International Monetary Fund

Iceland and the IMF

Press Release:
IMF Completes Fifth Review Under the Stand-By Arrangement for Iceland
June 3, 2011

Country's Policy Intentions Documents

Iceland: Letter of Intent, and Technical Memorandum of Understanding

May 19, 2011

Letter of Intent

Reykjavik, May 19, 2011

Mr. John Lipsky
The Acting Managing Director
International Monetary Fund
Washington, DC 20431
USA

Dear Mr. Lipsky:

1. **The Icelandic economy is gradually recovering**. Our policies have laid the basis for this recovery: domestic demand has started growing, inflation is low, and the trade balance remains strong. The krona has remained broadly stable. A key challenge for the coming year is to reduce the still-high level of unemployment.

2. **Our policy implementation remains broadly on track**. All end-March performance criteria, and the end-February structural benchmark on the FME requiring rehabilitation and/or recapitalization measures to be taken by non-bank financial institutions, have been met. Other structural benchmarks for this review have been delayed, although we have made significant progress on them. In particular, the cabinet approved in March a revised strategy for lifting capital controls and the Basel Core Principles assessment of weaknesses in the supervisory framework was completed in mid-April. The main problems in the former savings banks are being addressed by merging SpKef with a commercial bank (completed in March) and the restructuring of new Byr (which is still ongoing). The benchmark on the Icelandic State Financial Investment Company—a two-year strategic plan for savings banks—will not be met. However, the underlying objective of this benchmark is largely achieved by the SpKef merger and plans to present by end-May a strategy for the reorganization of the remaining savings banks. The status of all program measures is summarized in Tables 1 and 2.

3. **On this basis, and on the basis of the policies defined in this letter, we request completion of the fifth review under the Stand-By Arrangement**. As set out in Table 1, we request that quantitative performance criteria be modified for June 30, 2011. As detailed below, we propose that the structural benchmark on passage of the legislation to strengthen the fiscal framework for local government be reset to end-June 2011 (Table 2). In light of the modest delay in completing the fifth review, we also propose a rephasing of access to combine the seventh and eighth purchases into one tranche to be drawn upon completion of one final review, which we expect to be completed after July 14, 2011.

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. **We expect positive growth in 2011 for the first time since the crisis**.

- We expect the recovery in investment and private consumption to turn GDP growth positive in 2011. Unemployment is set to decline. But risks to the projected 2¼ percent growth are tilted to the downside. Prospects for investment are still uncertain, while still high unemployment and the need to restore balance sheets continue to weigh on private consumption.

- Headline inflation is slightly above the central bank's target (2½ percent), and we expect it to rise temporarily to just above 3 percent later this year due to the recent increases in petrol and commodity prices. The still significant slack in the economy and broadly stable exchange rate are expected to ensure that inflation returns to target in mid-2012. Risks to the inflation outlook emanate mainly from possible wage increases in export sectors spreading to non-tradables sectors and the rise in inflation expectations. To mitigate these risks, the government held discussions with social partners that culminated in a 3-year wage agreement signed in early May. Additional risks arise from fluctuations in the value of the krona and import prices.

- We believe that the balance of payments outlook is sufficiently strong to support a gradual lifting of capital controls. The current account surplus, the planned resumption of sovereign external borrowing, the realization of program financing, and disbursements from bilateral partners are expected to further increase reserves to about $6.2 billion at end-2011, or around 70 percent of short-term external debt. This will create scope to take some initial steps toward the gradual lifting of capital controls and offset payments to external creditors of the old banks. As steps towards the liberalization of capital controls could place the external position under pressure, the liberalization will be managed cautiously (paragraph 13).

6. **Both public and external debt ratios are expected to decline rapidly**. Gross external debt is projected to amount to about 240 percent of GDP in 2011, but we project that debt repayments, the release of captive non-resident krona holdings in line with our capital account liberalization strategy, and ongoing asset recovery will reduce this to around 150 percent of GDP by 2016. We expect general government debt to peak at 100 percent of GDP in 2011 before declining over the medium term, reaching 71 percent of GDP in 2016.

Policy overview

7. **Our policies are aimed at achieving a sustainable recovery**. We have made significant progress in stabilizing the economy and the exchange rate, and in bringing down

inflation, and our policies seek to build on these successes. In this regard, we expect to achieve a key fiscal milestone—a primary surplus—in 2011, which keeps our public finances on a sustainable path. The health of our banking system is gradually being restored, and the recently adopted measures to accelerate household and corporate debt restructuring should reduce the private sector debt overhang and improve bank balance sheets. While the unemployment rate remains high, it is our expectation that the measures we have put in place to facilitate job retraining and skill upgrading will help spur job creation this year. Looking ahead, our overarching policy challenge will be to lift the capital controls in an orderly manner that preserves the stabilization gains that we have achieved. To this end, we have published a revised strategy for the liberalization of capital controls. We are confident that the policies set out in this letter will lay the basis for a durable recovery.

Securing fiscal sustainability

8. **Our consolidation efforts delivered an improved primary fiscal position in 2010**. Revenues in 2010 exceeded expectations due to a pick-up in corporate and capital income tax revenues while central government expenditures remained within budgeted amounts. Despite preliminary data suggesting slippages in the local governments' fiscal performance, the general government overall balance improved by ¼ percent of GDP relative to the program, while the primary deficit reached 2½ percent of GDP (an improvement of 4 percentage points of GDP relative to 2009).

9. **We are committed to meeting our 2011 fiscal targets**. Our revenue projections for 2011 remain cautious in view of the fall in property prices and declines in nontax revenues that are putting downward pressure on local government revenues. Budget implementation has remained in line with expectations in the first quarter. However, our efforts to facilitate a long-term wage agreement among our social partners will lead to higher expenditures, which could amount to as much as ½ percent of GDP in 2011. This additional spending will be partly offset by higher government revenues arising from higher-than-expected wages. The remainder of the spending can be accommodated through our contingency fund, which is intended to meet unexpected outlays, such as those arising from price and wage fluctuations. Moreover, we are introducing a special levy on financial institutions to finance the temporary interest subsidy. Thus, we expect that the 2011 general government primary surplus will remain within the targeted ¼ percent of GDP and improve by 2¾ percent of GDP relative to 2010.

10. **We are revising our medium-term fiscal consolidation plan.** Given the evolution of the macroeconomy and the progress in putting our public finances on a sustainable path, we intend to update our medium-term plan in the coming weeks. In this context, we maintain our commitment to achieving an overall surplus in 2013, although we see scope to ease the pace of consolidation to accommodate higher spending on social protection and investment.

11. **We are strengthening the fiscal framework and finances of local governments**. With revenues declining, local governments plan to curtail costs in 2011 to keep primary fiscal positions near balance. Measures focus on reducing overhead and administrative costs, and better targeting social benefits. The comprehensive legislation on local government was presented to parliament in early April 2011, after extensive consultations. We will seek parliamentary approval of the new fiscal framework by end-June (**structural benchmark**). This will allow sufficient time for its implementation by the local governments in the 2012 budget cycle. The working group tasked with assessing the near-term external debt repayment capacity of the local governments has delivered its report and has been charged with a broader mandate to evaluate local governments' debt rollover difficulties. We will remain vigilant in monitoring the financial situation of the local governments, and will introduce a new quarterly data compilation system administered by Statistics Iceland by end-June.

12. **We do not envisage major changes to our medium-term debt management strategy**. The strategy was published in February, and its positive reception by market participants bodes well for implementing our 2011 annual borrowing plan. We achieved our funding objectives in the first quarter: the maturity profile of our debt portfolio has been extended with the successful issuance of a 20-year nominal bond. In line with the revised strategy for lifting capital controls (see below), we intend to issue a new 20-year inflation-linked bond that will help secure robust long-term funding in advance of the full lifting of capital controls. We still plan to access international capital markets in the coming months, but our plans have been somewhat delayed by the uncertainty regarding the impact of the outcome of the Icesave referendum on our sovereign rating. To the extent that the external environment is favorable, we may scale up our external borrowing over the medium term.

Capital controls

13. **We have revised our strategy for lifting capital controls**. The revised strategy was prepared by the CBI in coordination with key government ministries and the FME, and was approved by cabinet in late March (**structural benchmark**). Our legal experts have determined that the strategy is consistent with our EEA obligations.

14. **The revised strategy seeks to first address the challenge posed by the large stock of "offshore" krona.** The large amount of (mainly short-term) krona-denominated deposits and securities held by nonresidents (ISK 460 billion, about 30 percent of GDP, and 2/3 of gross reserves) and the large spread between the offshore and onshore exchange rates both undermine the confidence needed to ease controls. Our strategy aims to address these challenges by reducing the stock of potentially unstable "offshore" krona and replacing it with longer-term investment. Once the stock of offshore krona holdings has been sufficiently reduced we will proceed to a gradual, but eventually comprehensive, lifting of capital controls.

15. **The liberalization will take place in two phases and use a variety of methods.**

- The first phase will employ several market-based mechanisms to reduce the stock of "offshore" krona holdings by allowing those who do not wish to maintain their krona exposure to exit. In the first steps, offshore krona holders will be permitted to bid for foreign currency in CBI-organized auctions, while holders of foreign currency would be permitted to bid for krona to be invested in long-term government securities or other qualified investment projects. Later, we will broaden the range of investments available to offshore krona holders and may offer to swap krona-denominated government securities for long-term foreign exchange-denominated bonds. We have designed these steps to contain the impact on international reserves, safeguard government financing, and preserve exchange rate stability, while reducing the stock of short-term external debt.

- We recognize, however, that new inflows may not be available to finance the release of all offshore krona holdings and that central bank reserves may need to eventually be used. Thus, the strategy also envisages that, after reserve-neutral methods have been exhausted, some offshore krona would be allowed to exit after paying an exit levy.

- In the second phase, controls on onshore krona will be gradually lifted as warranted by the adequacy of the reserves and financial and exchange rate stability.

16. **The strategy maintains a gradual approach to capital account liberalization, and retains the flexibility needed to respond to developments during the liberalization process**. Our communication strategy has been carefully coordinated by the CBI and key ministries to guide investors' expectations for a gradual and orderly lifting of capital controls.

- In order to protect macroeconomic and financial stability, the pace of implementation of the strategy will be guided by macroeconomic developments, reserve adequacy, and the robustness of the financial sector. In this regard, whereas progress has been made in meeting macroeconomic preconditions for lifting controls, particular attention will be paid to the financial sector, which is still vulnerable and has limited capacity to withstand possible volatility in capital flows if controls where not in place.

- A comprehensive assessment of reserves and the medium-term balance of payments outlook will precede each major step toward liberalization to ensure that reserve adequacy will be maintained. Similarly, assessments will be undertaken with respect to the government bond market and financial sector stability (for instance, bank liquidity). Successful issuance of a long term sovereign bond in international markets would provide an important signal of investor confidence and will precede any liberalization steps that might result in significant outflows. To the extent that access to international capital markets is delayed, the lifting of capital controls will proceed more slowly and steps that are conditioned on market access will be delayed.

- A working group which includes the PMO, MoEA, the MoF, the FME and the CBI will monitor the implementation, pace, and adaptation of the strategy. Given the flexibility inherent in the strategy, we will consult with the Fund before taking each major step in liberalization process—including the steps involving the introduction of a new method of liberalization, such as the exit levy, and before beginning the release of onshore krona holdings—consistent with our undertakings in paragraph 4 of this letter.

17. **Throughout the liberalization process, the remaining controls will continue to be enforced**. We are in the process of amending our legislation on capital controls, taking into account the experience gained so far and the prospect for gradual liberalization. In addition, the repatriation requirement and the restriction on the use of krona in international transactions will remain in effect. Should circumvention arise, we will close any loopholes as needed. To this end, we will ensure that administrative capacity in the CBI and the police are sufficient to administer, monitor, and enforce controls which need to be maintained during the liberalization. Ongoing investigations of possible circumvention will be brought to closure and swiftly forwarded to the courts.

Monetary policy

18. **Our monetary policy will remain focused on inflation and preserving exchange rate stability**. The Monetary Policy Committee has removed the bias in monetary policy and kept rates on hold in its last two meetings. The uptick in inflation from rising commodity prices, higher inflation expectations, the somewhat weaker krona, and the forthcoming steps toward lifting capital controls underpinned this decision.

19. **We intend to further improve our liquidity management**. Ample liquidity and market fragmentation have kept short-term interest rates towards the lower-end of our policy corridor. Measures taken recently, notably the increase in the stock of CDs, had some success in moving market rates towards the center of the corridor, but their impact was short-lived. We will in the coming months endeavor to implement liquidity management more consistently, notably by improving management of the stock of CDs, strengthening our liquidity forecasting capabilities, and, if needed, engaging in high frequency fine-tuning operations. This should help keep interbank rates around the center of the policy corridor. Going forward, liquidity management will have to be strengthened as capital controls are liberalized. The first steps in the liberalization will drain some excess liquidity from the (currently highly liquid) banking system, increasing the need for liquidity management. To this end, we have undertaken a further evaluation of the availability and distribution of eligible collateral.

20. **We will continue to purchase foreign exchange to increase the CBI's non-borrowed reserves**. The large year-end foreign exchange operations undertaken to reduce commercial banks foreign exchange imbalances (€312 million purchased forward and €160 million spot) have helped accelerate this process. To ensure that reserves remain sufficient to ensure confidence in the krona during the process of lifting capital controls, we will closely monitor reserve adequacy using a range of indicators and periodic stress scenarios. When conditions permit, weekly purchase operations will be scaled up to help meet this goal.

21. **We are beginning to develop a new monetary policy framework**. The financial crisis has exposed the difficulties of implementing monetary policy in a small open economy like Iceland that is subject to large shocks and volatile capital flows. We believe that a new monetary framework must better take into account underlying imbalances in financial markets and their potential impact on the real economy without undermining the medium term commitment to low and stable inflation. Because of risks to financial stability, a strategic foreign exchange intervention and reserve management policy aimed at leaning against excessive swings in capital flows will be required. We also intend to deploy macroprudential tools to reduce the risks of a repeat of the pre-crisis excesses, and would seek to achieve better coordination of monetary and fiscal policies. The CBI has produced a report laying out some options. We are still at an early stage and are consulting with stakeholders to assess the relative merits of different monetary regimes.

Restoring the financial system

22. **Iceland's commercial banks remain well-capitalized, and we are in the process of bringing the rest of the financial system back into solvency**. Work is underway in several areas:

- ***Review of capital levels of the commercial banks***. The FME is currently reviewing the commercial banks' Internal Capital Adequacy Assessment Process (ICAAP). This review is supported by an ongoing special examination of the banks' loan portfolio with a forward looking view. If the FME were to find material discrepancies with the banks' asset valuation, it will promptly take action to determine the size of the potential overvaluation and the impact on bank capital. The situation of one small troubled commercial bank has been clarified and addressed with the participation of a group of private investors, and without the use of public funds.

- ***Wrapping up the recapitalization process of the savings banks*** (**structural benchmark**). The savings bank SpKef was intervened in early March and merged with a commercial bank, and we are preparing to inject funds to meet our obligations under the blanket guarantee. The agreement reached in October with the Winding-up Board of Byr savings bank on the restructuring of new Byr is being implemented: the recapitalization of new Byr is expected to be completed shortly once its 2010 financial statements have been finalized.

- ***Restoring the solvency of the Housing Finance Fund (HFF)***. We have injected funds equivalent to around 2 percent of GDP in order to increase the capital of the HFF towards the regulatory minimum of 5 percent. Furthermore, by end-June we will introduce legislation to put the HFF under full supervisory oversight by the FME. Finally, by end-September, we will publish a policy on the future structure of the HFF within the framework of a restored financial system.

- ***Recapitalizing remaining non-banks is near completion***. All credit card management companies and all leasing companies were adequately capitalized by end-April (**structural benchmark**). A decision as to whether, and if so to what extent, to recapitalize Byggdastofnun (a small regional fund) will be made on the basis of the recommendations of a working group, which will be presented in May.

23. **We continue to make progress in strengthening prudential rules and supervision**. Advances are being made on several fronts:

- ***Prudential rules***. Revised rules on connected lending have already been issued, and by end-June new prudential rules and guidelines on large exposures and sound banking practices will be issued by the FME, addressing key weaknesses leading to the crisis. By end-June 2011, the FME and the CBI, respectively, will prepare plans to strengthen their rules on capital and liquidity requirements in line with preparations for the eventual adoption of Basel III standards. Additionally, the FME is currently developing a new set of rules covering other banking services and ancillary activities, effects on capital requirements of the collateralization of bank shares and qualifications of board members and CEOs of financial undertakings. These will be made public by end-July 2011.

- ***Credit registry***. The FME, in collaboration with the CBI, is developing a data base to closely monitor exposures above ISK 300 million per borrower per bank. This registry—which is expected to be operating by end-July 2011—will allow the supervisory authority to identify credit concentration and large exposures of banks' related and non-related economic groups.

- ***Harmonization of bank reporting***. In February the FME completed its examination of the consistency and fairness of existing accounting practices related to income and impairment recognition on loans acquired at fair value by the new banks from the old banks. By mid-June 2011, the FME, drawing heavily on the work done by a technical committee comprising its staff and industry representatives, will issue guidelines to harmonize financial reporting on non performing loans and progress in debt restructuring and facilitate the comparison and understanding of the banks' financial statements.

- ***Identification of remaining supervisory gaps***. In mid-March the FME completed a self-assessment of the country's compliance with the Basel Core Principles for Effective Banking Supervision. This assessment was subjected to an independent evaluation by a well-known foreign assessor, who issued his report (containing recommendations and a possible agenda) in mid-April (**structural benchmark**). By end-June, the FME will have issued an action plan (including a clear timetable for deliverables over the following 24 months) to address remaining supervisory gaps.

24. **Operational restructuring of the savings banks is advancing**. With the merger of SpKef, 50 percent of the savings banks system by assets has been addressed. For the remaining savings banks the Icelandic State Financial Investments (ISFI) is cooperating with the privately held savings banks to develop proposals for further operational restructuring, including consolidation, to strengthen their medium-term viability. A working group with representatives of all savings banks, led by the ISFI, has been commissioned to develop proposals on the reorganization/restructuring of the remaining savings banks. This working group will submit its proposals to the boards of the savings banks and the ISFI by end-May. Depending on the decisions of the boards, these proposals would subsequently be presented to the guarantee capital holders, including the ISFI. These proposals, together with the SpKef merger, meet the objective of the end-March **structural benchmark** on a two-year strategic plan for the savings banks' restructuring and consolidation.

25. **We are reviewing the existing banking legislation and laws governing the FME and CBI as part of our further financial reforms.** Many improvements have been made to the legal and regulatory environment since the crisis of 2008, in line with recommendations by an external adviser and evolving developments in the EU. A revised Act on the deposit guarantee scheme will reestablish the private guarantee fund—we have introduced a legislative proposal to parliament that meets international best practices and core principles for effective deposit guarantee systems, notably regarding contributions, coverage and pay-out. The goal of this legislation is to help restore confidence in the banking system and pave the way towards the orderly and gradual lifting of the blanket guarantee on deposits. Further changes are envisaged. We will continue to focus our attention on current and future developments on banking regulation within EU, especially regarding the adoption of Basel III, the coordination of micro- and macro-prudential supervision and supervisory tools. A working group comprised of specialists in this field, will prepare a report—drawing on the experience in the EU and other financial centers as well as recommendations made by the international expert assessing country's compliance with Basel Core Principles for Effective Banking Supervision—to be presented to Parliament by the Ministry of Economic Affairs. On the basis of this report and consultations with stakeholders and the IMF, we plan to submit legislative proposals to the Parliament during its next session. The legislation will, inter alia, substantially reduce the threshold for reporting exposures to the credit registry in order to ensure more comprehensive coverage of the registry.

Accelerating private sector debt restructuring

26. **We are implementing measures for corporate and household debt restructuring**. We continue to attach high priority to accelerating private sector debt restructuring, as we believe that this will be critical to a sustainable recovery and job creation. The measures that we agreed with key stakeholders in December and January preserve scarce fiscal resources while imposing a manageable cost on creditors. We do not intend to take further measures, and have clearly communicated this to the public in an effort to advance the process. We are working with the FME and financial institutions to compile aggregate data to monitor progress with household and corporate debt restructuring.

- ***Corporate debt restructuring***. Restructuring of small- and medium-size enterprises (SMEs) and large corporates is advancing, but at a slower pace than we had expected. For SMEs, the agreed measures—consisting of a standardized approach for writing down debt to the value of the firm—are being implemented, but it is taking banks somewhat longer to prepare debt restructuring proposals for firms. The three commercial banks expect that this process will be largely completed by end-2011. We have requested monthly reports to monitor progress in SME debt restructuring and will take steps to remove obstacles that may arise. For large corporates, the process is likely to take longer, as these cases tend to be more complex and require significant documentation before restructuring can take place.

- ***Household debt restructuring***. The measures for household debt restructuring, alongside our commitment not to take further measures, has encouraged households to enter the debt restructuring process. The Office of the Debtor's Ombudsman is now processing roughly 1500 applications for debt mitigation, and banks have reported an increased number of applications for debt restructuring. At the same time, the process has been held up somewhat by delays in recalculating foreign-currency indexed mortgages (in line with the Supreme Court rulings) and in obtaining for HFF the legal authority to provide debt writedowns. Nonetheless, the three commercial banks expect to complete the household debt restructuring process by end-2011.

External financing

27. **We have made progress in securing adequate external financing and boosting reserves**. Reserves increased substantially in the last quarter of 2010, and we expect them to increase further during 2011. Our Nordic bilateral partners are in the process of extending the availability of financing under their arrangements until end-December 2011, and we intend to draw on this funding as financing gaps require. Going forward, our foreign currency borrowing strategy will be aimed at securing regular access to international capital markets and to maintaining a diversified investor base. The planned issuance of an external bond in the coming months and further rollovers in 2012 are an important part of this strategy, and will further strengthen reserves coverage. Progress towards covering our external financing

needs will be reassessed during the next program review and throughout the capital account liberalization process. In the event of shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertakings under paragraph 4 above).

28. **We attach high importance to resolving the Icesave issue**. For this reason, and despite our view that reimbursement of the Icesave deposit payouts is not a sovereign obligation, we sought and reached a negotiated solution with the United Kingdom and the Netherlands. Legislation authorizing the Minister of Finance to provide the necessary state guarantees was passed by parliament in February, but rejected in a referendum in April. The process regarding the disputed deposit guarantees will now continue through legal channels. We are fully engaged in this process. On May 2, 2011 we responded to the EFTA Surveillance Authority's (ESA's) Letter of Formal Notice, recommending that ESA close the issue on the basis of that response. If, however, a competent court finds that Iceland has a sovereign obligation stemming from the Icesave deposits, we will honor that obligation.

Yours sincerely,

/s/
Jóhanna Sigurðardóttir
Prime Minister

/s/
Steingrímur Sigfússon
Minister of Finance

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

/s/
Árni Páll Árnason
Minister of Economic Affairs

Table 1. Iceland: Quantitative Performance Criteria and Indicative Targets 1/

	Performance Criteria												
	Oct. 09 Prog.	Oct. 09 Actual	Dec. 09 Prog.	Dec. 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Prog.	Sep 10 Actual	Dec 10 Prog.	Dec 10 Actual	Mar 11 Prog.	Mar 11 Actual	Jun 11 Prog.
												(In billions of Króna)	
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-48.4	-140	-82.9	-150	-121	-40	-11.9	-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	1.1	40	-15	35	-29	13.5
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	9.6	80	41.6	70	-14	70
													(In millions of U.S. dollars)
4. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	68	-580	812	-592	369	-460
5. 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	1486	2500	1486	2000	0	2500
6. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	22	750	22	700	0	700
7. 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	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, as well as the increase in central government debt due to on lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut road projects (the latter up to a maximum of ISK 6 billion).
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. Iceland: 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 ¶11). *By end-December 2010.*	Not met/Reset to end-June 2011
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶22). *By end-February 2011.*	Not met/SpKef was merged with a commercial bank. Byr's recapitalization is awaiting finalization of 2010 financial statements.
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses (LOI ¶23). *By end-March 2011.*	Not met/Assessment completed in mid-April 2011.
• Completion by Icelandic State Financial Investment Company of the two year strategic plan to ensure medium term viability of the savings banks through consolidation (LOI ¶24). *By end-March 2011.*	Not met/Plan for reorganization of remaining savings banks to be presented by end-May 2011.
• Cabinet approval of the updated strategy for lifting capital controls in line with program objectives (LOI ¶13). *By end-February 2011.*	Not met/Updated strategy approved by cabinet on March 25, 2011.
• The FME to require rehabilitation and/or recapitalization measures to be taken by non-bank financial institutions (other than the Housing Finance Fund) as determined to be necessary by a review of their business plans (LOI ¶22). *By end-February 2011.*	Met

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. 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.

2. 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

3. 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.

4. **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

5. **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.

6. **Adjustment mechanism**:

- 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.

- For the purposes of the program, the net financial balance will exclude central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut projects. Such adjustment should not exceed ISK 6 billion in 2011.

7. 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.

- Data on central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut projects will be provided to the IMF monthly by the MoF.

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

8. **Definition:** Net international reserves (NIR) of the Central Bank of Iceland (CBI) are defined as the U.S. dollar value of reserve assets minus reserve-related liabilities of the CBI.

- **Reserve 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.

- **Reserve-related** 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 reserve-related liabilities. General government fx liabilities at the CBI will not be included in reserve-related liabilities.

- **For program monitoring purposes**, the stock of reserve assets and reserve-related liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to $1,511 million as of December 31, 2010 (at the program exchange rate).

9. Adjustment mechanism:

- The NIR floor will be adjusted upward at the program exchange rate by the cumulative amount of Nordic disbursements since December 31, 2010. For every one dollar of disbursements, the NIR floor for each period will be adjusted upward 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.

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

10. **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.

- **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)

11. **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

12. **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.

13. 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

14. 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.

15. 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

16. 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