

## International Monetary Fund

[Iceland](#) and the IMF

**Iceland:** Letter of Intent, and Technical Memorandum of Understanding

**Press Release:**

[IMF Completes Sixth and Final Review Under the Stand-By Arrangement for Iceland](#)

August 26, 2011

August 16, 2011

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## LETTER OF INTENT

Reykjavík, August 16, 2011

Ms. Christine Lagarde  
Managing Director  
International Monetary Fund  
Washington, D.C. 20431  
U.S.A.

Dear Ms. Lagarde:

1. **Our economic program has underpinned Iceland's emergence from crisis and the recovery underway.** Growth is resuming, and we have made significant achievements under the program. Public finances have been put on a sustainable footing, the exchange rate has stabilized, and the financial sector has been rebuilt. While the unemployment rate remains unacceptably high, the measures that we have put in place to facilitate job retraining and skill upgrading should help spur job creation by reducing skill mismatch. The recent issuance of an international sovereign bond marks a key milestone in our emergence from crisis and is a critical step toward the normalization of external financing. Looking ahead, we intend to press on with our policy agenda. Our key policy challenges are an orderly and gradual lifting of capital controls, the development of a post-capital controls monetary framework, completion of the fiscal consolidation with the aim of reducing public debt to a prudent level, and a further strengthening of financial sector supervision and regulation. We continue to attach high priority to accelerating private sector debt restructuring, as we believe that this will be critical to a sustainable recovery and job creation. Our policy plans in these areas are elaborated in this letter. Although the Stand-by Arrangement is ending, we will keep our close policy dialogue with the Fund and will consult with it from time to time in accordance with the Fund's policies on post-program consultations.

2. **Policy implementation under the program remains broadly on track.** All end-June and continuous performance criteria have been met (Table 1). We continue to make progress on the structural benchmark on the fiscal framework for local governments, and the relevant legislation is in parliament and is expected to be passed in September 2011 (Table 2). On this basis, and on the basis of the policies defined in this letter, we request completion of the sixth review under the Stand-By Arrangement.

### **The outlook**

3. **We continue to expect a gradual recovery to take hold this year.**

- Growth is expected to reach 2½ percent in 2011, and unemployment is set to decline. But risks to growth remain tilted to the downside. Prospects for investment are still

uncertain, while still high unemployment and the need to restore balance sheets continue to weigh on private consumption.

- We expect headline inflation to rise to around 4 percent this year on average due to the krona depreciation, wage increases, the pick-up in house prices, and rising commodity prices, before returning to the central bank's target of 2½ percent by early 2013. Risks to the inflation outlook emanate mainly from rising inflation expectations and higher pass through of wages into prices than expected in the baseline.
- The evolution of the balance of payments is supporting the lifting of capital controls. The current account surplus, the recent international sovereign bond issuance, the realization of program financing, and disbursements from bilateral partners are expected to further increase reserves to about \$6 billion at end-2011, or around 75 percent of short-term external debt.

4. **Public and external debt ratios should both decline rapidly over the medium term.** Gross external debt is projected to reach about 250 percent of GDP at end-2011, but we project that debt repayments, the release of captive non-resident krona holdings in line with our capital account liberalization strategy, and ongoing asset recovery will reduce it to around 150 percent of GDP by 2016. We expect general government debt to peak at around 100 percent of GDP in 2011 before declining over the medium term, reaching about 80 percent of GDP in 2016.

#### **Securing fiscal sustainability while supporting growth**

5. **We have slightly eased our fiscal target for 2011 to support the economic recovery.** In the first half of the year, revenue performance remained robust and spending contained, enabling us to meet our end-June target, despite cost increases due to exchange rate and interest rate fluctuations. Financial institutions and profits from foreign exchange auctions are expected to deliver sufficient revenue to cover the temporary interest subsidy. At the same time, as part of the wage agreements with social partners, we increased social benefits more than previously planned, to support the recovery and help shield our most vulnerable citizens, and raised public sector wages in line with the general labor market. To accommodate this, we have eased our fiscal target (general government primary balance) for 2011 by ½ percentage point of GDP. Despite these expenditure increases, we expect to end the year with a primary deficit of ¼ percent of GDP, coming close to obtaining a balanced primary position and representing an improvement of over 2 percent of GDP compared with 2010. We are actively seeking ways to reduce the primary deficit by containing expenditure. Moreover, if revenue is stronger than expected in the second half of 2011, we will save any excess.

6. **We aim to present a revised medium-term fiscal consolidation plan for 2012–2015 by end-September with a goal to strike a better balance between growth and continued adjustment.** With the output gap expected to remain in the near term, and given

the track record established by the strong front-loaded fiscal consolidation to date, we intend to ease the medium-term fiscal path to support economic activity. We remain committed to achieving the key goals in our initial medium-term fiscal plan, while moderating the pace of adjustment. Specifically, we plan to reach an overall fiscal surplus in 2014 (instead of 2013 as originally planned) and to reduce gross debt to 60 percent of GDP in the long-term. We believe that these goals are achievable with an improvement of the general government primary balance to 2 percent of GDP in 2012 and 5 percent of GDP by year 2016. We intend to take measures sufficient to reach these targets. To this end, as a first step, we are preparing a package of new measures amounting to 1¾ percent of GDP in 2012, of which two-thirds will be permanent:

- Permanent measures will make up over half of the adjustment on the revenue side in 2012. We are preparing a wide range of measures, including increasing environmental and resource taxation, introducing a financial activities tax, and changes related to the taxation of individual pension funds. To further strengthen the permanent revenue base the net wealth tax will be reviewed and extended over the medium term and the carbon tax will be made permanent. Asset sales will provide additional temporary revenues. In 2012 the ISFI will submit proposals for divestment of shares in financial institutions during 2012–15. We will, in early 2012, assess the prospects of reaching our revenue targets from assets sales. If revenue targets from asset sales cannot be attained, we will introduce further revenue measures within the fiscal year 2012 to ensure that overall revenue targets are met.
- Permanent measures on the expenditure side will make up the remainder of the 2012 adjustment, to be achieved, inter alia, through the ongoing public administration reforms, mergers of institutions, and efficiency improvements.
- Additional permanent measures are planned for 2013 through 2015, primarily on the expenditure side, with asset sales providing additional revenue each year.

7. **We are finalizing the new fiscal framework for local governments.** We expect that the new Local Government Bill will be passed by parliament by end September 2011 (**structural benchmark**), and we have begun preparing regulations that will clarify the implementation of the bill. Therefore, local governments will need to align their operations and finances with the new fiscal framework as they prepare the 2012 budgets. To this end, we have established a committee consisting of key Ministries and representatives from Municipalities to coordinate public finances. As many local governments' external obligations have been rolled over into long-term domestic loans, their repayment profile has significantly improved and contingent liabilities for the central government have diminished. We continue to monitor local governments' fiscal consolidation process and debt maturity profile. The new reporting system of local government operations will be introduced in October 2011.

## **Monetary policy and capital controls**

8. **Monetary policy will remain focused on inflation and preserving exchange rate stability.** In its June meeting, the MPC raised concerns about impact of the wage agreements on price stability and inflation expectations. To reduce the risk that long-term inflation expectations drift upwards, it indicated that tighter monetary policy may become warranted in the near term. To improve monetary policy implementation, the CBI will continue to strengthen liquidity management, particularly as the lifting of capital controls may lead to increased pressures on banking system liquidity. Purchases of foreign exchange in weekly auctions will permit further accumulation of non-borrowed reserves.

9. **We are implementing our strategy for lifting capital controls.** The first auction of foreign currency to holders of offshore krona went smoothly and led to a significant narrowing of the onshore-offshore exchange rate spread. The “second leg” of this auction, involving the sale of long-term krona-denominated government securities to holders of foreign exchange held abroad, was oversubscribed and achieved our objective of reducing the overhang of offshore krona while preserving foreign exchange reserves. The first leg of the second auction achieved similar levels and resulted in a marginal tightening of the offshore rate. The second leg of this auction is scheduled for August. In line with our strategy, we are also preparing liberalization channels that will allow krona acquired in the auctions to be invested in a broader range of long-term investment vehicles. We will adjust the pace of the liberalization process to maintain reserve adequacy and stability in the financial sector and the government bond market. Enforcement of capital controls will be maintained throughout the liberalization process, and any legislative changes will leave the CBI with flexibility to address any new channels of circumvention that may arise as the controls are gradually lifted. The Fund has in the past approved the temporary retention of a measure in the capital controls regime that gives rise to a restriction since it marginally affects the conversion and transfer of some interest on bonds. Given our strategy to lift such controls, we expect that this measure will be eliminated as soon as circumstances permit. Accordingly, we request temporary Board approval of further retention of the above-mentioned measure.

10. **Looking ahead, a key priority will be to design a post-capital controls monetary framework.** The new framework must take into account the need to manage large external shocks, volatile capital flows, and risks arising from the financial sector. This suggests that macroprudential tools will be a critical component. Our consultations with stakeholders are ongoing, notably with respect to assessing the relative merits of different future monetary regimes and the most appropriate institutional set-up of a new macroprudential framework.

## Restoring the financial sector to health

### 11. We have completed the recapitalization of the deposit taking institutions.

Concrete steps have been taken to ensure proper capitalization of banks.

- **Bank's capital adequacy has been confirmed.** The FME has concluded its annual review of the three large commercial banks' Internal Capital Adequacy Assessment Process (ICAAP) and confirmed that they hold sufficient buffers to address credit and market risks. Their core tier 1 capital remains above the 12 percent minimum currently required by the FME. This review has included a focused examination of the banks' audited loan portfolio (with the participation of local consultants) to ensure that loan valuations, after provisions and taking into account the discount at which they were purchased from the old banks, reflect their expected fair recovery value. In addition, the FME has determined that the impact of the June 2011 Supreme Court ruling regarding foreign exchange-indexed corporate loans on banks' capital is expected to be limited. Moreover, the FME's high level assessment of banks' capacity to absorb losses under plausible scenarios (based on the European Banking Authority's criteria) produced no undercapitalization events.
- **Recapitalization of the savings banks has been completed.** In July, new Byr's assets and deposits were sold to a commercial bank. The proceeds from the sale of the state's shares cover nearly all of the capital previously injected into New Byr. On SpKef, discussions are ongoing with a commercial bank on determining the size of our obligations under the blanket guarantee. We intend to present to parliament in October a bill authorizing the Ministry of Finance to meet these obligations. We have, through the Central Bank's Holding Company injected new capital into five savings banks, thereby enabling them to meet FME capital adequacy requirements. With these steps, we have completed the recapitalization of the savings banks.
- **Recapitalizing non-deposit taking institutions is near completion.** All remaining private finance companies hold capital above 8 percent of risk-weighted assets. A decision as to whether, and if so to what extent, to recapitalize Byggdastofnun (a small regional fund) will be made on the basis of the recommendations of a working group, which was presented in May.

### 12. We will press ahead with the further strengthening of commercial banks, the banking system, and reforms to HFF and the savings banks.

- **We attach high priority to ensuring that remaining legacy vulnerabilities in commercial banks are addressed.** While the banks' valuation of their assets at significantly below face value provides them with reasonable buffers to address financial risks, we will continue to closely monitor banks progress in reducing the still high level of non-performing loans and remaining imbalances. To this end,

beginning in September 2011, the FME will meet quarterly with each individual institution to take stock of progress made in cleaning up their balance sheets and to agree on targets to reduce remaining legacy vulnerabilities.

- **Identifying policy issues concerning the future of the financial system is critical.** The Ministry of Economic Affairs is preparing a report, to be delivered to Althingi during its autumn session, on the future of the financial system and its supervision. The report will be the basis for new legislation and analyze the present legal framework, international obligations and the financial institutions in light of the size of Iceland and the complexity of its economy. The aim is to identify decisions that will need to be taken on the future of the system, on strengthening financial sector supervision, and on enhancing financial stability.
  - **Reform of the Housing Finance Fund (HFF).** We are in the process of assessing HFF's capital needs in light of anticipated write-downs associated with the measures agreed in December 2010. Based on our assessment, additional funds may have to be injected in order to increase the capital of HFF to the regulatory minimum. Further steps towards reforming HFF will be taken based on the work on the future of the financial system (see previous bullet).
  - **Consolidating the remaining savings banks.** For the remaining eight small savings banks, the Icelandic State Financial Investment Company (which holds the government's shares in the three of these banks that are majority state owned) is exploring, together with the five privately held savings banks, options to strengthen their medium-term viability through consolidation (group merger or incorporation into the commercial banks). Meanwhile, the FME will closely monitor these institutions to ensure that viability issues are addressed in a timely fashion.
13. **Strengthening prudential rules and supervision will remain key priorities.**
- **The FME will continue to further strengthen its prudential framework in line with EU directives and regulations.** In September, it will issue rules on large exposures and additional own funds (hybrid capital) in accordance with the revised Capital Requirements Directive. The FME also intends to update measures to combat money laundering and terrorist financing in October.
  - **The credit registry is operational.** The FME, in collaboration with the CBI, has completed and made operational a database to closely monitor and identify credit concentration and large exposures (currently set at ISK 300 million) of banks' related and non-related economic groups.

- **Bank reporting is being harmonized.** In mid-July, the FME completed, in coordination with the banking industry, a standardized form on banks' loan portfolios. By mid-September the banks will submit the first fully harmonized reports. This report will facilitate the monitoring of progress on household and corporate debt restructuring. The FME also regularly assesses the consistency across banks of income recognition from asset recovery and restructured loans.
- **Filling supervisory gaps.** The FME has completed a two and a half-year plan to address supervisory gaps identified by an internationally recognized supervision expert. The plan includes actions on risk model supervision, on-site and off-site procedures, disclosure and reporting practices, organization and management, human resources management, training, and IT infrastructure, benchmarked against supervisory practices in an advanced European country. During 2013, we will request that the IMF undertake an independent assessment under a stand-alone Report on the Observance of Standards and Codes (ROSC) against Basel Core Principles for Effective Banking Supervision. We are committed to providing the FME with sufficient resources to ensure that it can successfully perform its duties.
- **Deposit insurance.** A bill is pending in parliament on revising deposit insurance legislation in line with recently introduced changes in European legislation. The proposed legislation aims to help restore confidence in the banking system and pave the way for an eventual orderly and gradual lifting of the blanket guarantee on deposits. We have also recently amended the existing legislation with an interim provision that secures payments of premiums for this year. Progress has also been made in identifying the remaining legal loopholes in the regulation of the banking industry, and coordination between the CBI and FME has been strengthened. We plan to complete and formalize our proposals as part of the discussions on the future of the banking system (see ¶12). A longer-term objective will be to improve the existing legal framework for bank resolution in line with the EU timetable.

### **Completing private sector debt restructuring**

14. **Corporate and household debt restructuring is advancing.** Data on debt restructuring compiled by the FME, the banks, and the Debtors Ombudsman shows progress. Banks have made restructuring proposals to nearly all eligible SMEs under the measures agreed in December 2010, and they are aiming to complete the restructuring of most large corporations by end-2011. Household debt restructuring is progressing steadily and banks expect to complete this process by end-2011. The granting of automatic protection from creditors upon applying to the Debtors Ombudsman ended as scheduled at end-June as did the deadline for applying for the household debt measures agreed in December 2010.

## External financing

15. **We have secured adequate external financing.** Our Nordic and Polish bilateral partners have completed the extension until end-December 2011 of the availability of financing under their arrangements, and we intend to draw on this funding if a financing gap arises. Our international sovereign bond issuance meets the central government's rollover requirements for 2011 and 2012. Nonetheless, depending on conditions in the international market, we may undertake an additional issue in coming months.

16. **We still attach high importance to resolving the Icesave issue.** The law authorizing the Minister of Finance to confirm the agreements reached between the Icelandic Government and, respectively, the Dutch and U.K. authorities on the Icesave issue was revoked following a national referendum in April last. We had negotiated these agreements in spite of our view that the reimbursement of the Icesave deposit payout is not a sovereign obligation and that Iceland's deposit guarantee scheme was set up in full compliance with the respective European directives. This is still our view. Consequently, it is likely that the dispute regarding the deposit guarantees will be settled through legal channels. We are ready to fully engage in such a process. We have already affirmed that should a competent court come to the conclusion that Iceland has a sovereign obligation stemming from the Icesave deposits, we will honor that obligation.

Yours sincerely,

/s/

Jóhanna Sigurðardóttir  
Prime Minister

/s/

Steingrímur Sigfússon  
Minister of Finance

/s/

Már Guðmundsson  
Governor of the Central Bank of Iceland

/s/

Árni Páll Árnason  
Minister of Economic Affairs

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

	Performance Criteria													
	Oct. 09 Prog.	Oct. 09 Actual	Dec. 09 Prog.	Dec. 09 Actual	May 10 Prog.	May 10 Actual	Sep 10 Prog.	Sep 10 Actual	Dec 10 Prog.	Dec 10 Actual	Mar 11 Prog.	Mar 11 Actual	Jun 11 Prog.	Jun 11 Actual
	(In billions of Króna)													
1. Floor on the change in the central government net financial balance 2/	-175	-139.5	-200	-166.7	-55	-48.4	-140	-82.9	-150	-121	-40	-11.9	-80	-55.4
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 3/	20	34	42.6	30.3	65	16.3	40	1.1	40	-15	35	-29	13.5	-40
3. Ceiling on the change in the net domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	19.5	80	9.6	80	41.6	70	-14	70	-7
	(In millions of U.S. dollars)													
4. Floor on the change in net international reserves of the Central Bank of Iceland 4/	-425	-278	-475	-319	-325	-122.9	-530	68	-580	812	-592	369	-460	904
5. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 5/	3500	54.5	3500	486.6	2500	0	2500	1486	2500	1486	2000	0	2500	1000
6. Ceiling on the stock of central government short-term external debt 6/	1400	0	1400	0	750	0	750	22	750	22	700	0	700	0
7. Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors 6/	0	0	0	0	0	0	0	0	0	0	0	0	0	0

1/ Cumulatively from the beginning of each year (unless otherwise indicated).

2/ The net financial balance excludes the capital injection cost of bank and central bank recapitalization and excludes the increase in debt from guaranteeing the repayment of depositors in foreign branches of Icelandic banks, as well as the increase in central government debt due to on lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadráheidargöng, and Reykjanesbraut road projects (the latter up to a maximum of ISK 6 billion).

3/ Excluding changes due to central bank recapitalization bond.

4/ (-) indicates decrease. NIR is defined as the difference of gross foreign assets and foreign liabilities (including all foreign currency deposits and other liabilities of financial institutions and the general government at the CBI; from September 2010, the definition excludes foreign currency deposits of the general government at the CBI, as specified in the TMU. NIR adjuster is specified in the TMU.

5/ Excludes IMF and excludes official bilateral loans for deposit insurance. Short term external debt has an original maturity of up to and including one year. Medium and long-term external debt has an original maturity of more than one year.

6/ Applies on a continuous basis.

Table 2. Iceland: Structural Conditionality

Structural Conditionality	Status
<p><i>Structural Benchmarks</i></p> <p>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 ¶17). <i>By end-June 2011.</i></p>	<p>Not met/To be passed by end-September.</p>

## TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Icelandic authorities and the IMF staff regarding the definitions of quantitative and structural performance criteria, as well as respective reporting requirements for the Stand-By Arrangement (SBA). These performance criteria and indicative targets are reported in Tables 1 and 2.
2. The exchange rate for the purposes of the program is set at 113.9 Icelandic króna per U.S. dollar. The corresponding cross exchange rates are provided in Table 3.

### Central Government

3. **Definition:** For the purposes of the program, the government includes the central government, which includes government entities of group “A” as defined in the Government Financial Reporting Act No.88/1997.
4. **Supporting material:** The Ministry of Finance (MoF) will provide to the IMF detailed information on monthly revenues and expenditures both on a cash and accrual basis, domestic and foreign debt redemptions, new domestic and foreign debt issuance, change in the domestic and foreign cash balances of the central government at the central bank of Iceland, all other sources of financing including capital transactions, and arrears of the central government. Data will be provided within 30 days.

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

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

5. **Definition:** The net financial balance of the central government will be measured from the financing side at current exchange rates, and will be defined after contributions to the government employee’s pension fund. The net financial balance will be defined as the negative of the sum of (i) net domestic financing and (ii) net external financing.
  - **Net domestic financing (NDF)** is defined as the change in the stock of the net domestic debt of the central government. Domestic central government debt consists of ISK-denominated debt financed by the banking system (the Central Bank of Iceland (CBI) and commercial banks) and non-bank financial institutions to the central government. It consists of treasury bills, government bonds, promissory notes and other domestic debt instruments issued by the government, including any interest arrears, and loans and advances to the central government by the commercial banks, including any interest arrears. Net domestic central government debt is calculated as the gross debt plus proceeds from the sale of financial assets (including, but not limited to, government, government-backed, or other bonds obtained during the central bank recapitalization process, and as a result of failed securities lending) or

proceeds from privatization, minus ISK-denominated government deposits with the central bank of Iceland and commercial banks. ISK-denominated government deposits at the central bank of Iceland include the deposits in the treasury current account, government institution current accounts and other time deposits. Domestic debt will be valued at the nominal price for T-notes. For T-bonds and other loans, both of which are indexed, the nominal value of the debt will be adjusted by the consumer price inflation.

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

#### 6. **Adjustment mechanism:**

- For the purposes of the program, the net financial balance will exclude any debt issuance for the purposes of bank restructuring and central bank recapitalization. It will; however, include the accrued interest on inflation indexed debts related to central bank and bank recapitalization. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8, 2008 to October 8, 2009.
- For the purposes of the program, the net financial balance will exclude central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadlaheidargong, and Reykjanesbraut projects. Such adjustment should not exceed ISK 6 billion in 2011.

#### 7. **Supporting Material:**

- Data on domestic bank and nonbank financing will be provided to the IMF by the Central Bank of Iceland and the Financial Management Department of the MoF

within three weeks after the end of the month. This will include data on redemptions of domestic central government liabilities and data on the cash balances in domestic currency of the MoF at the Central Bank of Iceland and in commercial banks.

- Data on net external financing (disbursement, net change in external arrears and amortization) as well as other external borrowing will be provided to the IMF monthly by the Financial Management Unit at the MoF within three weeks of the end of each month. Data on the fx cash balances of the MoF at the Central Bank of Iceland and in commercial banks will be reported daily.
- Data on central government debt issuance for on-lending to finance road construction related to the Suðurlandsvegur, Vesturlandsvegur, Vadhlaheidargong, and Reykjanesbraut projects will be provided to the IMF monthly by the MoF.

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

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

- **Reserve assets** are defined consistently with SDDS as readily available claims on nonresidents denominated in foreign convertible currencies. They include the CBI's holdings of monetary gold, SDRs, foreign currency cash, foreign currency securities, deposits abroad, and the country's reserve position at the Fund. Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered, claims on residents, precious metals other than gold, assets in nonconvertible currencies, and illiquid assets.
- **Reserve-related** are defined consistently with SDDS as all fx liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives, and all credit outstanding and SDR allocation from the Fund. Foreign currency deposits and other liabilities of financial institutions (both active and in the process of winding up) will be included in reserve-related liabilities. General government fx liabilities at the CBI will not be included in reserve-related liabilities.
- **For program monitoring purposes**, the stock of reserve assets and reserve-related liabilities of the CBI shall be valued at program exchange rates as described on paragraph 2 above. The stock of NIR amounted to \$1,511 million as of December 31, 2010 (at the program exchange rate).

9. **Adjustment mechanism:**

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

0.5 dollars. Nordic disbursements are defined as external disbursements from Denmark, Finland and Sweden to the Government of Iceland, and from Norway to the CBI.

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

### C. Ceiling on Net Domestic Assets

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

- **Net credit to the central government** is defined in criteria D.
- **Net credit to the private sector** is defined as the difference between credit to the private sector and liabilities of the private sector to the CBI. Credit to the private sector is defined as the sum of CBI lending to banks and other financial institutions (through its overnight and weekly collateral facilities and any other instruments to which the CBI would extend credit to the private sector) and other assets. Liabilities of the private sector to the CBI is defined as the sum of current account balances of the banks and other financial institutions at the CBI, central bank CDs in issuance and other liabilities.
- **Other items net** are defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.
- **Supporting material:** The CBI will provide to the IMF with data on net credit to the government and net credit to the private sector. Data on central bank lending to banks and other financial institutions through its overnight and weekly collateral facilities, any other instruments to which the CBI would extend credit to the private sector, current account balances of the banks at the CBI, and central bank CDs in issuance, on a daily basis. The CBI will provide the net domestic assets data based on the monthly balance sheets on the monthly basis within two weeks following the end of the month.

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

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

- **Deposits of the central government** at the CBI in domestic currency include the sum of deposits in the treasury current account, government institution current accounts and other time deposits.
- **Adjustment.** For the purpose of the program, the net credit of the CBI to the central government will exclude any debt issuance for the purposes of recapitalizing the CBI.
- **Supporting material:** The CBI will provide the IMF with data on central bank lending to the central government and central government deposits at the central bank, on a daily basis with a lag of no more than 10 days.

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

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

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

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

- **Suppliers' credits.** That is, contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided.
- **Leases.** That is, arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property. For the purpose of the program, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property.
- **Arrears, penalties, and judicially awarded damages** arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.”
- **Adjustments.** (i) Previously contracted debt that has been rescheduled will be excluded from the definition of “new debt” for the purposes of this performance criterion; (ii) excluded from the limits are purchases from the IMF Stand-By Arrangement and bilateral official loans extended and earmarked for payments on foreign deposit guarantees; (iii) changes in the stock of nonresident holding of medium and long-term debt in krona will also be excluded from definition of new debt; and (iv) arrears arising from intervened banks will be excluded.

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

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

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

15. **Ceiling on the accumulation of new external payments arrears on external debt contracted or guaranteed by central government from multilateral or bilateral official creditors.** This performance criterion applies on a continuous basis. External payment arrears consist of external debt service obligations (principal and interest) falling due after

October 20, 2008, and that have not been paid at the time due, taking into account the grace periods specified in contractual agreements. Data will be provided on a monthly basis with a lag of no more than 20 days.

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

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

Table 3. Program Exchange Rates

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