

Q & A

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

2. Central Bank of Iceland foreign currency auction

What do the Act entail? What is its objective, and what is being changed?

Even though significant progress has been made in reducing the overhang of capital waiting to exit the Icelandic economy upon liberalisation of the capital controls, about 320 b.kr. in so-called offshore krónur still remain. These offshore krónur, which in recent years have been traded at much lower exchange rates than are seen in the domestic foreign exchange market, are likely to seek an exit upon liberalisation of the capital controls, with negative effects on both the exchange rate of the Icelandic króna and the foreign exchange reserves. With the Act, the definition of which assets are considered offshore króna assets is passed into law for the first time. The principal objective of the Act is to segregate the offshore króna assets in a secure manner so that it will be 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 treatment of offshore króna assets has been subject to special restrictions ever since the capital controls were imposed. The Act provides for the segregation of these assets so as to facilitate general liberalisation of capital controls while simultaneously expanding the investment and withdrawal authorisations of the owners of offshore krónur.

How are authorisations for investment and withdrawals being expanded?

The withdrawal authorisations of individuals who own offshore krónur are expanded, and these individuals will be permitted to withdraw up to 1 m.kr. each year. All owners of offshore krónur are also authorised to invest in special certificates of deposit issued by the Central Bank of Iceland and initially bearing an interest rate of 0.5%, which will be reviewed annually.

Which assets are classified as offshore króna assets? Does the Act force owners to sell these assets?

Examples of such assets are deposits, funds held in custodial accounts, bonds, and bills. Offshore króna assets will continue to be subject to special restrictions according to the Act, but their owners may hold these

assets until maturity. Therefore, no one is being forced to sell offshore króna assets.

How is the planned Central Bank auction connected to the Act?

These are two separate steps in the capital account liberalisation strategy.

With the Act, preparations are being made for the liberalisation of controls on households and businesses in Iceland.

The foreign currency auction is the continuation of the measures that the Central Bank has been taking in recent years so as to facilitate the exit of offshore króna assets without negative effects of the foreign exchange market.

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 offshore króna assets without negative effects on either exchange rate stability in the domestic foreign exchange market or the Bank's foreign exchange reserves. The planned foreign currency auction is aimed at the same goal and provides an exit path for all owners of offshore króna assets that choose to exit. The Central Bank will publish more detailed information on the auction in the days to come.

In spite of the authorities' attempts to solve the problem centring on offshore krónur, it is not possible to guarantee ahead of time that the problem will be entirely resolved with the proposed foreign currency auction, as participation in the auction is voluntary. On the other hand, it is vital that further liberalisation of controls not be delayed further, and the Act is intended to address the current situation by obliging custodians of offshore króna assets to segregate those offshore króna assets that will not be used in the planned Central Bank foreign currency auction, so as to make it possible to take the next steps towards liberalisation.

How is this foreign currency auction different from previous auctions, and will the results in some way determine how the next steps in the liberalisation process will be carried out?

In the last five years, the Central Bank had held a total of 21 foreign currency auctions for owners of offshore krónur, with total transactions in the amount of 158 b.kr. The step being taken now is much larger, as owners of 320 b.kr. in offshore krónur are being given a clear exit path where all owners of offshore króna assets will be ensured an exit at a specified minimum price. This is therefore a much larger step than has been taken heretofore.

Participation in the auction is voluntary, and owners of offshore krónur decide their bids themselves. It is not known how strong participation in

the auction will be, but a key factor is that, irrespective of the outcome of the auction, the liberalisation of capital controls on households and businesses in Iceland must not be delayed further. With the Act, the groundwork is being laid so that the next steps in this essential process can begin.

What are the next steps in the liberalisation process once the Central Bank foreign currency auction is complete? What effect will this have on general liberalisation of capital controls? When can it be expected that these steps will be taken?

When this phase in the authorities' capital account liberalisation strategy is complete, the ensuing steps will focus on households and businesses in Iceland. Individuals' freedom to transfer capital will be expanded, as will firms' and pension funds' investment authorisations. For nearly eight years, the capital controls have put restrictions on risk diversification in resident investors' asset portfolios and have limited domestic firms' ability to participate in profitable collaborative projects with non-residents. The resulting economic complications grow greater over time, and the need for risk diversification in domestic asset portfolios accumulates.

The segregation of offshore króna assets provided for in the Act must take place no later than 1 September. The aim is to present before the parliament as soon as possible a bill of legislation providing for general removal of capital controls on households and businesses in Iceland

When can owners of offshore krónur who do not participate in the Central Bank foreign currency auction and do not take advantage of the exit route that is open until 1 November expect their next opportunity to come?

It can take many years to adapt domestic asset portfolios to a favourable balance between domestic and foreign assets. Furthermore, the need for outward foreign direct investment can prove substantial after nearly eight years under capital controls. When resident investors' asset portfolios become better balanced, attention will be directed once again at sequenced liberalisation of capital controls on offshore króna assets. When and how this happens will depend in part on resident entities' investment need, inward long-term foreign direct investment, the size of the foreign exchange reserves at any given time, developments in the current account balance, and the external position of the economy.

But will it be possible to lift the controls before the offshore krónur have been released? Doesn't Iceland have capital controls while the offshore krónur are subjected to these special measures?

It is true that Iceland will be listed by multilateral institutions as a country with capital controls until the offshore króna problem has been fully

resolved. On the other hand, with the authorities' measures, it will now be possible to take large steps towards lifting controls on households and businesses in Iceland without having previously solved the offshore króna problem in full.

The measures entail a realistic solution to the offshore króna problem but at the same time place Icelandic households and businesses in the foreground. As protracted capital controls have a negative economic impact that erodes economic prosperity and the living standards of the general public.

This prioritisation is fully consistent with the International Monetary Fund's (IMF) integrated three-step approach to capital account liberalisation, introduced in 2012.

How is it ensured that releasing offshore krónur now, through the foreign currency auction, will not further delay general liberalisation of the capital controls?

The capital account liberalisation strategy has the fundamental objective of ensuring that the foreign exchange reserves are sufficient and that the risk of substantial foreign currency outflows is minimised. The actions being taken by the authorities now are an element in preventing the offshore króna assets from having undesirable negative effects on the exchange rate and the foreign exchange reserves. The Central Bank will determine how much scope it has to allocate a portion of its foreign exchange reserves towards releasing offshore króna assets through the foreign currency auction before offshore króna assets are segregated. This assessment will take into account, among other things, the Bank's need for foreign exchange reserves when the time comes to lift controls on Icelandic households and businesses. While liberalisation is underway, the size of the foreign exchange reserves will be determined through a cautious approach consistent with guidelines and advice from the IMF.

Is it known who the owners of offshore króna assets are? Is it possible to allow them to exit if it is not known who the beneficial owners of the offshore krónur are? What if the owner group includes residents who have not reported their assets and the income deriving from them to the tax authorities?

The Central Bank of Iceland, in consultation with the Financial Supervisory Authority, requested information and documentation on the asset composition and addresses of beneficial owners of offshore króna assets. It requested information and documentation from foreign financial institutions, which gave information on the number of beneficial owners, their addresses, and whether they were legal entities or individuals. Data collection requests were sent to official financial supervisors in 11 countries in Europe, and responses were received from five institutions. The Central Bank has also sent special data requests to domestic financial

institutions, requesting information related to the offshore króna assets. According to the information that has been received, the beneficial owners of offshore króna assets are resident and non-resident individuals and legal entities.

It is clear that, through offshore transactions, ownership of offshore króna assets has become somewhat more concentrated in recent years. The four largest owners – international mutual and hedge funds – own nearly half of these offshore króna assets in mixed investment portfolios.

In the terms and conditions for the foreign currency auctions that the Central Bank has already held, domestic commercial banks, as intermediaries in the auctions, have only been authorised to collect bids stemming from their non-resident customers or those that are based on króna-denominated assets held by residents in foreign banks, if the assets have been continuously owned by that party since 28 November 2008. Bids stemming from other parties have been excluded from participation, and only bids based on capital stemming from and/or directed at capital account transactions have been permitted. Offers based on capital from current transactions have been excluded from participation.

The terms and conditions in this foreign currency auction will be identical to previous terms and conditions as regards the demarcation of the capital that may be used in the auction, but the Central Bank will also include further provisions that ensure more effective monitoring of compliance with the terms and conditions.

Isn't this a violation of the rights of owners of offshore krónur? Are the authorities' measures vis-à-vis owners of offshore krónur in compliance with the Constitution and Iceland's international obligations?

The Act was passed with the aim of maintaining protection of fundamental rights, particularly as regards protection of ownership rights and prohibition of discrimination. The measures provided for in the Act are considered constitutionally sound and consistent with Iceland's obligations under the European Human Rights Convention and the EEA Agreement.

The Act does not entail a requirement that owners of offshore krónur sell their assets, and their business relationships with domestic financial institutions and foreign securities depositories will remain unchanged.

In spite of the authorities' actions, 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 krónur in the offshore market. Furthermore, the investment authorisations of owners of offshore krónur will be expanded,

as will the withdrawal authorisations of individuals who are owners of offshore krónur.

The steps towards capital account liberalisation that are outlined in Act, which mainly entail the transfer of funds to special accounts, do not as such represent far-reaching restrictions on free movement of capital or other obligations under EEA law. Actually, the Act provides in many respects for broader authorisations to dispose of offshore króna assets than are currently in place. Furthermore, the segregation of assets provided for in the Act is based on substantive considerations that are related solely to the objectives of the Act and do not, in terms of purpose or impact, represent discrimination between parties in comparable situations as regards residence or nationality.

What effects will these measures have on the Treasury?

The further liberalisation of the capital controls will eliminate a major uncertainty concerning the Treasury's future credit options and debt service. International credit rating agencies have repeatedly pointed at the capital controls as one of the principal drags on Iceland's credit ratings and, therefore, on the terms offered to it in international credit markets. It is hoped that interest premia and interest expense on Treasury borrowing will decline, as other European countries with a similar position, economic framework, and public debt level enjoy much more favourable borrowing terms than the Republic of Iceland does.

What impact will the measures have on the Central Bank?

The Central Bank of Iceland implements the capital controls and carries out supervision and monitoring of the controls. The Act creates the foundations for the next steps in liberalisation and minimises the risk of circumvention during the easing process, which would otherwise require extensive supervision and monitoring. The Central Bank should not be required to incur increased supervisory costs because of the Act, and over time, the cost of supervision should decline as liberalisation proceeds.

The Central Bank will determine how much scope it has to allocate a portion of its foreign exchange reserves towards releasing offshore króna assets through the foreign currency auction before offshore króna assets are segregated. This assessment will take into account, among other things, the Bank's need for foreign exchange reserves when the time comes to lift controls on Icelandic households and businesses.

What impact will the measures have on the economy?

First of all, both the treatment of offshore króna assets provided for in the Act and the planned Central Bank auction are important elements in the

capital account liberalisation strategy. These measures will help make it possible to unwind the negative effects that protracted capital controls have on the economy. Second, the segregation of offshore króna assets will prevent circumvention and will prevent owners of offshore krónur from exiting the domestic economy unhindered when the next steps towards capital account liberalisation are taken, with the associated negative impact on Iceland's balance of payments.

The aim of the Act is to ensure that the liberalisation of capital controls does not have a significant negative impact on the exchange rate or the foreign exchange reserves. As a result, it can be expected that the impact on inflation will be limited and that, other things being equal, there will not be a negative effect on real disposable income and household debt service. The risk of a negative spiral of falling exchange rate and rising inflation is therefore limited.