

## Progress of the Plan for Removal of Capital Controls

This report is published by the Minister of Finance and Economic Affairs as provided for in Paragraph 2 of the Temporary Provision I in Act No. 87/1992 on Foreign Exchange

[The Minister shall make public a report on the progress of plans to remove restrictions on cross-border capital movements and foreign currency trading at six-month intervals until such restrictions are finally removed. The report referred to in the first sentence shall be published for the first time within six months of the entry into force of this act]

Former reports are available at the website of the Ministry of Finance and Economic Affairs<sup>1</sup>.

### Capital account liberalisation on individuals and businesses

Act No. 105/2016, amending the Foreign Exchange Act, No. 87/1992, which aimed at lifting capital controls on individuals and businesses entered into force on 21 October 2016. With the Act, controls on resident and non-resident individuals and legal entities were eased in two stages. The first stage entered into force on 21 October 2016 when investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment of foreign-denominated loans became permissible up to a ceiling of 30 m.kr. Furthermore, restrictions on foreign direct investment were abolished and individuals were allowed to purchase one real estate per calendar year<sup>2</sup>.

The second stage of the Act entered into force on 1 January 2017 when the ceiling on investment in financial instruments issued in foreign currency, other monetary claims in foreign currency, and prepayment and full payment of foreign-denominated loans was raised to 100 m.kr. Moreover, transfers of deposits were authorised up to the aforementioned ceiling, the requirement that foreign securities investments be held with custodians in Iceland was lifted and cross-border transfer of custodianship of foreign securities became unrestricted. Therefore, residents and non-residents were able to transfer deposits and securities to and from Iceland and trade in securities abroad within the limits specified in the Act from 1 January 2017. Furthermore, individuals' authorisations to purchase and withdraw foreign currency in cash were widely expanded, so that individuals were permitted to purchase or withdraw foreign currency in cash up to the aforementioned ceiling.

Concurrent with the amendments to the Foreign Exchange Act that entered into force in 1 January 2017, the Central Bank's Rules on Foreign Exchange were updated. The main changes were that reinvestment authorisation became independent of time limits, capital transfers from foreign financial undertakings' domestic currency accounts (Vostro accounts) were authorised if it is demonstrated that such transfers derive from the exercise of authorisations up to the aforementioned ceiling. Furthermore, investment in financial instruments issued in foreign currency between two resident entities were authorised up to the aforementioned ceiling. Other minor amendments included further authorisations regarding gifts and grants, movements of capital and cash withdrawals of individuals younger than 18

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<sup>1</sup> <https://www.ministryoffinance.is/news/nr/20084/>

<sup>2</sup> Further information on the first stage of the Act can be found in the report on progress of the plan to remove capital controls from October 2016. See:

<https://www.ministryoffinance.is/media/frettatengt2016/ProgressOfPlanForRemovalOfCapitalControls-2.pdf>

years old and foreign exchange transactions and/or movement of capital due to child support payments.

### **Amendments to the special reserve base of the Central Bank's capital flow management measure**

On 1 November 2016, the Central Bank amended the Rules on Special Reserve Requirements for New Foreign Currency Inflows. The special reserve base was changed so that domestic currency deposits bearing less than 3% annual interest became exempt from the special reserve base when they derive from new investment or reinvestment of such new investments. Furthermore, investments in unit share certificates in funds that have domestic currency deposits in Icelandic deposit institutions, bearing annual interest of 3% or more, were exempted from the special reserve base if the combined total of cash and deposits constitutes less than 10% of the fund's assets. Furthermore, individuals were exempted from the special reserve requirement up to a ceiling of 30 m.kr. alongside individuals' increased authorisations for cross-border capital transfers up to the same ceiling according to Act No. 105/2016 amending the Foreign Exchange Act, No. 87/1992, which entered into force on 21 October 2016, as it was considered appropriate to allow individuals to import capital up to the ceiling specified in the aforementioned Act without creating a special reserve requirement under the Rules. The authorisation is subject to the condition that the individual is the beneficial owner of the funds in question. On 1 January 2017, the abovementioned ceiling was raised from 30 m.kr. to 100 m.kr. as the second stage of lifting capital controls on individuals and businesses, according to the abovementioned Act from 21 October 2016, was implemented. These changes in the special reserve base were intended to facilitate enforcement of the Rules without affecting their objectives and efficacy<sup>3</sup>.

### **On the Treatment of Króna-Denominated Assets Subject to Special Restrictions**

On 22 November 2016, the Central Bank of Iceland amended the Rules on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, No. 425/2016. The amendments were technical in nature and served the purpose of clarifying the Rules and facilitate their implementation.

The Central Bank of Iceland administers securities falling within the scope of the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions vis-à-vis custodians – i.e., financial undertakings – and acts as an intermediary in registration of title vis-à-vis domestic securities depositories. The amendments highlight the Bank's administrative role for electronically registered securities held in administrative accounts as it was stated, inter alia, that the Bank is not the owner of such securities, that administrative accounts do not carry voting rights at shareholders' meetings and that the Bank shall keep such securities separate from its own assets. Moreover, the amendments stated that the Central Bank shall receive payments from individual issuers of electronically registered securities on behalf of custodians if the custodians so request. Furthermore, requirements concerning detailed due diligence checks by custodians were eased by taking into consideration those custodians that rely on information from third parties.

### **Restrictions on offshore króna assets are not in breach of the EEA Agreement**

On 23 November 2016, the EFTA Surveillance Authority, ESA, closed two complaints against Iceland which the institutions had received from owners of offshore króna assets<sup>4</sup>.

<sup>3</sup> <http://www.cb.is/publications/news/news/2016/11/01/Amended-Rules-on-Special-Reserve-Requirements-for-New-Foreign-Currency-Inflows/>

<sup>4</sup> <http://www.eftasurv.int/press--publications/press-releases/internal-market/internal-market-iceland-s->

The complaints regarded Act No. 37/2016, on the treatment of offshore króna assets, and an alleged violation of Articles 40, 41 and 42 of the EEA Agreement on free movement of capital.

Article 43 permits an EFTA country to undertake protective measures in the field of capital movements if such movements lead to disturbances in the functioning of capital markets or difficulties as regards its balance of payments. The complaint maintains that the substantive criteria laid down in Article 43 of the EEA Agreement were not met in the economic circumstances in Iceland. Furthermore, the complaint maintained that the provisions of the legislation for the treatment of holders of offshore króna assets are discriminatory and the special restrictions imposed are neither necessary, reasonable nor proportionate.

However, ESA concluded that Iceland's restrictions on offshore króna assets were not in breach of the EEA Agreement. The objective of the law was to create a foundation for unrestricted cross-border trade with Icelandic krónur, eventually allowing Iceland to participate fully in the free movement of capital. Although the Icelandic economy is now stronger, ESA's view that there still was a possibility that the lifting of capital controls would destabilise capital flows, causing renewed difficulties with the balance of payments.

### **Pension funds' authorisation for foreign investment**

The Central Bank of Iceland announced, on 28 December 2016, its decision to continue granting pension funds, and other domestic custodians of third-pillar pension savings, exemptions from the Foreign Exchange Act, thereby permitting them to invest in financial instruments issued in foreign currency. The exemption, which amounted to 100 b.kr., was meant to remain in effect until year-end 2017<sup>5</sup>. The investment authorisation was divided among pension funds and other custodians with a view of total assets, weighted at 86%, and premiums net of pension benefit payments, weighted at 14%. From mid-2015 through end-2016, pension funds and other domestic custodians of third-pillar pension savings were authorised to invest abroad for a total of 95 b.kr., 85 b.kr. of it in 2016.

Iceland's foreign exchange position had improved markedly concurrent with strong foreign currency inflows and the likelihood of large foreign currency outflows in the wake of further capital account liberalisation had diminished substantially. As a result, the Bank considered it possible to grant authorisations for foreign investment over a longer horizon than before – that is, for the whole year 2017 – as well as increasing the maximum authorisation. As before, it was required that the pension funds distribute their investments more or less evenly over the year. Furthermore, the authorisation was granted with the provision that amounts could change if the scope for foreign exchange purchases proves considerably less than was envisaged; for instance if the balance of payment developed unfavourably. The Bank further noted that it might be possible to increase pension funds' authorisation for foreign investment if foreign currency inflows continue to be strong in 2017.

As before, the rationale for such an authorisation was that there is an economic advantage in enabling the pension funds to further diversify the risk in their asset portfolios. Furthermore, it was deemed desirable to mitigate the pension funds' accumulated need for foreign investment before the capital controls are finally lifted, thereby reducing the risk of monetary and

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[restrictions-on-offshore-krona-assets-are-not-in-breach-of-the-eea-agreement](#)

<sup>5</sup> The pension funds' authorisation for foreign investment became unrestricted after the capital controls on individuals, businesses and pension funds were lifted. See further discussion below.

exchange rate instability<sup>6</sup>.

### **Emphases of the new government**

A new government took office on 11 January 2017. Its policy statement states that one of the government's main priorities is to continue with the progress of plans to remove capital controls. Furthermore, the Minister of Finance and Economic Affairs has reappointed a steering committee on capital account liberalisation. The committee's task is to work towards a full liberalisation of the capital account such that Iceland meets its international obligations, while also reserving financial stability as well as stability in exchange rate and monetary affairs. The members of the committee are Benedikt Jóhannesson, the Minister of Finance and Economic Affairs, Benedikt Árnason, appointed by the Prime Minister, Guðmundur Árnason, appointed by the Minister of Finance and Economic Affairs, Már Guðmundsson, Governor of the Central Bank of Iceland and Ragnhildur Arnljótsdóttir, appointed by the Prime Minister.

### **Investment funds allowed to receive an evaluation report from court-appointed assessors**

On 12 January, the Supreme Court of Iceland ruled in the case of investment funds Autonomy Capital LP, Autonomy Master Fund Limited, GAM Trading and Autonomy Iceland Two S.à.r.l against the Icelandic State. According to the ruling, the funds are allowed to submit five questions to assessors appointed by the court, although an actual case has still not been brought against the Icelandic State.

It is the funds' view that Act No. 37/2016, on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, involves restrictions of their constitutionally guaranteed rights without it having been demonstrated that public interests demand it or other reasons exist.

Originally, the funds requested that eleven questions be submitted to the court-appointed assessors. However, six of the questions were rejected by the Icelandic court.

### **Exemptions for derivatives trading for hedging purposes**

The Central Bank of Iceland announced on 24 February 2017, that the bank considered premises to exist to grant specific exemptions from the Foreign Exchange Act, no. 87/1992, upon receipt of application, for derivatives trading for long-term hedging purposes. More specifically, the exemptions in question could facilitate the mitigation of exchange rate risk in connection with both inward and outward direct investment. Furthermore, they enable firms to correct foreign exchange imbalances on their balance sheets. Among the objectives of the change was to assess businesses' need and interest in hedging to prepare for full liberalisation of capital controls. The exemptions were also conducive to reducing the risk in companies' operations and to favourably affecting their borrowing terms and creditworthiness.

In all instances, exemptions granted for derivatives trading for long-term hedging would be subject to specific conditions pertaining, for instance, length of contracts, timing, and information disclosure to the Central Bank. With these conditions, the Bank attempted to ensure that derivatives trading would actually be undertaken for the purpose of long-term

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<sup>6</sup> <http://www.cb.is/publications/news/news/2016/12/28/Pension-funds-authorisation-for-foreign-investment-in-2017/>

hedging against foreign exchange imbalances, not for the purpose of taking a position with or against the Icelandic króna<sup>7</sup>.

### **Capital account liberalisation for individuals, businesses and pension funds**

The Central Bank of Iceland published new Rules on Foreign Exchange on 12 March 2017, which took effect two days later. With the new Rules, wide and general exemptions have been granted from the restrictions of the Foreign Exchange Act No. 87/1992, on foreign exchange transactions and cross-border movement of domestic and foreign currency. In fact, the Rules provide for general exemptions to nearly all of the restrictions pursuant to the Foreign Exchange Act, no. 87/1992. However, restrictions regarding derivatives trading for purposes other than hedging, foreign exchange transactions carried out between residents and non-residents without the intermediation of a financial undertaking and lendings from domestic entities to non-resident entities for the purpose of carry trading, with the objective of ensuring the implementation of the capital flow management measure, remain in place.

The new Rules do not affect offshore króna assets, which remain subject to special restrictions pursuant to Act no. 37/2016. In accordance with the authorities' capital account liberalisation strategy, focus will shift again to offshore króna assets, now that capital controls on individuals and businesses have been lifted. Proposals concerning how offshore króna assets will ultimately be liberalised will be a part of the review of the Foreign Exchange Act, no. 87/1992, and the Act on the Treatment of Króna-Denominated Assets Subject to Special Restrictions, no. 37/2016.

The requirements obliging financial undertakings and other parties engaging in capital transactions to notify the Central Bank of capital movements remain largely unchanged for the present. However, various foreign exchange transactions and cross-border capital movements that were subject to confirmation by the Central Bank until 14 March 2017 became only subject to a disclosure requirement.

The reason it was deemed possible to undertake the abovementioned amendments to the Rules on Foreign Exchange was mainly that the risk of balance of payments disequilibrium that could cause monetary, exchange rate, or financial instability had diminished significantly over the past year. First of all, restrictions on cross-border capital transfers were eased in October 2016 and January 2017 without discernible impact on the foreign exchange market or on cross-border movement of capital. Second, the Central Bank's foreign exchange reserves had increased markedly in the months running up to the capital account liberalisation, to a total of about 800 b.kr. as of end-February. The build-up of the foreign reserves stems from a current account surplus in the amount of 8% of year-2016 GDP. Furthermore, the outlook is for a continuing current account surplus, foreign liabilities have declined and Iceland's net external position is now positive for the first time in the history of measurements, all of which further reduce the risk of instability<sup>8</sup>.

### **Amendments to the Central Bank's capital flow management measure**

Concurrent with new Rules on Foreign Exchange, the Central Bank also amended Rules no. 490/2016 on special reserve requirement for new foreign currency inflows. The reason for the amendments was that lifting the restrictions that had been applied to foreign exchange transactions and cross-border movement of capital between Iceland and other countries

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<sup>7</sup> <http://www.cb.is/publications/news/news/2017/02/24/Exemptions-for-derivatives-trading-for-hedging-purposes-/>

<sup>8</sup> <http://www.cb.is/publications/news/news/2017/03/12/New-Rules-on-Foreign-Exchange-/>



opened up new possibilities for carry trade, which necessitated a response. The amendments entailed that deposits used, directly or indirectly, for investments that otherwise constitute a special reserve base are subject to special reserve requirements.

The amendments were intended to ensure the effectiveness of the Rules and to support their objective of affecting the composition of inflows of foreign currency which is used for investment in Iceland and could potentially create systematic risk<sup>9</sup>.

#### **Agreement with owners of offshore króna assets**

On 12 March 2017 the Central Bank announced it had concluded agreements with several owners of offshore króna assets subject to special restrictions pursuant to Act no. 37/2016. Under the agreement, the Bank purchased offshore króna assets from its owners in the amount of close to 90 b.kr. at an exchange rate of 137.5 kr. per euro. With the transactions the scope of offshore króna assets reduced from approx. 195 b.kr. to approx. 105 b.kr. and the risk of large-scale outflows of offshore krónur through the foreign exchange market upon liberalisation of capital controls has decreased.

Owners of offshore króna assets who were not parties to the agreements were subsequently, on 4 April 2017, offered to conclude transaction with the Central Bank on the same terms. The Central Bank's offer is valid through 28 April 2017 but as of now it is unknown to what extent remaining owners of offshore króna assets will accept the offer<sup>10, 11</sup>.

#### **Upgraded credit rating following capital account liberalisation**

On 13 January 2017, the credit rating agency Standard & Poor's (S&P) raised the credit rating of the Treasury from BBB+ to A- with a stable outlook<sup>12</sup>.

The news release of the credit rating agency noted that Iceland's strong external position was one of the key elements of its credit rating assessment. S&P further stated that the surplus on the current account was robust, the net foreign exchange reserves had increased sharply in the past year and the surplus on the balance of payment had exceeded the agency's expectations. Furthermore, robust economic growth, a reduced external debt ratio and a strong fiscal position are also important factors in the rating increase.

S&P further noted it could raise the credit rating further if external capital controls would be fully removed without endangering financial stability or causing an adverse influence on the balance of payments. The rating could also increase further if the public sector debt ratio would decline faster than expected by S&P. Similarly, an uncontrolled liberalisation of the capital account could have an adverse impact on the financial system and thus impact the rating downwards. Furthermore, the rating could also lower if recent wage increases lead to an overheating in the economy and increased risk for monetary and fiscal policy as well as Iceland's net international investment position.

On the same day, Fitch confirmed the long-term ratings in foreign and domestic currency at

<sup>9</sup> <http://www.cb.is/publications/news/news/2017/03/12/Amended-Rules-on-Special-Reserve-Requirements-for-New-Foreign-Currency-Inflows/>

<sup>10</sup> <http://www.cb.is/publications/news/news/2017/03/12/Central-Bank-of-Iceland-concludes-agreement-with-owners-of-offshore-krona-assets/>

<sup>11</sup> <http://www.cb.is/publications/news/news/2017/04/04/Purchase-of-offshore-kronur-by-the-Central-Bank-of-Iceland/>

<sup>12</sup> <https://www.ministryoffinance.is/news/s-p-raises-the-credit-rating-of-the-treasury-to-a>

BBB+, but raised the outlook to positive. In Fitch's opinion the vulnerabilities towards external shocks had diminished considerably with the appreciation of the exchange rate and the accumulation of net foreign exchange reserves of the Central Bank. The declining debt ratio and strong economic growth have also influenced the changed prospects<sup>13</sup>.

Credit rating agencies responded positively to the capital account liberalisation on individuals, businesses and pension funds of 12 March 2017 and Standard & Poor's (S&P) raised the long-term ratings on Iceland from A- to A on 17 March 2017. Fitch and Moody's have assessed the prospects of an upgraded credit rating as positive. The S&P's rationale for an upgraded rating was that the likelihood of potential balance of payment stress upon the liberalization of the exchange restrictions had reduced and the removal of capital controls on individuals, businesses and pension funds should help further strengthen those parties' access to foreign capital markets as well as attract more foreign investment into the country. The rating agency also noted that while pension funds are expected to increasingly diversify their portfolios toward foreign assets, associated exchange rate risks are likely to remain contained as the Central Bank of Iceland has the necessary tools to monitor and regulate the pace of these potentially material outflows<sup>14, 15</sup>.

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<sup>13</sup> <https://www.ministryoffinance.is/news/fitch-raises-outlook-to-positive>

<sup>14</sup> <https://www.ministryoffinance.is/news/s-p-research-update-republic-of-iceland-ratings-raised-to-a-a-1-onlifting-of-capital-controls>

<sup>15</sup> <https://www.ministryoffinance.is/news/moody-s-investors-service-issuer-comment-on-the-government-of-iceland>