

Bill of Legislation

Amending the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016, with subsequent amendments (authorisations for withdrawals)

from the Minister of Finance and Economic Affairs

Article 1

Article 11, Paragraph 2 of the Act shall read as follows:

It is permissible to withdraw accrued interest, indexation of interest, dividends, contractual instalments on the principal of loan obligations prior to maturity, and indexation of such contractual instalments. The Central Bank of Iceland must be notified of withdrawals pursuant to the first sentence within five business days of their taking place.

Article 2

In Article 12, Paragraph 3, “1,000,000” shall be replaced by: 100,000,000.

Article 3

This Act shall enter into force at once.

Explanatory report

1 Introduction.

This bill of legislation was drafted by the Ministry of Finance and Economic Affairs, in cooperation with the Prime Minister’s Office and the Central Bank of Iceland. The bill is an element in the authorities’ capital account liberalisation strategy and proposes two types of expansions of authorisations to withdraw funds from accounts subject to special restrictions pursuant to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016. With that Act, it was stipulated that so-called offshore króna assets must be transferred to accounts subject to special restrictions; furthermore, electronically registered offshore króna assets must be transferred to special administrative accounts with the Central Bank of Iceland. This was done to facilitate the next steps in the liberalisation process and re-establish free cross-border trade with Icelandic krónur without jeopardising financial, monetary, or exchange rate stability.

2. Purpose and need for legislative amendment.

Iceland is one of the founding members of the International Monetary Fund (IMF), and the Fund’s Articles of Agreement lay down various conditions that member countries must satisfy. The Articles of Agreement refer, among other things, to payments falling under the capital account and those falling under the current account. The Articles of Agreement state that if conditions are such that it is necessary to restrict cross-border payments, such restriction is only permissible for payments falling under the capital account, as restrictions on cross-border payments falling under the current account are prohibited (cf. Article VIII, Section 2(a) of the Articles of Agreement) unless a special exemption is granted from that provision due to economic conditions. The definitions given in Article XXX of the Articles of Agreement explain more fully what is meant by payments falling under the current account, or *payments for current transactions*; cf. Article XXX(d). It is stipulated, among other things, that payments due in connection with foreign trade, payments due as interest and dividends, and payments which are not for the purpose of transferring capital – i.e., payments of moderate amount for amortization of loans – are considered payments for current transactions.

Because cross-border movement of capital for payment of interest, indexation, and dividend payments fall under the current account, Act no. 37/2016 authorises withdrawals of such payments from accounts subject to special restrictions. This authorisation was modelled on Article 13(j), Paragraph 1 of the Foreign Exchange Act, no. 87/1992, which exempts foreign exchange transactions and cross-border movement of capital – including those in connection with payments of interest, indexation, contractual instalments, and dividends – from the restrictions in Article 13(b), Paragraph 2 and Paragraph 3, Item 1, and Article 13(c), Paragraph 2 of the Act. As regards foreign exchange transactions and cross-border transfers due to contractual instalments, the aforementioned authorisation was narrowed with Act no. 17/2012, which entered into force on 13 March 2012, whereupon it was no longer permissible to conduct foreign exchange transactions using instalments and indexation on bond principal. Marketable bonds providing for equal payments of principal (annuity bonds) are structured such that payments of principal increase as a proportion of the total payment (interest plus principal) as the bond nears maturity. It was therefore possible to purchase such securities and export a large share of the principal as foreign currency that would otherwise have been restricted by law. Parties had taken advantage of this and shifted more of their assets over to annuity bonds, as it was then possible to convert interest, indexation, and principal payments to foreign currency and export them. Some also bought krónur in the offshore market and used them to buy such bonds, as there was a special authorisation for transactions with certain asset classes using offshore krónur. The differential between the onshore and offshore exchange rates created an arbitrage opportunity for investors. This development could be seen clearly in how non-residents' holdings of such securities surged during the prelude to the passage of the legislation in March 2012 and then contracted afterwards when they began to close out their positions, as there was little incentive to continue holding them once the restrictions had been put in place. These transactions were considered to undermine the objectives of the capital controls and the liberalisation strategy. As a result, it was deemed necessary to respond with the above-mentioned legislative amendment restricting such payments. This was done through an exemption to Article VIII of the Articles of Agreement, granted to Iceland by the IMF.

Offshore króna assets were segregated with the passage of Act no. 37/2016. This was done so as to mitigate the risk that was considered to be associated with expanded authorizations for movement of capital in two stages among at full liberalisation of the capital controls. Among other provisions, the Act stipulated that all payment flows in connection with specified securities issued in domestic currency should be deposited to accounts subject to special restrictions. Owners of offshore króna assets were still permitted to withdraw all interest and dividend payments from these restricted accounts, convert the funds in the foreign exchange market, and export them; cf. Article 11, Paragraph 2 of Act no. 37/2016. However, the Act does not authorise withdrawals of contractual instalments in the manner previously provided for in Article 13(j), Paragraph 1 of Act no. 87/1992, as such an authorisation would have been meaningless for owners of annuity bonds at the time the Act was passed, as the provisions of Article 13(j), Paragraph 5 of Act no. 87/1992 restricted such payments. By explicitly segregating offshore króna assets and placing special restrictions on them, the risk that transactions with these assets would jeopardise monetary and exchange rate stability was substantially reduced. This was considered a prerequisite for its being possible to begin lifting capital controls on individuals and firms, as was done with Act no. 105/2016, which entered into force on 21 October 2016. In the bill of legislation preceding that Act, consideration was given to the exemptions Iceland has received from Article VIII of the IMF Articles of Agreement and the authorities' objective of removing temporary restrictions from the Foreign Exchange Act, no. 87/1992, thereby satisfying Iceland's international obligations. In view of the authorities' objectives, a provision in Article 13(j), Paragraph 5 of Act no. 87/1992, on restrictions on the purchase of foreign currency from financial institutions in Iceland for payment of instalments and indexation on bond principal, was deleted.

The changes proposed in Article 1 of the bill aim to harmonise the provisions of Act no. 37/2016 with the aforementioned provisions of the IMF Articles of Association. With these

changes, owners of offshore króna assets held as deposits will be authorised to withdraw deposits deriving from contractual instalments of principal, apart from the final maturity date, from accounts subject to special restrictions and exercise authorisations pursuant to the Foreign Exchange Act to purchase and export foreign currency. The payment on the final maturity date entails the reimbursement of principal and is not considered a payment of moderate amount in the sense of Article XXX(d) of the Articles of Agreement. It is therefore proposed that the authorisation for withdrawals of deposits extend only to balances that can be traced to instalments of principal before the final maturity date.

The changes proposed in Article 1 also entail that withdrawals pursuant to Article 11, Paragraph 2 be subject to notification to the Central Bank within five days of the withdrawal, and not subject to prior confirmation, as is currently the case. The prior confirmation requirement is more onerous for the parties concerned and is no longer deemed warranted or necessary. The bill requires only that the parties notify the Central Bank of Iceland of such withdrawals within five days of carrying them out.

The main reason for presenting the amendment proposed in Article 1 now is that at the end of March 2017, a mission from the IMF concluded a two-week visit to Iceland, during which it met with representatives of the Prime Minister's Office, the Ministry of Finance and Economic Affairs, the Central Bank of Iceland, the social partners, and private entities. Following that visit, the authorities' attention was drawn to the fact that Article 11, Paragraph 2 of Act no. 37/2016 was not consistent with the aforementioned Article XXX(d) of the IMF Articles of Agreement, as the conditions for the above-described exemption had changed radically in the wake of an improving economic situation and the authorities' capital account liberalisation measures.

In the bill, it is also proposed that individuals' authorisation for withdrawals from account subject to special restrictions be increased. This refers to an authorisation for individuals who own deposits or securities that are classified as offshore króna assets pursuant to Act no. 37/2016 and have held them continuously since the capital controls were imposed.

During the handling of the bill of legislation passed as Act no. 37/2016, the majority of the Economic Affairs and Trade Committee concluded that it was appropriate to set a maximum of 1 m.kr. on withdrawals by individuals. According to the opinion submitted by the majority of the Committee, the majority considered it imprudent to set the maximum higher, as it was not established how strong outflows on the basis of the withdrawal authorisation would be. Furthermore, the majority considered it appropriate to exercise caution; therefore, it was recommended that the maximum be reduced from the 6 m.kr. originally provided for in the bill to 1 m.kr. It would be possible to review this at a later date.

According to the Central Bank of Iceland's 2016 *Annual Report*, the Bank received a total of 312 requests for confirmation of individuals' withdrawals on the basis of Article 12 of Act no. 37/2016, for a total of 66 m.kr. In 2017 to date, the Bank has received a total of 22 such requests from individuals for confirmation on the basis of Article 12, for a total of 20 m.kr.

In 45 instances, the individuals owned deposits of more than 1 m.kr. The total outstanding balance of those who have exercised their authorisation for withdrawals is currently 100 m.kr.

Requests for confirmation and the amounts involved were much smaller in scope than originally assumed. In view of this, it is not considered necessary to limit individuals' withdrawals to 1 m.kr. Therefore, this bill recommends that the authorisation be increased to 100 m.kr., the amount authorised for foreign exchange transactions and cross-border movement of capital pursuant to Act no. 87/1992; cf. Act no. 105/2016, which entered into force on 21 October 2016. Considerations of fairness and consistency recommend that individuals eligible for the authorisation under Article 12 be allowed more generous authorisations.

3. Main contents of the bill.

The bill proposes amendments to Articles 11 and 12 of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions no. 37/2016. First of all, amendments are proposed to Article 11, Paragraph 2 of the Act, which focuses on the authorisation for withdrawals of interest and dividend payments from accounts subject to special restrictions, subject to confirmation by the Central Bank of Iceland. The amendments also authorise the withdrawal of contractual instalments of principal on loan obligations, as well as indexation on them, from accounts subject to special restrictions before the final maturity date. Moreover, prior confirmation from the Central Bank is no longer required; instead, the Bank must be notified within five days of the date of the withdrawal. Second, it is recommended that Article 12, Paragraph 3 of the Act, on the maximum amount individuals may withdraw from accounts subject to special restrictions, be amended so as to raise the ceiling from 1 m.kr. to 100 m.kr.

4. Constitutionality and compliance with international obligations.

The bill of legislation proposes that the current restrictions pursuant to Act no. 37/2016 be eased. The amendments are an element in the authorities' capital account liberalisation strategy, which was published in spring 2015 and has been followed since. The bill is not considered inconsistent with either the Constitution or with Iceland's international obligations. The EFTA Surveillance Authority (ESA) has addressed the restrictions provided for in Act no. 37/2016 through two complaints it received in 2016. ESA concluded the cases with a decision published in November 2016. According to that decision, the Icelandic authorities' handling of offshore króna assets is consistent with the EEA Agreement, as the objective of the legislation pertaining to them is to create the foundations for free flows of Icelandic krónur.

As regards the IMF Articles of Agreement and changes in authorisations to withdraw contractual instalments of loan principal other than at maturity, the bill proposes concessions that are intended to ensure that Icelandic law will be consistent with the provisions of the Articles of Agreement; cf. the discussion in Section 2.

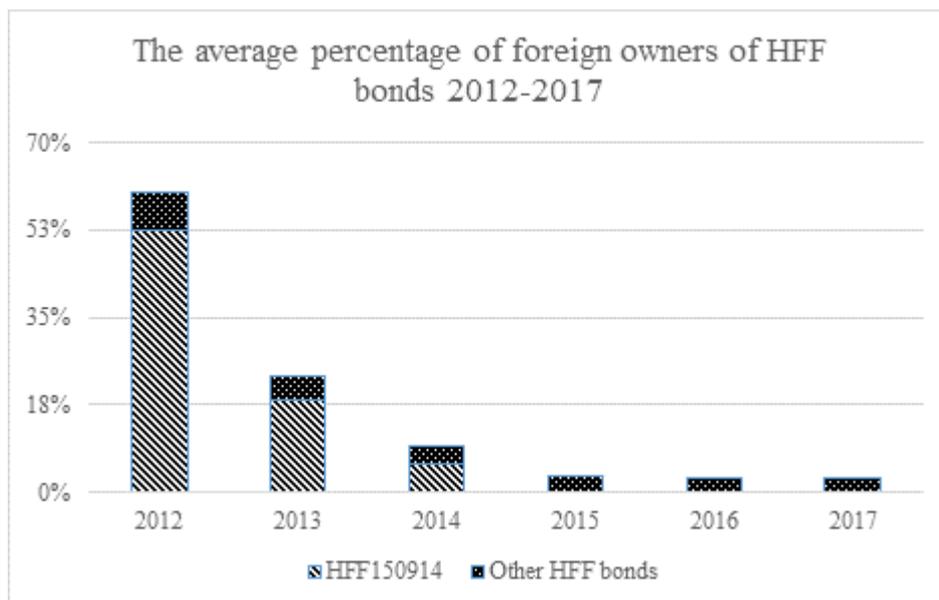
5. Consultation.

During the preparation of the bill, close consultation was held with the Central Bank of Iceland, which supervises the implementation of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions.

6. Evaluation of impact.

The passage of the bill will not have any discernible overall economic impact, and the measures proposed in the bill are not likely to have a noticeable effect on financial institutions and securities depositories. The impact on offshore króna holders will be primarily positive, as the bill expands their authorisations to make withdrawals from accounts subject to special restrictions.

For example, the chart below shows how the percentage of foreign owners of Housing Financing Fund (HFF) bonds declined during the period 2012–2017 and has remained stable at around 1% in each series since September 2014:



The chart indicates that, after the passage of amending legislation in March 2012, foreign owners of HFF bonds sold them and/or used contractual instalments on the bonds to reinvest in other Treasury bonds or Treasury bills. It has not proven possible to determine precisely in which assets the capital deriving from contractual instalments is currently invested, but it is likely that a large portion was converted to foreign currency in Central Bank auctions or subsequent transactions between the Bank and owners of offshore króna assets. However, it is probable that a portion of the capital that accumulated as a result of contractual instalment payments on HFF bonds during the period 2012–2017 was used to invest in Treasury bonds and a portion was invested in deposits. According to the HFF’s most recent report (for February 2017), non-residents’ holdings in HFF bonds currently total 5.4 b.kr. nominal value.

According to the Central Bank’s estimate of offshore króna assets in the form of HFF bonds, they totalled 5.3 b.kr. nominal value as of end-February 2017, or 98% of the total foreign-owned stock of HFF bonds. The outstanding stock of Treasury bonds and bills was 175.2 b.kr. at the time Act no. 37/2016 was passed but 38 b.kr. at the end of February 2017. Outstanding Treasury securities classified as offshore krónur therefore account for 22% of the total stock of offshore krónur at the time the Act was passed. If it is assumed that all capital deriving from contractual instalments and indexation (an estimated 12.1 b.kr.) was reinvested in Treasury bonds or bills in 2012–2014, about 2.6 b.kr. of the Treasury bonds and bills in the offshore stock as of end-February derive from transactions with HFF bonds before 2012. According to the Central Bank’s assessment, the amount that could end up in the domestic foreign exchange market on the basis of the authorisation to withdraw contractual instalments of principal apart from the final maturity could range up to a maximum of 12.1 b.kr. but is probably closer to 2.6 b.kr., or even less. In view of this, the impact of the bill on the Central Bank of Iceland and the foreign exchange reserves is considered minor.

Increasing individuals’ authorisations for withdrawal from 1 m.kr. to 100 m.kr. is not considered likely to lead to a sharp increase in utilisation of the authorisation. The authorisation applies only to individuals who have held offshore króna assets continuously since the capital controls were introduced. According to requests received by the Central Bank, the remaining deposits held by parties that exercised this authorisation in 2016 and in 2017 to date amount to about 100 m.kr.; however, it is likely that some depositors who satisfy the conditions in the provision are unaware of the authorisation and could exercise it at a later date.

In June 2017, the IMF Executive Board will discuss the report compiled by the Fund mission that visited Iceland in March 2017. If the bill is passed, it can be assumed that Iceland will be considered to satisfy the conditions laid down in Article VIII of the IMF Articles of Agreement and that the Fund will have no comment to make.

The measures proposed in the bill will not have any impact on Treasury performance.

Notes on individual Articles of the bill

On Article 1

This provision proposes that the withdrawal of deposits held in accounts subject to special restrictions and deriving from payment of contractual instalments of principal before maturity be authorised. Deposits deriving from payment of principal on the final maturity date will continue to be subject to the restrictions in the Act, however. It will therefore continue to be prohibited to withdraw deposits from accounts subject to special restrictions if they derive from, among other things, reimbursement of bonds issued by the Icelandic Treasury (RIKB) where the principal and indexation are paid in a lump sum on the final maturity date. Such payments entail the reimbursement of principal and fall under the capital and financial account; cf. the discussion in Section 2 of this report. The same applies to payments made on the final maturity date of bonds issued by the Housing Financing Fund (HFF). Furthermore, it is proposed to revoke the requirement that withdrawals according to the provision must receive prior confirmation from the Central Bank of Iceland and to require instead that they be reported to the Central Bank within five days of their occurrence.

On Article 2

This provision proposes that the maximum withdrawal from accounts subject to special restrictions that may be made by an individual who has owned offshore króna assets continuously since 28 November 2008, the date the capital controls were imposed, be increased from 1,000,000 kr. to 100,000,000 kr., in line with individuals' authorisation for foreign exchange transactions and cross-border movement of capital pursuant to Act no. 87/1992. Other conditions in that provision remain unamended, including the requirements pertaining to uninterrupted beneficial ownership.

On Article 3

The Article requires no explanation.