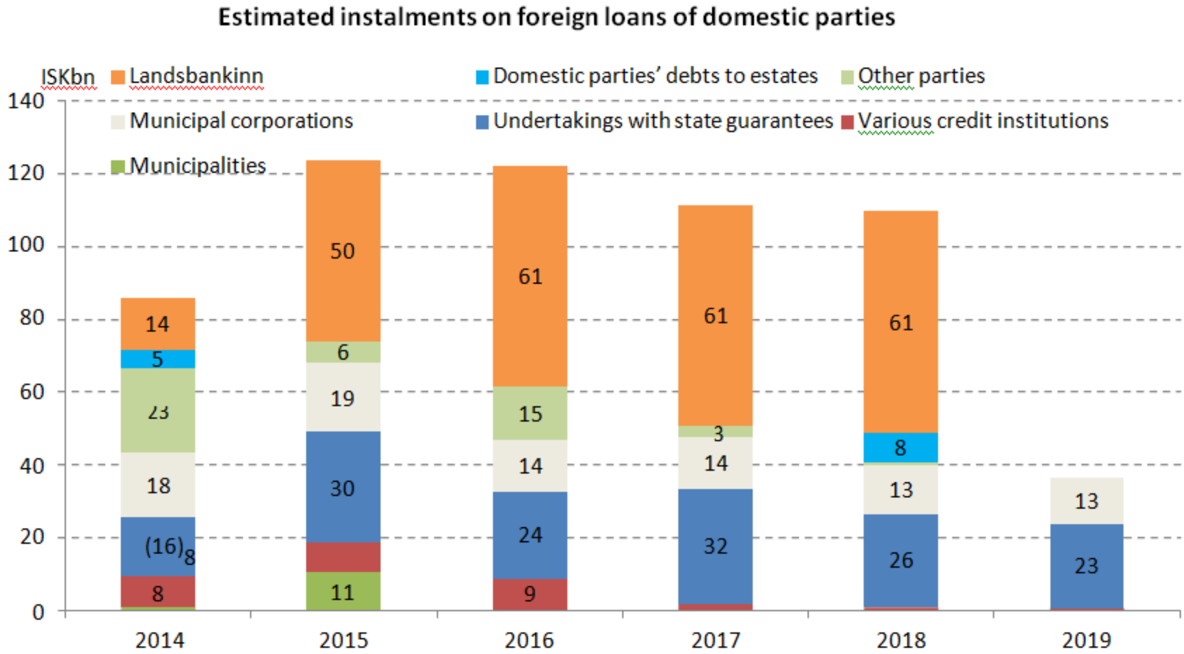
An analysis by IMF experts suggests that the outflow resulting from these sources could amount to 30-45% of 2011 GDP.[2.] Reference is made to the previous report of September 2013 for a discussion of this point, as well as to the chapter below on prudential regulation after removal of controls.

Repayments and refinancing of loans

Contractual instalments paid by domestic parties on foreign debts will also substantially affect the nation's balance of payments in coming years. Even though such instalments are generally not restricted by the capital controls they affect their possible removal because of the negative impact on the balance of payments. At year-end 2013 the Central Bank's gross foreign currency reserves were equivalent to around ISK 488 billion, most of this borrowed funds.

Apart from payments by Landsbankinn on its bond, the major items here are debts owed by the energy companies, not least Landsvirkjun. Landsvirkjun's management have publicly stated that the undertaking intends to refinance only a small portion of its debt maturing in the coming years, as the company's indebtedness is much higher than that of comparable undertakings in other Nordic countries. According to figures published by the Central Bank of Iceland in *Financial Stability*, instalments of undertakings with state guarantees amount to around ISK 150 billion until 2019.

Limited access by various other economic actors to foreign funding, including refinancing, can also have an effect. The Treasury's access to foreign capital markets has opened the way for other parties to foreign credit. This can make a decisive difference for the economy when it regains its feet once more after the difficult years following the financial crisis. Responsible fiscal management by public authorities therefore is of major significance for successfully removing capital controls. An important step was taken in this direction with the 2014 state budget, the first without a deficit since 2007.



It is therefore evident that Iceland will face balance of payments difficulties in the coming years. Removing controls without resolving these problems would put considerable pressure on the ISK exchange rate.

FX auctions of the Central Bank of Iceland

Following the approval of the strategy for liberalisation of capital controls in March 2011, the Central Bank began to hold auctions to reduce the stock of so-called offshore ISK. Auctions of Treasury securities for foreign currency began in the summer of 2011, and the first auction of the Investment Programme was held in February 2012. A total of 18 auctions of Treasury securities have been held and 16 auctions have been held under the Investment Programme. Investors have brought EUR 257.9 million into the country through Treasury securities, an amount which, based on the auction price in each instance and the Central Bank's quoted mid rate on the same date, is equivalent to a total of ISK 55.9 billion and another EUR 791.2 million, or ISK 156.3 billion, through the Investment Programme. Just under one-third of this has gone through the domestic FX market, as 50% of the amount invested through the Investment Programme has to be converted to ISK on the domestic FX market.

At the beginning of February this year, foreign investment through the Investment Programme amounted to approximately 12.5% of GDP in 2012. Around 44.9% of this capital inflow through the Investment Programme has been invested in bonds, around 42.3% in equities, 12.1% in real estate and around 0.6% in UCITS.

When auction participants are divided into residents and non-residents it turns out that 38% of the total amount was from domestic and 62% from foreign investors. In this analysis, foreign companies owned by Icelandic residents were classified as domestic investors.

An additional 17 auctions have been held inviting bids from parties wishing to sell their ISK assets in exchange for FX which is exempt from repatriation obligations. In 2011 two such auctions were held, with the exchange rate ISK 210 per euro. The price remained fairly steady in 2012, at ISK 240 per euro, then decreased in 2013. In the most recent auction, held in February this year, the auction price was ISK 210 per euro. Through the 17 auctions a total of ISK 358.7 billion has been offered for sale, of which the Central Bank has purchased ISK 127.7 billion.

The price is determined following three auctions on the auction date. The quantity of ISK which the Central Bank purchases for foreign currency is determined by the amount of FX which is offered for sale for purchase of long Treasury securities and for investment through the Investment Programme. The impact of the auctions on the currency reserves is thereby kept to a minimum. Auction dates are announced well in advance and are scheduled for 18 March, 14 May, 24 June and 2 September 2014.

Treasury securities option

One aspect of the collaboration between the Ministry of Finance and Economic Affairs and the Central Bank of Iceland regarding the removal of capital controls was the so-called Treasury securities option. The Treasury securities option originally served an important purpose, as there was uncertainty concerning the impact of the relaxing of controls on refinancing of the Treasury's domestic debt. This option was established in 2011, with the objective of ensuring refinancing and lengthening the repayment profile. It was important to ensure the sale of Treasury securities to new investors to replace those foreign investors wishing to exit. The Treasury securities option was directed primarily at pension funds, encouraging them to exchange foreign assets in return for long inflation-indexed Treasury bonds. The pension funds are not as interested in the Treasury securities option as they were in the beginning and have been replaced by other buyers. Since June 2011 there have been 18 auctions, in which EUR 437 million have been exchanged for Treasury notes. Their value in ISK is around ISK 51.3 billion. ISK 30 billion of this, or 58% of the total quantity sold, were sold in two of the first three auctions. Since the beginning of 2013, sales through the Treasury securities option have twice exceeded ISK 1 billion, i.e. in June 2013 and in February this year.

A stronger economic framework

In tandem with efforts towards removing capital controls the economic framework needs to promote the stability of the economic and financial system when capital movements are liberalised once again. The submission of bills of legislation on public finances and on the Financial Stability Board plays an important role here.

Attention also needs to be given to currency framework and the prudential regime which should apply in this regard. In its Special Publication *Prudential Rules Following Capital Controls* in August 2013[3] the Central Bank of Iceland discusses the prudential regime which it considers desirable to have in place when the controls are removed to ensure financial stability in Iceland.

In the Central Bank's estimation, the main risk factors with unrestricted capital movements are as follows: an immoderate in- or outflow of capital, currency mismatch and maturity mismatch. An immoderate inflow of capital boosts the exchange rate and asset prices, resulting, for instance, in increased purchasing power. Such a situation magnifies an upswing, which can abruptly be reversed, with an outflow, an exchange rate drop and a fall in asset prices and purchasing power. The sharp reversal can therefore exaggerate a contraction or cause one. A currency mismatch develops when borrowed funds in one currency are used to purchase assets, goods or service in another currency. Assets and liabilities therefore do not move in line with exchange rate movements. As an example, prior to the recent economic collapse households, municipalities and corporates in Iceland borrowed in foreign currencies without having corresponding foreign currency income. When the exchange rate plunged in the collapse, asset prices fell and equity shrank greatly. Maturity mismatch occurs, on the other hand, when foreign long-term assets are financed with short-term liabilities in the same currency. This situation can result in a liquidity shortage when funding cannot be obtained in time for maturities. In such instances it is the task of the Central Bank to act as lender of last resort; such credit is limited by the size of its foreign currency reserves.

The Central Bank proposes that legislation and rules be improved to ensure macroprudential regulation when the capital controls are fully removed. The bank's proposals are as follows:

1. Rules on liquidity and currency balance to reduce maturity mismatch in foreign currencies.
2. Restrictions on deposit-taking abroad to reduce maturity mismatch in foreign currencies and underline the role of the Central Bank of Iceland as lender of last resort exclusively in ISK.
3. Restrictions on or prohibition of FX lending to unhedged parties to reduced indirect currency mismatch.
4. Management instruments to curb large fluctuations in capital flows in and out of Iceland which magnify the business cycle. This could take the form of a tax on capital transfers or mandatory reserves of foreign funding.
5. Temporary limits on increases in pension funds' foreign assets to reduce pressure on the ISK.

At the end of November 2013 the Central Bank announced new rules on a liquidity coverage ratio (LCR) concerning, among other things, liquid funds in foreign currencies. The rules are intended to reduce FX liquidity risk, which proved to be one of the largest risks in the events leading up to the banking collapse of 2008. An amendment to the Act on the Central Bank of Iceland in mid-2013 reinforced the bank's authority to adopt rules on FX liquidity ratios. Further work lies ahead on rules concerning the minimum stable funding ratio (NSFR) of credit institutions in ISK and foreign currencies. Such rules are more long-term oriented than the LCR rules and are aimed at limiting maturity mismatch, especially in foreign currencies.

Work is underway in the Ministry of Finance and Economic Affairs on amendments to legislation concerning borrowing in foreign currency. A bill to this effect is expected to be submitted to the Althingi during the 2014 spring session.

The Pension funds' investment restrictions are currently being examined in the Ministry. Before the controls are fully removed the question of setting “speed limits” on the increase in pension funds' foreign assets will be examined, as the Central Bank has requested. In this respect, however, concerns to limit the outflow from Iceland conflict with the rationality of allowing the funds to once more build up an international asset portfolio with diversified risk, as these funds hold the lion's share of the savings of the Icelandic public.

Organisation of the plan

Steering committee

The overall management of the project is in the hands of a steering committee headed by the Minister of Finance and Economic Affairs. Other members of the steering committee are the Governor of the Central Bank, Permanent Secretaries of the Prime Minister's Office and the Ministry of Finance and Economic Affairs, and the Prime Minister's economic advisor. Committee meetings also include officials and experts from the Central Bank, Ministry of Finance and Economic Affairs and the Prime Minister's Office.

A special project management team operates under the steering committee which is comprised of representatives of the Ministry of Finance and Economic Affairs, the Prime Minister's Office, the Central Bank of Iceland and the Financial Supervisory Authority.

Parliamentary groups' consultation committee

A consultation committee of the parliamentary groups on removal of capital controls is to serve as a forum for communication of information and consultation on issues concerning capital controls and their removal. A Director in the Ministry of Finance and Economic Affairs chairs the committee, which is comprised of representatives of those parties with seats in the Althingi.

Advisory group

On 27 November 2013 the Prime Minister appointed an advisory group of six men with the task of making proposals to the Ministerial Committee on Economic Affairs and its sub-committees on individual steps and an overall plan for removal of capital controls. The group is to assess the economy's net IIP and economic stability, as well as analysing key aspects of the current plan for removal of controls, including settlements of the failed banks and the speed and progress of other factors. The group's chairman is Sigurbjörn Þorkelsson and other members are Eiríkur Svavarsson, Jón Helgi Egilsson, Jón Birgir Jónsson, Ragnar Árnason and Reimar Pétursson. Benedikt Árnason and Benedikt Gíslason also work with the group.

Previous committees

An Ad hoc working group of the Icelandic government and the EU Commission worked in the early months of 2013 on an interim report on the removal of capital controls, meeting on 22 January 2013 in Frankfurt in connection with this work. Leadership of the working group was in the hands of the Ministry of Finance and Economic Affairs. The European Central Bank and the IMF also participated in the group's work. On 15 November 2013 the EU Commission notified the Ministry of Finance and Economic Affairs that it could not continue its participation in the working group in light of the decision by the Government of Iceland to place accession talks on hold.

Outlook for removal of capital controls

Progress in removing capital controls will to a great extent be determined by the speed of the winding-up of the failed banks. As the figures mentioned previously clearly show, their winding-up could have a substantially negative impact on financial and economic stability if no action is taken. Auctions by the Central Bank of Iceland will continue, however, to allow the most impatient non-resident ISK owners to exit their positions. Auctions have been announced for March, May, June and September 2014.