

Progress of the Plan for Removal of Capital Controls

This report is published by the Minister of Finance and Economic Affairs as provided for in Paragraph 2 of the Temporary Provision I in Act No. 87/1992 on Foreign Currency

[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]

Former reports are available at the website of the Ministry of Finance and Economic Affairs.¹

Act on the treatment of króna-denominated assets subject to special restrictions

On 23 May 2016, Althingi passed into law a bill of legislation, introduced by the Minister of Finance and Economic Affairs on the treatment of króna-denominated assets subject to special restrictions. The Act is part of the authorities' capital account liberalisation strategy that was presented in June 2015. The assets concerned are believed to be more volatile than other assets and, thus, more likely to seek a quick exit from the domestic economy when the capital controls are lifted, with an accompanying negative impact on monetary and exchange rate stability. These króna-denominated assets have been referred to as offshore króna assets, as they are often held in custody by non-residents and will, thus, not be sold for foreign currency except in transactions with other non-residents. The exchange rate in such transactions is different than that applying to trade in goods and services undertaken by residents, which takes place in the domestic foreign exchange market, often referred to as the onshore market. These króna-denominated assets, however, are held in custody by credit institutions and investment firms in Iceland, although generally not in the name of its beneficial owners.

The principal objective of the Act is to segregate the offshore króna assets in a secure manner so that it is possible to take the next steps towards lifting the capital controls and re-establishing unrestricted cross-border transactions with krónur. It is important that this will be done without jeopardising financial stability or monetary and exchange rate stability. The stock of offshore krónur stood at 319 b.kr. when the Act was passed. These krónur had been actively traded in the offshore market at an exchange rate well below the exchange rate in the domestic foreign exchange market. The offshore króna assets are more likely than other króna-denominated asset to seek an exit through the foreign exchange market as the capital account is liberalised, due to the expected foreign exchange gains from those assets. This applies regardless of whether the beneficial owners are domestic or foreign. Furthermore, offshore króna assets are to a less extent subject to a home bias compared to other króna-denominated assets. In recent years, the Central Bank of Iceland has held foreign currency auctions and engaged in direct transactions so as to facilitate the exit of a part of offshore króna assets, as defined in the Act on the treatment of króna-denominated assets subject to special restrictions, without negative effects on either exchange rate stability in the domestic foreign exchange market or the Bank's foreign exchange reserves.

The Act obliges custodians of offshore krónur to segregate those offshore krónur that were

¹ <https://www.ministryoffinance.is/news/nr/20084/>

not bought in the Central Bank's foreign currency auction in June². According to the Act, custodians are obliged to transfer offshore krónur to restricted accounts identified with ledger code 21 in the Icelandic Banks' Data Centre hf. system, and to transfer electronically registered offshore króna assets in their custody to so-called administrative accounts with the Central Bank of Iceland. Balances on restricted accounts are subject to a special reserve requirement. With this arrangement, the risk of circumvention is alleviated and the Central Bank of Iceland's supervision is made more effective without requiring substantially increased supervisory expenses and a better oversight of offshore króna assets is ensured. Naturally, it is not possible to transfer electronic custody of offshore króna assets that are not electronically registered, but the Act assumes that all payments deriving from such assets will be deposited to accounts subject to special restrictions.

According to the legislation, offshore króna holders are allowed to invest in the same instruments as before according to a special exemption list from the Central Bank, with the addition of special certificates of deposit issued by the Central Bank. However, the banks holding the accounts of offshore króna owners are required to buy special certificates of deposit from the Bank for an amount equivalent to the total amount of deposits on those accounts, and these instruments will bear an interest rate of 0.5%. The interest rates shall be reviewed every twelve months by the Central Bank, with reference to the Bank's legally mandated objectives and returns on its assets.

Central Bank foreign currency auction

On 16 June 2016, the Central Bank of Iceland called for offers to sell assets registered in Icelandic krónur in return for cash payment in foreign currency. On 21 June, the Bank announced the main results of the auction and offered to purchase, at an exchange rate of 190 kr. per euro, the offshore króna assets not sold in the auction. The Terms of Tender for these transactions were announced on 22 June 2016.

A total of 1,715 offers were submitted and 1,688, or 98.4% of the total, were accepted. Accepted offers amounted to 83 b.kr., of a total of 188 b.kr. submitted in the auction and the post-auction tender. The Central Bank of Iceland's foreign exchange reserves were reduced by just over 54 b.kr. as a result.

The auction was part of the comprehensive capital account liberalization strategy of 8 June 2015. The auction on 16 June 2016 was the last in a series of twenty-three auctions that started in June 2011, in which owners of offshore krónur were invited to purchase foreign currency before the authorities begin lifting capital controls on resident entities; i.e., pension funds, other legal entities, and individuals.

The auctions helped to facilitate the exit of offshore króna assets without negative effects on the foreign exchange market, and the outstanding stock of offshore krónur was reduced markedly. The remaining owners of offshore króna assets in the form of cash or Treasury bonds and bills are a smaller and more homogenous group, mostly a few hedge funds and fund management companies. The remaining offshore króna assets have been transferred to accounts subject to special restrictions at credit institutions and on administrative accounts with the Central Bank of Iceland, in accordance with the newly passed legislation. Owners of offshore króna assets will continue to have the right to dispose of their assets; they can make withdrawals, exchange all interest payments in the foreign exchange market, and trade their

² See further discussion below

assets in the offshore market.

Capital flow management measures

On 2 June 2016, Althingi passed into law a bill of legislation introduced by the Minister of Finance and Economic Affairs on a capital flow management measure to alleviate potential negative impacts of capital inflows. The Act allows the Central Bank to set rules on necessary capital flow management measures in order to temper inflows of foreign currency and to affect the composition of such inflows. Two days after the bill was approved, the Central Bank published the Rules on Special Reserve Requirements for New Foreign Currency Inflows, which are intended to reduce the risk that could accompany excessive capital inflows under the current regulatory framework for foreign exchange, support other aspects of domestic economic policy, and contribute to macroeconomic and financial stability.

The Central Bank's capital flow management tool is based on the application of special reserve requirements for new inflows of foreign currency and is structured so as to reduce the risk potentially accompanying strong capital inflows by directly affecting the incentives for carry trades. The tool is therefore intended, among other things, to support effective monetary policy transmission. Furthermore, the structure is intended to ensure that the measure is flexible, effective, and efficient in implementation so as to make it possible to respond quickly to changed circumstances.

The Rules contain provisions on the implementation of special reserve requirements for new foreign currency inflows, including the special reserve base, holding period, special reserve ratio, settlement currency, and interest rates on deposit institutions' capital flow accounts with the Central Bank of Iceland. The special reserve base is defined as new inflows of foreign currency in connection with specified types of capital, particularly to include new investment in electronically registered bonds and bills, and deposits bearing at least 3% interest rates. In addition, new inflows related to loans taken for investment in such instruments can create the special reserve base. The Foreign Exchange Act states that the holding period may range up to five years and that the special reserve ratio may range up to 75%; however, the Rules currently set the holding period at one year and the special reserve ratio at 40%. The Rules also set the interest rate on capital flow accounts with the Central Bank of Iceland at 0% and specify the Icelandic króna as the settlement currency.

Capital account liberalisation on resident entities

On 11 October 2016, Althingi passed a bill, introduced by the Minister of Finance and Economic Affairs, amending Act No. 87/1992, on Foreign Exchange. The Act is part of the authorities' capital account liberalisation strategy, introduced on 8 June 2015. With it, important steps are taken to lift the capital controls in full. The bill was prepared in accordance with general recommendations from the International Monetary Fund (IMF), with economic stability and the public interest as guiding principles.

With the Act, consideration is given to easing controls on resident and non-resident individuals and legal entities, in two steps; first upon passage of the bill and second by the turn of next year. The conditions for liberalisation of the controls are in many respects optimal, and large individual risk factors, such as the settlement of the failed banks' estates or the offshore króna problem, no longer pose a threat. In spite of favourable conditions, it is important that the capital controls be lifted in structured phases where caution is observed, particularly as regards potential strain on the liquidity position of the financial system and the balance of payments.

Just over 54 b.kr. were allocated in the foreign currency auction, which was held in mid-June. Following the auction, the reserve adequacy ratio is approximately 158%, according to the International Monetary Fund's (IMF) reserve adequacy metrics (RAM) criteria. The Fund considers it desirable that Iceland's RAM threshold be at least 150% in the prelude to liberalisation of capital controls on residents, and the Central Bank agrees with this assessment. The reserves are roughly 34 b.kr. above the threshold.

The first phase of the Act

Upon the Act coming into effect on 21 October 2016 outward foreign direct investment (FDI) became unrestricted but subject to confirmation by the Central Bank, in part because it can involve very large sums of money. Furthermore, investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans became permissible up to a ceiling of 30 m.kr., which will be increased in stages. The authorisation is subject to certain conditions concerning beneficial ownership and financing of the transaction; moreover, it is initially required that the investment must be held with a domestic custodian. The purpose of this is to enable the Central Bank to oversee and supervise properly the transactions covered by the provision so that, among other things, it can take informed decisions on raising the ceiling in the provision when conditions allow.

Individuals are now allowed to purchase one real estate per calendar year, subject to prior confirmation by the Central Bank of Iceland. Until now, individuals' authorisations for foreign exchange transactions in connection with real estate purchases abroad have been restricted to purchases made due to a change of residence, and they have been subject to a ceiling of 100 m.kr.

The requirement that residents repatriate foreign currency has been scaled down so as to reduce the inconvenience to individuals and firms in connection with foreign investment. Now, the repatriation requirement does not extend to capital relating to loans taken abroad by individuals for the purchase of real estate or transport equipment abroad, or to capital relating to loans taken for other foreign investment.

With the Act, the Central Bank's authorisations to gather information has been expanded in order to monitor the development of systemic risk in the economy on the basis of the Act on the Central Bank of Iceland. Finally, various special restrictions are lifted and various special authorisations under the Act are expanded.

The second phase of the Act

The second phase of the law on capital account liberalisation will be implemented on 1 January 2017; cf. the new Temporary Provision in Article 14 of the aforementioned Act amending the Act on Foreign Currency. At that time, the ceiling on investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans will be raised to 100 m.kr. and transfers of deposits will be permissible, subject to the same ceiling, the domestic custodianship requirement for foreign securities investments will be revoked, and foreign currency purchases in cash will only be limited by the aforementioned ceiling. This will enable residents and non-residents to transfer deposits and securities to and from Iceland, to trade in securities abroad, and purchase or withdraw foreign currency in cash within the ceiling.

It is important that capital account liberalisation be structured so as to prevent undue strain on financial institutions' liquidity and on the balance of payments. Ceilings on deposit transfers and foreign investment must take account of the probable strain on the balance of payments and an analysis of the potential impact on financial institutions' liquidity. Deposit transfers entail funding losses for domestic financial institutions and will force them either to tap liquid assets or find other funding sources. As a result, it is advisable to raise the ceilings in stages.

Upgraded credit rating with stable outlook

On 1 September 2016, Moody's Investors Service upgraded Iceland's sovereign rating to A3 from Baa2. The rating outlook is stable. One reason for the upgrade was the progress of the plan for lifting the capital controls. In a news release following the publication of the upgrade, Moody's stated that Iceland's rating trajectory has lagged the improvement of some of its core fundamentals since the financial crisis, because of the residual risks posed to economic and financial stability by the complex process of removing the capital controls. The upgrade now, however, reflects Moody's expectation that the phasing out of capital controls will proceed smoothly to completion, without disrupting economic and financial stability.

Pension funds' authorisation for foreign investment

The Central Bank of Iceland has granted pension funds and other domestic custodians of third-pillar pension savings an exemption from the Foreign Exchange Act, no. 87/1992, thereby permitting them to invest in financial instruments issued in foreign currency. From mid-2015 through the end of 2016, pension funds have been authorised to engage in foreign investment for a total of 95 b.kr.

The grounds for exemptions to pension funds and other domestic custodians of third-pillar pension savings are related to macroeconomic benefits associated with allowing the pension funds to diversify their portfolios and reduce their pent-up investment need before controls on residents are lifted. This, in turn, reduces the risk of monetary and exchange rate instability upon full liberalisation of the controls.

Full liberalisation of the capital account

Both full liberalisation and its timing depend on several things; for instance, asset portfolios must have adjusted to a desirable composition of domestic versus foreign assets, outflow pressures must be manageable, and the authorities must be given the scope to develop appropriate prudential tools. Furthermore, the size of the foreign exchange reserves at any given time is important, as are developments in the current account balance and the external position of the economy.

The authorities' capital account liberalisation strategy is in line with recommendations from the IMF on an integrated three-stage approach to capital account liberalisation. More specifically, the Fund broadly recommends that restrictions on capital inflows for inward FDI be lifted first, followed by restrictions on outflow for outward FDI, other long-term capital movement and a portion of short-term capital movement. Other controls should be lifted last. The Fund also recommends that the authorities' supervision and oversight of external trade and the financial market be strengthened as these stages are implemented, including with increased and more effective information acquisition.

According to plan Icelandic authorities will, early next year, reassess the conditions for raising the 100 m.kr. ceiling on investment in financial instruments issued in foreign

21 October 2016

currency, other monetary claims in foreign currency, and prepayment and full payment (retirement) of foreign-denominated loans, transfer of deposits and foreign currency purchases in cash, as well as continuing the preparation for full capital account liberalisation.