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Iceland Schedules Auction to Buy Offshore Krónur, a Credit Positive

From Credit Outlook

Analyst Contacts:

NEW YORK	+1.212.553.1653
Kristin Lindow *Senior Vice President* kristin.lindow@moodys.com	+1.212.553.3896
Joshua Grundleger *Associate Analyst* joshua.grundleger@moodys.com	+1.212.553.1791

Last Wednesday, Iceland's (Baa2 stable) central bank announced that it will hold an auction in mid-June in which it will purchase offshore (so-called trapped) Icelandic krónur with euros from its sizable foreign exchange reserves. The Icelandic parliament had approved a bill authorizing the exchange the previous day, codifying restrictions on offshore krónur, clarifying the eligible assets that could be sold, and specifying the disposition of those krónur assets that are not tendered in the sale. The credit-positive auction is the latest in a series of steps that the authorities have taken to reduce the external vulnerabilities that led to the October 2008 banking system collapse and subsequent imposition of capital controls.

Investors who choose to participate in the auction will now be able to gain access to their Icelandic krónur-denominated assets from the Icelandic banking system, which had been restricted from being withdrawn since the capital controls were imposed except through intermittent auctions conducted by the central bank. The authorities have controlled the withdrawals of funds in order to avoid causing sudden violent shifts in the exchange rate and unsettling domestic financial markets, since the amount still trapped amounts to ISK320 billion, or roughly 15% of GDP.

Recent offshore transactions in these assets and the central bank's past auctions took place at much lower exchange rates (between ISK200 and ISK220 krónur per euro) than the current rate of around ISK140 per euro in the onshore foreign exchange market, which is not a true market rate owing to the presence of foreign-exchange restrictions. Accordingly, the central bank has offered to buy the trapped assets at rates similar to the average rate at which its previous auctions were held, offering more favorable exchange rates of up to ISK190 per euro the more that asset holders sell collectively.

Those assets not tendered in the 16 June sale can still be sold up until 1 November at an exchange rate of ISK220 per euro, otherwise they will thereafter continue to be held as they are now, in segregated bank deposits that can be converted into central bank certificates of deposit initially earning interest of 0.5% per year. The deposits also now can be exchanged for central bank certificates of deposit initially earning interest of 0.5% per year. Should investors currently holding krónur-denominated Icelandic government bonds decide not to tender them early, as they would be eligible to do in the auction, the bonds will continue to pay interest, again as is the case now. When those bonds mature, however, the principal will be trapped anew until such time as capital controls are further eased.

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The June auction is the latest step in the government's capital control liberalization process, which was preceded by last year's settlement of the failed banks' estates with their creditors, mainly hedge funds that bought up the failed banks' assets at values significantly below par after the imposition of the capital controls.[1] That settlement involved the banks' creditors paying the government to gain control of their foreign assets in return for writing off the banks' domestic holdings, virtually eliminating the country's net international investment deficit in the process. The next step will be an incremental release of the capital account restrictions on Icelandic residents, including pension funds, and then ultimately a general unfreezing of cross-border transactions in Icelandic krónur.

The upcoming auction is credit positive insofar as it gives investors whose money is currently trapped in offshore krónur an exit, if they so wish, and helps relieve some of the pressure that has built up on Icelandic domestic assets as a result of the capital controls, as reflected by a steep appreciation of the onshore exchange rate over the past two years. The timing is also prudent since the authorities waited to conduct the auction until they had sufficient foreign exchange reserves to both buy the trapped assets but still retain enough to fund the country's potential external liquidity needs.

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1 See Iceland's Capital Controls and the New Liberalization Strategy, 15 July 2015.

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Authors
Kristin Lindow
Joshua Grundleger

Senior Production Associate
Vikas Baisla

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