International Monetary Fund

Iceland and the IMF

Press Release:
IMF Completes Second Review Under Stand-By Arrangement for Iceland, Extends the Arrangement, Rephases Access and Approves US $160 Million Disbursement
April 16, 2010

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

April 7, 2010

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, April 7, 2010

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington D.C., 20431
U.S.A.

Dear Mr. Strauss-Kahn:

1. **Our economic program, supported by a Stand-By Arrangement from the Fund, is delivering on its objectives**. Progress towards fiscal sustainability is reflected in passage of a 2010 budget embodying significant adjustment, and in the approval of a rigorous public debt management plan. A key first step towards full restructuring of the financial sector—recapitalization of the banking system—is now all but complete. And the krona has been stable. While Iceland's economy faces a difficult period of adjustment, our policy successes to date have helped make the recession less severe than expected. With continued policy implementation Iceland's economic recovery should commence during 2010, setting the stage for declines in high public and external debt levels over time.

2. **Our policy implementation is broadly on track**. All performance criteria, including end-December targets, have been met. Benchmarks concerning approval of a public debt management plan, recapitalization of Landsbanki, and submission to parliament of legislation covering supervisory reforms have been met, albeit with delay in two cases. The benchmark on recapitalizing the savings banks has not been observed, but the work in this area is now almost complete. The status of all program measures is summarized in Tables 1–2.

3. **On this basis, we request completion of the second review under the Stand-By Arrangement.** In light of the delay in the second review, we request that the arrangement be extended to August 31, 2011 and purchases rephased. The third review would now be available on or after July 15, 2010, with quarterly reviews thereafter (beginning in the fourth quarter of 2010). Moreover, as set out in Table 1, we request that ceilings and floors for the quantitative performance criteria under the arrangement be established for May 31, 2010, and September 30, 2010, and that indicative targets be set for December 31, 2010. As detailed below, we also propose 5 new structural benchmarks against which to measure progress towards key fiscal and financial sector objectives for the next 12 months (Table 2).

4. **We believe that the policies set forth in this and previous letters 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.

The outlook

5. **We expect the economy to turn the corner in 2010 and begin a gradual recovery:**

- Quarterly growth should turn positive by the second half of 2010, on the back of strong export performance, but we expect the recovery to be gradual over the medium-term. Risks to growth remain significant, mainly from weaker than projected consumption and investment as the economy de-leverages, and from uncertainties surrounding the timing of investments in the energy intensive sector. Upside is also possible: strong competitiveness may lead to a stronger-than-projected response of exports, and there is ample upside potential through higher foreign direct investment.

- Headline inflation should subside to below 5 percent by end-2010 and fall to the 3–4 percent range in 2011. Stability of the krona and significant slack in the economy will reduce price pressures next year. Risks to the inflation outlook emanate from possible second-round effects of exchange rate fluctuations, and wage increases in export sectors, and potentially persistent inflation expectations. If the krona strengthens more than currently forecast, we may see faster disinflation. To help contain risks, the Government remains committed to a Stability Pact with its social partners.

6. **We expect debt levels to peak at high levels in 2010, and then recede:**

- Public debt is climbing at a slower rate than expected. We have been able to partly finance our deficit by selling some of the financial assets acquired during the crisis, while there had been less need than anticipated for government resources in recapitalizing the banking system, reflecting creditor acquisition of the government equity share in Islandsbanki and Arion Bank. Public debt is on a robust downward path, and with the further recovery and sale of assets acquired during the financial crisis, and careful management of our debt refinancing needs (as outlined below), we believe that by 2014 it can be reduced to below 90 percent of GDP in gross terms (including residual Icesave-related debt), or below 65 percent of GDP after netting out government deposits.

- For external debt, a clearer picture is emerging, and the overall level is expected to remain well below the pre-crisis peak. The total overall gross debt level is now projected to peak at about 300 percent of GDP, compared with over 600 percent of GDP pre-crisis. Private debt is now estimated to be higher because it has become apparent that old banks will recover some assets from domestic sources. Since these new private debts mainly have a medium to long term maturity, and capital controls are now in place, we do not expect them to exert near-term pressure on the balance of payments. In the medium-term, any over-indebted corporations will have to address their debt overhang, assisted by the framework for private sector debt restructuring. Overall, the gross external debt is expected to fall to under 250 percent of GDP by 2014.

7. **Underpinning these outcomes is the originally envisioned program financing, and a modified policy framework.** Our external financing needs continue to be satisfied by a combination of IMF funds, and loans from the Nordic countries and Poland. Slow progress in our Icesave discussions with the U.K. and Netherlands may delay realization of some of the programmed bilateral financing, but as discussed at the end of the letter we expect these negotiations to reach a conclusion soon. A current account surplus, in the context of capital controls, can help keep the program fully financed in the interim. Our key objectives—currency stability, fiscal sustainability and financial sector restructuring—are also unchanged and remain crucial for securing a durable recovery and reducing risks. However, we are introducing some policy modifications to support economic activity in the near term, as discussed in what follows.

Fiscal Policy

8. **We have adjusted the fiscal stance to help support the recovery**. Lower public debt and an improved outlook for public debt sustainability have paved the way for a more supportive stance. Thus the general government primary deficit adjustment, on a national accounts cash basis, will be 4¼ instead of 5½ percent of GDP in 2010 (which will deliver a general government primary deficit level of 2¾ percent of GDP). We expect local governments, in aggregate, to maintain broadly the same primary balance in 2010 as in 2009, and their budget plans are in line with this. Social security funds should show a mild deterioration in their balance. To achieve our target, we thus plan a central government primary adjustment of 4.4 percent of GDP (to achieve a primary deficit level of -2.4 percent of GDP). The central government budget, embodying the measures necessary to achieve this target, was passed by parliament in December (meeting a **prior action** for the review):

- **Revenue measures** will help raise the primary revenue ratio by 1.2 percent of GDP. Without these measures, cyclical and other factors would have led to a decline in the revenue ratio. We expect the changes to improve the fairness of the tax system:

    - Underlying measures amount to 2.1 percent of GDP and include: (i) introduction of a three-bracket PIT system with an increased tax-free allowance and an increase of the capital income tax; (ii) an increase in the standard VAT rate; (iii) a new tax on wealthy individuals; (iv) new environmental and carbon taxes; and (v) increases in excises, social security contributions and fees. To facilitate stronger administration, we have also amended the income tax law to address issues of tax circumvention and arbitrage.

    - Temporary measures amount to a further 0.4 percent of GDP. These include revenues from extending the possibility to withdraw savings from individual supplementary pension savings accounts, and from prepayment of corporate taxes by high-energy users.

- Expenditure measures will help reduce the primary spending ratio by 3.2 percent of GDP. They include general cuts in current expenditure and wages formulated at the agency level under the guidance of the Ministry of Finance; cuts in transfer payments, including from improved means-testing of social benefits and efficiency gains in the health system; cuts in investment and maintenance projects to pre-boom levels; non-indexation of wages and benefits; and reductions in discretionary spending items. These changes do not affect the key features of our social safety net, and indeed the budget allocates additional resources for vulnerable groups (e.g. for enhanced educational and work opportunities for the young).

- We will use any revenue over performance and under spending in 2010 to accelerate our fiscal adjustment, just as we did in 2009.

9. **The Ministry of Finance has approved a public debt management strategy** (a **prior action** for this review). The aim is to support the fiscal adjustment path by smoothing the financing of the deficit and refinancing of debt coming due, and by containing risks from contingent liabilities. The strategy emphasizes: (i) diversification across instruments and the investor base; (ii) prudent management of rollover risks; (iii) the sale of financial assets acquired during the crisis; (iv) a stronger framework for managing contingent liabilities; and (v) strengthened institutional arrangements.

10. **We will continue to strengthen the fiscal framework during 2010, with a focus on fiscal-federal relations**. We expect the new local government framework to comprise: (i) a fiscal rule; (ii) clear restrictions on municipal borrowing; (iii) robust mechanisms for dealing with volatility in local revenues; (iv) enhanced in-year surveillance of local government fiscal developments; (v) stronger national-local dialogue on fiscal objective-setting and budget planning; (vi) a range of sanctions for non-compliance. The preparatory work will be completed by end-August, and budgets for 2011 will be prepared in line with the new framework. We intend to enact these changes into law by end-2010, and propose this to be a new **program structural benchmark**.

Monetary Policy and Capital Controls

11. **Monetary policy will continue to be guided by the interim objective of currency stability.** The potential for currency depreciation, inflation pass-through, and further balance sheet stress call for caution concerning changes in the policy stance. To the extent the exchange rate strengthens, we will need to balance the benefits that can be delivered by accumulating reserves against those to be derived through interest rate reductions. Uncertainty about the precise timing of external financing argues for some reserve accumulation at an earlier stage than previously envisaged, done in a manner to preserve the gradual recovery of the króna. The scope for reducing interest rates will accordingly be more limited until the timing becomes clear.

12. **To enhance the effectiveness of policy, the MPC has realigned the CBI's interest rates within a narrower corridor.** The width of the corridor has been reduced to 300 bps, and the central bank CD rate and the 7-day repo lending rate have been positioned close to the center of it. One or the other will be used depending on the CBI's need to withdraw or inject liquidity. To further enhance liquidity management, the CBI has started pre-announcing targeted weekly volumes (set at a level to remove the estimated liquidity surplus at a given interest rate target), and accepting all bids up to this targeted volume.

13. **We have adjusted our capital controls regime, to enhance its effectiveness.** At end-October, we took the first step in our liberalization strategy by lifting controls on new investment (the initial inflow and proceeds from new investments in foreign currency became freely transferable).However, the conditions are not yet in place to begin liberalizing capital outflows, and in particular greater certainty about the timing of external financing will first be required. To enhance the effectiveness of administration in the near term, we have introduced revised rules, which include limitations on cross-border movements of krona and fewer exemptions. We have backed this up with increased resources for monitoring, and by enforcement actions. These steps are already showing results: the onshore rate has appreciated even while intervention has ceased. Looking forward, we will ensure adequate resources in monitoring and enforcement of the controls, and data collection, and stand ready to revise and extend the foreign exchange act and rules as necessary to ensure their effectiveness.

Financial sector policies

14. **Recapitalization of the banking sector will soon be complete.** This will mark a necessary first step towards a durable renewal of lending, and set the stage for more complete operational restructuring during 2010:

- New Landsbanki has been recapitalized to 12 percent of tier I capital to risk-weighted assets **(**a **prior action** for the review**)**. The government capital injection, ISK 122 billion, was made based on the bank's December 2008 audited financial statements. The compensation agreed with Old Landsbanki reflected a valuation methodology that the FME has accepted as consistent with industry standards. And the compensation package comprised a fixed instrument, a contingent bond and 19 percent of bank shares. This completes the recapitalization of the commercial banks.

- We have made substantial progress towards recapitalizing savings banks and, while we were not able to observe the end-November structural benchmark to this end, we will soon fully complete the process. An agreement has been reached with eight smaller savings banks to be confirmed in April by their boards and the FME. Three will be recapitalized by their owners, while the remaining five will be recapitalized up to 16 percent of their risk weighted assets. Negotiations with the creditors of the two largest savings banks— Sparisjóðurinn í Keflavik and Byr—on necessary haircuts and write downs of equity by owners have been completed and are now proceeding to documentation. These institutions will be recapitalized up to 16 percent of their risk weighted assets (tier 1 capital to 12 percent and tier 2 capital to 4 percent). If necessary, public funds will be used to the limits defined in the Emergency Law, but only after all existing losses are allocated to their owners and creditors, managers and directors that are deemed to be "non fit" and "not proper" are removed, and a strategy to strengthen their liquidity position is put in place. We propose the recapitalization of Sparisjóðurinn í Keflavik and Byr as a new program **structural benchmark** for end-May 2010. The total fiscal cost of addressing the recapitalization of the savings bank sector is not expected to exceed 1½ percent of GDP.

15. **The remainder of the financial system will be put onto a stronger footing**. We will take several steps to further enhance the medium-term viability of the non bank financial institutions and the Housing Financing Fund (HFF):

- By end-June 2010 the non bank financial institutions and HFF will present business plans to the FME (using macro assumptions in the Fund-supported program and the premises considered by the new banks in the preparation of their business plans) demonstrating their capacity to remain solvent and generate liquidity to honor debt coming due over the next three years, without government support. The FME will complete the review of the consistency and credibility of these reports and require rehabilitation and/or recapitalization measures where needed by end-August 2010. We propose this as a new program **structural benchmark.** We remain committed to no absorption of losses and no public assets will be used to rehabilitate the non bank financial institutions.

- We will ensure that the HFF is subject to prudential rules similar to those faced by other financial intermediaries, with an appropriate phase in for increases in capital.

16. **A bill has been submitted to parliament to strengthen our regulatory and supervisory practices** (meeting an end-December **structural benchmark**)**:**

- The draft legislation to address deficiencies in the bank regulatory framework is expected to be passed by end-June. The legislation mandates improved risk management systems and governance in banks (including via stronger rules on remuneration systems and severance agreements); strengthens provisions on large exposures and connected and related party lending; enhances fit and proper requirements for major shareholders; grants discretionary powers to the FME to act on key fronts (including concerning credit limits for institutions, and the eligibility of potential investors); permits the creation of a credit registry at the FME; boosts the quality of bank equity; and strengthens provisions covering both internal and external bank audit.

- We have also introduced a draft bill of law modifying the deposit guarantee regime. At the present time, we remain committed to protect depositors in full, but when financial stability is secured we will plan for the gradual lifting of this blanket guarantee. Only when we reach this point, will the coverage be gradually reduced to the EUR 50,000 defined in the bill. The framework will specify coverage in line with EU legislation, ensure quick repayment on a gross basis, and gradually introduce higher risk based insurance premia.

17. **We will take further actions to strengthen regulation and supervision during 2010–11:**

- On the basis of the revised legal framework, by end-September we intend to amend key prudential rules (regarding connected parties, large exposures and the use by banks of the consolidated information on borrowers in the FME's new credit registry). We also will ensure that commercial banks have adopted measures to address risk management and the governance issues identified in FME comments on their business plans. Finally, to facilitate prudential monitoring, we intend to introduce temporary requirements for commercial and savings banks to submit audited financial statements semi-annually (instead of annually) for the next two years.

- We intend to take stock of the implementation of recommended changes in our supervisory regime, and assess whether there is any need for further strengthening. We will complete an assessment of compliance with the revised Basel Core Principles and formulate a strategic plan to address identified weaknesses. The assessment and plan, which will be published by end-March 2011, will be led by independent and internationally-recognized assessors and conducted on the basis of the Core Principles Methodology. We propose this to be a new program **structural benchmark**.

Private sector debt restructuring

18. **The tools are being put into place to accelerate private sector debt restructuring**. This should place viable firms and households on a sounder footing and support private sector demand:

- A comprehensive framework is being established for household debt restructuring:

    - *Information.* All households have access to the Debt Advisory Services, which provides information and advice to individuals on restructuring options.

    - *Automatic measures*. Households holding CPI-indexed mortgages are automatically placed into a generalized payment smoothing program to provide debt service relief for mortgages (but can opt out). A similar scheme exists for fx-denominated mortgages and auto loans, albeit on an opt-in basis.

    - *Voluntary workouts.* All households can also seek a voluntary agreement with their lenders on a workout. Generalized guidelines have established eligibility and have specified criteria for debt write downs. Based on these guidelines, the banks and HFF have established their own frameworks for voluntary workouts.

- *Court-assisted processes.* If such measures prove insufficient, households have access to a court-supervised process covering residential mortgages, in which the court will decide a new payment mitigation scheme based on repayment capacity.

- To ensure that the framework functions smoothly, we intend to (i) provide debtors better access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) extend eligibility to households and individuals not now covered by the schemes; and (iii) create incentives for financial institutions and debtors to expedite voluntary restructuring agreements. We propose that passage of legislation to strengthen the framework along these dimensions be a **structural benchmark** for end-June 2010. We emphasize that with this refined framework in place, there will be *no further extensions* of the moratorium on foreclosures, and we will allow it to expire on schedule at end-October 2010.

- The framework is in line with the financial capacity of banks and financial institutions to engage in workouts. We will take the necessary measures to ensure the system has enough administrative capacity to process workouts. We do not expect any fiscal costs, but if any do emerge, they will have to fit within the agreed fiscal envelope.

- We have introduced a framework to support voluntary corporate debt restructuring. By law financial institutions are required to submit internal guidelines for debt restructuring to the FME for approval. The FME has evaluated and approved these guidelines and the Competition Authority is expected to sign off by end-April. These guidelines apply to businesses of all sizes, but banks may introduce more expeditious procedures to restructure smaller corporations as needed. The guidelines include: criteria under which loan terms can be altered, criteria to evaluate a debtor's assets and liabilities and a debtor's ability to service debt based on expected future income and cash-flow, as well as other objective criteria which may be used to evaluate the debtor, company management and owners. A special committee will monitor and report on whether debt restructuring guidelines adopted by financial institutions are being applied as intended and with an overall emphasis on transparency and fairness.

- Incentives are being introduced for banks to accelerate corporate debt restructuring. We have submitted a bill amending the Act on Financial Undertakings, which ensures that unrestructured loans are reflected in banks' books and provisions on a timely basis. The FME will also require more frequent independent auditing of the valuation of loan collateral, undertake enhanced onsite examination, and require incorporation of fx loans to unhedged borrowers (that are in the process of being converted into ISK) into the computation of market risk, by end-2011.

- The government will also take steps to facilitate restructuring (without absorbing any private sector losses). In particular, we will propose measures to ensure that the tax treatment of debt write-offs does not complicate debt restructuring. The government has also offered extended installment schemes to viable debtors; and, for other debtors, will review collection procedures to ensure that they maximize government recovery and allow for timely decisions.

19. **The insolvency regime will be refined.** This is necessary to support debt restructuring, and to address non-viable borrowers:

- We have submitted to Parliament proposals to amend the insolvency regime. We expect the amendments to be passed by end-June. The amendments will aim in particular to (i) simplify and expedite in-court proceedings for reaching restructuring agreements between viable debtors and a qualified majority of creditors, and for liquidating unviable debtors; (ii) facilitate cross-border insolvency proceedings by allowing a debtor or foreign bankruptcy trustee to seek assistance from Icelandic courts even in the absence of an international treaty; and (iii) ensure protection of secured creditors' claims. Finally, we will conduct an assessment to determine whether to implement a system of "pre-packaged debt restructuring plans" to enable viable debtors to reach out-of-court restructuring agreements with a qualified majority of creditors. This assessment will be concluded by end-June 2010, and if the conclusion is that the implementation of such a system is advisable, a proposal for its establishment will be submitted to Parliament by end-October 2010.

- We will also expand the capacity of the institutional framework to process cases by increasing the number of judges and assistant judges by 5 each. We have also appointed a working group to assess whether changes can be made to criminal procedural law to lessen the strain on the District Courts and the Supreme Court.

External Financing

20. **Our ability to fully implement the program described above is dependent on access to the external financing committed under the program**. We firmly expect to be able to meet the preconditions set by some of our bilateral partners to access this finance. In this context, we wish to reaffirm that Iceland will honor its obligations in regard to the insured retail depositors of the intervened banks. Iceland has already affirmed in its Letter of Intent dated 15 November 2008 that it is willing to ensure that the United Kingdom and the Netherlands will be reimbursed in respect of deposits of Landsbanki branches in those two countries (up to the Euro 20,887 minimum provided for under Icelandic Law and the EU Deposit Guarantee Directive 90/19/EC). Iceland has also given an assurance that the United Kingdom and the Netherlands will receive the reasonable time value of money, provided that comprehensive agreements are reached. Iceland remains ready to conclude at the earliest convenience the

negotiations with the Governments of the United Kingdom and the Netherlands regarding a legal and financial settlement of this matter.

21. **Progress in covering our financing need will continue to be assessed during quarterly program reviews**. In the event of further delays to financing, we stand ready to consult with the Fund on any additional measures that would prove necessary to meet program objectives (consistent with our undertaking in paragraph 4 above).

Very truly yours,

/s/	/s/
Jóhanna Sigurðardóttir	Steingrímur J. Sigfússon
Prime Minister	Minister of Finance
/s/	/s/
Gylfi Magnússon	Már Guðmundsson
Minister of Economic Affairs	Governor of the Central Bank of Iceland

Table 1. Iceland Quantitative Performance Criteria and Indicative Targets

	Performance Criteria						Indicative Target
	Oct 09 Prog. 1/	Oct 09 Actual 1/	Dec 09 Prog. 1/	Dec 09 Actual 1/	May 10 Ceiling/Floor 2/	Sep 10 Ceiling/Floor 2/	Dec 10 Ceiling/Floor 2/
	(In billions of Króna)						
1. Floor on the change in the central government net financial balance 3/	-175	-139.5	-200	-166.7	-55	-120	-150
2. Ceiling on the change in net domestic assets of the Central Bank of Iceland 4/	20	34	42.6	30.3	65	65	65
3. Ceiling on the change in the domestic claims of the Central Bank of Iceland to the central government (Indicative targets)	70	8.6	70	13.8	80	80	80
	(In millions of U.S. dollars)						
5. Floor on the change in net international reserves of the Central Bank of Iceland 5/	-425	-278	-475	-319	-325	-350	-425
6. Ceiling on the level of contracting or guaranteeing of new medium and long term external debt by central government 6/	3500	54.5	3500	486.6	2500	2500	2500
7. Ceiling on the stock of central government short-term external debt 7/	1400	0	1400	0	750	750	750
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 7/	0	0	0	0	0	0	0

1/ Cumulatively from January 1, 2009 (unless otherwise indicated).
2/ Cumulatively from January 1, 2010 (unless otherwise indicated).
3/ 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.
4/ Excluding changes due to central bank recapitalization bond.
5/ (-) 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, as specified in the TMU. NIR adjuster is specified in the TMU.
6/ 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.
7/ Applies on a continuous basis.

Table 2. Iceland: Prior Actions and Structural Conditionality

Structural Conditionality	Status
Prior actions	
• A capital injection into New Landsbankinn, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent.	Done
• Approval by the Ministry of Finance of a medium-term public debt management plan.	Done
• Passage of the 2010 central government budget consistent with program targets.	Done
Structural Benchmarks	
• A capital injection into New Landsbankinn, using tradable government bonds issued on market terms, to raise the capital adequacy ratio to at least 12 percent.	Implemented with delay as prior action (see above)
• Completion of the program of savings bank recapitalization, meeting FME and Ministry of Finance requirements.	Not observed (Reset as structural benchmark; see below)
• Approval by the Ministry of Finance of a medium-term public debt management plan.	Implemented with delay as prior action (see above)
• Submission to parliament of legislation to address deficiencies in the bank regulatory framework and supervisory practice. *By end-December 2009. 1/*	Done
New Structural Benchmarks	
• Passage of legislation to strengthen the fiscal framework for local governments, covering (i) the fiscal rule to be applied; (ii) restrictions on municipal borrowing; (iii) mechanisms for dealing with revenue volatility; (iv) surveillance modalities; (v) coordination mechanisms; and (vi) sanctions for non-compliance (LOI ¶10). *By end-2010.*	
• Recapitalization of Byr and Keflavik, the two largest savings banks, up to 16 percent of their risk weighted assets. (LOI ¶14). *By end-May 2010.*	
• The FME to require rehabilitation and/or recapitalization measures to be taken by non bank financial institutions and the Housing Finance Fund, as determined to be necessary by a review of their business plans (LOI ¶15). *By end-August 2010.*	
• Publication of a Basel Core Principles assessment of weaknesses in Iceland's supervisory framework, along with a strategic plan to address the weaknesses (LOI ¶17). *By end-March 2011.*	
• Passage of legislation to strengthen the framework for household debt restructuring, addressing (i) access to information, advice, and mediation mechanisms in the context of voluntary workouts; (ii) eligibility; and (iii) incentives for financial institutions and debtors to expedite voluntary restructuring agreements. (LOI ¶18). *By end-June 2010.*	

1/ Corrected from the structural benchmark listed in the table in the First Review Under the Stand-By Arrangement (IMF Country Report No.09/306) to reflect the agreed text in the Letter of Intent.

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.

- **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. It will; however, include the accrued interest on 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.

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 (both active and in the process of winding up) 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. **Adjustment mechanism:**

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

- For each period, the NIR floor will be adjusted up to an amount specified in the table below. The figures indicate a cap on the cumulative use of NIR.

NIR adjustment

Cumulative flows from End-December 2009	In millions of US dollars at program exchange rate	Adjustment per one dollar of additional Nordic disbursements
Nordic Disbursements (technical assumption for the adjuster purpose)		
End-May 2010	0	-0.50
End-September 2010	0	-0.50
End-December 2010	0	-0.50
NIR cap		
End-May 2010	-650	
End-September 2010	-650	
End-December 2010	-650	

9. **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.

11. **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)

12. **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

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

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

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

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

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

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

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

14. **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

15. **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.

16. **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

17. 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