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Unofficial translation of the report on the Progress of the plan to remove capital controls, published on 17 March 2013 by the Minister of Finance and Economic Affairs.

Progress of the plan to remove capital controls
Report pursuant to Act no. 16/2003 from the Althingi

This report is published by the Minister of Finance and Economic Affairs pursuant to Act no. 16/2013 from the Althingi.

> [The Minister shall publish reports on progress made in the plan to remove restrictions. A report, in accordance with the first sentence, shall be published within six months of this Act entering into effect.]

The first report pursuant to the Act was published on the website of the Ministry of Finance and Economic Affairs on 17 September 2013.[1] Reference is made to the report with respect to general discussion on the origin of the capital controls, their purpose and the main points of the plan to remove them.

The scope of the problem

The balance of payments problem facing the Icelandic economy, and that is the reason for capital controls being in force, is mainly related to potential outflow of capital as follows: 1) ISK owned by foreign parties, known as offshore ISK; 2) settlement of the failed banks; 3) outflow of ISK assets owned by domestic parties (for example pension funds) subsequent to controls having been lifted; 4) contractual payments by domestic parties on obligations to foreign parties. Were capital controls to be removed in an unorganised manner, the interaction of the above specified factors could cause instability and could undermine economic and fiscal stability.

The plan for removal of capital controls which has been adhered to since March 2011 has first and foremost aimed at mitigating risks related to offshore ISK. During the past few seasons, the government has however focused more attention on the problem created by the settlement of failed financial companies. That their settlement should not significantly impact the country's balance of payments, is a pre-requisite for removing capital controls without an undesirable effect on economic and fiscal stability.

Offshore ISK

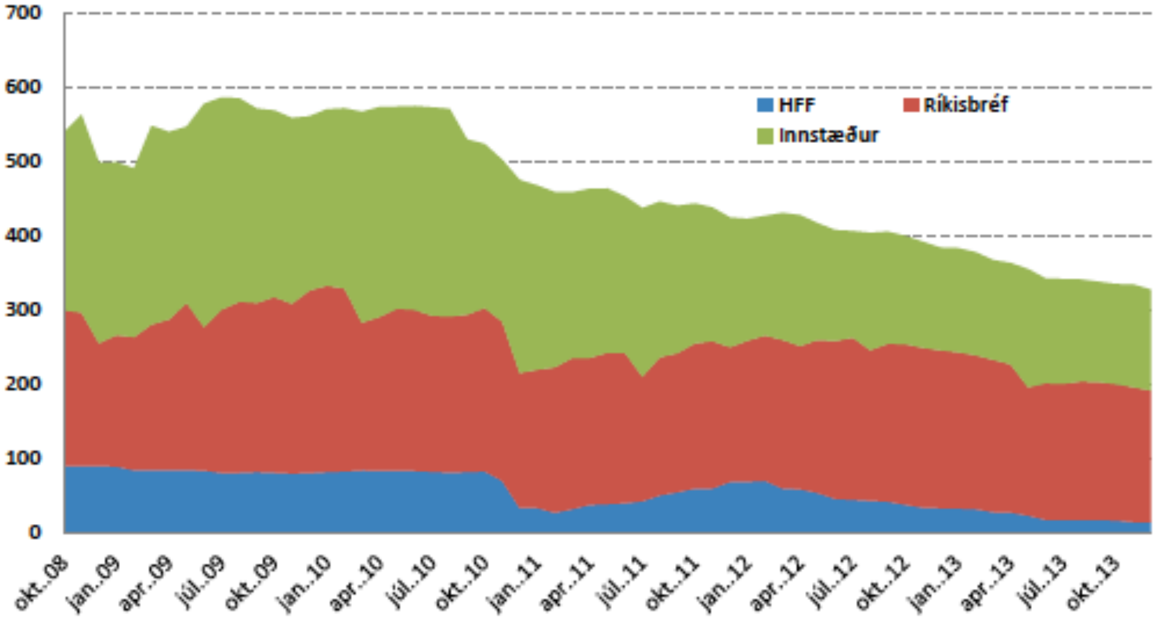
Offshore ISK were ISK 327 billion at the end of 2013 and were at ISK 565 billion subsequent to the collapse of the financial system in 2008. The Central Bank has reduced the position of offshore ISK both with special trading and auctions (see here below) in accordance with the plan for the removal of capital controls from March 2011. Auctions by the Central Bank have succeeded in systematically freeing foreign short-term investors in offshore ISK, thus reducing the proportion of offshore ISK held by parties that wish to redeem their investment almost without respect to the rate of

[1] http://www.fjarmalaraduneyti.is/frettir/2013/09/17/nr/17190

exchange. In parallel to this reduction, the composition of such assets has changed significantly. The major part of the reduction has been in deposits while foreign parties have also extended the lifetime of their assets in treasury bonds. At the turn of the year there were about 177 billion offshore ISK in treasury bonds, ISK 136 billion in deposits and ISK 14 billion in the State Housing Financing Fund (HFF). The amount of offshore ISK in deposits has not changed significantly since the middle of 2013 while investments of offshore ISK in treasury bonds have dropped to some extent. This is something of a change from the previous situation.

Table: ISK assets of foreign parties

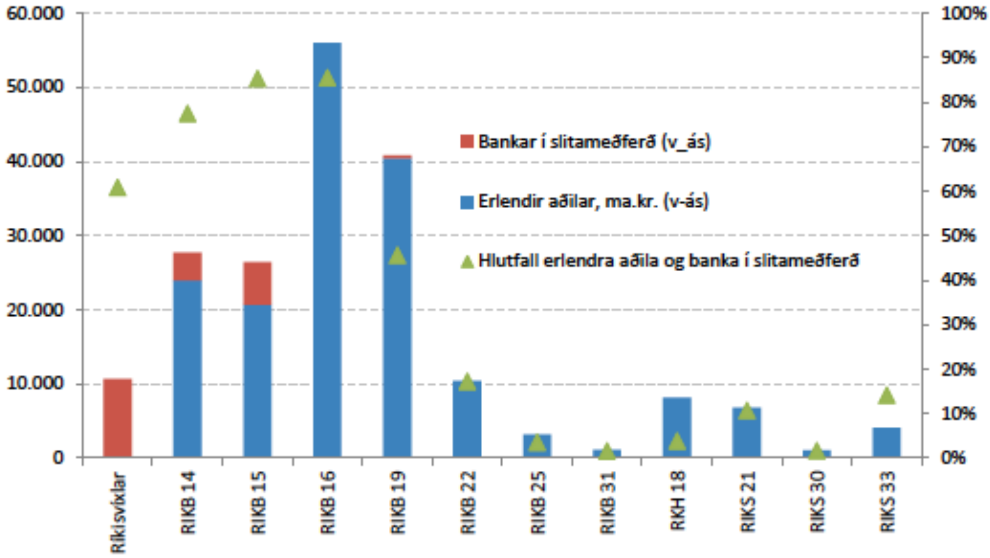
Blue: HFF *Red: treasury bonds* *Green: deposits*



It is difficult to evaluate the volatility of remaining offshore ISK. Investor willingness to sell their investments is decided first and foremost by the rate on offer to them at any given time and this interest could significantly increase with a reduction in the offshore rate. It is unlikely that offshore ISK will all be exchanged quickly into foreign currency but it will rather be the case that some investors will retain their investments subsequent to the removal of controls, but such development is difficult to predict.

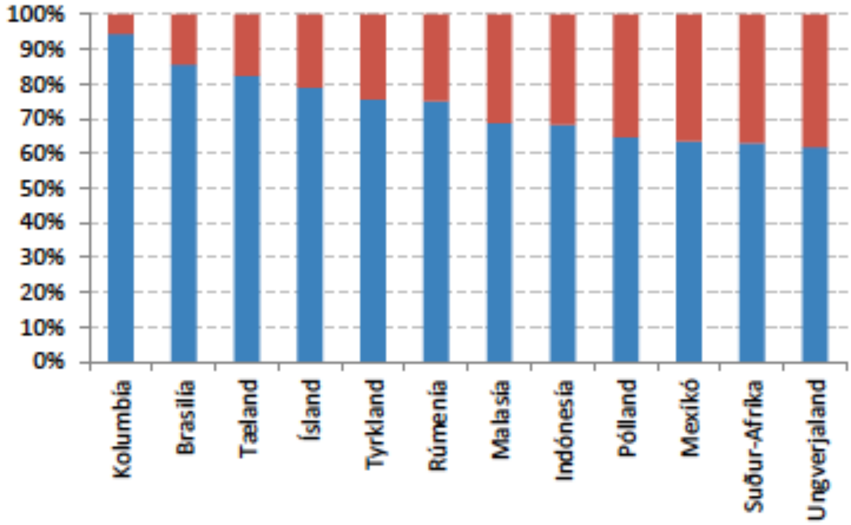
At the end of February 2014 foreign parties owned 22% of issued treasury bonds in ISK and they had no holdings in issued treasury letters of credit. Of the total issue of treasury bonds and treasury letters of credit, foreign parties owned 21%. Foreign parties own a rather high proportion of treasury bonds with the shortest terms and only a small proportion of bonds with longer lifetime. The winding up estates of the failed banks still have substantial holdings in treasury bonds with the shortest terms, as can be seen from the figure here below. In total, foreign parties and the winding up estates own about 24% of treasury bonds issued in ISK.

Table: Foreign ownership of treasury bonds
Red column: Banks in winding up processs (left axis)
Blue column: Foreign parties, billion ISK (left axis)
Green darts: Proportion of foreign parties and banks in winding up process



When evaluating likely outflow of offshore ISK it is worth pointing out that in many new market countries the proportion held by foreign parties in treasury bonds in domestic currency has been somewhat higher than it is in this country. Given this fact, one can expect that foreign parties will continue to purchase treasury issues in ISK subsequent to the removal of the controls.

Table: Breakdown of public debt in domestic currency, (source IMF 2013, Government Debt Management, February 2014)
Red column: Foreign
Blue column: Domestic
Countries listed below, from left to right: Colombia, Brazil, Thailand, Iceland, Turkey, Romania, Malaysia, Indonesia, Poland, Mexico, South Africa, Hungary



The failed banks

The winding up process of the failed banks has a significant impact on the development of the foreign position of the national economy in the coming years. In reality the problem related to the winding up of the banks has two main aspects. On the one hand it relates to the bond between the new and old Landsbankinn, and on the other hand to the settlement of the winding up estates of Kaupthing and Glitnir. Assets of the winding up estates are however to a significant extent in ISK, while almost 95% of their creditors are foreign parties. In addition to this, some funds in ISK will accrue to foreign creditors of other estates.

The bond between the new and old Landsbankinn was entered in the Landsbankinn books at ISK 238 billion at the end of 2013. The bond is to be paid with equal payments during the period 2014-2018. There is clearly a significant gap between the bond and potential Landsbankinn revenue in foreign currency for these years. This means that agreement has to be reached on amending the terms of the bond to ensure that the repayment process will not be too onerous for the Icelandic balance of payments with attendant negative impact on the ISK exchange rate or on foreign exchange reserves. The Winding up Committee of Landsbankinn and Landsbanki Íslands have for some time now been negotiating amendments to the terms of the bond.

The balance of payments problem related to the settlement of Kaupthing and Glitnir is in assets of approximately ISK 500 billion which is mainly in two parts, on the one hand liquid capital, which is expected to be received over a period of a number of years, and on the other hand an asset holding (book value) of approximately ISK 285 billion of the winding up estates in the new banks, Arion Banki and Íslandsbanki.

The sale of these assets can put pressure on the ISK exchange-rate if new (domestic) investors wish to purchase foreign exchange to pay for the assets or for payments to creditors should they receive payment in ISK which investors used to pay for the assets. If the assets are sold for foreign exchange to foreign parties that plan to retain them on a long-term basis, then such a negative impact would be avoided, though there might be pressure over a longer period when the banks pay dividends to their foreign owners.

In light of the high amounts at stake here, composition agreements of the failed banks that do not take into account their potential negative impact on balance of payments could for some time cause more damage to Iceland than continued capital controls. It is therefore important that composition agreements support stability and the objective of removing controls. According to the law the estates must be taken into bankruptcy if composition agreements are not reached.

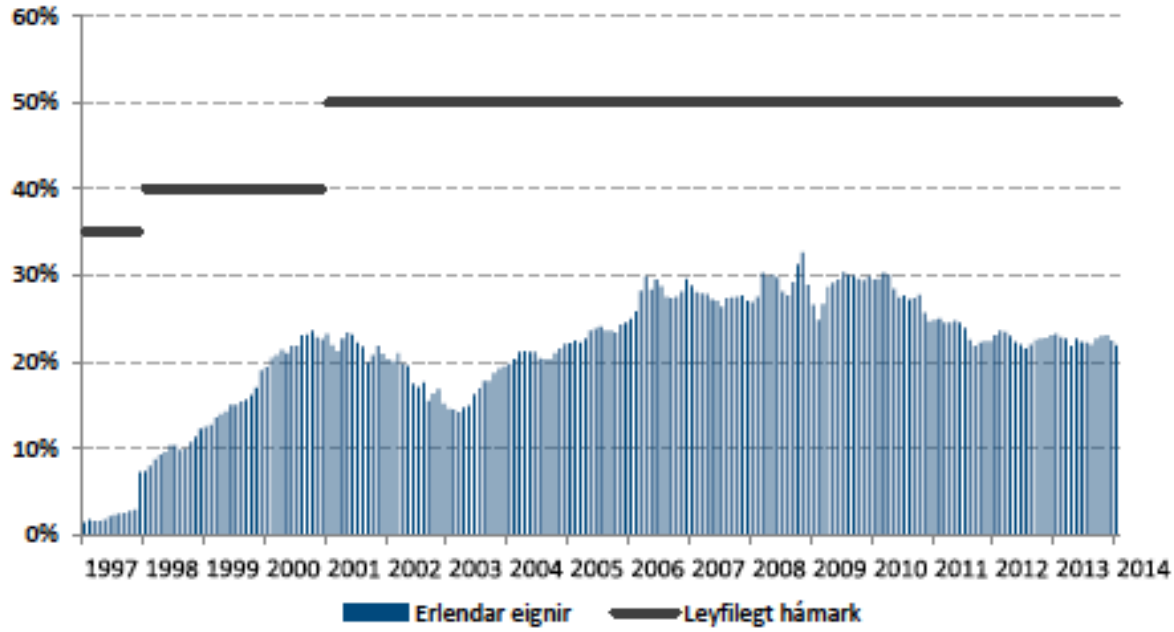
Domestic parties

When capital controls have been removed, one can assume that domestic parties will again look to foreign investments and therefore move funds from the country. A large amount of residential savings are tied in the pension system and it is certain that the pension funds will again aim for an increased proportion of foreign assets in their asset portfolios in order to assure spread of risk. Confidence in the Icelandic economy will be a deciding factor in the extent to which domestic parties will look outside the economy subsequent to the removal of capital controls.

Table: Foreign assets of pension funds, proportion of net assets to pension payments

Blue line: Foreign assets

Black line: Authorized maximum



An analysis by employees of the International Monetary Fund shows that potential outflow for these reasons is estimated at 30-45% of domestic product 2011.[2] References are made to a prior report from September 2013, with respect to discussion on this issue, and also to the section here below on prudential rules subsequent to controls.

[2] http://www.imf.org/external/pubs/ft/scr/2013/cr13257.pdf

Repayments and recapitalisation of loans

Contractual repayments by domestic parties of foreign debts also have a significant impact on the balance of payments of the national economy for the coming years. Despite the fact that such repayments are in general not subject to capital controls, they do have an impact on the possible removal of controls because of their negative impact on the balance of payments of the national economy. The Central Bank of Iceland foreign currency reserves were about ISK 488 billion at the end of 2013, and they are mostly funded with loans.

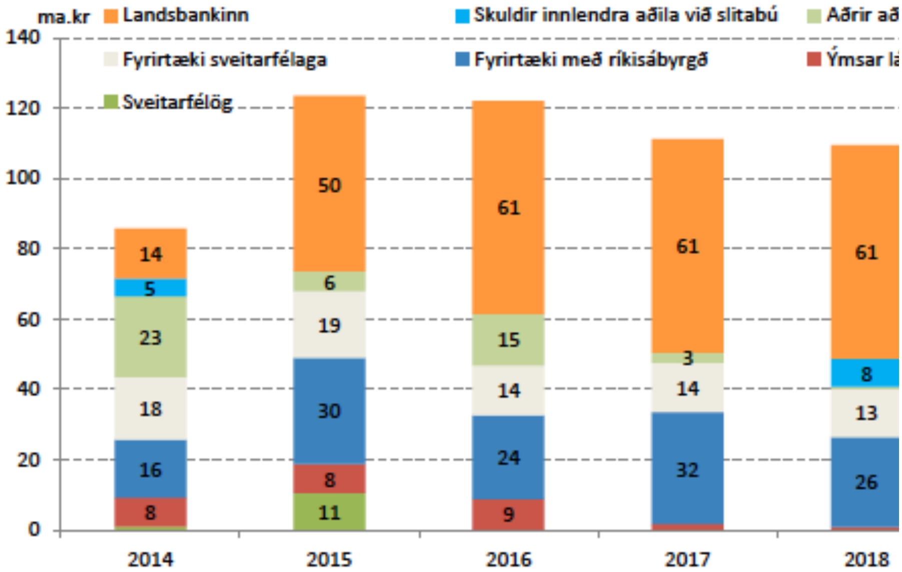
Apart from payments on the Landsbankinn bond, the most significant factors here are debts of energy companies, not the least Landsvirkjun [National Power Company of Iceland]. Representatives of Landsvirkjun have publicly stated that the company is not aiming for recapitalisation of loans, with the exception of a small part of the loans that will fall due in the next years, as the company's indebtedness is greater than that of comparable companies in other Nordic countries. According to figures published by the Central Bank of Iceland in *Financial Stability*, company repayments with state guarantee amount to about ISK 150 billion to the year 2019.

Limited access of various other parties in the economy to capital, including for the purposes of recapitalisation, can also have an impact. Treasury access to foreign capital has opened access for other parties to foreign loans, and foreign funding can be of vital importance to the economy when it achieves recovery subsequent to difficult years in the wake of the financial crisis. Responsible public sector management of the economy is thus extremely important for successful removal of capital controls. An important step was taken in this direction with the 2014 budget which was the first budget without a deficit since 2007.

Table: Scheduled repayments of foreign loans by domestic parties

Left axis: ISK billion

Orange: Landsbankinn	*Dark Blue: Companies with state guarantee*
White Companies of municipalities	*Light Green: Other parties*
Dark Green: Municipalities	*Red: Various lending institutions*
Light Blue: Debt of domestic parties to bankrupt estates	



It is clear that Iceland faces a balance of payments problem for the coming years. There would be significant pressure on the ISK were controls to be removed without this problem having been resolved.

Central Bank of Iceland foreign exchange auctions

Subsequent to an agreed plan for the removal of controls in March 2011, the Central Bank initiated auctions to reduce the position of what were called offshore ISK. Foreign exchange auctions of treasury bonds commenced in the summer of 2011, and the first auction according to the investment option was held in February 2012. There have been a total of 18 auctions of treasury bonds and 16 auctions have been held in connection with the investment option. Investors have brought EUR 257.9 million into the country with the treasury bond option, which is an equivalent amount on the basis of the auction price in each instance and the average Central Bank rate for the same day to a total of ISK 55.9 billion, and EUR 791.2 million or ISK 156.3 billion with the investment option. A little under 1/3 of this has been processed through the domestic foreign exchange market as 50% of the amount invested with the investment option must be converted to ISK through the domestic foreign exchange market.

At the beginning of February 2014, foreign investments using the investment option represented about 12.5% of gross domestic product for the year 2012. About 44.9% of incoming revenue through the investment option has been fixed in bonds, about 42.3% in shares, 12.1% in real estate and 0.6% in securities funds.

When distinguishing between domestic and foreign parties that participated in the auctions, it comes to light that 38% of the total amount came from domestic and 62% from foreign investors. In this analysis, foreign companies owned by Icelandic parties are categorised as domestic investors.

In addition to this, 17 auctions have been held where offers were invited from parties who wish to sell their ISK monetary assets in return for foreign currency which is exempt from the repatriation obligation. Two such auctions were held in 2011 at the rate of ISK 210 to the euro. The price remained relatively stable throughout 2012, about

ISK 240 to the euro, but it decreased in the year 2013. In the last auction, which was held in February 2014, the auction price was ISK 210 to the euro. In the 17 auctions a total of ISK 358.7 billion has been offered for sale, of which the Central Bank has purchased ISK 127.7 billion.

The auction price is decided on the conclusion of the three auctions on the day of the auction. The amount of ISK purchased by the Central Bank with foreign currency is decided by the amount of the foreign currency offered for sale on long treasury bonds and for investment through the investment option. In this way the impact of the auctions on foreign currency reserves is kept to a minimum. Auction dates are announced in advance and auctions are planned for 18 March, 14 May, 24 June and 2 September 2014.

Treasury bond option
One feature of the cooperation between the Ministry of Finance and Economic Affairs and the Central Bank with respect to the removal of capital controls is what is known as the Treasury bond option. The Treasury bond option initially served an important purpose when there was uncertainty about the impact of the lifting of controls on recapitalisation of Treasury domestic debts. This option was introduced in the year 2011 where its objective was to ensure recapitalisation and to lengthen the repayment process. It was important to ensure the sale of treasury bonds to new investors, to replace foreign investors that wished to exit. The Treasury bond option was first and foremost directed at pension funds so that they would bring in their foreign assets and receive long term indexed Treasury bonds. The pension funds are not as interested in the Treasury bond option as they were at the outset and have been replaced by other purchasers.

Since June 2011, 18 auctions have been held where EUR 437 million have been exchanged for treasury bonds. The value in ISK is about 51.3 billion, of which ISK 30 billion was sold in the 3 first auctions, which is about 58% of the total sold. From the beginning of 2013 sales in the Treasury bond option has twice exceeded ISK 1 billion, that is to say in June 2013 and in February of this year.

A stronger economic framework
At the same time as work is in progress on removing capital controls, the economic framework needs to support stability in the economic and fiscal system when capital movement is once more free. The introduction of a Parliamentary Bill on the Council for Public Finances and Fiscal Stability plays an important role in this respect.
One also has to protect the framework of the currency and the prudential rules that should apply in this context. The Central Bank of Iceland published a special report, Prudential Rules Following Capital Controls in August 2012.[3] In the report the bank covers the prudential rules that it considers desirable to have in place when controls have been removed, in order to ensure financial stability in the country.

In the opinion of the Central Bank of Iceland the main risk factors related to unrestricted capital movement are the following: Unrestricted inflow and outflow of

[3] http://www.sedlabanki.is/library/Skr%C3%A1rsafn/S%C3%A9rrit/S%C3%A9rrit%20nr%20%206%20_Var%C3%BA%C3%B0arreglur%20-%20Copy%20(1).pdf

capital, currency mismatch, and maturity mismatch. Unrestricted inflow of capital results in an increase in the exchange rate and in asset prices, which among other things leads to increased purchasing power. Such a situation amplifies economic upswing which can be reversed without warning with attendant outflow and currency depreciation, reduced value of assets and reduced purchasing power. Abrupt changes can thus amplify deflation or cause it. Currency mismatch occurs when borrowing in one currency is used to purchase assets, goods or services in another currency. Assets and liabilities thus do not develop hand-in-hand with the rate of exchange. An example of this is borrowing by households, municipalities and companies in this country in foreign currencies prior to the crash, without having corresponding revenue in foreign currency. The exchange rate fell with the crash and the price of assets dropped with very significant depreciation of equity. Maturity mismatch is however when foreign long-term assets are funded with short-term obligations in the same currency. This situation can cause lack of liquidity when funds cannot be made available to meet due dates. In such cases it is the role of the Central Bank to provide loans of last resort which are limited by the size of the currency reserves.

The Central Bank proposes to improve legislation and the regulatory framework for the purpose of ensuring macro prudential regulation when capital controls have been fully removed. The bank proposes the following:

1. Rules governing liquidity and currency balance to reduce maturity mismatch in foreign currencies.
2. Limits on the taking of deposits abroad in order to reduce maturity mismatch in foreign currencies and to emphasise the role of the Central Bank of Iceland as a lender of last resort in ISK solely.
3. Limits or ban of foreign currency loans for unhedged parties in order to reduce indirect currency mismatch.
4. Instruments to curb excessive fluctuation in outflow and inflow of capital to the country, which amplifies fluctuations in the economy. This could be in the form of a levy on capital transfer or special reserve requirements for foreign currency funding.
5. Temporary restrictions on increases to pension funds’ foreign assets in order to limit pressure on the ISK.

At the end of November 2013 the Central Bank announced the bank’s new liquidity rules, among other things on liquid capital in foreign currency, which are intended to reduce liquidity risk in foreign currency which proved to be one of the greatest risks leading up to the bank crash in 2008. Amendments to legislation on the Central Bank of Iceland in mid-2013 provided a more solid basis for the bank’s authority to set new rules on liquidity ratios in foreign currency. There is further work ahead on rules on minimum stable funding ratio for credit institutions in ISK and in foreign currency. Such rules look further ahead than rules on liquidity and aim at limiting maturity mismatch, particularly in foreign currency.

Amendments are being prepared in the Ministry of Finance and Economic Affairs to legislation that covers borrowing in foreign currencies. It is expected that a bill to this effect will be introduced in the spring Parliament of 2014.

Investment authorisation for pension funds is now being examined in the Ministry of Finance and Economic Affairs. Before controls are fully removed there will be scrutiny as to whether limits should be imposed on increases of pension fund foreign assets, such as the Central Bank has called for. Here however there is a conflict of opinion between limitation of outflow from the country versus the sense in the funds being able to develop an international asset portfolio with a spread of risk, as the funds represent the largest part of savings of the Icelandic public.

The organisational structure of the plan

Steering Committee

Senior management of the plan is in the hands of the Steering Committee led by the Minister of Finance and Economic Affairs. Other members of the Steering Committee are the Central Bank Manager, the Permanent Secretaries of the Prime Minister's Office and of the Ministry of Finance and Economic Affairs, and the Economic Adviser to the Prime Minister. Committee meetings are also attended by civil servants and specialists from the Central Bank, from the Ministry of Finance and Economic Affairs and from the Prime Minister's Office.

A special Project Management Team works under the Steering Committee, comprised of representatives from the Ministry of Finance and Economic Affairs, from the Prime Minister's Office, the Central Bank of Iceland and from the Financial Supervisory Authority.

Consultative Committee of Parliamentary Parties

The Consultative Committee of the Parliamentary Parties for removal of capital controls shall be the venue for dissemination of information on consultation on matters related to capital controls and to their removal. The Director-General in the Ministry of Finance and Economic Affairs chairs the committee while the committee comprises representatives from the Parliamentary parties that have seats in the Althingi.

Advisory Group

On 27 November 2013 the Prime Minister appointed a six-member Advisory Group which has the role of making proposals to the Ministerial Committee for Economic Affairs and to its sub-committees on specific measures and on the plan to remove capital controls. The Group shall assess the foreign position of the national economy and economic stability, and in addition to this it shall identify key issues in the current plan on removal of controls, including the settlement of the failed banks and the speed and progress of other issues. The group is chaired by Sigurbjörn Þorkelsson, while other members are Eiríkur Svavarsson, Jón Helgi Egilsson, Jón Birgir Jónsson, Ragnar Árnason and Reimar Pétursson. Benedikt Árnason and Benedikt Gíslason work with the Group.

Prior committees

A joint Working Group of the Icelandic authorities and the EU Commission worked for part of 2013 on an interim report on the removal of capital controls, and a meeting was held on 22 January 2013 in Frankfurt in connection with this work. The Working Group was chaired by the Ministry of Finance and Economic Affairs, and the European Central Bank and the International Monetary Fund also participated in the group's work. On 15 November 2013, the EU Commission informed the Ministry of Finance and Economic

Affairs that the Commission could not continue to participate in the committee work, in light of the Icelandic government's decision to put membership negotiations on hold.

Prospects for removal of capital controls

Progress in the removing of capital controls will, to a large extent, be decided by the speed of the winding up of the failed banks. From the figures here above, it is clear that their winding up could have a significant negative impact on fiscal and economic stability, should no action be taken. The policy is however to continue with the Central Bank of Iceland's auctions to ease the positions of the most impatient owners of offshore ISK. Auctions have been announced for March, May, June and September 2014.