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Global Tax Alert

Iceland removes most restrictions on foreign exchange transactions and cross-border movement of domestic and foreign currency

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On 13 March 2017, the Icelandic Government published new Rules on Foreign Exchange (the Rules) in the *Law and Ministerial Gazette*, effective the following day, 14 March 2017. With the new Rules, the restrictions on foreign exchange transactions and cross-border movement of domestic and foreign currency have largely been lifted. In general, households and businesses will no longer be subject to the restrictions that the *Foreign Exchange Act* placed on, among other things, foreign exchange transactions, foreign investment, hedging, and lending activity. Furthermore, the requirement that residents repatriate foreign currency has been lifted. These are the items that have had the greatest impact on households and businesses since the capital controls were introduced in 2008. With the amendments, foreign investment by pension funds, funds for collective investment (UCITS), and other investors in excess of the maximum amounts provided for in the *Foreign Exchange Act*, which until now have been subject to explicit exemptions by the Central Bank, are now authorized transactions.

In addition, cross-border transactions in Icelandic Krona (ISK) are now authorized. Accordingly, foreign financial undertakings are authorized to transfer ISK and financial instruments issued in domestic currency to and from Iceland. However, the status of ISK-denominated assets, subject to special restrictions pursuant to Act no. 37/2016 (the so-called offshore ISK assets), will be unchanged. Special reserve requirements for specified investments in connection with new inflows of foreign currency also remain in place.

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The Rules provide for general exemptions to nearly all of the restrictions pursuant to the *Foreign Exchange Act*, no. 87/1992. Restrictions on the following will remain in place, however: (i) derivatives trading for purposes other than hedging; (ii) foreign exchange transactions carried out between residents and nonresidents without the intermediation of a financial undertaking; and (iii) in certain instances, foreign-denominated lending by residents to nonresidents. It is considered necessary to continue to restrict such transactions in order to prevent trade on the basis of investments not subject to special reserve requirements pursuant to Temporary Provision III of the *Foreign Exchange Act* and the Rules on Special Reserve Requirements on New Foreign Currency Inflows, no. 490/2016. Guidelines explaining the above-mentioned restrictions will be issued to accompany the Rules.

Amendments have also been made to Rules no. 490/2016 so as to ensure their effectiveness and prevent undesirable inflows of foreign capital now that the above-mentioned Rules have taken effect. The above-described amendments to the Rules do not affect offshore ISK assets subject to special restrictions pursuant to Act no. 37/2016. Now that most restrictions have been lifted from households and businesses, it is considered necessary to assess the impact they have. In accordance with the authorities' capital account liberalization strategy, focus will shift again to offshore ISK assets. Proposals concerning how offshore ISK assets will ultimately be released will be a part of the review of the *Foreign Exchange Act*, no. 87/1992, and the *Act on the Treatment of ISK-Denominated Assets Subject to Special Restrictions*, no. 37/2016.

The requirements for financial undertakings and other parties engaging in capital transactions to notify the Central Bank of Iceland of capital movements will remain unchanged for the present. However, various foreign exchange transactions and capital transfers that have previously been subject to confirmation by the Central Bank will only be subject to a disclosure requirement. Concurrent with work on the review of the *Foreign Exchange Act*, attempts will be made to simplify disclosure requirements, which in the long run are the premise for the Central Bank's ability to identify risks to the balance of payments and the financial system.

The reason to the Government is now undertaking the above-mentioned amendments to the Rules is said to be that the risk of the imbalance of payments that could cause monetary, exchange rate, or financial instability has diminished significantly in the past year. First, the restrictions on capital transfers in excess of specified maximum amounts have been lifted without discernible impact on the foreign exchange market or on the cross-border movement of capital. When the ceiling on such transfers was lifted at the turn of the year, the vast majority of individuals and companies were effectively unrestricted by the *Foreign Exchange Act*. Second, the Central Bank's foreign exchange reserves have increased markedly in the past twelve months, to a total of about ISK800b as of end-February. The build-up of the foreign reserves stems from a current account surplus in the amount of 8% of year-2016 GDP, far outpacing forecasts. The outlook is for a continuing current account surplus, foreign liabilities have declined, and Iceland's net external position is now positive for the first time in the history of measurements, all of which further reduce the risk of instability. In addition, conditions in the global economy are said currently to be favorable for liberalization of the capital controls. Finally, the Central Bank's purchase of offshore ISK assets from the largest owners will greatly reduce risk in the long run and facilitate full removal of the capital controls with the appropriate statutory amendments.

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