

## 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 make public a report on the progress of plans to remove restrictions on cross-border capital movements and foreign currency trading 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. A second report was published on 17 March 2014,<sup>1</sup> a third on 18 September 2014<sup>2</sup> and a fourth on 18 March 2015.<sup>3</sup>

### Comprehensive strategy

On 7 June this year the Icelandic government agreed to present to the Icelandic parliament *Althingi* two bills from the Minister of Finance and Economic Affairs which together lay the foundation for a comprehensive strategy to liberalise the capital account. The bills were adopted as law by Althingi on 3 July.

The total scope of the problem which the strategy addresses amounts to as much as ISK 1,200 billion. The assets concerned consist of ISK assets of the insolvent estates of the failed commercial banks and savings banks amounting to ISK 500 billion, claims in FX held by these estates against domestic parties totalling ISK 400 billion and offshore ISK owned by non-residents amounting to ISK 300 billion. The actions comprising the authorities' plan to remove capital controls prevent the sales value of these assets from flooding the FX market and thereby undermining stability in economic and monetary affairs and financial stability.

#### *Stability conditions and a stability levy on the estates of failed financial undertakings*

A two-part solution is proposed by the authorities with regard to the estates of failed financial undertakings. It consists, on the one hand, of a stability levy to be assessed on the failed commercial banks and savings banks (taxable entities) based on their asset position as of year-end 2015, as provided for in Act No. 60/2015, on a Stability Levy, which was adopted by Althingi on 3 July this year. On the other hand, taxable entities will have the option, until year-end 2015, of requesting an exemption from the Foreign Currency Act to conclude winding-up proceedings with a composition if they fulfil stability conditions. Those estates which conclude a composition prior to year-end and can, on the basis of an exemption granted by the Central Bank of Iceland, make distributions to foreign creditors pursuant to a composition will be relieved of the obligation to pay the stability levy. The stability levy and stability conditions are intended to offset the negative impact on the balance of payments

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<sup>1</sup> <http://www.ministryoffinance.is/media/frettir/Progress-of-the-Plan-for-Removal-of-Capital-Controls.pdf>

<sup>2</sup> <http://www.ministryoffinance.is/media/rit2014/Framgangur-aaetlunar-fjarmagnsh-sept-14.pdf>

<sup>3</sup> <http://www.ministryoffinance.is/media/frettatengt2015/Progress-of-the-Plan-for-Removal-of-Capital-Controls-March-2015.pdf>

which the conclusion of winding-up proceedings of the failed financial undertakings would otherwise have, in order to preserve stability in exchange rate and monetary affairs and financial stability. To facilitate the composition process the rules which apply to financial undertakings' composition procedure have been simplified. This was done by Act No. 59/2015, amending the Act on Financial Undertakings, which was adopted by *Althingi* on 3 July this year. The entry into force of this Act added a provision preventing a composition proposal from being ratified by a District Court Judge without a prior assessment by the Central Bank of Iceland to ensure that the composition will not upset stability in exchange rate and monetary affairs and financial stability.

The Act on a Stability Levy provides for a one-off levy of 39% on the gross assets of the failed commercial banks and savings banks as assessed on 31 December 2015. The levy is intended to counteract the negative impact on exchange rate and monetary stability and financial stability which would develop from distribution of funds in connection with the conclusion of taxable entities' winding-up proceedings. Once the tax has been paid, and providing certain conditions are satisfied, taxable entities will be granted an exemption from the provisions of the second paragraph of Art. 13 b and the first sentence of the second paragraph of Art. 13 c of Act No. 87/1992 on Foreign Currency, and will be able to make distributions to non-residents on the basis of a ratified composition or a decision on liquidation. Estates which conclude their winding-up proceedings with a ratified composition prior to 31 December 2015 will not be considered taxable entities.

Taken together, these amendments to legislation comprise a comprehensive programme for the resolution of the difficulties which distributions of funds to creditors in the settlements of the failed commercial banks and savings banks would otherwise have caused. It is estimated that the Treasury revenues from the stability levy could amount to around ISK 702 billion, after allowed deductions are taken into consideration; if deductions are excluded the amount of levy would be around ISK 887 billion.<sup>4</sup> The stability levy ensures that stability in exchange rate and monetary affairs and financial stability will be maintained during the overall settlements of the failed commercial banks and savings banks. A composition which fulfils the stability conditions resolves the same sort of problems arising from each individual estate of the failed commercial banks and savings banks, based on the same perspectives as the stability levy but through measures which are based on the varying extent and nature of the difficulties deriving from each estate.

It is important that those funds which will accrue to the state as a result of the stability conditions, based on the Central Bank's exemptions from the restrictions of Act No. 87/1992 on Foreign Currency, or stability levy do not have undesirable effects on the money supply or other expansionary impact which could upset financial stability. These funds will be used, as the opportunity arises, to reduce public debt, as the Treasury has incurred high expenses from the financial system collapse. Concluding the settlements of the failed commercial banks and savings banks and liberalising the capital account will eliminate major factors of uncertainty concerning Treasury finances and the interest rate premium and interest expense on government debt can be expected to decrease substantially.

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<sup>4</sup> The amounts stated in the presentation of the programme on 8 June this year were lower. They have now been revised based on those entities which will be covered by the levy and updated to reflect the year-end position.

*FX auction for owners of offshore ISK*

ISK assets owned or held in custody by foreign financial undertakings, so-called offshore ISK, create problems for removal of capital controls, as they comprise liquid ISK assets held by non-residents which could have a major impact on exchange rate and monetary stability if an attempt were made to convert all or a large portion of them within a short period of time. The intention is to reduce liquid ISK assets and provide an exit for part of the offshore ISK still remaining after the Central Bank's previous actions with an auction of foreign currency and the sale of ISK and foreign-denominated bonds with repayment profiles which can be accommodated within the limits of the balance of payments in the economy. Owners of offshore ISK will be able to choose between three options: a foreign currency auction, investment in long-term Treasury bonds or interest-free accounts with no withdrawals permitted. The above actions are intended to ensure that offshore ISK will be disposed of in a permanent context. Those offshore ISK owners who take advantage of the auction to bid for foreign currency in exchange for ISK will pay a premium on this and in so doing bear the necessary cost of exiting from capital controls.

Short-term ISK assets of non-residents, i.e. offshore ISK, amounted to ISK 291 billion or 15% of GDP at the end of last February, decreasing by ISK 32 billion or around 1.5% of GDP over the past 12 months. The decrease can be attributed primarily to the Central Bank's currency auctions, as the bank has served as an intermediary in transferring ISK 29 billion of short-term ISK assets between owners during this same period.<sup>5</sup>

**Amendments to the Foreign Currency Act**

At the beginning of June this year *Althingi* passed amendments to Act No. 87/1992, on Foreign Currency. The principal changes made to the Act concern, firstly, general changes aimed at stopping circumventions of the capital controls and, secondly, specific changes concerning financial undertakings undergoing or having concluded winding-up proceedings based on Articles 101 and 103 a of the Act on Financial Undertakings.

In the first place, amendments were made to clarify the concept of contractual instalments and that provisions in loan contracts which can result in accelerating payments on loans in advance of their defined repayment schedule are unauthorised.

Secondly, an amendment was made to Art. 13 c of the Foreign Currency Act, concerning foreign currency transactions. The amendment requires failed financial undertakings and legal entities established in connection with the fulfilment of their compositions to conclude all their FX transactions involving ISK with a commercial bank or savings bank in Iceland. This restriction, however, will not prevent these legal entities from using foreign currency which they hold for distributions to creditors in connection with a settlement for which the Central Bank has granted an exemption.

In the third place, an amendment to Art. 13 g of the Foreign Currency Act concerns

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<sup>5</sup> For details see *Financial Stability 2015/1*, [http://www.sedlabanki.is/library/Skraarsafn/Fj%C3%A1rm%C3%A1last%C3%B6%C3%B0ugleiki/2015-1/Heildarskjal%20-%20Copy%20\(2\).pdf](http://www.sedlabanki.is/library/Skraarsafn/Fj%C3%A1rm%C3%A1last%C3%B6%C3%B0ugleiki/2015-1/Heildarskjal%20-%20Copy%20(2).pdf)

borrowing and lending between domestic and foreign parties. The amendment authorises failed financial undertakings and legal entities established in connection with the fulfilment of their compositions only to conclude intra-group loan transactions which satisfy the general requirements of the Act for cross-border lending and borrowing.

In the fourth place, an amendment to Art. 13 j of the Foreign Currency Act concerns payments on foreign currency loans. The change prohibits domestic parties from acquiring foreign currency to repay foreign currency loans from a financial undertaking in Iceland unless the loan term is at least two years or the loan has been granted for payment to a foreign party in connection with trade in goods and services. It applies to loans taken out after the entry into force of the Act. Furthermore, the change makes it only authorised to purchase foreign currency for repayment of loans and payment of guarantees called within the group if the loan fulfils the general conditions of the Act for cross-border lending and borrowing. The change also means that failed financial undertakings and legal entities established in connection with fulfilment of their compositions cannot purchase FX for repayment of loans and guarantees called unless such loans have been granted in connection with trade in goods and services.

Fifthly, special exemptions which the failed financial undertakings have held from restrictions of the Foreign Currency Act are cancelled. They retain, however, an exemption from the repatriation requirement for foreign currency, with the exception of FX borrowing, and special exemptions concerning their deposits with foreign financial undertakings and their FX deposits with the Central Bank on 12 March 2012.

The purpose of the above-mentioned amendments is to limit the possibilities that parties may circumvent capital controls, which is a premise for the success of the authorities' plans to liberalise the capital account.

### **Pension funds' authorisations to invest abroad**

On 15 July this year the Central Bank of Iceland published an announcement on its website of its plans to grant pension funds licensed to operate pursuant to Chapters V or XI of Act No. 129/1997, as well as other domestic custodians of private pension savings authorised by the Ministry of Finance on the basis of Art. 10 of Act No. 129/1997, exemptions from Act No. 87/1992, on Foreign Currency, to invest in financial instruments issued in foreign currencies. It is established that in total the authorisations granted to these parties will amount to ISK 10 billion. The quota has been allocated on the basis of their size (70% weighting) and net inflow of funds (30% weighting). Calculations are based on data from the most recent financial statement records of the Icelandic Financial Supervisory Authority (FME) on pension funds, i.e. on 2013 figures, authorising investments by each party until year-end 2015. Those pension funds and custodians of private pension savings interested were instructed to apply for an exemption for the above-mentioned transactions to the Central Bank's Capital Controls Surveillance Unit. The Central Bank has already granted parties who have submitted applications pursuant to the above authorisations for foreign investment totalling ISK 9,391,224,000.

The inflow of foreign currency to Iceland recently, together with less uncertainty concerning balance of payments developments following the adoption of legislation by *Althingi* on settlements by failed financial undertakings with their creditors and the announcement of

plans concerning so-called offshore ISK later this year, has in the estimation of the Central Bank created scope for investment by pension funds and other custodians of personal pension savings in financial instruments issued in foreign currencies. Such investments comprise an economic advantage, in the Central Bank's estimation, as they enable the pension funds to improve risk diversification in their portfolios while at the same time reducing the funds' accumulated need for foreign investments when capital controls are lifted, thereby reducing the risk of instability following removal of controls.

It should be underlined that domestic custodians of personal pension savings refers to parties authorised by the Ministry of Finance on the basis of Art. 10 of Act No. 129/1997. It is made clear that custodians of personal pension savings operating under Act No. 56/2010, on Insurance Activities, are not included under this authorisation.

### **Activities of the Financial Stability Council**

The Financial Stability Council was formally established in 2014 as a venue for consultation, exchange of information and policy formulation on financial stability and co-ordinates the preparedness of public authorities for financial crises. The Minister of Finance and Economic Affairs is chairman of the Council, which operates as provided for in the relevant Act, No. 66/2014, following the government's strategy for financial stability and the protocols for the Financial Stability Council. Meetings of the Financial Stability Council review reports of the Systemic Risk Board, which works on behalf of the Council, meeting as a rule two weeks before the Financial Stability Council convenes. Its focus is on systemic risk in the financial system and the economic situation, as well as other issues considered of significance for this collaborative venue. In 2015 the Council has met twice, on 19 January and 14 April, and its last meeting of the year is scheduled for 2 October.

The Financial Stability Council is to assess economic imbalances, financial system risks, undesirable incentives and other circumstances liable to jeopardise financial stability; At its most recent meeting the Financial Stability Council was of the opinion that the external environment of the financial system was favourable, external balance was good and conducive to stability. The position of the commercial banks was very good, their need for foreign currency funding in the coming years was moderate while one-off items dominated their performance. The principal factors which could threaten the stability which had been achieved were connected with the removal of capital controls.

The government's policy on financial stability defines six intermediate objectives, based both on international criteria and Icelandic circumstances. Taken together, these intermediate objectives are used to assess financial stability, through indicators which determine when actions need to be taken. In 2015 the Financial Stability Council approved three core indicators for the first intermediate objective: to counteract immoderate lending growth, indebtedness and asset market imbalances. Indicators for other intermediate objectives are in preparation and are expected to be ready by year-end. One of the Council's tasks is to approve a definition of systemically important factors which can influence financial stability. At the Council's meeting on 14 April this year the Systemic Risk Board's definition of systemically important supervised entities was submitted for approval. The Financial Stability Council confirmed the methodology and that Arion Bank hf., Landsbankinn hf., Íslandsbanki hf. and the Housing Financing Fund were considered systemically important supervised entities.

The Council defines those actions, other than implementing the Central Bank's monetary policy management tools, which are considered necessary at any given time to influence the financial system with the objective of reinforcing and safeguarding financial stability. Rather than taking direct action, the Council recommends actions to the competent authorities based on the analysis of the Systemic Risk Board and its own assessment. Among those actions which the authorities can undertake are macroprudential measures such as capital buffers, which were adopted as legislation on 2 July this year. Three of the four buffers introduced are applied following recommendations of the Financial Stability Council. The buffers are intended to reduce systemic risk and reinforce financial undertakings' operations; they reflect both internal and external circumstances. Additional macroprudential tools are to be introduced in coming quarters. A draft bill on new consumer housing mortgages, for instance, proposes to authorise FME, following recommendations from the Financial Stability Council, to adopt rules on loan-to-value (LTV) ratios for real estate mortgages. Capping LTVs can restrain real estate mortgage growth and, in turn, impending housing market overheating. In the coming quarters additional macroprudential tools will be introduced, including those provided for in Regulation (EU) No. 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (Capital Requirements Regulation, CRR).

### **Outlook for removal of controls**

The circumstances for removal of controls have not been as favourable since the financial crisis. Economic growth is robust, public finances have become sustainable with debt declining, inflation has slowed and there is an underlying current account balance surplus. Access by Icelandic financial undertakings to foreign capital markets is improving and the international ratings agencies Fitch Ratings, Standard & Poor's and Moody's all upgraded Iceland's sovereign rating a notch this summer. The ratings of the three large commercial banks were also upgraded this summer, making all of them investment grade for the first time since the financial crisis.

Major public interests demand that removal of capital controls be achieved without threatening economic and financial stability. The objective of the current plan is based on the key premise of removing controls in stages without disrupting economic equilibrium and without placing additional financial burdens on the Treasury or the public at large.