



Annual Report 2012

ANNUAL REPORT 2012

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Supervisory Board and senior officers of the Central Bank of Iceland (photo taken 7 March 2012). From left: Þórarinn G. Pétursson Chief Economist, Lilja D. Alfreðsdóttir Secretary of the Supervisory Board, Birgir Þór Runólfsson, Anna Ólafsdóttir Björnsson, Már Guðmundsson Governor, Björn Herbert Guðbjörnsson, Ingibjörg Ingvadóttir and Arnór Sighvatsson Deputy Governor. Sitting from left: Katrín Olga Jóhannesdóttir, Lára V. Júlíusdóttir Chairman and Hildur Traustadóttir.

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I Objectives and policy

As is stated in the Act on the Central Bank of Iceland, no. 36/2001, with subsequent amendments, the Bank's principal objective is to promote price stability. By agreement with the Minister of Finance and Economic Affairs, the Bank is authorised to declare a numerical inflation target. The inflation target is defined in a joint declaration issued by the Icelandic Government and the Central Bank of Iceland on 27 March 2001 as a 2½% rise in the price of goods and services over the previous 12 months (as measured by the consumer price index).¹ The Central Bank Act grants the Bank full independence to implement monetary policy so as to achieve this objective; however, it also states that the Bank shall contribute to the implementation of the Government's economic policy unless it considers that policy inconsistent with its own objective of promoting price stability. Moreover, the Act states that the Bank shall undertake such tasks as are consistent with its role as a central bank, such as maintaining external reserves and promoting an efficient and secure financial system, including payment systems domestically and with foreign countries. The Act also clarifies provisions on accountability, transparency of monetary policy, and the Bank's activities in general.²

Monetary policy

Monetary policy implementation is based on the Central Bank's inflation forecast, prepared over a horizon of three years. The forecast is published in the Bank's *Monetary Bulletin*, which was issued four times in 2012. *Monetary Bulletin* includes an in-depth analysis of economic and monetary developments and prospects as well as the Bank's forecast.

Amendments to the Central Bank Act, passed in 2009, provided for a five-member Monetary Policy Committee whose task is to take decisions on the application of monetary policy instruments. In this context, the Bank's monetary policy instruments are its interest rate decisions, transactions with credit institutions other than loans of last resort, decisions on reserve requirements, and foreign exchange market transactions. The Committee has adopted rules of procedure that have been approved by the Bank's Supervisory Board.³ The Governor is the chair of the Monetary Policy Committee, which also includes the Deputy Governor, a senior Central Bank executive in the field of monetary policy formation (currently the Chief Economist), and two other economic and monetary experts appointed by the Minister.

In 2012 there were eight interest rate decision dates, four of which were also publication dates for *Monetary Bulletin*. Interest rate decision dates are announced in advance; however, the Committee is authorised to change the announced dates or schedule additional ones.

1. The declaration was published in *Monetary Bulletin* 2001/2 and on the Bank's website. Minor changes were made to it in November 2005.

2. The Bank's tasks and activities are further described in various sections of the present report.

3. The Rules of Procedure for the Monetary Policy Committee can be found on the Central Bank website.

Financial stability

The Central Bank is obliged to promote a safe and effective financial system, including domestic and cross-border payment systems. The Bank attempts to maintain a constant, clear overview of the position of credit institutions and financial markets, and in its twice-yearly Financial Stability report, it publishes a detailed analysis of factors relating to financial stability. In addition, the Central Bank promotes an efficient and secure financial system by ensuring that Icelandic payment and settlement systems operate in line with internationally recognised standards.

As authorised by law, the Central Bank has set rules on minimum liquidity of credit undertakings and on their foreign exchange balance. The Bank carries out transactions with credit institutions, both receiving deposits from them and granting them loans. In special circumstances, when the Central Bank deems it necessary in order to preserve confidence in the domestic financial system, it is authorised by law to issue guarantees to credit institutions experiencing liquidity difficulties.

Foreign reserves, Treasury debt management, foreign exchange issues, and other tasks

The Central Bank maintains the nation's foreign exchange reserves. The reserves are intended to enhance security in transactions between Iceland – particularly the State and parties with a State guarantee – and other countries, and they are handled in accordance with rules of maintenance set by the Governor and confirmed by the Supervisory Board. The Central Bank is authorised to borrow funds in order to reinforce the foreign exchange reserves and to participate in international co-operation, in part for this purpose. The Central Bank of Iceland administers domestic and foreign borrowings and debt management for the Treasury as the representative of the Ministry of Finance and Economic Affairs.

Because of the extraordinary circumstances that developed after the banks' collapse in the fall of 2008, exchange rate stability (achieved in part through restrictions on capital outflows) became one of the key factors in the monetary policy devised jointly by the Government, the Central Bank, and the International Monetary Fund (IMF). The capital control liberalisation process is currently underway, and the inflation target has attained greater importance in monetary policy as the effects of the financial crisis diminish.

In recent years, including the post-crisis period, the Bank has been entrusted with new and expanded tasks. The Bank oversees the capital controls following amendments to the Foreign Exchange Act. Furthermore, the Bank has taken on new tasks related to domestic payment intermediation and now owns the company Greiðsluveitan ehf., which handles the operational aspects of important payment intermediation systems. It also owns the Central Bank of Iceland Holding Company ehf. (ESI), which manages assets and claims in the wake of the banking collapse. In addition, the Central Bank handles specified projects in relation to Iceland's application for European Union membership.

II Monetary policy

According to the Act on the Central Bank of Iceland, the Central Bank's principal objective is to promote price stability. This objective is further described in the joint declaration issued by the Bank and the Icelandic Government on 27 March 2001 as an inflation target of 2½%. Other monetary policy tasks involve contributing to financial and overall economic stability.

Interest rate, exchange rate, and inflation developments

In terms of the trade-weighted exchange rate index (TWI), the króna depreciated by about 6.6% over the course of the year, including some 6.5% against the euro and 4.7% against the US dollar (see Chart II-1). During the summer, however, it appreciated somewhat. In January 2012, twelve-month inflation measured 6.5%, its highest value for the year. It tapered off gradually during the year and measured 4.2% in December (see Chart II-2). Inflationary pressures were considerably stronger in the first half of the year, owing largely to the depreciation of the króna and to rising prices for petrol and services. Inflation declined somewhat in the latter half of the year, in the wake of the appreciation of the króna over the summer and the slowdown in the economic recovery. Even though the exchange rate fell again in the autumn, the depreciation was offset to some degree by the slack in the economy. Underlying twelve-month inflation as measured by core index 3 (which excludes the effects of taxes, volatile food items, petrol, public services, and real mortgage interest expense) measured 5.7% in January 2012 and fell to 4% by the end of the year.

At the beginning of 2012, the deposit rate (current account rate) was 3.75% and the maximum bid rate for 28-day certificates of deposit (CDs) was 4.50%. At that time, the Bank's collateralised lending rate was 4.75%. The Bank's effective policy rate – that is, the rate that most strongly influences money market rates – has in the recent term been close to the simple average of the Bank's current account rate and the maximum CD rate. At the beginning of the year, it was just over 4%. The Central Bank Monetary Policy Committee (MPC) decided to raise nominal interest rates three times in the first half of the year and again in November 2012. Following the MPC's December 2012 interest rate decision, the current account rate was 5%, the maximum rate on 28-day CDs was 5.75%, and the collateralised lending rate was 6%. The effective rate had therefore risen to 5.4% (see Chart II-3 and Table II-1).

The grounds for the rate increases were the deterioration of the inflation outlook in the first half of the year, due in part to the depreciation of the króna, and the prospect that inflation would be more persistent and remain above the inflation target longer than previously anticipated. Furthermore, the MPC was of the opinion that, as spare capacity disappeared from the economy, the slack in monetary policy should disappear as well. In the recent past, the Central Bank's real effective policy rate has been below the level that can be expected to be consistent with the inflation target once the slack has disappeared

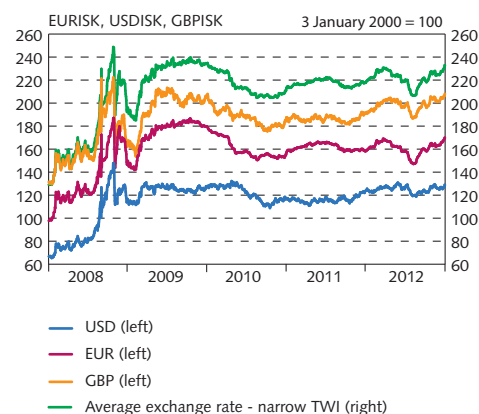
Table II-1 Central Bank of Iceland interest rates 2012 (%)

Date	Current account	28-day CDs (max)	7-day collateral	Over-night lending rate
12 Dec.	5.00	5.75	6.00	7.00
14 Nov.	5.00	5.75	6.00	7.00
3 Oct.	4.75	5.50	5.75	6.75
22 August	4.75	5.50	5.75	6.75
13 June	4.75	5.50	5.75	6.75
16 May	4.50	5.25	5.50	6.50
21 March	4.00	4.75	5.00	6.00
8 Feb.	3.75	4.50	4.75	5.75

Source: Central Bank of Iceland.

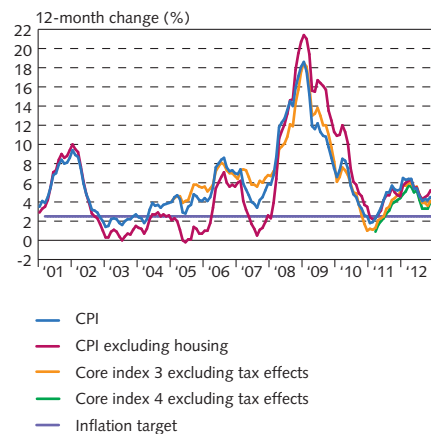
Chart II-1
Exchange rate of the króna

Daily data 3 January 2008 - 31 December 2012



Source: Central Bank of Iceland.

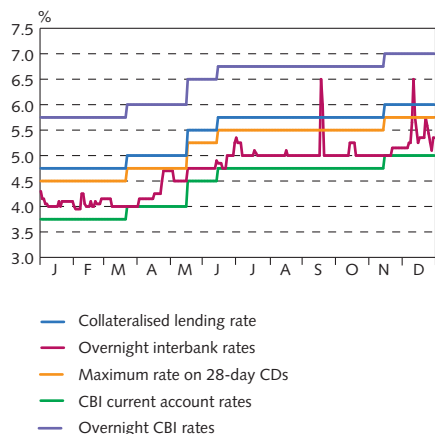
Chart II-2
Various inflation measurements
January 2001 - December 2012



Sources: Statistics Iceland, Central Bank of Iceland.

Chart II-3

Central Bank of Iceland interest rates
and short-term market interest rates
Daily data 1 January 2012 - 31 December 2012



Source: Central Bank of Iceland.

from the economy. The relaxed monetary stance has therefore supported the economic recovery. The Bank's real effective rate was about 1% at year-end 2012, after having risen by some 1.3 percentage points since the beginning of the year.

Monetary policy decisions and the rationale behind them

The Central Bank is required to publish reports on its monetary policy, as well as on monetary, exchange rate and foreign exchange developments and its measures in these areas. In its quarterly *Monetary Bulletin*, the Bank reports on the economic and monetary outlook. *Monetary Bulletin* is also issued in Icelandic under the title *Peningamál*.

The Act on the Central Bank of Iceland requires that the Bank's Monetary Policy Committee make public the minutes of its meetings and that it explain its decisions and the rationale behind them. The MPC publishes the minutes of its meetings two weeks after each interest rate decision is announced. The minutes contain the Committee's assessment of the status and outlook in economic and monetary matters and the members' arguments for their votes.

The Act also stipulates that, twice yearly, the Monetary Policy Committee shall submit to Parliament a report on its activities and that the contents of the report shall be discussed in the Parliamentary committee of the Speaker's choosing.

To pursue forward-looking monetary policy, a central bank needs models for assessing the economic outlook, especially inflation. The Bank is constantly developing models for use in assessing the economic outlook and analysing the impact of monetary policy. One means of enhancing transparency is to make the Bank's main forecasting model and its database accessible on the Central Bank website.

The Monetary Policy Committee and its decisions

The Monetary Policy Committee takes decisions on the application of the Bank's monetary policy instruments. In this context, the Bank's monetary policy instruments are its interest rate decisions, specified transactions with credit institutions, decisions on reserve requirements, and foreign exchange market transactions intended to influence the exchange rate of the króna.

The Monetary Policy Committee was chaired by Governor Már Gudmundsson, as is provided for by law. Other members were Deputy Governor Arnór Sighvatsson, Chief Economist Thórarinn G. Pétursson, Professor Anne Sibert of Birkbeck College in the UK, and Professor Gylfi Zoëga of the University of Iceland. Anne Sibert left the Committee in March 2012 and was replaced by Katrín Ólafsdóttir, Assistant Professor at Reykjavík University.

Interest rate decisions 2012

The Central Bank Act requires that the Monetary Policy Committee meet at least eight times each year. Eight meetings were held during the year. The Committee's decisions were as follows:¹

1. The members' arguments are presented in the minutes of the meetings.

8 February: The Governor proposed that the Bank's interest rates be held unchanged. Arnór Sighvatsson and Gylfi Zoëga voted in favour of the Governor's proposal, while Anne Sibert and Thórarinn G. Pétursson voted against it, voting instead in favour of a rate increase of 0.25 percentage points.

21 March: The Governor proposed that the Bank's interest rates be raised by 0.25 percentage points. Arnór Sighvatsson, Gylfi Zoëga, and Katrín Ólafsdóttir voted in favour of the Governor's proposal, while Thórarinn G. Pétursson voted against it, voting instead in favour of a rate increase of 0.5 percentage points.

16 May: The Governor proposed that the Bank's interest rates be raised by 0.5 percentage points. Arnór Sighvatsson, Gylfi Zoëga, and Katrín Ólafsdóttir voted in favour of the Governor's proposal, while Thórarinn G. Pétursson voted against it, voting instead in favour of a rate increase of 0.75 percentage points.

13 June: The Governor proposed that the Bank's interest rates be raised by 0.25 percentage points. All members supported the Governor's proposal. Gylfi Zoëga would have preferred to keep interest rates unchanged but was of the opinion that the difference was small enough that he was willing to vote in favour of the Governor's proposal.

22 August: The Governor proposed that the Bank's interest rates be held unchanged. Arnór Sighvatsson, Gylfi Zoëga, and Katrín Ólafsdóttir voted in favour of the Governor's proposal, while Thórarinn G. Pétursson voted against it, voting instead in favour of a rate increase of 0.5 percentage points.

3 October: The Governor proposed that the Bank's interest rates be held unchanged. Gylfi Zoëga and Katrín Ólafsdóttir voted in favour of the Governor's proposal, while Arnór Sighvatsson and Thórarinn G. Pétursson voted against it, voting instead in favour of a rate increase of 0.25 percentage points.



The Monetary Policy Committee as it was during the most part of 2012. From left to right: Chief Economist Thórarinn G. Pétursson, Assistant Professor Katrín Ólafsdóttir of Reykjavík University, Governor Már Guðmundsson, Chairman, Deputy Governor Arnór Sighvatsson and Professor Gylfi Zoëga of the University of Iceland.

7 November: The Governor proposed that the Bank's interest rates be raised by 0.25 percentage points. Arnór Sighvatsson, Katrín Ólafsdóttir, and Thórarinn G. Pétursson voted in favour of the Governor's proposal. Katrín Ólafsdóttir would have preferred to keep interest rates unchanged but was of the opinion that the difference was small enough that she was willing to vote in favour of the Governor's proposal. Gylfi Zoëga voted against the proposal, voting instead in favour of keeping rates unchanged.

12 December: The Governor proposed that the Bank's interest rates be held unchanged. All members supported the Governor's proposal. Thórarinn G. Pétursson would have preferred to raise rates by 0.25 percentage points but was of the opinion that the difference was small enough that he was willing to vote in favour of the Governor's proposal.



III The financial system

One of the Central Bank of Iceland's legally mandated roles is to promote a safe, effective financial system; that is, to promote financial stability. *Financial stability* means that the financial system is equipped to withstand shocks to the economy and financial markets, to mediate credit and payments, and to redistribute risks. A healthy financial system is a prerequisite for positive economic developments and effective monetary policy.

Emphases in financial stability

The main tasks in the field of financial stability are to analyse risks in the financial system, to research and draft rules on credit institutions' liquidity and foreign exchange balance, and to conduct monitoring on the basis of these rules. It is also to participate in setting policy on financial system development, the financial stability structure, and the formulation of further prudential rules for the financial system. Other tasks are to interact closely with other institutions involved with domestic financial stability, particularly the Financial Supervisory Authority, and participate in broad-based international cooperation. The Central Bank published two *Financial Stability* reports in 2012.

In the recent term, increased emphasis has been placed on analysis of private sector balance sheets and financial conditions. An in-depth analysis is prepared in co-operation with other departments in the Bank, based on data available in the Bank and a broad range of other information. Particular attention is paid to developments in private sector debt, which is placed into context with various other economic variables. Examples of variables monitored are default, frequency of bankruptcy and unsuccessful restraint measures, and household and corporate financial restructuring.

Prudential rules

In August 2012, the Bank issued a Special Publication entitled *Prudential rules following capital controls: the Central Bank's report to the Minister of Economic Affairs*. In the *Capital Account Liberalisation Strategy* published in March 2011, it was stated that before the capital controls would be lifted vis-à-vis Icelandic residents, it would be necessary to set prudential rules designed to protect the financial system against the risk that could accompany unrestricted capital flows, including financial institutions' foreign liquidity risk and the risk entailed in foreign-denominated lending to residents without income or underlying assets in the borrowed currencies. The report also included a discussion of the possibility of placing temporary restrictions on the pace at which pension funds may build up foreign assets after the controls have been lifted. In addition, it discussed possible rules or policy instruments that could be used in response to excess capital inflows of the type that occurred in Iceland during the run-up to the financial crisis.

Amended Central Bank liquidity rules for credit institutions took effect in October 2012. The main changes involve increased reserve

requirements for the deposits of financial institutions in winding-up proceedings. Previously, financial institutions in winding-up proceedings had lost their operating licences and their deposits had therefore been subjected to lower reserve requirements. After the changes took effect, deposits of financial institutions in winding-up proceedings were classified as debts to credit institutions, with a 100% reserve requirement. In general, it can be said that credit institution deposits are more liquid than other conventional deposits – for instance, deposits of parties that have business relationships with the bank concerned – and that it is therefore logical that they should have more weight than general deposits, which are subject to a 5-10% reserve requirement. In addition, it is clear that the deposits of financial institutions in winding-up proceedings are waiting to be paid out to creditors and are therefore more liquid than general deposits. The Central Bank liquidity rules are prudential rules, and information on liquidity positions based on the rules is used to assess credit institutions' position at any given time. In 2012, the Central Bank, in collaboration with the Financial Supervisory Authority and the largest commercial banks, worked on the implementation of new liquidity rules with reference to the new international liquidity rules that will take effect in the next few years (Basel III). The rules provide for active monitoring of two measurements of liquidity: the liquidity coverage ratio, which is intended to determine whether a financial institution can withstand substantial outflows over a 30-day period, and the net stable funding ratio, which is intended to encourage stable funding over longer periods of at least one year so as to ensure that long-term assets are funded with at least a specified percentage of stable funding with respect to liquidity risk.

At year-end 2012, the Central Bank of Iceland's authorisation to grant exemptions from foreign exchange balance rules because of conditions developing in the wake of the banking system collapse in autumn 2008 was renewed; cf. the Temporary Provisions of the Rules on Foreign Exchange Balance. The Bank may authorise financial institutions to hold a separate positive or negative foreign exchange balance on a temporary basis if there is a pressing need to do so. This Temporary Provision expires on 1 January 2014, as will all exemptions granted in accordance with it.

Payment Systems

Payment and settlement systems

The Payment Systems Unit is one of three operating units within the Payment Systems Department. The other two are the Cashier's Unit and Greiðsluveitan ehf. The tasks of the Payment Systems Unit centre are policy-making in the area of payment intermediation, formulation of rules on payment and settlement systems, monitoring, assessment of efficacy and safety, and oversight of systemically important payment and settlement systems in Iceland.

The Cashier's Unit handles the issuance and processing of banknotes and coin, as well as related administrative matters.

Greiðsluveitan, a company owned by the Bank, handles the operational aspects of important payment intermediation systems. The Central Bank's main objective and policy with the operation of

Greiðsluveitan is to ensure secure, efficient, and economical payment intermediation services.

Real-Time Gross Settlement (RTGS) system

As of 31 December 2012, participants in the RTGS system were the following: Arion Bank hf., Clearstream Banking société anonyme, the Housing Financing Fund, Íslandsbanki hf., Landsbankinn hf., MP Bank hf., and Straumur Investment Bank hf., in addition to the Central Bank of Iceland.

The RTGS system carries out the final monetary settlement of securities transactions from the Icelandic Securities Depository securities settlement system and the Greiðsluveitan netting system.

Total turnover in the RTGS system rose by 4.8% year-on-year in 2012, to 13,106 b.kr. The number of payment orders increased 7.8%, to over 89,000.

Netting system

As of end-2012, direct participants in the netting system were Arion Bank hf., the Housing Financing Fund, Íslandsbanki hf., Landsbankinn hf., MP Bank hf., and the Central Bank of Iceland. Total netting system turnover increased by 1.6% year-on-year in 2012, to 2,941 b.kr. The number of transactions fell by 1.4%, to just under 73 million.

Icelandic Securities Depository securities settlement system

As of 31 December 2012, settlement institutions in the securities settlement system were Arion Bank hf., Clearstream Banking s.a., HF verðbréf hf., Íslandsbanki hf., Landsbankinn hf., MP Bank hf., and Straumur Investment Bank hf. The number of settled transactions fell by 6% between 2011 and 2012, to 23,331 transactions with a total value of 2,414 b.kr. Off-exchange transactions rose by 15%, to a total of 59,665.

Payment instruments

Payment cards

All types of payment card transactions increased in number and turnover in 2012, with the exception of corporate card turnover, which fell by 10%.

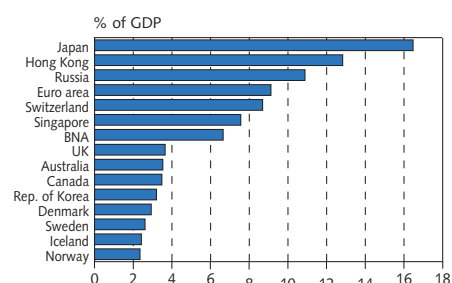
Total turnover for Icelandic payment cards amounted to 772 b.kr. during the year and was divided more or less equally between debit cards (51%) and credit cards (49%). Transactions were some 119 million in number. Credit card turnover rose by 9% in 2012, and debit card turnover by 3%.

Icelanders' payment card turnover abroad totalled 73 b.kr., with credit card use accounting for 59 b.kr. and debit card use the remaining 14 b.kr. About 4% of Icelandic debit card turnover was due to use abroad, as opposed to 16% of credit card use. Year-on-year in Icelanders' card use abroad measured 13% for debit cards and 9% for credit cards.

Cheques

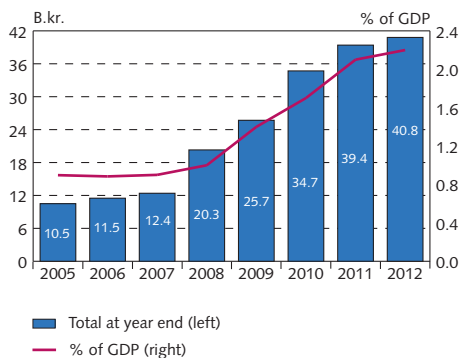
Use of cheques in the domestic market has contracted steadily in recent years. In 2012, the total amount of issued cheques was 47.3

Chart III-1
Cash in circulation in some countries 2011



Sources: Central Bank of Iceland, BIS, Norges Bank, Danmarks Nationalbank og Statbank Danmark.

Chart III-2
Banknotes and coin in circulation 2005-2012



Source: Central Bank of Iceland.

b.kr., as opposed to 55.7 b.kr. in 2011, a contraction of 15.1%. A total of 63,000 cheques were redeemed in 2012, as opposed to 104,000 in 2011, a reduction of 39.4%.

Banknotes and coin

The Central Bank of Iceland has the exclusive right to issue Icelandic currency. The Central Bank Act requires, among other things, that the Bank always have a sufficient supply of banknotes and coin. The Central Bank gives high priority to security of Icelandic banknotes, by processing them regularly and incorporating security features into them, among other things. The aim of the security features is to facilitate the detection of counterfeit banknotes and the classification of notes as fit and unfit for use. In 2012, the note processing department received about 12 million notes from commercial banks and savings banks, and destroyed 4.6 million notes. Counterfeiting is very rare in Iceland.

Cash in circulation outside deposit institutions and the Central Bank totalled 40.9 b.kr. as of year-end 2012. The increase during the year was 1.5 b.kr., or 3.7%. During the period 2008-2011, cash in circulation skyrocketed, with the year-on-year increase ranging from 13% to 52%. As these figures show, the scenario changed markedly in 2012.

Iceland is among the countries that use the least cash. For a long period, cash in circulation amounted to less than 1% of GDP. At end-2012, it amounted to 2.2% of GDP.

In 2006, the Central Bank began preparation for the issuance of a 10,000 kr. banknote. In 2012 it announced the issuance of the note, which will be similar in appearance to those already in circulation and will incorporate a greater number of more advanced security features. The theme of the note relates to poet Jónas Hallgrímsson. The banknote was designed by Kristín Þorkelsdóttir.



IV Foreign reserves

One of the Central Bank of Iceland's legally mandated tasks is to maintain the foreign exchange reserves. The foreign exchange reserves limit and mitigate the effects of external risks related to changes in access to foreign credit and fluctuations in capital flows to and from Iceland. The reserves enable the Bank to help the Treasury meet its need for foreign currency and fulfil its foreign debt obligations. Sufficiently large reserves create confidence in the market that Iceland is able to service its foreign debt. They can also be used to support monetary policy.

Size of the foreign exchange reserves

The size of the reserves is determined with reference to the scope of external trade, the exchange rate and monetary regime, laws and rules on capital movements and foreign exchange transactions, and Iceland's foreign liabilities. At any given time, the necessary size of the reserves is also determined by the balance of payments outlook. The Governor issues instructions on the desirable size of the reserves, based on the above-mentioned factors.

On 31 December 2012, the Central Bank's foreign exchange reserves amounted to 540 b.kr., or 32% of year-2011 GDP. At that time, Iceland's foreign exchange reserves were sufficient to cover 13 months of goods imports and amounted to 35% of M3. Furthermore, they are sufficient to service Treasury debt through 2022.

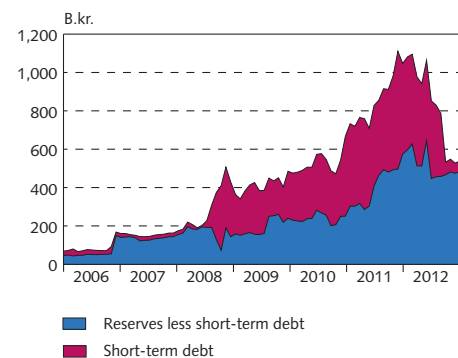
Changes in the reserves

From 2008 onwards, the Central Bank emphasised fortifying its foreign exchange reserves. With loans from the International Monetary Fund (IMF), bilateral loans from the Nordic countries and Poland, market issuance, and prepayment of shorter loans, the net foreign exchange reserves have trebled in size since end-2008.

The gross reserves declined considerably in 2012, however, due primarily to a reduction in short-term liabilities. The reserves totalled 1,044 b.kr. at the end of 2011 and 540 b.kr. at the end of 2012. The changes in 2012 are attributable to three factors: reductions in the foreign-denominated deposits held by financial institutions in winding-up proceedings, Treasury borrowing in the market, and prepayment of the Treasury and the Central Bank's loans from the Nordic countries and the IMF.

The Bank and the Treasury prepaid approximately 284 b.kr. of loans from the IMF and the Nordic countries during the year. In addition, the Treasury paid off a 6.6 b.kr. loan granted by the Faeroese to Iceland in the wake of the 2008 collapse. In all, the foreign-denominated deposits of financial institutions in winding-up proceedings declined by some 313 b.kr. in 2012, but this did not affect the net reserves.

Chart IV-1
Distribution of reserves



Source: Central Bank of Iceland.

1. Average of five-year monthly imports.
2. The net reserves are defined by the IMF as the reserves less fixed net disbursements on reserve assets in the upcoming 12 months.

Chart IV-2
Management of the foreign exchange reserves

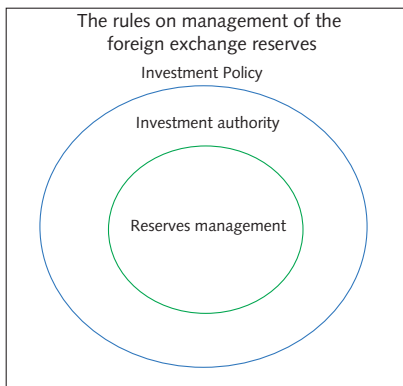
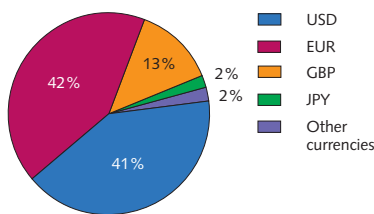
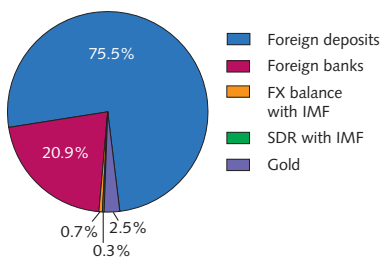


Chart IV-3
Currency composition
End of year 2012



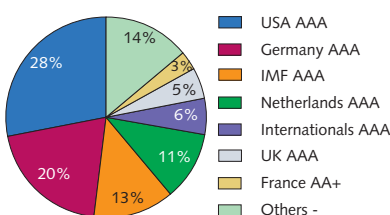
Source: Central Bank of Iceland.

Chart IV-4
Distribution of reserves
End of year 2012



Source: Central Bank of Iceland.

Chart IV-5
Geographical distribution of reserves
At end of 2012



Source: Central Bank of Iceland.

In May the Treasury issued a 10-year bond in the amount of 1 billion US dollars, the equivalent of about 129 b.kr., to strengthen the foreign exchange reserves. The loan prepayments and the new bond issue lengthened the maturity profile of the Treasury and the Central Bank's foreign debt, thereby increasing the net reserves.

Management of the foreign exchange reserves

The rules on management of the foreign exchange reserves have been thoroughly revised. New rules of maintenance of the reserves were set by the Governor on 29 August 2012 and approved by the Supervisory Board of the Bank. The new rules define outside limits for acceptable financial risk due to the foreign exchange reserves. They also contain stipulations on responsibility and division of tasks related to the investment of the reserves and set forth the principles governing financial risk and how it is measured, identified, and managed.

In accordance with the rules, an investment committee was established. Members are the Governor, who also chairs the committee, the Deputy Governor, the Director of Treasury and Market Operations, the Chief Economist, and the Head of Reserves Management. The investment committee meets monthly and formulates policy on reserves management by setting an investment policy within the framework of the rules of maintenance of the foreign exchange reserves.

The Central Bank of Iceland must address a variety of financial risks. The size of the reserves and the requirements concerning the share of liquid reserves at any given time place limitations on investments. It is critical that reserve assets be both sound and sufficiently liquid that the Bank can use them to achieve its objectives and carry out its tasks. This could limit the Bank's options in seeking the best returns available at any given time. Management of the foreign exchange reserves aims at minimising the Bank's risk-adjusted cost of reserve maintenance and managing the Bank's balance sheet in an efficient, economical manner.

The currency composition of the foreign exchange reserves is adjusted with the aim of minimising fluctuations in foreign-denominated assets net of foreign-denominated liabilities. The currency composition of this net position, or the Central Bank's foreign exchange balance, is reviewed regularly and confirmed in the reserve investment policy. The Bank uses derivatives, among other instruments, to manage its foreign exchange balance.

Maintenance of the reserves

The Bank attempts to ensure that the reserves are maintained and invested in a secure manner, and it exercises particular caution because of the current instability in the global financial markets.

The vast majority of the Bank's foreign exchange reserves are invested in foreign securities and deposits with foreign central banks and the Bank for International Settlements (BIS). The percentage of foreign securities assets grew sharply in 2012, to 75.5% by year-end. There are three main reasons for this. The liquid balance declined because of winding-up committees' withdrawals of foreign currency

Table IV-1 Returns on bonds in the reserves

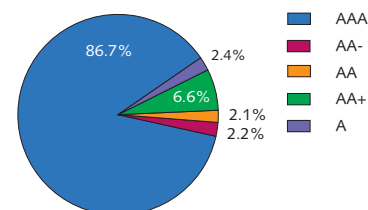
	GBP	USD	EUR	PLN
Total amount of bonds in b.kr. end of 2012	38.9	227.9	183.1	3.1
Returns in bonds 2012, %	1.9	2.0	4.2	16.9

from the Central Bank and because of prepayments of foreign loans. In addition, investment in foreign securities was increased.

Table IV-1 shows returns on bonds in the foreign exchange reserves in 2012 and the position, in billions of krónur, in each currency.

Charts IV-4, IV-5, and IV-6 show the division of the reserves as of year-end 2012, their geographical distribution, and the credit ratings of reserve assets.

Chart IV-6
Credit ratings of reserve assets
End of 2012



Source: Central Bank of Iceland.





V Treasury debt management

Agreement on Treasury debt management

The Central Bank of Iceland administers domestic and foreign borrowings and debt management for the Treasury as the representative of the Ministry of Finance and Economic Affairs. An agreement concluded between the Bank and the Ministry on 18 October 2010 provides for division of tasks and decision-making authority. The Central Bank is entrusted with overseeing the Treasury's foreign borrowings and administering auctions, buybacks, and redemption of Treasury securities, as well as preparing primary dealer agreements and administering securities lending to primary dealers. The Central Bank of Iceland carries out risk management and debt management according to Treasury debt management guidelines set by the Ministry. The Bank is also responsible for regular disclosure of information on Government debt affairs to the market participants and the Ministry and maintains the websites www.bonds.is and www.lanamal.is. The above-mentioned agreement entrusts the Bank with communications and disclosure of information on the Icelandic economy to foreign credit rating agencies and credit institutions, in addition to tasks related to Government guarantees and relending, such as administration of Government guarantees and the assessment of the Treasury's risk due to such guarantees. The Bank provides the Ministry with opinions on Government guarantees, administers such guarantees in accordance with ministerial decisions, and collects fees for them. The Central Bank also issues bonds for relending.

Domestic debt management

At the end of December 2011, the Central Bank, on behalf of the Treasury, published its Government Debt Management *Prospect* for 2012. According to the *Prospect*, Treasury bonds were to be issued for a total of 75 b.kr. in 2012 in order to fund the Treasury's operational deficit and the debt maturing during the year. In 2012, Treasury bond series RIKB 12 0824 matured in the amount of 49 b.kr. Net Treasury bond issuance, including other smaller maturities, was estimated at 8 b.kr. In addition, the outstanding amount of Treasury bills was to be reduced by about 14 b.kr.

The *Prospect* announced the issuance of a new two-year nominal bond series and a new series maturing in 2020, as well as the plan to continue building up RIKB 16 1013 and RIKB 22 1026 as five- and ten-year benchmark issues. The objectives set forth in the *Prospect* were met in almost all particulars.

The Government's *Medium-Term Debt Management Strategy for 2012-2015* was published at the beginning of the year. The strategy sets forth the authorities' plans for credit financing during the specified period. Its principal objectives are to ensure that the Treasury's medium- to long-term financing needs and financial obligations are met at the lowest possible cost that is consistent with a prudent degree of risk.

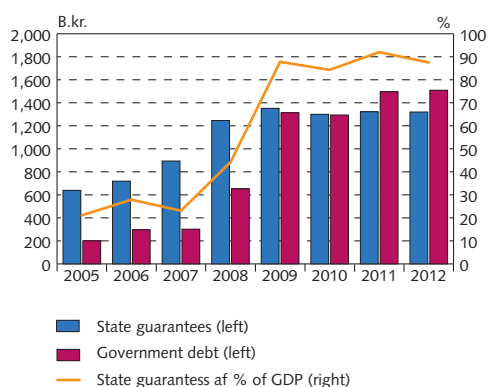
On 14 March 2012, a new indexed bond issue was announced in connection with the capital account liberalisation strategy. The new bond, RIKS 33 0321, took the place of RIKS 30 0701, which Government Debt Management considered to have reached the desired size. In all, bonds were issued for 27 b.kr. in connection with Central Bank foreign currency auctions during the year, while total auction-based issuance amounted to 81 b.kr. nominal value. In addition, indexed bonds were issued in the amount of 1.75 b.kr. in order to improve the Icelandic Regional Development Institute's capital position.

Foreign debt management

The Treasury's foreign debt totalled 430 b.kr. at year-end 2012. It can be divided into two categories: bilateral loans and market loans. The bilateral loans were from the treasuries of Denmark, Finland, Poland, and Sweden. The loans from the Norwegian Treasury and the IMF were disbursed directly to the Central Bank of Iceland and are therefore not considered part of Treasury debt. The market loans are five in number, the most recent of them a ten-year, USD 1 billion bond issued in May 2012. The bond bears fixed interest and was sold at a yield of 6.0%. Investors were keenly interested, with demand totalling 4 billion dollars.

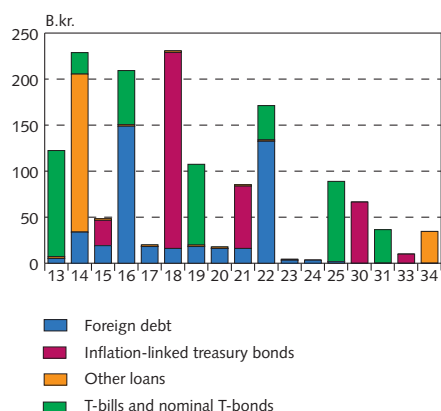
In March, the Treasury and the Central Bank repaid 366 million euros and SDR 289 million on the loans from the Nordic countries and the IMF, or approximately 20% of the loans taken in connection with the IMF-led Stand-By Arrangement. The payments included, on the one hand, prepayment of a portion of 2013 instalments to the IMF and, on the other hand, prepayment of the instalments due in 2014 and 2015, plus partial reimbursement of 2016 instalments, on the Nordic loans. In June the Treasury and the Central Bank made further payments on these same loans, in the amount of SDR 319 million, or 33% of the original loan from the IMF, and 674 million euros, or 39% of the original Nordic loans. The prepayments included instalments for 2013 and 2014 in the case of the IMF loan, and instalments for 2016, 2017, and 2018 in the case of the Nordic loans. In December the Treasury paid off the loan from the Faeroe Islands, in the amount of 300 million Danish kroner.

Chart V-1
Government debt and state guarantees
2005-2012



Source: Central Bank of Iceland.

Chart V-2
Redemption profile of government debt



Source: Central Bank of Iceland.

Table V-1 Treasuries total foreign debt year-end 2012

Nominal price with accrued indexation

Nominal debt	677,326
Inflation-linked debt	396,639
Foreign debt	435,021
Total	1,508,986

Treasuries total foreign debt year-end 2012

Interest is one of the Treasury's largest expenditure items. In 2012, the Treasury's charged net interest expense totalled 75 b.kr., as opposed to 64 b.kr. in the previous year. Yield in auctions of nominal Treasury bonds rose in 2012. The weighted average rate on accepted bids in auctions of nominal Treasury bonds was 5.58% in 2012, as opposed to 5.28% in 2011. In all, nominal Treasury bonds were sold for 54

b.kr. The weighted average rates on indexed bonds fell over this same period, from 2.78% in 2011 to 2.62% in 2012. In total, indexed Treasury bonds were sold in the amount of 27 b.kr. in connection with Central Bank foreign currency auctions.

The weighted average flat rate for accepted offers in Treasury bills was virtually unchanged between years, at 3.08% (instead of 3.09% in 2011), and bills were sold for the total amount of 134 b.kr.

Euro Medium-Term Note (EMTN) Programme and issuance in the US

The framework agreement establishing the Euro Medium-Term Note (EMTN) Programme was first signed in 2001. The agreement is administered by Citibank and provides for both public and private issues. It was most recently renewed in the summer of 2008, and the ceiling now amounts to 5 billion euros. Currently outstanding on the basis of the agreement are four bond issues in the total amount of 2.5 billion euros, or 435 b.kr. The debt management goal set at the beginning of 2012 was to seek out foreign credit markets, in part to build further confidence after the successful bond issue in 2011. In May 2012, the Treasury issued the aforementioned 1 billion US dollar bond.

Government guarantees and relending

Government guarantees are provided for in Act no. 121/1997. The Treasury may not undertake a guarantee unless authorised by law. Because of the risk to the Treasury, collateral must be provided that is deemed satisfactory by the State Guarantee Fund, which is authorised by law to supervise Government guarantees, keep track of the operations of entities that have received Government guarantees, and maintain a register of obligations backed by Government guarantees. The bulk of Government guarantees are due to the Treasury's holdings in the Housing Financing Fund and Landsvirkjun. These parties' borrowings are not handled through the State Guarantee Fund in the same way as those of parties outside the public sector that request Government guarantees for specified loans. Parties that enjoy Government guarantees due to Government ownership are required to obtain the Central Bank's approval of the terms and conditions for loans they intend to take abroad. Treasury guarantees totalled 1,319 b.kr. at the end of 2012, as opposed to 1,217 b.kr. at year-end 2011.

Sovereign credit rating of the Republic of Iceland

The main agencies that assign the Treasury a credit rating are Standard & Poor's, Moody's Investors Service, and Fitch Ratings. The Central Bank of Iceland communicates regularly with these agencies on behalf of the Government. Rating agencies have significant influence on lending terms in the global credit markets, and an entity's credit rating is, among other things, an indicator of the terms it will enjoy as a borrower. Iceland's credit ratings fell in the wake of the 2008 banking collapse but have been improving since 2011.

At year-end 2011, Moody's rating was Baa3 for long-term foreign and domestic obligations, and P-3 for short-term obligations. The outlook was negative. The ratings are considered investment-grade.

The rating from Moody's remained unchanged during the year, but in November it was stated that the agency considered Iceland's economy, fiscal affairs, and public sector debt on the right track, although significant risks remained, including risks related to capital account liberalisation and the Icesave dispute.

Standard & Poor's ratings for Iceland's foreign and local long- and short-term obligations were BBB- and A-3. The outlook was deemed stable, reflecting improving economic conditions, on the one hand, and risks related to removal of the capital controls, on the other.

In February, Fitch Ratings upgraded the Republic of Iceland's credit rating for long-term obligations in foreign currency from BB+ to BBB-. The ratings for short-term obligations and for long-term obligations in local currency were also upgraded and affirmed, with a stable outlook. The upgrade in the sovereign rating for long-term foreign obligations to investment-grade was considered to reflect the progress made in re-establishing economic stability, enforcing systemic improvements, and rebuilding confidence in Iceland's creditworthiness. The program to strengthen public sector finances was considered an indication that the public debt-to-GDP ratio had peaked in 2011.

With the upgrade from Fitch, Iceland has investment-grade ratings from all of the major agencies.



VI International cooperation

The Central Bank of Iceland communicates and transacts business with international institutions on behalf of the Government or in accordance with its statutory role.

International Monetary Fund

The Central Bank represents Iceland at the International Monetary Fund (IMF). Two missions from the IMF visited Iceland during the year to engage in discussions with the authorities. One of the missions was for a regular Article IV consultation and the other for post-programme monitoring of the Stand-By Arrangement with the IMF, which was in effect from 2008-2011. In addition, the Icelandic authorities received technical assistance with budget preparation from the IMF. All reports in connection with regular and post-programme monitoring by the IMF are published on the Central Bank website.

The Icelandic authorities received a loan of SDR 1.4 billion, or 277 b.kr. at the year-end exchange rate, from the IMF in connection with the Stand-By Arrangement. In addition, they received a loan from the Nordic countries, also in connection with the IMF Stand-By Arrangement, in the amount of 1,775 million euros, or 301 b.kr. In March and June, the Treasury and the Central Bank prepaid a portion of the IMF loan, in the amount of SDR 608 million, or 120.4 b.kr. Other repayments during the year totalled SDR 280 million, or 55.4 b.kr. Total repayments of the IMF loan amount to SDR 888 million, the equivalent of 176 b.kr., or 63% of the original amount borrowed. The loan will be paid off in 2016. The funds disbursed are held at the Central Bank of Iceland. Concurrent with the payments to the IMF, prepayments in the amount of 1,040 million euros, or 177 b.kr., were also made on the Nordic countries loans.

Iceland cooperates with the Nordic and Baltic countries through a Constituency at the IMF, and they jointly elect an Executive Director as one of the Fund's 24 Executive Board members. In 2012, the Constituency's permanent representative on the IMF Executive Board in Washington was Benny Andersen from Denmark. The spring meetings of the Board of Governors and the International Monetary and Financial Committee (IMFC) were held at the IMF headquarters in Washington, DC, and the annual meeting was held in Tokyo. In connection with these meetings, the reports of the Nordic-Baltic Constituency Office are published on the Central Bank website. The reports focus on topics of relevance in the work of the Fund and the Executive Board. The joint Nordic-Baltic speeches presented to the IMFC and the IMF Annual Meeting are also published. The Annual Meeting of the IMF was held on 12 October and the meeting of the IMFC the day after. Már Gudmundsson, Governor of the Central Bank of Iceland and Iceland's representative to the Board of Governors of the IMF, attended the meetings. The Nordic-Baltic Constituency's speech for the Annual Meeting was delivered by Nils Bernstein, Governor of Denmark's Nationalbank. The Constituency's representatives on the Board of Governors were Margrethe Vestager, Danish Minister for

Economic and Interior Affairs (spring meetings) and Swedish Minister of Finance Anders Borg (annual meetings).

On 1 February, Parliament passed Act no. 5/2012, authorising the Government to approve an increase in Iceland's IMF quota and confirm amendments to the IMF Articles of Agreement on Iceland's behalf. The changes were approved in 2008 by the IMF Board of Governors. The amendments focus on changes to voice and representation and member countries' quotas. Further amendments to the Articles of Agreement were approved by the Board of Governors in 2010, including a substantial increase in quotas in order to meet increased need for the Fund's assistance around the world. As a result, Iceland's quota will increase from SDR 117.6 million to SDR 321.8 million.

On 30 August, Parliament passed Act no. 100/2012, which changed the division of tasks among governmental ministries. Among other provisions, affairs relating to the IMF now fall under the Ministry of Finance and Economic Affairs.

The Executive Board of the IMF agreed to distribute profits from its gold sales to member countries, provided that they contributed a corresponding amount to the Poverty Reduction and Growth Trust, or PRGT fund, which provides financial assistance to poor member countries. This decision took effect on 12 October 2012, after the majority of member countries had given their approval. With a 7 December 2012 letter from the Governor of the Central Bank, Iceland agreed, upon obtaining approval from Parliament, to contribute its entire share, in the amount of SDR 305,000 (about 60 m.kr.), to the PRGT fund.

The Bank for International Settlements (BIS)

The Central Bank is a shareholder in the Bank for International Settlements (BIS) in Basel, Switzerland, which is an important consultative forum for central banks, as an information and research institution in the field of monetary policy and financial stability, and a provider of various banking services to central banks. The Governor attends central bank governors' meetings held regularly by BIS, and other Bank staff members participate in various projects carried out by the bank.

Organisation for Economic Co-operation and Development (OECD)

During the year, Central Bank representatives participated in the work of various committees and groups of the Organisation for Economic Co-operation and Development (OECD), including the Economic Policy Committee, Working Party 1, the Committee on Financial markets, and an expert committee on government debt management. OECD experts come to Iceland on a regular basis to keep abreast of economic developments, and they issue frequent reports setting forth the Organisation's opinion of economic affairs in the country. In addition, the Governor participated in panel discussions at an OECD conference on controls and freedom of capital flows, held in Paris in October.

Co-operation with other central banks and financial supervisors

During the year, the Central Bank of Iceland engaged in a variety of tasks in co-operation with other central banks. The central banks in

the Nordic region have long enjoyed close collaboration. The Bank also works regularly with the European Central Bank and, increasingly, with other central banks in Europe. The Governor also attends regular meetings with central bank governors and financial supervision officials in the Nordic and Baltic countries. Furthermore, the Central Bank participates in the European Financial Stability Board (FSB), which is the world's foremost harmonisation body in the field of financial stability, and is represented at meetings of the European Banking Authority (EBA).

Other financial institutions

The Central Bank cooperates with a large number of foreign financial institutions in connection with the management of its foreign exchange reserves, Treasury foreign debt, and other topics related to its operations.





VII Special projects

Central Bank of Iceland Holding Company ehf. (ESÍ)

After Iceland's banks collapsed in the autumn of 2008, the Central Bank acquired sizeable claims against domestic financial institutions. The claims were backed by collateral of various types. Some of them were transferred to the Treasury at year-end 2008, and the Central Bank administered them.

At the end of 2009, these assets were transferred to a separate company owned by the Central Bank, the Central Bank of Iceland Holding Company ehf. (ESÍ). Another company owned by the Central Bank, Sölvhóll ehf., is an operating company whose role is to maximise the value of the assets in the holding company (ESÍ) and divest them when market conditions permit, subject to the approval of the ESÍ Board of Directors. This arrangement provides the Bank with an effective means of separating the operations and assets related to the crash from its conventional activities. ESÍ has one subsidiary, Hilda ehf., which it took over in mid-2011. On the Hilda balance sheet are claims against individuals and small companies.

The board of ESÍ and Sölvhóll stepped down and a new board was selected in 2012. Members are Chairman Jón Þ. Sigurgeirsson, Ingibjörg Guðbjartsdóttir, and Sturla Pálsson. Members of the Hilda ehf. board are Chairman Haukur C. Benediktsson, Birgir Birgisson, and Eva Benediktsdóttir.

At year-end 2012, ESÍ's balance sheet totalled 326 b.kr., and its assets had declined by 13.3 b.kr. since year-end 2010, primarily due to asset recovery and reduction of debt to the Central Bank. The company's after-tax profit amounted to 5.6 b.kr.

Capital Controls Surveillance Unit

The Central Bank of Iceland's Capital Controls Surveillance Unit (CCSU) was formally established as a separate department within the Bank in September 2009. During the year, the department was divided into three units focusing on exemptions, surveillance, and investigation. The Exemption Unit's main tasks in 2012 were to process and take decisions on applications for exemptions from the Foreign Exchange Act and to provide general information and instructions to individuals and legal entities. The main tasks of the Surveillance Unit were to carry out general monitoring of the Foreign Exchange Act and conduct initial pre-investigation analyses of possible violations of the Act. Other projects undertaken by the Surveillance Unit include administration of new investments, supervision of the Bank's Investment Programme, follow-up on conditional exemptions, and assistance with analysis of information from other CCSU units. In 2012, the main tasks of the Investigation Unit centred on investigation of alleged violations of the Foreign Exchange Act and the Rules on Foreign Exchange.

A total of 27 cases involving alleged violations of the Foreign Exchange Act were reported to the Investigation Unit by the Surveil-

lance Unit, and another nine were referred by the Exemption Unit. A further 46 cases were investigated within the Investigation Unit. By the end of the year, 41 cases were in the process of being referred to the police due to suspicion of major violations of the Foreign Exchange Act and the Rules on Foreign Exchange.

The CCSU received 973 requests for exemptions from the Foreign Exchange Act in 2012. During the year, 711 requests were processed: 557 were approved, 15 approved in part, 39 rejected, and 100 withdrawn or concluded through issuance of guidelines or in another manner.

During the year, the Central Bank received 279 notifications of new investment (cf. Article 13(m) of the Foreign Exchange Act) in the total amount of 19.3 b.kr. This substantial increase from the previous year was due in part to investors' participation in the Bank's Investment Programme.

Foreign currency auctions

Treasury bond option and Investment Programme

The first auction according to the Investment Programme was held in February 2012. The Bank had announced in November 2011 that it intended to hold auctions for the purchase of foreign currency in exchange for Icelandic krónur for long-term investment in Iceland. These auctions are part of the capital account liberalisation strategy. Also held in 2012 were foreign exchange auctions according to the so-called Treasury bond option, in which foreign currency was purchased in exchange for Treasury bonds. The table shows the highlights of the auctions:

Table VII-1 Purchase of foreign currency

Key figures	Total 2012	Treasury bond option	Investment programme
Number of auctions	16	8	8
Number of offers	548	204	344
Total amount in million euros	497.1	279.9	217.2
Accepted offers in million euros	322.9	124.7	198.2

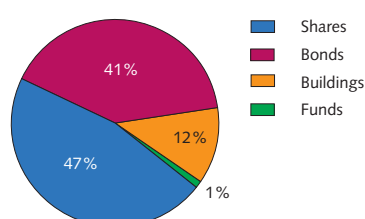
Treasury bond buyers included pension funds (81%) and other investors (19%).

In 2012, combined investment under the Investment Programme totalled 396.4 million euros, or just over 79 b.kr. The investments therefore amount to 4.9% of year-2011 GDP. An analysis of the investments, by amount, shows that 43% of participation in the Investment Programme was due to domestic investors, while foreign investors accounted for the other 57%. Foreign companies under domestic ownership were considered domestic investors for the purposes of this analysis.

Table Purchase of krónur

Key figures	2012
Number of auctions	7
Number of offers	239
Total amount b.kr.	136.4
Accepted offers b.kr.	41.7

Chart VII-1
Distribution by investment



Source: Central Bank of Iceland.

Purchase of krónur in exchange for euros

Concurrent with the above-described auctions, the Bank also advertised for bids on the sale of Icelandic krónur for cash payment in foreign currency. The table shows the highlights of the króna purchase auctions:

Release of offshore krónur

From 2011 through the 18 December 2012 króna purchase auction, a total of 70 b.kr. have been released through the auctions. The Avens transaction released some 120 b.kr., and other transactions released about 20 b.kr. With these transactions, the offshore króna overhang has been reduced by about 210 b.kr.

Application for EU membership

In 2012, the Central Bank carried out analysis and other preparatory work in connection with the EU accession negotiations. Particular topics included currency issues and other matters related to Section 17 of the negotiations, which focuses on EU legislation in the areas of economic and monetary policy. The Governor chairs the negotiating committee on currency issues in the EU accession discussions and is a member of the main negotiating committee.

National Festival Fund

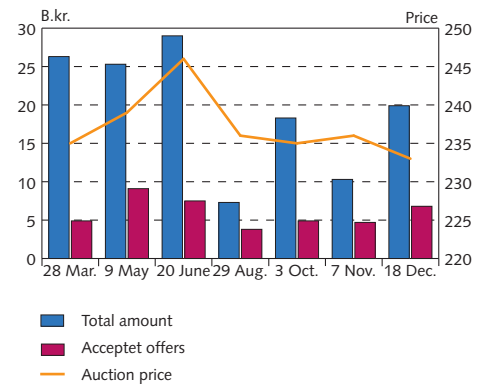
On 6 December 2012, the board of the National Festival Fund decided to grant the Árni Magnússon Institute for Icelandic Studies the last grant from the Fund. The grant, in the amount of 892,790 kr., will be used for repairs to Flateyjarbók. The last of the Fund's capital has now been allocated, as was stipulated in the National Festival Fund charter.

Jóhannes Nordal cultural heritage grants

On the occasion of its 50th anniversary in 2011, the Central Bank of Iceland decided to grant an annual cultural heritage grant in the name of Jóhannes Nordal. The objective of the grants is to support individuals whose aim is to preserve objects of cultural value that the

Chart VII-2

Options Auctions, purchase of krónur for euros



Source: Central Bank of Iceland



current generation has inherited. The first allocation was made in April 2012, and the grantees were Sigríður Dóra Sverrisdóttir and Páll Valsson. Dóra worked with rimes from Northeast Iceland and held a seminar for young people, in which they composed rimes on rights and responsibilities in the labour market. Páll worked on writing a book on the life and work of magistrate and poet Bjarni Thorarensen.



VIII Accounts and organisation

Central Bank accounting principles

According to Article 32 of the Act on the Central Bank of Iceland, no. 36/2001, with subsequent amendments, the preparation of the Bank's annual accounts "shall comply with laws, rules and good account practice. The Minister shall set detailed rules on the accounting principles and preparation of the annual accounts." In March 2013, changes were made to the Treasury's interest rate terms for 2012 with Governor's Decision no. 1235. According to the Decision, with consideration of the Treasury's cost in financing the foreign exchange reserves, the Treasury shall receive a 55% share of foreign interest income from foreign assets in the reserves in 2012, less interest expense due to the deposits of financial institutions in winding-up proceedings. On the other hand, the Ministry of Finance and Economic Affairs agreed that, from the 2012 accounting year onwards, no contribution would be paid on unrealised profit from gold and securities in the foreign exchange reserves. A change to this effect in the rules on the Bank's financial reporting was the basis for the Decision, which was signed by the Minister on 12 March 2013. However, minor changes have been made in the presentation of individual items. These changes are explained in the notes to the consolidated financial statements, which appear in this *Annual Report*.

Operating results and balance sheet

According to its profit and loss account, the Central Bank of Iceland recorded a net profit of 14,323 m.kr. in 2012, compared with a profit of 14,398 m.kr. in the previous year. Excluding exchange rate gain and loss and income tax, the Central Bank recorded a profit of 12,124 m.kr. in 2012, compared with a profit of 11,539 m.kr. the year before. The table illustrates the changes in the principal items of the Bank's profit and loss account. The transfer to the Treasury for 2012 was 2,186 m.kr. Exchange rate gains for the year totalled 4,719 m.kr.

As the table shows, the Bank's earnings declined by 75 m.kr. from the previous year. Net interest income declined by 18,853 m.kr., due primarily to a reduction in interest income on indexed securities and other domestic assets in the amount of 16,360 m.kr. and a reduction in interest paid on foreign bank accounts in the amount of 2,084 m.kr. This is due both to reduced principal amounts of foreign interest-bearing assets and to lower interest rates. Other operating revenues increased by 716 m.kr. Service expense rose by 744 m.kr. year-on-year, largely due to companies owned by the Central Bank. The revaluation of securities increased by 3,304 m.kr. between years. Exchange rate gains on foreign exchange transactions declined by 1,985 m.kr. year-on-year because the bulk of the 2011 gains were due to relaxation of the capital controls. The revaluation of gold was 774 m.kr., as compared with 881 m.kr. in 2011. Operating expenses rose by 327 m.kr. year-on-year, due principally to an increase in expenses related to management of the assets and liquid assets of companies owned by the Bank. Salaries and related expenses rose between years because of contractual pay increases and increased

Table VIII-1 Profit and loss account highlights

(Figures in ISK millins)	2012	2011	Change
Performance for the year	14,323	14,398	-75
<i>Changes specify as follows:</i>			
Net interest income	14,678	33,531	-18,853
Other revenues	5,430	4,714	716
Operating expenses	-3,126	-2,799	-327
Loan impairment	-4,858	-23,907	19,049
Transfer to the Treasury	-2,186	-3,464	1,278
Exchange rate difference	4,719	7,471	-2,752
Income tax	-334	-1,148	814

staffing levels. The Bank's assets totalled 1,068 b.kr. at year-end 2012, as opposed to 1,581 b.kr. at the end of 2011. Foreign assets declined by 513 b.kr. during the year. The decrease is due to the prepayment of the Treasury and the Central Bank's foreign loans. In all, 53% of the original IMF loan and 59% of the Nordic loans were repaid. The loans from the Nordic countries are disbursed both to the Treasury, which deposits the funds to its accounts with the Central Bank, thus expanding the foreign exchange reserves, and to the Central Bank itself. Foreign deposits from the financial firms in winding-up proceedings contracted by 313 b.kr. year-on-year.

At year-end 2012, the Bank's foreign assets constituted 51% of its total assets, as opposed to 67% at the previous year-end. The Central Bank's accounts are presented later in this report, together with detailed explanatory notes on individual items.

Supervisory Board

The Central Bank Act, no. 36/2001, stipulates that there shall be seven members of the Supervisory Board, which shall be appointed by Parliament following each Parliamentary election. During the year, members of the Supervisory Board were Chairman Lára V. Júlíusdóttir, Ragnar Arnalds, Björn Herbert Guðbjörnsson, Hildur Traustadóttir, Ragnar Árnason, Katrín Olga Jóhannesdóttir, and Ingibjörg Ingvadóttir, who replaced Daniel Gros.

Governor and Deputy Governor

During the year, Már Guðmundsson served as Governor of the Central Bank, and Arnór Sighvatsson served as Deputy Governor. Mr. Guðmundsson was appointed for a term of five years, effective 20 August 2009, and Mr. Sighvatsson was appointed for a term of four years, effective 1 July 2009.

Central Bank organisation

The Bank's activities in six main departments and three support departments, in addition to International Relations and General Secretariat, which provides general office and administrative services to the Governor, oversees public relations and information disclosure for the Bank, and supervises the publication of the Bank's *Annual Report* and website. The International Relations and General Secretariat department also handles regular communications with international credit rating agencies, the International Monetary Fund, foreign financial institutions (apart from financial transactions), and other domestic and foreign organisations.

The Economics and Monetary Policy Department carries out economic and monetary research, prepares macroeconomic and inflation forecasts, participates in formulating policy in currency and monetary matters, and analyses developments in domestic and foreign economic and monetary affairs, including the macroeconomic elements of financial stability. The Department oversees the issuance of various Bank publications, including *Hagvísar/Economic Indicators*, *Peningamál/Monetary Bulletin*, *Working Papers*, *Economic Affairs*, and *Economy of Iceland*. The Department comprises two units: the Analysis and Publications Unit and the Research and Forecasting Unit.

Table VIII-2 Balance sheet highlights

(Figures in ISK millions) 2012 2011 Change

Equity:	98,100	83,777	14,323
<i>Changes specify as follows:</i>			
Assets:			
Gold	13,757	12,249	1,508
Foreign assets	531,583	1,044,516	-512,933
FX balance with the IMF	3,710	3,525	185
Domestic financial assets	502,669	502,332	337
Fixed and liquid assets	4,963	4,891	72
Other assets	11,415	13,198	-1,783
Liabilities:			
Banknotes and coin	45,142	43,205	1,937
Foreign debt	135,971	341,604	-205,633
Counterpart to IMF	22,214	21,141	1,073
Deposits of financial institutions	72,606	61,997	10,609
Other deposits	569,693	919,729	-350,036
Domestic financial liabilities	113,953	85,914	28,039
Other liabilities	8232	19,880	-11,648
Unpaid transfer to treasury	2,186	3,464	-1,278
Equity	98,100	83,777	14,323

The Treasury and Market Operations oversees domestic money markets and currency markets, as well as transactions with domestic financial institutions. It also manages the Bank's foreign reserves and oversees government debt affairs, as well as Treasury guarantees and relending. The Department also oversees communications with the foreign financial institutions with which the Central Bank and the Treasury interact.

The Central Bank of Iceland's Capital Controls Surveillance Unit's (CCSU's) function is to ensure compliance with regulatory instruments on foreign exchange. The unit also participates in amending rules, publishing guidelines, and interpretation of such instruments. In addition, the CCSU processes requests for exemptions to the Foreign Exchange Act and is authorised to investigate alleged violations of the Foreign Exchange Act and the Rules on Foreign Exchange.

The Statistics Department handles the compilation, entry, and processing of statistical data collected by the Bank for its work and for official reporting. The Bank collects information on a regular basis about the domestic credit market, balance of payments, and external position of the economy. These data form the basis for the Bank's assessment of important aspects of monetary developments and for regular dissemination of statistical information, both in its publications and on the Statistics pages of its website. The Statistics Department is divided into three units: Financial Institutions, Balance of Payments, and Markets.

The Financial Stability Department analyses financial system risks and participates in formulating prudential rules for the financial system. The department has also placed increased emphasis on analysing the position of households and businesses. The *Financial Stability* Department publishes the Bank's Financial Stability reports.

The Payment Systems Department's role is to contribute to the safety and efficacy of important payment systems, issue and administer banknotes and coin, and operate the Bank's vaults. One company owned by the Central Bank, Greiðsluveitan ehf., operates under the auspices of the department.

The three support departments are Operations and Human Resources, Finance, and Legal.

The Operations and Human Resources Department handles security, procurement, budgeting, expenditure control, and the operation and administration of the Bank's real estate and equipment. The Department also handles human resources and payroll affairs, as well as a variety of in-house services. Furthermore, it oversees document storage and information technology, as well as the Library and Collection Department, which operates the Bank's library and the Central Bank and National Museum numismatic collection.

The Finance Department oversees the financial information for the Bank and companies owned by it, as well as overseeing the bookkeeping for the Norwegian National Festival Gift Fund and the Greenland Fund, which are administered by the Bank. The department administers domestic and foreign loans for the Treasury and the Central Bank. Furthermore, it administers the Bank's SWIFT system, as well as overseeing domestic and cross-border payments for the Bank, the Treasury, and State enterprises. The department also oversees custody of securities and settlement of securities transactions.

The Finance Department's activities comprise two operational units: Accounting and Bank Office.

The Legal Department provides the Governors and the various departments of the Bank with legal advice on matters related to the Bank's role and operations. Legal Department staff members participate in the preparation of legislation and other regulatory instruments, prepare legal opinions, prepare contractual agreements on behalf of the Bank, and finalise legal instruments and contracts.

The Internal Auditor works according to Article 28(c) of the Act on the Central Bank of Iceland, no. 36/2001, under the supervision of the Supervisory Board, and is responsible to the Board. Internal audit is defined as activity that provides impartial and objective confirmation and whose aim is to enhance value and improve the operations of the Bank and the companies it owns. The Internal Auditor assesses the efficiency of risk management and governance practises through systematic procedures, thereby supporting the Bank in achieving its objectives.

Human resources

The Bank's staff numbered 137 at the beginning of 2012, in addition to the Governor and Deputy Governor and nine part-time custodial employees, bringing the total to 148. At the end of the year, there were 151 employees in addition to the Governors, nine part-time custodial employees, and one custodial employee replacing a staff member on sick leave, or a total of 163. During the year, 28 employees were hired and 13 left the Bank. Nine summer staff members were employed by the Bank in 2012. The gender ratio changed slightly during the year: at the beginning of 2012 there were 73 males and 75 females, and at the end of the year there were 83 males and 80 females. The gender ratio among directors remained unchanged at five men and five women. As of year-end 2012, employees of companies owned by the Bank were 15, including 11 employed by Greiðsluveitan ehf. and four by Sölvhóll ehf.

Five of the 13 employees who left the bank during the year retired:

- Guðrún Sigmarsdóttir, Internal Information Services, after 32 years of service.
- Valborg Stefánsdóttir, Library and Collections, after 31 years of service.
- Magný Gyða Ellertsdóttir, Library and Collections, after 30 years of service.
- Tryggvi Eyvindsson, Statistics and IT, after 16 years of service.
- Hrafnhildur Georgsdóttir, Operations, after four years of service.

No major changes were made in the Bank's organisational structure during the year, although the Bank's staff grew considerably in number. The largest increase was in the Capital Controls Surveillance Unit, whose staff grew from nine to 15. The Library and Collections Department was transferred from the General Secretariat and merged with Internal Information Services under the auspices of Operations and Human Resources.

Nanna Huld Aradóttir was hired as Internal Auditor beginning on 1 March. She was previously employed as team manager of risk services for Deloitte hf., with specialisation in internal audit for financial institutions, insurance companies, and pension funds; external quality assessment for internal audit departments; and corporate consultancy on governance, risk management, and internal audit.

Central Bank of Iceland 31 December 2012

Supervisory Board

Principal members

Lára V. Júlíusdóttir, Chairman
 Ragnar Arnalds, Deputy Chairman
 Björn Herbert Guðbjörnsson
 Hildur Traustadóttir
 Ragnar Árnason
 Katrín Olga Jóhannesdóttir
 Ingibjörg Ingvadóttir

Alternates

Margrét Kristmannsdóttir
 Anna Ólafsdóttir Björnsson
 Sigrún Elsa Smáradóttir
 Guðrún Ágústa Guðmundsdóttir
 Birgir Þór Runólfsson
 Jón Helgi Egilsson
 Ingvi Hrafn Óskarsson

Governor

Már Guðmundsson

Deputy Governor

Arnór Sighvatsson

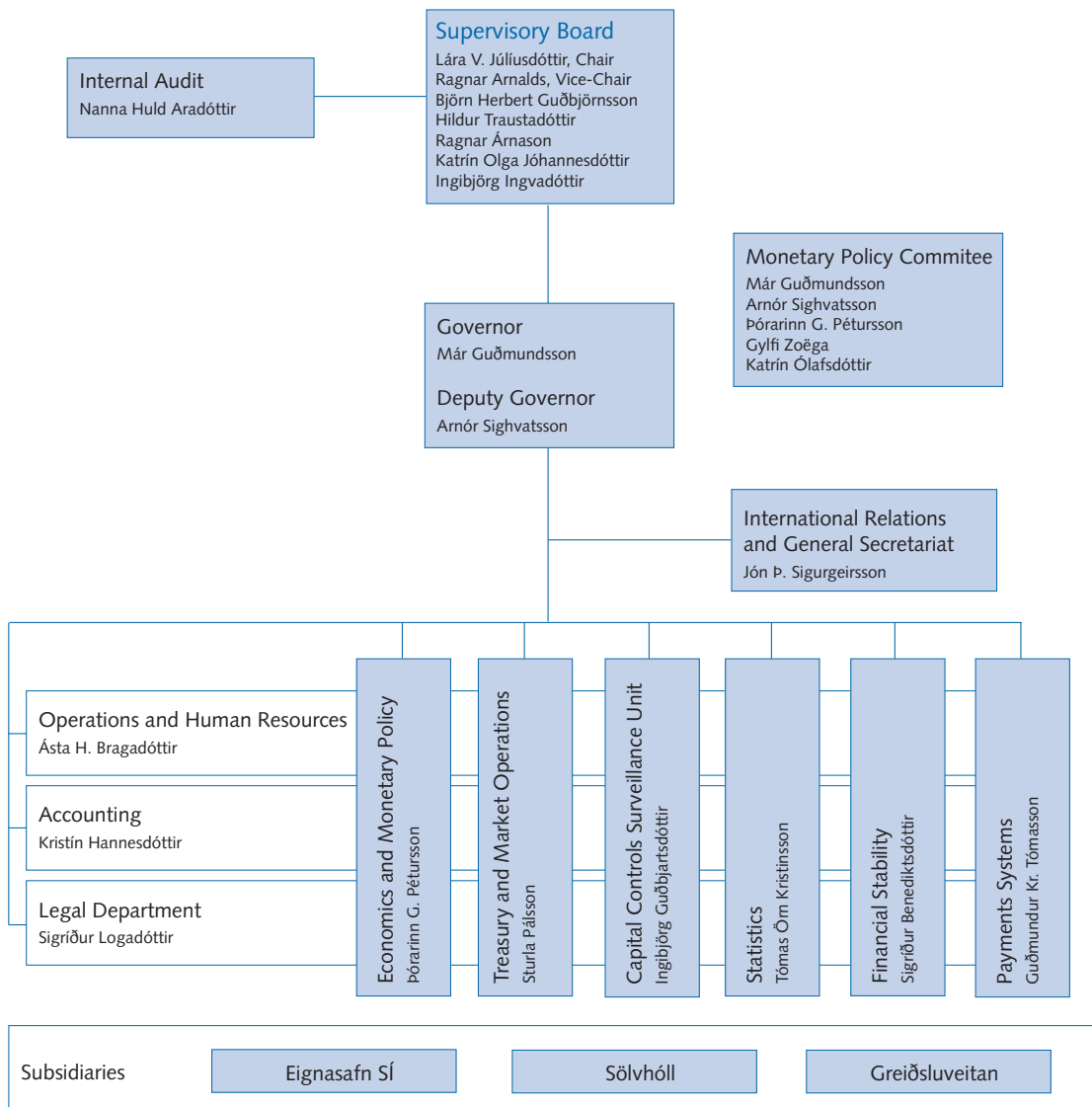
Principal Officers

International Relations and General Secretariat:	Jón Þ. Sigurgeirsson, Director
Finance:	Kristín Hannesdóttir, Director
Financial Stability:	Sigríður Benediktsdóttir, Director
Statistics and IT:	Tómas Örn Kristinsson, Director
Capital Controls Surveillance Unit:	Ingibjörg Guðbjartsdóttir, Director
Payment Systems:	Guðmundur Kr. Tómasson, Director
Economics and Monetary Policy:	Þórarinn G. Pétursson, Chief Economist
Legal Department:	Sigríður Logadóttir, General Counsel
Market Operations and Finance Management:	Sturla Pálsson, Director
Operations and Human Resources:	Ásta H. Bragadóttir, Director
Internal Auditor:	Nanna Huld Aradóttir

Companies owned by the Central Bank of Iceland

Greiðsluveitan ehf.:	Logi Ragnarsson Director
Sölvhóll ehf. (ESÍ):	Haukur C. Benediktsson Director

The organisational chart of the Central Bank of Iceland





CONSOLIDATED
ANNUAL ACCOUNTS 2012

Independent Auditor's Report

To the Supervisory Board and the Governors of the Central Bank of Iceland

We have audited the consolidated annual accounts of the Central Bank of Iceland for the year 2012. The consolidated annual accounts include confirmation by the senior management of the Central Bank of Iceland, a profit and loss account, a balance sheet, a statement of cash flows, information on accounting principles, and other explanatory notes.

Management's responsibility for the consolidated financial statements

Management is responsible for the preparation and fair presentation of these Consolidated Annual Accounts in accordance with generally accepted accounting principles in Iceland and the Icelandic Annual Accounts Act. This responsibility includes designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of Consolidated Annual Accounts that are free of material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on these Consolidated Annual Accounts based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the Consolidated Annual Accounts are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the Consolidated Annual Accounts. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the Annual Accounts, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the Annual Accounts in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the Consolidated Annual Accounts.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

It is our opinion that the consolidated annual accounts give a true and fair view of the results of operations of the Central Bank of Iceland for the year 2012, the financial position as at 31 December 2012, and cash flows for the year then ended, in accordance with the Annual Accounts Act and the Rules on the Central Bank of Iceland's Accounting and Annual Accounts.

Kópavogur, 14 March 2013

Deloitte ehf.

Benóni Torfi Eggertsson
State-Authorised
Public Accountant

Jón Rafn Ragnarsson
State-Authorised
Public Accountant

Confirmation by the management of the Central Bank of Iceland

The Supervisory Board and Governor of the Central Bank of Iceland hereby confirm the Bank's annual financial statements for the year 2012 with their signatures.

Reykjavík, 14 March 2013

Confirmation by the Supervisory Board

Lára V. Júlíusdóttir
Chairman

Ragnar Arnalds
Hildur Traustadóttir
Katrín Olga Jóhannesdóttir

Björn Herbert Guðbjörnsson
Ragnar Árnason
Ingibjörg Ingvadóttir

Confirmation by the Governor

Már Guðmundsson

Confirmation by the Minister of Economic Affairs

With reference to the statements by the auditor, the Supervisory Board, and the Governor of the Central Bank, I hereby ratify these financial statements.

Reykjavík, 21 March 2013

Katrín Júlíusdóttir

Profit and Loss Account for the Year 2012

	Notes	2012	2011
Interest income			
From domestic assets		33,376,241	49,694,764
From foreign assets		8,283,280	11,658,597
	1	<u>41,659,521</u>	<u>61,353,362</u>
Interest expense			
From domestic liabilities		(20,679,535)	(17,061,232)
From foreign liabilities		(6,302,241)	(10,761,361)
	2	<u>(26,981,776)</u>	<u>(27,822,593)</u>
		Net interest income	33,530,769
Operating revenues			
Service revenues	3	1,414,176	1,201,897
Service expenses	4	(1,415,627)	(671,266)
Revenues from shareholdings	5	78,454	60,697
Revaluation of foreign securities	6	4,458,541	1,155,346
Revaluation of gold	7	773,775	881,405
Exchange rate gains on foreign exchange transactions	8	120,959	2,086,187
		<u>5,430,278</u>	<u>4,714,265</u>
		Net operating revenues	38,245,034
Operating expenses			
Salaries and related expenses	9	(1,821,446)	(1,599,320)
Other operating expenses	10	(1,037,233)	(825,146)
Expense due to banknotes and coin	11	(96,674)	(218,560)
Depreciation of property and equipment	26	(170,658)	(155,981)
Impairment of claims	12	(4,858,429)	(23,906,948)
		<u>(7,984,440)</u>	<u>(26,705,955)</u>
		Profit (Loss) for the year before taxes and contrib. Treasury	11,539,079
Income tax (20%)	14	(333,959)	(1,148,005)
		Profit (Loss) w/o exchange rate differences	10,391,074
Contribution to the Treasury	15	(2,185,769)	(3,463,692)
Exchange rate difference	13	4,718,657	7,470,603
		<u>14,322,512</u>	<u>14,397,984</u>
		Profit for the year	14,397,984

Amounts are in ISK thousands

Balance Sheet 31 December 2012

Assets	Notes	2012	2011
Gold	16	13,757,459	12,248,658
Foreign assets	17-20	531,582,836	1,044,515,699
FX balance with the IMF	21	3,710,222	3,525,215
Domestic financial assets	22-25	502,669,107	502,332,405
Real estate and liquid assets	26	4,962,531	4,890,746
Appropriated assets		1,748,836	1,457,739
Other assets	27	2,630,952	6,678,029
Income tax credit	28	7,034,895	5,062,286
Assets		<u>1,068,096,838</u>	<u>1,580,710,777</u>
Equity and liabilities			
Capital		57,501,000	57,501,000
Revaluation reserve and liquid assets		4,449,711	4,501,922
Other equity	37	36,148,944	21,774,221
Equity		<u>98,099,655</u>	<u>83,777,143</u>
Banknotes and coin	30	45,142,048	43,204,646
Foreign debt	31	135,971,231	341,603,677
Counterpart to IMF	21	22,213,920	21,140,864
Deposits of financial institutions	32	72,605,932	61,997,455
Other deposits	33	569,693,223	919,729,302
Domestic financial liabilities	34	113,952,726	85,914,469
Income tax obligation	28	20,174	5,348
Pension obligations	35	318,117	321,113
Other liabilities	36	7,894,044	19,553,069
Unpaid contribution to Treasury	15	2,185,769	3,463,692
Liabilities		<u>969,997,184</u>	<u>1,496,933,635</u>
Equity and liabilities		<u>1,068,096,838</u>	<u>1,580,710,777</u>

Statement of Cash Flows 2012

	2012	2011
Operating activities		
Collected interest income	25,160,995	51,971,706
Paid interest expense	(21,710,466)	(26,858,465)
Net collected interest income	3,450,529	25,113,241
Collected service revenues	1,429,596	1,115,505
Paid-out service expense	(1,370,047)	(664,583)
Paid-in dividends on shareholdings	78,454	60,697
Collected net operating revenues	3,588,532	25,624,860
Paid operating expense	(2,774,953)	(2,404,591)
Cash and cash equivalents w/o taxes and contribution to Treasury	813,579	23,220,269
Paid income tax	(5,052,568)	(5,014,012)
Paid contribution to the Treasury	(3,463,692)	0
Net cash (to operating activities) from operating activities ..	(7,702,682)	18,206,257
Investment activities		
Collateralised loans and overnight loans, (increase) decrease	(12,350,000)	41,819,956
Purchased property and equipment	(185,869)	(53,026)
Sold property and equipment	0	4,000
Capital shares sold	2,420,404	4,964,132
Sold (purchased) Government bonds	4,440,590	(18,518,856)
Securities purchased	(3,323,957)	(57,785,246)
Securities sold	3,476,603	66,305,337
Instalments on securities, etc,	12,104,667	70,393,197
Securities purchased in foreign reserves	(278,298,973)	(178,191,076)
Securities sold in foreign reserves	177,077,127	136,324,418
Investment tax, Bank-owned companies	28,604	226,057
Special drawing rights with the IMF	87,931,479	(87,295,046)
	(6,679,327)	(21,806,154)
Financing activities		
Banknotes and coin in circulation, increase	1,937,402	4,935,168
Loan from IMF, (instalments)	(165,795,064)	96,303,980
Loans taken from Nordic central banks, (instalments)	(45,550,750)	38,121,600
Other loans taken, (instalments)	0	(58,373)
Certificates of deposit, increase	14,895,864	13,063,339
Treasury time deposits, (decrease)	0	(98,854,554)
Instalments on Treasury borrowings for FX reserve expansion	0	(11,000,000)
FX deposits, (decrease) increase	(380,603,352)	245,224,831
Increase (decrease) in deposits, DMBs	31,125,772	(27,085,115)
(Decrease) in deposits, other	(7,798,087)	(63,233,951)
(Decrease) Increase in deposits, central government	(2,900,953)	13,185,676
Investment tax	0	(326,705)
	(554,689,169)	210,275,896
Changes in cash position		
Foreign bank deposits, (decrease) increase	(573,515,883)	206,675,999
Exchange rate difference on bank deposits	14,613,528	32,207,501
Foreign deposit balance at beginning of year	672,143,912	433,260,411
Foreign cash balance at year-end	113,241,556	672,143,912

Amounts are in ISK thousands