Prudential regulation on liquidity ratio and foreign exchange balance

Prudential regulation in financial markets generally 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, 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 sets rules for the liquidity ratio of credit institutions and for their foreign balance. Other prudential regulations in financial markets are either sanctioned by law, or set by a government minister or the Financial Supervisory Authority.[1] The main content of the 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. Rule no. 386 of May 29, 2002 (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 their nature, maturity and risk. The proportion of each category included in the calculation is also specified. For example, all 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 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 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-denominated assets and liabilities, on and off the balance sheet. Foreign balance is therefore a measurement of an institution's foreign exchange risk. Rule no. 387 of May 29, 2002 (cf. Art. 13 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 balance from exceeding certain limits. Two types of limit 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 according to the most recently published financial statements. An exception is made for the US dollar and euro, however, where the limit is 20%. The other limits apply to the total foreign exchange position in all currencies, calculated in domestic currency, which is the sum of positions in individual currencies and may neither be long nor short by more than 30% of equity according to the most recently published financial statements. Credit institutions are obliged to submit regular monthly 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 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 per diem penalties.

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).