

## **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. The second report was published on 17 March 2014<sup>1</sup> and the third on 18 September 2014.<sup>2</sup>

### **Advisors and administrative organisation**

The report of 18 September 2014 gave an account of the appointment of advisors and an Executive Committee for Removal of Capital Controls. The composition of the Executive Committee has undergone changes. Glenn V. Kim continues to serve as Committee chairman. Vice-chairmen of the Committee are Benedikt Gíslason, advisor to the Minister of Finance and Economic Affairs regarding capital controls, and Dr Sigurður Hannesson. Other Committee members are District Court attorney Ásgeir Helgi Reykafjörð Gylfason, Ingibjörg Guðbjartsdóttir, managing director of the Capital Controls Surveillance Unit of the Central Bank of Iceland, and Jón Þ. Sigurgeirsson, managing director of International Relations and General Secretariat of the Central Bank of Iceland.

This six-person Executive Committee works closely with the government's foreign advisors. The group's task is to provide an overall solution, dealing with all aspects of the capital controls, and specific proposals on steps towards their removal to the Working Group. The work focuses on both legal and economic issues, and in particular on the macroeconomic conditions upon the removal of controls and possible granting of exemptions.

### **Scope of the problem**

The removal of capital controls is a complex task due to the large amounts of capital which are or will be owned by short-term investors, and which as a result could exit the economy within a short period of time once controls are lifted, thus creating considerable pressure on the ISK. The potential outflows can be divided into three types:

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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>

i) Offshore ISK: ISK assets owned by and in the custody of foreign financial undertakings currently amount to around ISK 235 billion, of which ISK 156 billion are in Treasury securities, ISK 77 billion in deposits and money market facilities and ISK 1.5 billion in HFF bonds. Ownership of these ISK assets has become highly concentrated. Around 80% of the notes mature within five years, as offshore ISK in Treasury securities are primarily in shorter Treasury notes. In addition to this, non-residents (apart from foreign financial undertakings) hold deposits in domestic financial institutions, Treasury securities and HFF bonds which are not in the custody of foreign financial undertakings amounting to close to ISK 60 billion.

Investment by non-residents in ISK-denominated domestic securities has increased greatly in recent years in tandem with their participation in the Investment Programme of the Central Bank. Total investment through the Investment Programme from the time it commenced at the beginning of 2012 now amounts to ISK 206 billion, of which ISK 97 billion is invested in bonds and ISK 82 billion in equities. Of this amount, non-resident investors own ISK 134 billion. At the beginning of 2017 the encumbrances on the first investments under the Investment Programme expire; however, these investments did not include an exit ticket. Non-residents have furthermore invested in Treasury securities through the Central Bank's foreign currency auctions; their outstanding holdings in two inflation-indexed bond series currently amount to around ISK 9 billion. In addition to this, non-residents hold various other domestic assets which can be regarded as liquid or volatile. The conceivable outflow in connection with these assets, however, is subject to high uncertainty.

ii) Outflows in connection with financial undertakings in winding-up proceedings, including parties which have concluded the winding-up with a composition or decision on liquidation. The balance sheets of some of these undertakings are among the largest existing in the Icelandic economy, and distributions to foreign creditors will comprise a major share of potential outflows upon the removal of capital controls. The total assets of these dozen or so undertakings currently amount to over ISK 2,400 billion, or equivalent to 120% of GDP, with a sizeable imbalance between the share of foreign assets and claims which creates a risk.

Table 1. *Estimated breakdown of assets of financial undertakings in winding up proceedings or which have concluded a composition, distributions of which affect the balance of payments*

	Assets	Claims
Domestic	41%	7%
Foreign	59%	93%

The mismatch of foreign assets and foreign claims creates a considerable problem. Other things remaining equal, domestic assets amounting to around ISK 900 billion would be distributed to foreign creditors, including around ISK 500 billion of assets in ISK which they would wish to convert to foreign currency and withdraw from Iceland. Other domestic assets are foreign currency obligations of domestic parties towards the insolvent estates. The estates' largest ISK assets are holdings in the new banks, in addition to which they own considerable amounts of cash. Distributions by these domestic undertakings to resident creditors will not affect the balance of

payments, but distributions to foreign creditors will impact the balance of payments when the distributed assets exit Iceland.

iii) possible outflows by domestic parties.

It is difficult to assess the possible outflows from domestic parties upon the removal of capital controls. A report by the IMF of 13 March this year estimates that possible outflows from domestic parties could amount to as much as 25% of GDP, or around ISK 500 billion. It points out, however, that this depends upon various factors, such as investors' attitude at any given time to domestic and foreign investment options and credibility in removal of capital controls.<sup>3</sup>

### **Actions for removal of controls**

The principal emphasis of the 2011 plan to remove controls has been to reduce the risk which a possible outflow by impatient owners of offshore ISK could create. The Central Bank held regular auctions for this purpose until February 2015. In recent months the authorities have placed increasing emphasis on preparing actions to reduce the risk which financial undertakings in winding-up proceedings could create and to shape a framework for economic affairs and financial stability which would reduce the desire of domestic parties to seek to move capital out of Iceland.

#### *FX auctions of the Central Bank of Iceland*

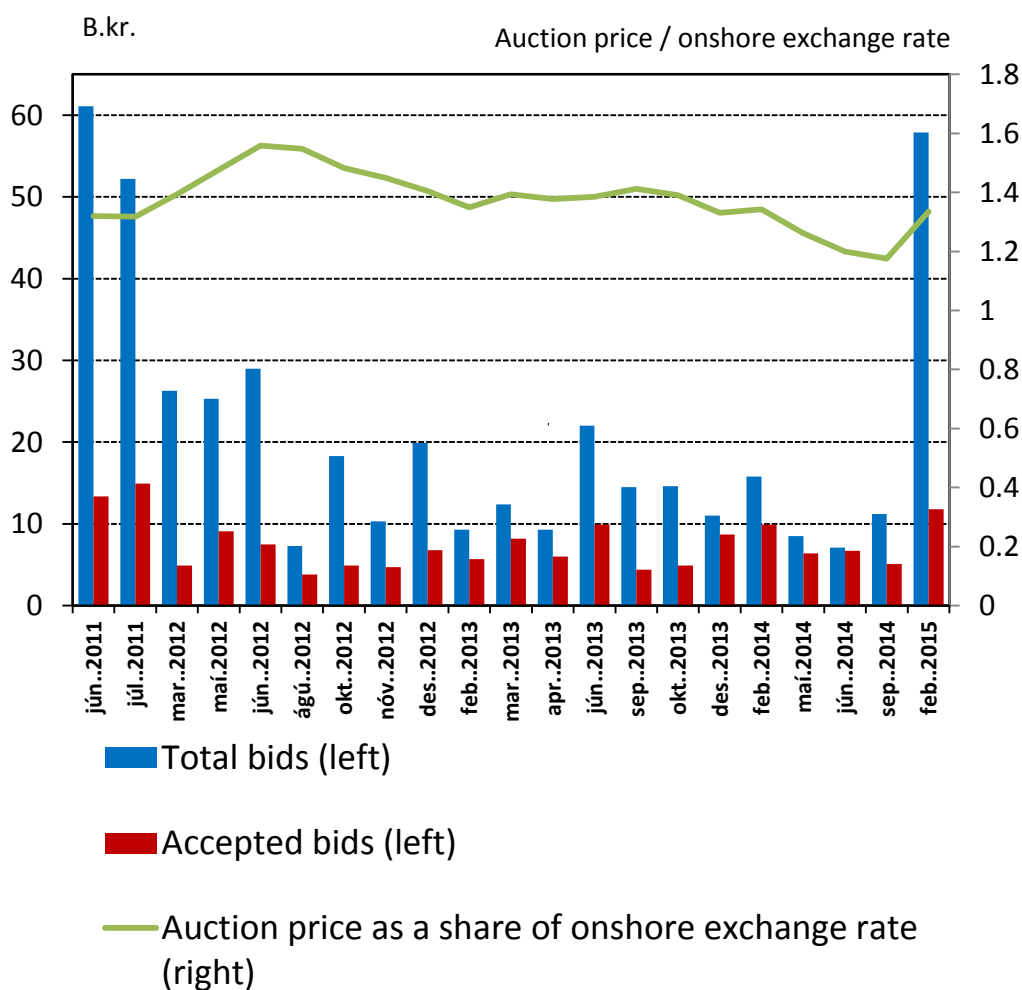
The Central Bank of Iceland has continued its FX auctions in accordance with its programme for removal of capital controls published in March 2011. The auctions are intended to reduce the stock of volatile ISK assets held by non-residents. Through the FX auctions which have been held since mid-2011 it has been possible to transfer ISK 175 billion in volatile ISK assets from non-residents to the hands of long-term domestic and foreign investors. Of this amount, ISK 118.5 billion, or 68% of the total have been locked-in through the Investment Programme; the final auction under this programme was held in February 2015. As a proportion of GDP this ISK position has decreased from the equivalent of 25% of GDP at year-end 2011 to 15% at year-end 2014. It is therefore evident that the FX auctions have achieved considerable success which will facilitate the next steps taken towards removal of controls.

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 23 auctions of Treasury securities have been held and 21 auctions have been held under the Investment Programme. In both cases investors oblige themselves to hold the investment for at least five years. When auction participants are divided into residents and non-residents it turns out that 35% of the total amount was from domestic and 65% from foreign investors. In this analysis, foreign companies owned by Icelandic residents were classified as domestic investors. During this same period an additional 22 auctions have been held inviting bids from non-residents wishing to sell their ISK assets in exchange for FX which is exempt from repatriation obligations. The final auction was held in February 2015 and no further auctions have been announced.

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<sup>3</sup> <http://www.imf.org/external/pubs/ft/scr/2015/cr1572.pdf>

## Central Bank of Iceland foreign currency auctions Purchases of krónur in exchange for euros



Source: Central Bank of Iceland.

### Investment Programme

In the Investment Programme, which has now concluded, investors could purchase ISK at the auction exchange rate for the equivalent of 50% of the amount invested, while the other 50% was converted on the domestic FX market. To date investors have brought EUR 1,099.2 million, or ISK 206 billion, into the country through the Investment Programme, with over 33% of this amount passing through the domestic FX market. Total foreign investment under the Investment Programme amounts to over 10% of Iceland's 2014 GDP. Around 47.2% of this capital inflow through the

Investment Programme has been invested in bonds, around 40.0% in equities, 12.2% in real estate and around 0.6% in UCITS.

#### *Treasury securities option*

One of the objectives of the Treasury securities option was to ensure refinancing of Treasury debt and extend its repayment profile. When the Treasury securities option was established, it was considered important to ensure the sale of Treasury paper to new investors to replace those non-residents wishing to transfer their capital out of the country. The Treasury securities option was directed primarily at pension funds, encouraging them to exchange foreign assets in return for long inflation-indexed Treasury bonds. In more recent auctions the pension funds have not been as interested in the Treasury securities option as they were in the beginning and have been replaced by other buyers. Investors have invested a total of EUR 263 million in Iceland through the Treasury securities option, or ISK 56.8 billion, based on the auction price in each instance. Of this amount, ISK 32.7 billion, equivalent to just over 58% of the total amount sold, was sold in two of the three first auctions.

#### *Sales of ISK for EUR*

Auctions of EUR in exchange for ISK are intended to provide an exit route for non-residents wishing to dispose of ISK. In 22 auctions a total of ISK 459.6 billion have been offered for sale, of which the Central Bank has purchased ISK 157.7 billion or just over 34% of the total amount offered. The amount of ISK acquired by the Central Bank for FX in each instance is determined by the quantity of the foreign currency offered for sale through the Treasury securities option and Investment Programme. In this manner the impact of the auctions on the currency reserves is kept to a minimum. The auction price is determined following the three auctions on the auction date. 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, but has decreased since then. In 2013 the price fluctuated between ISK 210 and 230 per euro, then declined still further in 2014. However, in the most recent auction in February 2015 the auction price rose again to ISK 200 per euro. The higher exchange rate than in the preceding auction is the result of changes in the auction terms, as in this instance commercial banks were authorised to collect bids based on the ISK assets of non-residents arising from distributions of an insolvent domestic estate towards claims recognised with reference to Articles 109-112 of the Act on Bankruptcy etc.

#### *Changes to lists of exemptions and FX rules of the Central Bank of Iceland*

The lists of exemptions published on the website of the Central Bank of Iceland based on Articles 2 and 3 of Rules No. 565/2014, on Foreign Currency, cf. the fourth paragraph of Art. 13 b of the Foreign Currency Act, was altered after market closing on 6 March 2015. The announcement thereof followed the final auction in February this year by the Central Bank in accordance with its 2011 plan. The exemption list is now limited to Treasury bills and one Treasury note series, RIKB 15 0408. This change reduces the classes of financial instruments on the exemption list.

Cross-border capital movements in connection with transactions in those classes of financial instruments on the current list are therefore still exempt from the restrictions in the Foreign Currency Act, provided the requirements laid down in Articles 2 and 3 of the Rules on Foreign Currency are satisfied. The Central Bank reserves the right to revise the currently applicable exemption list in light of circumstances at any given time.

In tandem with the change to the Central Bank's exemption list, Rules No. 565/2014, have been amended. Owners of those notes series which no longer benefit from exemption may sell their financial instruments. However, they will not be authorised to reinvest funds in other classes than those which enjoy exemption according to the decision of the Central Bank of Iceland.

The purpose of the above-mentioned changes is to prepare the way for further steps towards removal of capital controls. These will involve, among other things, offering the owners of ISK assets investment options which will substantially reduce the likelihood of instability when controls are lifted. The timing of these changes to the exemption list announced recently is aimed, among other things, at maintaining the efficiency and credibility of the bond market.

#### **Changes to the terms of Landsbankinn's bonds**

In December 2014 the authorities approved requests for exemptions for priority claims against the estate of the former Landsbanki Íslands hf. (now LBI hf.) which apply to liquid funds in foreign currency. The amount of the exemption is over ISK 400 billion, or close to 5% of the original claims against the estates of the failed banks. This amount has been recovered and was available for distribution in bank accounts of LBI hf.

The Icelandic authorities did not approve requests from the Winding-up Board of LBI hf. for exemptions from capital controls made in a letter of 12 June last year. It was not agreed that bonds issued by Landsbankinn will be exempt from capital controls.

LBI hf. and Landsbankinn have presented to the authorities a new agreement amending the terms of bonds issued by Landsbankinn. Previously the same parties had reached an agreement on changes to the terms of the bonds in May this year, which they presented to the authorities together with requests to be granted extensive exemptions from capital controls for payments to creditors of LBI's estate. The amendments which have now been agreed upon will, among other things, substantially reduce Landsbankinn's refinancing risk.

The above-mentioned decision to grant an exemption was restricted to distributions to priority creditors. With those distributions which will now be authorised, priority creditors of LBI will have received payment of around 85% of the principal of their claims. Recognised priority claims against the estates of Glitnir and Kaupthing have already been paid in full. Icelandic authorities will not grant exemptions for general creditors except in accordance with their policy concerning removal of capital controls, which is intended to safeguard exchange rate and monetary stability.

Amendments of the terms of the bonds between LBI hf. and Landsbankinn were a premise for authorising these exemptions for priority creditors. The bonds' repayment profile has been extended, reducing repayment risk after 2018. It should be pointed out that the bonds are callable, making it possible for Landsbankinn to refinance the bonds as soon as better terms are available on capital markets.

Settlement of priority claims marks a major step forward in the winding-up proceedings of the three banks and will, along with other measures, enable the government to implement an overall strategy for removal of capital controls.

### **Improved macroprudential framework**

As discussed in the report on removal of controls of September 2014, a stronger framework for financial stability is one prerequisite for removing capital controls successfully. Following the inception of the Financial Stability Council, work is underway on preparing legislation introducing macroprudential tools. Two Bills of Legislation to this effect have been presented to the spring session of the Icelandic parliament *Althingi* amending, firstly, the Act on Financial Undertakings by introducing capital buffers<sup>4</sup> and, secondly, amending the Act on Interest and Indexation with regard to indexation of loans in foreign currencies.<sup>5</sup> In addition, the Central Bank has set rules on commercial banks' funding ratio in foreign currencies. This funding ratio is intended to ensure minimum net stable foreign currency funding for a one-year period, thereby limiting the extent to which commercial banks can rely on volatile short-term funding to finance long-term foreign currency lending. In 2015, the Central Bank plans to introduce new rules on the ratio of foreign currency funding which will apply for a period of up to three years.<sup>6</sup>

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

The problem faced by Iceland concerns its balance of payments. As explained above, the problem consists of three parts, i.e. the offshore ISK problem, difficulties arising from distributions by financial undertakings in winding-up proceedings and potential capital outflows from other parties, including residents. Plans for removal of controls must ensure that they do not give rise to serious risks or difficulties in exchange rate and monetary affairs. The capital controls are a protective measure, which has ensured the stability which was a premise for restructuring the financial system and dealing with household and corporate debt in Iceland.

Although progress has been made in dealing with these difficulties, the economy still faces a sizeable balance of payments problem. The economy has undergone a major adjustment in recent years. It is important that resolving the balance of payments question take this into consideration and that this process does not threaten economic and financial stability.

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<sup>4</sup> <http://www.althingi.is/altext/144/s/0990.html>

<sup>5</sup> <http://www.althingi.is/altext/144/s/0975.html>

<sup>6</sup> <http://sedlabanki.is/utgefid-efni/frettir-og-tilkynningar/frettasafn/frett/2014/12/04/Nyjar-reglur-um-fjarmognunarhlutfall-vidskiptabanka-i-erlendum-gjaldmidlum/>

The current circumstances are in many respects favourable for removing controls. The economy is in good balance, with a fiscal surplus, low inflation and an underlying current account surplus which has enabled the accumulation of debt-free foreign currency reserves currently amounting to some ISK 60 billion.

Access to foreign capital markets by Icelandic financial undertakings is improving slowly, although their interest rate premium is still high. Fitch Ratings has changed Iceland's sovereign rating outlook from stable to positive. Low interest rates on international markets also facilitate relaxing controls with a high domestic-foreign interest rate differential. Uncertainty concerning developments on markets abroad, not least the Greek difficulties, however, could make removal of controls more risky than otherwise. The amendments to the bonds issued by Landsbankinn to the old bank's estate will also facilitate the former bank's long-term financing and contribute to more stable payment flows.

There are actually two possible options to deal with balance of payments problems such as those currently faced by Iceland. This can either be done by (i) imposing a haircut on domestic assets when they are converted to foreign currency, or (ii) ensuring that volatile assets are transferred to long-term assets, i.e. extending the term of liabilities. The terms and conditions of such converted assets and liabilities must ensure that they cannot be accelerated or revert to their former status. If this is done, short-term owners of such instruments can be expected to accept a discount (haircut) upon their sale while longer-term investors will profit on them in the longer term.