27 October 2015

Settlement of the failed financial institutions on the basis of stability conditions: impact on balance of payments and financial stability

According to the current draft composition proposals from Glitnir hf., Kaupthing hf., and LBI hf.

Introduction and main conclusions

On 12 March 2012, restrictions were placed on authorisations for distributions in Icelandic krónur from domestic insolvency estates and for payments to non-residents of contractual claims according to composition agreements (cf. the Act on Bankruptcy, etc., no. 21/1991). At the same time, restrictions were imposed on the authorisation of the failed financial institutions' estates to transfer foreign currency, which had enabled them to pay their creditors in foreign currency. Since spring 2012, the failed banks' estates have needed exemptions from the Foreign Exchange Act, no. 87/1992, in order to conclude their winding-up proceedings, either with composition agreements entailing foreign exchange transactions and cross-border capital transfers and/or with distributions to foreign creditors.

According to Article 13(o) of the Foreign Exchange Act, no. 87/1992, cf. Article 7 of the same Act, it is the Central Bank of Iceland that grants such exemptions. If an exemption requested for a financial undertaking in winding-up proceedings entails an authorisation to carry out foreign exchange transactions and cross-border capital transfers in an amount exceeding 25 b.kr. in a single year, or if an exemption requested for a legal entity whose balance sheet is over 400 b.kr. in size and could have a major impact on Iceland's debt position and could affect the ownership of the commercial banks, the Bank must consult with the Minister of Finance and Economic Affairs and the Minister must acquaint the Parliamentary Economic Affairs and Trade Committee with the economic impact of the exemption before it may be granted; cf. Article 13, Paragraph 2 of the Act.

The winding-up boards of the three largest failed commercial banks, Kaupthing hf., Glitnir hf., and LBI hf. (hereinafter referred to as the estates), have requested that the Central Bank of Iceland grant them exemptions from the Foreign Exchange Act in connection with the proposed composition agreements with their creditors and the conclusion of the winding-up proceedings for the companies; cf. Article 103(a) of the Act on Financial Undertakings, no. 161/2002. According to Article 7 of the Foreign Exchange Act, exemptions may only be granted from the restrictions provided for in the Act if it is ensured that monetary, exchange rate, and financial stability will not be jeopardised by the winding-up process. In order to ensure that the settlement of the estates does not cause instability, it is necessary to adopt countervailing measures in order to mitigate the adverse effects deriving from distributions of domestic assets to foreign creditors.

The report that follows contains the Central Bank of Iceland's assessment of the effect that winding up Kaupthing hf., Glitnir hf., and LBI hf. will have on monetary and exchange rate stability, on the one hand, and financial stability, on the other, on the basis of the estates' proposals for the conclusion of winding-up proceedings, with reference to stability conditions. The Bank has concluded that the drafts submitted satisfy the requirements set forth in the Foreign Exchange Act, in that the fulfilment of the composition agreements together with the proposed countervailing measures will not jeopardise monetary, exchange rate, or financial stability.

The estates' proposals include a number of countervailing measures that all but eliminate the likelihood of capital transfers that could cause instability. These measures entail the conversion of foreign currency deposits in operating financial institutions to medium-term loans, the prepayment of loans granted by the State and the Central Bank to Arion Bank hf. and Íslandsbanki hf. upon their establishment, and the payment of a stability contribution that, among other things, ensures that low-ranking assets on the estates' balance sheets do not cause balance of payments problems if they prove more valuable than originally estimated. A portion of the estates' current króna-denominated assets will be allocated to taxes, expenses, and reserves; therefore, they will not have any adverse effects on the balance of payments. Furthermore, the Central Bank of Iceland Asset Management Company's (ESÍ) foreign-denominated recoveries in connection with the settlement of the estates would also counteract the negative impact of the settlement on the balance of payments. In addition, the transfer of Glitnir hf.'s holding in Íslandsbanki hf. to the State would dramatically reduce the balance of payments risk connected with the sale of Íslandsbanki. Together with domestic assets already backed with foreign assets, this creates a counterweight to potential outflows from the estates' domestic assets in the amount of 856 b.kr. Excluding domestic assets backed with foreign assets, there remain current and planned mitigating measures equivalent to 807 b.kr. The planned mitigating measures alone total nearly 660 b.kr., assuming that Arion Bank hf. is sold at book value (see Table 1). In addition, it should be noted that the difference between nominal value and book value of transferred assets equals 720 b.kr. If low-value assets prove more valuable than previously estimated, the stability contribution – and therefore the mitigating measures as a whole – will total a larger amount. If recoveries exceed 15% of that difference, the planned mitigating measures increase to about 770 b.kr., and current and planned mitigating measures combined will total 920 b.kr.

Settling the failed banks' estates on this basis does not jeopardise the stability of operating financial institutions. Their króna-denominated liquidity could deteriorate, but within manageable limits, and their foreign-denominated liquidity will improve. The banks' external financing will be improved because of conversion and lengthening of foreign-denominated loans.

As regards economic stability in Iceland, the principal benefits of winding up the failed financial institutions according to their proposals, with reference to the stability contributions, are as follows:

- Negative effects on the balance of payments and risks deriving from settlement of the estates are eliminated with the above-mentioned mitigating measures, both current and planned. The negative impact on the balance of payments due to low-value assets and the future sale of

Arion Bank and Íslandsbanki is significantly reduced. Current and planned mitigating measures plus domestic assets backed by foreign assets amount to a total of 856 b.kr. Of that total, planned mitigating measures amount to approximately 660 b.kr. but, as is mentioned above, could significantly exceed that amount. Including the mitigating measures that have already been implemented (such as the lengthening of the Landsbanki Íslands - LBI hf. debt), the measures amount to 807 b.kr. This is the equivalent of the estates' domestic assets net of those domestic assets that are backed by foreign assets and therefore do not cause a balance of payments problem.

- Iceland's net debt position will improve significantly following settlement on the basis of the stability conditions. Net foreign debt will decline by 3,740 b.kr., and Iceland's underlying net international investment position (NIIP) will improve by 360 b.kr. as a direct result of the winding-up. After adjusting for other factors and growth in nominal GDP, the debt position is projected to improve from just under a third of GDP this year to less than 10% of GDP by the end of 2016.[1] This does not include the reduction in debt that will occur as a result of the planned auction of offshore krónur, as it is not possible to predict how much that will be. Iceland's net international investment position (NIIP) has not been this favourable in decades.
- The foreign exchange reserves will expand in coming years because of ESÍ's foreign-denominated recoveries of domestic assets and the estates' refinancing of the facilities granted by the Central Bank and the State to the new commercial banks. There will be some offsetting outflows due to króna-denominated assets converted to foreign currency. The overall impact of these factors on the foreign exchange reserves is estimated to be positive by just over 40 b.kr.
- Kaupthing hf., Glitnir hf., and LBI hf. will pay a total of 490 b.kr. to the authorities in the form of stability contributions, tax payments, and ESÍ's recoveries from the three estates. The recoveries will ultimately revert to the Treasury, in accordance with the rules governing financial interactions between the Central Bank of Iceland and the State.
- Because of the transfer of shares in Íslandsbanki hf. and related changes in deductions due to foreign currency inflows, the reserves will grow less next year than they would have under previous proposals. Offsetting this, the balance of payments risk due to the sale of Íslandsbanki hf. no longer exists, and Iceland's net external debt position will be better in coming years than it would otherwise have been because dividend payments from Íslandsbanki hf. to non-residents put less strain on the balance on income.
- Treasury debt will decline, as the stability contribution is to be allocated towards the reduction of Treasury debt, including debt to the Central Bank.[2] Reduced Treasury debt is also conducive to improved access to foreign credit and reduced refinancing risk for both the State and the banks. This will also reduce the risk of balance of payments problems. Credit rating agencies

[1] The underlying IIP is defined as the NIIP excluding the estates and including the estimated external position due to the estates once all assets have been distributed to creditors.
[2] It should be noted that prepaying debt using liquid assets could cause instability unless it is done over a long period of time. Therefore, the Stability Tax Act contains provisions stating that the allocation of the stability contribution shall be subject to the opinion of the Central Bank.

upgraded Iceland's sovereign ratings in July, following the announcement of the liberalisation strategy in June and the creditors' proposals submitted afterwards. The agencies' analysis implies that Iceland's sovereign ratings will improve even further once the composition agreements have been approved.

- The banking system's external financing will be lengthened, which also tends to reduce the refinancing risk of systemically important financial institutions, thereby contributing to the stability of the financial system and reducing the likelihood of the monetary and exchange rate instability that refinancing risk can entail.
- Scenarios showing developments in the balance of payments assuming settlement based on the above indicate that, in the absence of economic policy mistakes that derail the domestic economy in coming years, Iceland's NIIP could turn positive by the beginning of the next decade; that is, its foreign assets will exceed its foreign liabilities.
- Granting exemptions on the basis of stability conditions reduces the risk of legal disputes, which could entail long-term balance of payments risks that would delay the removal of capital controls on residents. This risk is not easy to assess, however.
- It is certain that disputes concerning tax issues (bank levy, financial administration tax, etc.) do not entail further capital outflows, which could otherwise total just over 60 b.kr.
- The winding-up boards, on behalf of the failed banks' estates, creditors, and shareholders, submit statements where the companies in question and their estates and creditors irrevocably release the Icelandic authorities from any type of claim or liability to the extent permissible by law.

It is appropriate to emphasise that the amount of the stability contribution and the amount of the stability tax are not comparable. It is necessary to assess the measures entailed in the estates' proposals on the basis of the stability conditions in their entirety and the impact they have on economic stability, and not the amount of the stability contribution *per se*. The proposed mitigating measures total nearly 660 b.kr. but will probably be higher. In comparison, it should be noted that, based on the estates' most recent financial statement and accounting for exchange rate movements, the stability tax totals 770 b.kr. in all, and 620 b.kr. after adjusting for deductions. Concluding composition agreements on the basis of the stability conditions is much less risky than the stability tax option, as risk is contained with various measures and the risk of legal action will be greatly reduced. The amount of the imposed stability tax reflects this risk in part. It is possible that credit ratings would improve more slowly under the tax option, in spite of the positive outcome that has been shown. The domestic economy would therefore be denied those benefits. This would delay the removal of capital controls on Icelandic residents. The Central Bank is therefore of the view that both financial stability and the balance of payments are better served if creditors agree to composition agreements that fulfil the stability conditions on the basis of the proposals submitted than if they are taxed. Furthermore, in the interest of finality, this option must be recommended if it can ensure adequate stability in the long run. Presumably, views of this type must have been considered when Parliament decided that the stability tax legislation would provide taxable entities the possibility of deductions upon fulfilment of certain conditions. The assessment of the balance of payments scenarios based on less favourable assumptions than are used in the baseline scenario discussed later in this report does not change the fundamental aspects of this positive development (see Appendix I). It can be assumed that the uncertainty relating to the implementation of the composition agreements is relatively minor in comparison with various other uncertainties that could affect the results of the balance of payments estimate – such as changes in Iceland's terms of trade.

In view of the above, the Central Bank recommends that the Minister of Finance and Economic Affairs approve the exemptions that the Bank wishes to grant to the estates. The Bank's analysis and assessment are discussed in greater detail below.

This report is divided into two sections, followed by an appendix. Section I discusses the impact on the balance of payments of settling the estates with composition agreements on the basis of the stability conditions and assesses whether winding up the estates will jeopardise monetary and exchange rate stability. Section II focuses on the impact of winding-up on financial stability.

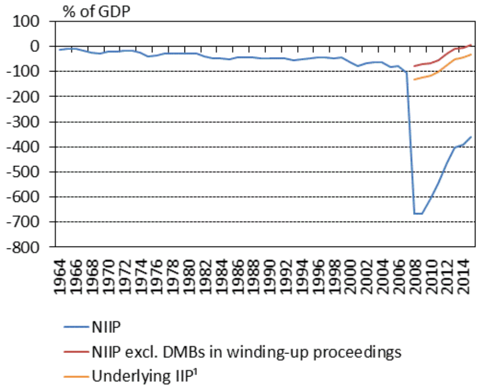
Impact of settlement on the balance of payments

Favourable external conditions

Conditions for winding up the estates of the failed commercial and savings banks and lifting the capital controls appear favourable at present. When assessing the problem stemming from the settlement of the estates vis-à-vis their creditors – the so-called balance of payments problem – it is important to bear in mind that it is not a debt problem in the sense that Iceland's foreign-denominated revenues will not cover imported goods and services, interest on foreign financial obligations, and other primary expenditure. On the contrary: because there is a sizeable current account surplus, foreign-denominated revenues from goods and services exports not only cover imports but also suffice to pay interest on residents' foreign debt, as well as dividends and other primary expenditure, including that stemming from claims against the failed banks' estates. A current account surplus implies that after these payments, there remains a surplus that can be used to reduce residents' foreign debt without weakening the Icelandic króna. Added to this are the significant capital inflows that have taken place this year, owing in part to non-residents' purchases of stocks and bonds, which total about 50 b.kr. year-to-date. The Central Bank has used the current account surplus and capital inflows to buy foreign currency in the market for over 200 b.kr. year-to-date. The Bank's accumulated net purchases in the market since 2010 total roughly 380 b.kr. In this way, the Bank has prepared the way for capital account liberalisation.

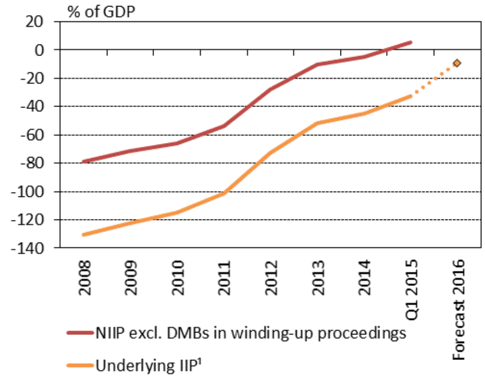
Iceland's net international investment position (NIIP) has improved rapidly in recent years, whereas most comparison countries' NIIP has either held unchanged or deteriorated. If forecasts materialise, Iceland's net debt will be extremely low in historical context and quite modest in international comparison. At mid-2015, Iceland's underlying debt amounted to approximately one-third of GDP, the most favourable in decades and the best since the early 1980s. Winding up the failed banks' estates will improve it still further. It is estimated that, in the wake of composition agreements, Iceland's debt position will continue to improve over the next five years and will be nearly in balance soon after 2020. This assessment, however, is subject to considerable uncertainty that stems from factors other than the composition agreements. These uncertainties are discussed in Appendix I.

Net international investment position



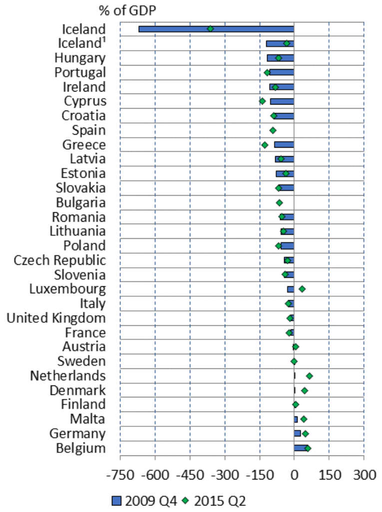
1. Assuming equal distribution of assets held by DMBs in winding-up proceedings to all creditors. Neither the stability tax nor the stability contribution is taken into account.
Sources: Statistics Iceland, Central Bank of Iceland.

Net international investment position



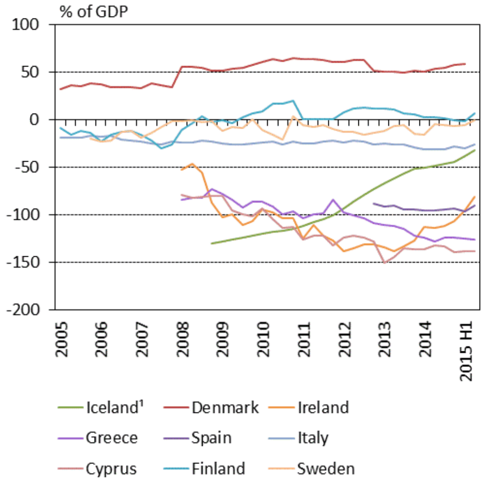
1. Assuming equal distribution of assets held by DMBs in winding-up proceedings to all creditors. 2. The forecast for 2016 includes the estates' stability contributions and other factors that could affect Iceland's IIP.
Sources: Statistics Iceland, Central Bank of Iceland.

Net international investment position of comparison countries



1. Iceland's IIP based on the calculated settlement of the failed banks' estates.
2. The most recent published values, either Q1/2015 or Q4/2014.
3. Data for Q4/2009 are not available.
Sources: Eurostat, Central Bank of Iceland.

Net international investment position in international context



1.Based on Iceland's underlying IIP. The IIP is calculated based on the settlement of the failed banks' estates and assuming equal distribution of all estate assets to all creditors. Neither the stability contribution nor the stability tax is taken into account.
Sources: Eurostat, Statistics Iceland, Central Bank of Iceland.

The balance of payments problem

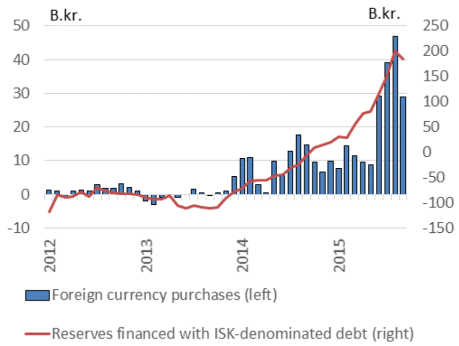
In spite of the above-described positive developments in its debt position, Iceland faces a difficult balance of payments problem that the Central Bank has analysed in some detail in several of its publications.[3] Iceland's balance of payments problem has primarily been of two kinds.

First of all, access to foreign credit markets for the purpose of refinancing foreign debt has been limited. This problem was probably of shorter duration than it might have been, however, because of

[3] See, for instance, the Bank's *Financial Stability* reports and *Special Publications*.

the measures adopted in autumn 2008. Since then it has subsided, in part because of the economic measures taken under the Stand-By Arrangement with the International Monetary Fund (IMF). In addition, the revised capital account liberalisation strategy introduced by the authorities early this summer has been well received. The authorities' measures have created confidence, improved credit ratings, and thereby facilitated the Treasury's access to foreign credit. The Treasury already has access to foreign credit markets on acceptable terms, and the IMF loans and the bilateral loans from neighbouring countries have been repaid. The commercial banks, which now have investment-grade credit ratings, have followed in the Treasury's footsteps and also have access to foreign credit markets, on terms that are improving. The same is true of systemically important firms such as Landsvirkjun and Reykjavík Energy (Orkuveita Reykjavíkur, OR), which have improved their debt position markedly in recent years, thereby improving their access to foreign credit. The external position of systemically important entities without foreign-denominated revenues has also improved. Municipalities have paid down all of their foreign debt apart from one municipality's 5 b.kr. debt, which is payable in Q4/2015, and the Treasury and Central Bank currently hold more foreign-denominated assets than liabilities (see the chart showing reserves financed domestically in krónur). The problem has not been resolved in full, however, as only the Treasury, the banks, and a very few large companies have acceptable access to foreign credit markets.

Central Bank foreign currency purchases and reserves financed domestically in krónur



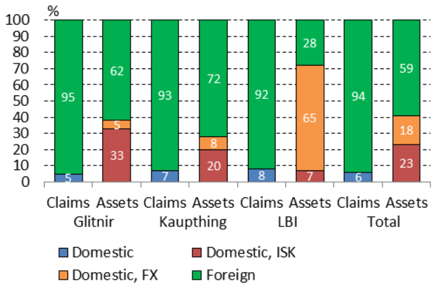
1. Foreign exchange reserves net of total external liabilities to residents and non-residents.
Source: Central Bank of Iceland.

The latter part of the problem is that, in spite of favourable developments, Iceland's foreign currency revenues have not been sufficient to release over a short period of time all of the potentially volatile króna-denominated assets held by non-residents, both creditors of the failed banks' estates and owners of offshore krónur. Considerable progress has been made in resolving the offshore krónur problem, however. As a share of GDP, non-residents' claims against the banking system and the Treasury that cannot be redeemed for foreign currency because of the capital controls have declined by over half since the controls were imposed. They are now equivalent to 14% of GDP, or approximately 11% if only short-term ISK assets owned or held in custody by foreign financial institutions (so-called offshore krónur) are included. The problem stemming from settling the failed banks' estates is quite a bit larger, however. Other things being equal, settling the estates could result in substantial foreign currency outflows and thereby cause monetary and exchange rate instability.

The estates' króna-denominated assets currently amount to 25% of GDP. Because 93.5% of the claims are held by non-resident creditors, distributing the value of these assets to them could cause substantial instability if most or all ISK assets are converted to liquid ISK funds and distributed to creditors, who in turn would seek to exchange liquid ISK for foreign currency.

Estimated domestic/foreign breakdown of assets and claims of DMBs in winding-up proceedings[1]

Book value of assets 30.06.2015



1. Based on real underlying owners of claims when calculating the share of domestic claims.

Sources: Claims lists and financial informations Glitnir, Kaupthing and LBI; Central Bank of Iceland.

Winding up the estates without mitigating measures

The balance of payments problem relating to the settlement of the estates is a pure flow problem. That is, it lies in non-residents' claims against residents, which are large in scale, short-term, and volatile by nature. When a failed financial undertaking's estate is settled, assets are liquidated and subsequently paid out to creditors. Without countervailing measures, net outflows through the foreign exchange market could total as much as 400 b.kr. when the estates are settled. This is because of the mismatch between the proportion of assets in foreign vs. domestic currency and the proportion of foreign vs. domestic creditors. Glitnir and Kaupthing's foreign creditors hold claims against 95% and 93% of assets, respectively, whereas the two estates' foreign-denominated claims account for 67% and 80%, respectively, of total assets. LBI's imbalance is much less pronounced, however. It is estimated that non-resident creditors' indirect claims on unfunded domestic assets, which could cause instability, may amount to as much as one-fourth of GDP.

Stability conditions and mitigating measures[4]

Provided that the debt position is sustainable, there are usually two ways to deal with flow problems: to reduce the claims or lengthen their maturity. This is the idea behind the so-called stability conditions announced this past June. Composition agreements and exemptions on the basis of stability conditions do both, with the provision of a stability contribution, the lengthening of certain of the estates' claims

[4] The stability conditions are contained in the Central Bank's statement of 8 June 2015. According to that statement, in assessing possible exemptions in connection with composition agreements, the Bank will take account of the following: i) that measures be adopted that sufficiently reduce the negative impact of distributing the proceeds of the sale of the assets in Icelandic krónur; ii) that other foreign-denominated domestic assets owned by the failed banks be converted into long-term financing to the degree required; and iii) where applicable, that the foreign-denominated loan facilities granted by the authorities to the new banks following the financial market collapse be repaid.

against resident banks, and certain conditions concerning the disposal of Íslandsbanki hf. and Arion Bank hf., which are their most valuable domestic assets. Differences in the composition of the estates' assets call for different versions of the stability contribution so as to fulfil the stability conditions. It is therefore a feature of the stability conditions that the estates can eliminate the negative balance of payments effects of settlement in various ways and through voluntary means.

The estates' stability contributions vary, and they are designed to enable each estate to solve the problem arising from it. They comprise one or more of the following elements: delivery of cash and assets, transfer of domestic assets and claims, indirect transfer via a cash sweep provision, issuance of bonds against holdings in banks, and profit-sharing agreements. In addition, the stability conditions are fulfilled with the retirement of the foreign loans that the authorities granted to the new banks in the wake of the crisis and the allocation of deposits towards the purchase of deposit institutions' bonds. [5] All of the estates retain enough capital to defray operating expenses and pay taxes. In some instances, funds are also retained for ISK-denominated claims that are still disputed and for other payments subject to uncertainty, but if those payments are not made, the funds will revert to the stability contribution in accordance with cash sweep provisions.

Overall impact of settlement

The three estates' estimated mitigating measures are specified in Table 1, and the impact of the composition agreements on the Central Bank of Iceland's foreign exchange reserves can be seen in Table 2, based on the estimated position at year-end 2015. The planned mitigating measures total nearly 660 b.kr. As the sale price for Arion Bank hf. rises and low-value assets prove to have higher values than is now assumed, the amount of the mitigating measures rises as well. It is assumed that Arion Bank hf. will be sold at book value, and if Íslandsbanki's capital is also assessed at book value, the mitigating measures break down as follows: The estates' stability contribution totals nearly 379 b.kr., including 229 b.kr. from Glitnir hf., 127 b.kr. from Kaupthing hf., and 23 b.kr. from LBI hf. The allocation of domestic ISK assets towards taxes, expenses, and other items totals 46 b.kr. and does not have a negative impact on the financial balance. Lengthening of debt and prepayments of credit facilities total 151 b.kr. Recoveries of current claims owned by ESÍ total 81 b.kr. Planned mitigating measures total nearly 660 b.kr., as is stated above. If recoveries of low-value assets prove greater than expected, the mitigating effect could be commensurably greater.

It is estimated that with the delivery of the stability contribution, net capital flows upon the winding-up of the estates will be negative by 28 b.kr., assuming that all of the estates' assets are paid out immediately. This is somewhat of an oversimplification, however, as some of the assets are not in liquid form. Consideration must be given to this when the overall long-term impact is examined. The net impact on the foreign exchange reserves is estimated to be positive by 41 b.kr. This is due in particular to a 74 b.kr. reimbursement of the foreign-denominated credit facilities granted by the authorities to the new banks following the collapse of the financial system.

[5] It should be borne in mind that the Government contributed capital to the new banks in Icelandic krónur and is now being repaid in foreign currency.

Table 1 Mitigating measures related to settlement of failed banks' estates – position as of year-end 2015

B.kr.	Glitnir	Kaupthing	LBI	Total
Transferred assets and cash sweep assets				
Liquid assets	3	-	5	8
Other ISK assets	22	4	15	41
Other foreign-denominated assets	-	14	0.5	15
Contingent cash sweep assets	7	6	3	15
Fund for Glitnir holdings in Íslandsbanki	12	-	-	12
Total	44	24	23	91
Transferred assets and cash sweep assets that are non-liquid at book value	41	24	18	83
Transferred assets and cash sweep assets that are non-liquid at claim value	131	412	262	804
Difference between book value and claim value	90	388	244	722
Costs, funds, and taxes				
Domestic costs payable before year-end	2	2	3	6
Domestic costs payable after year-end	2	4	3	9
Fund for disputes	1	-	-	1
Bank levy	9	10	8	26
Other taxes	2	1	-	3
Total	15	17	13	46
Contribution due to commercial banks				
Íslandsbanki	185	-	-	185
Collateralised bond due to Arion Bank	-	84	-	84
Profit-sharing agreement due to sale of Arion Bank at book value	-	20	-	20
Total	185	104	-	288
Stability contribution				
Stability contribution in ISK	229	113	22	365
Stability contribution with recoveries in FX	-	14	0.5	15
Total	229	127	23	379
ISK allocation w/o impact on reserves (taxes, costs, and reserve funds)	15	17	13	46
Lengthening and prepayment of debt				
Deposits: lengthened and converted	35	42	-	77
Refinancing of banks' debt to State and Central Bank	20	54	-	74
(Size of Landsbankinn bonds adjusted for recent refinancing and exchange rate at end-September 2015	-	-	*149*	*149)*
Total	55	97	-	151
Recoveries of current claims owned by ESÍ	27	40	14	81
Proposed counterweight	**327**	**281**	**50**	**658**
Proposed counterweight assuming recovery of 15% of assessed difference in assets	340	339	87	766
Assets with underlying foreign currency				
Covered assets	26	9	0.5	35
Contribution in FX	-	14	-	14
Total	26	23	0.5	50
Proposed counterweight plus Landsbankinn bonds and assets with underlying foreign currency	353	304	200	856
Counterweight assuming recovery of 15% of assessed difference in assets	366	362	236	964
For information: Direct contribution to State and through ESÍ	267	179	45	490

Table 2 Impact on foreign exchange reserves of settling failed banks' estates – position as of year-end 2015

B.kr.	Glitnir	Kaupthing	LBI	Total
Capital flows				
ISK converted to FX	-72	-46	-	-118
ESÍ's foreign recoveries from estates, in FX, through 2019	21	44	3	69
ESÍ's domestic recoveries in FX, long-term	3	7	11	21
Net capital flows	-48	5	15	-28
Change in foreign exchange reserves				
Kaupthing's FX deposits with Central Bank withdrawn and used to fund Arion Bank	-	-5	-	-5
Refinancing of banks' debt to State and Central Bank	20	54	-	74
Total	20	50	-	69
Total impact on foreign exchange reserves	-28	55	15	41

Table 3 Further detail: Mitigating measures related to settlement of smaller estates

B.kr.	Total smaller estates
Total assets	
ISK-denominated domestic assets	42
Foreign-denominated domestic assets	22
Foreign assets	107
Total	172
Stability contribution	7
Capital flows	-
ISK converted to FX	13
ESÍ's foreign recoveries from estates, in FX	18
Net capital flows	4

Impact of winding-up upon fulfilment of stability conditions

The consultation letters to the Minister, which accompany this report as attachments, review the estates' specific measures aimed at eliminating the negative balance of payments impact of settlement. The highlights of them are briefly reviewed below.

According to LBI hf.'s composition proposals, the estate will deliver all of its ISK-denominated assets, a total of 23 b.kr., in the form of a stability contribution. Just over 5 b.kr. of that total are in liquid form. The estate will also pay approximately 8 b.kr. in bank tax during the year. According to proposals from the LBI hf. creditors, no krónur will be paid out or converted to foreign currency; they will be subject to direct transfer or the cash sweep provision. Foreign-denominated recoveries will total about 46 b.kr. for distribution to general creditors, plus the balance of the Landsbankinn bond, once priority creditors have been paid. The outstanding balance on the bond is approximately 190 b.kr., but after accounting for the portion that Landsbankinn hf. has already financed, it is just under 150 b.kr. Landsbankinn hf. and LBI hf. recently concluded an agreement providing for additional prepayments, assuming that LBI hf. enters into a composition agreement. The outstanding balance of the bond is estimated to total 121 b.kr. next year. LBI hf. will grant Landsbankinn hf. a unilateral option to convert current collateralised euro-denominated bonds to marketable bonds under the bank's EMTN programme, thereby giving the bank the option of converting from secured to unsecured funding. With the composition agreement, the bank's need for foreign-denominated refinancing is dramatically reduced and its foreign debt repayment profile is lengthened. It can be said that with the 2014 agreement lengthening the Landsbankinn bond and conferring conversion rights now, LBI hf. has fulfilled the stability conditions as regards the repayment profile of its foreign-denominated domestic assets.

Net foreign-denominated capital flows due to the winding-up of LBI hf. will be positive by 14 b.kr., but the long-term impact on the exchange rate or foreign exchange reserves will be determined by how the bank intends to pay the balance of the Landsbankinn bond; that is, whether the outstanding balance is refinanced in foreign credit markets, paid with foreign income, or paid by purchasing foreign currency in the market.

Glitnir hf.'s composition proposal aims to neutralise the balance of payments impact of the estate, as its stability contribution is larger than that of the other estates because of the large share of foreign creditors and domestic assets. Glitnir's stability contribution totals 229 b.kr., including the delivery of the holding in Íslandsbanki hf., which accounts for 185 b.kr.[6] The proposal entails delivery of the estate's liquid assets in krónur, about 3 b.kr., and the delivery of all of Glitnir's domestic assets and claims that are collected in krónur, partly through a cash sweep provision, for a total amount of 41 b.kr.

Íslandsbanki hf.'s external financing will improve because of an agreement according to which the Glitnir hf. estate will lengthen its foreign-denominated deposits, which amount to about 35 b.kr. In addition, Glitnir hf. will contribute foreign currency to refinance the Treasury's subordinated loan to Íslandsbanki hf. in the amount of 20 b.kr., expanding the foreign exchange reserves by about that amount. In the short run, the total impact of winding up Glitnir hf. on the foreign exchange reserves is negative by about 28 b.kr. because the estate will be authorised to convert 36 b.kr. to foreign currency for transferring all of ISB Holding ehf.'s share capital in Íslandsbanki hf. to the Government as part of its stability contribution. In addition, the estate will be authorised to convert 16 b.kr. to foreign currency in return for not paying foreign-denominated dividends from Íslandsbanki hf. to creditors, as earlier proposals had provided for. Offsetting this, the balance on income and the net debt position will improve in the years to follow, which could contribute to a higher exchange rate or larger foreign exchange reserves than would otherwise result. In order to further reduce the impact of the winding-up on the foreign exchange reserves, the Central Bank could conduct transactions with banks that have a positive foreign exchange balance. The economy's foreign exchange position would not change as a result of such transactions, however. Further discussion of changes in the composition proposals as regards the sale of Íslandsbanki hf. can be found in Appendix II.

The Kaupthing hf. estate has few domestic assets other than Arion Bank hf.; therefore, the negative impact on the balance of payments is almost solely due to the bank. The proposal for Kaupthing hf.'s stability contribution entails the delivery of domestic assets and claims valued at 24 b.kr., including 14 b.kr. with underlying foreign assets, which increases the authorisation to use the remaining krónur in the estate to purchase foreign currency. The estate will use liquid assets to defray operating expenses and cover reserve funds, as nearly all of Kaupthing hf.'s ISK recoveries are subject to the cash sweep provision. Kaupthing hf. will issue and transfer a bond in the amount of 84 b.kr. for the sale of Arion Bank hf. It will be secured with bonds issued by Arion Bank hf. and owned by Kaupthing hf. and with Kaupthing hf.'s holding in Kaupskil ehf. Interest on the bond is payable annually, and the estate must convert foreign currency in order to pay it. The bond will then be paid up when Arion Bank hf. is sold, as the principal may only be paid with the proceeds of the sale of the bank. In addition, sales proceeds of Arion Bank hf. in excess of 100 b.kr. will be divided between Kaupthing hf. and the Central Bank in accordance with a profit-sharing agreement.[7] The contribution due to the sale of Arion Bank hf. will therefore be approximately 20 b.kr. if the bank is sold at book value.[8] Based on these assumptions, Kaupthing hf.'s stability contribution will amount to 127 b.kr.

In order to fulfil the stability conditions, Kaupthing hf. must also lengthen Arion Bank's external financing. According to the composition proposals, Arion Bank hf. will issue a foreign-denominated bond in the amount of 97 b.kr. under the bank's EMTN programme. Kaupthing hf. buys the bond and

[6] The estimated book value of the Íslandsbanki hf. holding to be transferred is 185 b.kr.
[7] Kaupthing hf. will deliver 1/3 of the sale price of Arion Bank between 100 b.kr. and 140 b.kr., ½ of the amount between 140 b.kr. and 160 b.kr., and ¾ of the amount in excess of 160 b.kr.
[8] The book value of Kaupthing's holding in Arion Bank as of end-2015 is estimated at 152 b.kr.

pays for it with its foreign-denominated deposits with Arion Bank hf., plus 54 b.kr. that Arion Bank uses to pay up its foreign-denominated loans from the Central Bank and Kaupthing's deposits with the Central Bank, which amount to about 5 b.kr. The Central Bank's foreign exchange reserves are estimated to expand by about 55 b.kr. upon the winding-up of Kaupthing hf.

Winding-up and the impact on financial stability

For some time, the estates have held a portion of their liquid assets as deposits with the commercial banks. The deposits are denominated in both krónur and foreign currencies. The banks have not been able to make full use of the deposits to finance lending, owing to stringent rules requiring that they hold sufficient liquid assets to cover the estates' deposits. According to the estates' proposals, the deposits in krónur will be paid out, and those in foreign currency will be lengthened. As a result, it is clear that settling the estates will affect currently operating banks. This will also affect the money stock: in the absence of mitigating measures, the money stock will shrink when capital is transferred out of the banking system and into accounts with the Central Bank. Because of stringent rules on liquidity that require the estates' deposits to be covered by liquid assets s, and because the banks have held a portion of these liquid assets in the Central Bank, the effect of withdrawals of these deposits is less than it might otherwise be. The disposal of the stability contribution could also have effects on the money stock that would necessitate a monetary policy response. Mitigating measures soften this effect, and the Central Bank will respond when needed so as to ensure that the money stock is in line with the intended monetary stance.

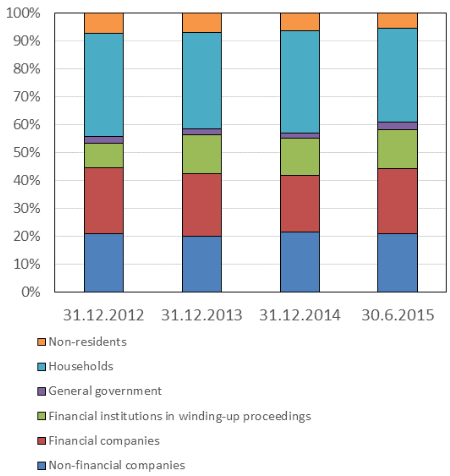
Impact on operating banks

Liquidity and funding

The estates' deposits with the banks amount to roughly 300 b.kr., or 16% of the banks' deposit portfolios and 9% of their funding. The deposits have been classified as unstable funding, and the banks have had limited scope to use them to finance lending, as it has been assumed that the estates would withdraw them when the capital controls are lifted. The composition agreements assume that the large commercial banks' foreign-denominated deposits, which amount to 97 b.kr., will be lengthened.

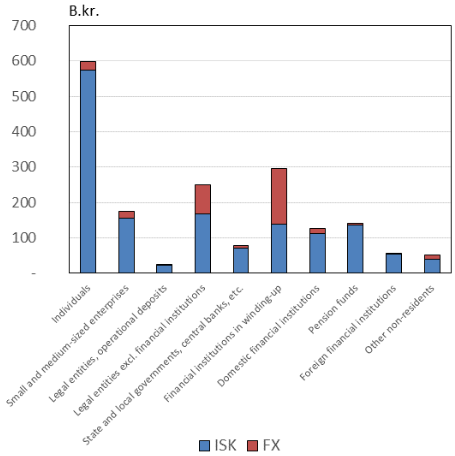
This will provide the banks with secure long-term foreign-denominated funding and will raise their net stable funding ratios (NSFR) in foreign currencies. The banks can use this funding for foreign-denominated lending and, because it is assumed to be at market rates, it reduces the need for other external financing.

Depositors[1]



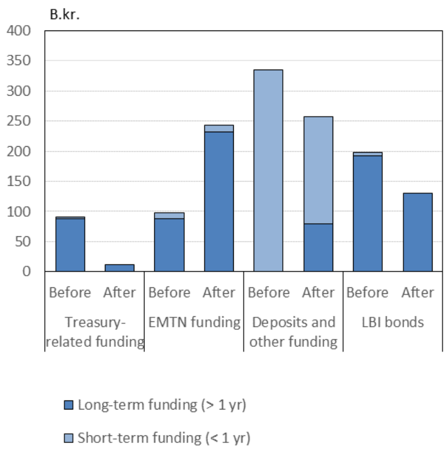
1. Commercial banks' parent companies.
Source: Central Bank of Iceland.

Commercial bank deposits,[1] by deposit category and currency



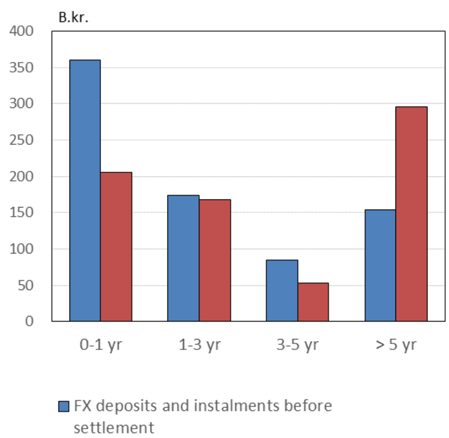
1. Commercial banks' parent companies. As of end-September 2015.
Source: Central Bank of Iceland.

Changes in commercial banks' foreign funding before and after settlement of estates



As of end-September 2015.
Source: Central Bank of Iceland.

Commercial banks' deposits and payments on foreign funding



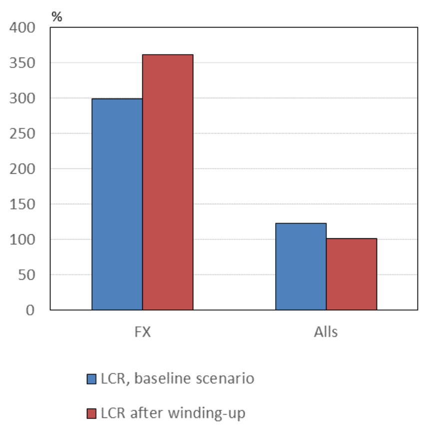
As of end-September 2015
Source: Central Bank of Iceland.

It can be assumed that the banks' liquidity ratios in foreign currencies will rise with the lengthening of their deposits. The banks' overall liquidity is well above the required minimum. Withdrawals of deposits in krónur for payment of the stability contribution, taxes, operating expenses, and the like will erode their liquidity, however. The banks can pay out the estates' deposits without falling below acceptable liquidity levels, and after adjusting for proposed mitigating measures designed to improve their liquidity position, they will be somewhat above the 90% minimum that takes effect at year-end

2015. Liquidity rules assume that the banks will have sufficient liquid assets to cover prompt payment of all obligations due in the next 30 days, plus a portion of deposits and other potential obligations.[9] The banks must satisfy the requirements in the liquidity rules in foreign currencies and overall; i.e., for foreign and domestic currency combined.

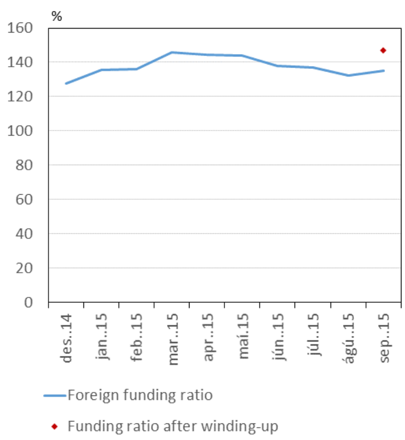
The Central Bank also carries out regular assessments of whether the banks can tolerate adverse developments other than those provided for in liquidity rules, also considering time periods longer than the 30 days covered in the rules. In other words, the Bank conducts liquidity stress tests in which it examines withdrawals of the offshore krónur held in the banks as deposits, the estates' foreign-denominated deposits, and a portion of individuals' and firms' deposits (among other things, the effects of withdrawing deposits above specified amounts are examined, and consideration is given to whether the deposits are in krónur or foreign currencies). In addition, outflows of deposits in other countries that have recently undergone financial crises – such as Spain, Greece, and Cyprus – have been examined and compared with the banks' capacity to pay out deposits. Moreover, the banks' liquidity is examined in terms of sensitivity to changes in bond prices and the exchange rate of the króna. Stress tests on the banks' liquidity show that as before, the banks can tolerate sizeable outflows following the distribution of the estates' deposits and therefore remain relatively well prepared to face potential shocks.

Impact of settlement on the new banks' liquidity ratios (LCR)[1]



1. Commercial banks' parent companies. As of end-September 2015.
Source: Central Bank of Iceland.

Winding up the failed banks: impact on the commercial banks' funding ratios (NSFR)[1]



1. Commercial banks' parent companies.
Source: Central Bank of Iceland.

Foreign exchange balance

The commercial banks must fulfil the requirements set forth in rules on foreign exchange balance. According to the rules, a bank's open foreign currency positions in individual currencies may not be

[9] Liquidity rules have now been implemented as part of the recommendations of the Basel Committee on Banking Supervision (BCBS). The liquidity rules in Iceland are based on the BCBS recommendations; however, the Central Bank liquidity rules require that the liquidity requirements be satisfied in foreign currency as well.

positive or negative by more than 15% of its capital base. The estates' proposals will not affect the banks' foreign exchange balances, which currently provide them considerable room for manoeuvre.

Capital

The commercial banks' capital ratios are high. In addition to the regulatory minimum, the Financial Supervisory Authority determines each bank's additional capital requirements according to the supervisory review and evaluation process (SREP). Furthermore, the law has been amended to include four capital buffers, three of which are subject to guidelines submitted by the Financial Stability Council (FSC) to the Financial Supervisory Authority (FME). It can be expected that the FME requirements plus the capital buffer guidelines from the FSC will remain high.

Other factors related to the banks' sensitivity to changed conditions

Stress tests

The Central Bank has collaborated with the FME and the three largest banks to carry out stress tests designed to assess the banks' resilience and sensitivity to a shock entailing substantial capital outflows, a crisis in trading partner countries, and a contraction in fish catches. According to this stress scenario, export volumes will contract, terms of trade will deteriorate, and the króna will depreciate. Unemployment will rise, purchasing power will decline, and private consumption will contract. GDP will contract by 2.6% in the first year and 1.3% in the second year. The results show a deviation in both capital ratios and liquidity ratios, but on the whole, the banks are relatively well prepared for such a shock (for a more detailed discussion, see Chapter II of *Financial Stability* 2015/2).

Appendix I : Balance of payments scenarios assuming proposed composition agreements

According to the estates' proposals for settlement on the basis of stability conditions, most of the effects of settlement will come to the fore in 2016. On the other hand, it is useful to examine developments in the balance of payments over a longer period, based on the financial structure provided for in the composition agreements. Such scenarios must be considered with caution, however, and cannot be viewed as actual forecasts, as they are based on a number of assumptions that are highly uncertain. It should also be noted that the uncertainty relating to the implementation of the composition agreements is relatively minor in comparison with various other uncertainties that could affect the results of the balance of payments estimate – such as changes in Iceland's terms of trade. On the other hand, the scenarios give an indication of whether there are signs pointing to undue strain on the foreign exchange reserves or the exchange rate of the króna, based on relatively conservative assumptions concerning the key variables that could influence the development.

The baseline scenario is based on the Central Bank's forecast published in the August *Monetary Bulletin*. According to that forecast, Iceland's GDP growth will be the strongest among developed countries, at an average of 3.3% in 2015-2017. Inflation will average 3.5% over that same period, and real disposable income will rise by 5.8%. The forecast is based on the technical assumption that the exchange rate will remain stable throughout the forecast horizon. The surplus on goods and services trade is projected to average 5.8% of GDP. After the end of the forecast horizon, it is expected that the trade surplus will subside to 3% of GDP from 2018 onwards and the estates will be settled in accordance with the exemption requests submitted to the Central Bank of Iceland in October. In addition to the large estates that are examined here, consideration is given to the likely impact of winding up smaller commercial and savings banks.

The primary income scenario is based on roughly 70 assumptions concerning returns, interest rate terms, and risk premia on assets and liabilities, although many of the assumptions are interrelated. In addition, the estimated financial account is based on various assumptions concerning funding and refinancing. The financial account entails instalments on foreign loans, refinancing assumptions, and reinvestment of interest and dividends on assets. It is assumed that residents will reinvest all interest and dividends income on their foreign assets (included in the primary income). Foreign asset portfolios will therefore grow over time. It is necessary to assess both the extent to which residents will refinance outstanding debt and the scope of capital inflows from foreign investment. Only a very few domestic firms are able to obtain financing abroad at present. It is assumed that, until 2017, the Treasury, the Central Bank, and the commercial banks will be the only entities that refinance their debt. It is also assumed that Landsvirkjun will refinance 20% of its instalments from 2017 onwards. Furthermore, it is assumed that Landsvirkjun will finance new development and maintenance projects with foreign credit throughout the forecast horizon (40 b.kr. through 2023). Reykjavík Energy (OR) is expected to begin refinancing in 2021 and refinance all of its debt. Fisheries and airlines are expected to obtain credit financing for investments in ships and aircraft, and the commercial banks are expected to increase their foreign lending by 5-15 b.kr. from 2016 onwards, funding it with foreign credit. In addition to this, it is assumed that 10% of business investment excluding ships and aircraft will come from abroad in the form of foreign direct investment. The baseline scenario does not assume continued inflows relating to non-residents' investments in Treasury bonds. By the same token, it is not assumed that residents will transfer funds abroad in connection with capital account liberalisation, apart from a 10 b.kr. increase in pension funds' investment authorisation.

Table 1 Baseline scenario – key assumptions concerning returns

%	*2015*	*2016*	*2017*	*2018*	*2019*
Foreign short-term interest (50/50 LIBOR/EURIBOR)	0.2	0.6	0.9	1.2	1.5
10-yr USD interest (forward)	2.2	2.6	2.7	2.8	2.9
10-yr EUR interest (forward)	0.5	1.2	1.4	1.6	1.7
Risk premium onTreasury's external financing	1.7	1.4	1.2	1.1	1.1
Risk premium on commercial banks' external financing	3.1	2.8	2.6	2.5	2.5
GDP (nominal growth)	10.1	8.2	6.6	6.0	5.5

Sources: Bloomberg, Central Bank of Iceland.

It is assumed that the exchange rate of the króna will remain stable over the entire period and that there will be no exchange rate adjustment due to changes in financing needs, but that they will emerge entirely in changes in the foreign exchange reserves. If foreign-denominated capital outflows exceed Iceland's current account balance, the foreign exchange reserves will be tapped. It is assumed that the surplus on the balance of payments (the current account balance adjusted for capital movements outside reserves) will be used to shore up the reserves. The risk premium on Treasury debt is expected to narrow in the wake of composition agreements, as the agreements will eliminate important uncertainties concerning Iceland's debt and balance of payments, thus preparing the ground for liberalisation of the capital controls. The stability contributions are to be used to pay down Treasury debt. Gross Treasury debt is projected at 62% of GDP by the end of the year, falling to 45% of GDP upon payment of the stability contribution. This would reduce the Treasury's annual interest expense by about 20 b.kr.[10] Credit rating agencies upgraded the sovereign in July, in connection with the measures announced in June, and implied that Iceland's sovereign ratings would rise still further following the approval of composition agreements. The spread on Treasury debt is estimated at 1.5% at present, and the commercial banks' recent issues indicate a spread of 2.8-3%. It is assumed that premia on the debt of the commercial banks and other firms will move in line with premia on Treasury debt.

[10] Assuming that the nominal interest rate on the debt averages 5.25%.

Table 2 Financing need, baseline scenario

% of GDP unless otherwise specified	*2015*	*2016*	*2017*	*2018*	*2019*
Trade balance	6.7	5.5	4.1	3.0	3,0
Balance on primary income plus secondary income.	-2.5	-3.1	-2.9	-2.8	-2,4
Current account balance	4.2	2.4	1.2	0.2	0,6
Financial account excluding reserve activity	-3.6	0.8	-1.1	-0.9	-0,8
Estimated financing need (Δreserves)	0.6	3.2	0.1	-0.6	-0,2
Reserves (b.kr.)[1]	574	645	646	629	623
Reserves/short-term debt (%)[2]	150	207	163	191	138
NIIP	-31	-9	-7	-6	-4

1. The reserves could expand without its showing in the financing need; for example, if there is a transfer of foreign assets/liabilities between the Central Bank/ESÍ and resident entities such as the estates.
2. Short-term ISK assets owned by non-residents (excluding those participating in the product mix auction) are included with short-term debt.

Source: Central Bank of Iceland.

There will be a surplus on external trade throughout the period, but it will diminish somewhat in 2018-2019, when the surplus on combined goods and services trade is expected to fall to 3% of GDP. The current account surplus is less than the estimated financial account deficit excluding reserve activity, which will cause the reserves to contract slightly. The financial balance excluding reserve activity is negative for the entire period apart from 2016, when it is estimated to be positive by 0.8% of GDP because of the settlement of the estates. The financial balance is dominated by instalments on the loans of State- and municipal-owned companies (Landsvirkjun and OR), which are only expected to refinance their debt to a limited degree. The underlying balance on primary income will be more favourable as the period progresses, owing both to declining debt and to declining domestic interest rates as the period progresses and the economy returns to balance. The ratio of foreign exchange reserves to short-term debt, which is well below 100%, could be interpreted as a risk to the balance of payments. If this risk is considered to exist, resident entities' access to foreign credit could tighten and risk premia on domestic financial obligations could rise. If the ratio of foreign exchange reserves to short-term debt falls far below 75%, the risk that access to market refinancing (including access by the Treasury and the Central Bank) will be cut off can be assumed to rise.

Developments in foreign exchange reserves according to balance of payments scenario

In the balance of payments analysis, it is assumed that the estates will be wound up in 2016 and will be granted full exemptions from the capital controls. The effects will therefore show most in the foreign exchange reserves in 2016, when it is assumed that ISK assets not paid towards the stability contribution will be distributed to creditors. The table above shows that, in 2016, the reserves expand by nearly 60 b.kr. year-on-year in the baseline scenario, as the current account surplus is estimated to be somewhat large and the financial balance excluding reserve activity is positive. There is some uncertainty about the total effect of the estates' proposals on the reserves; this will depend, for example, on the sale price of Arion Bank. On the other hand, the Central Bank's loan to Arion Bank hf. will be refinanced by Kaupthing hf. with Arion's EMTN issue, and Glitnir hf. will buy Íslandsbanki hf.'s loans from the Treasury. The positive effect on the reserves will be 74 b.kr. The reserves will shrink by about 59 b.kr., however, because estimated distributions of krónur (foreign exchange transactions) to non-residents exceed inflows of foreign currency to residents. This is due predominantly to increased distributions (36 b.kr.) related to the Glitnir hf.'s transfer of Íslandsbanki hf. to the State. If the banks that have a positive foreign exchange balance decide to reduce their imbalances, this could have an offsetting effect, and the combined impact of such measures on the reserves could be positive by just over 20 b.kr. Furthermore, ESÍ will receive payment of its claims against the estates (about 27 b.kr.) over the period from 2017-2026.

Underlying international investment position

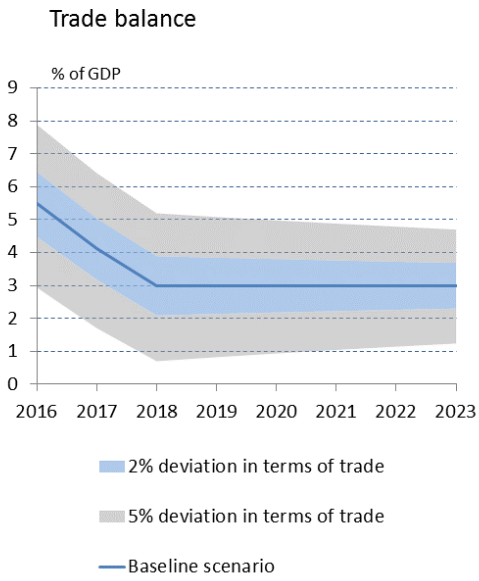
Seen through the settlement of the failed banks' estates at book value of assets, their contribution to Iceland's net international investment position (NIIP) was negative by just over 38% of GDP at the end of Q2/2015. If the estates are settled on the basis of the current proposals, the underlying net IIP should improve by 16% of GDP. The net IIP is projected to be negative by 9% of GDP by year-end 2016. It would then have improved by 121% of GDP since 2008. The net IIP is expected to continue improving, but long-term projections are subject to considerable uncertainty arising from factors other than the settlement of the estates. These are covered in the next section.

Uncertainties and their potential impact on sustainability

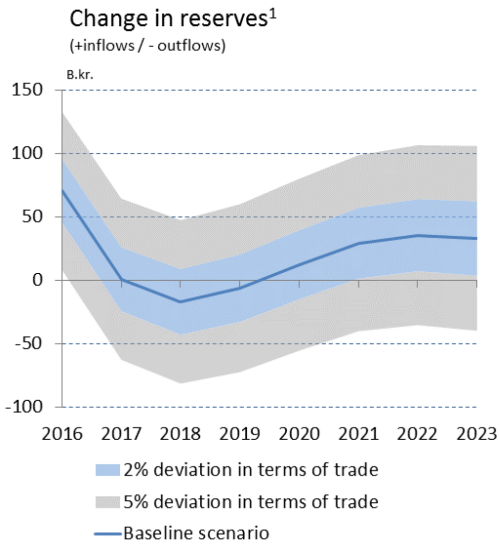
The above-described assessment of the balance of payments effect of settling the failed banks' estates is based on premises that are currently considered the most likely. However, it is clear that factors such as changes in terms of trade, international interest rates, or fish catches could have a significant impact, either positive or negative. The baseline outlook is positive in that there is a significant current account surplus, terms of trade have improved markedly in the past two years, and international interest rates are low. Relatively conservative assumptions concerning developments in terms of trade and interest do not reveal any signs of risk to the balance of payments. Continued positive developments in these factors would only serve to make a good situation even better and need not be examined in depth here. It is appropriate to bear in mind, however, that terms of trade are still somewhat below their historical average, even though they have improved substantially from their forty-year low in 2013. The assessment below aims to ensure that, even in the event of relatively unlikely yet possible adverse developments, settling the failed banks' estates without instability will create conditions conducive to lifting capital controls on residents.

The balance of payments analysis is based on the assumption that the surplus on goods and services trade will average 5.8% of GDP over the period 2015-2017, in line with the forecast in the August *Monetary Bulletin*, and 3% of GDP after the end of that forecast horizon. The effects of several deviations from the baseline scenario are described below.

First of all, a 2-5% deterioration in terms of trade is examined. A 2% deterioration in terms of trade will reduce the trade surplus by about 25 b.kr. per year. This could correspond, for instance, to a rise in crude oil prices to USD 71 per barrel or an 8% decline in marine product prices in early 2016. It is assumed to have no impact on economic variables other than GDP, which will changed commensurably, although it is likelier that a portion of the adjustment will show in a depreciation of the króna. The trade surplus will narrow by about 1% of GDP per year, or a total of 2.8% of GDP through 2018. As a result, there would be a slight deficit on the current account that year, although it would be well within sustainable limits. By end-2018, the foreign exchange reserves would be 76 b.kr. less, which is well within suitable limits. The ratio of reserves to short-term debt would also be above the 100% threshold.

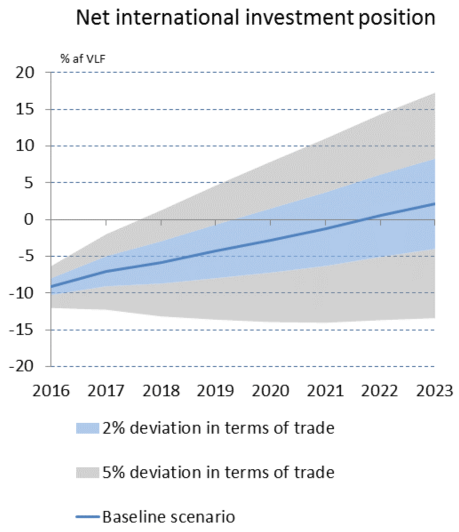


Source: Central Bank of Iceland.



1. Year-on-year change in reserves. If the change is less than zero, the reserves have contracted year-on-year, and if it is greater than zero, the reserves have expanded.
Source: Central Bank of Iceland.

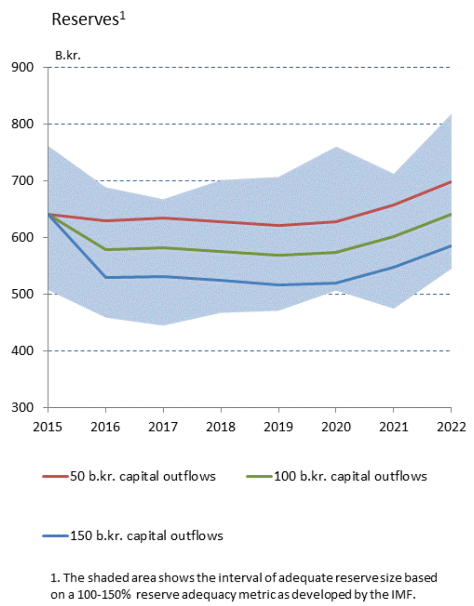
A 5% deterioration in terms of trade would reduce the trade surplus by about 60 b.kr. per year. A deterioration of that magnitude could occur if, marine product prices fell by 22% or if the recent decline in oil prices reversed in full and prices rose to USD 95 per barrel. If terms of trade deteriorated by 5% in comparison with the baseline scenario, the foreign reserves would be reduced by nearly 200 b.kr. by year-end 2018. The reserves would then stand at about 440 b.kr., which is still above the threshold in accordance with the IMF's reserve adequacy metrics (RAM) criteria. Furthermore, the ratio of reserves to short-term debt would still be above 100%. Iceland's NIIP would be negative by 13% of GDP.



Source: Central Bank of Iceland.

The above-described alternative scenario could also apply to a change in the outlook for exports. A 2% deviation in terms of trade would be equivalent to an 8.7% change in the volume of marine product exports in 2016, although the volume change in the years to follow would remain the same. The impact on the trade balance would therefore be permanent in comparison with the baseline scenario. By the same token, a nearly 5% change in the volume of exported services in 2016 would entail the same change in the trade balance as a 2% change in terms of trade. This would occur, for instance, if the number of foreign tourists contracted slightly in 2016 rather than growing by over 10%, as is assumed in the Bank's August forecast. The foreign reserves would be 76 b.kr. smaller than in the baseline scenario by end-2018. If the number of foreign travellers increased by just under 18%, however, this would be equivalent to a 2% improvement in terms of trade and would result in a 1% improvement in the trade balance. Other things being equal, this would improve the foreign reserves by 76 b.kr., and Iceland's NIIP would improve. It would be negative by 3% in 2018 instead of being negative by 6%, as is assumed in the baseline scenario.

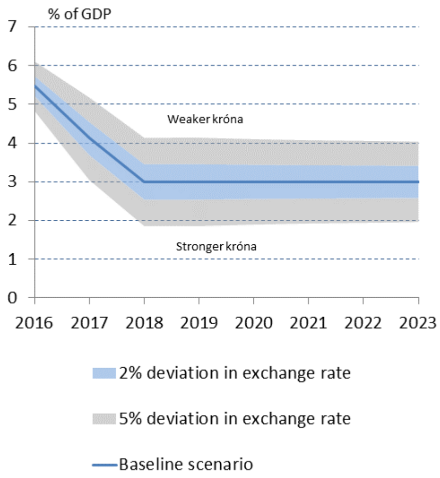
Second, the effects of an increase in capital outflows on the foreign reserves and the NIIP are examined. In the baseline scenario, it is assumed that there will be capital outflows in connection with instalments of external debt. To a large extent, instalments on external debt are refinanced, or an average of 88% of instalments through 2020. Some of the foreign-denominated outflows derive from reinvestment by residents. It is assumed that these investors will take all of their interest income on foreign assets (included in the primary income) and invest it abroad, which will cause foreign asset portfolios to grow over time. Pension funds have been authorised to maintain foreign investment obligations entered into before the capital controls were imposed, and their investments are estimated to average 6.3 b.kr. over the next three years. In addition, the pension funds' authorisation has been increased by 10 b.kr. per year since the authorities announced the capital account liberalisation strategy. These capital movements are assumed to show only in the balance of the foreign exchange reserves and not to affect the exchange rate, GDP, or domestic interest rates.



One-off capital outflows amounting to an additional 50-150 b.kr., which could possibly occur after the capital controls are lifted (although it is considered unlikely) will add to private sector foreign assets over time. Because it is assumed that the króna will hold stable, this change will reduce the balance of the foreign exchange reserves. The reduction in the reserves would slightly exceed the capital outflows, as interest income on private sector investments would be reinvested entirely abroad and interest income on the reserves would be lower than in the baseline scenario. At the end of 2020, the NIIP would be ½% more favourable than in the baseline scenario because private sector interest income would exceed the interest income on the reserves, as private entities have more scope to invest in riskier high-yielding assets.

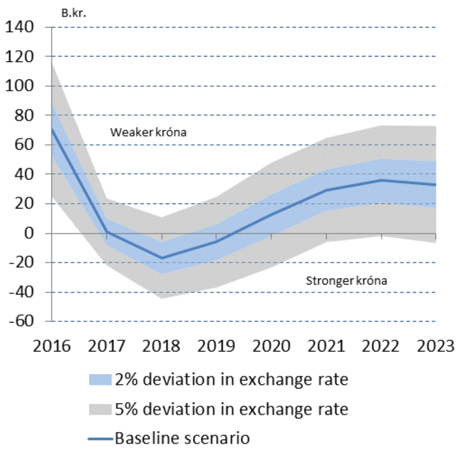
Third, a 5% change in the exchange rate of the króna is examined. In the baseline scenarios above, it has been assumed that the exchange rate would remain constant and that all adjustments would show as changes in the foreign reserves. Although such an assumption is useful in highlighting the strain on the reserves, it is likely that the actual impact will show to some extent in an adjustment of the exchange rate. The currency depreciation (due to the impact on imported goods and services prices), intervention, and the MPC's responses combined would reduce domestic demand and therefore cause imports to contract and the trade surplus to grow. Furthermore, a currency depreciation should stimulate exports somewhat in the long run. The impact on the current account balance would therefore be positive, but a weaker currency would have a negative effect on the balance on income, and the debt position would improve. The improvement in the debt position is because of the trade surplus and because foreign assets will be more valuable, whereas only a portion of Iceland's foreign debt will increase with a drop in the exchange rate. A portion of Iceland's debt is in domestic currency; for instance, non-residents' investments in stocks, Treasury bonds, and equity of foreign-owned domestic companies. The total impact is therefore positive, so that the adjustment adds to the trade surplus and the external debt situation will improve. The impact of the currency depreciation will be greatest at the outset but will taper off over time.

Trade balance



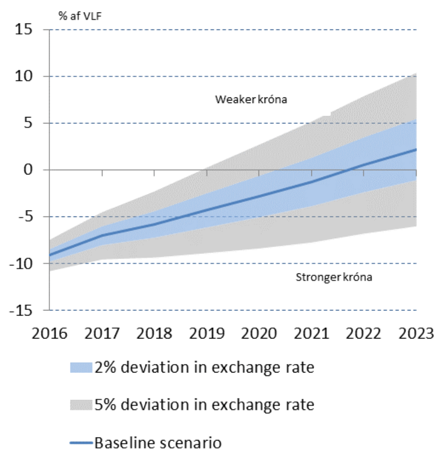
Source: Central Bank of Iceland.

Change in reserves[1]
(+inflows / - outflows)



1. Year-on-year change in reserves. If the change is less than zero, the reserves have contracted year-on-year, and if it is greater than zero, the reserves have expanded.
Source: Central Bank of Iceland.

Net international investment position



Source: Central Bank of Iceland.

According to the Central Bank's macroeconomic model, QMM, the impact of a 5% currency depreciation on the current account balance should increase the surplus by 0.7% of GDP in the same year and then grow, so that the current account surplus will be over 1% larger during the years that follow. It can be concluded from this that a roughly 10% depreciation will be needed to create a trade surplus of 5% instead of 3%, if this is the result at the exchange rate assumed in the examples above. On the other hand, it should be borne in mind that in order to overtake the negative impact on the balance on income, the depreciation would have to be somewhat greater.

Fourth, the impact of changes in foreign interest rates or risk premia on the interest on foreign debt is examined. There is considerable uncertainty about developments in interest on residents' foreign debt and income on foreign assets. In the examples above, it was assumed that the risk premium on

Treasury foreign debt is 1.5% and will fall to 1.1% by 2018 and subsequently remain stable. It is assumed that the premium on bonds issued by the commercial banks is 2.75% and will fall to 2.5% by 2018 and then remain unchanged. The premium on bonds issued by State- and municipal-owned firms lies in between these two.[11] On the whole, the baseline scenario assumes that the interest rate on foreign debt will average 3½%. This is based on the premises concerning the risk premium on foreign liabilities and the interest rate forecast for coming years. These assumptions could easily change, either because baseline interest rates will diverge from the assumed path or because interest rate premia on residents' debt will develop differently. It is therefore instructive to examine how sensitive the results are to changes in interest rate assumptions.

If the interest premium on the debt of the Treasury, the commercial banks, and other borrowers that tap foreign credit markets rises by 2 percentage points, Iceland's factor expense will rise and the current account surplus will shrink to 0% of GDP by 2018 instead of 0.2%, as in the baseline scenario. In the baseline scenario, only these parties' refinancing will be affected, and it is assumed that the scope of foreign credit financing will be unchanged from the baseline example. The foreign reserves will be 20 b.kr. lower by 2018 than in the baseline scenario, and the NIIP will be ¾% poorer.

At best, scenarios like those discussed above can give only a rough indication of the unsustainability or risk to the balance of payments, and they should not be viewed as forecasts. The analysis indicates that it would take sizeable shocks to upset the prevailing balance with the most favourable debt position in decades. This emphasises that conditions are now favourable for the measures that are necessary in order to lift the capital controls. Naturally, it does not mean that misguided economic policy or unforeseeable shocks could not derail that equilibrium, which would also affect the exchange rate of the króna. On the other hand, that is a risk unrelated to the settlement of the failed financial institutions and can never be entirely prevented.

[11] These are energy companies whose revenues are partly in foreign currency. They have better access to financing than other firms do.

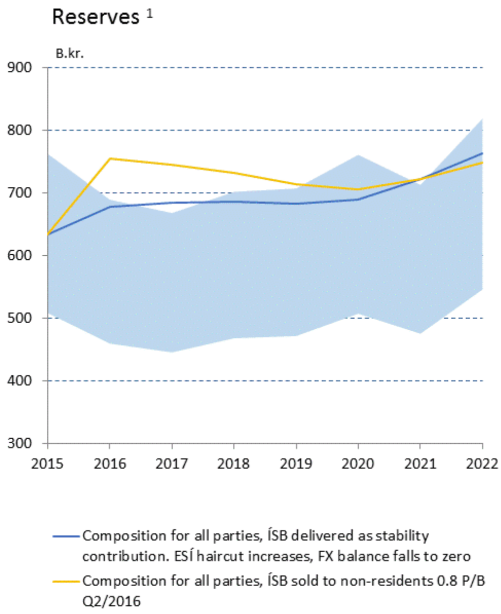
Appendix II: The balance of payments impact of various scenarios concerning the sale of Íslandsbanki

According to the June 2015 letter from Glitnir hf. to the authorities, the delivery of the stability contribution at the time of the composition agreement was set up in two scenarios pertaining to the sale of Íslandsbanki hf. (ISB). Both assumed that dividends would be paid before the bank was sold: on the one hand, a cash dividend of 38 b.kr. paid in domestic currency to the State and, on the other, a 16 b.kr. payment made to Glitnir hf. creditors in foreign currency. This last amount would not be paid out at the time of the composition agreement but would be used to establish a subordinated 10-year loan between Glitnir hf. and ÍSB. It was recommended that if ÍSB were sold to residents, the sales proceeds[12] would be paid in the form of the stability contribution, and if it were sold for foreign currency, the State would receive a stability contribution amounting to 60% of the purchase price in foreign currency, adjusted for the cost of selling the bank. It is useful to compare the balance of payments effects of winding up Glitnir hf., where the transfer of ISB Holding ehf.'s stake in Íslandsbanki hf. is a part of the stability contribution, with previous ideas concerning the allocation of the proceeds of selling the bank.

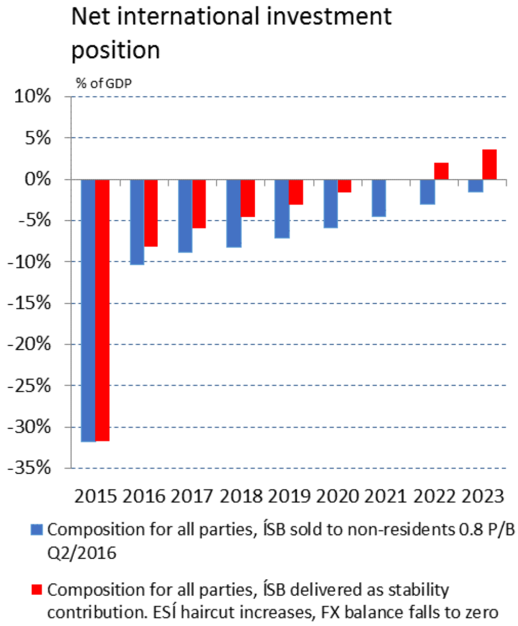
During the processing of Glitnir hf.'s exemption request, it emerged that ÍSB cannot pay the planned dividend without violating the Central Bank's liquidity rules. Alternatively, the issuance of a six-year bond was considered in connection with the 38 b.kr. dividend payment that was to be part of Glitnir hf.'s stability contribution. It was also clear that the planned 16 b.kr. subordinated loan would have had a somewhat negative impact on Iceland's balance of payments. It is not impossible that the factor expense associated with a foreign sale could exceed the amount in foreign currency that would be delivered as a stability contribution over a five-year period.

According to Glitnir hf.'s new proposal, the authorisation to convert króna-denominated assets to foreign currency will increase by about 52 b.kr., provided that all of Glitnir's stake in ISB Holding ehf. is transferred to the authorities as a part of the stability contribution and that the 16 b.kr. foreign-denominated dividend payment will not be made. In other words, the said 16 b.kr. will become part of Íslandsbanki's capital and therefore a part of the asset transferred to the State. The net impact is therefore 36 b.kr. The book value of Glitnir's holding in the bank as of end-2015 is estimated at 185 b.kr. Under the new proposal, Glitnir hf. will deliver its holding in the bank but, in return, will be authorised to convert more of its liquid ISK assets to foreign currency than was provided for under the previous proposal. Outflows from the balance of payments are estimated to be 49 b.kr. more because of this, but on the other hand, Iceland's net debt position will be better in coming years.

[12] For domestic sale, the sales proceeds as a portion of the stability contribution were subject to a profit-sharing agreement comparable to the agreement in connection with the sale of Arion Bank.



1. The shaded area shows the interval of adequate reserve size based on a 100-150% reserve adequacy metric as developed by the IMF.

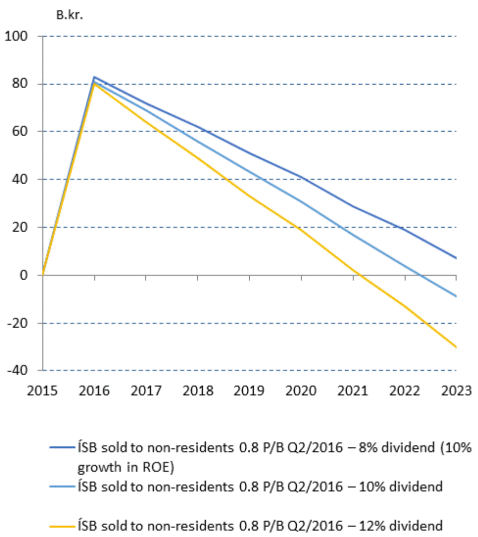


Source: Central Bank of Iceland.

Because Glitnir's entire stake in ISB Holding ehf. will be delivered as a part of the stability contribution instead of the previous proposal, the factor expense due to the dividend payments to the bank's foreign owners will not be accrued, and the special dividend payment that was to be used for the subordinated loan to Íslandsbanki hf. will not take place. The net debt position will improve by 42 b.kr.in comparison with the sale of the bank to non-residents, which would have increased Iceland's external debt by the value of the bank, net of the increase in the foreign exchange reserves resulting from the stability contribution. The main items that change under this arrangement are:

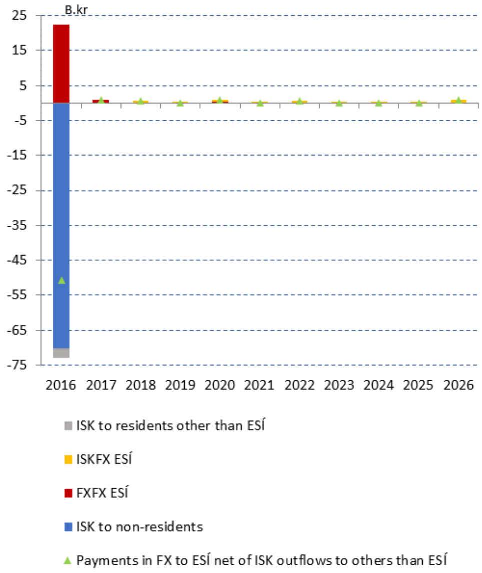
- The stability contribution will be 13 b.kr. higher than if the bank were sold at book value and about 27 b.kr. higher than if it were sold for foreign currency at 20% below book value. This is assuming that the authorities sell the bank at book value.
- On the other hand, a smaller amount of liquid assets will revert to the stability contribution.
- The foreign reserves will shrink by 40 b.kr. instead of increasing by 56 b.kr. if ÍSB were sold for foreign currency.
- Iceland's NIIP will improve, and factor expense will be lower in the future.
- The sale of Íslandsbanki hf. will be under the Government's control.
- Uncertainty about the impact of the bank's growth and dividend policy on the balance of payments and the balance of the reserves will be less than if attempts are made to sell the bank to non-residents (see the chart below, which shows the impact of various dividend policies on the size of the reserves).
- Payments from the Glitnir estate to non-residents will be front-loaded. Outflows from the balance of payments will total 49 b.kr. at the time of the composition (see the chart showing Glitnir's estimated payment flows), but if Íslandsbanki's foreign exchange balance were written down by 7%, expected outflows would total 40 b.kr.

Change in size of reserves: Impact of foreign sale based on different dividend payment scenarios



Source: Central Bank of Iceland.

Estimated distributions from Glitnir estate



Source: Central Bank of Iceland.