Prudential regulation on liquidity ratio and foreign exchange balance

The general objective of prudential regulation of financial markets is to establish secure and reliable practices in financial services. This is a fairly broad concept, including regulations on requirements for management practices in financial institutions, their liquidity, consumer protection and effective internal and external supervision of their activities. In a broad sense prudential regulation also aims to contribute to financial and economic stability. By law, the Central Bank of Iceland adopts rules for the liquidity ratio of credit institutions and for their foreign exchange balance. Other prudential regulations of financial markets are either sanctioned by law, or adopted by a government minister or the Financial Supervisory Authority[1]. The main content of the rules on liquidity ratio and foreign exchange 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. Regulation No. 905 of December 27, 1999 (cf. Art. 12 of the Central Bank Act No. 36/2001) stipulates the liquidity ratio of credit institutions. The regulation aims 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 time to maturity or liquidity. The proportion of each category included in the calculation is also specified. For example, the total amount of an institution's cash is considered a liquid claim, but only 5% of overdrafts. The ratio is calculated for four periods, namely liquidity 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 ratio of claims to liabilities which fall due or can be liquidated within the three-month period must not be lower than 1. If an institution fails to fulfil the requirements for three-month liquidity, the rules provide for penalties in the form of interest on default which is 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 exchange balance

A credit institution's foreign exchange balance may be defined as the difference between its foreign-denominated assets and liabilities, on and off the balance sheet. Foreign exchange balance is, therefore, a measurement of an institution's foreign exchange risk. Regulation No. 421 of July 1, 1997 (cf. Art. 12 of the Central Bank Act No. 36/2001) stipulates the foreign balances of credit institutions and financial intermediaries. The regulation aims to limit foreign exchange risk by preventing the foreign exchange balance from exceeding certain limits. Two limits are stipulated in this respect. One is exposure in individual currencies, which may neither be positive (long) nor negative (short) by more than the equivalent of 15% of equity at the beginning of the year. An exception is made for the US dollar, however, where the limit is 20%. The other limit applies to the total foreign exchange position in all currencies, calculated in the domestic currency, which is the sum of positions in individual currencies and may neither be long nor short by more than 30% of equity at the beginning of the year. Credit institutions are obliged to submit regular reports on their foreign balances to the Central Bank. Credit institutions with a balance exceeding the above limits shall take immediate measures to adjust it, and are allowed three days to bring it back within permissible limits.

1. See the websites of the Ministry of Commerce (http://www.stjr.is/interpro/ivr/ivr.nsf/pages/log) and Financial Supervisory Authority (http://www.fme.is/fme.nsf/pages/index.html).