

20 April 2011

Screening report

Iceland

Chapter 4 – Free movement of capital

Date of screening meeting:

Bilateral meeting only: 10 December 2010

I. CHAPTER CONTENT

As regards **capital movements and payments**, member States must remove, with some exceptions, all restrictions on movement of capital both within the EU and between Member States and third countries. The relevant Treaty provisions governing the freedom of capital movements are enshrined in Articles 63 to 66 of the Treaty on the Functioning of the European Union (TFEU). The definition of the different types of movement of capital relies on Annex I of Directive 88/361/EEC. Relevant case-law of the European Court of Justice and Commission Communications 97/C220/06 and 2005/C293/02 provide additional interpretation of the above Articles.

The liberalisation of payments is also an essential requirement for the free movement of capital. Regulation 924/2009 on **cross-border payments** regulates the charges levied by an institution on electronic payment transactions in euro and other notified Member State currencies (e.g. credit transfers, direct debits, card payments, ATM withdrawals). The Directive 97/5/EC on cross-border credit transfers and the **payment services** Directive 2007/64/EC aim to facilitate payment transactions within the EU, creating a legal framework for the single "domestic" payments market. The **e-money** Directive 2009/110/EC amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC, provides the legislative framework for the taking up, pursuit and prudential supervision of the business of electronic money and creates a single market in e-money services. The relevant supervisory authorities mandated to oversee payments and deal with complaints need to be staffed accordingly. The possibility for out-of-court complaint and redress procedures for the settlement of disputes should also be established.

The key piece of legislation in the field of **anti-money laundering** is the Directive 2005/60/EC on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing (amended by Directives 2007/64/EC, 2008/20/EC and 2009/110/EC) together with its implementing measures specified in the Directive 2006/70/EC. It requires entities subject to the Directive to apply customer due diligence and to report suspicious transactions, as well as take relevant supporting measures, such as record keeping, training and establishing internal procedures. Furthermore, Regulation 1889/2005 governs cash entering or leaving the EU and Regulation 1781/2006 stipulates that transfers of funds are accompanied by meaningful information on the payer in order to ensure full traceability of funds.

In order to successfully combat financial crime, member states need to make sure that effective administrative and enforcement capacity is in place, including co-operation between supervisory, law enforcement and prosecutorial authorities.

The entire *acquis* in this chapter on free movement of capital is covered by the EEA Agreement. Articles 63 ff of the Treaty on the Functioning of the European Union (TFEU) corresponds to Articles 40 ff of the EEA Agreement. Iceland benefits from an EEA derogation restricting foreign investments in fishing vessels and fish processing.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarizes the information provided by Iceland and the discussion at the screening meeting held on 10 December 2010.

Iceland indicated that it can accept the *acquis* regarding free movement of capital and it does not expect any difficulties to implement the *acquis* by the time of accession. However, in

view of upcoming accession negotiations Iceland flagged two issues in this chapter for special attention to the Commission. These issues are fisheries-related restrictions for non-Icelandic legal and physical persons (see chapter 13 Fisheries) and possible future restrictions on rules on investment in properties in rural areas with the aim of maintaining rural population.

II.a. Capital movements and payments

Following the financial crisis in 2008, the Icelandic government put in place a number of capital controls in order to control outflows of capital. These controls were imposed through amendments to the Icelandic Act on Foreign Exchange in November 2008, and extended in April 2009, July 2009 and June 2010 respectively. The temporary provisions set to expire in August 2011 will be extended until 31 December 2015. The timeframe is chosen to allow for the liberalization of the capital controls without threatening financial stability. However, the government may lift the controls at an earlier date if conditions permit and normalization of capital markets remains a priority for Iceland.

The current restrictions on outflows of capital from Iceland apply to transactions in the context of the following operations:

- Direct investments;
- Investments in real estate;
- Operations in securities normally traded on the capital market;
- Operations in units of collective investment undertakings;
- Operations in securities and other instruments normally traded on the money market;
- Operations in current and deposit accounts with financial institutions;
- Credit related to commercial transactions or to the provision of services in which a resident is participating;
- Financial loans and credits;
- Transfer in performance of insurance contracts;
- Personal capital movements.

The above-mentioned capital controls were properly notified to EEA institutions according to the provisions enshrined in the EEA Agreement (Part III, Chapter 4, Article 45). They are reviewed and updated regularly by the Central Bank in consultation with the Ministry of Economic Affairs.

A two-stage capital controls liberalisation strategy was first published in August 2009. The first step according to that strategy was taken on 31 October 2009 when controls on new inflows were abolished.

In light of changing circumstances and a better understanding of the challenges ahead, the government approved a revised strategy for lifting the controls on 25 March 2011. The

strategy was prepared by the Central Bank of Iceland in cooperation with key ministries and the Financial Supervisory Authority and in consultation with the International Monetary Fund. Like its predecessor, it contains two main phases and retains a gradualist, non-discriminatory approach without prescribing a time-frame. It deviates from the previous strategy in that it focuses on systematic measures aimed at transferring unstable ISK assets into the hands of long-term investors at an early stage.

Phase I of the liberalisation strategy provides for measures to reduce distressed investors' offshore króna holdings and channel, through a series of currency auctions, offshore krónur into the Icelandic economy and the Treasury's long-term funding. It is estimated that this foreign-held króna amount to ISK 465 billion (approx. 2.8 billion Euros) or around 25 percent of Iceland's annual GDP. The range of investment opportunities involving offshore króna will be expanded in a controlled way while the present controls remain in effect and are fully enforced.

When sufficient progress has been made under Phase I – that is, when the stock of offshore ISK assets held by distressed investors has been reduced to a level the CBI deems manageable in terms of external reserves, and when the offshore exchange rate has approached the onshore rate – Phase II, or the liberalisation of onshore króna holdings, can begin, provided that an assessment of the balance of payment outlook indicates that reserves will be adequate and other economic preconditions have been met. Iceland's future monetary policy framework will also have to be in place. The timeframe for implementing the second phase will be decided by the government in cooperation with the Central Bank of Iceland.

Iceland is currently seeking assistance from the EU on the sequencing of the lifting of capital outflow controls.

Under the EEA Agreement, Iceland benefits from a derogation allowing restrictions of foreign investments in the fishing and fish processing sectors (see chapter 13 *Fisheries*).

Iceland has investment restrictions in the movement of capitals in other areas, such as energy, air transport or real estate, which apply only to third country nationals, and not to EEA nationals.

II.b. Payment systems

On **payment services**, Iceland has transposed the Directive 97/5/EC on cross-border credit transfers with the following legislation: Act on Foreign Exchange No 87/199217; Regulation No 56/2000 on Cross-border Credit Transfer; Regulation No 679/1994 on Foreign Exchange. Iceland stated that it has yet to implement Directive 2007/64/EC on payment services. A draft bill is expected to go to the Icelandic Parliament in early 2011. This is expected to be a purely technical alignment and no difficulties are foreseen. Iceland stated that its administrative capacity in this area is sufficient.

On **e-money**, Iceland has transposed the Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions with the following legislation: Act on Financial Undertakings No 161/200220 and Regulation No 671/2002 on investments of Electronic Money Institutions. However, Iceland has not yet transposed Directive 2009/110/EC on e-money, which has only recently been

incorporated into the EEA. A draft bill is expected to go to parliament in late 2011 and Iceland stated that it does not expect any difficulties with the transposition.

On **cross-border payments**, Iceland stated that it has enacted Regulation (EC) No 2560/2001, replaced by Regulation 924/2009, with the Act on Cross-border Payments in Euro No 146/2004. Iceland has yet to implement Regulation 924/2009 on cross-border payments, which has not yet been incorporated into the EEA Agreement. Iceland stated that it does not expect any difficulties with the transposition.

The Central Bank of Iceland (Seðlabanki Íslands) is responsible for overseeing intermediation payments and settlement systems. Iceland stated that it has sufficient administrative capacity in this field.

II.c. Fight against money laundering

Iceland has enacted Directive 2005/60/EC with Act No. 64/2006 on measures against money laundering and terrorist financing, as amended by Acts No. 77/2008 and 116/2009 as well as Regulation No. 626/2006 on the handling of reports regarding suspicion of money laundering. According to Iceland, a draft bill with the purpose of transposing the amending Directive 2009/110/EC is expected to be introduced for analysis and vote in the Icelandic parliament in late 2011. Iceland does not expect any problems with the transposition of this directive. Commission Directive 2006/70/EC has been transposed with Regulation No 811/2008 on politically exposed persons with respect to measures against money laundering and terrorist financing.

Iceland does not implement Regulation 1889/2005 since it has not yet been incorporated into the EEA agreement. Iceland stated that it does not expect any problems with transposition. Existing customs legislation stipulates that travelers and crew members arriving in or departing from Iceland shall voluntarily declare amounts of cash or bearer negotiable instruments, including travelers' cheques, which they have in their possession exceeding an amount equal to EUR 10,000. Regulation 1781/2006 on information on the payer accompanying transfer of funds is implemented by Icelandic Regulation No 386/2009.

Iceland has been a member of FATF (Financial Action Task Force) since 1991. The 40 FATF Recommendations on money laundering and the 9 FATF Special Recommendations have been taken into account by Icelandic legislation.

Iceland stated that its Financial Intelligence Unit (FIU) is sufficiently staffed, and that the FIU can get all the information it needs from reporting entities online and without a court order. Iceland also acknowledged that its financial supervisory authority, the FME, is sufficiently staffed and that it is involved in both onsite and offsite inspections. The Office of the Special Prosecutor was set up in 2008 with the mandate to investigate suspicions of criminal actions in the period preceding, in connection with or in the wake of the collapse of the Icelandic banks, whether these relate to the activities of financial undertakings, other legal entities or individuals, and, as appropriate, to follow up these investigations by bringing charges in court against those concerned. There is a good level of cooperation between the FME and the Special Prosecutor Office.

Iceland agreed that its preparedness in the field of fight against money laundering should be read in connection with its performances in applying relevant aspects covered by the *acquis* under chapter 24- *Justice, freedom and security*.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY

Overall, Iceland has already reached a high level of alignment and applies a substantial part of the *acquis* in the fields covered by this chapter, due to its EEA membership. New EU legislation, relevant to this chapter, is regularly incorporated into the EEA Agreement.

Further alignment with the *acquis* is expected to take place in line with the existing EEA deadlines for transposition. The Commission will need to monitor Iceland's alignment with the updated *acquis*. Current exchange controls and investment restrictions will need to be fully removed before accession. Overall, administrative capacity in this area can be considered to be sufficient.

III.a. Capital movements and payments

Following the financial crisis of 2008, Iceland introduced a number of capital controls. Amendments to the foreign exchange act introduced since 2008 have tightened the exchange controls. As a result, the country is currently not aligned with EU *acquis* in this area.

These capital controls are in line with recommendations made by the International Monetary Fund and Iceland has properly notified them to the EEA institutions. A strategy has been prepared for the removing of the controls and qualitative conditions have been identified. It has taken Iceland longer than originally anticipated to create the conditions required to lift the capital controls without causing significant instability. The initial strategy proved unable to channel unstable assets into long-term investments before other controls were to be lifted.

In early 2011 Iceland has officially requested advice and assistance from the EU on the careful design and sequencing of the capital controls removal.

The inflation rate and policy interest rate fell significantly in the last months of 2010, while foreign exchange reserves have increased considerably. Nevertheless, a number of issues will still need to be resolved before the capital controls can be lifted, including among others the problem of uncertainty in the banking sector related to the continuously large proportion of non-performing loans (40% for corporate loans, 15% for private). There is also a strong need to restructure the private sector debt and to build up a functioning asset market.

In the framework of the EEA Agreement, Iceland benefits from a derogation restricting foreign investments in the fishing and fish processing sectors. This particular issue will be dealt with in chapter 13- *Fisheries*.

Existing investment restrictions in the areas of energy, air transport and real estate, which apply only to third country nationals, would need to be examined alongside a formal justification from Iceland during specific chapter negotiations.

III.b. Payment systems

Alignment with previous legislation in this field is largely complete. However, Iceland is not yet fully aligned with the recently adopted EU *acquis* on payment systems. It is expected that Iceland will have no problems in implementing the new *acquis* in the area of payment systems, once this will have been adopted by the parliament. Iceland's administrative capacity in this area is sufficient.

III.c. Fight against money laundering

Iceland largely complies with the EU *acquis* in the area of anti-money laundering. It is preparing to align with the most recent amendments in the EU *acquis*, in line with its EEA obligations.

There is good cooperation between the various bodies dealing with anti-money laundering. The staffing of the Financial Intelligence Unit (FIU) is low in absolute terms (one full-time person), which could cause problems in the event of a sudden increase in workload. The FIU is, however, able to draw on additional resources from other departments as needed, so the administration can be expected to effectively exercise its functions in light of the rather limited number of suspicious transaction reports normally received. Iceland's preparedness in the field of fight against money laundering should be read in connection with its performances in applying relevant aspects covered by the *acquis* under chapter 24-*Justice, freedom and security*.