INTENT FOR LEGISLATION

- cf. the Cabinet Resolution of 10 March 2017, Art. 1-4.

Item heading and no.	National Fund of Iceland, FJR18080052
Ministry/Project Manager	Ministry of Finance and Economic Affairs
Transposition of EEA Act?	☐ Yes ☒ No
Date	23 August 2018

A. Issue under consideration

1. Background and rationale

The authorities intend to establish a sovereign wealth fund, the National Fund of Iceland. The purpose of the Fund will primarily be to serve as a sort of disaster relief reserve for the nation, when the Treasury suffers a financial blow in connection with severe, unforeseen shocks to the national economy, either due to a plunge in revenues or the cost of relief measures that the government has considered unavoidable to undertake. This refers to disruptions which occur very rarely but, as history shows, can strike at intervals of several decades, such as major natural catastrophes which could result in extensive damages to settlements, transport infrastructure or hydroelectric power plants and power-intensive industry, ecosystemdisasters, epidemic diseases or other shocks, causing huge economic damage beyond what is insured by other means, such as through Natural Catastrophe Insurance of Iceland. Examples of such major events occurring in the past include natural catastrophes such as the Skaftáreldar eruptions and the ensuing Móðuharðindi famine (1783-85) or the Westman Islands eruption (1973), ecosystem failures such as the collapse of the herring stock (1969) or an epidemic such as the Spanish flu (1918). It could also include events or circumstances of a completely different nature, such as the consequences of large-scale cyberattacks on the country's key infrastructure or acts of terrorism. These could comprise shocks that the Treasury, as things currently stand, lacks sufficient financial strength to withstand without causing significant debilitating impacts on the social welfare of the natinon as a result of cutbacks to public services, or which would impose a debt burden that would be onerous for a long period or even unsustainable. Therefore the legislation is based on the long-term perspective of creating a very substantial fund, which could respond to the consequences of major unforeseen and rare shocks to public finances, rather than having the fund itself directly finance compensation, e.g. for damages suffered by specific industrial sectors or groups. All response measures will thus be in the hands of state agencies in the existing administrative structure intended to deal with such events, i.e. through the institutional administration and under the auspices of the Icelandic parliament Althingi in regard to budget appropriations. The unpredictability and uncertain magnitude of such large-scale shocks makes it practically impossible for the government to prepare for the consequences through its normal budgeting process and medium-term fiscal planning otherwise than by having the foresight to accumulate sufficient reserve funding.

The adoption of legislation establishing such a contingency fund is also prompted by the prospect of considerable new Treasury revenues in the coming years from dividends or resource rents from power production companies under state control, especially the National Power Company, Landsvirkjun. These revenue prospects are due to that undertaking's improved equity position in recent years. Debt has been reduced to a moderate level, major depreciation has been applied to structures and installations and there is little prospect of very high investment needs in the coming years. Ahead is a period during which there does not appear to be a great need to reinforce further the company's financial position. The company's directors and prominent speakers in the public forum have put forward ideas and proposals for the undertaking to deliver increased dividends to the state, as the owner of the company and the energy resources. This additional revenue could accrue over an extended period, provided that electricity prices remain unchanged or rise and that no need arises for major investments in energy production beyond what is currently anticipated, and that other such premises determining the financial position of energy production companies remain stable. It is thought advisable that these new revenues should not be utilised just as any other revenue base to cover regular state expenditures, but rather set aside to build up financial readiness in a National Fund to mitigate unforeseen shocks.

Furthermore, in its platform of 30 November 2017, the current coalition of the Progressive Party, Independence Party and Left-Green Movement proposed to establish a National Fund from dividends arising from the country's resources, beginning with energy resources, and that the role of this Fund should be to increase resilience to financial shocks.

In discussing the plan regard was had for many sovereign wealth funds operated around the world. Such funds are investment funds, owned and administered by states for a specific purpose. They are commonly based on revenue from commodity exports, often of non-renewable commodities, such as petroleum. The funds are primarily of two types: savings funds and stabilization funds. Savings funds are often linked to the ageing of nations and foreseeable increases in public expenditures resulting from it, both as pensions and health care costs. The purpose of stabilization funds is usually to even out fluctuations in export earnings, in particular in commodity exporting countries dependent on a single type of commodity.

Iceland’s position is in many ways different from countries which have established sovereign wealth funds. Unlike many other countries, Iceland has a robust system of pension funds, which means the nation is considerably better prepared for the ageing of the population and growing pension expenditures than are many others. There is therefore not the same need here as in many other places to build up special funds to meet pension payments. It should also be borne in mind that, although Iceland is, in the traditional sense, dependent upon export of commodities, both marine products and products of power-intensive industries, its situation differs from that of other commodity exporters who have established sovereign wealth funds, as they are usually dependent on one type of commodity, such as petroleum. Icelandic exports today rest on three main pillars: fisheries, power-intensive industry and tourism. The Icelandic fisheries industry is highly diversified, involving a variety of fish species, fisheries, processing and markets, which supported by an effective fisheries management system means that the sector is not subject to fluctuations of the same nature as single commodity sectors. Although aluminium smelting falls under the definition of commodity production it has not been a cause of serious volatility in the Icelandic economy, nor does it dominate exports, although it is significant. Tourist services have become one of the pillars of the Icelandic economy and can be subject to sudden changes for a variety of reasons that are difficult to anticipate.

Nor is it the intention in establishing the National Fund to create an arrangement to promote economic stability for the short or medium term in the form of a fiscal counterweight to regular or temporary business cycles, i.e. a scheme which would to some extent substitute for measures which the government should have in place as part of its fiscal policy and monetary policy according to the arrangements enshrined in the Public Finance Act. In other words, allocations will not be made from the Fund to finance expanded government operations, transfers to households or public works in order to offset an economic downturn, nor will a state budget surplus be channelled into the Fund during an economic upswing. Fiscal management should serve these economic needs in a conventional manner by delivering surpluses and repaying debt during an upswing while reducing the surplus and perhaps developing a deficit and accumulating debt in a downturn. There is a risk that the development of the Fund would not be sufficiently long-term and continuous to ensure it had the capacity to meet major setbacks if it were regularly used for general counter-cyclical adjustments. In other words, the Fund is not intended to be a means of financing current projects that should generally be financed through the government's annual budgeting. As previously mentioned, its object is rather to create a sort of defence of last resort against large-scale economic disasters, above and beyond the preparedness which already exists, and which the National Treasury otherwise would not have had sufficient financial strength to respond to.

With reference to the above, no reason is seen to establish a special stability or stabilisation fund, nor to build a special fund to cover future pension obligations, as various nations have found themselves required to do. During a normal economic period and through normal business cycles, the Icelandic economy should not encounter difficulties which cannot be dealt with through traditional economic policy responses and instruments, including the effects of so-called automatic fiscal stabilisers. As has been the experience in the past, the fiscal position will improve during an upswing and deteriorate during a slowdown.

2. What is the issue to be resolved?

The intention is for the National Fund to receive allocations from the Treasury equivalent to the dividends paid by power companies. These funds are to be invested exclusively in foreign securities under an investment strategy set by the Fund's Board with the Minister's approval. The allocations will be made having regard for the income from the respective dividend payments, however, this will not involve a so-called earmarking of state revenues. The Fund's finances will be provided for in the state's medium-term fiscal plans and annual budgets. In the case of an unforeseen shock of the type previously referred to, and if specific conditions are satisfied and an assessment made of the financial impact of the shock, the Minister may propose to Althingi a parliamentary resolution with provisions for the Fund's Board to allocate to the Treasury a contribution equivalent to up to half of the Fund’s assets for one event. Authorisations for such contributions and regarding the Fund's finances in other respects shall also be adopted in the annual budget passed by the Althingi. In this connection it is assumed that contributions from the National Fund will be paid after an assessment is available of the scope of the damage to the Treasury from a special independentcommittee, and that the Treasury may therefore have to finance the cost provisionally.

The National Fund of Iceland will be owned by the Icelandic state and recognised on the Treasury's balance sheet, as it will in fact be a specific arrangement for the management and investment of a designated part of the Treasury’s monetary assets. The state's financial position will be improved by an amount equivalent to the size of the Fund. The establishment of the Fund will reinforce the sustainability and stability of public finances, and trust in the Icelandic economic system and national economy will increase, thereby boosting the Treasury's credit rating and that of other domestic parties linked to it.

The intention is to set up a separate independent Board for managing the Fund. The Board will be responsible for the Fund's operations, set itself working protocols and make recommendations for its investment strategy, to be approved by the Minister based on criteria which will be defined in broad terms in the law. The Fund's investment strategy is expected to exclude financial instruments issued by undertakings or institutions which carry out or are connected with activities regarded as unethical, such as the employment of child labour and the manufacture and sale of weapons for war. Under these arrangements care will be taken to comply with arm's length considerations, such as that the Minister will not prevail over decisions by the Board and will not be involved in individual investments, while, on the other hand, ensuring that the Minister will be able to fulfil his responsibility for monitoring that the Board's work complies with law and good governance, and that it follows an appropriate investment strategy.

The Fund's day-to-day operations are expected to be moderate in scope and its expenditures will be paid from its revenues or equity. Essentially this will include, firstly, remuneration to Board members and other expenses of its operations and, secondly, management fees to asset managers with whom contracts are expected to be concluded concerning securities purchases and fund management.

Naturally it is by no means possible to guess with any accuracy how great the financial loss could become as a result of the shocks envisaged here. Due to the good insurances which are already in place there does not appear to be reason to set aside for this purpose an amount equivalent to several dozen per cent of GDP. As a rough estimate it could be suggested that such a Fund could be assumed to be needed when setbacks had amounted at least to several tens of billions of ISK, e.g. ISK 50 billion, in excess of what might be covered by other insurances. On this basis and assuming that only half of the Fund’s assets would be withdrawn in each instance, it is considered advisable to aim at a future size for the Fund of around ISK 250-300 billion, or almost 10 per cent of GDP. Based on conservative assumptions with regard to the amounts which can be expected to accrue to it in the coming years and the return on their investment, the building up a Fund of this size can be expected to take around 15 to 20 years. In this connection, the example of the Norwegians can be seen as a noteworthy precedent. where the political parties reached a consensus to have the state's petroleum fund grow without tapping into it to meet the needs of public operations until now, when it has assets equivalent to or exceeding

USD 1 trillion. It will be in the hands of the governments of the future to assess whether the Fund has grown so large that revenues intended for it would be of greater use elsewhere.

In accordance with the government's platform, the proposed bill of legislation is also expected to include a Temporary Provision providing for the annual contributions to the National Fund to temporarily be lower than the dividend revenues, as part of these will be used, on the one hand, for a major advance in development of nursing homes and, on the other hand, to boost innovation efforts in business and industry. As a specified portion of new revenues will be utilised for these temporary special projects, this arrangement will have no impact on the Treasury's overall balance.

3. To what extent are existing legislation and regulations not sufficient?

Significant preparedness has already been established in Iceland for shocks, in particular natural catastrophes, as all buildings and moveable assets which are insured against fire with an insurance company licensed to operate in Iceland must also be insured with Icelandic Natural Catastrophe Insurance (previously Iceland's Disaster Fund). In addition, Icelandic Natural Catastrophe Insurance insures heating and water utilities, sewer installations, harbour facilities and other infrastructure. These insurances are backed by foreign re-insurers. In fact, the strength of Icelandic Natural Catastrophe Insurance is such that its insurances can be expected to suffice to cover considerably more extensive damage than has occurred in at least the past century or two, with the exception of the Westman Islands eruption.

Large-scale transport and communication structures, as well as the majority of the road system, are not covered by insurance. Considerable losses could arise from the derivative effects of natural catastrophes which Icelandic Natural Catastrophe Insurance does not cover. It would be advisable to develop a contingency scheme which would enable the government to respond to the consequences of that portion of losses not covered by Icelandic Natural Catastrophe Insurance, so that the Treasury could avoid undertaking excessive debt in such circumstances.

No legislation exists on significant financial preparedness for major shocks of a type other than natural catastrophes. The Public Finances Act assumes that the budget will always allow for reserve funds equivalent to at least 1% of total budget appropriations, which currently amounts to around ISK 8.5 billion. This appropriation is intended in particular to meet deviations from the budget assumptions on wages and prices, exchange rate effects and various unforeseen expenditures and overruns which may occur and can generally not be utilised except to a very limited extent for external shocks which are not of major significance. The proposed National Fund of Iceland is intended to remedy this situation, to enable the society to counteract more effectively the negative impact of large-scale events, such as the consequences of ecosystem failure or serious epidemics, or shocks of other types which are completely unknown and unforeseen.

B. Objective

1. Public policy in the respective field/function

The proposed National Fund and the financial preparedness which it implies in the longer term would comprise new arrangements to meet financial risk in public finances which has not previously existed in the current scope of state functions and therefore no specific policy has previously been formulated for it. The Fund's activities are expected to be initiated as a special function under the current field no. 34 - General reserve fund and special financial measures.

In this connection, however, there is reason to mention that the establishment of a National Fund in addition to Icelandic National Catastrophe Insurance would correspond to general perspectives voiced over the years at conferences and reports in international fora regarding modern thinking in structuring public finances with regard to the risk of a variety of economic shocks.

In addition, it is evident that the operation of such a reserve fund directly supports the strategy laid down in the main basic principles of Act No. 123/2015, on Public Finances: sustainability, prudence and stability, cf. the discussion of these in the Explanatory Notes to the Act.

2. Objectives aimed at with the legislation, in view of the project and government policy

- to bolster the nation's resilience against shocks when the Treasury suffers a financial setback in connection with major, unforeseen shocks to the national economy;

- to mitigate the economic contraction following setbacks to national economic activity;
- to follow up on plans in the government's policy platform to establish a National Fund, and for part of the funds concerned to be used temporarily to increase nursing home capacity and to boost innovation in business and industry;
- to collect and invest a specific portion of state revenues in the form of monetary assets, which should deliver a better return than otherwise in a cost-efficient manner;
- to use the Fund's assets exclusively for investment abroad, which will be conducive to diversifying the financial risk to the national economy and prevent the Fund from directly influencing individual domestic sectors or undertakings;
- to eventually have a positive influence on the assessment by specialised consultancy firms and the financial market of the Treasury's credit rating and that of other domestic parties linked to it, and thereby reduce financing costs;
- to ensure the Fund's independence and arm's length distance from public administration and short-term political issues, taking into account its long-term role, while at the same time ensuring the Minister's administrative responsibility and his duty to supervise the Fund's operations and finances;
- to ensure the involvement of the Althingi in allocations from the Fund to the Treasury by a suitable implementation procedure, in accordance with the parliament's funding powers and arrangements for approval of medium-term financial planning and annual budgets.

C. Options

1. What would be the consequences of no action?

The government would be in a weaker position to meet the consequences of major shocks which are not covered by other funds or insurance such as the Icelandic Natural Catastrophe Insurance. Under such circumstances, the Treasury could be required to cut back its activities, increase taxes considerably or acquire more debt than can be regarded as desirable.

Furthermore, the government would be less capable of undertaking necessary actions in the wake of major unforeseen setbacks to the nation's situation.

The credit rating of public bodies, as well as the confidence and trust of domestic stakeholders and international institutions in the government's economic management, could be lower because the pillars providing sustainability for public finances in the long term would not be as solid.

2. Actions other than legislation which have been considered

The possibility could be considered of following a fiscal strategy resulting in a surplus each year equivalent to the said revenues from energy resources, together with any other surplus arising from regular activities, and utilise this to continue to reduce Treasury debt, in this manner boosting the state's financial capacity to grapple with unexpected shocks or disasters. This route is not considered to comprise a sufficiently clear framework and definitive direction in creating funding which would be available and could be dealt with separately by the Althingi when necessary. The same applies if such surpluses were allowed to accumulate as a balance with the Treasury, in addition to which the return would be considerably lower than on a special investment fund in foreign markets. It must also be borne in mind that within a few years reduction of public debt may have become so successful that the Treasury's bond issuance will approach the minimum limit considered advisable for maintaining an efficient domestic financial market, and that therefore continuing improvement to net debt will have to be directed to a greater extent to the acquisition of monetary assets.

3. Possible routes for legislation

It does not appear that the legal arrangements in this matter could differ to any great extent from that anticipated here, given the project.

D. What route is planned, and why?

1. Brief description of the planned route and grounds for this

The route proposed with this legislation is to establish a reserve fund to meet conceivable rare economic setbacks, such as due to ecosystem failure or natural catastrophe. The Fund will be provided with a special Board, which will be ultimately responsible for its operations and investments on foreign financial markets. The state's contributions to the Fund will be equivalent to new revenues from publicly owned power productiokn companies which are expected to accrue in the coming years. Should the National Treasury suffer major financial losses due to unforeseen shocks striking the national economy, it will be possible, with the approval of the Althingi, to allocate funds from the National Fund to the Treasury equivalent to up to half of the Fund's current assets. With reference to those perspectives outlined above, this route is regarded as the most likely to prove successful in achieving the objectives aimed at.

2. Main amendments (additions or deletions) proposed to existing legislation and rules

At this stage no need is seen for significant amendments to existing Acts and rules.

E. Constitutional conformity and international law - other basic considerations

1. Do these plans affect constitutional and international obligations?

No.

2. Do the plans concern provisions of the EEA Agreement concerning state aid, technical rules on goods and distance services, or freedom to provide services?

No.

3. Is there any other basic legislation which needs to be considered?

No.

F. Consultation

1. Who are the principal stakeholders?

The plans concern the interests of the general public, but not the interests of some individual groups of individuals or legal entities more than others.

2. Is there any overlap with the administrative functions of other Ministries?

There is overlap with the administrative functions of the Prime Minister's Office, which is responsible for the commons and rents for utilisation of rights within their bounds.

3. Consultation which has already taken place

A working group under the auspices of the Prime Minister's Office, which was entrusted with preparing a draft bill for the plans, met in the course of its work with representatives of Landsvirkjun, the Prime Minister's Office, the Ministry of Finance and Economic Affairs, the Ministry for the Environment and Natural Resources, the Central Bank of Iceland, Icelandic Natural Catastrophe Insurance and natural scientists.

4. Consultation envisaged

Consultation with the public concerning plans for legislation and in connection with the draft bill when the time comes.

G. Assessment of the impact of those routes planned

1. Conclusion of preliminary assessment of impact, cf. appendix

The provisional assumption is that new revenues in connection with the establishment of the National Fund will amount to at least ISK 10 billion annually, and that a contribution equivalent to that amount will be made to it. Based on this revenue and prudent assumptions concerning its return, it can be estimated that a fund of some ISK 250-300 billion can be accumulated over two decades, as a contingency fund to meet financial shocks to the Treasury.

H. Next steps, implementation

1. Has a project plan been prepared for drafting the bill?

Yes. The bill is expected to be ready for presentation in the autumn of 2018.

2. **How will the introduction of the Act be accomplished? How much time can those parties who will be affected, public institutions/stakeholders/the general public, be expected to need to prepare/adapt?**

The plans provide for the establishment of the Fund and the details of its administrative structure. Preparation can be expected to proceed rapidly and no time will be necessary for adjustment.

3. **What premises need to exist for the legislation to prove successful?**

The government must decide on the future arrangements for the dividend policy of power companies owned by the state. It is desirable that widespread acceptance of the planned arrangements be achieved, so that the Fund will be capable of meeting setbacks.

4. **Measures of success and results**

That the accumulation of assets managed by the Fund will be in accordance with revenues from energy producing companies owned by the state.

5. **Has attention been paid to gathering data to assess the success when the time comes?**

Yes, reports are expected to be issued regularly on the Fund's activities.

I. Other business

J. Appendices

1. **Assessment of the impact of the legislation - Preliminary assessment of financial impact, cf. form**
2. **Other appendices as appropriate**