

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 2014,¹ a third on 18 September 2014,² a fourth on 18 March 2015³ and a fifth on 21 September 2015.⁴

Legislative reform in the fall of 2015

In the fall of 2015 it was deemed necessary to clarify and simplify legislation to facilitate the making of composition agreements by the estates of the failed financial undertakings. The Minister of Finance and Economic Affairs submitted a bill to Althingi which aimed at laying the groundwork for entities taxable according to the Act on Stability Tax to complete the part of their winding-up process of having a composition agreement ratified by the courts by year-end 2015.

In Althingi, some changes were made to the bill, including some clarifications on the taxation of financial undertakings in winding-up proceedings and the proceedings themselves. Furthermore, the Act on Stability Tax was amended as the deadline to conclude winding-up proceedings with a ratified composition agreement was moved from year-end 2015 to 15 March 2016. The additional time was provided on the grounds of i.a. input from the winding-up boards of the failed banks relating to the unlikelihood of concluding the proceedings before year-end, and the fact that the courts required ample time to consider the ratification of complex composition agreements.

The bill was ratified as Act No. 107/2015 on 4 November 2015, amending the Income Tax Act, Act on Special Tax on Financial Institutions, Act on Stability Tax and the Act on Financial Undertakings.

The estates of the failed banks – stability conditions met by all estates

The estates of the three large failed banks, Glitnir hf., Kaupthing hf. and Landsbanki Íslands hf., all requested an exemption from the Foreign Currency Act to conclude winding-up proceedings and submitted their draft composition agreements to the Central Bank of Iceland.

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

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

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

⁴ <https://www.ministryoffinance.is/media/frettatengt2015/Progress-of-the-Plan-for-Removal-of-Capital-Controls-September-2015.pdf>

In the drafts proposed retaliatory action and stability contributions were detailed.

The Central Bank of Iceland published its findings on the winding-up proceedings based on stability conditions and their impact on the balance of payments and financial stability in a detailed report on 27 October 2015.⁵ The Bank's conclusion was to recommend to the Minister that he ratify the exemptions proposed by the Bank.

The three estates' exemption requests were of such scale that the legislation required a process of consultation. The Central Bank shall consult with the Minister if the exemption pertains to a financial undertaking in winding-up proceedings and involves the authorisation of foreign currency transactions and cross-border movement of capital in excess of 25 billion ISK in a year or pertains to an entity whose balance sheet exceeds 400 billion ISK. If such an exemption could severely affect the net international investment position and pertains to the ownership of a commercial bank, it shall only be granted after consulting with the Minister of Finance and Economic Affairs, followed by a ministerial presentation of its economic impact to the Economic Affairs and Trade Committee of Althingi.

With the aforementioned stipulations of the Foreign Currency Act in mind, the Central Bank consulted with the Minister in the run-up to granting the conditional promise of exemption to the three estates. Moreover, the Minister presented the issue to the Economic Affairs and Trade Committee of Althingi with the Governor of the Central Bank.

The composition agreements of Glitnir, Landsbanki Íslands and Kaupthing were ratified by the courts in December 2015. According to the assessment of the Central Bank of Iceland the agreements met the criteria put forth in the Foreign Currency Act that their implementation along with proposed retaliatory action does not cause volatility in the exchange rate or monetary policy or threaten financial stability. As a result, all estates were granted exemptions from the Foreign Currency Act No. 87/1992.

On 18 February 2016 the Central Bank of Iceland issued a press release which stated that the Bank had signed the final exemption from the Foreign Currency Act in relation to the winding-up of failed commercial and savings banks. The Bank had granted an exemption to a total of seven estates and additionally one estate did not require an exemption. Therefore all former commercial and savings banks covered by the Act on Stability Tax, a total of eight, made their composition agreements by meeting the stability conditions.

The retaliatory action of the three large estates is broken down in the Central Bank's report. The measures are estimated to amount to 660 bn ISK of which 384 bn ISK are direct stability contributions.

The dispersal of direct stability contributions is stipulated in Article 1, paragraph 2 of Act No. 60/2015 on Stability Tax, which states that the contributions shall accrue to the treasury, and the allocation of the funds shall conform to economic and financial stability. The stability contributions of the estates are divided into cash, assigned assets and retained assets. Assigned assets are both listed and unlisted securities and other claims. The largest share of unlisted shares are Íslandsbanki shares and the Icelandic State Financial Investments will manage the state's holdings in the bank. The administration of retained assets will remain in

⁵ <http://www.cb.is/publications/news/news/2015/10/28/Central-Bank-concludes-assessment-of-preliminary-composition-proposals/>

the hands of the estates but delivered to treasury in the form of cash when realized. Cash will be placed in a special deposit account owned by the treasury in the Central Bank. With the amendment to Act. 36/2001 on the Central Bank of Iceland, which passed 17 March 2016, a temporary provision authorises the Minister to establish a body which administers, executes and sells assets, reporting to the Ministry of Finance and Economic Affairs. The processing of the assets is expected to take place in the next three years and the body shall be dismantled no later than 31 December 2018.

The revenue stemming from the stability contributions will firstly be used to meet the revenue loss from the special tax on financial undertakings. Secondly it will be used for the payment of a bond the treasury issued to refinance the Central Bank, as this will inhibit an increase in the supply of money and the negative impact it would have on price and exchange rate stability. The bond amounted to 90 bn ISK by year-end 2015. On 1 March the first share of the stability contributions were allocated to the bond, a total of 25 bn ISK. The remaining balance is now 65 bn ISK.

Auction for holders of offshore ISK

As stated in the comprehensive strategy for capital account liberalisation, which was made public in June 2015, the offshore ISK problem is set to be addressed with a currency auction. The preparations have been delayed somewhat, however, the plan remains. The preparation for this phase of the strategy is taking place in the Central Bank of Iceland and the Ministry of Finance and Economic Affairs.

Pension funds receive limited authorisation for foreign investment

On 8 January 2016, the Central Bank of Iceland announced a decision to grant an exemption from the Foreign Exchange Act, no. 87/1992, to pension funds that have operating licenses according to Chapter V or Chapter XI of Act no. 129/1997 and other domestic custodians of third-pillar pension savings that have received confirmation from the Ministry of Finance on the basis of Article 10 of the same Act, thereby permitting them to invest in financial instruments issued in foreign currency. The authorisation thus conferred amounts to 20 bn ISK, which will be distributed over the first four months of the year. In July 2015, these same parties were granted an exemption for foreign investment in the amount of 10 bn ISK, which was spread over the second half of 2015.

The Central Bank made this decision on the basis of an evaluation of the balance of payments. Foreign currency inflows in 2015 and reduced uncertainty about developments in the balance of payments following creditors' approval of composition proposals from the failed banks' estates have created the scope to authorise pension funds and other third-pillar pension savings custodians to invest further in foreign-denominated financial instruments. Such investments represent an economic advantage, as they allow the pension funds to improve the risk diversification in their portfolios while reducing their accumulated foreign investment need once the capital controls have been lifted.

Outlook for removal of controls

The outlook for removal of capital controls is favourable. Continued economic growth is forecasted, as well as a current account balance surplus, despite the economy showing early signs of overheating. Public finances are on a sustainable path and public debt is trending downward. In January Standard & Poor's upgraded the treasury's long-term rating from BBB to BBB+ and Fitch confirmed their earlier BBB+ rating. The outlook is stable, according to both agencies. As the estates of the failed commercial and saving banks have met the stability

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conditions a big step has been taken towards the removal of capital controls.