ATTACHMENT I. LETTER OF INTENT

1. **In the wake of the recent international financial turmoil, Iceland's economy is facing a banking crisis of extraordinary proportions**. Triggered by a loss of confidence and fuelled by the financial sector's high leverage and dependence on foreign financing, the crisis led to the collapse of Iceland's three main banks, accounting for around 85 percent of the banking system. This precipitated an abrupt adjustment in key asset prices, while the onshore foreign exchange market dried up, and external payment systems have been severely disrupted. The economy is heading for a deep recession, a sharp rise in the fiscal deficit, and a dramatic surge in public sector debt—by about 80 percent of GDP—reflecting an unprecedented high fiscal cost of restructuring the banking system.

2. **While the economy is flexible, adjustment to this significant shock could be sharp and costly**. The Icelandic economy has a history of quickly adjusting to shocks, mainly through large and swift import compression and strong improvements in the current account. Still, given that confidence has been severely shaken, potentially substantial capital outflows could lead to a further large loss in the value of the króna. In the context of the high leverage in the economy, this would produce massive balance sheet effects and a substantial contraction in domestic activity. The immediate challenges facing us are, therefore, to restore a functioning and viable banking system, and to stabilize the króna. Looking further ahead, the challenge will be to reduce a very high level of public debt, by embarking on a process of sustained fiscal consolidation.

Banking sector restructuring and insolvency framework reform

3. **We have embarked on a comprehensive strategy to address the crisis in the banking sector that has been escalated by the global credit crunch**. As an emergency measure the Parliament of Iceland on October 6, 2008 passed a law that gave the Iceland Financial Supervisory Authority (FME) far-reaching powers, which it used to intervene in three of the larger banks. These banks also had a number of branches and subsidiaries, mainly in several European countries.

4. **The strategy for intervening the banks was driven by the need to secure continued domestic operations and downsize the banking sector to a level consistent with the size of the economy**. To achieve this objective each of the three banks was split into a new bank and an old bank. The new banks included the domestic operations funded by local depositors. The old banks included activities in foreign branches and subsidiaries, mainly funded through the issuance of bonds and foreign deposits. Derivatives were left in the old banks. In each of the three banks, the FME replaced the board with a resolution committee and named a team of professional auditors from three of the major international auditing firms to be in charge of a preliminary assessment about asset quality. In this regard, appropriate loan provisions were made in the new banks, bringing loan values in line with expected market values.

5. **We have decided on the organizational structure to resolve intervened banks and to transparently maximize asset recovery**. Our strategy has developed in recent days. A well-reputed expert in banking was appointed to be in charge of managing the bank restructuring process. The expert reports to the Prime Minister and has the overall responsibility of developing, implementing and communicating a comprehensive strategy for bank restructuring. A committee comprising representatives from the Prime Minister's Office, the Financial Supervisory Authority, the Central Bank of Iceland, the Ministry of Finance, and the Ministry of Commerce has been established to coordinate policy input and will be chaired by the expert (*prior action*).

6. **The next step in the restructuring process will be a second valuation of both the new and the old banks to ensure that creditor recovery is not affected by the split.** A well-reputed international auditing firm will be hired to oversee the process and to assist the FME in developing a methodology in accordance with international best practice on which the valuations will be based. The methodology will be finalized by November 15, 2008 after which separately hired international auditing firms will conduct the valuations, to be completed by end-January, 2009 *(structural benchmark).* The auditing firm overseeing the process will confirm by February 15, 2009 that the valuations have been conducted according to the prescribed methodology and make a final decision on the valuation. The valuation process will also include an assessment of whether or not managers and major shareholders have mismanaged or abused the banks.

7. **After the completion of the second valuation we will recapitalize the three new banks up to a capital adequacy ratio of at least 10 percent**. The total amount of capital to be injected has been estimated at 385 billion ISK. The injection, which will be made using tradable government bonds issued on market terms, will be completed by end-February 2009 *(performance criterion).* Consistent with standard procedures in licensing new banks and to monitor their operational soundness, the FME will review the business plans of each new bank (*January 15, 2009; structural benchmark)*. These five-year business plans will describe banking services, capitalization, staffing, profitability, and branch network. We plan to sell the government's holdings of bank equity—as and when the situation stabilizes and market conditions permit.

8. **The government is determined to ensure that asset recovery is maximized.** To that end, the plan is to put the old banks into Moratorium under the Insolvency Act and the Act on Financial Undertakings, under which the resolution committees will continue to work on maximizing the value of the assets under the supervision of a court-appointed administrator. To ensure asset recoveries are maximized, we will hire an advisor, who will assist us in developing by end-November 2008 a strategy for asset recoveries *(structural benchmark).*

9. **We are committed to progressing a sound and transparent process as regards depositors and creditors in the intervened banks.** We will be working constructively

towards comparable agreements with all international counterparts for the Iceland deposit insurance scheme in line with the EEA legal framework. Under its deposit insurance system Iceland is committed to recognize the obligations to all insured depositors. We do so under the understanding that prefinancing for these claims is available by respective foreign governments and that we as well as these governments are committed to discussions within the coming days with a view to reaching agreement on the precise terms for this prefinancing. Furthermore, we recognize that the payment by the new banks of the fair value for the assets transferred from the old banks is a key factor in the fair treatment of depositors and creditors in the intervened banks. Accordingly, we have instituted a transparent process involving two sets of independent auditors to establish the fair value of the assets. More generally, we will ensure the fair, equitable and non-discriminatory treatment of depositors and creditors in line with applicable law.

10. **Going forward, we will review the bank regulatory framework and supervisory practice to strengthen the safeguards against potential new crises**. We will invite an experienced bank supervisor to assess the regulatory framework and supervisory practices and to propose needed changes. In particular, the expert will assess the framework of rules on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and proper" status of owners and managers. Previous senior managers and major shareholders in intervened banks who are found to have mismanaged the banks should not assume similar roles for at least three years. The assessment, which will be made public, should be completed by end-March 2009 *(performance criterion).* We will discuss in advance with IMF staff any changes to the adopted strategy.

11. **We need to address the insolvency framework to manage deleveraging and recovery in the banking, corporate and household sectors**. A special bank insolvency law (distinct from the general insolvency law) is needed to resolve the uncertainty over the legal status of intervened banks and to provide a coherent framework for the supervisory and debt-resolution aspects of bank insolvencies. The corporate insolvency regime, which has been relatively effective in normal times, should be refined to facilitate out-of-court workouts between creditors and viable firms. In particular, provisions to include secured creditors in agreed restructuring plans and to facilitate new financing during a firm's rehabilitation are critical.

Fiscal policy

12. **The resolution of the banking crisis will result in a huge burden being placed on the public sector**. Preliminary estimates suggest that the *gross* cost to the budget of honoring deposit insurance obligations and of recapitalizing both commercial banks and the Central Bank of Iceland could amount to around 80 percent of GDP. The *net* cost will be somewhat lower on the assumption that money can be recovered by selling assets from the old banks. To this cost should be added the surge in the overall deficit of the general government to 13.5 percent of GDP that is expected in 2009 because of the recession that is likely to follow

in the wake of the banking crisis. Overall, gross government debt could rise from 29 percent of GDP at end-2007 to 109 percent of GDP by end-2009. Thus, the banking crisis will significantly constrain the public sector and burden the public for years to come.

13. **We plan to let the automatic fiscal stabilizers operate in full in 2009**. In order not to exacerbate the recession, our intention is to allow the fiscal deficit to widen to the extent that this is driven by higher expenditures and lower revenues due to the effects of the economic cycle. But given the high financing need and the dramatic increase in public sector debt, we plan to significantly scale back a planned discretionary fiscal relaxation in 2009, keeping it to no more than a ¼ percent of GDP. Should revenues exceed expectations, we intend to save any windfall and lower the deficit accordingly. Pressures on financial markets resulting from the sharp rise in the government's financing need are expected to be limited by increased purchases of government securities by the pension funds. The operations of the central government will be subject to a quarterly ceiling on net borrowing, and agreement on the 2009 budget will be a key condition for the completion of the first review of the Stand-By Arrangement.

14. **We plan to embark on an ambitious medium-term fiscal consolidation program.** Such a plan will start to be implemented with the 2010 budget. Our intention is to take measures that will reduce the structural primary deficit by 2–3 percent annually over the medium-term, with the aim of achieving a small structural primary surplus by 2011 and a structural primary surplus of 3½-4 percent of GDP by 2012. We will begin soon the development and consensus-building process around this plan, with the aim of identifying the broad areas of focus before the end of 2008 and having a fully calibrated plan ready by mid-2009. Progress in this regard will be a key condition for completion of each of the quarterly reviews under the Stand-By Arrangement during this period. Icelandic society has a strong track record in responsible fiscal management as evidenced by the very low level of public debt at the outset of this crisis. This policy has been supported by broad social consensus. A significant reduction in government debt through the sale of the government's stake in the new banks could help reduce the needed fiscal adjustment over the medium term.

15. **To underpin confidence in debt sustainability, we will also strengthen our fiscal framework**. For the first time this year, a four-year medium term framework was sent to parliament at the same time as the budget. Moreover, we will undertake a debt sustainability analysis and develop a debt strategy. Nonetheless, we realize that more needs to be done to improve the current framework. Therefore, we will conduct a thorough analysis of our fiscal framework and make recommendations, including on how local government finances can be better aligned with the governments' overall fiscal plans. The findings of this analysis will be discussed during the first program review, and progress in improving the fiscal and expenditure frameworks will be a condition for completion of each of the quarterly reviews under the program.

16. **The public sector will not take on additional obligations with regard to the banking crisis.** Unfortunately, the pension funds, domestic money market funds, and various foreign creditors, among others, are set to incur significant losses as a result of the collapse of the private commercial banks. Given the already high debt level, it will be critical not to burden the public sector balance sheet by further socializing such losses.

Monetary and exchange rate policy

17. **The immediate challenge facing the Central Bank of Iceland at this time is to stabilize the króna and set the stage for a gradual appreciation.** During the run-up to the banking crisis, the króna depreciated precipitously, culminating, when the banks collapsed, in the shut-down of the on-shore foreign exchange market and a further sharp depreciation in the off-shore market. The depreciation and the attendant surge in inflation have severely strained household and corporate balance sheets because of the high share of foreign-currency denominated and inflation-indexed debt. To prevent a wave of defaults from exacerbating what already is set to be a severe recession, we believe that it is a matter of urgency for the Central Bank of Iceland to stabilize the króna.

18. **We are particularly concerned about the near-term risk of pressure on the króna when the normal functioning of the foreign exchange market is restored.** While we believe the króna to be significantly undervalued, the collapse of the three banks has shaken confidence in the currency and the risk of substantial capital outflows in the short term is considerable. Concerns in this regard are heightened by uncertainty about the liquidity of the newly restructured banking system. This suggests that we need extraordinary measures to deal with short-term risks. The next paragraph describes these measures; the subsequent paragraph is devoted to monetary policy once a return of confidence will allow us again to use traditional monetary policy instruments.

19. **In the very short-run, we intend to adopt the following pragmatic mix of conventional and unconventional measures to stem capital outflow**:

- **To raise the policy interest rate to 18 percent.** We stand ready to increase it further, but we are aware that higher interest rates alone may not suffice to stem capital outflow in the current exceptional circumstances.

- **To maintain tight control over banks’ access to Central Bank credits.** We are tightening liquidity management, in particular by adjusting the structure of our liquidity facilities, so that the Central Bank can manage more proactively the volume of reserve money; and we have raised the spread of the standing facility rate to avoid excessive liquidity being drawn down through this route. We have narrowed the range of instruments accepted by the Central Bank as collateral — newly-issued uncovered bank bonds will no longer be acceptable. If necessary, we are ready to adjust the operational framework for reserve money management further, such as by changing parameters for reserve averaging and collateral requirements. Initially, we will allow little if any increase in the volume of central bank credit.

- **To stand ready to use foreign reserves to prevent excessive króna volatility.** While we do not have an exchange rate target and are prepared to let the rate move to equilibrate supply and demand, we are conscious that excessive short-run volatility would be undesirable and so are ready to draw on our reserves, to support the market if needed. Our ability to do so has been helped by the augmentation of our reserves, as discussed below.

- **To temporarily maintain restrictions on capital account transactions.** We realize that such restrictions have considerable adverse implications and intend to remove them as soon as possible. But their interim use is necessary until we have ensured that our monetary policy instruments are correctly calibrated to deal with the extreme uncertainty and lack of confidence that followed the banking sector collapse.

20. **We expect confidence to return soon, paving the way for a reduction in interest rates.** This process of normalization can start as soon as the króna stabilizes in the foreign exchange market, all demand for foreign exchange in respect of current account transactions is having unrestricted access to the foreign exchange market, and we no longer need to support the market by drawing on our reserves. With the current account rapidly swinging into a surplus, the króna significantly undervalued, the bank resolution scheme not giving rise to net outflow of foreign exchange in the coming year, and—above all—the policy undertakings and the support from the international community described in this letter, we expect to reach this point soon. This will allow us to begin to ease control over Central Bank's credit volume and increasingly rely on the policy interest rate as the primary monetary policy instrument, in the context of a flexible exchange rate policy. In this regard, we expect to see an early strengthening of the króna and a fast reduction in inflation year-on-year of 4½ percent at end-2009, with additional strengthening of the króna and further disinflation in 2010.

21. **The calibration of monetary policy is hampered by unusual uncertainty about monetary conditions.** Considering the uncertainties about the restructuring of the banking system, overall liquidity conditions, and the stability of monetary parameters, we intend to review comprehensive end-October monetary data with Fund staff as soon as data become available, and will present a modification of the monetary program to the Executive Board if required. Our program contains a quarterly ceiling for net domestic assets and a quarterly floor for net international reserves of the Central Bank of Iceland.

22. **The exchange controls, temporarily imposed on October 10 in response to the sharp deterioration in the króna and pressures on reserves, will be removed during the program period**. These controls include exchange restrictions on certain current international transactions, which have contributed to private external payment arrears.

Implementation of the key program objective of strengthening the current account position to allow bolstering reserves and reestablishing free international payments through the banking system would support removal of the exchange restrictions and clearance of these private external payment arrears. In the meantime, we request temporary Fund approval of the exchange restrictions in line with Fund policy, on the basis that they have been imposed for balance of payments reasons and are non-discriminatory. Furthermore, we commit not to impose or intensify restrictions on the making of payments and transfers for current international transactions nor to introduce multiple currency practices (*continuous performance criteria*).

Incomes policy

23. **It will be important to have a national consensus consistent with the objectives of the macroeconomic program**. Historically, income policy in Iceland has been very effective, with past agreements supporting the economic adjustment when difficult circumstances demanded it. Social partners recognize the need to enter an agreement that is commensurate with the severity of the situation.

External financing

24. **The collapse of the banking system has left us with considerable external financing needs**. We estimate this need to be about $25 billion during the period from now and until the end of 2010. Of this, about $19 billion are composed by arrears on obligations of the three intervened private banks as well as financing earmarked for payments in relation to foreign deposits, leaving a cash financing need of $5 billion. We expect purchases from the IMF to amount to about $2 billion, leaving a residual need of $3 billion. We expect to cover this through assistance from bilateral creditors, and to obtain concrete commitments in this regard before IMF Board consideration of our program. Progress in covering our financing need will be assessed during the quarterly program reviews.

Fund arrangement

25. **Given our extraordinary financing needs, we request a Stand-By Arrangement for the period of November 2008 to November 2010** in the amount of SDR 1.4 billion, equivalent to 1190 percent of our quota**.** The program will be supported on the basis of policies and specific targets described in this letter. We believe that the policies set forth in this Letter are adequate to achieve the objectives of its program, in particular underpinning renewed confidence in the Iceland economy. However, we will take any further measures that may become appropriate for this purpose. Iceland will consult with the IMF on the adoption of these measures, and in advance of revisions to the policies contained in this Letter, in accordance with the IMF's policies on such consultation. We will maintain a close and proactive dialogue with the Fund, in accordance with Fund policies on such matters.

26. **We recognize the importance of completing a first-time safeguards assessment of the CBI by the first review of the SBA**. In this regard, the Central Bank will receive a safeguards mission from the Fund and provide the information required to complete the assessment by the first review.

27. We authorize the IMF to publish the Letter of Intent and its attachments, and the related staff report.

Sincerely yours,

Davíd Oddsson	Árni M. Mathiesen
Chairman of the Central Bank	Minister of Finance