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Bill of Legislation

Amending the Foreign Exchange Act, the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, and the Act on a Special Tax on Financial Undertakings (capital flow management measures to mitigate adverse effects of capital inflows)

(Submitted to the 145th Legislative Session of Parliament 2015–2016.)

CHAPTER I

Amendments to the Foreign Exchange Act, no. 87/1992, with subsequent amendments

Article 1

Article 13(m) shall be amended to include two new paragraphs, which shall read as follows:

It is permissible to reinvest capital released by the sale or prepayment of new investments that satisfy the requirements set forth in Paragraphs 2, 3, and 4.

With the assistance of a financial undertaking in Iceland, the investor shall report the reinvestment to the Central Bank of Iceland according to Paragraph 6, within one week of the date it takes place. The notification shall be accompanied by documents confirming that the investment satisfies the requirements set forth in Paragraph 6.

Article 2

A new temporary provision shall be added to the Act and shall read as follows:

The Central Bank of Iceland is authorised, upon receiving approval from the Minister, to lay down rules providing for special reserve requirements relating to new inflows of foreign currency in connection with:

1. New investments and reinvestment of such new investments according to Article 13(m), in bonds or bills issued in domestic currency, or in domestic currency deposits.
2. Domestic currency deposits with deposit institutions in Iceland, other than those deriving from capital that is eligible for reinvestment according to Article 13(e) or Article 13(f), or that falls under Article 13(l) or Article 13(m), but not those deriving from capital according to Item 5 of this Paragraph.
3. New investments and reinvestment of such new investments according to Article 13(m), in unit share certificates of funds that invest in bonds or bills issued in domestic currency, or that own domestic currency deposits.
4. New investments and reinvestment of such new investments according to Article 13(m), in the equity of a company that is established for the purpose of investing, directly or indirectly, in bonds or bills issued in domestic currency, or in domestic currency deposits.
5. Loans granted to resident entities that are used for investments in domestic currency, for the benefit of the lender, in bonds or bills issued in domestic currency, or deposited to domestic currency deposit accounts. The same applies to such loans that are used for investments in unit share certificates of funds or in the equity of a company that is invested or disposed of, directly or indirectly, in the manner described in the first sentence.

The special reserve requirements shall be satisfied by depositing the special reserve amount to a special reserve account with a deposit institution in Iceland. The special reserve ratio is applied to the special

reserve base to determine the special reserve amount. The deposit institution shall, within the same business day, deposit an amount corresponding to the entire special reserve amount according to the first sentence to a special reserve account with the Central Bank of Iceland. Special reserve requirements shall expire at the end of the holding period, irrespective of whether new inflows of foreign currency that constitute the special reserve base have been released via sale or redemption. Withdrawals from special reserve accounts are prohibited during the holding period. Deposits to deposit institutions' special reserve accounts with the Central Bank of Iceland shall be subject to the same holding period and a corresponding special reserve amount. It is prohibited to hypothecate both the special reserve amount and deposit institutions' deposits to special reserve accounts with the Central Bank of Iceland.

The rules according to Paragraph 1 shall contain further provisions on the implementation of the special reserve requirements, including:

1. the holding period, special reserve ratio, and interest rates on deposit institutions' special reserve accounts with the Central Bank of Iceland; cf. the third sentence of Paragraph 2.
2. the settlement currency for the special reserve amount and the corresponding amount in deposit institutions' special reserve accounts with the Central Bank of Iceland.

The special reserve ratio may range up to 75%, and the holding period may range up to five years. The Central Bank of Iceland's decisions on special reserve ratios, holding periods, and interest rates shall be based on the Bank's legally mandated objectives and on a thorough assessment of developments and prospects for the economy, monetary policy, and financial stability.

The rules according to Paragraph 1 may stipulate different holding periods, special reserve ratios, settlement currencies, and interest rates, depending on the type of funds that constitute the special reserve base.

Violations of this provision and the rules set on the basis of it are punishable by administrative fines and by penalties according to Articles 15(a)-15(d) and Articles 16, 16(a), and 16(b).

CHAPTER II
Amendments to the Act on the treatment of króna-denominated assets subject to special restrictions, no. 37/2016

Article 3

Article 3 shall be amended to include a new numbered subparagraph, which shall read as follows: Those that are exempt from Article 13(b), Paragraph 3 of the Foreign Exchange Act due to transfer of custody from a non-resident legal entity to a deposit institution or custodian in Iceland on the basis of a written application received by the Central Bank of Iceland prior to the entry into force of this Act.

Article 4

The following shall be added to the third sentence of Article 4, Paragraph 1 of the Act: participation in the Central Bank of Iceland's 2016 foreign currency auction, transfers between accounts according to Article 2, Item 1(a), and investments in financial instruments according to the exemption list issued by the Central Bank of Iceland, cf. the authorisation in Article 13(b), Paragraph 4 of the Foreign Exchange Act, after 23 May 2016.

Article 5

In Article 9, Paragraph 1, the following shall be inserted after the words "to use the funds": for foreign exchange transactions in the Central Bank of Iceland's 2016 foreign currency auction or .

Article 6

The following amendments shall be made to Article 10 of the Act:

a. The following shall be added to Paragraph 1: and in financial instruments issued in domestic currency that are specified on the Central Bank of Iceland's investment list according to Paragraph 5.
b. The words "shall be held" in Paragraph 3 shall be replaced by: and other financial instruments according to Paragraph 1 shall be held.
c. The following shall be added to Paragraph 4, after the words "Central Bank of Iceland certificates of deposit": and other financial instruments according to Paragraph 1.
d. A new paragraph shall be added and shall read as follows:
   The Central Bank of Iceland is authorised to decide at any time which financial instruments issued in domestic currency the owners of deposits according to Paragraph 1 may invest in. The financial instruments according to the first sentence shall be specified on a special investment list that shall be published on the Central Bank website.
e. The title of the Article shall read as follows: *Authorisation for investment in Central Bank of Iceland certificates of deposit and financial instruments issued in domestic currency*

CHAPTER III
Amendments to the Act on a Special Tax on Financial Undertakings, No. 155/2010, with subsequent amendments

Article 7

A new temporary provision shall be added to the Act and shall read as follows:

It is permissible to deduct from the tax base according to Article 3 the liabilities of a taxable entity in an amount corresponding to the total of the special reserve amounts according to Temporary Provision III of the Foreign Exchange Act.

CHAPTER IV
Entry into force

Article 8

This Act shall enter into force at once. Without prejudice to the provisions of Article 8, Paragraph 2 of the Act on the *Law and Ministerial Gazette* and the *Official Gazette*, this Act shall enter into force upon publication.

Explanatory Notes on this Bill of Legislation

1 Introduction.

This bill of legislation was drafted in the Ministry of Finance and Economic Affairs, in cooperation with the Prime Minister's Office and the Central Bank of Iceland, and is related to the authorities' capital account liberalisation strategy.

This bill of legislation contains recommendations for amendments to the Foreign Exchange Act, no. 87/1992, the Act on a Special Tax on Financial Undertakings, No. 155/2010, and the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016.

The amendments are intended to authorise the Central Bank of Iceland to set rules on necessary capital flow management measures to temper inflows of foreign currency and to affect the composition of such inflows. The bill also contains recommendations for amendments intended as a compromise vis-à-vis owners of offshore krónur that own deposits that have been transferred to accounts subject to special restrictions prior to the Central Bank of Iceland foreign currency auction to be held in 2016.

2. Occasion and purpose of the legislation.

The first step in liberalisation of the capital controls was the removal of restrictions on inflows of foreign currency. Since 31 October 2009, new domestic investment using inflows of foreign currency has been unrestricted according to the Foreign Exchange Act and Rules on Foreign Exchange, apart from certain narrow exceptions. New investment entails that investors, both residents and non-residents, may import foreign currency to Iceland and invest it in the country without any capital account restrictions on the principal and the return on the investment. According to the Foreign Exchange Act, new investment is investment commencing after 31 October 2009 and based on new inflows of foreign currency that is converted to domestic currency at a financial undertaking in Iceland. Investments in Iceland using new inflows of foreign currency that could create the foundations for carry trade are therefore permissible if they are undertaken on the basis of new investment as defined in the Foreign Exchange Act. Furthermore, investors have been authorised to deposit new inflows of foreign exchange to deposit accounts with deposit institutions in Iceland on the basis of the new investment authorisation. Moreover, inflows of foreign currency are unrestricted, and commercial banks and savings banks are authorised to receive such inflows that are deposited to deposit accounts and money market accounts in domestic and foreign currency without satisfying the conditions for new investment. Such deposits could also create the foundations for carry trade.

In recent years, there has been a growing consensus that cross-border capital flows can be associated with severe risk. As a result, the authorities may need policy instruments intended to reduce such risk while simultaneously working to ensure maximum freedom

of movement of capital.[1] The substance of this bill of legislation is directed at the risk related to strong capital inflows, which is determined primarily by the volume and composition of inflows at any given time, the way in which the capital in question is used, and the resilience of domestic markets and balance sheets vis-à-vis increased foreign currency inflows.

In general, inflows stemming from foreign direct investment (FDI) are considered to confer many benefits and limited risk because they are generally based on long-term business relationships, as the capital inflows are accompanied by the dissemination of knowledge and technology. Research has shown, however, that various other types of inflows are accompanied by limited or negligible benefits and significant risk in the form of economic instability, disturbance of monetary policy transmission, and the risk of financial crises. This applies not least to speculative inflows in the form of bond purchases and bank loans, which are generally undertaken with an eye to short-term profits on cross-border carry trade.[2]

Other things being equal, capital inflows generally lead to rising asset prices, appreciation of the domestic currency, reductions in interest rates and risk premia, increased demand with the associated current account deficit, and increased foreign-denominated borrowing. While the inflows last, domestic balance sheets tend to appear to strengthen because of these effects, which is conducive to spurring even greater domestic demand and continued balance sheet expansion. The risk is that the inflows will contribute to increased imbalances in the real economy and within the financial system while making it more difficult for domestic economic policy to preserve macroeconomic and financial stability, and they can even lead to a financial crisis. A recent study showed that, in one-fifth of instances (30 out of 152) of a surge of capital inflows to emerging countries in recent decades, a financial crisis resulted.[3] According to the same study, the risk of a financial crisis was at least three times greater in countries with capital inflow surges. Furthermore, the risk varied inversely with the weight of FDI in the inflows and varied directly with the accumulation of imbalances in the domestic economy and financial system.

Because domestic markets are shallow and investment options relatively homogeneous, inflows are more likely to have an impact and trigger larger-scale instability than they would in an economy with deeper markets and a wider variety of investment options. Therefore, because of the small size of the economy, relatively small amounts in the context of international trade could weigh heavily and have a strong impact on, for

[1] International Monetary Fund (2012). The liberalization and management of capital flows: an institutional view. IMF Policy Paper, 14 November 2012 and OECD (2015).The OECD's approach to capital flow management measures used with a macro-prudential intent. Report to G20 finance ministers, 16–17 April 2015.

[2] Dell'Ariccia, G., J. di Giovanni, A. Faria, A. Kose, P. Mauro, J. D. Ostry, M. Schindler, and M. Terrones (2008). Reaping the Benefits of Financial Globalization. IMF Occasional Paper, no. 264, and Ostry, J.D., A. Prati, and A. Spilimbergo (2009). Structural Reforms and Economic Performance in Advanced and Developing Countries. IMF Occasional Paper, no. 268.

[3] Ghosh, A.R., J.D. Ostry, and M.S. Quereshi (2016). When Do Capital Inflow Surges End in Tears? *American Economic Review: Papers & Proceedings,* 2016, 581–585.

instance, asset prices and the exchange rate. Strong capital inflows also bring with them the risk of a sudden stop, with the associated adverse effects on economic and financial stability.

Experience shows as well that, with increased integration of financial markets, it becomes more difficult for smaller countries to deviate markedly from the monetary policy pursued in the larger countries that determine financial conditions globally. This could be seen clearly prior to last financial crisis, both in New Zealand and in Iceland. The same effects have also emerged recently in countries such as Switzerland and Sweden. This is because capital markets have become more effective at smoothing out the difference in risk-adjusted returns in different countries, with the result that monetary policy transmission along the interest rate channel is severely weakened in small, open, and financially integrated economies where long-term interest rates are determined to an increasing degree by rates in the largest countries. In such cases, monetary policy transmission takes place to an ever greater degree through the exchange rate channel. But transmission through the exchange rate channel is uncertain and volatile, as the exchange rate is also an asset price that fluctuates with speculative capital flows and can deviate from equilibrium over time, only to correct quite suddenly. Unless the financial system is that much better protected, this process can interact negatively with financial stability, as was the case in Iceland during the financial crisis.[4]

Iceland's experience during the run-up to the last financial crisis is a clear example of excessive inflows that contributed to large macroeconomic and financial imbalances that ended with the most severe financial crisis in the country's history.[5] As a result, the authorities have assumed that capital flow management tools would be introduced before general liberalisation of capital controls takes place, not least because of the shallowness of the markets and the small size of the economy. Such tools were described in two Central Bank of Iceland reports – *Monetary Policy After Capital Controls* and *Prudential Rules Following Capital Controls* – which were published in 2010 and 2012.

Immediately after the authorities presented the capital account liberalisation strategy in June 2015, capital inflows increased, particularly in connection with new investment in long-term Treasury bonds. Even though the amount of these inflows was not large, they strongly affected the bond market and the transmission of monetary policy along the interest rate channel. As a result, changes in the Central Bank's interest rates no longer had the same effect on other market rates. This was particularly the case with interest rates on long nominal Treasury bonds, which had fallen by approximately 2 percentage points from mid-June through the end of October; as a result, the yield curve flattened out, and the term premium on longer bonds appeared to have virtually disappeared. These

[4] Obstfeld, M. (2015). Trilemmas and trade-offs: living with financial globalisation. Bank for International Settlements *Working Paper,* no. 480, and Már Gudmundsson (2016). Monetary policy after capital controls. Speech given at the annual meeting of the Confederation of Icelandic Employers, 7 April 2016.

[5] Bjarni G. Einarsson, Kristófer Gunnlaugsson, Thorvardur Tjörvi Ólafsson, and Thórarinn G. Pétursson (2015). The long history of financial boom-bust cycles in Iceland – Part I: Financial crises. Central Bank of Iceland, *Working Paper* no. 68.

disturbances in monetary policy transmission along the interest rate channel reversed to some extent after the Bank's rate increase in early November and the subsequent announcement that the Bank was considering using other policy instruments to restrict carry trade-related capital inflows.

New investment in the bond market has increased again, however. It totalled nearly 22 b.kr. in nominal terms in the first four months of 2016, as compared with 49 b.kr. in all of 2015. As before, the new investment was largely restricted to long nominal Treasury bonds. The nominal value of all of the Treasury's outstanding nominal benchmark bonds is just under 500 b.kr. (including just under 138 b.kr. held by owners of offshore krónur and subject to special restrictions). Therefore, inflows into the bond market area already significant relative to the size of the market, and it is likely that new investment will continue in the near future and could even increase rapidly. Domestic economic conditions have continued to improve, uncertainty about the liberalisation of the capital controls has diminished, and yields on foreign bond markets are very low in historical context. The incentives for carry trade are therefore strong. The interest rate differential with abroad is wide, and the Central Bank of Iceland's Monetary Policy Committee (MPC) has stated that it will probably be necessary to raise the Bank's interest rates further, in view of growing tension in the domestic economy. The CDS spread on the Icelandic Treasury's five-year US dollar bonds has narrowed by 0.5 percentage points in the past year, and the exchange rate of the króna has risen by approximately 9% in trade-weighted terms. In addition, the economic outlook has improved and unemployment declined. At a time when the domestic incentives for inflows have increased, the stock of financial assets bearing historically low interest rates abroad has continued to grow. The stock of outstanding foreign treasury bonds bearing negative interest grew seven-fold between August 2015 and end-April 2016, from about 1,000 billion US dollars to nearly 7,600 billion US dollars.[6] Conditions in the global financial markets are therefore virtually without precedent.

It is essential to enable the Central Bank of Iceland to reduce the risk of strong inflows when the auction of offshore króna assets has been held and preparation for general liberalisation of capital controls moves forwards. Otherwise, there is the risk that the economic stability that has developed in recent months and years will be jeopardised, as it is impossible to exclude the possibility that the scale of the inflows could overwhelm the domestic institutional framework. By taking the measures provided for in this bill of legislation, the authorities are protecting Icelandic social welfare and safeguarding critical public interests, while considering constitutional law and the authorities' obligations.

3. Main contents of the bill.

3.1. Amendments to the Foreign Exchange Act

[6] J.P. Morgan (JPM Global Government Bond index).

The main purpose of the bill of legislation is to authorise the Central Bank of Iceland to adopt rules on a new *capital flow management measure* designed specifically to temper inflows of foreign currency and to affect the composition of such inflows. It is therefore intended to reduce the risk that could accompany excessive capital inflows and support other aspects of domestic economic policy, thereby contributing to macroeconomic and financial stability.

The Central Bank would therefore be authorised to set rules providing for special reserve requirements relating to new investments, deposits, and loans granted using new inflows of foreign capital. The Bank could therefore make general administrative instructions entailing the obligation to deposit cash, in an amount ranging up to 75% of the investment, deposit, or loan concerned, to an account with a deposit institution in Iceland, for a period not to exceed five years. The deposit institution shall then deposit an amount corresponding to the entire special reserve amount to a special reserve account with the Central Bank. It is considered appropriate that the authorisation to apply this capital flow management measure be incorporated into a Temporary Provision in the Foreign Exchange Act, no. 87/1992, because it represents a temporary measure based on the current regulatory framework for foreign exchange and makes it possible to respond to the risk that could accompany substantial capital inflows.

The capital flow management measure with which the Central Bank of Iceland is entrusted by this bill of legislation is based on the Bank's adopting rules on special reserve requirements for new inflows of foreign capital in specific instances. The rules shall, among other things, specify the types of new investment, deposits, and loans within defined limits which are subject to special reserve requirements; they shall also specify the holding period, the special reserve ratio, the settlement currency, and the interest rates on deposit institutions' special reserve accounts with the Central Bank of Iceland, where the special reserve amounts are held. This arrangement is similar to that which has been employed in Croatia, various Southeast Asian countries, and South America, with the aim of directly affecting cross-border interest rate differentials, reduce the risk associated with speculation, and support improved monetary policy transmission.

The implementation of the Central Bank of Iceland's capital flow management measure has the following aims: (i) to reduce the risk that substantial capital inflows could cause and to support other aspects of domestic economic policy; (ii) to be flexible, goal-oriented, and cost-effective in implementation; (iii) and to be based on a temporary, transparent, and recognised method of managing capital flows.

Various types of risk can develop as a result of capital inflows. Disruption of monetary policy transmission developed as a result of capital inflows soon after the authorities announced the liberalisation strategy. Difficulties in monetary policy conduct could escalate, thereby making it more difficult for the Bank to achieve the intended interest rate level. If capital inflows grow without restriction, they could create the risk of financial instability. For this reason, care is taken to ensure that the capital flow management measure proposed here support monetary policy and could reduce systemic

risk so as to safeguard financial stability if necessary, within the current regulatory framework for foreign exchange.

Subjecting a portion of the inflows imported to the country as new investment, deposits, or bonds to special reserve requirements for a specified period – for example, one year – in an account bearing negative, zero, or low interest reduces the returns on such transactions. The profit on carry trade is therefore less, particularly on short-term transactions, and monetary policy is rendered more able to achieve the necessary monetary stance. Profits on long-term investments will be affected very little, and investments in equity via FDI are exempted, as they are considered desirable and low-risk capital inflows. As a result, this arrangement contributes to reducing the scale of carry trade, ensuring a lower-risk composition of capital inflows, and enhancing the efficacy of monetary policy transmission.

The bill assumes authorises the Central Bank to adopt rules on the framework for the capital flow management measure and respond quickly if conditions change. This applies to the definition of the transactions that create a special reserve base, the special reserve ratio, the interest rates on the special reserve amount, and other factors. Other countries' experience shows clearly that such flexibility to respond is highly important; for example, to halt circumvention and respond to fluctuations in capital inflows and changes in important drivers such as interest rate differentials with abroad, risk premia, and so forth. The Central Bank must be able to guarantee systematic, efficient implementation in order to achieve the intended results.[7]

The orchestration of the capital flow management measure is in line with advice from the International Monetary Fund (IMF) on the design of such tools to counter excessive capital inflows.[8] This entails that the use of the capital flow management measure is intended not to replace optimal implementation of conventional fiscal and monetary policy but to support it. It also entails temporary special reserve requirements on the portion of inflows that obstruct monetary policy transmission and are conducive to economic instability.[9] Care is taken to ensure that the special reserve requirements directly affect the incentive for carry trade and that it will be possible to respond effectively to changed circumstances. For some time, the Central Bank has considered it necessary to have such tools in place, and nearly a year has passed since the Bank announced that work on these tools would be expedited. Therefore, this should not come as a surprise, and representatives of the Government have repeatedly discussed the necessity of such tools in speeches given in Iceland and abroad in recent months.

[7] Ostry, J.D., A.R. Ghosh, K. Habermeier, M. Chamon, M.S. Qureshi, and D.B.S. Reinhardt (2010). Capital Inflows: The Role of Controls. *IMF Staff Discussion Note,* no. 10/04.

[8] International Monetary Fund (2011). Recent Experiences in Managing Capital Inflows – Cross-Cutting Themes and Possible Guidelines. IMF Policy Paper, 14 February 2011 and International Monetary Fund (2012). The liberalization and management of capital flows: an institutional view. *IMF Policy Paper,* 14 November 2012.

[9] Taxation for capital flow management purposes, such as that pursued in Brazil, Thailand, and Korea, has drawbacks in that double taxation treaties and multinational treaties to which Iceland is a party greatly reduce the possibility of implementing such measures.

3.2. Amendments to the Act on a Special Tax on Financial Undertakings.

The bill also recommends one amendment to the Act on a Special Tax on Financial Undertakings (the Bank Tax Act) to permit the deduction of the special reserve amount deriving from Central Bank rules restricting capital inflows from the tax base for the bank tax. The aim of the new Temporary Provision of the Foreign Exchange Act is, in particular, temper inflows of foreign currency and to affect the composition of such inflows, not to create a revenue source for the State; therefore, it is recommended that the special reserve amount not create a tax base according to the Bank Tax Act.

3.3. Amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions.

Finally, the bill of legislation provides for several minor amendments to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016.

First of these are amendments intended to reach a compromise with those holders of offshore krónur that own deposits transferred to accounts subject to special restrictions prior to the Central Bank of Iceland foreign currency auction. Since Act no. 37/2016 was passed, certain deposit institutions and foreign securities have responded to the obligation on custodians to transfer offshore króna assets, as provided for in the Act, by transferring them earlier than was assumed within the time frame granted them. In order to ensure offshore króna holders' equal rights to dispose of their assets, it is recommended that withdrawals from restricted accounts be authorised for the purpose of participating in the foreign currency auction, on the one hand, and for the purpose of investing in specified financial instruments selected by the Central Bank of Iceland, on the other.

Second, it is recommended that offshore króna assets that are exempt from Article 13(b), Paragraph 3 of the Foreign Exchange Act due to transfer of custody from a non-resident legal entity to a deposit institution or custodian in Iceland on the basis of a written application received by the Central Bank of Iceland prior to the entry into force of the Act be excluded from its scope. To a large extent, these are small amounts that have been continuously owned by individuals since before the imposition of the capital controls, or since 28 November 2008, and would have fallen under the criteria originally proposed for inclusion in Article 12 of the bill of legislation subsequently passed as Act no. 36/2016.

Third, it is recommended that owners of offshore króna assets be authorised to invest in the financial instruments appearing on the Central Bank of Iceland's investment list at any given time. This is an expansion of the current authorisations, as owners of offshore krónur have been permitted to invest only in Central Bank of Iceland certificates of deposit since Act no. 37/2016 entered into force.

4. Constitutionality and compliance with international obligations.

This bill of legislation authorises the Central Bank of Iceland to restrict capital inflows under specified conditions. Such measures do not curtail individuals' or legal entities' constitutional rights but primarily make it more difficult than it would be otherwise to

exploit the interest rate differential between Iceland and other currency areas. In addition, the bill provides for derived amendments to the Act on a Special Tax on Financial Undertakings, as well as follow-up and minor additions to the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions. As a result, there is no reason to expect that bill to be unconstitutional or in contravention of the human rights conventions that Iceland is obliged to honour.

As regards the EEA Agreement, the authorities are of the view that capital flow management could be considered a protective measure in the field of movement of capital in the sense of Article 43 of the Agreement. The measures provided for in the bill of legislation will only be authorised in order to counter the risk of imbalances in the real economy and within the financial system; therefore, the bill is consistent with obligations under the EEA Agreement, as the case handling set forth in Articles 44 and 45 of the Agreement, which lay down provisions on information disclosure and consultation in the EEA Joint Committee in connection with measures undertaken in accordance with Article 43. Furthermore, care has been taken to ensure that the rules laid down in the bill are conducive to achieving the objectives described in Chapter II and in the provisions of the bill. Moreover, the provisions of the bill entail that, in applying the policy instruments entrusted to it, the Central Bank will not go further than is necessary to achieve the aforementioned objectives.

5. Consultation.

This bill of legislation was prepared in close consultation with the Central Bank of Iceland, which supervises the Foreign Exchange Act. The bill is related to other measures proposed in connection with capital account liberalisation.

6. Evaluation of impact.

6.1. Impact on financial undertakings.

The bill makes requirements of financial undertakings that act as intermediaries in foreign exchange transactions. They appear in that a portion of capital inflows are deposited to accounts with intermediaries, which then deposit a corresponding amount to a special reserve account with the Central Bank of Iceland. The purpose of the special reserve requirements is primarily to temper inflows of foreign currency and to affect the composition of such inflows and not to have a direct impact on the operations of intermediaries in foreign exchange transactions. As a result, the balances on these special reserve accounts with deposit institutions do not create an increased conventional reserve requirement for these undertakings, nor do they create a tax base for the so-called bank tax. Given that the bill assumes that the special reserve requirements can be applied only to new inflows of foreign currency, it can be assumed that the impact on the real economy will be limited or non-existent.

6.2. Impact on Treasury finances.

The bill is directed at specific financial instruments in the domestic financial market, and it cannot be seen that this will have any direct financial impact on the Treasury. Special

reserve requirements on new inflows of foreign currency could conceivably have an indirect impact on public sector finances through the Central Bank of Iceland's returns on these special reserves if such returns should exceed the costs of the arrangement. In this context, it is appropriate to point out that the returns on the Bank's foreign currency are very low at present, as interest rates are historically low in most foreign financial markets. Furthermore, it can be assumed that the legalisation of this capital flow management tool for the Central Bank will have a deterrent effect on short-term carry trade-related investment and will prevent such capital inflows from increasing excessively.

The bill also recommends an amendment to the so-called Bank Tax Act with the aim of preventing special reserves of this type from affecting this tax base and thereby preventing the passage of the bill from affecting Treasury revenues.

Notes on individual Articles of the bill

On Article 1

This Article proposes an amendment to Article 13(m) of the Foreign Exchange Act, which provides for authorisations and execution of new investment. It is recommended that, when a new investment is sold or redeemed and the proceeds used to reinvest, the investor must report the reinvestment to the Central Bank of Iceland within one week of the date it takes place and provide confirmation that it satisfies the requirements set forth in Article 13(m), Paragraph 6. It is necessary to provide for this because of the amendments recommended in Article 2 of the bill of legislation.

On Article 2

Paragraph 1 authorises the Central Bank of Iceland to adopt rules on special reserve requirements for new inflows of foreign currency, as listed in five numbered subparagraphs. It also specifies the types of new inflows of foreign capital that are covered by the Bank's authorisation to adopt rules.

Article 2 states that the special reserve requirements are filled by depositing the special reserve amount to a special reserve account with a deposit institution in Iceland, which shall, on that same day, deposit a corresponding amount to a special reserve account with the Central Bank of Iceland. It also removes all doubt that the holding period is not dependent on the holding period or maturity of the investment, deposit, or loan in question. In other words, the holding period of the special reserve requirements is never shorter than is provided for in the Central Bank rules at the time the investment is undertaken, the deposit made, or the loan granted. Therefore, special reserve funds will not be released if the investment is sold, the deposit withdrawn, or the loan repaid. Furthermore, it is stipulated that withdrawals from the special reserve accounts are prohibited for the entire holding period. Moreover, it is stated that deposits to deposit institutions' special reserve accounts with the Central Bank shall be subject to the same holding period as the corresponding special reserve amount. In addition, it is prohibited

to hypothecate either the special reserve amount in accounts with deposit institutions or these institutions' deposits held in special reserve accounts with the Central Bank of Iceland.

Paragraph 3 states that the rules adopted by the Central Bank shall include further provisions on the implementation of the special reserve requirements. It is assumed that the Central Bank will determine the holding period, special reserve ratio, and interest rate on deposit institutions' special reserve accounts with the Central Bank, within the framework laid down in Paragraph 5. Furthermore, it is stipulated that, in the rules, the Central Bank will decide the settlement currency for the special reserve amount and the corresponding amount held in special reserve accounts with the Central Bank. It is assumed that the settlement currency will at first be the Icelandic króna, but the Bank may decide to use another settlement currency, if it considers it a better way to mitigate the risk of substantial capital inflows.

Paragraph 4 states that the special reserve ratio to be decided by the Central Bank in its rules may range up to 75% of the special reserve base and that the holding period may range up to five years. Furthermore, it is stated specifically that the Central Bank's decisions on the special reserve ratio, holding period, and interest rate shall be based on the Bank's legally mandated objectives and on a thorough assessment of developments and prospects for the economy, monetary policy, and financial stability. The provision aims to ensure a professional foundation for such decisions. In its assessment, the Central Bank will consider the risk related to capital inflows, including interest rate differentials between domestic and financial markets. As the risk relating to inflows grows, it may prove necessary to maintain a higher special reserve ratio, a longer holding period, and/or lower interest rates on deposit institutions' special reserve accounts with the Bank, and it can therefore be assumed that they may bear no interest or even negative interest.

Paragraph 5 removes all doubt about the Central Bank's authorisation to set differing rules on holding periods, special reserve ratios, settlement currencies, and interest rates, depending on the type of capital creating the special reserve base.

Paragraph states that violations of the provision or rules adopted on the basis of it shall be subject to the penalties provided for by the Act.

On Article 3

This Article recommends an amendment to Article 3 of Act no. 37/2016. The amendment entails that funds owned by parties that have received an exemption from the Central Bank of Iceland on the basis of Article 13(o), cf. Article 7 of the Foreign Exchange Act, which authorises the transfer from the custody of a non-resident legal entity to a deposit institution or custodian in Iceland shall fall outside the scope of the Act, notwithstanding the provisions of Article 13(b), Paragraph 3. This is conditional upon the Central Bank's having received a written application to this effect before 23 May 2016.

On Article 4

An amendment is recommended to the third sentence of Article 4, Paragraph 1 of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, which obliges deposit institutions and foreign securities depositories operating in Iceland to transfer offshore króna assets according to Article 2, Items 1(a) and 1(b) of the Act to accounts subject to special restrictions. The amendment aims to increase the number of items that must be considered in determining the amount that shall be deposited to the restricted accounts; i.e., capital used for participation in the Central Bank of Iceland's 2016 foreign currency auction or for investment in financial instruments on the exemption lists issued by the Central Bank in accordance with the authorisation contained in Article 13(b), Paragraph 4 of the Foreign Exchange Act, no. 87/1992, shall also be deducted. Furthermore, it is recommended that consideration be given to the fact that the amount could decline because of transfers between accounts with deposit balances according to Article 2, Item 1(a), which in turn would lead to a corresponding increase in the amount that another deposit institution is required to transfer according to Article 4.

On Article 5

This Article recommends an amendment to Article 9, Paragraph 1 of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, where owners of offshore króna assets according to Article 1, Items 1(a)-1(d) are granted a temporary authorisation to withdraw funds from restricted accounts in order to use them in the Central Bank of Iceland's 2016 foreign currency auction.

On Article 6

With reference to the amendments recommended in Article 2 of the Bill, it is recommended that Article 10 of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions be amended so as to authorise owners of deposits in accounts subject to special restrictions and comparable accounts with the Central Bank of Iceland to withdraw funds in order to invest in financial instruments issued in Icelandic krónur and included on the Central Bank of Iceland's investment lists. It is assumed that the financial instruments will be held in custody in Central Bank of Iceland administrative accounts and that the resulting sales proceeds and other revenue flows will be transferred to accounts subject to special restrictions, as is the case with certificates of deposit. Furthermore, the Central Bank of Iceland is authorised to decide at any given time which financial instruments issued in domestic currency the depositors according to Paragraph 1 may invest it; such financial instruments shall be included in a special investment list to be published on the Central Bank website. This is an execution similar to the one the Central Bank has used for exemptions to the Foreign Exchange Act for investment financial instruments issued in domestic currency and for which payment takes place by withdrawal from accounts owned by foreign financial undertakings with domestic financial undertakings. The Bank has issued and published on its website an exemption list on the basis of the authorisation contained in Article 13(b), Paragraph 4 of

the Foreign Exchange Act, no. 87/1992, and Article 3 of the Rules on Foreign Exchange, no. 430/2016.

On Article 7

A new Temporary Provision II to the Bank Tax Act recommends that it be permitted to deduct from the tax base according to Article 3 of the Act an amount equal to a taxable entity's special reserve requirements deriving from new inflows of foreign capital according to Temporary Provision III of the Foreign Exchange Act.

On Article 8

This provision recommends that the Act enter into force at once. The Act on the *Law and Ministerial Gazette* and the *Official Gazette* stipulates that statutes shall be binding on all parties beginning on the day after the date of their publication in the *Law and Ministerial Gazette*, where the instructions were published. Due to the nature of the provisions of this bill of legislation, it is necessary that the Act be binding upon all parties immediately upon publication.