International Monetary Fund

Iceland and the IMF

Press Release:
IMF Completes Third Review Under Stand-By Arrangement for Iceland, Concludes 2010 Article IV Consultation
September 29, 2010

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Iceland: Letter of Intent, and Technical Memorandum of Understanding

September 13, 2010

The following item is a Letter of Intent of the government of Iceland, which describes the policies that Iceland intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Iceland, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

LETTER OF INTENT

Reykjavik, September 13, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington D.C., 20431
U.S.A.

Dear Mr. Strauss-Kahn:

1. **Iceland's economic program is laying the foundation for a sustainable recovery**. Progress towards fiscal consolidation has been reflected in improving confidence, falling debt spreads and an appreciating krona. The post-crisis recession eased in the fourth quarter of 2009, unemployment appears to have peaked, and while the economy faces headwinds, we expect a durable but gradual recovery to take hold in the second half of 2010.

2. **Our policy implementation remains broadly on track**. All end-May performance criteria have been met. The end-June structural benchmark concerning the passage of legislation to strengthen the framework for household debt restructuring has also been met. Although we have taken steps to intervene in weak savings banks, as discussed below their recapitalization, a structural benchmark for end-May, has been delayed to account for the impact of a recent court decision. The status of all program measures is summarized in Tables 1 and 2.

3. **On this basis, we request completion of the third review under the Stand-By Arrangement.** As set out in Table 1, we request that ceilings and floors for the quantitative performance criteria under the arrangement be modified for end-September 2010, and established for December 31, 2010, and that indicative targets be set for March 31, 2011 and June 30, 2011. As detailed below, we also propose two new structural benchmarks covering bank recapitalization and authorization for bond issuance in support of bank recapitalization (Table 2).

4. **We believe that the policies set forth in this and previous letters will deliver the objectives of our program.** We stand ready to take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of any such measures and in advance of revisions to the policies contained in this letter, in accordance with the Fund's policies on such consultation.

The outlook

5. **Iceland's economy is beginning to emerge from recession, and a gradual recovery remains our expectation:**

- The outlook for real GDP growth remains broadly unchanged, with a durable but gradual recovery expected to take hold in the second half of 2010. Economic activity broadly stabilized at the end of 2009, driven by strong exports and a recovery in consumption. However, continued delays in large investments projects and the impact of the spring volcanic eruption on tourism have led to a temporary setback during the first half of 2010. Deleveraging and external demand remain the key downside risks. Upside could conversely be realized through higher investment, particularly in the now competitive tradables sector, and we are committed to removing obstacles to investment.

- We expect the headline 12-month end-period inflation rate to continue to decline. It should reach 4 percent by end-2010 and 2–3 percent in 2011. Significant slack in the economy helps, but our cautious monetary policy, which has contributed to a gradual appreciation of the krona, has been crucial towards disinflation. Risks to the outlook emanate from possible wage increases in export sectors spreading to non-tradables sectors, and from still volatile inflation expectations. To attenuate these risks, the government is committed to discuss a new stability pact with our social partners, with a view to reach an agreement by end-September.

- The outlook for the balance of payments is strong. Over the next 12 months, we expect continued reserve accumulation due to a continuing trade surplus and the realization of program financing. Looking further ahead, our asset and liability management transactions (paragraph 6) have markedly reduced debt service through 2012. Overall, our reserve coverage stands at a healthy 125 percent of short term debt (by residual maturity, adjusted for continuing capital controls).

6. **While Iceland's gross debt levels remain high, they are being addressed.** We have significantly reduced both gross and net external and public debt through the purchase of a Luxemburg-based holding company and its assets, comprised of krona deposits and Icelandic government and government guaranteed bonds ("Avens"); and through direct Eurobond repurchases from the market. We expect continued declines in gross public and external debt over the medium term, but levels will remain high for the time being, with gross general government debt expected to peak at about 120 percent of GDP in 2010, and gross external debt projected to amount to 280 percent of GDP in 2010. The high debt ratios pose risks, which are attenuated somewhat by significant public and external assets (the net international position amounts to only -30 percent of GDP at end-March 2010). Remaining risks can be managed through firm implementation of the program, including the policies laid out below.

Restoring the financial system

7. **A ruling by Iceland's Supreme Court has required us to revisit the issue of recapitalization of banks.** The three new commercial banks were set up with significant capital buffers, and all exceeded the regulatory minimum prior to the ruling. However, capital levels will be affected by the decision (which stated, among other things, that foreign exchange indexation clauses in domestic currency loans are illegal). The ongoing strategy and timetable to restore the solvency of Byr and SpKef (successors to savings banks intervened in April) has also been affected by the court ruling. To preserve market confidence in the financial system and protect depositors, while encouraging bank owners to bring new capital in (thus minimizing fiscal costs), the following steps will be taken:

- *Assessment.* The FME has asked banks and savings banks to assess potential losses on their pool of fx loans. The loans have been provisionally classified as probably affected by the ruling, possibly affected by the ruling, and not likely to be affected. A legal audit of banks' loan contracts, to be completed by end-September, will help refine the classification, and the classification will be updated as necessary, as court rulings bring further clarity.

- *Accounting for losses.* The FME will require banks to fully provision likely losses on probably affected loans by end-October. To the extent court rulings establish additional probably-affected loans (as losses on possibly affected loans crystallize), we will require these loans to be provisioned fully and immediately.

- *Recapitalization of the three new commercial banks*. Banks will be required by end-October to commit to a credible plan to meet within 60 days: (i) minimum regulatory capital requirements; and (ii) at least 6 percent total tier I capital to risk weighted assets (after deducting from capital potential losses on possibly affected loans). The FME will adopt a decision on all three banks' plans by November 15 (a **structural benchmark**). In the event that subsequent court decisions crystallize possible losses, banks would have 2 weeks to present revised credible plans to meet these targets, and a new 60 day period would be provided to meet the targets.

- *Government participation in recapitalization*. If any of the three new commercial banks cannot demonstrate that they will be able to meet their capital requirement within the designated time frame, or proves unable to do so, we will support their recapitalization by injecting tier I capital using an instrument that will be structured to isolate the government from initial impact of potential future losses (for instance, preferred shares). Recapitalization could have a substantial cost to the government and taxpayers, but it is a cost that will have to be borne to preserve financial stability.

To facilitate potential recapitalization, the 2010 supplementary budget, which we will submit to Parliament by October 15, will: (i) authorize sufficient bond issuance to cover the recapitalization need if losses on all probably affected and possibly affected loans are realized; and (ii) enable the Ministry of Finance to recapitalize the banks in amounts needed (on the request of the Icelandic State Bank Agency which will manage, on behalf of the government, any shares acquired (a **structural benchmark**). We anticipate that this supplementary budget will be considered by Parliament by mid-November. Enactment would ensure that funds are available if government participation in recapitalization becomes necessary at this early juncture. The authority to issue sufficient bonds will be renewed in the 2011 budget.

- *Recapitalization schedule for Byr and Keflavik.* By end-September we aim to complete negotiations with the Resolution Committees on recapitalization plans. The plans would account for losses on loans that are affected by the Supreme Court ruling, and would require enough capital to address losses from loans that may possibly be affected by future rulings. If agreements cannot be reached, new asset valuations would be undertaken to prepare the ground for recapitalization by the government. In either case we expect that by end-December these institutions will meet FME capital requirements.

- *Reducing uncertainty.* It is in the interest of both lenders and borrowers to reduce the uncertainty surrounding the status of foreign currency linked loans, and this would also contribute to better macroeconomic performance. To this end we will identify any remaining legal uncertainties regarding foreign currency linked loans, and address them in a manner that protects the government from absorbing private sector losses.

8. **We are working to address bank balance sheet vulnerabilities.** This will set the stage for a durable renewal of lending:

- *Updated prudential rules*. On the basis of the recently passed amendments to the banking legal framework, by end-October the FME will strengthen prudential rules, including on connected parties, large exposures, foreign exchange lending, and liquidity.

- *Revised business plans*. By end-December 2010, the FME, with technical support of an internationally recognized consulting firm, will assess progress made by banks in reducing operational, risk management and governance gaps, and in addressing the capital implications of the Supreme Court ruling on foreign exchange loan indexation clauses, and sign off on the revised business plans submitted by the institutions.

- *Implementation*. On the basis of revised business plans, the FME will negotiate a timetable on quarterly targets with banks covering the gradual reduction of remaining financial imbalances, restructuring of their operations, and adjustment of their credit exposures and liquidity positions to the new prudential regulations (if they are not already in compliance).

9. **We are also working to address weaknesses in the non-bank sector**:

- *The Housing Finance Fund (HFF).* By end-September, we expect to formulate a rehabilitation and recapitalization plan based on the HFF's business plan. This will cover, inter alia: (i) recapitalizing the HFF by end-December 2010, by injecting enough marketable government securities to keep its capital above the regulatory minimum for the period defined by its business plan; and (ii) the establishment of a timetable for harmonizing capital and other requirements with those of other financial institutions.

- *Other non-bank financial institutions.* Since these institutions were affected by the Supreme Court ruling on foreign exchange indexed loans, the FME has requested an acceleration of the work on rehabilitation and recapitalization plans, following the requirements laid out above for commercial banks. For these other non-banks, public funds will not be available for recapitalization, and if they cannot identify corrective actions, they will be resolved in an orderly fashion.

Restoring private sector balance sheets

10. **We remain committed to a targeted, voluntary approach to debt restructuring.** Moreover, we are determined to see the work through to a conclusion as soon as possible and in particular to ensure that the frameworks we have designed for household and corporate debt restructuring function efficiently and productively. While we remain committed to simplifying the process, we have ruled out an across-the board debt write down (e.g., for borrowers not affected by the Supreme Court ruling on foreign exchange indexed loans). This reflects the enormous and unaffordable fiscal cost, the need to preserve an operating and stable banking system, and the detrimental impact this would have on Iceland's payment culture. We will continue to focus attention on the distressed borrowers who fortunately remain a minority of total borrowers.

11. **We have amended Iceland's voluntary framework for household debt restructuring** (meeting the end-June **structural benchmark**). Key aspects of the changes include the establishment of a Debtor's Ombudsman (to provide advisory and mediation services to debtors, and help address creditor hold-out problems); and the extension of the framework to several classes of solvent borrowers who have not previously been eligible (e.g., individuals having some debts arising from business activities). We have implemented changes to forced auctions to address market failures and have also clarified the conditions under which debtors can temporarily remain in a foreclosed home (they must pay market rent and can be asked to provide a guarantee against damages). Guidelines provide for a

minimum stay of 6 months (and longer if specific social criteria are met). Finally, we will encourage banks to offer debtors the option of short-selling their properties, and we have removed tax disincentives for households that receive relief.

12. **With the framework now finalized, our focus will be on encouraging greater participation by households.** We set up in August the new Debtors' Ombudsman's Office, and are scaling its operations up (including via outsourcing), and engaging in enhanced public outreach to explain the framework. This should help quickly guide debtors through the many options available to them. Finally, with the framework in place, we are proceeding as planned to remove temporary post-crisis measures—like the moratorium on home foreclosures—the continuance of which represent a barrier to debtor participation.

13. **We have made further progress in operationalizing a framework for voluntary corporate restructuring.** Banks have now developed and put in place general guidelines. The FME will also instruct banks to produce specific guidelines covering the treatment of small and medium sized enterprises (where a case-by-case approach would prove difficult to implement). A special committee will monitor and continuously report on the application of these guidelines, putting special emphasis on ensuring transparency and fairness. One by-product of the recent strengthening of supervisory oversight powers, and actions to strengthen banks' balance sheets, will likely be faster progress with restructuring. This would come both via the quarterly targets for eliminating remaining fx imbalances, and via a requirement for banks to adopt semi-annual audits (which will speed the FME's ability to detect loan losses associated with delays in debt restructuring, and thus speed up provisioning, giving banks a financial incentive to restructure).

14. **The insolvency regime has been refined.** Recent amendments to the Bankruptcy Act simplified and expedited in-court proceedings for restructuring agreements and liquidations; addressed operational issues arising in the context of cross border insolvency of companies; and ensured preservation of secured creditors' rights. A Committee on Procedural Law under the Ministry of Justice assessed whether there is a need to introduce additional changes to Iceland's insolvency regime to better expedite out-of-court restructurings. The Committee has concluded that such changes are not needed at this stage while recognizing that further assessments of specific measures could possibly be undertaken at a later stage based on the experience of a recently passed Danish Law (Act no. 718 of June 25, 2010).

Monetary Policy and Capital Controls: Preserving Currency Stability

15. **Given the recent krona strength and continuing balance of payments inflows, we will place increased emphasis on reserve accumulation.** A higher level of non-borrowed reserves will improve confidence in the economy (lowering debt spreads), and strengthen the CBI position ahead of the phase out of capital controls. The aim of the purchases will be to accumulate non-borrowed reserves, not to set a level or direction for the krona. The CBI began to undertake auctions beginning at end-August 2010, and these will continue on a

regular schedule. Initial purchases will be small, and will gradually mount over time in a manner tied to projected market conditions. The CBI may undertake additional purchase, via auctions if possible, in the event of large and irregular inflows into the market.

16. **Once the preconditions are in place, we will take the next step towards capital account liberalization.** Capital controls continue to be an essential tool to stem large-scale capital outflows which could destabilize the currency. However, they do represent an obstacle to higher investment in Iceland, and we are committed to careful removal of the controls, in a manner that preserves currency and financial system stability. Consistent with our liberalization strategy, the next step will involve lifting controls on long term assets. Assuming the balance of payments outlook remains unchanged, the next step can be taken once the banking system is deemed sufficiently strong (with enough liquidity to handle possible outflows, and sufficient capital to buffer against any losses). Any subsequent steps will be taken on the basis of the outcome of previous steps.

17. **We remain committed to effective enforcement of the capital control regime.** To help deliver continuing compliance as liberalization proceeds, we will ensure that enough resources are available to take cases from their initial stages of investigation right through court proceedings. As the capital control regime marginally affects the conversion and transfer of a certain component of current payments, namely interest on bonds (whose transfer the foreign exchange rules apportion depending on the period of the holding). We request temporary Fund approval of further retention of the measure that gives rise to the existing exchange restriction in line with Fund policies.

18. **The CBI's policy stance will be set to preserve currency stability and continued disinflation.** Currency depreciation brings with it significant inflation pass-through and additional balance-sheet stress, both of which must be minimized to secure Iceland's economic recovery. Looking ahead, each step towards capital control liberalization will increase the influence of monetary policy on the exchange rate, and we will thus need to ensure that Iceland's risk-adjusted interest rate differential is sufficient to preserve currency stability. We expect currency stability and Iceland's significant output gap to promote continued disinflation, but in the event of inflation persistence, will adjust our policy to attain end-year inflation objectives.

Fiscal Policy: Securing Public Debt Sustainability

19. **We are on track to hit our 2010 primary fiscal deficit target.** Government revenue collections are broadly on track, and central government spending remains below budget limits. The general government primary deficit should reach the targeted level of 2¾ percent of GDP in 2010 (an improvement of about 4¼ percent of GDP over 2009). Should revenues exceed targets during the second half of 2010, we will preserve the structural adjustment implicit in the 2010 budget targets.

20. **We aim to achieve a general government primary surplus in 2011.** Based on the updated forecasts for 2010, we are preparing the 2011 budget for the central government aiming at a general government primary surplus of ½ percent of GDP (implying an adjustment of 3¼ percent of GDP). This is broadly in line with the planned adjustment in our medium-term consolidation plan (3¾ percent of GDP); the slight reduction is to provide insurance against downside risks to domestic demand. We expect that local governments will deliver a balanced primary position, backed by a strengthened fiscal framework. The central government will therefore target a primary surplus of ½ percent of GDP (implying a central government primary adjustment of 3¼ percent of GDP).

21. **A package of measures has been identified to help deliver the central government fiscal adjustment in 2011.**

- *Revenue measures*. These will yield about 0.6 percent of GDP, and include increasing the corporate income tax and capital income tax rates from 18 to 20 percent. The tax measures will mainly offset the impact of expiring one-off measures from the 2010 budget, but will also generate a small increase in the ratio of primary revenue to GDP.

- *Expenditure measures*. These will amount to 2 percent of GDP relative to the budget baseline for 2011 (and 3 percent of GDP measured against the projected 2010 outturn). The measures include no nominal wage or benefit increases; a 5 percent reduction of health, primary education, and police service costs; a 7½ percent reduction in higher education costs; and a 9 percent reduction in general administrative costs (including through reduction in overtime, reorganizations, and contract renegotiations).

22. **We have updated our medium term fiscal consolidation plan**. We remain firmly committed to stabilizing the fiscal position by achieving a positive primary balance in 2011, a positive overall balance in 2012, and a significant general government primary surplus by 2013 (6 percent of GDP). To the extent that debt falls faster than expected and if contingent bank recapitalization liabilities prove to be contained, then we may revisit the medium-term targets. We have identified a number of options to help us achieve our targets. On the revenue side, the entire structure is under review, and technical assistance has identified several options including, among others, restoring aspects of the VAT system to their pre-crisis status; and improving the progressivity of the personal income tax. On the expenditure side, we remain committed to improving the progressivity of benefits.

23. **We will steadily improve our financial balance sheet.** We have increased issuance of long-term bonds, responding to investor appetite for longer maturities and in line with our objective of extending average time to maturity. To ensure that investors are aware of changes in our annual borrowing plan, we have published an update and have committed to announcing any further changes at the end of each quarter. Our recent repurchase of Eurobonds has helped smooth the profile of our external debt coming due. To prepare the

ground for a return to the international market, we will publish our medium-term debt management strategy. Consistent with our medium term debt strategy, we will maintain an adequate deposit buffer in our treasury single account. To the extent a surplus of funds emerges, we will use it to repurchase outstanding government debt, beginning with non marketable issues (e.g., the CBI recapitalization bonds).

Strengthening the policy framework

24. **A stronger institutional framework will support the achievement of our program objectives**. To date we have focused on rectifying the key financial sector regulation and supervision shortcomings that contributed to the crisis. We have also addressed issues with our fiscal-framework, to support our fiscal consolidation objective. Over the course of the coming year we plan to identify ways to strengthen our monetary policy framework to better secure our objective to deliver low and stable inflation, and a stable financial system.

25. **Reforms to banking regulation and supervision are on track:**

- *FME*. Following the recent amendments to the banking law, the FME has introduced organizational reforms to enhance on-site inspection and off-site supervision. Looking forward, the FME will articulate an action plan to operationalize its registry of large exposures by end-June 2011; and by December 2011, the number of staff in the areas of risk assessment, forensic accounting, and information technology will be brought into line with numbers in peer advanced countries. The FME will also take a more proactive role in the oversight of financial products, and will require banks to strengthen their approval policy for new products

- *Bank resolution procedures and prudential requirements.* The recent amendments to the banking law did not address all framework issues, and in any event the upcoming Basel capital and liquidity requirements may require further revisions. We intend a two-part approach to deal with remaining issues. By end-February 2011, we plan to submit legislation to parliament to tackle the resolution framework for banks, and to address the respective powers of the FME and CBI to supervise and regulate the financial system. We remain committed to a new Basel Core Principles assessment in March 2011. This and any revised EU directives on capital and liquidity requirements will form the basis for further revisions during the second quarter of 2011.

- *Deposit insurance and phase out of blanket deposit guarantee.* We now expect that the draft bill of law harmonizing the deposit guarantee regime with the relevant EU directives will be passed by end-September 2010. The blanket guarantee will remain in place when the law becomes effective. As the financial system strengthens, we will gradually phase out this blanket deposit guarantee. To help define a timetable, the CBI and the FME will jointly prepare a report for the Minister of Economic Affairs on the resilience of the banking system, and undertake a survey of public confidence and market belief in the strength of financial institutions and prudential regulation and supervision.

26. **Public financial management reforms are also on track:**

- *Budget framework.* We have been implementing the various reforms adopted in mid-2009, in particular, the two-stage budget approval process, the creation of an adequate budget contingency, and limits on and closer scrutiny of carryovers. Looking forward, the 2011 budget will continue these practices, and establish binding two-year nominal ceilings, a crucial reform to help guide consolidation efforts. We are also committed to reduce the earmarking of revenues.

- *Framework for local governments (a structural benchmark for end-December)*. We are on track to propose amendments to the Local Government Act and complete the reform in time for fiscal year 2011. Two key fiscal rules embedded in the framework will be: (i) a zero-balance fiscal rule requiring corrective measures if a local government is in breach; and (ii) a ceiling on the ratio of local government debt and commitments to tax revenues.

External Financing

27. **Our ability to fully implement the program described above remains dependent on access to adequate external financing**. This financing will help us smoothly manage our external debt rollover during 2011–12, and contribute to confidence during the gradual capital account liberalization process. We have already fully drawn on available tranches from our bilateral partners, and have obtained significant additional resources through the Avens transaction. We intend to draw remaining amounts of committed financing, as financing gaps require. Progress in covering our financing need will continue to be assessed during quarterly program reviews. In the event of any shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertaking in paragraph 4 above).

28. **We expect to meet the preconditions of some of our bilateral partners to access bilateral program financing.** In particular, we remain committed to finalizing arrangements for the reimbursement of the governments of the United Kingdom and the Netherlands for amounts expended to settle retail deposits in the fallen banks. In this regard, we here reiterate the undertaking contained in our Letter of Intent dated 15 November 2008 and our Letter of Intent of 7 April 2010, to ensure that the United Kingdom and the Netherlands will be reimbursed in respect of deposits of Landsbanki branches in those two countries (up to the Euro 20,887 minimum provided for under Icelandic Law and the EU Deposit Guarantee Directive 90/19/EC); and will receive the reasonable time value of money, provided that comprehensive agreements are reached. Discussions on this topic have taken place since the Second Review (and drafts of the legal documents have been exchanged and discussed).

While a number of issues remain outstanding we remain committed to bringing those arrangements to a close.

Very truly yours,

/s/
Jóhanna Sigurðardóttir
Prime Minister

/s/
Steingrímur J. Sigfússon
Minister of Finance

/s/
Már Guðmundsson
Governor of the Central Bank of Iceland

/s/
Árni Páll Árnason
Minister of Economic Affairs

Iceland Quantitative Performance Criteria and Indicative Targets 1/

	Performance Criteria								Indicative Target	
	Oct 09 Prog.	Oct 09 Actual	Dec 09 Prog.	Dec 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Ceiling/Floor	Dec 10 Ceiling/Floor	Mar 11 Ceiling/Floor	Jun 11 Ceiling/Floor
									(In billions of Króna)	
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-41.0	-140	-150	-40	-80
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 3/	20	34	42.6	30.3	65	16.3	40	40	20	20
3. Ceiling on the change in the net domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	19.5	80	80	70	70
									(In millions of U.S. dollars)	
5. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	-580	-210	-250
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 5/	3500	54.5	3500	486.6	2500	0	2500	2500	2000	2000
7. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	750	700	700
8. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors 6/	0	0	0	0	0	0	0	0	0	0

1/ Cumulatively from the beginning of each year (unless otherwise indicated).
2/ The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks.
3/ Excluding changes due to central bank recapitalization bond.
4/ (-) indicates decrease. NIR is defined as the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI; from September 2010, the definition excludes foreign currency deposits of the general government at the CBI, as specified in the TMU. NIR adjuster is specified in the TMU.
5/ Excludes IMF and excludes official bilateral loans for deposit insurance. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.
6/ Applies on a continuous basis.

Table 2. Structural Conditionality

Structural Conditionality	Status
Structural Benchmarks	
• Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶26). *By end-2010.*	
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶7). *By end-May 2010.*	Not met 1/
• The FME to require rehabilitation and/or recapitalization measures to be taken by non bank financial institutions and the Housing Finance Fund, as determined to be necessary by a review of their business plans (LOI ¶9). *By end-August 2010.*	Not met 1/
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses (LOI ¶25). *By end-March 2011.*	
• Passage of legislation to strengthen the framework for household debt restructuring, addressing (i) access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) eligibility; and (iii) incentives for financial institutions and debtors to expedite voluntary restructuring agreements (LOI ¶18). *By end-June 2010.*	Met
New Structural Benchmarks	
• A decision by the FME on commercial banks' plans to meet capital requirements as defined in the Letter of Intent (LOI ¶7). *By November 15, 2010.*	
• Submission of a supplementary budget to parliament requesting authorization to issue sufficient bonds to cover recapitalization needs of the banking system if losses on all probably affected and possibly affected loans are realized (LOI ¶7). *By October 15 2010.*	

1/ Delayed because of SC ruling

TECHNICAL MEMORANDUM OF UNDERSTANDING

29. This memorandum sets out the understandings between the Icelandic authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria, as well as respective reporting requirements for the Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2.

30. The exchange rate for the purposes of the program is set at 113.9 Icelandic króna per U.S. dollar. The corresponding cross exchange rates are provided in Table 3.

Central Government

31. **Definition:** For the purposes of the program, the government includes the central government, which includes government entities of group "A" as defined in the Government Financial Reporting Act No.88/1997.

32. **Supporting material:** The Ministry of Finance (MoF) will provide to the IMF detailed information on monthly revenues and expenditures both on a cash and accrual basis, domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the central government at the central bank of Iceland, all other sources of financing including capital transactions, and arrears of the central government. Data will be provided within 30 days.

Quantitative Performance Criteria, Indicative Targets, and Continuous Performance Criteria: Definitions and Reporting Standards

A. Floor on the Cumulative Net Financial Balance of the Central Government

33. **Definition**: The net financial balance of the central government will be measured from the financing side at current exchange rates, and will be defined after contributions to the government employee's pension fund. The net financial balance will be defined as the negative of the sum of (i) net domestic financing and (ii) net external financing.

- **Net domestic financing** (NDF) is defined as the change in the stock of the net domestic debt of the central government. Domestic central government debt consists of ISK-denominated debt financed by the banking system (the Central Bank of Iceland (CBI) and commercial banks) and non-bank financial institutions to the central government. It consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears, and loans and advances to the central government by the commercial banks, including any interest arrears. Net domestic central government debt is calculated as the gross debt plus proceeds from the sale of financial assets (including, but not limited to, government, government-backed, or other bonds obtained during the central bank recapitalization process, and as a result of failed securities lending) or proceeds from privatization, minus ISK-denominated government deposits with the central bank of Iceland and commercial banks. ISK-denominated government deposits at the central bank of Iceland include the deposits in the treasury current account, government institution current accounts and other time deposits. Domestic debt will be valued at the nominal price for T-notes. For T-bonds and other loans, both of which are indexed, the nominal value of the debt will be adjusted by the consumer price inflation.

- **Net external financing** is defined as the total of foreign currency denominated financing disbursed to the central government minus the net accumulation of foreign currency deposits at the CBI and at commercial banks, plus accrued interest from the Icesave-related debt, net change in external arrears, minus amortization paid. Amortization includes all external debt-related payments of principal by the central government. Disbursements and amortization will be valued at the exchange rate at the time of the transaction. Net accumulation of foreign currency deposits is defined as the sum of daily change in the stock of foreign currency deposits at the CBI and at commercial banks in foreign currency, valued at the current daily exchange rate. Accrued interest on Icesave-related debt will be calculated based on the average monthly value of the outstanding stock of Icesave-related debt. The stock of outstanding Icesave-related debt will be calculated as sum of the outstanding loans and the accrued interest from the previous period minus the amount paid out from recovered assets. The stock of Icesave-related debt will be calculated in the currency of the loan agreements (sterling and euro). Accrued interest will be converted to krona at the current (monthly average) exchange rate.

- **Adjustments**: For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring and central bank recapitalization. It will; however, include the accrued interest on inflation indexed debts related to central bank and bank recapitalization. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8, 2008 to October 8, 2009.

34. **Supporting Material**:

- Data on domestic bank and nonbank financing will be provided to the IMF by the Central Bank of Iceland and the Financial Management Department of the MoF within three weeks after the end of the month. This will include data on redemptions of domestic central government liabilities and data on the cash balances in domestic currency of the MoF at the Central Bank of Iceland and in commercial banks.

- Data on net external financing (disbursement, net change in external arrears and amortization) as well as other external borrowing will be provided to the IMF monthly by the Financial Management Unit at the MoF within three weeks of the end of each month. Data on the fx cash balances of the MoF at the Central Bank of Iceland and in commercial banks will be reported daily.

B. Floor on the Net International Reserves of the Central Bank of Iceland

35. **Definition:** Net international reserves (NIR) of the Central Bank of Iceland (CBI) are defined as the U.S. dollar value of gross foreign assets minus foreign liabilities of the CBI.

- **Gross foreign assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the CBI's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.

- **Gross foreign liabilities** are defined consistently with SDDS as all fx liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding and SDR allocation from the Fund. Foreign currency deposits and other liabilities of financial institutions (both active and in the process of winding up) will be included in gross foreign liabilities. General government fx liabilities at the CBI will not be included in gross foreign liabilities.

- **For program monitoring purposes**, the stock of foreign assets and foreign liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to $634 million as of December 31, 2009 (at the program exchange rate).

36. **Adjustment mechanism:**

- The NIR floor will be adjusted downward at the program exchange rate by the amount of Nordic disbursements relative to the technical assumption below. For every one dollar of disbursements, the NIR floor for each period will be adjusted downwards by 0.5 dollars. Nordic disbursements are defined as external disbursements from Denmark, Finland and Sweden to the Government of Iceland, and from Norway to the CBI

- For each period, the NIR floor will be adjusted up to an amount specified in the table below. The Figures indicate a cap on the cumulative use of NIR.

NIR Adjustment

Cumulative flows from End-December 2009	In millions of US dollars at program exchange rate	Adjustment per one dollar of additional Nordic disbursements
Nordic Disbursements (technical assumption for the adjuster purpose)		
End-September 2010	0	-0.50
End-December 2010	0	-0.50
NIR cap		
End-September 2010	-750	
End-December 2010	-880	

37. **Supporting material:** Data on net international reserves (both at actual and program exchange rates) and on net foreign financing (balance of payments support loans; cash grants to the consolidated government; amortization (excluding repayments to the IMF); interest payments on external debt by the MoF and the CBI) will be provided to the IMF in a table on the CBI's fx flows (which include details of inflows, outflows, and net international reserves) on a monthly basis within two weeks following the end of the month. Flows of net international reserves will be provided on a daily basis.

C. Ceiling on Net Domestic Assets

38. **Definition:** Net domestic assets of the CBI are defined as the sum of net credit to the government, net credit to the private sector and other items net.

- **Net credit to the central government** is defined in criteria D.

- **Net credit to the private sector** is defined as the difference between credit to the private sector and liabilities of the private sector to the CBI. Credit to the private sector is defined as the sum of CBI lending to banks and other financial institutions (through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector) and other assets. Liabilities of the private sector to the CBI is defined as the sum of current account balances of the banks and other financial institutions at the CBI, central bank CDs in issuance and other liabilities.

- **Other items net** are defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.

39. **Supporting material**: The CBI will provide to the IMF with data on net credit to the government and net credit to the private sector. Data on central bank lending to banks and other financial institutions through its overnight and weekly collateral facilities, any other instruments to which the CBI would extend credit to the private sector, current account balances of the banks at the CBI, and central bank CDs in issuance, on a daily basis. The CBI will provide the net domestic assets data based on the monthly balance sheets on the monthly basis within two weeks following the end of the month.

D. Ceiling on Net Credit of the Central Bank of Iceland to the Central Government (Indicative Target)

40. **Definition**. Net credit of the CBI to the central government is defined as the difference between CBI lending to the central government and central government deposits at the CBI in domestic currency.

- **Deposits of the central government** at the CBI in domestic currency include the sum of deposits in the treasury current account, government institution current accounts and other time deposits.
- **Adjustment**. For the purpose of the program, the net credit of the CBI to the central government will exclude any debt issuance for the purposes of recapitalizing the CBI.
- **Supporting material**: The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis with a lag of no more than 10 days.

E. Ceiling on Contracting or Guaranteeing of New Medium and Long Term External Debt by Central Government

41. **Definition:** The performance criterion covers public and publicly guaranteed external debt in foreign currency with an original maturity of more than one year. Debt falling within the limit shall be valued in U.S. dollars at the time the contract or guarantee becomes effective.

The term “debt” will be understood to mean a liability created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows.

- **Loans**. That is, advances of money to an obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers’ credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements).

- **Suppliers' credits**. That is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided.

- **Leases**. That is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the leaser retains the title to the property. For the purpose of the program, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.

- **Arrears, penalties, and judicially awarded damages** arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt."

- **Adjustments**. (i) Previously contracted debt that has been rescheduled will be excluded from the definition of "new debt" for the purposes of this performance criterion; (ii) excluded from the limits are purchases from the IMF Stand-By Arrangement and bilateral official loans extended and earmarked for payments on foreign deposit guarantees; (iii) changes in the stock of nonresident holding of medium and long-term debt in krona will also be excluded from definition of new debt; and (iv) arrears arising from intervened banks will be excluded.

42. **Supporting material:** Details of all new commitments and government guarantees for external borrowing, with detailed explanations, will be provided by the MoF to the IMF on a monthly basis within two weeks of the end of each month. Data will be provided using the actual exchange rates in effect at the time of contract or guarantee.

F. Ceiling on the Stock of Central Government Short-Term External Debt

43. **Definition:** The limit on short-term external debt applies on a continuous basis to the stock of short-term external debt in foreign currency owed or guaranteed by the central government of Iceland, with an original maturity of up to and including one year. It applies to debt as defined in paragraph 10 above. Excluded from the limit are any rescheduling operations (including the deferral of interest on commercial debt) and nonresident holding of short-term debt in krona. Debt falling within the limit shall be valued in U.S. dollars at the time the contract or guarantee becomes effective.

44. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after October 20, 2008, and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements. Data will be provided on a monthly basis with a lag of no more than 20 days.

G. Reporting Requirement for Financial Institutions in the Winding-up Process

45. The CBI will provide to the IMF data reports from all financial institutions in the winding-up process on a quarterly basis. The reports will be in the format according to the CBI reporting template agreed with the IMF. The required data will allow the CBI and the IMF to track asset recovery and payout to creditors against their claims for both domestic and external assets and the cross-border movement of the proceeds.

Table 3. Program Exchange Rates

Icelandic króna per U.S. dollar	Icelandic króna per euro	Icelandic króna per pound
113.9	150.5	193.6