Iceland and the IMF

Press Release:
IMF Completes Fourth Review Under the Stand-By Arrangement for Iceland
January 11, 2011

Country's Policy Intentions Documents

Iceland: Letter of Intent, and Technical Memorandum of Understanding

December 22, 2010

LETTER OF INTENT

Reykjavik, December 22, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC 20431
USA

Dear Mr. Strauss-Kahn:

1. **An economic recovery is gradually taking hold**. The policies in place have underpinned continued stability of the krona, a declining debt path, and falling inflation. Trade surpluses have allowed us to begin purchases of foreign currency to bolster reserves. Recent indicators suggest that demand is slowly picking up, and we expect growth to turn positive in 2011.

2. **Our policy implementation remains broadly on track**. All structural benchmarks relevant for this review have been met, except the one on passage of legislation for the new fiscal framework for local governments. The latter has been incorporated into a wider reform of local government legislation which will be presented to parliament in February 2011. We request waivers of applicability for all end-December performance criteria except the ceiling on net domestic assets of the CBI, since data on those PCs for which we are requesting the waivers will not be available at the time that the Fund's Executive Board considers the Fourth Review. The status of all program measures is summarized in Tables 1 and 2.

3. **On this basis, and on the basis of the policies defined in this letter, we request completion of the fourth review under the Stand-By Arrangement**. As set out in Table 1, we request that quantitative performance criteria be established for March 31, 2011 and June 30, 2011. Following previous delays due to the Supreme Court decisions on foreign-exchange linked loans, we request that the structural benchmark on recapitalization of Byr and SpKef be reset to end-February 2011. The structural benchmark on nonbank financial institutions and the HFF was also delayed on account of the Supreme Court rulings, but progress on recapitalizing these institutions is proceeding at different paces. Consequently, we request that a new benchmark, for end-February 2011, be established on other non-bank recapitalization. As detailed below, we also propose two new structural benchmarks covering: (i) completion by Icelandic State Financial Investments company of a two-year strategic plan to ensure medium-term viability of the savings banks through consolidation, by end-March 2011; and (ii) cabinet approval of the updated strategy for lifting capital controls, by end-February 2011, as set forth in ¶20 of this letter (Table 2). Our program will continue to be monitored by quarterly performance criteria and reviews.

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

The outlook

5. **Iceland's economy is recovering, but at a slower pace than we had previously expected**.

- We estimate that recovery began in the second half of this year, and will continue next year. We project buoyant net exports and a nascent recovery in private consumption, resulting in GDP growth of about 2 percent in 2011.We expect growth next year to be largely driven by investment. Several investment projects are expected to begin in 2011, although not on as large scale as previously expected resulting in lower growth than previously projected. The private sector debt overhang, further delays in investment projects, and shocks to external demand remain the key downside risks. Upside potential could be realized through higher investment.

- Headline inflation has reached the central bank's target (2½ percent), and we expect it to remain close to the target in 2011. The appreciation of the krona, the weak economy, and inflation expectations that have converged to our target contributed to the faster-than-projected disinflation in 2010. The still significant slack in the economy, alongside a stable krona, is expected to keep inflation in check next year. Risks to the outlook emanate from possible wage increases in export sectors spreading to non-tradables sectors.

- The outlook for the balance of payments remains strong. Over the next 12 months, we expect continued reserve accumulation due to a trade surplus, recovery of assets related to CBI claims on failed financial institutions, and the realization of program financing. However, short-term external debt is expected to increase by more, which will reduce the coverage of reserves in 2011.

6. **We expect public and external debt to decline**. We have further reduced gross external public debt through the recent repurchase of a syndicated loan. Gross general government debt is expected to reach 96 percent of GDP in 2010 and gross external debt is projected to amount to about 330 percent of GDP in 2010. Over the medium term, gross public and external debt are set to continue to decline, but levels will remain high. Risks associated with high debt ratios can be managed through the continued firm implementation of the program.

Policy overview

7. **With the economy now largely stabilized, the key objective of our policies is to lay the basis for a sustainable economic recovery**. We have identified a package of policies to deliver this objective. To address the debt overhang in the private sector, which is essential to boost consumption and investment, we have modified the existing frameworks for households and corporate debt restructuring. To provide additional support to domestic demand, we have revised our fiscal targets to allow for a more moderate fiscal adjustment in 2011. With respect to monetary policy, the overarching challenge will be to ensure that interest rate decisions are carefully coordinated with the eventual and gradual lifting of capital controls, in a manner that preserves currency and financial stability. Finally, fully restoring the health of the banking system remains a key objective. Our policies in this area are focused on continuing to strengthen bank balance sheets and improving supervision and regulation. Although we face a formidable challenge in revitalizing our economy after the significant shock that it has endured, we are confident that these policies will underpin a durable recovery.

Accelerating private sector debt restructuring

8. **We attach high priority to accelerating private sector debt restructuring, and have identified measures to further improve the framework**. Restoring the balance sheets of households, corporates, and banks is critical to a sustainable recovery and job creation. We believe that the measures elaborated in ¶9 and ¶10 will eliminate remaining gaps in the existing debt restructuring framework, and we do not intend to take further measures. To ensure that debt restructuring proceeds in a way that preserves scarce fiscal resources, we will avoid absorption of private sector losses by the public sector.

9. **We have worked with banks and other stakeholders to strengthen the existing, targeted framework for household debt restructuring**. Before taking key decisions, we established a commission to assess the costs and effectiveness of various debt-relief proposals. Based on the commission's findings, we reaffirm our position that across-the-board writedowns of household debt would be excessively costly and would not provide sufficient relief to the vast majority of households in distress. To ensure that distressed borrowers receive debt relief targeted to their individual needs, we have taken the following measures:

- Through an agreement with the financial sector we have formalized a process for writing down mortgages to 110 percent of the value of the mortgaged assets, up to a certain ceiling and subject to meeting criteria on debt services capacity. This writedown will be offered to debtors until July 1, 2011. The special voluntary debt mitigation scheme launched in October 2009 has also been adjusted with the aim of increasing access for low-income households.

- The supplementary tax rebate on interest that has been in effect in 2009 and 2010 will be preserved and made more progressive. In addition, an interest rate subsidy, financed by the financial sector, has been introduced.

- We have increased the capacity of the Office of the Debtor's Ombudsman (DO) to enable faster processing of applications.

- We have enacted into law a temporary suspension of all debt payments for households who file an application with the DO for debt mitigation, in an effort to encourage greater participation in the framework.

- We have also amended the Bankruptcy Act to limit to two years the discharge period following bankruptcy to ensure that individuals facing bankruptcy are quickly given a fresh start.

- Although we were committed to not extending further the period in which households could apply for a 3 months stay on forced sales, a final extension, to March 2011, was needed to allow households to avail themselves of the new options for debt restructuring.

- In collaboration with the banking sector and social partners, we will continue to raise awareness of the options available to households under the debt restructuring framework.

These measures are beginning to bear fruit: applications for debt restructuring have increased, and the DO is currently processing some 1500 applications.

10. **In partnership with key stakeholders, we are advancing corporate sector debt restructuring**.

- Legislation is in place on how to handle corporate tax arrears and tax liabilities arising from corporate debt writedowns.

- We have developed, in coordination with the corporate and banking sectors, a new framework to accelerate voluntary debt restructuring of small and medium enterprises (SMEs) in a harmonized manner. The framework is intended for viable SMEs (corporates with liabilities under ISK 1 billion) whose liquidation is likely to lead to larger loss of value for stakeholders than restructuring. The framework is designed to encourage owners to restore the value of the company and contains provisions that discourage misuse. It also addresses a number of bottlenecks, including by introducing a mechanism for resolving disputes among the parties involved. The aim is for the banks to finalize proposals on restructuring by end-May 2011.

11. **Legislation has been passed that addresses a number of uncertainties associated with the June and September Supreme Court rulings on the legality of foreign indexed loans**. In particular, this legislation clarifies in general how loans that are found to be illegal are to be adressed and recalculated. It also includes a temporary provision on how qualified foreign-currency mortgages and car loans with foreign-exchanged linked clauses are to be recalculated and settled.

Securing fiscal sustainability

12. **We are on track to meet our 2010 fiscal targets**. Windfall revenue from asset sales will allow us to deliver a stronger primary balance than expected under the program. Revenue projections (excluding the one-off windfall revenue) are broadly on track, as underperformance of personal income tax and VAT was partly offset by strong excise revenue performance. We are also undertaking some additional investment spending, amounting to about ¼ percent of GDP, which will be carried over from 2009 appropriations. Other primary expenditures are broadly in line with budget projections. The general government primary deficit will reach 2¼ percent of GDP in 2010, which is an improvement of about 4¼ percent of GDP over the finalized 2009 accounts. Interest costs have declined considerably relative to our previous budget projection, contributing to an improvement in the overall balance and a reduction in our financing needs. We are committed to saving any windfall revenue.

13. **We have moderately eased the fiscal targets for 2011 to provide support to the economy, while still achieving a key program objective**. In mid-December, parliament approved a 2011 budget for the central government that targets a small primary surplus of the general government (an improvement of about 2½ percent of GDP over 2010). With passage of this budget, we have achieved a key milestone in the medium-term consolidation strategy that we set out in 2009. The easing of the fiscal target in 2011 (by ¼ percentage point of GDP relative to the program) will provide room for automatic stabilizers and allow us to increase and better target the interest tax rebate (as discussed in ¶9 above). We expect that the local governments will deliver a balanced primary position, while phasing in the new fiscal framework (see below).

14. **We have further elaborated the package of measures to deliver our 2011 fiscal targets**.

- *Revenue measures*. These amount to about ¾ percent of GDP and include increases in the capital and corporate income tax rates from 18 to 20 percent, the inheritance tax rate from 5 to 10 percent, the wealth tax rate by 25 basis points, as well as the rates of excise taxes on alcohol, tobacco, and carbon emissions. We will also revise the base for motor vehicle levies, introduce a new bank tax, and increase the allowance for withdrawal of voluntary pension savings.

- *Expenditure measures*. These will amount to about 1½ percent of GDP relative to the budget baseline for 2011. Civil service nominal wages and benefits will not be increased, curtailing baseline spending by about ¼ percent of GDP. Rationalization of medical insurance costs (by 3 percent), education and police service costs (by 5 percent), and general administrative costs (by 9 percent) are expected to reduce expenditures by 1.1 percent of GDP relative to the budget baseline. A targeted reduction of welfare benefits and subsidies has also been introduced.

- *Household debt restructuring measures*. As described above (¶9), the costs of the temporary interest subsidy (up to 1/3 percent of GDP) will be fully financed by temporary revenue raised from the financial sector, with no net impact on the primary balance. These revenues and expenditures are in addition to those discussed earlier in this paragraph.

15. **We continue to work to improve the fiscal framework and finances of local governments**. The working group tasked with providing recommendations on this issue has published its report. The reformed fiscal framework is part of a comprehensive new Local Government Bill—which has been prepared in consultation with local governments—and will be presented to parliament in February 2011. We intend to pass this legislation by end-June 2011 **(structural benchmark)**. The bill includes fiscal rules for local governments, and its explanatory notes provide for a three-tier system for monitoring municipal finances, to be implemented by regulation. Meanwhile, we have strengthened our efforts to improve the financial situation of highly-indebted local governments, including through the creation of a special commission to recommend how these local governments will meet their obligations. Local governments' 2011 budgets were prepared under the old framework, but the surveillance function has already been strengthened and will lead to closer and more intrusive monitoring. The new law will be fully operational for fiscal year 2012. To this end, we are preparing an agreement on economic coordination between central and local governments to ensure that common economic and financial objectives are met.

16. **We have published an updated medium-term consolidation plan**. We remain committed to an overall general government surplus by 2013. We expect that the plan will deliver a stable gross general government debt ratio of 60 percent of GDP in the long run. To achieve this, we have introduced 3-year binding nominal expenditure constraints—one essential element of strengthening our budgetary framework. Medium-term targets will be kept under review, and could be modified if contingent liabilities remain contained and private sector losses are not absorbed by the public sector.

17. **We have updated our medium term debt management strategy**. Its publication in early January 2011 will strengthen our communication with market participants and facilitate a broadening of market access. We will seek opportunities to further extend the average maturity of domestic debt as well as to reduce the amount of non-marketable debt.

Monetary policy and capital controls

18. **We plan to revise our strategy on the lifting of capital controls**. We consider a revision appropriate on account of a stronger external position and because we now have better information on the investor base and on market behavior in the face of the controls than when the original strategy was formulated.

19. **The updated strategy will retain a cautious approach to lifting controls, as preconditions are met**. The lifting of controls will proceed in a way that does not jeopardize macroeconomic or financial stability, including by ensuring adequate reserve coverage. The updated strategy will elaborate measures to ensure that system liquidity can be adequately managed during the liberalization process and in the context of an open capital account. It will specify the methods and techniques for capital control liberalization. It will also clarify how we will assess whether the following preconditions have been met: (i) the sustainability of the government debt and confidence in our ability to access international capital markets; (ii) the availability of sufficient investment opportunities in Iceland, including through the revival of domestic capital markets; and (iii) financial sector stability in the context of a liberalized capital account. Since the effectiveness of the controls needs to be maintained throughout the liberalization process, we will continue to provide sufficient resources to administer, monitor, and enforce the controls.

20. **The updated strategy will be coordinated with debt management, and monetary and financial sector policies**. To this end, it will be prepared by the CBI, in cooperation with the FME and the government. The updated strategy will be adopted by the cabinet by end-February 2011 (**structural benchmark**). To increase public awareness of the strategy, we intend to publish it following its adoption. We will consult with the Fund before finalizing and adopting the new strategy, consistent with our undertakings in paragraph 4.

21. **Against this background, we will continue our purchases of foreign exchange to increase our non-borrowed reserves**. Weekly purchase auctions that began in late August 2010, as well as some one-off exceptional operations, have allowed us to accumulate close to EUR 25 million in the past two months. The krona has remained stable despite these operations. Given the strong balance of payments, we plan to scale up the weekly purchases of foreign exchange to further improve our reserve position.

22. **We have taken steps to normalize liquidity conditions in the interbank market**. The increase in the outstanding amount of central bank CDs has helped shift short-term interest rates towards the center of our policy corridor. However, banks continue to exhibit a preference for liquidity, and money market transactions remained centered on very short-term maturities. In preparation for capital control liberalization, we will strengthen our capacity for more active liquidity management by enhancing our liquidity forecasts and by engaging in more high-frequency operations.

23. **Monetary policy decisions will remain focused on inflation and preserving krona stability**. Rapid disinflation, the appreciation of the krona, and the reduction in the risk premium have supported steady interest rate cuts. While the slower-than-expected recovery may warrant further monetary accommodation, this will need to be balanced against the need to preserve currency stability as capital controls are eventually lifted.

Restoring the financial system

24. **We are addressing the effects of the Supreme Court rulings on banks**.

- *Assessment.* The FME, in coordination with banks and with external legal support, has completed its assessment of potential losses on the banks' pool of foreign exchange-indexed loans arising from the Supreme Court rulings in June and September. The impact of these rulings on bank capital is considered to be manageable and banks are expected to remain in compliance with minimum capital requirements. A communication on individual results has been sent to the commercial and savings banks. For the next two years, the FME, jointly with banks, will update its assessment on a quarterly basis.

- *Accounting for losses.* On an on-going basis, at the end of each quarter and based on prior discussion with individual banks on the potential impact of Supreme Court rulings, the FME will require banks to fully provision likely losses on probably affected loans. The FME will include as a supervisory deduction for the banks' capital computation the amount of expected losses, on current estimates, as of end-December 2010.

- *Recapitalization when needed.* We will encourage bank owners to provide additional capital (thus minimizing fiscal costs). If, at any time, any of the three new commercial banks cannot demonstrate that they will meet their capital requirements within the designated time frame, the government will provide sufficient funds to bring their capital to required levels after losses have been absorbed by the current shareholders (the mid-October **structural benchmark** on authorization to issue recapitalization bonds was met).

25. **Significant progress has been made in resolving the savings banks.** We have completed negotiations with the Resolution Committee of old Byr on the recapitalization of new Byr, and we are now finalizing the legal documentation. We are also finishing discussions to buy out old Keflavik's creditors for a very modest sum, after which we will proceed with the new Keflavik's (SpKef's) recapitalization. We expect that by end-February 2011 all savings banks will be recapitalized (**structural benchmark**). Upon completion of the savings banks' recapitalization, the Icelandic State Financial Investment Agency will complete a two year-strategic plan aimed at ensuring medium-term viability of the savings banks through operational restructuring, including business consolidation where necessary.

We propose that the completion of the two- year strategic plan become a **structural benchmark** for end-March 2011.

26. **We are continuing our work to strengthen the non-bank sector:**

- *The Housing Finance Fund (HFF).* In late November, the FME communicated to HFF the minimum capital injection required to bring its capitalization to 5 percent of risk-weighted assets. By end-December, we expect to make the required capital injection into HFF and submit to the FME a timetable for harmonizing HFF capital and other requirements with those of other financial institutions. By end-March 2011, we plan to submit legislation to put the HFF under full supervisory oversight by the FME.

- *Other non-bank financial intermediaries.* Negotiations between owners and creditors of the largest leasing company on the necessary haircuts and writedowns to restore their solvency have been completed, and legal documentation is now being finalized. Two leasing companies related to commercial banks are in process of being recapitalized by their parent institutions. The FME will require all non-bank financial intermediaries to complete their recapitalization by end-February (**structural benchmark**). If these institutions are not recapitalized by this time, the FME will begin the winding-up process.

27. **We continue working on several fronts to address bank balance sheet vulnerabilities**. This is key to ensuring financial stability going forward:

- *Updated prudential rules*. In October 2010, the FME published guidelines regarding: board members' roles and responsibilities; sound management and supervision of liquidity risk; and fit and proper criteria for key bank officers. The regulations on large exposures, sound business practices, and loans to related parties have been drafted and will be published by end-January 2011.

- *Revised Internal Capital Adequacy Assessment Process (ICAAP).* The FME has initiated its annual ICAAP to ensure that banks hold sufficient capital to cover the risks associated with their activities. This review is expected to be completed by end-March 2011.We remain committed to ensuring that banks are adequately capitalized and to taking prompt action when capital shortages are identified.

- *Revised bank accounting practices*. To ensure that banks are properly accounting for restructured or impaired loans, the FME has taken a number of measures. It will complete by end-February 2011 its assessment of whether banks are accounting for interest income from restructured or impaired and non-performing loans in a manner consistent with international standards. Should deviations from such standards be identified, the FME will require banks to revise their financial statements and will also issue guidelines to ensure consistent application of accounting standards. Banks are also being required to engage in semiannual audits of their financial statements, (during 2011-12) to ensure appropriate loan valuation.

28. **Reforms to banking legislation are on track**:

- *Central bank and banking law:* We intend to establish a Committee of Experts by end-December to gather information on new trends and international best practices in supervision of financial institutions and markets. This work will be a key input to any revisions to the legislative and regulatory framework for financial supervision. At the same time, we plan to submit to parliament technical amendments to the Act on Financial Undertakings regarding the definition of tier I capital, limitations on large exposures, and information sharing between the relevant supervisory authorities (both within and outside Iceland).

- *Deposit insurance.* We now expect that the draft bill fully harmonizing the deposit guarantee regime with the relevant EU directives—especially regarding coverage and timeframe to reach the targeted fund—will be passed by end-January 2011.

External financing

29. **Our ability to fully implement the program described above remains dependent on access to adequate external financing**. This financing will contribute to confidence during the gradual capital account liberalization process and help us smoothly manage our external debt rollover during 2011–12. We have further improved our reserves position through asset recovery and foreign currency purchases. We have also requested an extension of the availability of financing from our bilateral partners to end-December 2011, and our Nordic counterparts have agreed to support this request. We intend to draw remaining amounts of committed financing, as financing gaps require. In the event of any shortfalls, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertaking in paragraph 4 above).

30. **We have made significant progress in meeting the preconditions of some of our bilateral partners to access bilateral program financing**. We have reached an agreement on the level of negotiators with the Netherlands and the United Kingdom respectively over the deposit guarantees of the Landsbanki Icesave accounts. On that basis, legislation authorising the Minister of Finance to sign the agreements and thereby undertake the commitment contained therein, has been presented to parliament and referred to the budgetary committee following its first reading. A second reading is scheduled in the latter half of January once Parliament resumes after the Christmas recess. We are confident that the agreement, negotiated by a team jointly appointed by all parliamentary parties, will be approved by parliament.

Yours sincerely,

/s/
Jóhanna Sigurðardóttir
Prime Minister

/s/
Steingrímur Sigfússon
Minister of Finance

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

/s/
Árni Páll Árnason
Minister of Economic Affairs

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

	Performance Criteria										
	Oct 09 Prog.	Oct 09 Actual	Dec 09 Prog.	Dec 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Prog.	Sep 10 Preliminary	Dec 10 Ceiling/Floor	Mar 11 Ceiling/Floor	Jun 11 Ceiling/Floor
									(In billions of Króna)		
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-41.0	-140	-81.9	-150	-40	-80
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 3/	20	34	42.6	30.3	65	16.3	40	1.1	40	35	35
3. Ceiling on the change in the net domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	19.5	80	10.1	80	70	70
									(In millions of U.S. dollars)		
5. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	68	-580	-592	-588
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 5/	3500	54.5	3500	486.6	2500	0	2500	150	2500	2000	2000
7. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	22	750	700	700
8. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors 6/	0	0	0	0	0	0	0	0	0	0	0

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

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Table 2. Iceland: Structural Conditionality

Structural Conditionality	Status
Structural Benchmarks	
• Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶15). *By end-December 2010.*	Not met 1/
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶25). *By end-May 2010.*	Not met /Reset to end-February 2011 (LOI ¶26) 1/
• The FME to require rehabilitation and/or recapitalization measures to be taken by the Housing Finance Fund, as determined to be necessary by a review of their business plans (LOI ¶26). *By end-August 2010.*	Not met 1/
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses. *By end-March 2011.*	
• Passage of legislation to strengthen the framework for household debt restructuring, addressing (i) access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) eligibility; and (iii) incentives for financial institutions and debtors to expedite voluntary restructuring agreements. *By end-June 2010.*	Met
• A decision by the FME on commercial banks' plans to meet capital requirements as defined in the Letter of Intent. *By November 15, 2010.*	Met
• Submission of a supplementary budget to parliament requesting authorization to issue sufficient bonds to cover recapitalization needs of the banking system if losses on all probably affected and possibly affected loans are realized. *By October 15 2010.*	Met
New Structural Benchmarks	
• Completion by Icelandic State Financial Investment Company of the two year strategic plan to ensure medium term viability of the savings banks through consolidation (LOI ¶25). *By end-March 2011.*	
• Cabinet approval of the updated strategy for lifting capital controls in line with program objectives (LOI ¶20). *By end-February 2011.*	
• The FME to require rehabilitation and/or recapitalization measures to be taken by non-bank financial institutions (other than the Housing Finance Fund) as determined to be necessary by a review of their business plans (LOI ¶26). *By end-February 2011.*	

1/ Delayed because of SC ruling

TECHNICAL MEMORANDUM OF UNDERSTANDING

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

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

Central Government

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

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

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

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

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

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

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

6. **Adjustment mechanism**:

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

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

7. Supporting Material:

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

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

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

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

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

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

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

9. Adjustment mechanism:

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

NIR Adjustment

Cumulative flows from End-November 2009	In millions of US dollars at program exchange rate	Adjustment per one dollar of additional Nordic disbursements
Nordic Disbursements (technical assumption for the adjuster purpose)		
End-March 2011	0	-0.50
End-June 2011	0	-0.50

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

C. Ceiling on Net Domestic Assets

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

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

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

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

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

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

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

- **Deposits of the central government** at the CBI in domestic currency include the sum of deposits in the treasury current account, government institution current accounts and other time deposits.

- **Adjustment**. For the purpose of the program, the net credit of the CBI to the central government will exclude any debt issuance for the purposes of recapitalizing the CBI.

- **Supporting material**: The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis with a lag of no more than 10 days.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Table 3. Program Exchange Rates

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