MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
15 JULY 2015

Rate this Research

ANALYST CONTACTS

Kristin Lindow 212-553-3896
Senior Vice President
kristin.lindow@moodys.com

Anna Snyder 212-553-4037
Associate Analyst
anna.snyder@moodys.com

Dietmar Hornung 49-69-70730-790
Associate Managing Director
dietmar.hornung@moodys.com

Yves Lemay 44-20-7772-5512
MD-Banking & Sovereign
yves.lemay@moodys.com

Iceland, Government of

FAQ: Capital Controls and the New Liberalization Strategy

In early June, the [Government of Iceland (Baa2 stable)] outlined its plans to gradually lift capital controls that were first put in place in November 2008. Given the importance of capital account liberalization to Iceland's overall credit profile, our FAQ clarifies the key details of the extremely complex set of transactions involved in unwinding the controls, and examines the implementation risks to the government's plans.

» **What led to the banking sector collapse and the introduction of capital controls in November 2008?** Between 2003 and 2008, significant massive external imbalances developed in Iceland's banking system as a result of (1) substantial capital inflows due to favourable interest rate arbitrage; (2) an overheating of the economy and associated increase in private-sector leverage; and (3) banks' increased focus on wholesale funding and overseas acquisitions. In October 2008, the three largest banks failed over the course of a week as interbank funding dried up and investors rushed to exit, causing large capital outflows, a steep depreciation of the Icelandic króna and high inflation.

» **How and when were capital controls implemented in Iceland?** In order to regain domestic economic and financial stability after the banking sector collapse, Iceland introduced comprehensive capital controls via "the Rules on Foreign Exchange Act" on 28 November 2008.

» **Who held the assets and liabilities that were the focus of the capital controls, and how big of a problem were they?** More than half of the assets of the three largest failed banks were held abroad, concentrated in the banks' subsidiaries and branches in the UK and the Nordic countries. More than 75% of banks' liabilities were in global wholesale markets, which are inherently more volatile than deposits. Because private-sector balance sheets were highly leveraged and denominated in foreign currency and held abroad, the banking sector collapse and the system-wide loss of confidence that followed threatened to drain the Icelandic system of liquidity.

» **What is the status of capital controls in Iceland, and who holds the trapped assets today?** The restrictions on capital account transactions have been modified several times since 2008. Most importantly, the prohibition on two-way capital flows related to trade in goods and services was lifted almost immediately in November 2008. In October 2009, controls on inflows of foreign capital were lifted, allowing foreign and domestic investors to import foreign capital to Iceland to invest domestically, with full freedom to repatriate those funds and/or their earnings.

» **How will the capital account liberalization strategy proceed? When will capital again flow freely?** The capital account liberalization is a three-step process. The first stage targets a reduction in and maturity extension of the ISK900 billion in non-resident net claims on domestic assets held by the failed banks' estates. The second deals with the principal and interest associated with non-resident-owned, ISK-denominated bonds that matured after the capital controls were imposed and whose proceeds could not be repatriated. The third addresses the gradual releases of capital controls on Icelandic residents, the timing and sequencing of which has yet to be fully elaborated.

» **What is the link between neutralizing the ISK1.2 trillion balance-of-payments overhang and the government's receipt of ISK400-470 billion in new revenue?** The boon to government finances is concentrated in Phase 1, in which a significant portion of the ISK900 billion in trapped bank assets is used to repay the government for its cumulative costs of supporting the new banks. The strategy will then lock in around ISK300 billion into the new banks via the conversion of short-term foreign-currency deposits and other sources of funding into long-term funding.

» **Are there implementation risks?** Yes, and they include (1) a disorderly unwinding of trapped assets; (2) emergence of larger-than-expected asset quality problems in the new banking system; and (3) a slower-than-envisaged path toward liberalization. Any of these risks could bring negative consequences for the domestic economy and/or renewed financial volatility, as well as undermining investor confidence.

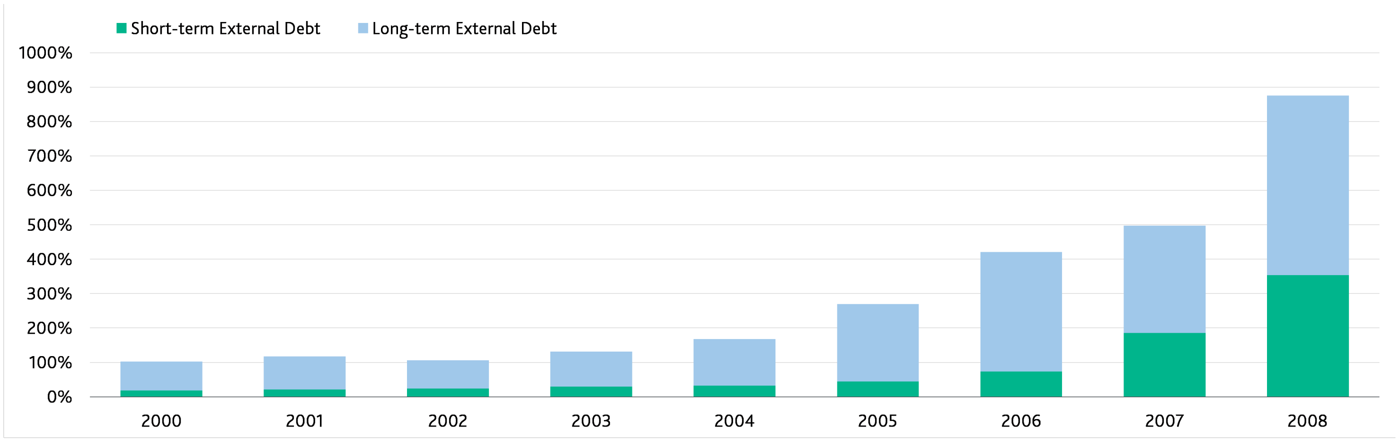
» **What are the implications of the orderly removal of capital controls on the sovereign's credit profile?** An orderly removal of capital controls has two discrete and positive implications for Iceland's credit profile. First, the repayment of funds that the government loaned to the new banks is important for Iceland's credit profile because the public debt trajectory is a key factor in our assessment of a sovereign's creditworthiness. Second, the significant reduction in the external overhang and banking sector risk – which has laid the foundation for an orderly removal of capital controls – suggests that Iceland has a much stronger credit profile than it had just a year ago, with already-strong institutional strength supporting its efforts to overcome the country's distress.

Question 1: What led to the banking sector collapse and the introduction of capital controls in Iceland in November 2008?

A variety of triggers led to substantial capital inflows to Iceland in the years leading up to 2008. First, Iceland's appreciating currency and high interest rate differentials against other highly rated advanced economies brought in foreign capital attracted by the carry trade. Second, over the same period, Icelandic companies – both commercial banks and non-financial corporates – began to borrow heavily in international markets, further increasing capital flows into Iceland. Third, motivated by easy access to inexpensive foreign funding thanks to their high credit ratings, Iceland's commercial banks expanded their offshore balance sheets during this period. The assets of the three largest banks (Kaupthing, Landsbanki and Glitnir) grew to the equivalent to more than 10 times the value of Icelandic GDP by the second quarter of 2008.

The capital inflows quickly ran up Iceland's external debt, creating significant external imbalances: Iceland's external debt had ballooned from 174% of GDP in 2004 to 543% of GDP by the end of 2007. The Central Bank of Iceland (CBI) was unable to maintain a sufficiently large reserve buffer to match short-term external debt obligations. In fact, reserve coverage amounted to less than 10% of short-term debt in 2007. By the time the global banking crisis created refinancing problems for Iceland's commercial banks in late 2008, non-residents' króna positions totaled ISK680 billion (roughly 40% of 2008 GDP), with short-term positions totaling approximately ISK330 billion.

Exhibit 1
Iceland's external debt ballooned alongside capital inflows in the run-up to 2008
External debt to GDP (%)



Source: Central Bank of Iceland

With the escalation of the global financial crisis, the country's three big banks collapsed over the course of a week in October 2008, as interbank funding pressures grew and liquidity quickly dried up. Simultaneously, investors rushed to exit, causing large capital outflows, rapid króna depreciation and high inflation; during 2008 the króna lost 86% of its value against the euro, and 95% of its value against the dollar.

Question 2: How and when were capital controls implemented in Iceland?

In order to restore a semblance of stability to the domestic economy and financial market following the banking sector collapse, Iceland introduced comprehensive capital controls via "the Rules on Foreign Exchange Act" (the Rules) on 28 November 2008. Enacted with the primary goal of stabilizing the exchange rate without an overreliance on monetary policy, the controls deviated from Iceland's obligations under the European Economic Area (EEA) Agreement to uphold free capital movement, but they were endorsed by the IMF as necessary to stabilize the domestic financial market and exchange rate and later gained a temporary exemption from the EEA.

In accordance with the Rules, both residents and non-residents are restricted from converting capital already in the Icelandic financial system at the time that the controls were put in place from ISK to FX. This means that ISK-denominated bonds and similar instruments also cannot be converted to foreign currency upon maturity. Rather, the proceeds must be reinvested in other ISK instruments. The Rules also require residents to repatriate all foreign currency they acquire by exporting goods and services.

Question 3: Who held the assets and liabilities that were the focus of the capital controls, and how big of a problem were they?

By year-end 2007, the total consolidated assets of Iceland's three large commercial banks

(Glitnir, Kaupthing, and Landsbanki) were equal to roughly 923% of GDP (up from 100% of GDP in 2004)[1] . At the time, more than half of these banks' assets of were held abroad. Though the geographical breakdown varied by bank, foreign assets were concentrated in the banks' subsidiaries and branches located in the UK and in the other Nordic countries (although significant bank assets were also held in Ireland, Luxembourg and other international locales).

On the liabilities side, more than 75% of the banks' funding relied on global wholesale markets by end-2007. This strategy allowed the banks to fund their rapid global expansion beyond what the domestic financial system could finance. However, wholesale funding is almost always a more volatile source of funding than deposits or other domestic borrowing, and reliance on such funding exposed the banks to significant liquidity and refinancing risks that ultimately materialized as the global financial crisis deepened towards the end of 2008.

Moreover, compared to the banks' assets, a significantly smaller share of the banks' liabilities were in krónur (although the majority of both assets and liabilities were in foreign currency), exposing the banks to exchange-rate risks associated with the asset-liability mismatch. The majority of the domestic banks' deposits and other short-term liabilities, in particular, were denominated in foreign currencies. By end-2007, some 80% of Iceland's 543% of GDP gross external debt was made up of banking sector liabilities and more than one-third was short term.

Because the financial sector and private sector balance sheets were highly leveraged, with a significant proportion of assets and liabilities denominated in foreign currency and held abroad, the banking sector collapse and the system-wide loss of confidence that followed threatened to drain the Icelandic system of liquidity. Iceland's net foreign liabilities position widened sharply from 106% of GDP in 2007 to 605% of GDP in 2010, with external liabilities dwarfing the economy's size, not to mention the banks' capital buffers (which were denominated mostly in krónur) and the government's foreign exchange reserves.

Exhibit 2

Iceland's External Positions in 2004 versus 2007

% of GDP

	December 31, 2004	December 31, 2007	December, 31 2010
Estimated Total Consolidated Assets of Iceland's Three Large Commercial Banks	100%	923%	
Total External Debt	174%	543%	
of which Short-Term	32%	185%	
of which Long-Term	142%	358%	
Total External Liabilities	189%	627%	
Net International Investment Position	-64%	-106%	-605%

Source: Central Bank of Iceland, IMF

Question 4: What is the status of capital controls in Iceland and who holds the trapped assets today?

The restrictions on capital account transactions have been modified several times since 2008. Most importantly, the prohibition on two-way capital flows related to trade in goods and services were released immediately following the adoption of the Foreign Exchange Act in November 2008. Then in October 2009, controls on inflows of foreign capital were lifted, allowing foreign and domestic investors to import foreign capital to Iceland and invest it domestically, with full freedom to repatriate those funds and/or their earnings. Certain Icelandic companies, including major exporters and firms with large international operations, also were given full or partial exemption from the Rules upon fulfilment of certain criteria (for example, firms with more than 80% of both revenues and expenses abroad were exempt).

Further, in mid-2011, controls on short-term króna assets were partially lifted when the central bank began to hold foreign-currency auctions, allowing non-residents holding short-term króna assets to sell them to long-term investors (for long-term investment in Icelandic treasury bonds or Icelandic enterprises) in exchange for foreign currency.[2] Following the latest auction in February 2015, short-term króna assets have been reduced to 15% of GDP, compared to 25% of GDP in 2011. By reducing the size of these short-term, króna-denominated claims, the auctions have reduced the potential króna outflows emanating from this stock of króna assets when capital account controls are removed.

Today, however, funds equivalent to roughly ISK1.2 trillion remain trapped by the Icelandic authorities. Although substantially reduced compared to when capital controls were first imposed, they are equivalent to 65%-70% of Iceland's current GDP and a sudden withdrawal of such funds would therefore be extremely destabilizing to the domestic economy, financial markets and exchange rate[3] . As a consequence, the Icelandic authorities have engaged in consultations with the creditors of Iceland's failed banks (which today include hedge funds that began purchasing the banks' distressed assets in 2010) in order to restructure the banks' portfolios in such a way that mitigates the balance of payments (BOP) risks, while awarding those creditors that own claims against the failed banks an acceptable level of recovery on their investments.

Question 5: How will the capital account liberalization strategy proceed? When will capital again flow freely?

In June 2015, the Icelandic authorities announced a long-awaited update to their strategy for capital account liberalization. The newly updated strategy takes a three-stage approach to lifting capital account restrictions, with the success of each step in avoiding disruption to the Icelandic economy and financial markets key to the success of the next. The first stage targets a reduction in and maturity extension of the ISK900 billion in non-resident net claims on domestic assets held by the failed banks' estates (the estates). The second stage deals with the principal and interest associated with non-resident-owned, króna-denominated bonds (the so-called trapped ISK) that matured after the capital controls were imposed, the proceeds of which were not able to be repatriated. The third stage addresses the gradual release of capital controls on Icelandic residents, the timing and sequencing of which has yet to be fully elaborated.

Phase 1: Reducing the potential economic and financial disruptions (i.e., neutralizing the BOP overhang) of the failed banks' estates

The first step in the process is the requirement that the creditors of the estates of the three large Icelandic banks that failed in 2008, which at ISK900 billion are the largest component of these claims, adopt "stability conditions". These conditions are essentially threefold: (1) a release of domestic assets (the so-called "stability contribution"); (2) an extension of maturities on foreign currency-denominated domestic deposits; and (3) the refinancing of government foreign-currency funding from the time when the new banks were launched. The failed bank estates have all voluntarily submitted proposals on the basis of these conditions rather than incur a 32%-39% "stability tax" on the total assets of the failed banks.

In return for their adoption of these conditions, and with an exemption from the Foreign Exchange Act from the Central Bank, the creditors of the old banks will be able to achieve composition, that is, they can dissolve the failed banks without undergoing bankruptcy. The rest of their assets are held abroad, and therefore will not be liquidated in the Icelandic foreign-exchange market and cause disruption there. Although these obligations had not been serviced since the banks collapsed, they represented notional external liabilities in excess of 400% of GDP. After the write-off, Iceland's net external debt position will be reduced to around 20%-24% of GDP.

In the composition process, the failed banks' creditors will transfer ISK assets to the Icelandic authorities so that they cannot disrupt economic and financial stability as they would if converted into foreign currency in the domestic FX market. Another new piece of legislation, the Stability Tax Bill, earmarks these proceeds for the reduction of government debt as the assets mature, a process that is expected to be front-loaded over the next three years. Moreover, the estates' creditors will write-off the substantial external liabilities owed to them by the estates.

Phase 2: Addressing remaining offshore liquid króna (OLK) holders, using an auction format

The second phase of the liberalization strategy involves dealing with the large stock of so-called offshore liquid króna, mostly owned by non-residents, that are trapped by the capital controls. Holders of these assets will be offered a choice between three options: long-term treasury bonds denominated in either krónur or euros, a currency auction, or locked non-interest-bearing accounts. The main aim of the Icelandic authorities will be to extend the maturity profile of these liabilities, and investors who choose the foreign-currency auction to exit will pay a premium to do so.

Phase 3: Gradual removal of capital controls for residents

The third stage of the capital account liberalization process will take longer to complete, and will involve the gradual lifting of restrictions on foreign capital transactions of Icelandic residents. The capital controls constrain portfolio diversification, and key asset managers such as the pension funds, as well as households and corporates, have a smaller proportion of their portfolios invested abroad than they did before the old banks collapsed. The timetable for this stage of the process is not yet defined, and will likely be dictated by the success of the earlier stages of liberalization in avoiding disruptive capital flows.

Question 6: What is the link between neutralizing the ISK1.2 trillion BOP overhang and the ISK400-470 billion repayment to the Icelandic authorities?

The capital controls liberalization strategy serves the dual purpose of both neutralizing the balance of payments overhang and shoring up the government finances. The boon to government finances is concentrated in Phase 1, in which a significant portion of the ISK900 billion in trapped bank assets are used to repay the government for its cumulative costs of supporting the new banks. Both Phase 1 and Phase 2 enhance financial sector stability, as foreign currency-denominated domestic assets of the failed banks are converted into longer-term deposits and as the maturity profile of offshore króna is extended in the currency auctions slated for the this coming October, as described above. Below, we summarize the mechanics of how government funding and financial stability are supported by the liberalization roadmap:

First, in the base case, the failed banks' creditors will transfer between ISK400 and ISK470 to the Icelandic authorities, exclusively earmarked for paying down debt.

The payments to the government range from ISK400-470 billion if the composition agreements are finalized to ISK680-840 billion if, instead, a 32-39% stability tax is imposed (should the estates fail to compose by end of December 2015). In what we consider to be the likeliest scenario, all three banks will complete their proposed compositions by the end of this year, rather than opting for the more expensive stability tax. The ISK400-470 billion range relates to uncertainty over the sale price of the old banks' króna assets and whether or not certain króna assets are sold to a domestic or foreign investor. With these proceeds, the government estimates that government debt, currently equal to 77% of GDP, would be reduced by up to a third over four to five years and as a consequence, its annual debt service requirements will be cut sharply as well.

Second, the strategy locks in around ISK300 billion into the new banks via converting short-term FX deposits and other sources of funding into long-term funding.

The failed estates have deposits and assets denominated in foreign currency amounting to around ISK400 billion. Under the capital account liberalization strategy, the old bank estates will convert these short-term deposits into long-term, market-standard global issues issued by the new banks (EMTNs). Terming out these deposits into long-term bonds (7-12 years) ensures financial stability by reducing refinancing risk.

Third, if the composition agreements are finalized, foreign exchange reserves at the central bank will increase by between ISK77 billion and ISK127 billion, adding an important buffer to the external accounts.

When and if the composition agreements are finalized by year-end 2015, the central bank's foreign exchange reserves will increase by at least ISK77 billion when the old banks' estates repay the Icelandic authorities for the funds borrowed to recapitalize the new banks during the crisis. There are two ways of doing this: the estates can either buy CBI or Treasury bonds directly, increasing the reserves accordingly, or they can buy a new bank bond issue (in foreign currency), with the new bank, then use the proceeds to repay the loan facilities extended during the crisis. The end result is the same: an increase in government foreign-exchange reserves, for which there is no corresponding liability. This will increase the “free” foreign-exchange reserves by between roughly $600 million to $1 billion.

Question 7: Are there implementation risks?

Yes. We note that the Icelandic authorities and their advisors have designed a strategy that, faithfully implemented, should neutralize the balance of payments risks directly related to both sides of the failed banks’ balance sheets while repaying the government for the costs it incurred to get the new banks on their feet.

However, implementation risks include (1) a disorderly unwinding of trapped assets; (2) emergence of larger than expected asset quality problems in the new banking system; and (3) a slower than envisioned path toward liberalization. Any of these risks could bring negative consequences for the domestic economy and/or renewed financial volatility, as well as having a deleterious impact on investor confidence.

In view of these risks, we nevertheless foresee the dismantling of capital controls as unambiguously credit positive. Now that the economy has rebounded, with stronger macro- and micro-prudential regulation of the financial sector, the opportunity cost of maintaining capital controls is much higher than the costs associated with temporary but controlled instability wrought by winding them down.

Question 8: What are the implications of the orderly removal of capital controls on the sovereign's credit profile?

An orderly removal of capital controls has two discrete and positive implications for Iceland's credit profile:

First, the repayment of funds that the government loaned to the new banks is important for Iceland's credit profile because the public debt trajectory is a key factor in our assessment of a sovereign's creditworthiness. Iceland's government debt-to-GDP ratio – which rose to over 100% of GDP as a consequence of the bank crisis and subsequent recession – has already fallen by 36.6 percentage points since 2011 and another 7 percentage point drop is anticipated by the end of 2016 on the basis of debt dynamics alone. Expectations that the failed bank estates' proceeds could be used to make additional debt prepayments within our forward-looking timeframe (2015-16) would make a further dent in the debt burden, which bodes well for the sovereign's fiscal strength, current assessed at 'moderate(-)' in our Sovereign Bond Methodology.

Second, the significant reduction in the external overhang and banking sector risk – which has laid the foundation for an orderly removal of capital controls – suggests that Iceland has a stronger credit profile than it did a year ago, with robust institutional strength supporting its efforts to overcome the country's economic and financial distress. If poorly handled, the capital account liberalization process could lead to renewed financial volatility and bring negative repercussions for the government's credit metrics and rating. To the extent that the process occurs without meaningful incident, then additional upward rating pressure is likely to arise, consistent with high Baa-range countries like Mauritius (Baa1 stable) or Ireland (Baa1 stable).

Moody's Related Research

Rating Action:

» Moody's upgrades Iceland's sovereign ratings to Baa2; outlook stable, June 2015

Credit Opinion:

» Iceland, Government of

Country Statistics:

» Iceland, Government of

Issuer Comment:

» Iceland, Government of: Arion Bank Bond Sale Reflects Continued Recovery from Banking Crisis, March 2015 (1003667)

Rating Methodology:

» Sovereign Bond Ratings, September 2013 (157547)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Endnotes

1 Total financial sector assets were equal to over 12 times GDP at end-2007, with pension funds, insurance companies and mutual funds accounting for the balance of financial sector assets.

2 For more details on the mechanics of the foreign-exchange auctions of offshore krónur, please see Iceland's 2011 update to its Capital Account Liberalization Strategy .

3 We note that estimates of the value of assets that would have to be potentially converted into FX in Iceland's FX market in order to pay foreign creditors is lower, at around ISK800 billion (composed of the 300 billlion in offshore ISK and 500 billion ISK in domestic assets of failed banks), or approximately 40% of GDP.

AUTHORS

NEW YORK	+1.212.553.1653		+1.212.553.1653
Kristin Lindow *Senior Vice President* kristin.lindow@moodys.com	+1.212.553.3896	**Anna Snyder** *Associate Analyst* anna.snyder@moodys.com	+1.212.553.4037

MOODY'S
INVESTORS SERVICE