

Prudential regulation on liquidity ratio and foreign exchange balance

Prudential regulation in financial markets aims to contribute to secure and reliable practices in financial services. This is a fairly broad concept, including regulations on requirements for management practices in financial companies, liquidity, consumer protection and effective internal and external supervision of their activities. Prudential regulation also aims to contribute to financial and economic stability. By law, the Central Bank of Iceland sets rules for the liquidity ratio of credit institutions and for their foreign balance.¹ Other prudential regulations in financial markets are either sanctioned by law, or set by a government minister or the Financial Supervisory Authority (FME).² Financial companies have also set their own internal prudential rules, such as for risk management. The main content of the Central Bank's rules on liquidity ratio and foreign balance is as follows:

Liquidity ratio

A credit institution's liquidity ratio may be defined as the ratio between its liquid claims and liquid liabilities. Central Bank Rules No. 317 of April 25, 2006 (cf. Article 12 of the Central Bank Act No. 36/2001) stipulate the liquidity ratio of credit institutions. The Rules aim to ensure that credit institutions always have sufficient liquidity to meet foreseeable and conceivable payment liabilities over a specified period. They are obliged to submit a monthly report to the Central Bank containing data on which calculation of the liquidity ratio is based. Claims and liabilities included in these calculations are classified according to their nature, maturity and risk, and assigned a weighting. The liquidity ratio is calculated for four periods, namely within one month, from one and up to three months, from three and up to six months, and from six and up to twelve months. The ratios of claims to liabilities which fall due or can be liquidated within one month and three months shall not be lower than 1. If an institution fails to fulfil these requirements, the Rules provide for periodic penalty payments (per diem penalties) which are levied on the shortfall. Credit institutions must also report their liquidity ratios for other periods, although no specific levels are required to be maintained.

Foreign balance

A credit institution's foreign balance may be defined as the difference between its foreign currency-denominated assets and liabilities, on and off the balance sheet. Foreign balance is therefore a measurement of an institution's foreign exchange risk. Rules No. 318 of April 25, 2006 (cf. Article 13 of the Central Bank Act No. 36/2001), stipulate the foreign balances of credit institutions and financial intermediaries.

1. These Rules are published on the Central Bank of Iceland website (<http://www.sedlabanki.is>)

2. See the websites of the Ministry of Commerce (<http://eng.idnadarraduneyti.is/laws-and-regulations/nr/1254>) and FME (<http://www.fme.is/?PageID=612>)

The regulation aims to limit foreign exchange risk by preventing the foreign balance from exceeding certain limits. Two types of limit are stipulated. One is exposure in individual currencies, and the other applies to the total foreign exchange position in all currencies, which is the sum of positions in individual currencies. Exposures in individual currencies may neither be long nor short by more than 20% of equity according to the most recently published financial statements, nor the total foreign exchange position by more than 30%. Credit institutions are obliged to submit regular monthly reports on their foreign balances to the Central Bank. Credit institutions with a balance exceeding the limits shall take immediate measures to adjust it, and it shall be brought inside the permissible limits within three business days. If an institution fails to correct its balance within this time limit, the rules provide for periodic penalty payments. The Central Bank may allow credit institutions to maintain a separate positive foreign balance outside their total foreign balance as a hedge against the effect of exchange rate movements on their capital adequacy ratios. The development of credit institutions' foreign exchange balances is discussed in Box 4 on p. 54, in the section on Financial companies.