International Monetary Fund

Iceland and the IMF

Press Release:
IMF Completes First Review Under Stand-By Arrangement with Iceland, Extends Arrangement, and Approves US$167.5 Million Disbursement
October 28, 2009

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Iceland: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

October 20, 2009

The following item is a Letter of Intent of the government of Iceland, which describes the policies that Iceland intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Iceland, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

LETTER OF INTENT

Reykjavik, October 20, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund

Washington, D.C., 20431
U.S.A.

Dear Mr. Strauss-Kahn:

1. In the attached Memorandum of Economic and Financial Policies (MEFP), we describe progress towards meeting the objectives laid out in our Stand-By Arrangement. As defined in the original program Letter of Intent of November 15, 2008, policies were to be oriented towards stabilizing the currency, restoring the financial system to health, and securing medium-term fiscal sustainability.

2. **Our implementation of policies has been delayed, but we are now on track to meet program objectives.** We request waivers for nonobservance of performance criteria covering the end-December 2008 central government net financial balance and net international reserves, the end-February 2009 recapitalization of banks, and the continuous obligation to refrain from imposing or intensifying exchange restrictions. As described in the MEFP, we have implemented prior actions to bring policies back on course. In particular, reserves have been kept above an appropriate floor as of end-August (with monetary policy used to preserve currency stability); a plan for gradual capital account liberalization, consistent with currency stability going forward) has been approved; two of the three large banks have been recapitalized; and our fiscal consolidation plan has been approved. The status of all program measures is described in Tables 1–2 of the MEFP.

3. **On this basis, we request completion of the first review under the Stand-By Arrangement.** We also request the second purchase under this arrangement in an aggregate total amount of SDR 105 million.

4. **In light of the delays in the first review, we also request that the arrangement be extended to end-May 2011 and purchases rephased.** We request that ceilings and floors for the quantitative performance criteria under the arrangement be established for October 31, 2009, and for December 31, 2009, with quarterly reviews, as set out in the attached Technical Memorandum of Understanding (TMU). The second review will take place after December 15, 2009. We also request that the performance criteria on the change in net credit of the CBI to the private sector and the change in net credit of the CBI to the general government be dropped and in their place, a new performance criterion be introduced

on the change in net domestic assets of the CBI. Since government deposits at the CBI remain an important component of the debt management strategy, we request that the ceiling on net credit of the CBI to the general government be kept as an indicative target. As detailed below, we propose three new structural benchmarks against which to measure progress towards key fiscal and financial sector objectives (MEFP Table 2). The TMU explains how program targets are measured.

5. **We believe that the policies set forth in the Letter of Intent of November 15, 2008 and in the attached MEFP are adequate to achieve 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.

Very truly yours,

/s/

Johanna Sigurdardottir
Prime Minister

/s/

Steingrímur J. Sigfússon
Minister of Finance

/s/

Már Guðmundsson
Governor of the Central Bank of Iceland

ATTACHMENT I. ICELAND—MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. **The sharp adjustment of Iceland's economy to the 2008 crisis continues, but some positive signs are beginning to emerge.** The contraction in economic activity has to date proved less severe-than-expected, largely because a sharper-than-expected drop in domestic demand has fallen on imports. Regarding demand, business investment has been weaker-than-expected, and there is some uncertainty about when large projects in the aluminum and energy sector will be initiated. However, a broadly stable krona has contributed to falling inflation. The end-2008 year-on-year rate of 18 percent came in below the program projection, and the year-on-year rate has now dropped to about 11 percent. Moreover, we continue to foresee that economic activity will stabilize in 2010.

2. **Our external financing needs remain broadly as anticipated in the program**. Exports will be lower than expected in 2009–10 due to slower global growth, but the sharper-than-expected contraction in domestic demand should bring imports down as well. For the capital account, there may be delays in aluminum sector FDI, but the planned gradual phase out of capital controls should reduce the amount of capital outflows and offset this. An examination of newly available external debt data for end-2008 has led to an upward revision in the external debt stock and medium-term debt service, but the stronger policies outlined in this letter are expected to compensate for this.

Monetary Policy

3. **Monetary policy will continue to be guided by the objective of maintaining a stable krona, within a flexible exchange rate regime.** While from a long term perspective, we perceive the krona to be undervalued, there remain high risks in the present that absent a firm monetary policy (involving both capital controls and interest rates), sharp capital outflows could lead to an overshooting depreciation. This would strain household and corporate balance sheets, and through this channel create unacceptable risks to inflation and growth.

4. **An appropriate level for interest rates remains essential for krona stability.** Capital controls have helped to take the pressure off of policy rates, but nonetheless since it is very difficult to eliminate all capital control circumvention, relatively high interest rates have also been necessary to stabilize the exchange rate. Beginning in March, with the krona well above its all time lows and our international reserves stable, we were able to reduce the policy rate in steps. We will continue to monitor the stability of both the currency and our level of reserves as indicators for future policy actions, and stand ready to tighten policy if necessary. Achievement of our reserve targets, without compromising currency stability, will be a **prior action** for the review. Looking forward, the comprehensive policy package that we have put in place, including external financing assurances, fiscal commitments and tangible progress in financial sector restructuring is expected to support krona appreciation

and reserve accumulation. This would in turn create room for gradual reductions in the policy rate, and for gradual lifting of capital controls.

5. **We have designed a strategy to phase out capital controls over the medium term.** It has been approved by cabinet (a **prior action** for the review) and has the following features:

- The lifting of controls can begin once key preconditions are in place. In particular, we need to: (i) fully implement our macroeconomic stabilization package; (ii) establish a strong, well-managed and adequately supervised financial sector that will be able to withstand unpredictable capital flows once controls are lifted; (iii) implement and operate an efficient liquidity management framework; and (iv) accumulate adequate reserves (so that we can support exchange rate stability and banking system liquidity if necessary). We expect these conditions to be in place in late 2009.

- The strategy will distinguish accounts, asset classes and transactions to be liberalized early in the process from others which will remain controlled for a longer period of time. These latter "blocked accounts" will comprise those where there is a large potential for outflows, and where early liberalization might undermine effective administration of the system.

- The lifting of controls will be sequenced. Once liberalization starts, controls on all foreign exchange capital inflows can be removed in a relatively short time frame. In a second stage, controls on outflows from non-blocked accounts, asset classes and transactions will be gradually liberalized, consistent with the balance of payments outlook and improvements in confidence in the domestic banking sector. In the final stage, blocked accounts will be gradually released. This stage will only commence once the others are complete, and once we have available surplus reserves (to help contain any exchange rate volatility). The use of krona for international transactions will remain controlled until the final stage of liberalization.

- Controls on outflows from blocked accounts, when they are lifted, will be lifted either through a gradual increase in thresholds or through targeted auctions of FX-convertible bonds.

- Since the controls cannot immediately be lifted and must be kept effective, the strategy also provides for stronger administration. In particular, we have strengthened regular reporting by banks and other participants in foreign exchange transactions, established a dedicated monitoring unit in the CBI, and set up a special investigation unit in the FME. The latter two units are sharing information and working together to intensify surveillance and ensure compliance under a formal agreement between the

CBI and the FME signed in June. We expect this tightening of administration to help loosen constraints on our interest rate policy.

- The strategy will be refined and revised based on the experience from early phases of the plan. We will continuously review the design of the controls to ensure that they are functioning with minimum administrative burden while containing circumvention. The CBI indeed stands ready to tighten administration of "blocked" accounts if the situation requires.

- While current payments are generally transferable, the capital control regime marginally affects the conversion and transfer of two components of current payments, as defined by the IMF: interest on bonds (whose transfer the FX rules apportion depending on the period of the holding) and the indexed portion of amortized principal on bonds. To the extent that these measures give rise to exchange restrictions, we request IMF temporary approval and waiver of the nonobservance of the performance criterion under the Stand-by Arrangement.

6. **Monetary operations have been strengthened in support of our strategy**. The CBI has defined an intervention strategy that sets indicative levels for acceptable exchange rate volatility and targets for net foreign exchange accumulation consistent with the program NIR target. Domestic liquidity management has also been tightened. We have enhanced control of the volume of open market operations from July 1, and have established a program of weekly CD issuance (28-day CDs will be used to mop up liquidity and thus make the CB interest rate corridor more relevant).

Financial Sector Policies

7. **Our financial sector strategy will continue to be guided by several principles.** First, it is crucial, from a macroeconomic perspective, to have a sound banking system as soon as possible. Second, while we remain committed to protecting domestic deposits, we have no fiscal capacity to absorb any further private sector losses from the banking crisis, whether this be through direct use of government resources, or an indirect use of the government's balance sheet to assume risk. Third, there must be a fair, equitable, and non-discriminatory treatment of depositors and creditors in line with applicable law.

8. **We have strengthened the oversight of the restructuring of the financial system.** An Executive Committee, with a mandate from the Prime Minister, Minister of Finance and Minister of Business Affairs and the Central Bank, will continue to oversee the overall financial sector restructuring. A special committee was set up with participation of the Ministry of Finance, Ministry of Business Affairs, and the Prime Minister's Office to manage the process of recapitalizating the three new banks. Reputable financial advisors were retained to discuss compensation instruments. We have publicly clarified to all stakeholders these new lines of responsibility and decision-making.

9. **Recapitalization of the three new banks (that were established after the collapse of the old banks) is a key objective.** We have made much progress, but a few more steps will be required to bring the process to a conclusion:

- The valuation of the assets transferred from the old banks to the new banks was concluded in April. This produced, for each bank, an estimated range of asset value under a given set of assumptions. This valuation exercise was an important means of gathering information and a helpful input into negotiations with creditors.

- To underpin fair and transparent discussions on compensation payable to the old banks and on the potential structure of a compensation instrument, we completed the exchange of information with the Resolution Committees of the old banks (RCs). We have also ensured full access by the RCs to the independent report on valuation of the assets, and to banks' business plans. Finally, we have met and shared information with representatives of the old bank creditor groups (in addition to the information that these parties have received through the RCs).

- The period for discussions had to be time-bound, but with enough flexibility to allow creditors to process information and to consider alternative options. Discussions began in April and accelerated in early June after the RCs gained access to the new banks' business plans and to the independent report on valuation. Extensions were granted in mid-July and mid-August at the request of creditor representatives.

- The instruments of compensation have been, and will continue to be, designed to account for the uncertainty about asset valuation in a fair manner. They may in each case comprise a fixed debt component and a component for which the return will vary with economic outcomes. We have already reached such agreements with the Kaupthing and Glitnir RCs. We aim for an agreement with the Landsbanki RC by mid-November.

- Islandsbanki and New Kaupthing have been recapitalized (**prior action** for the review) after a preliminary audit of their opening balance sheets (on the basis of IFRS), and an accounting of the compensation instrument. The capital adequacy ratio (including capital requirements to cover market and operational risk) has in each new bank been brought to 12 percent, by means of an injection of tradable government bonds. We expect Landsbanki to be recapitalized to the same capital adequacy ratio, again using tradable government bonds. We propose that this recapitalization of New Landsbanki be a **structural benchmark** for end-November.

10. **The process of operationally restructuring the new banks has commenced:**

- We have developed a plan to address their financial imbalances. Banks' excess of FX assets over liabilities exposes them to large potential losses in the event of currency volatility. Eliminating this excess will take time, and as discussed above, capital requirements will be set to help mitigate any problems that arise. We expect the solution to vary by bank. We expect to employ some combination of an FX compensation instrument; FX-subordinated debt (as part of recapitalization); review of lending and deposit rates; and voluntary debt conversion (consistent with the restructuring strategy laid out below) in each bank.

- The three new banks have submitted to the FME revised business plans for the next three years (business plans were submitted to and reviewed by the FME in mid-January 2009, meeting a program **structural benchmark**). These plans are based on the program macroeconomic scenario, and cover the staffing needs, organizational structure and the kind of services they will be offering their customers in the future. They include quarterly targets to gradually eliminate financial imbalances (consistent with the bank-by-bank plan in the bullet above), restructure loans, and bring the system into line with best international practices.

- As part of the governance framework for the new banks, we have set up an agency to be the depository of bank shares held by the treasury. The agency will be operational by end-October 2009. It will be responsible, through a board composed of well-trained and fit and proper banking experts, for negotiating agreements with banks to restructure their operations to achieve and maintain profitability, and more generally to ensure prudent conduct of their operations. The agency will also be responsible for maintaining the level of bank capitalization in full compliance with regulatory requirements, and approving capital increases to sustain asset growth.

11. **The three old banks are now in winding up proceedings.** The ultimate recovery of creditors is to be determined in accordance with the legal ranking of secured creditors, depositors, and unsecured creditors, under the applicable insolvency law. Separately, a special prosecutor's office has been established to investigate and prosecute possible criminal offenses in the past management of the old banks. We are committed to providing this office with adequate resources to carry out its functions.

12. **We are taking action to secure the remainder of the financial system.** A number of domestic savings banks and an investment bank suffered from the collapse of the three old banks, and from the aftermath of domestic and international financial turbulence. We had to intervene in several of these institutions in March 2009, after creditors and owners were unable to find a satisfactory solution to solvency and/or liquidity problems (despite repeated deadline extensions). Deposits were transferred to other financial institutions. For remaining saving banks we have a program in place which allows us to inject capital to bring viable institutions up to a capital adequacy ratio of 12 percent of their risk-weighted assets. The public contribution is limited to 20 percent of end-2007 capital. To qualify, their business plans and the fit and proper status of senior managers and directors must first be subjected to thorough scrutiny by the FME, and the Ministry of Finance must be satisfied that their

business plans do not shift risk or losses onto the public sector. We expect this program to be complete no later than November 30, at which point all operating savings banks will be fully capitalized. We propose completion by this date as a **structural benchmark**.

13. **The government has adopted a statement of its intentions as owner of financial institutions during the reconstruction of the financial system.** The principal objectives are to ensure the provision of banking services throughout the country while promoting the development of a sound, trusted and profitable financial system, thereby contributing to economic growth. Other objectives are to strengthen competition, enhance efficiency and encourage transparency in the financial sector. We plan to reduce government holdings of bank equity as market conditions permit.

14. **We are also taking action to improve our regulatory and supervisory practices.** An international expert has concluded and published a review (meeting a program **structural performance criterion**), and we plan to implement the key recommendations:

- We intend to introduce legislation into parliament covering the powers given to the supervisory agency; the creation of a national credit registry (to allow identification and monitoring of large exposures); improvements in the deposit insurance system; and prudential regulations on large exposures and connected lending. We propose that the introduction of this legislation become a **structural benchmark** for end-December.

- The FME will place emphasis in its annual work plan on higher onsite inspection frequency, by means of more specialization within the authority and more resources allocated to onsite inspection. To bolster its investigative capacity, the FME is in the process of establishing a forensic accounting unit with a specialized staff to uncover and prevent financial fraud and wrongdoing, support prosecution efforts, and play a proactive role in risk reduction. It formally began operating in August.

- We also intend to introduce a bank insolvency bill of law to provide a predictable framework for bank resolution.

Debt Restructuring

15. **Targeted household and corporate debt restructuring are important complements to our financial sector restructuring strategy going forward.** Addressing non-performing loans and those at risk of becoming non-performing will be crucial to facilitate prompt economic recovery. In designing and refining policies in this area we will be guided by several principles, including the need to: target our interventions to those truly in need (and in line with fiscal and financial sector capacity); preserve the payment culture and avoid strategic loan defaults; maximize asset recovery; and facilitate market distinctions between rehabilitation of viable borrowers and the efficient exit from the economy of non-viable borrowers.

16. **For the household sector, we have already put in place several measures and a key focus now will be the household insolvency regime.**

- Targeted measures to assist distressed household debtors have included: (i) the law on "Temporary Mitigation of Residential Mortgage Payments" that provides for the extension of maturities of moderate mortgage loans if voluntary restructuring is not sufficient; and (ii) amendment of the insolvency law to facilitate agreements between individual debtors and their unsecured creditors. With these laws now in place, we have lifted the informal freeze on mortgage loans payments and we will allow the standstill on foreclosures to expire, beginning at end-October with full phase out by end-January 2010.

- We are studying household income and debt data to determine whether these initiatives should be adjusted. We will also develop guidelines consistent with international best practices to support and promote voluntary and expedited debt restructurings in the household sector, which will ensure that a coherent and consistent strategy is implemented across financial institutions, taking account of existing measures.

- In addition, we have reviewed the household insolvency regime to determine whether further legal reforms are required including whether to integrate debt counseling services into the insolvency law process and to include secured creditors in an individual's rehabilitation proceedings. The Ministry of Justice has issued a report containing the key recommendations for reform and will submit a bill to Parliament in November 2009.

17. **For the corporate sector, voluntary and insolvency law-based tools, along with an asset management company (AMC) will be needed to address debt distress:**

- We will work with the banks to facilitate voluntary corporate debt workouts. We will jointly revisit with the banks their existing guidelines on out-of-court restructurings. In line with best international practice, these would cover: voluntary stay of payments and enforcement actions; provision of new financing; and information flows from debtor to creditors. The guidelines will lay out the minimum criteria under which loan terms can be changed (if necessary), including the conditions to be applied to debtors when loans are restructured. The process is expected to accelerate once suitable guidelines are in place and changes in the corporate insolvency regime have been passed.

- The Ministry of Justice has issued a report containing the key recommendations for corporate insolvency regime reform and the corresponding proposals for amendments will be submitted to Parliament in November 2009. The review focuses on the following areas: (i) incorporating a liquidity test for initiation of insolvency proceedings; (ii) expediting court approval of restructuring plans concluded between viable firms and a requisite majority of creditors; (iii) including secured creditors in agreed restructuring plans, (iv) facilitating new financing during a firm's rehabilitation by clarifying the priority ranking of such financing; (v) introducing the subordination of related-party claims in insolvency proceedings, where warranted; (vi) strengthening procedures for the efficient liquidation of non-viable firms; and (vii) addressing coordination between Icelandic and foreign courts on cross-border insolvencies.

- A law has been passed by parliament in July 2009 enabling us to establish an AMC. The AMC would ensure that the pace of bank-led restructuring for the targeted group of large firms is sufficient. The AMC would be designed to manage assets without necessarily owning them and allow us to leverage expertise and promote synergies (in the latter case through proxies to restructure firms that are common customers of the banks). The AMC would focus on debt and operational restructuring of large viable firms. It would be placed under professional management, which would be tasked to maximize asset recovery.

Fiscal Policy

18. **Our fiscal strategy remains to consolidate towards a sustainable fiscal position, and to cushion the public in the near-term from the sharpest impacts of the crisis.** Fiscal consolidation is necessary to achieve a sustainable debt position, contain our financing requirements, and provide support for gradual and sequenced monetary and capital controls relaxation. But it should be done at an appropriate pace that avoids exacerbating the crisis, and allows us to preserve the key elements of a Nordic welfare state model.

19. **In line with our overall fiscal strategy, we have allowed a sharp increase in the deficit in 2009, but we will now begin to take measures to limit this increase.** The 2009 budget fully accommodated the estimated automatic effects of the crisis on revenues and expenditures, but these effects have since grown significantly. With the severe financial turbulence now behind us, and having had time to develop and build consensus around fiscal measures, we will begin to tighten fiscal policy. Overall we are implementing an adjustment of krona 30 billion (2 percent of GDP). On the expenditure side measures include savings in operational spending, cut-backs in capital investment and maintenance, and further means testing of social benefits. Overall, the General Government deficit in 2009 (including accrued interest payments) would be limited to 14.4 percent of GDP, which would be consistent with a Central Government net financial balance (including accrued interest payments) of krona 200 billion. We hope to surpass this target by saving all revenue over performance.

20. **We have set out a plan for medium-term fiscal consolidation.** The plan has been approved by cabinet (a **prior action** for the review). It has been discussed with social

partners in the context of the June 2009 stability pact and also presented to parliament for discussion. It has several dimensions:

- It establishes a clear objective for fiscal policy. It commits to implement measures that will improve the *general government* primary balance by 5½ percent of GDP in 2010 (including the full year impact of measures taken in 2009); by 4½ percent of GDP in 2011; and by 3½ percent of GDP in 2012 (from an initial level of about -8¼ percent of GDP in 2009). The overall deficit of the general government would thus be expected to fall from 14.4 percent of GDP in 2009 to 10.9 percent of GDP in 2010 (including accrued interest), and by 2013 there would be a surplus.

- In order to achieve these targets, we will adjust the net financial balance of the central government. As indicated in the stability pact between government and social partners, central and local governments will cooperate closely in implementing fiscal restraint and on developments in the overall government fiscal balance. We will also better align local authorities' budgets with central government fiscal policy (via stronger balanced budget requirements and firmer borrowing limits).

- It establishes policies towards the needed adjustment, discusses the yield from key measures, and the motivation for the potential policy mix. The measures consist of a mix of revenue adjustments and expenditure cuts:

  - Revenue measures aim to raise the central government primary revenue ratio to at least 32 percent of GDP by 2013, and to achieve a fair distribution of the increased tax burden. They include a revision of the individual and corporate income tax systems, higher consumption taxes, measures to adequately finance unemployment benefits, environmental taxes, and a repeal of certain tax expenditures.

  - Expenditure measures aim to reduce the central government primary spending ratio to about 25 percent of GDP by 2013. They focus on further cuts in operational spending; tighter means testing for social benefits; and significant scaling back of investment spending, which had escalated in recent years. Socially important sectors are to be protected, along with labor intensive investment and maintenance.

21. **In the context of our budget preparations for fiscal year 2010, we have begun to implement the consolidation plan**. In order to meet our target to improve the general government primary balance by 5½ percent of GDP, we anticipate that we will need to raise the primary revenue ratio of the general government by 3¼ percent of GDP, and reduce general government primary spending by 2½ percent of GDP, compared with the projected 2009 outturns (central government accrual-based primary spending would then amount to krona 456 billion). New revenue measures include reforming the personal income

tax system including by harmonizing it with the taxation of investment income, as well as some further increase in excise and environmental taxes, and further changes to the VAT system. New expenditure measures include reductions in the wage bill, cuts in current expenditures, improving the targeting of social benefits, and further scaling back of investment and maintenance expenditures.

22. **We are developing a strategy to ensure smooth financing of high near-term deficits, and to contain risks from contingent liabilities.** This public debt strategy will be aimed at lengthening the maturity profile of krona debt, smoothing the profile of external debt repayments, preserving adequate levels of government deposits, and limiting risks from contingent liabilities. This plan will be fine-tuned with technical assistance on debt and cash management, including by the IMF. We propose that approval of the plan by the Ministry of Finance be a **structural benchmark** for end-December 2009.

23. **Measures have been elaborated to improve the fiscal framework and public financial management (**meeting an end-June **structural benchmark).** The aim is to support fiscal consolidation efforts by limiting within-year expenditure drift (a negative characteristic of recent budget implementation). As articulated in our fiscal consolidation plan, the new policies include a multi-year binding nominal expenditure ceiling (with a limited number of volatile non-discretionary categories outside the ceiling and an escape clause for inflation deviations that would exhaust budget flexibility); a 1–2 percent contingency fund to cope with deviations and unforeseen outlays; restrictions on the scope of the supplementary budget; restrictions on borrowing from future appropriations; elimination of a large amount of accumulated carry-forwards, and limits on recurrent spending carry-forwards.

External Financing

24. **Almost all of the previously committed bilateral official financing has now been agreed:**

- Agreements have been finalized and fully ratified with the Nordic countries and with Poland involving a total of $2¾ billion in financial assistance. Financing from the Faroe Islands has also been finalized and disbursed.

- Agreements have been finalized with the UK and the Netherlands, at the executive level, to cover deposit insurance in the foreign branches of Landsbanki. We expect the agreements, which should help facilitate access to already committed bilateral financing, to soon be fully ratified. The agreements anticipate that the deposit insurance will be mostly covered by assets recovered from the failed bank, with any residual amount to be covered by a loan guaranteed by the Government of Iceland.

Together with IMF financing, these various loans will help us maintain an adequate level of reserves. While they will add substantially to Iceland's high external debt burden, the terms are consistent with our near- and medium-term debt servicing capacity. Progress in covering our financing need will continue to be assessed during quarterly program reviews.

Safeguards

25. **We have strengthened external audit provisions for the CBI.** The Central Bank safeguards assessment, completed by the IMF, found good controls in accounting and reporting, but suggested modifications to our external audit arrangements. In line with its recommendations the Auditor-General has appointed an international audit firm to conduct on the Auditor-General's behalf the annual external audits of the Central Bank, in accordance with international accounting standards on auditing.

Table 1. Iceland Quantitative Performance Criteria Under the 2008–09 Economic Program.

	Performance Criteria		Indicative Targets				Prior Action		Performance Criteria	
	Dec 08 Program 1/	Dec 08 Actual	Mar 09 Ceiling/Floor 2/	Mar 09 Actual	Jun 09 Ceiling/Floor 3/	Jun 09 Actual	Sep 15 Ceiling 4/ 5/	Sep 15 Actual	Oct 09 Ceiling/Floor 5/	Dec 09 Ceiling/Floor 5/
					(In billions of Króna)					
1. Floor on the change in the central government net financial balance 6/	-12	-117	-55	1.7	-55	-51			-175	-200
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 7/									20	20
3. Ceiling on the change in net credit of the Central Bank of Iceland to the private sector	25	2.1	50	28.9	50	-27.5			--	
4. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government (*indicative target for end-October and end-December*)	25	7.8	25	-31.1	25	41.4			70	70
					(In millions of U.S. dollars)					
5. Floor on the change in net international reserves of the Central Bank of Iceland 7/ 8/	-500	-543	-500	-70	-500	-28.9	-96.6	-82.9		
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 9/	4000	0	4075	54.5	4150	54.5			3500	3500
7. Ceiling on the stock of central government short-term external debt 9/	650	137.0	650	189.4	650	281.8			1400	1500
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 10/ 11/	0	0	0	0	0	0			0	0

1/ From October 22, 2008 to December 31, 2008 (unless otherwise indicated).
2/ From January 1, 2009 to March 31, 2009.
3/ From April 1, 2009 to June 30, 2009.
4/ Prior action for the first review. Defined as NIR, cumulative from January 1, 2009.
5/ Cumulatively from January 1, 2009 (unless otherwise indicated).
6/ Dec 08 target defined from Oct 1 2008 to Dec 31 2008. At end-Sep 08, the central government net financial balance was króna 4.28 billion, after contributions to the government employees pension fund. 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.
7/ Excluding changes due to central bank recapitalization bond and adding back the effect of the transfer of collateral from the CBI to the government as described in the Technical Memorandum of Understanding.
8/ (-) indicates decrease. NIR is 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). Excludes new SDR allocation.
9/ 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.
10/ Applies on a continuous basis.
11/ On October 20 the central government had no arrears to multilateral and official bilateral creditors

Table 2. Iceland Structural Conditionality Under the 2008–09 Economic Program

Structural Conditionality	Status
Prior actions for the First Review	
• Implementation of monetary policy towards the currency stability objective, and in line with reserve targets.	• *Done*
• Approval by cabinet of a strategy to phase out capital controls.	• *Done*
• Approval by cabinet of a medium-term fiscal consolidation plan.	• *Done*
• Recapitalize New Kaupthing and Islandsbanki, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent.	• *Done*
Structural Performance Criteria	
• A capital injection into the three new banks, made using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 10 percent. *By end-February 2009*.	• *Not observed (see prior action and new structural benchmark)*
• An experienced banking supervisor to provide an assessment (to be published) of the regulatory framework and supervisory practice, including the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers, and propose needed changes. *By end-March 2009.*	• *Done*
Structural Benchmarks	
• Develop a strategy for asset recoveries. *By end-November 2008.*	• *Done.*
• Prepare plans to embark on medium-term fiscal consolidation. *By end-2008*.	• *Implemented with delay (see prior action)*
• FME to review the business plans of each of the new banks. *By January 15, 2009.*	• *Done.*
• International Auditing Firm to conduct valuations of the old and new banks using a methodology in accordance with international best practice. *Complete by end-January 2009.*	• *Done.*
• Improve the medium term fiscal framework. *By end-June 2009*.	• *Implemented with delay in mid-July.*
New Structural Benchmarks	
• A capital injection into New Landsbanki, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent. *[By end-November, 2009*]	
• Completion of the program of savings bank recapitalization, meeting FME and Ministry of Finance requirements. *[By end-November, 2009*]	
• Approval of legislation to address deficiencies in bank regulatory framework and supervisory practice. *[By end-December 2009]*	
• Approval by cabinet of a medium-term public debt management plan [*By end-December 2009].*	

ATTACHMENT II. TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)
October 20, 2009

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.

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 employees 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 or government-backed bonds obtained during the central bank recapitalization process, and as a result of failed securities lending) 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 the value of the difference between outstanding loans and recovered assets. It will be valued at the exchange rate on the day of the assumption of the guarantee and recovered assets will be valued at the exchange rate on the day the sales of assets occurs.

- **Adjustments**: 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. Net domestic financing will exclude the retro-active accrued interest on the bank capitalization bonds from October 8th, 2008 to October 8th, 2009.

6. **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

7. **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 and the general government at the CBI will 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 -$425 million as of October 21, 2008 (at the program exchange rate).

8. **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

9. **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** is defined as the sum of capital contributions, revaluation accounts and retained earnings. Performance against the NDA target will be measured at program exchange rates.

10. **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.

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 some time 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.

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.

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