

Iceland: Financial System Stability Assessment

This Financial System Stability Assessment on Iceland was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on April 10, 2001. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Iceland or the Executive Board of the IMF.

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Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by V. Sundararajan and Michael Deppler

April 10, 2001

- The Financial System Stability Assessment (FSSA) is based on the work of an IMF mission that visited Reykjavik as part of the Financial Sector Assessment Program (FSAP) from November 8 to 22, 2000. The mission met with the Chairman of the Board of Governors of the Central Bank of Iceland (CBI), governors, and other senior officials of the CBI, the Director General of the Financial Supervisory Authority of Iceland (Fjármálaeftirlitið) (FME) and other officials of the FME, as well as officials from the Ministry of Industry and Commerce (MIC) and Ministry of Finance (MOF). The mission also exchanged views with representatives of commercial banks, the Iceland Stock Exchange (ISE), the Chamber of Commerce, securities brokers, insurance companies, pension funds, and other market participants. The findings of the FSAP mission were discussed with the authorities on January 11, 2001, in the context of the 2001 Article IV consultation.
- The mission was led by William E. Alexander (IMF, Team Leader) and comprised Luca Errico (Deputy Team Leader), Kai Barvell, Ritu Basu, and Lourdes Horton (administrative assistant) (all MAE), Frank Engels (EU1), Paul-Willem van Gerwen (expert, Securities Board of the Netherlands), Amalendu Ghosh (expert, Reserve Bank of India), Tuomo Malin (expert, Finnish Financial Supervisory Authority), Lone Mørup (expert, Danish Finastilsynet), and Morten Jonassen (expert, Norges Bank). Jon Sigurgeirsson, Advisor to the Executive Director for Iceland, participated in the final discussions.
- The mission's overall assessment is that, particularly as a result of the rapid evolution of the financial market in recent years—in effect, outpacing to some extent the evolution of the regulatory framework—and partly as a result of the emergence of imbalances in the macroeconomic environment, notably an enduring, large current account deficit and low national savings rate, significant vulnerabilities exist. At the same time, it is important to recognize that the financial sector is dynamic, appropriately responding to regulatory reform and market signals, and that there is competence in prudential oversight. With this background, the authorities appear to be in a relatively strong position—and to possess the willingness and resolve—to address the existing vulnerabilities.
- This report is divided in two parts. The first part presents the mission's main findings and overall assessment, while the second part presents summary assessments of observance of standards and codes regarding banking supervision, insurance regulation, securities markets, payment and settlement systems, and transparency in monetary and financial policies. The FSAP report, containing detailed institutional information and analysis, as well as detailed assessments of observance of international standards and codes, will be transmitted to the authorities upon approval by Fund management.
- The main authors of this report are: William E. Alexander and Luca Errico (both MAE).

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GLOSSARY

CAR	Risk-weighted Capital Adequacy Ratio
CB Act	Central Bank Act
CBI	Central Bank of Iceland
DVP	Delivery-versus-Payment
EAA	European Economic Area
EU	European Union
FGM	Net Settlement Systems
FME	Fjármálaeftirlitið, Financial Supervisory Authority of Iceland
FSAP	Financial Sector Assessment Program
FSD	Financial Stability Department of the Central Bank of Iceland
FSSA	Financial System Stability Assessment
HBD	Housing Bond Division of the State Housing Fund
IAIS	International Association of Insurance Supervisors
IOSCO	International Organization of Securities Commissions
ISD	Icelandic Securities Depository Ltd.
ISE	Iceland Stock Exchange
MIC	Ministry of Industry and Commerce
MOF	Ministry of Finance
NDMA	National Debt Management Agency
NOREX	Cooperation Agreement among Nordic Stock Exchanges
NPL	Non-performing Loans
OSFO Act	Legislative Framework of the Financial Supervisory Authority of Iceland
OTC	Over-the-Counter
RB	Icelandic Banking Data Center
ROA	Return on Assets
ROE	Return on Equity
RTGS	Real-Time Gross Settlement System
SHF	State Housing Fund

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. OVERVIEW OF CURRENT VULNERABILITIES AND ISSUES

1. Over the course of the last decade, Iceland has implemented a broad-based program of financial liberalization and market reforms, encompassing changes in the structure of the financial system, prudential and supervisory frameworks, and monetary management. New financial legislation based on European Union (EU) directives was enacted in 1993 in connection with Iceland's participation in the European Economic Area (EEA). The capital account was fully liberalized in 1995 in the context of an adjustable peg exchange rate regime.¹ All restrictions on short-term capital movements were abolished. As a result, a competitive, dynamic, and sophisticated financial system quickly emerged, comprised of a wide array of financial institutions and products, as well as short- and long-term money and capital markets.

2. The legislative framework in which this development and growth have occurred is generally modern and in broad conformity with the major supervisory standards, although some shortcomings exist and there is room for improvement in a number of areas. Overall, the regime is compliant or largely compliant with 20 of the 25 core principles in banking supervision, observes or largely observes 13 of the 17 IAIS core principles of insurance supervision, while all of the 30 IOSCO core principles of securities supervision are implemented or partially implemented.

3. Iceland's conduct of monetary and financial policies is highly transparent, which contributes in an important way to the stability and efficiency of the financial system, including the financial markets that are the primary source of systemic liquidity. These financial markets—including the short-term money market and the markets for treasury bills, government bonds, and foreign exchange—are small and highly concentrated by international standards. Their ability to supply liquidity, particularly at a time of stress, appears to be somewhat fragile. Important and welcome changes have been made to the system in recent months; however, their effectiveness has yet to be tested under suitably stressful conditions.

4. The current Central Bank Act has no special provision for a lender-of-last-resort function. However, the Central Bank of Iceland (CBI) has a general legal basis for providing loans against collateral. Financial market participants expect that the authorities would provide financial support to banks should the need arise. The private deposit insurance fund in Iceland is fairly small and could be quickly exhausted in a crisis situation. The fund can, however, borrow should the need arise. While the authorities have at their disposal what appear to be adequate measures to bring about corrective actions when financial institutions face difficulties, the applicability of these measures has yet to be tested in practice.

¹ On March 27, 2001, the authorities implemented an inflation targeting framework for monetary policy, including a floating exchange rate.

5. The payment system has been a source of potential financial sector vulnerabilities. At the time of the assessment, only three of the 11 Core Principles for Systemically Important Payment Systems were observed or largely observed, leaving the CBI to guarantee settlement. Subsequent to the FSAP mission, however, the CBI approved a number of changes to the system that had been under discussion at the time of the assessment, including the implementation of a new Real-Time Gross Settlement System (RTGS) which began operation in late December 2000 and is expected to reach full coverage of all payments by end-May 2001. The RTGS currently works in parallel with the existing net settlement system (FGM). As a result, currently, out of the 11 Core Principles, five principles and four principles are observed or largely observed for the RTGS and the FGM, respectively. When fully implemented as envisaged, these changes will bring the system broadly into line with international best practice.

6. As to deviations from the various supervisory core principles and their implications for the overall adequacy of the supervisory framework, shortcomings were identified in the following areas: inadequate legal authority and independence of the supervisor; lacunae in the coverage of the regulatory framework which left responsibility for supervision of the payment system unclear and some institutions (equity funds) essentially unsupervised; deviations from international best practice in parts of the regulatory framework (particularly with respect to connected lending, asset classification, loan loss provisioning, and valuation of collateral); weaknesses in the implementation of supervisory measures, such as on-site inspections and the absence of written procedures for the evaluation of fit and proper criteria for managers and shareholders. The implementation problems are in no small part related to the overall size of the supervisory authority, Fjármálaeftirlitid (FME), which is understaffed.

7. Both macroprudential and microprudential indicators suggest that the system may be vulnerable to a macroeconomic shock. The current account deficit, which has been running around 7 percent of GDP since 1998,² exceeded 10 percent of GDP at the end of 2000 and is being projected by IMF staff at 10.6 percent of GDP for the year 2001. The annualized growth rate of lending by banks remains above 20 percent (for the third successive year), a significant portion of which has been funded by the banking system through foreign borrowing. The exchange rate regime in place until March 27, 2001—an adjustable peg against a basket of currencies—has likely been perceived as an implicit guarantee against exchange rate risks and, thus, has probably set the stage for moral hazard among domestic agents, which contributed to the rapid expansion of foreign exchange-denominated borrowing. Property and asset prices more generally have risen rapidly. There has been increased interest rate and exchange rate volatility, and the exchange rate has come under pressure on several occasions since early summer 2000; the CBI in its publications has characterized one these occasions as a speculative attack.

² IMF staff estimate that the underlying current account deficit based on the present level of the real effective exchange rate and a zero output gap is around 7 percent of GDP.

8. As to the microprudential indicators, the risk-weighted capital adequacy ratio (CAR) of the banking system declined to 9.6 percent in the year 2000 (down from 10.1 percent at the end of 1999), and the ratio excluding subordinated loans declined to 6.5 percent (from 7.4 percent). Moreover, owing to the high level of economic interconnectedness in the Icelandic financial system and deficiencies in asset classification and provisioning arrangements (below), measured indicators give an unduly optimistic assessment of the underlying health of the banking sector. The FME and CBI have repeatedly warned that the CAR is low under current circumstances and when compared to other Nordic countries, and they have urged the banks to take remedial measures. The FME has clearly indicated its view that the biggest banks with effective risk management and internal control should have a minimum required CAR of at least 10 percent, but lacks clear legal authority to mandate increased capital requirements. In addition, the banking system is highly concentrated, and has large exposures primarily to fisheries and fish processing enterprises. The aggregate profitability of banks is on a downward trend and, indeed, declined sharply in the year 2000 due mostly to unfavorable developments in domestic securities markets. The assessment confirmed that while bank borrowing in foreign currency is essentially matched by lending in foreign currency, a significant share of foreign currency loans has been extended to the service and household sectors, which do not have fully matching sources of foreign exchange income. The assessment also underscored that there was significant credit risk in the insurance sector and, to a lesser extent, in pension funds, both of which have made consumer and mortgage loans to customers and members.

9. The assessment identified a number of institutional features of the Icelandic financial system, which, in interaction with the macroeconomic environment, may give rise to systemic instability. These include the high level of economic interconnectedness, possible increased competition due to foreign entry, the ongoing process of corporate mergers and restructuring, and deficiencies in the prudential, regulatory, and supervisory frameworks.

10. Various stress tests and scenarios tests for the financial system were undertaken as part of the assessment, and concluded that the Icelandic financial system was vulnerable to market risk and credit risk. In present circumstances, the most likely shock that financial markets might face would involve a sharp depreciation of the exchange rate. A sharp movement of the exchange rate would have an impact on the level of interest rates, unhedged foreign currency borrowers, and asset prices. Over time, and particularly if the rate of economic growth was adversely affected by the exchange rate shock, there could be a serious deterioration in the asset quality of banks and a rise in nonperforming loans. Thus, the effects of an exchange rate shock would be likely to manifest themselves over time in credit risk and interest rate risk (as interest rates rose), rather than in the form of a change in the net value of foreign exchange assets and liabilities. These risks would have an impact on insurance companies and pension funds in addition to banks.

11. If an exchange rate shock were to occur, nonperforming loans might well reach levels observed earlier in the previous decade. In that event, capital adequacy of the banking system would fall below mandated levels, and the effects would be compounded by market risk to the extent that interest rates rose in response to the shock. These results therefore confirmed the public position taken by both the CBI and the FME that there was a pressing need for

banks to increase their capital positions. In addition, the assessment concluded that the regulations governing asset classification, loan loss provisioning, and collateral valuation did not fully meet international best practice as reflected in the Basel Core Principles for Effective Banking Supervision. As a result, the true capital position of banks was likely below reported values, which increased vulnerability to a shock. Thus, it would be advisable for the authorities to take action to strengthen the regulatory framework, as well as to increase banks' capital position. In light of the identified risks, there was a need to intensify on-site and off-site supervision of financial institutions, particularly of the largest banks, as well as insurance companies and pension funds.

12. The team's overall assessment was that, particularly as a result of the rapid evolution of the financial market in recent years—in effect, outpacing to some extent the evolution of the regulatory framework—and partly as a result of the emergence of imbalances in the macroeconomic environment, notably an enduring, large current account deficit and low national savings rate, significant vulnerabilities existed. At the same time, it was important to recognize that the financial sector was dynamic, appropriately responding to regulatory reform and market signals, and that there was competence in prudential oversight. With this background, the authorities appeared to be in a relatively strong position—and to possess the willingness and resolve—to address the existing vulnerabilities.

13. The authorities were in agreement with most of the recommendations and have expressed their intention to use the results of the assessment to further strengthen their operations and enhance improvements to the regulatory framework. As a matter of practice, the FME did not share the view that current arrangements may hinder its independence and, while acknowledging that CARs were too low and that current practices for asset classification and loan-loss provisioning needed strengthening, they preferred to wait for the revision of the Basel Accord to be finalized and for decisions by an EU task force presently reviewing loan-loss provisioning rules to be reached before making any change.

14. After the assessment was concluded, the authorities took several actions, which had been under preparation for some time, including: (i) they approved suggested changes to the payment system; (ii) they transformed the former Financial Stability Committee (a consultative body to the CBI's Board of Governors) into a formal Financial Stability Department (FSD) within the CBI effective January 1, 2001. This new department will, inter alia, prepare with the FME a joint contingency plan of the two authorities, including the development of more comprehensive early warning indicators; and (iii) the FME hired three professional experts and improved data collection. A committee appointed by the Prime Minister has recently finalized a proposed draft Central Bank Act, which, inter alia, defined price stability as the main objective of monetary policy and included a provision allowing the adoption of an inflation target. The proposed draft Central Bank Act is likely to become law in the spring.

15. On March 27, 2001, the Prime Minister and the Governors of the CBI signed a declaration adopting inflation targeting effective immediately to avoid undue uncertainty before the revised Central Bank Act came into force. This declaration stated, among other things, that the CBI was granted by the government full authority to use its instruments in

16. order to attain its main policy target of price stability. Moreover, the adjustable exchange rate peg was abandoned and the króna, consequently, floated. The change in the exchange and monetary policy framework does not affect the report's analysis or its conclusions. Strictly speaking, the new draft Central Bank Act also would have no effect, as it has not yet become law; however, the proposed changes will give operational independence to the CBI and will bring Iceland close to full observance of the Code of Good Practices on Transparency in Monetary and Financial Policies.

II. SECTOR SPECIFIC VULNERABILITIES

A. Overview of the Financial System

17. The financial system has developed rapidly. It comprises some 120 institutions: 29 deposit money banks (commercial banks and savings banks); 4 investment banks; 9 other financial institutions, including mortgage and development credit institutions and finance companies; 14 insurance companies, and some 60 pension funds and foundations (see Table 1). All financial institutions operating in Iceland are under the purview of the FME, a single, unified supervisory agency which was established on January 1, 1999, by merging the Bank Inspectorate (previously a part of the CBI) and the Insurance Supervisory Authority.

18. The banking sector is highly concentrated with one commercial bank accounting for about 30 percent of total banking assets and three commercial banks accounting for some 75 percent of total banking assets. The State Housing Fund (SHF) is the largest institution in the Icelandic financial system, accounting for almost 15 percent of total financial system assets. Financial markets, especially in an international comparison, are small and have mostly developed during the last five years. Total financial assets for all financial institutions amount to ISK 1,904 billion (US\$23 billion), or about 300 percent of GDP. The government still has a large ownership interest in financial institutions.

19. The Icelandic Stock Exchange (ISE) was established in 1985, with new legislation having been implemented in 1998. Electronic securities registration began in 2000. The ISE is part of NOREX, which is a cooperation agreement among Nordic stock exchanges. The largest brokers operate an over-the-counter market for nonlisted shares. Several types of securities are issued in Iceland, see Table 2 below.

20. The largest securities markets, measured by outstanding volumes, are the stock market, the housing bond market, and the treasury bond market. Other markets, like short-term securities markets, are quite small. The strongest growth since 1995 took place in the stock market and in housing fund bonds. There also has been some growth in bank bills and bonds, while the volume of outstanding treasury bills has been reduced quite significantly. There is a two-tier system with indexed and nonindexed bonds. Only the newest issues of

Table 1. Iceland: Overview of the Financial System, 1999/2000

Institution	Number of			Assets			
	Institutions	Branches	Employees	Financial (Kr. Millions)	Total	% of tot. (percent)	As of (date)
Central bank	1	1	109	109,815	109,815	5.71	June 2000
Deposit Money Banks (DMBs)							
Commercial banks	4	130	2224	644,569	655,821	34.11	June 2000
Savings banks	25	54	597	107,211	109,567	5.70	June 2000
<i>Total DMBs assets</i>				751,780	765,388	39.81	
Other							
Investment banks	4	4	224	67,957	69,039	3.59	June 2000
<i>Total bank assets</i>				819,737	834,427	43.40	
Other financial institutions							
Mortgage credit institutions	1	1	59	278,903	279,188	14.52	1999
Development credit institutio	1	2	21	8,564	8,701	0.45	1999
Finance companies (1)	6	6	73	58,584	58,857	3.06	1999
Others (2)	1	1	21	46,839	46,893	2.44	June 2000
Insurance institutions							
Insurance companies	14	14	526	61,604	63,873	3.32	1999
Pension funds and foundations (3)	64	64	140	520,520	520,717	27.09	1999
All financial institutions	120	276	3994	1,904,566	1,922,471	100.00	

Source: Financial Supervisory Authority.

(1) Finance companies includes 3 Investment funds (Lanasjodur landbunadarins; Ferdamalasjodur; and Hafnabotasjodur) and 3 Leasing companies (Glitnir hf.; Lysing hf.; and SP Fjarmognun hf.).

(2) Others consist of the Icelandic Government Student Loanfund (Lanasjodur isl. Namsmanna).

(3) At the beginning of the year 2001, there were 54 pension funds in Iceland.

21. government bonds are conventional, nonindexed bonds, while all other bonds are real interest rate bonds indexed to the consumer price index. Treasury notes are nonindexed.

22. Turnover in the Icelandic financial markets has grown rapidly over the last years, albeit from a low base. Previously, most of the market was limited to transactions between the central bank on the one hand, and credit institutions on the other. For example, in 1995 the central bank was involved in close to 90 percent of the turnover in the foreign exchange market. In 1999, this number was down to 4 percent. In the same period, turnover grew by an average of 70 percent per year, but is still only about US\$5.6 billion per year.

Table 2. Iceland: Types of Securities
(in ISK million)

Securities	1995	1999	Percent change	Percent of total (1999)	Percent of total (1999), including stocks
Treasury bills	15,459	9,899	-36	3	1
Bank bills	4,028	11,860	194	3	2
Treasury bonds	77,959	84,286	8	22	11
Treasury notes	6,577	13,369	103	3	2
Bank bonds	20,067	51,077	155	13	7
Housing bonds	77,637	146,732	89	38	19
State housing fund bonds	7,603	33,950	347	9	4
Bonds issued by other investment credit funds	17,497	24,800	42	6	3
Bonds issued by leasing companies	4,866	9,237	90	2	1
Total of above	231,693	385,210	66	100	
Shares (market capitalization)	65,327	369,835	466		49
Total	297,020	755,045	154		100
Total as percentage of GDP	65.8	120.9			

Source: FME and CBI.

B. The Banking Sector

An analysis of aggregate microprudential indicators for deposit money banks suggests that Icelandic banks' defenses to cushion possible negative shocks appear to have become less robust in the past few years.³ The broad thrust of these indicators is a picture of some potential vulnerability to an economic shock, including in some of the larger financial institutions.

23. Declines in Icelandic banks' CARs (both including and excluding subordinated loans), reflect the continued rapid expansion of banks' balance sheets without a corresponding increase in capital, as well as losses sustained on portfolio investments as a

³ Deposit money banks comprise the 4 commercial banks and the 25 savings banks, representing about 92 percent of total bank assets.

result of the emerging pressures in the domestic and foreign markets. While reported nonperforming loans (NPL) as a percentage of total loans have slightly improved on the one hand, loan loss provisions have stagnated on the other. The aggregate profitability of Icelandic banks may now be on a downward trend, although individual banks show different performances on this score. Indicators of earnings and profitability, such as return-on-equity (ROE) and return-on-assets (ROA), are weakening.

24. Banks' profitability in 2000 has been adversely affected by turbulence in domestic financial markets owing to the large portfolios of bonds and securities that banks hold, which make banks vulnerable to interest rate risk (see below). In the year 2000, only one bank marked-to-market its entire portfolio holdings to reflect market value changes. The resulting adjustment totaled almost 20 percent of net operating income and significantly lowered that bank's ROE. Managements of certain banks indicated that if they were to mark-to-market their asset portfolio, there would be a notable adverse effect on their banks' reported profitability and capital adequacy. Additionally, all Icelandic banks continue to rely heavily on non-interest income, which accounts for about 40 percent of banks' gross income. These nonrecurring sources of income (e.g., fees for a wide variety of services and capital gains) are subject to fluctuation. This may reduce the incentives for banks to improve operational efficiency in traditional banking business and, in turn, profitability, in a sustained fashion.

25. The declining trend in Icelandic banks' profitability is cause for concern also because it may put Icelandic banks at risk of increased competition from foreign banks with lower operating cost structures, particularly those of Nordic countries which may seek to enter the Icelandic market.⁴ This may lead to an increase in risk-taking as Icelandic banks seek to maintain or enhance return on equity (although risk-adjusted rates of return would likely fall).

26. Further, the banking sector is highly concentrated and has large sectoral exposures primarily to fisheries and fish processing enterprises. The degree of economic "connectedness" or dependence, as gauged by an analysis of large exposures, appears to be very high in Iceland. This situation, coupled with the fact that banks have several large borrowers in common, increases the probability that financial distress in one or more of these large borrowers may affect the economic outlook of more than one bank at the same time, thus increasing the potential for negative spillovers.

27. Additionally, there are reasons to believe that banks' soundness and profitability may be even more fragile than the microprudential indicators suggest, owing to some deficiencies in the current system of asset classification and loan loss provisioning, which provides banks with leeway to implement their own asset classification and loan loss provisioning arrangements within the general framework of Icelandic accounting rules. Banks are required to undertake a classification of the loan portfolio twice a year. In practice, loans with

⁴ All Icelandic banks, as well as virtually all nonbank financial institutions, are domestically owned.

principal and/or interest past due need not be classified as “nonperforming” until six months following nonpayment of interest on principal. Neither does the current system specify a grid of sub-categories for a more detailed classification of loans falling into the category of “nonperforming.” After a loan is classified as “nonperforming,” accrual of interest is stopped (but may not necessarily be reversed) and the bank is required to make a specific provision. There are no minimum percentages for provisioning against NPL. In calculating provisions, substantial weight may be given to banks’ assessment of the realization value of collateral that backs the loan. As a result, Icelandic banks’ actual CAR could be significantly lower than currently recorded if asset classification and loan loss provisioning systems were brought more in line with international best practices. These considerations compound the concerns that underpin the CBI’s own view, expressed in a recent analysis, that many banks have an undesirably low equity ratio, given the present stance of the economic cycle. This assessment is also shared by the FME. Indeed, in their Annual Report, they indicated that the biggest banks with effective risk management and internal control should have a minimum required CAR of at least 10 percent.

C. Pension Funds

28. The pension funds in aggregate are now the second largest part of the financial system. At end-1999, the share of pension fund’s assets rose to 80.4 percent of GDP and, according to recent analyses, is likely to increase to 120–150 percent of GDP before it stabilizes.

29. The rapid pace with which the portfolio diversification of pension funds has taken place over the last few years has had significant liquidity impacts on the domestic bond markets. As pension funds shifted a large and growing share of their investment from government and housing bonds toward (foreign) equity investment, yields on traditional bonds increased markedly. In addition, the rapid rise of pension fund investments in foreign equity generated a capital outflow at a time the current account deficit reached a historic high due to the sustained overheating of the domestic economy.

30. Pension funds are not likely to be vulnerable to the direct effects of foreign exchange depreciation because they have in aggregate built up a long position in foreign exchange due to the increased investment in foreign equity. Moreover, because the pension funds’ net exposure to unindexed instruments is low and because pension funds are likely to have a positive net asset position on inflation-indexed instruments, owing to their sizeable holdings of treasury-guaranteed securities, interest rate risks are limited. Given the rapid buildup of foreign equity in their portfolios, pension funds would be vulnerable to a decline in international equity prices.

31. Underfunding of government-guaranteed pension funds could lead to a significant deterioration of government finances and possibly result in an increase in domestic interest rates due to a rise in the public borrowing requirement. While recent estimates suggest that potential contingent liabilities for the government budget are on the order of ISK 50 billion, or 7.4 percent of GDP, the government has started to use a part of the budget surplus for appropriations to the government-guaranteed pension funds. Moreover, given the favorable

demographic conditions in Iceland, premium revenues of the pension fund system are expected to exceed pension payments at least for the next two decades; therefore, there is no immediate risk of systemic underfunding.

32. On balance, it does not seem that pension funds are either very vulnerable to a macroeconomic shock, or that they are likely to be a source of financial instability in the foreseeable future.

D. Insurance and Securities

33. Insurance and securities companies are small by comparison with other financial institutions, notably banks and pension funds (see Table 1 above). They are therefore unlikely to pose a systemic problem, although individual institutions may well come under serious stress. The latter is a possibility owing to a number of shortcomings in the regulatory and supervisory frameworks governing insurance and securities activities (below).

34. That said, however, it is still the case that insurance companies face particular credit risk because, in contrast to practices in many other countries, they participate in consumer lending. Insurance companies routinely lend to individuals, using motor vehicles as collateral. Moreover, because of the large share of marketable securities in their portfolios, insurance companies would be affected by efforts to sell collateral assets and by reduced liquidity in financial markets should an exchange rate shock occur.

E. Systemic Liquidity Issues

35. In assessing the systemic liquidity arrangements, it is vital to evaluate how the system would handle different kinds of shocks, such as a depositor run on one or more banks or a downgrading of a bank's credit rating that could make it difficult for institutions to roll over short-term foreign funding, both for individual institutions and for the entire banking sector. Liquidity problems for single institutions can, in principle, be solved in the market place. The capability of the markets to handle sizable transactions without large price movements is vital in this context.

36. The microstructure of financial markets in Iceland has developed rapidly in the last five to ten years, to the point where the central bank is no longer a major player during normal business conditions. However, due to the small size of the market and a high degree of concentration, its ability to provide liquidity is still somewhat fragile. The main weaknesses of current arrangements are: (1) the very limited number of market-makers in the foreign exchange market, which, in spite of substantial improvements in the formal market-making arrangement, may make the market more prone to "herd behavior" and increase the liquidity risk in foreign exchange both for the banks and their customers; (2) the interbank money market is mainly an overnight market and there is no active foreign exchange swap market, which clearly limits the possibility of banks for effective liquidity management; (3) the fact that the National Debt Management Agency (NDMA) and the State Housing Fund (SHF) both have to pay a commission to market participants in order to secure a binding market-maker agreement; (4) the fact that there are no repo markets in government

bonds or bills or in SHF bonds; and (5) the fact that the long-term securities market is divided between government bonds and government-guaranteed SHF bonds. Even though the structure of benchmarks recently has improved markedly, it is still quite fragmented as there are altogether ten benchmark bonds guaranteed by the government.

37. On the other hand, the main strengths of current arrangements are: (1) the existence of formal market-maker agreements that require participants to quote binding prices, which makes the price discovery process simple; (2) the bid-ask spreads are generally low; (3) the fact that the volumes that can be traded in the active markets during normal business conditions without unreasonable market impact are quite high compared to market size; and (4) the fact that, after recent improvements, the transparency of issuance in the primary markets is up to international standards with a highly specified auction calendar, etc.

38. On balance, the market microstructure appears to work fairly well under normal market conditions, but it may not be robust in the face of disturbances. In addition, banks rely to a large extent on foreign exchange liquidity. As a small and “exotic” market, the króna—as well as Icelandic banks’ access to foreign markets—may be vulnerable to changes in international risk attitude. Banks report that neither the Russian financial crisis in 1998 nor Y2K negatively affected their access to foreign markets. However, a major risk for the banks is a downgrade of credit rating by international credit rating agencies, for example, due to credit losses in domestic markets.

39. The current Central Bank Act has no special provision for a lender-of-last-resort function.⁵ However, the Central Bank of Iceland (CBI) has a general legal basis for providing loans against collateral. Financial market participants expect that the authorities would provide financial support to banks should the need arise. The private deposit insurance fund in Iceland is fairly small and could be quickly exhausted in a crisis situation. The fund can, however, borrow should the need arise.

40. There appears to be some scope for the CBI to make adjustments in its monetary policy implementation framework that would strengthen market liquidity by helping to promote a more active market in maturities longer than overnight. It would be desirable, for example, for the CBI to discontinue its current practice of accepting all bids in the repo auctions and begin either to accept only the amount necessary for the banking sector’s fulfillment of the reserve requirement, or to pre-announce the quantity to be auctioned. If implemented, it would be important that this change in the way the CBI and the banking sector currently operate be appropriately timed so as to give market participants sufficient advance warning to get prepared for it, and to allow the CBI time to make any necessary improvement in its liquidity forecasting techniques. The CBI should also consider keeping the repo rate closer to the middle of the interest rate corridor. Banks would then have a

⁵ The new draft Central Bank Act does provide explicit lender-of-last-resort powers.

clearer incentive to use the overnight interbank market and not resort to central bank credit, because the interbank rate would, in normal market conditions, tend to be close to the repo auction rate.

III. THE REGULATORY FRAMEWORK

41. The overall Icelandic legislative and regulatory framework is based on the EU model. As such, the backbone of Icelandic laws and prudential regulations is fundamentally sound, although a number of weaknesses and areas for improvement have been underscored as a result of the FSAP exercise.

42. Weaknesses and areas for improvement fall into four broad categories, three of which cut across all sector-specific supervision; the fourth is more specific to particular sectors. The three general categories are: (i) limitations or inadequacy of supervisory powers; (ii) lacunae in the legislative framework; and (iii) deficiencies in implementation. The fourth category relates to shortcomings in the regulatory framework that are sector-specific. In the following paragraphs, general weaknesses and areas for improvement cutting across all sectors are first identified. Sector-specific weaknesses in the regulatory framework are then briefly introduced. Summary assessments for each of the sectors of supervision, including with regard to transparency issues, are included in Section II of this report.

43. The main problems with respect to the limitations of supervisory powers concern:

- **Licensing/delicensing.** The licensing authority and the power to revoke a license are now entrusted to the Ministry of Industry and Commerce (MIC) and Ministry of Finance (MOF) and not to the supervisory agency (FME), the latter being the norm in most countries;⁶ and
- **General powers to issue prudential regulations.** The powers to frame rules and regulations are not the exclusive responsibility of the FME, as the CBI, MIC, and the MOF are also involved in the rule-making process. This situation is less than optimal as it may create confusion and opacity in the “rules of the game.” While a case can be made that the supervisor should not be put in the position of both making and then applying the rules, as a practical matter, most of the rule-making expertise already resides at the FME.

44. The main lacunae in the legislative framework are as follows:

- **The supervision of the payment system is in limbo.** Currently, no authority is clearly constituted under the law (or any other provision) to supervise the Icelandic

⁶ The MIC has responsibility for licensing and issuing regulations on banks, insurance, and securities companies. The MOF has responsibility for licensing and regulating pension funds.

payment system.⁷ This lacuna needs to be addressed as a matter of priority. Equally important is the establishment of a clear distribution of duties and responsibilities between the CBI and the FME in this area. In this connection, substantial progress has been achieved with the recent establishment of the FSD in charge, inter alia, of the coordination with the FME on payment system supervision; and

- **The lack of supervision over equity funds and the State Housing Fund (SHF).⁸** These institutions currently escape supervisory reach for all practical purposes. This is particularly worrisome given the rapidly growing exposure of domestic residents to equities, including foreign-issued ones, as well as the extensive involvement of the SHF in lending to the private sector (currently around 40 percent of GDP).

45. The lack of de jure operational independence for the FME is a matter of concern. The lack of licensing powers and general powers to issue regulations are important reasons for these concerns. The appointment of the members of the board of the FME by the minister of the MIC, one of them on the recommendation of the CBI, could, under certain circumstances, make the FME subject to outside influence. In addition, the consultative committee of the FME, composed of representatives of the supervised entities, has the right to submit its views on the FME's budget to the MIC. There is therefore a possibility that the supervised entities may seek to limit the budgetary resources available to the FME, with potential consequences for the scale and scope of its operations. In a related vein, the role in supervision of the MIC, which now controls licensing and rule making, among other things, appears to be excessive, and may give rise to situations of conflict of interest given the public ownership of a number of institutions under the purview of the FME. In practice, however, the FME has not found that the lack of formal independence has been a problem for it.

46. Deficiencies in implementation derive from a mix of reasons, mostly linked to the role of the FME and its size, which is too small to allow it to fully carry out all the necessary aspects of supervision. This is the case notwithstanding that certain economies and synergies have been derived from the fact that supervision of all types of financial institutions has been concentrated in a single, unified supervisory agency. The FME recognizes the need for additional resources and is in the process of adding a few more staff. But the scale of the planned expansion may be inadequate.

⁷ The CBI's role in the payment system is to oversee the system, which is not the same as to supervise.

⁸ According to Article 27 of the Housing Affairs Act No. 44/1998, only the Housing Bond Division (HBD) of the SHF is under the supervision of the FME. The FME ensures that the operation of the HBD is in accordance with the provisions of the Act and relevant regulations. The HBD is not, however, required to fulfil the same prudential requirements as other credit institutions. Supervision of the HBD has been focused on off-site monitoring.

47. There is a tendency among market participants to judge appropriateness of the relative size of the FME by other Nordic experiences. This would not appear to be a correct approach because special circumstances work against this comparison. First, regardless of the size of any given country, including Iceland, supervisory functions need to reach a critical size or mass to function effectively. Second, the FME is coping with a large learning and organizational problem given the newness of many of the tasks at hand, as well as the newness of the FME itself. This is taking place in a legislative and organizational framework less supportive than it could be, as noted previously. Finally, the special risks surrounding the Icelandic economy at this time underscore the need to implement consolidated supervision, as well as to strengthen off-site monitoring and the development of early warning indicators through more comprehensive and systematic data collection and analysis efforts, as a matter of priority.

48. **Banking.** There are potential constraints on the FME's powers to exercise consolidated supervision in relation to acquisitions of foreign banks and/or the establishment of branches abroad. This is the case for establishments in countries where the authorities do not allow the free flow of supervisory information between supervisors, or that otherwise prevent the home supervisory authority from performing efficient consolidated supervision on a global basis. There is also a need for a more comprehensive definition of connected or related parties in the law or in the regulation. The legal and regulatory framework relating to prudential standards and control over management needs to be revisited. The absence of supervisory guidelines for due diligence and the fit and proper concept over the bank management is a flaw. In addition, the banks' classification and provisioning scheme needs to be brought into closer alignment with international best practice. Out of the 25 Core Principles for Effective Banking Supervision, Iceland complies with five principles and largely complies with fifteen. It is materially noncompliant with three Principles and noncompliant with two Principles. For a summary assessment, see Section II of this report.

49. **Insurance.** When considering the ownership structure of the insurance sector, there is a need for analyzing the consequences of the connectedness on the capital strength of the insurance companies particularly because there are no rules on intra-group transactions including intra-group loans. The issue of which authority should be responsible for licensing and delicensing is a concern; another concern is the need for further guidance covering key risk management issues such as underwriting, reinsurance, provisioning, and assets. In addition, the supervisor's practice in relation to internal control is not attuned to ongoing enforcement of good management practices, and there are no guidelines on corporate governance. There also exists a potential conflict of interest between the FME's role as a prudential supervisor and its role in the field of consumer protection with regard to insurance premiums. Out of the 17 Core Principles on IAIS Insurance Supervisory Principles, 7 Principles are observed, 6 are largely observed, and 3 are materially nonobserved. Core Principle 9, which covers derivatives and off-balance sheet items, is not applicable as the insurance companies are not active in the derivatives market. For a summary assessment, see Section II of this report.

50. **Securities.** Although the regulatory framework for securities appears to cover most areas, there are some gaps. These concern, for example, the collective investment schemes

that are not supervised, and also the supervision of the ongoing obligations for companies that have issued nonlisted securities (OTC).⁹ Furthermore, there exists no legal basis for the FME to share information with the ISE, which is necessary for the ISE's supervisory duties. Out of the 30 Objectives and Principles for Securities Regulations, Iceland has fully implemented 15 and partly implemented 15. For a summary assessment, see Section II of this report.

51. **Payment and settlements.** Central banks have the role of overseeing the payment system. This means reviewing or deciding upon the rules of the system and reviewing the set-up and functions of the system. Performing oversight means that one looks at the system as such; it is not institution-based. The role of performing institution-based supervision should remain the role of the supervisory authority. There is a need for the CBI and the FME to define clearly and to agree on their roles in the payment system as overseer and supervisor, respectively. The CBI has, according to the current Central Bank Act, the role of promoting the prompt, efficient, and secure transfers of payments domestically and cross-border. The CBI, however, does not have an unambiguous right to issue rules and regulations for the country's payment and settlement systems, but it has assumed this role, based upon its overall concern for the stability of the payment system and the financial market in Iceland, which facilitates conducting an effective monetary policy. It is also a fact that the settlement system settles over the account at the CBI.

52. The legal framework for the payment system covers all relevant aspects, but the existing rules, including manuals of procedures for participants in the system, are not sufficiently developed. There is no law that explicitly covers electronic payments, i.e., one that assures that electronic information can be used as evidence in a court of law. Currently, out of the 11 Core Principles, the RTGS observes 3 principles in full and the FGM observes 2 principles in full. Two principles are largely observed for the RTGS and the FGM, and two principles and three principles are materially nonobserved for the RTGS and the FGM, respectively. Three principles are nonobserved, one is not applicable for the RTGS, and four principles are nonobserved for the FGM. However, as stated above, with the already ongoing process of reform, it is expected that the payment system in Iceland will comply with all the Core Principles at the end of the year 2001. For a summary assessment, see Section II of this report.

53. **Monetary policy transparency practices.** The practice of monetary policy in Iceland can be regarded as open and transparent, notwithstanding shortcomings with respect to transparency standards in the legislative framework for monetary policy. There exist some potential conflicts between the CBI's policy objectives of the exchange rate and price stability, as the current Central Bank Act does not define the achievement of a low inflation rate and a stable financial system as the principal objective of monetary policy. There is no mandatory requirement for the government to disclose disagreements that may lead it to

⁹ Regulations to cover ongoing information obligations are expected to be issued by the MIC shortly.

override central bank policy decisions. Nor is it required to disclose special agreements between the central bank and the minister of finance concerning various forms of central bank lending to the government. The current Central Bank Act allows for the use of wide discretion by the board of directors with regard to reasons for recommending the removal of governors.¹⁰ Out of the 17 Principles for the Observance of the Code of Good Practices on Transparency in Monetary Policy, 12 principles are observed, 3 are largely observed, 1 is largely nonobserved, and 1 is nonobserved. For a summary assessment, see Section II of this report.

54. **Financial policy transparency practices.** The practice of financial policies conducted by the FME can be regarded as open and transparent, but could be enhanced by revising the present legislative framework of the FME (OSFO Act). There has been no disclosure of the relationship between the CBI and the FME with regard to the oversight and supervision of the payment system in Iceland, as an agreement in this regard remains to be defined. Although the FME has the supervisory duty over the major payment system participants—the banks and the Icelandic Securities Depository Ltd. (ISD), its supervision has been on an ad-hoc basis, focusing on special projects, such as the Y2K and the licensing procedures for the ISD. The relationship between the CBI and the Icelandic Banking Data Center (RB) has not been set out in detail and publicly disclosed. There does not appear to exist any clear disclosed rules on information-sharing and reporting guidelines between the RB and the financial agencies, which would increase the accountability of the RB and improve the transparency of its operations in the payment system.

55. The rules covering different parts of the payment system do not seem to cover all necessary areas, nor have they been disclosed. Specific rules with regard to the relationship of the FME's staff with parties that are subject to supervision, including provisions on limitations on the extent to which financial obligations or shares may be held toward these parties, have yet to be published. It would increase transparency in the conduct of financial policies if such rules were publicly disclosed. The housing bond division of the State Housing Fund is an important participant in the financial market, but only limited disclosure has been made by the FME concerning its supervision of the activities of this institution. There are 20 Core Principles for the Observance of the Code of Good Practices on Transparency in Financial Policies, of which 14 are observed, 4 are largely observed, 1 is largely nonobserved, and 1, nonobserved. For a summary assessment, see Section II of this report.

¹⁰ The new draft Central Bank Act defines price stability as the main objective of monetary policy. The CBI will have full operational independence (“instrument” independence) to achieve the price stability objective, which, by agreement with the Prime Minister, may be specified as a numerical target for inflation. There will no longer be a provision for a government override of the CBI's monetary policy decisions. The CBI will not be permitted to make loans to the government, although it will be permitted to purchase government securities in the secondary market for monetary policy purposes. The new draft Central Bank Act does not provide a basis for the removal of a governor.

IV. SYSTEMIC VULNERABILITIES

56. The main purpose of an FSSA is to present an overall assessment of the financial system's stability, drawing on an assessment of the macroeconomic environment, thus incorporating the probability of macroeconomic shocks, as well as the vulnerability of the financial system to a set of stylized shocks. In this regard, the usual approach is to stress test the system by simulating the effects of various shocks and then to analyze the effects of a shock on individual financial institutions and on the system as a whole. Such stress tests typically introduce shocks in isolation and focus on the effects on the solvency of financial institutions. The usual battery includes testing for the effect of a change in interest rates, a change in creditworthiness of major borrowers, a change in the exchange rate, and/or a change in key asset prices.

57. Such tests were performed as an integral part of the assessment. They were performed only for the banking sector and ignore possible effects on other financial institutions, the justification being that banks play a pivotal role in the system and are at the moment the dominant institutions. Another reason for exclusive focus on banks is that the other large financial institutions—pension funds—appear to be well placed to withstand a shock at this time. Other classes of financial institutions, notably insurance companies and securities market participants, are small by comparison and may be less likely to be the source of a systemic problem, although individual institutions may well come under serious stress, as noted previously. Overall, these tests show that the direct effect of an exchange rate shock on the banking system is insignificant; the system is, however, vulnerable to credit risk and interest rate risk. However, stress tests need to be interpreted with caution because the relevant variables do not change in isolation when a shock occurs, nor do they capture more than the “first round” effects of a shock.

58. At the time of the assessment, the most likely shock that Icelandic financial markets might face was a sharp depreciation of the exchange rate. Indeed, it could be said that such a shock already occurred last summer and that the economy was in the process of working through the effects of what then was an 8 percent depreciation against the currency basket. As to second round effects, it was already clear that a sharp movement in the exchange rate had had an impact on the level of interest rates, unhedged foreign currency borrowers, and asset prices. While it was then still too soon to see the effects, the rate of growth of economic activity was likely also affected. Over time, and particularly if economic growth was adversely affected by the shock, there could in the future be a serious deterioration in the asset quality of banks and a rise in nonperforming loans. These effects would not be picked up in a standard stress test. Indeed, the major impact of an exchange rate shock, as described in the foregoing scenario, would manifest itself over time in credit risk and interest rate risk rather than in the form of a change in the net value of foreign exchange assets and liabilities. This would suggest that the focus should be on the stress tests of exchange rate-induced credit risk and interest rate risk.

59. The dynamics of the effects of an exchange rate shock in the context of Iceland are described schematically in Figure 1.¹¹ It shows that an exchange rate shock is likely to be accompanied by a rise in interest rates (reflecting a rise in the risk premium and/or a policy response by CBI), and a drying up of liquidity in financial markets as market-makers likely widen spreads in the face of uncertainty. Bank borrowers who owe unhedged foreign currency-denominated loans are likely to react to cover their positions, possibly by selling other assets, and will in any case suffer losses. The combined effects of reduced liquidity in financial markets, higher interest rates, and actions by uncovered borrowers to sell assets seem likely to put significant downward pressure on asset prices. These pressures will, inter alia, affect the value of collateral underpinning the outstanding loans of banks. Over time, the exchange rate shock is likely to have a negative effect on economic activity.¹²

60. On balance, the effects of weaker economic activity and reduced collateral values could be expected to show up in the form of a rise in nonperforming loans and a concomitant reduction in the capital adequacy of banks. These effects would likely be magnified if the second round effects on the credit position of households were included. In the Icelandic context, given that asset classification and loan-loss provisioning regulations are below international best practices, and also that collateral is given larger weight when establishing provisions against doubtful loans, the impact of a shock might well be greater than would be reflected in the statistics and figures that banks would calculate using the existing regulatory regimes.

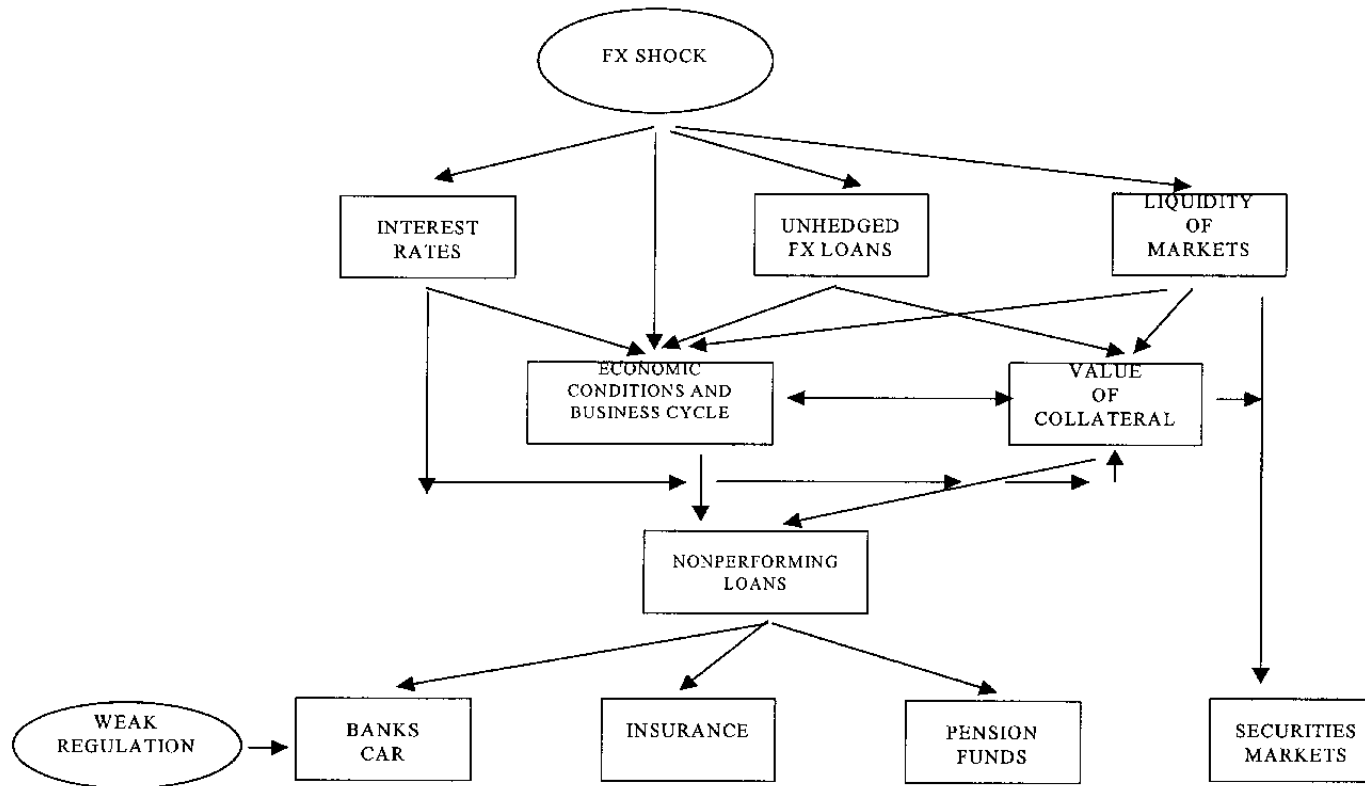
61. Another feature of the Icelandic economy is that it is not only banks that would be exposed to credit risk. Both insurance companies and, to a lesser extent, pension funds have a significant portion of their portfolios invested in loans to customers and members, respectively. As well, securities market participants could expect to be affected by efforts to sell collateral assets and by reduced liquidity in financial markets.

62. A final feature of the Icelandic financial system that would need to be taken into account would be the extent of interconnectedness among financial institutions. As noted previously, the regulatory framework and supervision does not adequately focus on interconnectedness. Such interconnectedness, including ownership linkages as well as lending, could generate a further round of contagion not only among banks themselves (through the interbank market or bank runs), but also among nonbank financial institutions.

¹¹ The following scenario abstracts from the effects that an exchange rate shock might be expected to have on the price level and inflation.

¹² The positive effect from the switch from nontradables production to tradables production is likely to be outweighed by the negative effects of higher interest rates and lower wealth resulting from valuation losses felt by unhedged borrowers of foreign exchange and lower asset prices.

Figure 1. Iceland: Foreign Exchange Shock

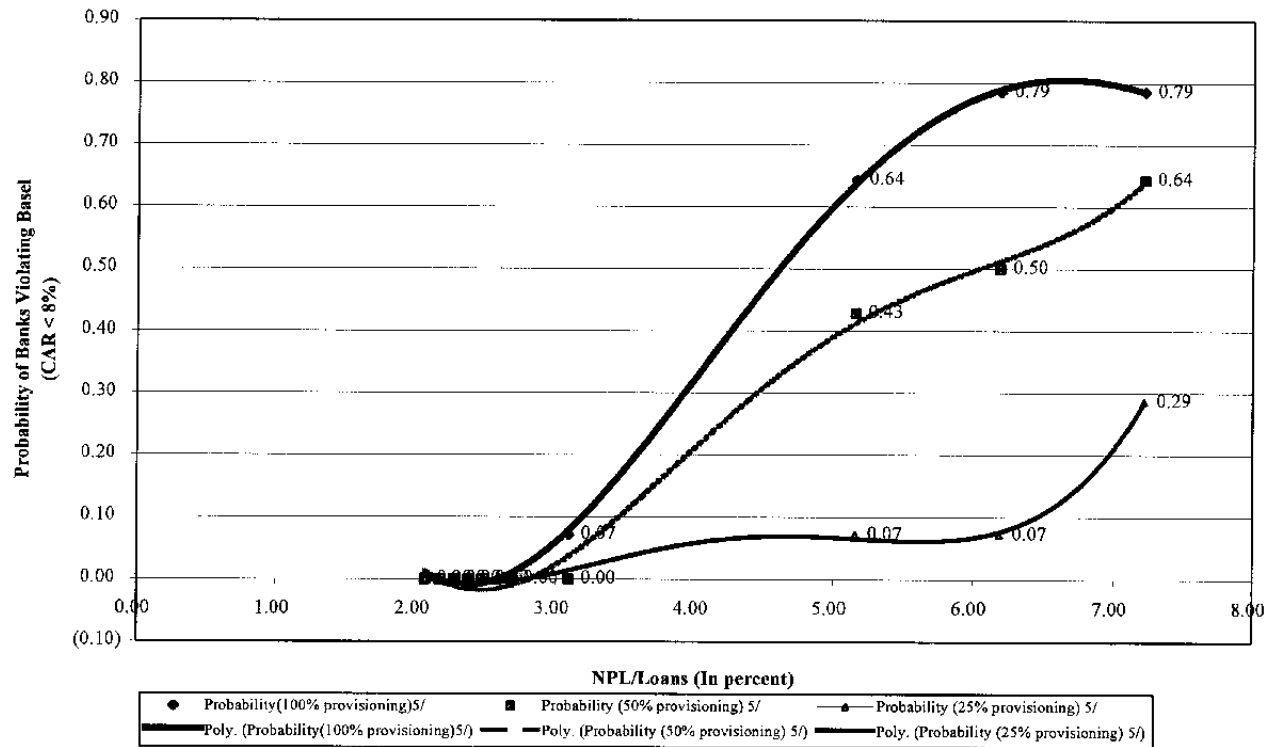


63. Although the scenario is complex and the speed with which all of its effects could work themselves out is difficult to predict, in fact it may be analyzed by a conceptually relatively simple test. This test would focus on the growth of nonperforming loans and measures of capital adequacy. The key problem would be to estimate by how much nonperforming loans might be expected to grow. The team was unable to make this kind of a calculation with any precision, given the complexity of the process that has been described. However, it might well be reasonable to assume that history provides a reasonable guide to the magnitude of the shock, i.e., it would be within the bounds of reason to assume that nonperforming loans measured as a share of assets might reach levels reached in the early 1990s.¹³ Changes in the loan-loss provisioning rules in the direction of a movement toward international best practices might be proxied by raising the coverage of provisions (i.e., the proportion of nonperforming loans that are matched with an increase in provisions). Additional increases in coverage of the proportion of nonperforming loans could also be used as proxy for the effects of a reduction in collateral values or a change in the regulatory regime that reduced the weight that can be given to collateral when establishing provisions.

64. Calculations reflecting how capital adequacy would vary, depending on the extent to which nonperforming loans rise toward the maximum values realized in the preceding decade and for changes in the extent to which nonperforming loans are “covered” by provisions are presented in Figure 2. It charts the relative proportion (referred also as “probability,” for sake of brevity) of Icelandic banks that would violate the minimum Basel capital adequacy requirement of 8 percent of risk-weighted assets (CAR < 8 percent) for different levels of nonperforming loans (NPL)-to-total loans ratios. The positive slope of the curve indicates that as asset quality (proxied by higher values of the NPL-to-total loans ratio) deteriorates, the number of banks whose CAR falls below the minimum 8 percent requirement increases. The sensitivity of the probability measure increases with higher levels of provisioning because it reflects the underlying assumption that poorer quality loans require higher amounts of provisions. Figure 2 shows that the probability measure is fairly insensitive to small increases in NPL-to-total loans ratios (roughly, for values of this ratio below 2.5 percent), but increases quickly thereafter, especially for higher provisioning levels. It also shows that restricting the NPL-to-total loans ratio to the lower (higher) bounds of 4.86 percent and 7 percent, respectively, could raise the probability of banks violating the minimum capital adequacy requirement from about 22 percent (50 percent) and 58 percent (79 percent) in correspondence to provisioning levels of 50 percent and 100 percent, respectively. In sum, Figure 2 shows that, for plausible values of the parameters, capital adequacy of the system would fall below required minimum values.

¹³ The marked deterioration in the Icelandic financial sector’s condition that occurred in the early 1990s was driven by economic recession. It manifested itself in sustained high NPL-to-total loans ratios in the middle of the decade. Based on historic data provided by the FME, the likely bounds for NPL-to-total loans ratios in the event of a shock were estimated to be in a range between 4.86 percent and 7 percent.

Figure 2. Iceland: Banking System—Sensitivity of Capital Adequacy to Changes in Ratio of NPL/Loan
 Assumes No Substandard Loans as per Weaknesses in Loan Classification
 As of June 2000



65. The second key stress test that was performed examines the effect of a rise in interest rates. The banking system is quite vulnerable to interest rate risk. A key feature of the Icelandic economy is the high proportion of indexed financial assets, which complicates the computation of the effects of an interest rate shock. Not only would unindexed instruments be affected by a change in nominal interest rates but, to the extent that real interest rates were affected, so would there be an impact on indexed assets. Real rates might be expected to move in the case of an exchange rate shock, for example, as risk premiums on domestic financial assets might increase in response to the shock.

66. Figures 3 and 4 chart the sensitivity of banks' capital adequacy ratio to changes in non-indexed and indexed interest rates, respectively. The X-axis measures the pass-through rate of an interest rate shock due to imperfect indexation (for non-indexed securities the likely pass-through rate is 100 percent); the Y-axis measures the relative proportion of Icelandic banks whose CAR would fall below the minimum 8 percent requirement. Figure 3 shows three curves corresponding to three scenarios of nominal interest rate volatility defined as various positive proportions of the standard deviation of the nominal interest rate (NYTM) for non-indexed securities. Figure 4 shows the sensitivity of banks to real interest/indexed security rate (RYTM) volatility. Both figures show that banks are sensitive to movements in non-indexed and indexed interest rates, and are consequently exposed to some risk in these securities. They again indicate that, for plausible values of the parameters, the capital adequacy of the system would fall below the minimum Basel requirement.

67. Finally, it is worth noting that the two scenarios just presented should not necessarily be considered in isolation. In part depending on the policy response of the authorities (i.e., how much interest rates might be raised in response to an exchange rate shock), both shocks could be operative and the overall effect might well be more than additive. In that case, the interest rate scenario might be expected to unfold in the immediate to short term, while the credit risk scenario might build up more gradually over time. Owing to current arrangements for asset classification, nonperforming loans will begin to be recognized with a lag of at least six months.

68. The two scenarios also indicate the potential dilemma that monetary policy might face in responding to the shock. If interest rates are not raised, the magnitude of the exchange rate shock might well grow and result in even larger effects on nonperforming loans and bank solvency. On the other hand, the stronger the interest rate response by the authorities is, the greater is likely to be the effect of the interest rate shock on capital adequacy.

69. The stress and scenario tests were intended to illustrate the potential vulnerability of the financial system to an economic shock. They caution that the capital position of the banks may be readily eroded under plausible assumptions that are within the range of historical experience. The analysis broadly corroborates the public positions taken by the CBI and the FME on the need to raise the capital base of financial institutions, particularly banks.

Figure 3. Iceland. Banking System: Sensitivity of Capital Adequacy to Changes in Nominal Interest Rate
 Based on Standard Deviation Volatility Average Nonindexed Security Interest Rate;
 Duration of Assets is 1; Duration of Liabilities is 0.5

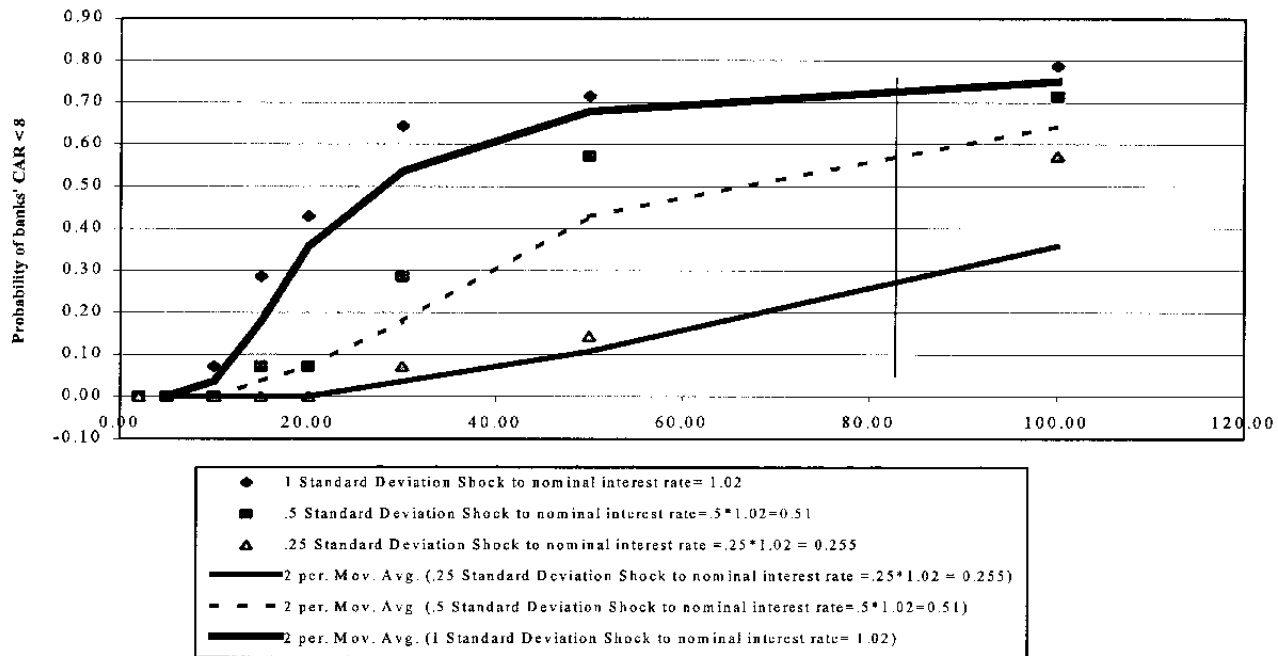
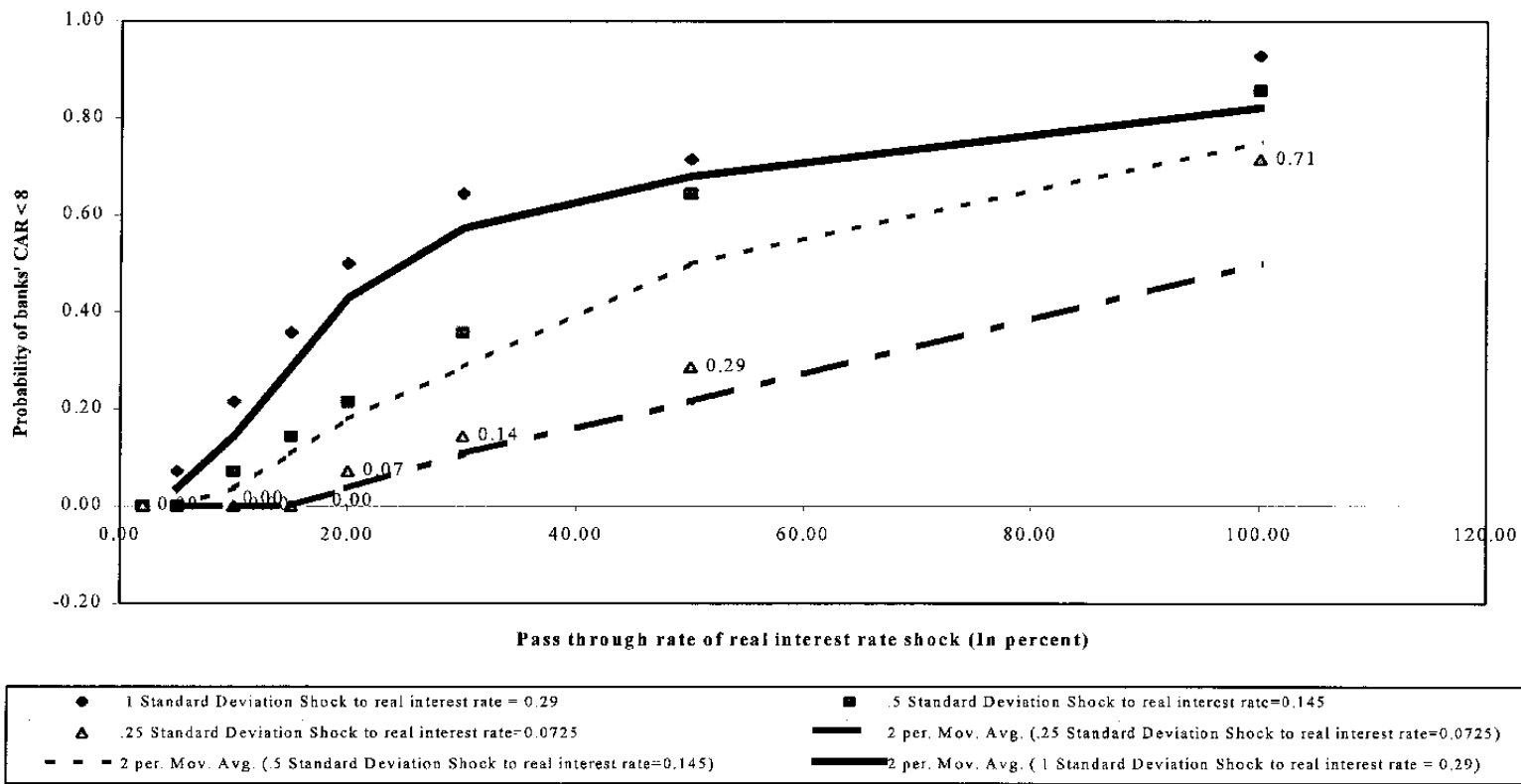


Figure 4. Iceland: Sensitivity of Capital Adequacy to Changes in Real Interest Rate Based on One Standard Deviation Volatility (0.29 for Jul 99-Jun 00) of Average Indexed Security Interest Rate; Duration of Assets is 2.5; Duration of Liabilities is 1.5



V. RECOMMENDED ACTIONS

70. As part of the overall financial system assessment of systemic risks and vulnerabilities, the legal, institutional, and operational framework for the supervision of the financial system was reviewed and the degree of observance of international standards and practices in this area was assessed. The mechanisms in place to encourage compliance with prudential regulations were also assessed, and whether the FME has the proper legal authority and protection to conduct its task to enforce actual regulations, or take prompt action when necessary, was considered. This section summarizes the recommendations for policy actions intended to strengthen the regulatory framework and bring the Icelandic financial system into full compliance with international best practices.

71. The list of recommendations is lengthy, but some priorities may be underscored. From a systemic stability perspective, the most pressing issue is to raise the defenses against a deterioration in credit quality that may result from the króna's recent depreciation. Thus, it is crucial that the Icelandic authorities take urgent action to increase the minimum capital adequacy ratios for banks and strengthen current arrangements for asset classification and loan-loss provisioning. Additionally, it is essential that the authorities step up efforts to strengthen their capabilities for on-site inspection, especially on a consolidated basis—to ensure that they will not be taken by surprise should credit quality begin to deteriorate—and off-site monitoring of financial institutions. Equally crucial is that the authorities strictly adhere to the envisaged timetable for the implementation of reforms in the payment and settlements system. Then, the authorities should seek to correct regulatory deficiencies that are judged to be non-compliant or materially non-compliant with international best practices.

72. Following are the recommendations for policy actions intended to strengthen the regulatory framework and bring the Icelandic financial sector into full compliance with best international practices. As noted at various points in this report, the Icelandic authorities are already preparing to implement many of the actions that follow.

A. Banking

- Raise minimum capital adequacy requirements to reflect market and credit risks and provide legal power to supervisors to mandate increased capital requirements for banks thought to be at particular risk
- Strengthen asset classification and loan-loss provisioning rules.
- Strengthen the FME's powers to exercise effective consolidated supervision.
- Provide the FME with powers to block acquisitions and branches in foreign jurisdictions, which do not allow home supervisory control.
- Strengthen the legal and regulatory framework relating to prudential standards and control over management.

- Clarify and tighten definition of connected lending.

B. FME

- Strengthen the FME's capabilities for on-site inspection and off-site monitoring.
- Move the power of licensing and delicensing to the FME.
- Move the power to frame rules and regulations to the FME, with the exception of those covering the payment system for which the CBI should be responsible.
- Review the necessity for the Consultative Committee of the FME to have the right to submit views on the FME's budget.
- Give the FME substantially more resources, including a larger staff of qualified professionals.
- Introduce written procedures for evaluating the fitness and propriety of owners, members of the board of directors, and managing directors.
- Publish an internal Code of Conduct for the FME.

C. Systemic Liquidity and Monetary Policy Implementation

- Accept bids in the repo auctions equal to the amount that meets banks' needs to fulfill their reserve requirement, or, alternatively, announce in advance of the auction the quantity of repos that will be accepted.
- Keep the repo rate closer to the middle of the interest rate corridor.
- Prohibit large-value customer payments following the daily closure of the money market.
- Create a marginal or end-of-day repo financing facility at market rates for the market-makers in government securities and government-guaranteed securities, with the issuers or with the central bank.

D. Payment and Settlements

- Clarify and disclose the role of the CBI and the FME in relation to overseeing and supervising the payment system.
- Consider giving the CBI an explicit right to issue rules and regulations for the payment and settlement systems.

- Consider making amendments to the legal framework for the payment system concerning the need to include in a law that electronic information can be used as evidence in the court of law.
- Change the settlement procedure for securities transactions, not having been traded at the ISE, so that these transactions settle on a DVP basis.
- Develop necessary features to allow settlement of securities transactions through the RTGS system.
- Change the settlement date in the FGM so that it settles on the day of value.
- Implement as soon as possible all necessary agreements with the payment system participants pursuant to the new “Rules on Access to Settlement Accounts with the Central Bank of Iceland.” This will include drawing up and publishing the rules for the RTGS system; Rules on the FGM Netting System; Agreement on participation in the netting service with the FGM and the CBI payment settlement; Declaration regarding guarantees for the completion of payment settlements in the FGM netting system.
- Prohibit the CBI to lend to banks, except against adequate collateral.
- Change settlement practices so that the authorities will make their payments early in the morning in order to increase the liquidity during the day for payment systems purposes.
- Agree that all monetary and exchange rate policy operations of the CBI will be settled through the RTGS system.

E. Pension Funds

- Amend the legislative framework with respect to the provision on the investment policy of pension funds (Art. 36) so as to contain explicit provisions with regard to the maximum share of loans to members in the asset portfolio of pension funds. Establish and gradually phase in specific provisions regarding the investment in derivatives other than for hedging purposes.
- Provide the FME with authority to grant authorization for a merger and to revoke the license of the fund which is ceasing its activities in the context of the merger.
- Strengthen the supervision of risk and internal risk management and control, including through on-site inspections.
- Strengthen prudential supervision of corporate governance in pension funds.

F. Insurance

- Adjust the off-site supervision to include stress testing and the calculation of a risk profile of insurance companies.
- Require insurance companies to report risk-based information.
- Use on-site inspections not only to monitor and enforce rules and in cases of problems, but also as part of the ordinary supervisory process. Introduce a risk-based approach to on-site inspections.
- Introduce guidelines on corporate governance.
- Adjust the FME project on internal control to include a stronger focus on insurance.
- Consider requiring auditors to certify the existence and sufficiency of certain internal procedures, risk management, and controls.
- Consider the ownership structure of the insurance sector, especially the consequences of the connectedness on the capital strength of the insurance companies, and give priority to the implementation of rules on intra-group transactions including intra-group loans.
- Consider the potential conflict of interest between the FME's role as a prudential supervisor and the role in the field of consumer protection with regard to insurance premiums.

G. Securities

- Provide the legal basis for the FME to provide the ISE with information that it needs to perform its own supervisory duties.
- Provide legislative authority to place equity funds and all other forms of collective investment, and the SHF under the supervision of the FME.
- Consider giving a supervisor from the FME responsibility for the ongoing obligations of companies that have issued securities that are not listed (OTC). The envisaged regulations on ongoing information obligations being finalized by the MIC will likely address this issue.
- Strengthen the legislation concerning collective investment schemes.

H. Transparency

Monetary policy ¹⁴

- Consider removing potential conflicts between the policy objectives of the exchange rate and price stability in the Central Bank Act.
- Establish a mandatory procedure to disclose significant disagreements that may lead the government to override central bank policy decisions.
- Establish and disclose potential reasons that could lead to the dismissal of governors.
- Disclose terms and conditions of CBI lending to the treasury.

Financial policy

- Add a line in Article 2.1 of the OSFO Act to include the payment system as an activity to be supervised by the FME.
- Set out in detail and publicly disclose the CBI's relationship to the RB.
- Establish rules on information-sharing and reporting guidelines between the RB and the financial agencies in order to increase the accountability of the RB and improve the transparency of its operations in the payment system.
- Disclose the regulations set up by the MIC, which defines the role, composition, and tasks of the FME's Consultative Committee of parties subject to supervision. The envisaged publication of these regulations shortly will address this issue.
- Improve data collection and data management practices mainly by focusing increasingly on risk-based indicators.
- Give more attention to the so-called "other financial institutions," notably the housing bond division of the State Housing Fund, and disclose a greater deal of information on the FME's supervision of the activities of these institutions.

¹⁴ The new draft Central Bank Act defines price stability as the main objective of monetary policy. The CBI will have full operational independence ("instrument" independence) to achieve the price stability objective, which, by agreement with the Prime Minister, may be specified as a numerical target for inflation. There will no longer be a provision for a government override of the CBI's monetary policy decisions. The CBI will not be permitted to make loans to the government, although it will be permitted to purchase government securities in the secondary market for monetary policy purposes. The new draft Central Bank Act does not provide a basis for the removal of a governor.

SECTION II—OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information on adherence to and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory frameworks have been adequate to address the potential risks in the financial system. It has also provided a source of good practices in financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process under the supervision of Mr. Alexander, Team Leader, as part of the Financial Sector Assessment Program (FSAP), by Amalendu Ghosh (Reserve Bank of India) and Tuomo Malin (Finnish Financial Supervisory Authority) for the *Basel Core Principles for Effective Banking Supervision*; Lone Mørup (Danish Finanstilsynet) for the International Association of Insurance Supervisors (IAIS) *Insurance Core Supervisory Principles*; Paul-Willem van Gerwen (Securities Board of the Netherlands) for the International Organization of Securities Commissions (IOSCO) *Principles of Securities Regulation*; Kai Barvell (IMF) for the *Core Principles for Systemically Important Payment Systems*; and Frank Engels (IMF) for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The team of assessors prepared detailed assessments by drawing on information provided by the Icelandic authorities, including self-assessments, and fieldwork during the November 2000 mission. This section contains a summarized version of the detailed assessments included in the FSAP report.

The overall Icelandic legislative and regulatory framework is based on the EU model. As such, the backbone of Icelandic laws and prudential regulations is fundamentally sound, although a number of weaknesses and areas for improvement have been underscored as a result of the FSAP exercise. Weaknesses and areas for improvement fall into four broad categories, three of which cut across all sector-specific supervision; the fourth is more specific to particular sectors. The three general categories are: (i) limitations or inadequacy of supervisory powers; (ii) lacunae in the legislative framework; and (iii) deficiencies in implementation. The fourth category relates to shortcomings in the regulatory framework that are sector-specific. The main weaknesses are in the following areas, respectively: (1) licensing/delicensing: the licensing authority and the power to revoke a license are now entrusted to the Ministry of Industry and Commerce (MIC) and Ministry of Finance (MOF) and not to the supervisory agency (FME); (2) general powers to issue prudential regulations: powers to frame rules and regulations are not the exclusive responsibility of the FME, as the CBI, MIC, and the MOF are also involved in the rule-making process; (3) the supervision of the payment system is in limbo: no authority is clearly constituted under the law (or any other provision) to supervise the Icelandic payment system; (4) the lack of supervision over equity funds and the State Housing Fund (SHF); and (5) deficiencies in implementation which derive from a mix of reasons, mostly linked to the role of the FME and its size, which is too small to allow it to fully carry out all the necessary aspects of supervision as warranted.

The Icelandic authorities are already preparing to implement several of the recommendations offered by the mission. This, coupled with new or upgraded regulations that are being finalized by the MIC and recent new hiring of professional staff by the FME, is expected to address many of the issues underscored in this section.

I. OBSERVANCE OF BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

A. General

1. This is an assessment of compliance with the Basel Core Principles for Effective Banking Supervision by the Financial Supervisory Authority of Iceland, Fjármálaeftirlitid (FME). It was undertaken as part of a Financial Sector Assessment Program (FSAP) mission.

2. The assessment was conducted in November 2000 by Amalendu Ghosh (Reserve Bank of India) and Tuomo Malin (Finnish Financial Supervisory Authority). Major sources of information used for the assessment included the answers to a questionnaire submitted by the FME prior to the mission; a review of the Act on Commercial Banks and Savings Banks, No. 113/1996, the Act on Credit Institutions other than Commercial Banks and Savings Banks, No. 123/1993, the law governing the FME, the Official Supervision of Financial Operation Act No. 87/1998, as well as various rules and regulations dealing with various aspects of banking activity, risk management, and reporting and disclosure; and extensive discussions with representatives from the FME, the National Association of Auditors, the Ministry of Industry and Commerce (MIC), and the banking industry.

3. The assessment of Iceland's compliance with the Core Principles required judgments by the assessment team. Banking systems differ from one country to another, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, by adhering to a common, agreed methodology, the assessment should provide the Icelandic authorities with a reliable measure of the quality of its banking supervision in relation to the Core Principles, which are internationally acknowledged standards.

4. The assessment of compliance with each Core Principle is made on a qualitative basis. A four-part assessment system is used: compliant; largely compliant; materially noncompliant; and noncompliant. To achieve a "compliant" assessment with a Principle, all essential criteria must be met without any significant deficiencies. A "largely compliant" assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that Principle. A "materially noncompliant" assessment is given when the shortcomings are sufficient to raise grave doubts about the authority's ability to achieve compliance, but substantive progress has been made. A "noncompliant" assessment is given when no substantive progress toward compliance has been achieved.

B. Market Structure and Overview

5. The Icelandic banking sector is composed of the CBI, 29 deposit money banks, of which 4 commercial banks and 25 savings banks, and 4 investment banks. The branch network totals some 188 branches with some 3,000 employees. Total bank assets represents about 43 percent of the total assets of the Icelandic financial system, which represents about 300 percent of GDP. The banking sector is very concentrated with one commercial bank accounting for about 32 percent of total bank assets and 3 commercial banks accounting for

some 75 percent of total bank assets. At end-June 2000, the Herfindhal-Hirschman Index of concentration was about 2,180.

C. General Preconditions

6. The legal framework applying to the supervision of banks and to banking activity appears generally adequate. Notwithstanding the fact there is only an inconsequential amount of cross-border banking activity, the laws do not provide for seeking prior approval of the FME by banks for the establishment of subsidiaries and branches outside the EEA. Accounting and financial disclosure standards are broadly in line with international standards.

7. The FME is the sole supervisor of banks. All banks must have a license, issued by the MIC in consultation with the FME. The following types of banks may be licensed: commercial and savings banks (deposit money banks) and other credit institutions (other than those meant in the Act on Commercial Banks and Savings Banks) which include leasing companies. The Banking Act sets out the permissible activities for credit institutions. Banks may have fund management and securities subsidiaries as well as insurance subsidiaries.

8. The FME was founded in the beginning of 1999 when the Banking Inspectorate of the CBI and the Insurance Supervisory Authority were merged together. The FME has a competent and quite young staff; however, there is a need to somewhat raise the number of its staff with highly skilled experts. Some of the staff have extensive supervisory experience. In recent years, the supervisor has had to compete with the private sector for workers. Although, through the board of the FME, the MIC and the CBI have a possibility to have an influence on the supervisor's work, there are no indications of governmental interference in the implementation of supervisory policy in recent years. As a special feature of the supervisory framework, the supervised entities are legally entitled to express their opposition to an expansion of the FME's resources.

9. The assessment of the effectiveness of banking supervision focuses primarily on the institutions responsible for it. The FME collects both quantitative and qualitative information on the banks. Because of the relatively small size of the FME, the supervision function is not divided into functional units. The main functions of the FME are supervision, relationships, and data systems. There are currently 28 persons employed at the FME, of which 22 are professional experts. All the personnel to some extent are involved in the supervision of both banks, insurance companies, and securities firms.

D. Main Findings—Summary

10. Traditionally, the Basel Core Principles are grouped into seven major categories: (i) preconditions for effective banking supervision; (ii) licensing and structure; (iii) prudential regulations and requirements; (iv) methods on ongoing supervision; (v) information requirements; (vi) formal powers of supervisors; and (vii) cross-border banking. In addition to the summary assessment of each Principle presented in this chapter's section on the Main Findings, the results are summarized here by these groups.

11. When measured against the Essential and the Additional Criteria in combination, the FME is fully compliant with 5 CPs, largely compliant with 15, materially noncompliant with 3, and noncompliant with 2.

- **Preconditions for effective banking supervision and CP 1.** The general legal and accounting framework in which banking and banking supervision takes place is sound. Financial statements provide meaningful information; the relevant EU directives have been implemented. Accounting is in line with international accounting standards. The issuance of regulations and guidelines is, in principle, divided between the MIC and the FME. In addition to regulations on the main prudential standards, there are scarcely any guidelines on general aspects of risk management and internal control.

Under the FME Act No. 87/1998, the FME is the sole supervisor of banks. The FME has to report to the MIC on its activities. The MIC appoints the three-member board of the FME which, in turn, appoints the director general of the FME. All subdivisions of CP 1 are largely complied with except CP 1 (5) concerning the legal protection of supervisors. Licensing is the duty of the MIC, but there is under consideration the possibility to concentrate all regulatory powers at the FME. Some aspects of the consultative committee and the composition of the FME's board lend themselves to doubts as to the independence of the FME in all circumstances.

- **Licensing and structure, CPs 2–5.** These Principles focus on the definition of banking activities and the proper use of the name “bank,” as well as the supervisory means to protect sound ownership and structure of banks. The FME complies with these Principles, with two exceptions. The more serious one, albeit currently not critical, relates to the lack of direct powers to prevent corporate structures that would prevent the FME from exercising effective consolidated supervision. In the context of licensing, the fitness and propriety of management are being monitored but there are no guidelines on ongoing fit and proper tests and adjacent reporting.
- **Prudential regulations and requirements, CPs 6–15.** The FME complies largely with the CPs except asset valuation and loan-loss provisioning (CP 8): regulations do not provide for subclassification of problem loans which may require higher provisioning; recognition and monitoring of connected lending (CP 10); and recognition of country risk (CP 11). Laws require all banks to maintain minimum CAR not lower than what was established in the Basel Capital Accord (CP 6). Laws, however, restrict the FME's powers to increase CAR beyond the minimum level. The FME ensures that prudent credit and investment criteria, policies, practices, and procedures are formulated, approved, implemented and reviewed by bank management and the boards of directors (CP 7). The FME requires banks to formulate specific policies for identifying problem credits, including procedures for loan-loss provisions and write-offs. The rules on loan classification and provisioning, however, are not stringent. The rules do not provide for subclassification of problem loans which may require higher provisioning (CP 8). Banking laws impose prudential limits on large exposures (CP 9) but laws do not define connected lending. Client-wise or

aggregate limits on connected lending are not in place (CP 10). Country and transfer risks are not recognized within the risk management framework (CP 11). The FME requires, through on-site inspections, that banks meet organizational requirements for risk management and internal control (CPs 12-14). Money laundering regulations are in place and implemented by banks (CP 15). Banking laws identify the responsibilities of boards of directors with respect to corporate governance principles.

- **Methods of ongoing supervision, CPs 16–20.** The Principles are being largely complied with. The major qualifications have to do with some deficiencies in the reporting framework used by the FME and the need to increase the authorities' resources for undertaking analyses on the basis of the prudential reports (CP 18). There are no clear guidelines for controlling management quality (CP 17). Moreover, foreign acquisitions may escape consolidated supervision owing to a lack of supervisory powers to prevent certain corporate structures (CP 20).
- **Information requirements, CP 21.** Iceland is largely compliant. The major qualification is that the accounting practices followed by banks do not contain certain essential elements of best international practices; the FME has not issued general rules on valuation by marking to market.
- **Remedial measures and exit, CP 22.** According to law, the FME has wide powers to demand corrective action and impose penalties. The FME is lacking some supervisory instruments enumerated in the Principle.
- **Cross-border banking, CP 23–25.** These Principles are all related to cross-border banking such as cooperation between home and host country supervisors and exchange of information, consolidated supervision on a global basis, and equal treatment of foreign establishments. While the FME practices consolidated supervision on a global basis, its possibilities to exercise its powers are partly circumscribed by its not being able to block investments deleterious to supervision.

E. Authorities' Response

12. The FME welcomes the work done by the IMF mission, and is determined to use the results of the comprehensive work to further strengthen its operations and enhance improvements to the regulatory framework. However, the FME is not in total agreement with all points of the assessments.

13. The FME does not share the concerns expressed, relating to the lack of independence of the FME. The Act on Official Supervision of Financial Operations, No. 87/1998, clearly stipulates the legislator's intentions to secure the Authority a greater independence than most

Summary of Main Findings

Criteria	Gradings 1/				Remarks
	1	2	3	4	
1(1) Responsibilities		X			Largely compliant, because the FME's regulatory powers could be strengthened as well as clarified in relation to MIC and the CBI.
1(2) Independence & Resources		X			Largely compliant: the FME is liable to be subject to outside control on the part of the MIC and the CBI; through the consultative committee's legal opinion on budget, market participants may pose undue interference in the FME's functions.
1(3) Licensing		X			Compliant, but the licensing authority would appropriately belong to the FME.
1(4) Compliance Powers		X			Compliant, but the FME is in some respects lacking direct powers to impose its opinion.
1(5) Legal Protection				X	Noncompliant, although civil servants are not likely to be sued individually.
1(6) Information Sharing		X			Compliant.
1. Objectives, Autonomy, and Powers		X			Largely compliant: outside interference has not been in evidence; strengthening of the FME's regulatory powers is under consideration.
2. Permissible Activities		X			Compliant.
3. Licensing Criteria		X			Largely compliant, because supervisory guidelines for the evaluation of "fit and proper" criteria for management have not been issued as yet.
4. Ownership Transfer		X			Compliant.
5. Investment Criteria			X		Materially noncompliant: no prior approval is required for material investments in banking companies, no prior notification requirements are in place for other investments.
6. Capital Adequacy		X			Compliant, although the FME has no legal powers to insist on a higher capital ratio even though its risk profile or general conditions would warrant it.
7. Credit Policies		X			Largely compliant: exclusive reliance on boards of banks to frame credit policies, no statutory power with FME to give directions.
8. Loan Evaluation			X		Materially noncompliant: asset classification and loan-loss provisioning requirements are to be improved to be in line with the best international practices. The FME has no legal powers to demand a bank to increase its level of provisioning; lending policies and procedures are not inspected on an annual basis.
9. Large Exposures		X			Compliant.
10. Connected Lending				X	Noncompliant: connected or related parties are not defined in law or regulations.
11. Country Risk				X	Noncompliant: country and transfer risks need to be recognized due to growing overseas exposures.
12. Market Risks		X			Largely compliant, but inability of the FME to impose higher capital requirement for market risk

Criteria	Gradings 1/				Remarks
	1	2	3	4	
13. Other Risks		X			Largely compliant: no separate guidelines in place for overall risk management.
14. Internal Control		X			Largely compliant, because the FME has not imposed guidelines on internal controls although so empowered in law.
15. Money Laundering		X			Compliant.
16. Onsite and Offsite Supervision		X			Largely compliant: overall strategy and supervisory resources need to be strengthened.
17. Bank Management		X			Largely compliant: the FME should develop a 'fit and proper' regime covering all banks, and extending to all directors and key senior executives.
18. Off-site Supervision		X			Largely compliant: reporting and review system could be improved.
19. Validation of Information		X			Largely compliant: the FME should explore more extensive cooperation with external auditors.
20. Consolidated Supervision		X			Largely compliant: foreign acquisitions can escape consolidated supervision due to lack of controls.
21. Accounting		X			Largely compliant: asset classification and loan-loss provisioning practices provide banks with an inordinate amount of discretion in the preparation of their financial statements. The FME lacks the legal authority to revoke the appointment of an auditor.
22. Remedial Measures		X			Largely compliant: the supervisor has no legal authority, e.g., to prevent corporate affiliations, restrict dividend payments, or replace managers, directors, or controlling owners.
23. Global Consolidation			X		Materially noncompliant: lack of powers to prevent opening of subsidiaries or branches in foreign locations that will not allow consolidated supervision by the home authority.
24. Host Country Supervision.		X			Largely compliant: MOU only with Nordic countries but no power to prevent foreign acquisitions.
25. Supervision of Foreign Establishments		X			Largely compliant, but supervisors have no legal authority to prevent foreign acquisitions from taking place.

Explanations: The columns marked 1-2-3-4 indicate the degree of compliance. 1= full compliance; 2= largely compliant; 3=materially noncompliant; 4=noncompliant.

other state authorities. The existence of a special board, the Appeals Committee, and the special funding arrangements, securing independence from parties subject to supervision, point to that direction. Therefore, the FME considers its institutional framework to be sound, although division of duties between the FME and relevant ministries could be further clarified.

14. The FME agrees with assessments concerning principles on connected lending, country risk, investment criteria and global supervision, assessed to be noncompliant or materially noncompliant. These are relatively new risk factors in the Icelandic financial market that deserve more attention, both as regards the legal framework and the FME's supervisory operations.

15. The FME disagrees with IMF's assessment that Principle 8, concerning loan evaluation and loan loss provision, is materially noncompliant. The FME considers Principle 8 to be largely compliant, when the regulatory and supervisory framework and procedures are assessed against the methodology developed by the Basel Committee on Banking Supervision. In addition, it is the view of the FME that Icelandic rules for provisioning for loan losses and the Icelandic banks' internal rules and practices regarding recognition and measurement of impairment of loans are largely compliant with the "Sound Practices for Loan Accounting and Disclosure" laid down by the Basel Committee on Banking Supervision. In this regard, it should be mentioned that accounting firms that are member firms of international accounting firms perform the auditing of all the Icelandic banks, except three small savings banks. The accounting is therefore in line with standards of the international accounting firms although the FME is aware that this does not reduce its supervisory duties.

16. The FME acknowledges that the rules relating to asset classification and loan-loss provisioning requirements should be improved and has begun the process of such improvements. The FME is now aligning its supervisory practices and data collection to the recommendations made by the IMF. In relation to this, the FME now participates in a work within the European Economic Area, the object of which is to formulate best practice rules based on the aforementioned principles from the Basel Committee on Banking Supervision.

17. As to other principles assessed to be largely compliant, deviations relate mostly to gaps in the legislative/regulatory framework or lack of written procedures within the FME. The FME acknowledges this and is in the process of formulating some of the guidelines. For example, the FME is evaluating possible contents of guidelines on internal controls, in connection with a special project regarding supervision of risk management and internal controls of financial institutions. In some assessments, inproportionate importance is given to formal predefined procedures, while the small market in Iceland implies that such procedures would themselves be more extensive than the reality encountered in the supervision. As to assessments regarding fitness and propriety, the FME considers the regulatory framework to be adequate, although written procedures could be enhanced. Amendments in the regulatory framework of fitness and propriety of holders of qualifying holding in financial institutions are currently discussed in the Parliament.

18. As to the resources of the FME, it should be pointed out that since the assessment took place, three professional experts have joined the staff and further additions are being prepared. As a result of the assessment, several amendments to the supervisory functions are implemented or underway, such as improvements in data-collection.

F. Recommended Next Steps

19. The FME's supervisory powers are clearly stated in law. Powers to frame rules and regulations are not solely its responsibility. The CBI and the MIC are also involved in the rule-making process. A review of the existing arrangement with regard to the duties of the different parties concerned would be in order. A rearrangement of regulatory powers ought to entail that the licensing authority and the power to revoke a license, now entrusted to the MIC, would also reside at the FME. The supervisory authority's powers to issue prudential rules vis-à-vis other authorities should be clarified. Such a concentration of prudential regulatory power at the supervisory authority would enable the supervisory authority to have a more coherent approach on the banking market.

20. As to the accountability and the operational independence of the FME, the appointment of members of the board of the FME by the minister of the MIC could, under certain circumstances, make the FME subject to outside control. Since the consultative committee of the FME has, according to law, the right to submit its views on the FME's budget to the MIC, there is a possibility that the supervised entities may seek to limit the amount of the FME's budgetary resources, which might result in interference with the supervisory authority's functions. The possibility of outside influence from within the government and the financial markets ought to be taken into serious consideration.

21. With the inherent risks involved in the Icelandic financial markets and the great number of individual entities under supervision, it would be advisable to strengthen the agency's resources, in particular the number of its staff. The more complex operations the local banks are likely to be engaged in should make it expedient to lay more emphasis on the ability of the FME to monitor and assess the risk involved. The integrity of the Icelandic financial markets is, to a large extent, dependent on the quality of supervision the financial institutions are subject to.

22. There are potential constraints on the FME's powers to exercise consolidated supervision. The authority ought to be provided with explicit powers to block acquisitions and branches in foreign jurisdictions that do not follow the free flow of supervisory information between supervisors or that otherwise prevent the home authority from performing efficient consolidated supervision on a global basis.

23. The regulatory framework relating to prudential standards and control over management needs to be revisited. The absence of explicit supervisory guidelines for due diligence on fit and proper concept over the management is a flaw in the supervisory process. The lack of a clear definition of a connected and related party prevents the supervisor from taking a view of the abuse of the financial system by interested parties. Laws and regulations on loan classification and provisioning need to be revised in order to provide a more realistic

view of the risks involved. This would also contribute to protecting the viability of the financial entities and to maintaining the stability of the financial system.

II. OBSERVANCE OF IAIS INSURANCE CORE SUPERVISORY PRINCIPLES

A. General

24. This is an assessment of the observance of the Core Principles of the International Association of Insurance Supervisors (IAIS) by the Financial Supervisory Authority of Iceland, Fjármálaeftirlitid (FME). It was undertaken as part of a Financial Sector Assessment Program (FSAP) mission.

25. The assessment was conducted in November 2000 by Lone Mørup, Deputy Director in the Danish financial supervisory authority, Finanstilsynet. Major sources of information used for the assessment included the answers to the questionnaire submitted by the IMF prior to the mission, a self-assessment made on the basis of the Core Principles Methodology of the International Association of Insurance Supervisors (IAIS), information available on the FME website including unofficial translations into English of some of the relevant legislation, an advance copy of the English summary of the 1999 to mid-2000 Annual Report of the FME, and other information provided by the FME. Not all relevant legislation and regulation were available in English. In addition, extensive interviews were conducted with officers of the FME and of the Ministry of Industry and Commerce (MIC), members of the accounting profession, and senior managers of three insurance companies. All those interviewed gave generously of their time and were anxious to be helpful.

26. This assessment has been based on the Insurance Core Principles Methodology of the International Association of Insurance Supervisors adopted at the Annual Conference of the IAIS in October 2000. This contains all the Core Principles being used in FSAPs by the IMF. The methodology lists essential criteria required to meet the Core Principles and additional criteria and/or additional measures that may also be needed in order for the aspect of insurance supervision to be considered effective.

B. Institutional and Macprudential Setting, Market Structure Overview

27. Iceland is a fairly small insurance market. The total population of Iceland is 279,000. The Icelandic insurance sector primarily underwrites domestic nonlife business. Fourteen companies are licensed to do insurance business in Iceland. Of these, ten are nonlife insurance companies, three are life insurance companies, and one is a reinsurance company. Three of the nonlife insurance companies cover around 90 percent of the market. Four mutual companies are specialized marine insurers. A state-owned marine insurance company is being privatized. The reinsurance company has stopped writing new business. The life insurance sector in Iceland is small. One state-owned company underwrites catastrophe insurance. This company is governed by special legislation. One hundred fifty nine European insurance companies are notified to provide insurance in Iceland on a cross-border basis and one European insurer has established a branch in Iceland. There is no important foreign ownership of insurance companies in Iceland and no non-European insurers are licensed to

do business in the country. The number of licensed independent brokers is 31. In addition, three foreign brokers are registered to do business in Iceland.

28. Total premiums written in 1999 in nonlife insurance were ISK 15,096 million and in life insurance and reinsurance, total premiums were ISK 965 million and ISK 1,096 million. Premiums mediated through brokers amounted to ISK 915. The level of nonlife premiums has been rather stable over the last four years.

29. The market for nonlife insurance is relatively constant relative to the economy, with gross premiums being approximately 2.3 percent of GDP, compared to 2.8 percent in 1990. The life insurance market is small, but it is expected to grow with the introduction of new types of products.

30. There has been a major consolidation in the Icelandic insurance market during the recent decades. The number of insurance companies operating in the market has declined from 30 in 1987 to 14 in 2000. During this period, the supervisory framework has also undergone major changes. Before 1994, the supervisory authority had to give prior approval of insurance policies and premiums. New legislation on competition was introduced in 1993, and in 1994 new insurance legislation implementing the EU directives came into force. The financial sector has developed into being more market-based. This has changed the focus of supervision from being largely prescriptive and focusing on product design and pricing into a more prudential approach.

31. The supervisor has a staff of 28 of whom 22 are professional staff. Of the professional staff, five mainly work on insurance supervision.

32. The MIC is responsible for laws and regulation. They also have a large role in licensing and revoking of licenses. This role can be seen as being mostly a formal role.

C. General Preconditions

33. A successful insurance market requires strong and enforceable legal rights, low inflation (unless indexed assets are available), and wide and liquid investment markets. General preconditions include a well-developed public infrastructure such as sound legal, accounting, actuarial, and payments practices. Other important factors are early identification and procedures for efficient resolution of problems in insurance companies, effective market discipline including transparency and corporate governance, and a sound and sustainable macroeconomic environment. In addition, it requires a well-founded supervisory function with a wide range of available responses.

34. There have been major developments in the financial market in Iceland over the last decade toward fulfilling these preconditions. Thus, there is scope for changing the focus of supervision toward a more risk-based focus and focus on corporate governance and risk management and more reliance on the work of professionals, e.g., accountants and actuaries. This process is already under way in the FME and should be encouraged.

D. Main Findings—Summary

35. The FME is an integrated supervisory authority established in January 1999. The insurance legislation in its present form is an implementation of the EU directives. While there have been major changes in the financial sector, including the insurance sector, toward a market-based system, the insurance market is still small and largely a local market. There is scope for changing the focus of supervision toward a more risk-based focus and focus on corporate governance and risk management and more reliance on the work of professionals, e.g., accountants and actuaries. This process is already under way in the FME and should be encouraged.

36. The main findings by category of Core Principle are as follows:

Principle 1: Organization

37. The supervisor is an independent government authority reporting to the minister of the MIC. Its resources and powers need to be expanded. The current level of involvement of the minister in issuing rules appears to be unnecessary. The same applies to the involvement of the minister in the licensing and delicensing process. There may be potential conflicts of interests in the role of the FME as a prudential supervisor and its role in the field of consumer protection with regard to insurance premiums.

Assessment: Largely observed.

Principle 2: Licensing

38. The fact that the minister of the MIC is only involved in the first license, but not in subsequent extensions or changes in the license, is not necessarily logical. The process would be more consistent if the authority to grant both the first license and any subsequent changes to the license, as well as revoking the license, were delegated to the FME.

Assessment: Materially nonobserved.

Principle 3: Changes in control

39. So far, the FME has no written procedure for evaluating the fitness and propriety of the owners of qualifying interests.

Assessment: Observed.

Principle 4: Corporate governance

40. There is a need for further guidance on corporate governance covering key risk management issues such as underwriting, reinsurance, provisioning, and assets. If new standards are introduced, their implementation should be checked during on-site inspections. It may be considered to require the external auditor to certify compliance with the rules in the audit minutes.

Assessment: Materially nonobserved.

Principle 5: Internal controls

41. The FME has the authority to issue rules on internal controls, but has not done so yet. The FME is currently working on a project on internal control and risk management. This project should be given high priority and adjusted to include a stronger focus on insurance. It may be considered to require the external auditor to certify compliance with the rules in the audit minutes.

Assessment: Materially nonobserved.

Principles 6-10: Prudential rules

42. The insurance law and regulations clearly address most of the criteria under the prudential heading. The main area where there is scope for improvement is an introduction of stress testing and the calculation of a risk profile of insurance companies. There is a need for analyzing the consequences of the connectedness in the financial sector on the capital strength of the insurance companies and to give priority to the implementation of rules on intra-group transactions and intra-group loans. The FME may consider evaluating whether the Icelandic insurers' claims and potential claims on their reinsurers are likely to be recoverable, i.e., the security of the reinsurers. The principle on derivatives is not applicable, as Icelandic insurers use no derivatives.

Assessment: Largely observed, except for derivatives.

Principle 11: Market conduct

43. There may be potential conflicts of interests in the role of the FME as a prudential supervisor and its role in the field of consumer protection with regard to insurance premiums.

Assessment: Observed.

Principles 12-14: Monitoring, inspection, and sanctions

44. On site inspections should not mainly be used to monitor and enforce rules and in situations of problems, but also as part of the ordinary supervisory process. This would imply the introduction of a risk-based approach to on site supervisions. In order to facilitate a more risk based focus to off site and on site supervision insurance companies should be required to report more risk based information.

Assessment: Largely observed.

Principle 15: Cross-border operations

45. Within the framework of the system of home country control and the Insurance Act, the FME has sufficient powers and practice to monitor cross-border operations.

Assessment: Observed.

Principles 16-17: Supervisory coordination and cooperation, and confidentiality

46. Within the framework of the system of home country control and the Insurance Act, the FME has sufficient powers and practice to ensure supervisory coordination and cooperation, and confidentiality.

Assessment: Observed.

47. Medium-term challenges for insurance supervision include an adjustment of the off site supervision to include stress testing and the calculation of a risk profile of insurance companies and more use of on-site inspections as part of the ordinary supervisory process. In addition, a number of specific issues need to be dealt with including the introduction of guidelines on corporate governance, focus on risk management and control systems, and requiring auditors to certify the existence and sufficiency of certain internal procedures, risk management, and controls.

Summary of Main Findings	
Subject	Main Findings
Organization of a Supervisory Body (CP 1)	Largely observed. Resources and powers of the FME need to be expanded. Licensing and delicensing should be transferred to the FME.
Licensing and Changes in Control (CPs 2-3)	Materially nonobserved on licensing principle and observed in changes in control principle. Licensing and delicensing should be transferred to the FME.
Corporate Governance (CP 4)	Materially nonobserved. There is a need for further guidance on corporate governance covering key risk management issues such as underwriting, reinsurance, provisioning, and assets.
Internal Controls (CP 5)	Materially nonobserved because the supervisor's practice is not attuned to ongoing enforcement of good management practices.
Prudential Rules (CPs 6-10)	Largely observed except for derivatives. A risk-based approach is also wanting under these criteria.
Market Conduct (CPs 11)	Observed.
Monitoring, Inspection, and Sanctions (CPs 12-14)	Largely observed. On-site inspections should be used as part of the ordinary supervisory process applying a risk-based approach. Insurance companies should be required to report more risk-based information.
Cross-Border Operations (CP 15)	Observed because the EU home country control principle is applied.
Supervisory Coordination and Cooperation, and Confidentiality (CPs 16-17)	Observed.

E. Authorities' Response

48. The assessment of the IAIS core principles was a valuable exercise with an able IMF delegate. Some of the issues the IMF proposes to be mended in the supervision of insurance companies were already being tackled, some are new or were put in a new light during the discussions.

49. There is not a total agreement on all points of the assessment between the IMF and the FME. In particular, the FME objects to the conclusion that principle 2 on licensing is materially nonobserved and considers it to be largely observed.

50. The FME agrees with the main findings of the assessment that more supervisory procedures should be formalized. It should, however, be noted that in the assessment of some of the principles, there is inappropriate importance given to formal predefined procedures, while the small market implies that such lists would themselves be more extensive than to reality encountered in the supervision.

51. The FME is in general agreement with the listing of the recommended next steps, although they differ in importance and matter of urgency. Many of the recommendations are in conformity with the policy formulation of the FME and its working schedule. The FME likes to point out that since the assessment took place, three professional experts have joined the staff and further additions are being prepared.

F. Recommended Next Steps

- Transfer the power to grant and revoke licenses to the FME.
- Adjust the off-site supervision to include stress testing and the calculation of a risk profile of insurance companies.
- Require insurance companies to report risk-based information.
- Use on-site inspections not mainly to monitor and enforce rules and in situations of problems, but also as part of the ordinary supervisory process. Introduce a risk-based approach to on-site inspections.
- Make more resources available to the FME for the operational supervision including on-site supervision.
- Introduce guidelines on corporate governance.
- Adjust the FME project on internal control to include a stronger focus on insurance.
- Consider requiring auditors to certify the existence and sufficiency of certain internal procedures, risk management, and controls.
- Considering the ownership structure of the insurance sector, there appears to be a need for analyzing the consequences of the connectedness on the capital strength of

the insurance companies and to give priority to the implementation of rules on intra-group transactions including intra-group loans.

- Introduce a written procedure for evaluating the fitness and propriety of owners, members of the board of directors, and managing directors.
- Consider the potential conflict of interests between the FME's role as a prudential supervisor and the role in the field of consumer protection with regard to insurance premiums.

III. OBSERVANCE OF IOSCO PRINCIPLES OF SECURITIES REGULATION

A. General

52. This assessment covers the regulation of the securities sector in Iceland. The main objectives of the assessment are to determine levels of observance of the International Organization of Securities Commissions (IOSCO) principles and to suggest areas where further development may be appropriate. Although Iceland is not a member of IOSCO, it has sought to follow the IOSCO principles, including through the Forum of European Securities Commissions (FESCO).

53. This assessment was undertaken as part of a Financial Sector Assessment Program (FSAP) report on Iceland. The assessment was conducted by Paul-Willem van Gerwen, account manager of the Supervision of Markets Department of the Securities Board of the Netherlands. In addition, a review of the securities acts, the Iceland Stock Exchange Annual Report, and other public information was undertaken. Extensive discussions were held with the Financial Supervisory Authority (FME), the Ministry of Industry and Commerce (MIC), the Iceland Stock Exchange (ISE), and market participants.

54. Although not all the updated securities acts were available in English, this did not affect the objectivity or accuracy of the assessment.

55. The assessment is based on the Objectives and Principles of Securities Regulation adopted by IOSCO at its Annual Conference in September 1998. The principles are based on the three fundamental objectives of securities regulation:

- protecting the investors;
- ensuring that markets are fair, efficient, and transparent; and
- reducing systemic risk.

B. Industry Background and Overview

Supervisory framework

56. Founded by a merger of two supervisory authorities, the Bank Inspectorate (a division of the CBI) and the Insurance Supervisory Authority, the FME was established in 1999

through the implementation of the Act on Official Supervision of Financial Operations (Act No. 87/1998). It is an independent state authority and is paid by fees from parties subject to its supervision.

57. The FME's policy is as follows:

- “The FME regulates the activities of parties subject to supervision in a constructive and goal-oriented way and supports the development of efficient and reliable financial operations where the professional internal organization of financial companies is emphasized.”
- “The FME supervises these activities of parties subject to supervision by ensuring that these are in accordance with laws, regulations, rules, and by-laws governing such activities, and that they are in other respects consistent with sound and proper business practices.”
- “Effort is made to create an interesting work environment where emphasis is placed on increasing and maintaining the competence, knowledge, and experience of the employees.”

Market structure

58. Licensed companies in the Securities Business. The MIC has granted a license to six securities companies and four securities brokers to engage in securities-related activities. The activities of securities brokers are limited to acting as an intermediary for a fee in buying and selling shares of securities and to providing investment advice relating to securities transactions. They are permitted to receive funds or securities in their operations from their customers for a short time, provided that this is essential to complete the transaction. Under special circumstances, a securities broker may engage in securities transactions for its own account. At year-end 1999, the total assets of securities companies were ISK 7,700 million and their total income was ISK 2,151 million. The total assets of securities brokers at year-end 1999 were ISK 50.3 million and their income was ISK 11.6 million. The securities companies are obliged to report monthly to the FME with respect to their capital adequacy. Securities brokers are obliged to do so quarterly. Banks are the biggest players in securities markets.

59. Iceland Stock Exchange. Trading on the Iceland Stock Exchange (ISE) is continuous in a computerized, order-driven trading system. This means there is no trading floor, but members operate from their offices. Various types of securities can be traded at the ISE, comprising equities, bonds, housing authority bonds, treasury instruments, money market instruments, and mutual funds, but not derivatives. The ISE's 22 members¹⁵ include the CBI, all commercial banks, securities companies, and some savings banks are members of the ISE. One member is located outside of Iceland.

¹⁵ The figures are as of November 2000.

60. Iceland's stock market has grown dramatically recently. In 1999, market capitalization of the 75 listed companies was ISK 370 billion, while equity turnover, on-exchange and off-exchange, was ISK 120 billion. That same year, the number of listed companies increased from 67 in 1998 to 75, but by November 2000, fell slightly to 74 listed institutions.

61. The main price index for equities (the ICEX-15 index) has increased from 1,097.59 (year-end 1998) to 1,618.36 (year-end 1999), a gain of 47.5 percent. By November 10, 2000, however, the ICEX-15 index had fallen back to 1,375.78, a loss of 15 percent.

62. Trading (turnover) of debt securities decreased in 1999 by 20 percent, although the market value of listed bonds rose by ISK 68 million (from ISK 320 million in 1998 to ISK 388 million in 1999). Debt-trading may have decreased because new rules came into force on liquid assets. Bonds with the highest market value are housing and housing authority bonds (ISK 175 million).

63. The ISE made a profit of ISK 11.5 million in 1999 compared with a profit of ISK 12.4 million in 1998.

64. Collective Investment Schemes. The MIC has granted a license to nine Undertakings for Collective Investment in Transferable Securities (UCITS). These UCITS are obliged to inform the FME quarterly with respect to the funds' assets.

C. General Preconditions

65. IOSCO lists numerous preconditions for effective securities supervision, but perhaps the most critical ones include sound and sustainable macroeconomic policies conducive to investment and savings, enforceable property rights, a supportive political environment free from corruption, a well-developed infrastructure (such as legal and accounting practices, clearing and settlement systems, payment system), and an effective judicial system, as well as corporate governance and insolvency mechanisms.

66. The agency also enumerates several attributes for effective regulation: no unnecessary barriers to entry and exit from markets and products; markets should be open to the widest range of participants who meet specified entry criteria; regulators should consider the impact of requirements when developing policy; and all who make financial commitments or promises must bear an equal regulatory burden.

D. Main Findings—Summary

67. The securities market in Iceland is a relatively small and domestic market. Recently, as a result of Iceland having become a member of NOREX, a cooperative framework for Nordic stock exchanges to operate a joint securities market, more securities firms have shown an interest in securities activities in Iceland. Because of this increased activity, regulators must be prepared to strengthen international cooperation with other supervisors. It is possible that with the NOREX connection, more foreign investors will enter the Iceland stock market, and new products will be introduced. Thus far, the derivatives market in Iceland is small and in practice used only by professional parties.

68. The establishment of the FME in 1999 has provided the market with a clear regulatory environment. On the other hand, the FME appears to lack adequate financial and personal resources to perform its increasing supervisory functions as warranted. Given the current size of the FME (25), it is recommended that the number of staff members be increased so they can perform all its expanded activities, including its supervisory tasks. In addition to the need to increase the number of the staff, a plan for its continued education is being developed. This is a must to keep the staff informed about new developments in the securities business. Consideration could be given to making use of a new course that IOSCO has developed.

69. Although the securities law includes some detailed and rather technical legislation, it would probably be more appropriate and flexible if the Act itself were more general and also included language that would authorize supervisors to issue more detailed instructions in the form of regulations and interpretations. Such a strategy for drafting legislation would be highly desirable, notwithstanding either the fact that amended legislation typically can be passed quickly in Iceland or that the trend is for the courts to demand clear and specific legal grounds for regulations.

Core Principles 1–5: The Regulator

70. The FME is responsible for the supervision of the securities markets and its intermediaries, and has a special department for this supervision. The responsibilities of the FME are stated in Act No. 87/1998 on the official supervision of financial operations and Act No. 13/1996, the Act on Securities Transactions, both of which give the FME the necessary powers to ensure compliance with the securities laws. These powers, which include market surveillance and investigation of violations of the law, require supervised parties to provide the FME with all the information it considers necessary.

71. The agency also is authorized to issue sector-specific regulations in areas that are specifically identified in the law. An example of such an authorization is Article 11 of Act No. 13/1996, concerning the qualifications of employees of a securities firm.

72. The MIC appoints the board members of the FME (Act No. 87/1998). The minister appoints the chairman of the board and decides the remuneration of the members of the board. Based on the same law, the FME must report to the MIC annually on its activities, which subsequently informs the parliament.

73. The MIC grants and revokes licenses to exchanges and intermediaries. In these cases, the FME plays an important advisory role. Because of this arrangement, a good and informal relationship has developed between the FME and the MIC. In most jurisdictions, in contrast, it is the exclusive responsibility of the supervisor to deal with licensing and de-licensing.¹⁶ This means that the FME, in practice, is not fully operationally independent in exercising its powers. It is therefore recommended that full licensing powers be transferred to the FME.

¹⁶ Exceptions are sometimes made in the case of a stock exchange.

74. The ISE approves the listing of issuing companies and has drafted the necessary listing rules. It remains for these rules to be referred to the FME. These rules must be in conformity with a regulation issued by the MIC.
75. Legislation and regulations are public documents and they are available on FME's website. Most of the documents are also available in both Icelandic and English.
76. Because of the relatively small size of the securities market, informal contacts between the FME and the supervised institutions often occur.
77. Decisions made by the FME can be referred to a special Appeals Committee, (Law No. 87/1998). The minister of the MIC appoints this committee, which provides a significant measure of accountability. The treasury meets the costs of this committee.
78. A Complaints Committee was created in the summer of 2000 and is available to customers with complaints in general regarding financial institutions which are members of the committee. The decisions of this committee are binding, unless the parties involved seek judicial remedies to solve the subject matter.
79. The FME is funded by the supervised institutions (Act No. 99/1999 on the Payment of Costs for Public Supervision of Financial Activities).
80. The Act provides guidelines with respect to the internal Code of Conduct of the FME. The Code is in the process of being finalized. It should be implemented soon. There is still a need for the regulations concerning the Code to be issued/approved by the MIC.

Core Principles 6–7: Self-Regulation

81. The ISE, the only licensed stock exchange in Iceland, operates as a self-regulatory organization (Act No. 34/1998) and is supervised by the FME.
82. An institution can only apply for ISE membership if it has a license issued by the FME. In case an application for membership is accepted by the ISE, it must be announced to the FME. Currently, the ISE has 22 members, with one situated outside of Iceland.
83. The ISE is funded by its members with fees paid by the listed companies. Based on the Act, the ISE must forward its annual accounts to the FME, which must be audited by a certified public accountant or audit bureau.
84. The board of directors of the ISE must be of unblemished reputation. All employees are bound by obligations of confidentiality, even after their employment ceases.

Core Principles 8–10: Enforcement of Securities Regulation

85. The FME has the right of access to all documents and information that it may consider necessary for the conduct of its supervision of an institution (Act No. 87/1998 and Act No. 13/1996 (Act on Securities Transactions)). The FME can decide to take some corrective action within a certain time limit, and may apply sanctions in the form of fines in

cases where a supervised institution fails to forward the requested information, or when an institution fails to take corrective action within the time limit. The FME also may perform on-the-spot inspections. The FME has developed a checklist/working program for such checks at supervised institutions.

Core Principles 11–13: Cooperation in Regulation

86. The FME may disclose information to supervisory authorities in other member states of the European Economic Area (EEA) (Article 14 of Act No. 87/1998). This article also authorizes disclosure of information to supervisory authorities outside the EEA. The FME is required to establish procedures for such an information disclosure in a Memorandum of Understanding (MOU) signed by the countries involved. In addition, the Forum of European Securities Commission (FESCO) has developed a multilateral MOU to facilitate sharing of information among member countries, including Iceland. The FME should consider establishing additional MOUs in markets beyond the EEA and FESCO with mutual involvement. The consequences of the growing use of the internet in the securities market would justify additional MOUs. The FME can provide public information to foreign regulators who need such information. However, without an MOU, the FME may share only public information.

87. Within Iceland, the FME and the CBI have established an agreement of cooperation. This agreement fulfills the requirement in Article 15 of Act No. 87/1998.

88. Although Iceland's legal supervisory structure is in relatively good form, there still need to be established an appropriate legal basis for the FME to provide the ISE with the necessary information for the ISE to perform its supervisory duties. It is recommended that this legal basis be created, taking into consideration all the complexities of the relationship between the FME and the ISE mentioned in this report.

Core Principles 14–16: For Issuers

89. The ISE has the power to operate as the competent authority concerning issuing companies (Act No. 34/1998). The ISE is supervised by the FME, which also has direct powers to investigate any issuing institution, although to date, there has been no reason to exercise this right. The Act authorizes the ISE to issue rules. For example, the stock exchange has formulated detailed rules on the listing of securities and on the disclosure requirements for issuers. However, before the ISE approves its rules, it must refer them to the FME for its opinion. At the time of the mission (November 2000), the parliament was discussing an amendment to Act No. 13/1996 which would deal with the powers of the ISE to review a prospectus. In this amendment, review of the prospectus would become the responsibility of the FME. Subsequently, the proposed amendment has been passed.

90. The ISE is also responsible for the ongoing obligations of issuing companies, for example, the compilation of the annual and semi-annual accounts. It seems that the focus of the ISE's supervision is on listed companies. With respect to the ongoing obligations of companies that have issued securities that are not listed over-the-counter (OTC issuers), one of the above-mentioned amendments to Act No. 13/1996 stipulates that the MIC should issue

a regulation regarding public offerings of securities, inter alia, covering ongoing information obligations. The regulation is being finalized and expected to be published shortly. Rules concerning the disclosure of major holdings in listed companies are in force.

Core Principles 17–20: Collective Investment Schemes

91. Act No. 10/1993 on Undertakings for Collective Investment in Transferable Securities (UCITS) provides rules with respect to the UCITS, which have been implemented in Iceland only for UCITS funds. The MIC has established a committee to revise the legislation. That revision will also include coverage of other forms of collective investment that are not supervised now, for example, the equity funds. The discussion has been heavily influenced by the discussions within the European Community concerning UCITS. However, the FME has indicated its intention to suggest revisions to the legislation irrespective of the discussions within the EU, as a means of seeking to accelerate the legislative process.

Core Principles 21–24: Market Intermediaries

92. The MIC approves the application for a license by a market intermediary in consultation with the FME. The FME supervises the ongoing obligations of the licensed companies. An institution has the right to appeal a decision of the FME to the Appeals Committee. Act No. 13/1996 stipulates the requirements for applicants, including detailed requirements concerning initial capital and own funds.

93. Employees of a securities firm that are responsible for the daily management of the company must have passed an entrance examination. Rule No. 1 of the ISE stipulates that members must establish rules and regulations on ethics, both for themselves and for their staff. These guidelines deal with the implementation of a code of conduct for employees of a securities firm. The FME has prepared draft guidelines on personal trading in securities firms and their employees. These guidelines have yet to be issued and will upgrade existing guidelines issued in 1997–1998.

Core Principles 25–30: Secondary Market

94. Because the ISE is subject to supervision by the FME, it fulfills the market surveillance function. Members of ISE are obliged to inform the exchange of any insider trading transactions. The ISE informs the FME about these transactions. The FME has, with respect to possible insider trading or price-manipulation activities, not only the possibility to receive information from supervised institutions but also from unsupervised institutions and natural persons. The FME is now in the process of establishing a market surveillance unit within their authority. The just-completed amendments to Act No. 13/1996 on Securities Transactions strengthened provisions regarding trading of insiders, notification and registration of such trades, and a public register of insiders.

95. The FME supervises the Icelandic Securities Depository Ltd. based on Act No. 131/1997 on the Electronic Registration of Title to Securities.

Summary of Main Findings		
Subject	Assessment	Main Findings
Principles Relating to the Regulator	Partially Implemented	The FME has adequate legislative powers to perform its supervisory activities. However, the Ministry of Commerce grants and revokes licenses, based on the opinion of the FME. It is recommended that the FME be given full licensing authority. The FME needs to publish a code of conduct for its staff.
Principles of Self-Regulation	Implemented	The ISE operates as an SRO and has rule-making powers.
Principles for the Enforcement of Securities Regulation	Implemented	The size of the staff of the FME should be increased.
Principles for Cooperation in Regulation	Partially Implemented	The FME lacks suitable formal legal authority to provide necessary information to the ISE to enable it to carry out its supervisory role. It also lacks information-sharing arrangements with foreign supervisors outside the EEA.
Principles for Issuers	Partially Implemented	The ongoing obligations of OTC-issuers are not supervised. Regulations are being drafted but remain to be issued.
Principles for Collective Investment Schemes	Partially Implemented	Only some types of collective funds are supervised.
Principles for Market Intermediaries	Implemented	Minimum requirements to obtain a license are specified clearly in the legislation. The Deposit and Investors Compensation Scheme provides a minimum level of protection to investors.
Principles for the Secondary Market	Implemented	

E. Authorities' Response

96. According to the assessment of the level of observance of the IOSCO principles, all of the principles are deemed to be fully or partially implemented. The FME welcomes this conclusion and is in general agreement with the assessment made. Many of the issues brought forward are already being tackled, but some are new and put in a new light during the discussions. They also differ in importance. Most of the recommendations are in conformity with the policy formulation of the FME and its working schedule. To this effect, the FME will continue to benefit from the work of the Forum of European Securities Commissions (FESCO), the FME being one of its members.

97. The FME is in the process of establishing more comprehensive market surveillance procedures. Since the assessment took place, the FME has increased the number of its staff by hiring three professional experts, one of them designated to market surveillance. Further additions are being prepared.

98. In the assessment a lacunae in the regulatory framework is identified, regarding other forms of collective investment schemes than UCITS. The FME agrees with this conclusion and has in the past made recommendations to the MIC to that effect.

F. Recommended Next Steps

99. The first recommendation is to increase the number of staff members of the FME to enable them to perform its increasing supervisory responsibilities as warranted. The securities market is experiencing growth, and the further internationalization of the market, underscored by the membership in NOREX, will very likely introduce new financial instruments into the market creating both volume of work and increased complexity for the regulator. The number of new staff for the securities department would be two or three. This has to be accompanied with a plan for continuing education.

100. The MIC is the institution that grants and revokes licenses, with the FME having an advisory role. In most jurisdictions, it is the exclusive responsibility of the supervisor to grant and revoke licenses. It is recommended that the FME receive full licensing authority. This would give the FME the legal authority to take immediate action without the need first to discuss specific issues with the MIC.

101. It is recommended that an appropriate legal basis be established for the FME to provide the ISE with information that it needs to perform its supervisory duties, taking into consideration all the complexities of the relationship between the FME and the ISE.

102. The MIC has set up a committee to revise the legislation concerning collective investment schemes. That revision will include coverage of other forms of collective investment that are not supervised now. It is recommended that the revision of the Act take place soon.

103. The FME and the MIC should move quickly to complete all the necessary steps to publish a code of conduct for the FME staff.

104. Consider giving a supervisor from the FME responsibility for the ongoing obligations of companies that have issued nonlisted securities (OTC). The envisaged new regulations, expected to be issued shortly by the MIC, will likely address this issue.

105. Currently, detailed and rather technical legislation has been incorporated in the Act. However, it would be far more appropriate to incorporate more general legislation in the Act, and also to include language that would authorize supervisors to issue more detailed instructions in the form of regulations and interpretations. Such a strategy for drafting legislation would be highly desirable, notwithstanding either the fact that amended legislation typically can be passed quickly in Iceland or that the trend is for the courts to demand clear and specific legal grounds for regulations.

IV. OBSERVANCE OF CPSS CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS

A. General

106. This assessment pertains specifically to the new Real-Time Gross Settlement System (RTGS) and the net settlement systems Fjölgreiðslumiðlun hf. (FGM), which are both

operated by the Icelandic Bank's Data Center (RB) and which give rise to debits and credits to bank accounts with the CBI. The assessment was made in the context of a Financial Sector Assessment Program (FSAP), and was conducted by Kai Barvell, a payment systems expert from the Monetary and Exchange Affairs Department (MAE), and was based on information provided by the CBI in the form of the Red Book prepared for the BIS, articles in CBI publications, answers to the IMF questionnaire with regard to payment and securities issues. These sources were supplemented by discussions held with officials of the CBI, as well as with officials of the Financial Supervisory Authority (FME), the RB, the Icelandic Securities Depository (ISD), Islandsbanki-FBA, Landsbanki, Bunadarbanki, and VISA.

107. A full assessment was limited by the fact that time did not permit the examination of many of the laws that are relevant to payments, such as Iceland's contract law and bankruptcy law. A second limitation relates to the fact that many of the rules and regulations for the payment system have been agreed upon on an informal basis and those that are in writing are not available in English.

108. The authorities and others were fully cooperative.

109. The principles used in the assessment are the Core Principles for Systemically Important Payment Systems (SIPS), approved by the G-10 central bank governors.

110. The CBI recommended in 1997 that the financial sector should analyze the risks in the payment system and decide how these should be managed. The CBI suggested a strengthening of the legal foundation, opening up of access criteria for taking part in the system, and making the payment system more transparent. The CBI also suggested that the pricing in the system should be based on real cost. A working group, comprising members from the CBI, the Federation of Icelandic Banks (SIV), and the four major banks in Iceland, has presented recommendations on future developments in payment intermediation in Iceland. Following these recommendations a company has been established to operate the payment and settlement system and to provide the EFT-POS system. The purpose of establishing a company was to provide new interested participants with the same possibilities of access to the payment and settlement systems that the current owners of the RB enjoy.

111. The CBI decided December 29, 2000 on New Rules on Access to Settlement Accounts with the CBI (New Rules). These rules deals, among other things, with definitions of payment systems, points to be stated in rules or agreements with participants in payment systems, opening hours, default on payment settlement, settlement delays and collective guarantees for settlement in net settlement systems to be introduced by March 2001. The New Rules, also includes temporary provisions that state that the rules should be reviewed before end of September 2001, when a provision shall be incorporated into them concerning responsibility and completion of any balances which may be outstanding after all the collective guarantees have been drawn upon. Netting system times should also be changed so that settlements are completed on the same day.

112. A new RTGS system started to operate in early December 2000, and all transactions with a value of ISK 100 million and above should be channeled through this system. This amount will, after short period, be lowered to ISK 50 million and it is expected to be lowered even further. In May 2001, the CBI will introduce a collateralized overdraft facility. Initially,

the collateral requirement will 20 percent, but will be gradually increased to reach 100 percent by January 2002. The CBI is considering also to put into force some kind of queuing mechanism to facilitate the payment flow.

B. Institutional Setting and Market Structure

113. The RB has a unique position in the financial market, as it is not only responsible for the operation and development of the new RTGS systems and the multilateral netting system in Iceland, the FGM, but for the major computer systems of all Icelandic banks and the CBI. The three largest banks handle about 75 percent of the payments in Iceland. The use of electronic means for payment purposes is highly developed in Iceland. The use of debit cards has risen substantially while the use of checks has diminished. Deposits and check withdrawals are posted in real time and the account holders have immediate access to available funds. Final settlement, however, occurs in the morning of the next day with value back-dating.

114. The ISD is responsible for the settlement of securities transactions and Iceland has just started to dematerialize securities. The settlement is done on a delivery-versus-payment (DVP) basis and the cash side of a transaction takes place via the netting system directly over the accounts of the central bank. The system is likely to comply with the forthcoming CPSS/IOSCO Recommendations for Securities Settlement Systems. Moreover, transactions outside the Iceland Stock Exchange (ISE) do not settle in the form of DVP.

115. The CBI shall promote smooth, efficient, and secure transfers of payments domestically and cross-border. The CBI is not formally responsible for issuing rules and regulations for the country's payment system. However, it is doing that in cooperation with the commercial banks and savings banks. The reason why the CBI, like most central banks, has assumed this role, is based upon its overall concern for the stability of the payment system and the financial market in Iceland, which is a prerequisite for conducting an effective monetary policy. Another reason is that the final settlement of the banks respective net positions occurs over the participants' accounts with the central bank.

116. It is important to note that the CBI will continue to be the guarantor of settlement in the payment systems for the rest of 2001. The CBI will cease to be the guarantor of the payment system when the banks' borrowing from the CBI is 100 percent collateralized, and they have agreed on a collective guarantee for the settlement in the net settlement system, including responsibility for settlement of any balances outstanding after all collective guarantees have been drawn upon.

117. Although the FME has a supervisory duty for banks and for the ISD, it does not, in practice, exercise any direct supervision over the payment system or take part in discussions about its development.

C. General Preconditions

118. Iceland has a well-developed public infrastructure which supports the financial market. The fact that major participants in the payment systems area uses the computer facilities of the RB facilitates integration between different systems and organizations. The

financial sector is small, which makes it easy for discussion and agreement on various common issues in an informal way. On the other hand, this could also lead to increased exposure to operational risks, especially if it involves oral agreements, which are not followed by written confirmation and information about these agreements to all concerned staff members involved in payment systems activities.

119. The rule of law is well-and long-established in Iceland. Contracts, laws, and rules are relatively efficiently enforceable. The rules governing the payment system has become clearer with the New Rules.

120. The CBI's and the FME's roles in payment and settlement systems are not as fully or clearly developed as in many other developed countries, but efforts are being made to build up a capacity in this field.

121. The transparency concerning the payment system varies. The CBI has, by law, the role to promote smooth, efficient, and secure transfers of payments, but it has not defined clearly its payment systems objectives. The CBI and the FME are discussing to establish a more formal agreement that covers their respective interest in the payment system. Many of the rules covering the payment system have not been published. The CBI publishes some information about the payment system in the Annual Report and in the quarterly Monetary Bulletin.

D. Main Findings—Summary

122. Iceland's observance of the Core Principles is at present mixed, but a number of initiatives have been taken, which indicates that all principles are likely to be observed by the end of 2001. Transfers of funds can be made in real time, including the settlement information about checks. In contrast to most other countries, there does not seem to exist any float in the system. However, the final settlement in the net settlement system occurs the next day. The major problem in the net settlement system is the fact that the system itself does not have any risk management functions. The system has no means of containing risk, nor does it produce any incentive for the banks to limit their risk exposure on the other banks in the system. All of this is based upon the fact that, although the CBI requires collateral for lending to banks, should a bank default the CBI would have to supply the necessary funds. The CBI has publicly stated that an unwinding of payments would be impossible.

123. The new RTGS system, which will handle all large value payments, the creation of a guarantee fund and 100 percent collateralized borrowing from the CBI will solve most of the existing risk management problems in the payment system.

E. Assessments

124. The assessment has been made for the RTGS system and for the FGM.

Principle 1: Well-founded legal basis in all relevant jurisdictions

Assessment: Observed for both RTGS and FGM.

Principle 2: Understanding of the system's impact on risks

125. New agreements as a result of the New Rules, including the collective guarantee fund for the settlement in FGM, have to be finalized. An institution cannot follow its position against other participants in real-time and it cannot stop any incoming payments, which will increase the settlement risk.

Assessment: Materially not observed for RTGS and for FGM.

Principle 3: Procedures for the management of risks

126. Participants do not yet have the mechanisms to monitor their risks in FGM, and lack the incentive to do so as long as the CBI's lending is uncollateralized.

Assessment: Materially not observed for RTGS and for FGM.

Principle 4: Final settlement

127. The RTGS settles immediately when a payment is accepted. The settlement in the FGM does not take place on the same day.

Assessment: Observed for RTGS and not observed for FGM.

Principle 5: Inability to settle by the participant with the largest single settlement obligation

128. FGM does not have full provisions to settle if the largest participant defaults.

Assessment: Not applicable to the RTGS and materially not observed for FGM.

Principle 6: Assets for settlement

129. The system settles in central bank money.

Assessment: Observed for both RTGS and FGM.

Principle 7: Security and operational reliability; and contingency arrangements

130. The systems have adequate provisions to ensure a high degree of security and operational reliability. However, no live testing of the contingency arrangements has taken place.

Assessment: Largely observed for both RTGS and FGM.

Principle 8: Practical for the markets and efficient for the economy

131. The systems seems to be efficiently organized, but it will not meet the efficiency criteria in full as long as the CBI, in practice, guarantees the settlement of the payment system.

Assessment: Largely observed for both the RTGS and FGM.

Principle 9: Objective and publicly disclosed criteria for participation

132. The criteria for participation have not been published.

Assessment: Not observed for both RTGS and FGM.

Principle 10: Governance of the system should be effective, transparent, and accountable

133. According to the Transparency Code, good governance calls for central banks and financial agencies to be accountable, particularly where monetary and financial authorities are granted a high degree of autonomy. The CBI needs to define clearly its payment systems objectives, and make the governance of the payment system more effective so that the system meets all the principles. There is a lack of information to the public about the payment system.

Assessment: Not observed for both RTGS and FGM.

Principle 11: Responsibilities of the Central Bank in Applying the Core Principles with other central bank and relevant domestic or foreign authorities.

Assessment: Not observed.

F. Authorities' Response

134. In 1996 the CBI initiated an effort to enhance certain aspects of the payment systems. The first priority was to accumulate knowledge in this field and disseminate it to the participants in the payments intermediation. Particular emphasis was placed on elaborating on the risks in the payments intermediation process that had increasingly been focussed on in the international forum. The central bank thought to generate a broad consensus on reforming the payment systems and has worked closely with the payment systems participants to ensure that they are fully informed and satisfied with the changes. This has obviously been time consuming, but the process is now well advanced and the central bank expects that the payment systems in Iceland will be compliant with most, if not all, of the Core Principles on Payment Systems by the end of the year 2001. As far as the supervision of the payment systems is concerned, the central bank and the FME have turned their attention to that issue with the aim of clarifying their respective responsibilities.

Summary of Main Findings								
CP	Principle		O 1/	LO 2/	MNO3/	N4/	NA5/	Comments and Corrective Actions
1	Legal foundation	RTGS=R FGM=F	X X					
2	Clear understanding of financial risks	R F			X X			R-Rules have to be published and CBI lending has to be 100% collateralized. F -New agreements including the collective guaranty have to be finalized between the participants. Information about net positions in real time and a possibility for banks to limit their settlement exposure on other banks.
3	Procedures for management of risks	R F			X X			R-Rules have to be published and CBI lending has to be 100% collateralized. F-New agreements have to be finalized between participants Abolishment of the implicit guarantee of settlement by the CBI. Development of risk management tools in the system.
4	Final settlement on the day of value	R F	X				X	F-Decision to change the to settlement time to the day of value is expected before end September 2001.
5	Ensuring settlement in a multilateral net settlement system	R F			X		X	F-Expected to be in place at the end of 2001.
6	Settlement assets – central bank money	R F	X X					
7	High degree of security and operational reliability	R F		X X				Test the contingency arrangements regularly.
8	Practical and efficient for its users	R F		X X				The implicit guarantee of settlement of the CBI is expected to disappear at the end of 2001.
9	Objective and publicly disclosed access criteria	R F					X X	Publish the access criteria
10	Governance	R F					X X	The CBI should define clearly its payment system objectives. Information about the system, including cost performance etc. should be made public. All other 9 principles need to be observed
11	Central bank responsibilities	R F					X X	The CBI should define clearly its payment system objectives. The CBI has to make sure that the payment system complies with all 10 principles. CBI and the FME need to clarify their respective roles in the payment system.

1/ O: Observed.

2/ LO: Largely observed.

3/ MNO: Materially nonobserved

4/ N: Nonobserved.

5/ NA: Not applicable.

G. Recommended Next Steps

- Clarify and disclose the role of the CBI and the FME in relation to overseeing and supervising the payment system.
- Consider giving the CBI an explicit right to issue rules and regulations for the payment and settlement systems.
- Consider making amendments to the legal framework for the payment system concerning the need to include in a law that electronic information can be used as evidence in the court of law.
- Change the settlement procedure for securities transactions, not having been traded at the ISE, so that these transactions settle on a DVP basis.
- Develop necessary features to allow settlement of securities transactions through the RTGS system.
- Change the settlement date in the FGM so that it settles on the day of value.
- Implement as soon as possible all necessary agreements with the payment system participants pursuant to the new “Rules on Access to Settlement Accounts with the Central Bank of Iceland.” This will include drawing up and publishing the rules for the RTGS system; Rules on the FGM Netting System; Agreement on participation in the netting service with the FGM and the CBI payment settlement; Declaration regarding guarantees for the completion of payment settlements in the FGM netting system.
- Prohibit the CBI to lend to banks, except against adequate collateral.
- The authorities should make their payments early in the morning in order to increase the liquidity during the day for payment systems purposes.
- The CBI should decide that all monetary and exchange rate policy operations should be settled through the RTGS system.

V. OBSERVANCE OF TRANSPARENCY PRACTICES OF THE CENTRAL BANK IN MONETARY POLICY

A. General

135. This report assesses the consistency of monetary policy in Iceland with the Good Transparency Practices for Monetary Policy by Central Banks. This assessment was made in the context of an FSAP mission. The assessment was undertaken by William E. Alexander, Assistant Director of the Monetary and Exchange Affairs Department of the IMF, and Frank

Engels, Economist in the European I Department of the IMF, and was based largely on discussions with officials of the CBI, which is responsible for monetary policy, as well as with officials of the Financial Supervisory Authority, Fjármálaeftirlitið (FME). In addition, the assessment drew on the CBI Act No. 36/1986 and on answers prepared by the CBI to questions sent prior to the mission.

136. The Icelandic authorities cooperated fully with the assessment and all required information and documents were provided.

137. The assessment was based on the Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Code) approved by the IMF Executive Board on July 9, 1999, and the supporting document approved by the Executive Board on July 24, 2000. No assessment methodology has been developed yet.

B. Institutional Setting¹⁷

138. Until March 27, 2001, by consensus rather than a clear mandate, monetary policy in Iceland was aimed primarily at achieving a low inflation rate and a stable financial system. For this purpose, the exchange rate—pegged to a trade-weighted basket of currencies with horizontal fluctuation bands of ± 9 percent when the assessment was undertaken¹⁸—served as intermediate target and the interest rate on 14-day maturity repos was the main policy instrument. Other instruments available to the central bank included: bond and money market operations, central bank standing facilities, intervention in the foreign exchange market, reserve requirements, and liquidity requirements, which were introduced in early 1999 and modified on December 31, 1999.

139. In the current system, the central bank is fully accountable for the conduct of monetary policy on the basis of its legislative framework. In this regard, the central bank submits—at a minimum—twice a year to the minister a report on developments and prospects in monetary affairs, matters of balance of payments, and the rate of exchange. However, the existing legislative framework does not guarantee institutional nor operational independence to the central bank. In the event of a significant disagreement with the government on the views on policy in economic affairs and the implementation thereof, the government has the authority to override central bank policy decisions. In practice, the governors discuss monetary policy decisions with the prime minister before they are finalized, and public disclosure is left to the discretion of the governors. The legal basis for

¹⁷ The discussion in this section is based on the existing institutional setting, while acknowledging the important changes announced on March 27, 2001. The new draft Central Bank Act is expected to become law later in the Spring. Until that time, the institutional setting in force is the one being described in this section.

¹⁸ Since liberalization of the capital account in 1995, the central bank has gradually widened the exchange rate bands twice.

the central bank to utilize monetary policy instruments is constrained, as changes in reserve requirements are subject to ministerial concurrence. The government also still retains the legal right to overdraw on its current account with the central bank, but refrains from using it by formal agreement with the CBI.

C. Main Findings—Summary

140. The conduct of monetary policy in Iceland is largely transparent. In practice, the objectives and operations of monetary policy are generally open and transparent; however, gaps between the monetary policy *de jure* and monetary policy *de facto* leave room for improvement in transparency in the following areas: first, the multiple functions of the CBI under the central bank lack internal consistency and clarity with regard to the ultimate objectives of monetary policy; second, lack of clarity of the Central Bank Act (CB Act) regarding the conditions under which governors can be removed from office by the government leaves room for indirect government interference in monetary policy; third, the lack of public disclosure of special agreements between the minister of finance and the central bank affects transparency adversely; and fourth, the absence of legislative specification of the use of the override policies by the government and public disclosure thereof weakens the independence of the central bank. A review and subsequent modification of the legislative framework of the central bank along the above lines would lay the basis for a substantial increase in the transparency of the framework for monetary policy.

Principle 1: Clarity of Roles, Responsibilities and Objectives

141. The conduct of monetary policy in Iceland can be judged as largely transparent. However, gaps between the responsibilities and objectives of policy *de jure* and *de facto* leave room to enhance transparency in several areas. First, the extensive list of policy objectives set out in the CB Act is not necessarily consistent internally, and lacks an explicit specification of the ultimate objective of monetary policy. For instance, repeated interventions in the foreign exchange market aimed at stabilizing the exchange rate of the domestic currency so as to contain inflationary (or deflationary) pressures stemming from exchange rate volatility could raise the perception among the public that exchange rate stability as opposed to price stability was the main objective of monetary policy. In practice, however, consensus on the principal policy objectives of monetary policy has emerged gradually in Iceland, as the CBI has repeatedly stated in public that the achievement of a low inflation rate and a stable financial system is the principal objective of its policy. Although the effectiveness of monetary policy does not seem to have been critically undermined by the lack of legal specificity in Iceland, a resolution of the principal objectives of the central bank's policy would improve transparency. It also would enhance the credibility of the central bank's commitment to achieving its policy objectives.

142. Second, the legislative framework for the conduct of monetary policy clearly lacks explicit restrictions and public disclosure on the use of the override policies by the government. The present CB Act leaves the disclosure of the use of the override policy by the government to the discretion of the governors of the central bank. Therefore, in achieving enhanced transparency in the conduct of monetary policy, it would be desirable to specify a

maximum period of time within which public disclosure must occur. It also would be transparency-enhancing to require the government to publicly disclose the underlying reasons for the disagreement with the governors on economic policy and the implementation thereof.

143. Third, the need for government approval for utilization of some of the monetary policy instruments (notably reserve requirements) is likely to diminish the transparency and effectiveness of policy implementation; the latter, in turn, results in a weakening of the central bank's accountability.

144. Finally, as to the potential dismissal of governors, the legislative framework contains no specification of the reasons for a dismissal. The law states only that the minister may dismiss a governor, after having had the opinion of the board of directors. In practice, the board of directors likely would send a letter of dismissal specifying the grounds of removal to the minister. While this may provide significant protection against arbitrary or capricious removal, the board of directors may exercise wide discretion with regard to reasons for recommending removal of governors. It is also unclear whether conviction by a court is required before a governor may be deemed to have committed an offense. This lack of clarity with regard to the legal provisions for the removal of the head and the governing body of the central bank provides scope for indirect government interference in monetary policy and thus reduces transparency.

145. On March 27, 2001, a new draft Central Bank Act was made public and is expected to receive Parliamentary approval by late Spring. It noticeably strengthens the clarity of roles, responsibilities, and objectives of monetary policy. In particular, the new draft Central Bank Act defines price stability as the main objective of monetary policy. The CBI will have full operational independence ("instrument" independence) to achieve the price stability objective, which, by agreement with the Prime Minister, may be specified as a numerical target for inflation. There will no longer be a provision for a government override of the CBI's monetary policy decisions. The CBI will not be permitted to make loans to the government, although it will be permitted to purchase government securities in the secondary market for monetary policy purposes. The new draft Central Bank Act does not provide a basis for the removal of a governor.

Assessment: Largely observed. To be fully observed when the new draft Central Bank Act becomes law.

Principle 2: Open Process for Formulating and Reporting Monetary Policy Decisions

146. The formulation and reporting of monetary policy decisions is open and transparent. As the CBI does not have a monetary policy committee as such, the decision-making power for monetary policy is vested in the board of governors, which is composed of three governors. The board of governors meets more or less daily and takes monetary policy decisions when circumstances warrant. Changes to monetary policy are publicly announced by simultaneous issuance of a press release and disclosure on the central bank's website at close of business of the same day. The monetary instruments and targets used to pursue the monetary policy objectives and the legislative framework are explained and disclosed in the

regular publications of the central bank, including the quarterly Monetary Bulletin which also contains biannual reports on issues on the financial system, as well as a model-based inflation forecast. The central bank's main assumptions behind the forecast are also stated. The regulations of monetary operations are publicly disclosed, and the settings of monetary policy instruments and operations are reported monthly on the central bank's website. However, regulations on the publication of data provided by financial institutions are not publicly disclosed.

Assessment: Observed.

Principle 3: Public Availability of Information on Monetary Policy

147. In addition to its quarterly Monetary Bulletin, the CBI makes available a wide array of high-quality information in different media. Iceland subscribes to the IMF's Special Data Dissemination Standards (SDDS), and according to the IMF's Observance and Transition Plan, and the central bank meets the SDDS specifications on financial sector and external sector data, except for the data on the International Investment Position (IIP) where Iceland has made use of the SDDS' flexibility.¹⁹ The central bank's balance sheet is publicly disclosed on a monthly basis in the Government Gazette and the central bank's website, supplemented with a short description of main changes. Information on the foreign exchange reserves assets, liabilities, and commitments by the central bank is published monthly in a press release. Financial statistics are publicly disclosed on the central bank's website with a one-month time lag and on a preannounced schedule, which is accessible on the central bank's website. Daily quotations are published for both interbank rates and the exchange rates of major trading partners. Daily quotations of the trade-weighted official exchange rate index are published daily on the central bank web site. Press releases addressing monetary policy and financial issues are issued regularly and the governors and relevant senior staff appear regularly in the media and before the various public authorities to elaborate on the policies of the central bank. As to the lender-of-last-resort powers of the central bank, the CB Act is silent regarding lender-of-last-resort lending powers, and the CBI has not stated publicly whether or not it would, in principle, be prepared to be a lender-of-last resort. Therefore, there is no policy on disclosure in place.

Assessment: Observed.

Principle 4: Accountability and Assurances of Integrity by the Central Bank

148. The transparency of accountability and integrity by central bank officials is good. The governors and senior central bank staff are always prepared—though not legally obliged—to appear before a designated public authority to report on the conduct of monetary policy. The

¹⁹ The coverage of the IIP statistics will be brought into observance of the SDDS and will comply fully with the methodology and standards of the fifth edition of the IMF's balance of payments manual no later than June 30, 2002.

accounts of the central bank are audited by an internal auditor appointed by the board of directors of the bank, the state auditor general and an independent external auditor appointed by the minister. The accounts are disclosed in the annual report, which is publicly available on the website of the central bank. Standards for the conduct of personal financial affairs and rules to prevent exploitation of conflicts of interest are in place. However, these rules have not been publicly disclosed so far.

Assessment: Observed.

Summary of Main Findings		
Section	Assessment	Comments
Clarity of Roles, Responsibilities, and Objectives of Monetary Policy	Largely observed	Lack of transparency arises from lack of internal consistency and clarity in the legislative framework regarding the policy objectives of the central bank. However, the central bank has compensated for this lack of clarity through careful and repeated publicly disclosed explanations of its principal policy objectives. Lack of transparency also arises from a lack of (i) explicit restrictions and public disclosure on the use of the override policies by the government and (ii) specificity concerning reasons for the removal of governors. Special agreements between the minister of finance and the central bank on credits, advances, or overdrafts to the government and on current accounts and interest terms for primary debt issues and secondary market arrangements have not been publicly disclosed. However, the authorities' intention to do so in the near future would significantly enhance transparency.
Open Process for Formulating and Reporting Monetary Policy Decisions	Observed	Regulations on the publication of data by financial institutions are not publicly disclosed.
Public Availability of Information on Monetary Policy	Observed	Data on the International Investment Position do not yet meet the IMF's dissemination standards.
Accountability and Assurances of Integrity by the Central Bank	Observed	The rules to prevent exploitation of conflicts of interest have not been publicly disclosed.

D. Authorities' Response

149. In recent years, the CBI has placed increasing emphasis on openness and transparency. In that effort, it reorganized its publications so as to be able to frequently report its assessment of the economic and monetary situation and trends as well as to explain its conduct of monetary policy. Coverage of other activities of the bank has also been significantly expanded, particularly in the Annual Report of the Bank. The bank therefore welcomes the conclusion of the IMF that "the practice of monetary policy in Iceland can be regarded as open and transparent." In the section on *Clarity of Roles, Responsibilities, and Policy Objectives of Monetary Policy*, it is noted that lack of transparency arises from a lack

of internal consistency and clarity in the legislative framework regarding the policy objectives of the central bank. In this connection, it should be noted that the current Central Bank Act, which dates back to the mid-1980s, is presently under review. The clarity of the legislative framework is likely to be substantially enhanced in a new Central Bank Act.

E. Recommended Next Steps

150. Notwithstanding shortcomings with respect to transparency standards in the legislative framework for monetary policy, the practice of monetary policy in Iceland can be regarded as open and transparent. However, the mission encourages the authorities to revise the present CB Act in the near future to address shortcomings and to further enhance the transparency in the conduct of monetary policy in Iceland.

151. Potential conflicts between the policy objectives on exchange rate and price stability could be removed, if the CB Act defined the achievement of a low inflation rate and a stable financial system as the principal objective of monetary policy. This would not only add clarity to the legislative framework but also increase the internal consistency of the list of policy objectives presently contained in the CB Act.

152. As to the override clause of the government, disclosure of significant disagreements that leads the government to override central bank policy decisions should become mandatory; and the venue for disclosure should be specified (e.g., the Government Gazette and the central bank's website). It would be desirable also to specify a maximum period of time within which disclosure must occur. Moreover, the government should be required to explain the reasons for the disagreement with the governors. In some countries, provision is made for parliamentary debate on any use of override powers.

153. The present legislation allows for the use of wide discretion with regard to reasons for recommending the removal of a governor. In this context, the CB Act could usefully specify potential reasons that could lead to the dismissal of a governor. It should be clarified also whether conviction by a court is required before a governor may be deemed to have committed an offense.

154. Special agreements that refer to the relationship between the central bank and the minister of finance concerning credits, advances, or overdrafts to the government, as well as on current accounts and interest terms for primary debt issues and secondary market, arrangements should be publicly disclosed. The authorities' intention to do so in the near future would enhance transparency.

VI. OBSERVANCE OF TRANSPARENCY PRACTICES OF THE FINANCIAL SUPERVISORY AUTHORITY IN FINANCIAL POLICIES

A. General

155. This report assesses the consistency of financial policy in Iceland with the Good Transparency Practices for Financial Policy by Financial Supervisory Authorities. This assessment was undertaken in the context of an FSAP mission. The assessment was conducted by Frank Engels, Economist in the European I Department of the IMF, under the supervision of William E. Alexander, Assistant Director of the Monetary and Exchange Affairs Department of the IMF. It was based largely on discussions with officials of the Financial Supervisory Authority of Iceland, Fjármálaeftirlitið (FME) and the CBI as appropriate (e.g., with regard to the oversight of the payment system). In addition, the assessment drew on the Act No. 87/1998 on Official Supervision of Financial Operations (OSCO Act) and on answers prepared by the FME to questions sent prior to the mission.

156. The Icelandic authorities cooperated fully with the assessment and all required information and documents were provided.

157. The assessment was based on the Code of Good Practices on Transparency in Monetary and Financial Policies (MFP Code) approved by the Executive Board of the IMF on July 9, 1999, and the supporting document approved by the Executive Board on July 24, 2000. No assessment methodology has been developed yet. The assessment does not cover the Icelandic private deposit insurance fund.

B. Institutional Setting

158. The FME is the sole financial agency in Iceland which is in charge of supervision of the financial system, except for the oversight and maintenance of operations of the payment system, which is conducted by the CBI. The FME was founded in January 1999 by a merger of the Bank Inspectorate—a former division in the CBI—and the Insurance Supervisory Authority. The FME is an independent state authority and has its own board, whose members are appointed by the Minister of Industry and Commerce (MIC). The FME is accountable to the MIC and the parliament. Rules and regulations containing provisions on the activities of the FME are issued by the minister. At present, the FME consists of 28 staff, 22 of whom are professional experts in the area of financial policies and supervision.

159. The operations and activities of the FME are based on a matrix organization, i.e., public relations, supervisory operations, and data collection and management are administered in groups and task forces of supervisory staff across the different sectors of the financial system. The financial system is broken down into loan markets (commercial banks, savings banks, and other credit institutions), securities markets (stock exchanges and other regulated markets, undertakings engaged in securities services), insurance markets (insurance companies and individuals acting as insurance brokers), pension funds, and other institutions (housing bond division of the housing financing fund, central securities depositories, quota exchange, new business venture fund, postal gyro, and cooperative societies).

160. Parties subject to supervision have to pay fees for supervision. These fees finance the operations of the FME. They can also refer decisions of the FME regarding their rights and responsibilities to a special Appeals Committee.²⁰ At the administrative level, rulings of this committee are final and cannot be referred to the MIC. The MIC has licensing authorities in the banking, insurance, and securities sectors, whereas the Ministry of Finance (MOF) provides licenses for pension funds. In any event, the ministries' decision whether or not to provide and/or revoke a license for a financial institution is based on recommendations provided by the FME. A consultative committee composed of representatives from the supervised financial institutions participates in discussions regarding the FME's budget.

C. Main Findings—Summary

161. The conduct of financial policies in Iceland can be assessed as largely transparent, given that most of the objectives and operations of financial policies carried out by financial agencies are generally open and transparent. However, both the current legislation as well as the conduct of financial policies exhibit the following weaknesses with regard to transparency. First, the role and relationship between the two financial agencies which conduct financial policies in Iceland, namely the FME and the CBI, lack sufficient specificity, in particular with regard to the supervision and oversight of the payment system. At present, information about the FME's role in supervising the activities of the institutions that are an integral part of the payment system is virtually nonexistent. Moreover, the legislation lacks a specific provision for the supervision of those institutions, which are part of the payment system.²¹ Also, rules and regulation regarding the oversight and maintenance of the payment system by the CBI and the Banking Data Center (RB), respectively, have not been formulated. Second, with respect to the openness of the formulation and reporting of financial policies, most principles are fully observed. However, the transparency of the legislative framework with regard to the supervisory power of the FME in the area of the housing funds and other institutions that are subject to supervision by the FME should be improved, as it is presently not clear how the FME (i) formulates its policies with regard to the supervision of these institutions and (ii) reports about its activities in these areas. Third, while nearly all principles on the public availability of information on financial policies are observed, current data collection procedures and data analysis tools lack a sufficient focus on the report of risk-based aggregate indicators by each sector of the financial system and could be issued more frequently. Fourth, while the FME publishes consultative papers on its website in order to summarize conclusions of its consultations with financial institutions, specific regulations issued by the MIC that would set out specific provisions on the role,

²⁰ This provision also holds for other parties that have a case in that regard.

²¹ At present, the OSFO Act only *explicitly* defines the supervision of central securities deposits as an area of responsibility of the FME. All other institutions that are part of the payment system are either *implicitly* contained in Items 1–9 or Item 10 of Article 2.1 of the OSFO.

relationship, and composition of the consultative committee of parties subject to supervision are not yet in force, but are expected to be published shortly.

Principle 5: Clarity of Roles, Responsibilities, and Objectives of Financial Agencies responsible for Financial Policies

162. The broad objectives of financial agencies responsible for financial policies are set out in the OSCO Act and aim to promote compliance of financial institutions with the laws, regulations, rules, and by-laws governing their financial operations so as to ensure that financial institutions adhere to sound and proper business practices. The FME strives to regulate the activities of parties subject to official supervision in a constructive and goal-oriented way in order to support the development of an efficient and reliable financial system. These objectives are applied by the FME in its oversight of each sector of the financial system in accordance with its legislative framework and are publicly disclosed. The roles and responsibilities of the financial agencies are enumerated in the OSCO Act and apply across all sectors of the financial system, which are subject to supervision by the FME. The responsibilities include to: (i) supervise financial institutions; (ii) advise the management of financial institutions in case of problems; (iii) monitor and evaluate system-wide and Sectoral events that may have an adverse impact on the financial condition of institutions subject to supervision; (iv) promote adoption of policies and procedures to control and manage risks; and (v) promote a frequent and open communication with all institutions subject to supervision.

163. The governance framework of the FME for the financial system is transparent, as the supervision of all financial sectors except for most parts of the payment system is embedded in the legislation of the FME. However, with regard to the payment system, neither the OSCO Act nor the Central Bank Act (CB Act) or the existing cooperation agreement between these two financial agencies provides a clear delineation of responsibilities on this matter. The CBI is in charge of the maintenance and oversight of the payment system on the basis of CB Act No. 36/1986, whereas the legislation of the FME defines supervision of the central securities depositories (CSD) and all other financial institutions which are authorized by law to receive deposits and, therefore, also are a component of the payment system, as part of the supervisory authority of the FME. While a special cooperation agreement between the FME and the CBI sets out guiding principles of the information exchange and cooperation between the two institutions, it does not provide explicit guidance on the delineation of supervision and oversight of payment system between the FME and the CBI.

164. At present, regulations to be issued by the MIC on the role and responsibility of the consultative committee of parties subject to supervision also are not yet in force and publicly disclosed, which leads to a lack of transparency as concerns the relationship of the FME with parties that are subject to supervision. However, it is envisaged that these regulations be published shortly.

Assessment: Largely observed

Principle 6: Open Process for Formulating and Reporting of Financial Policies

165. The conduct of financial policies is transparent, as the OSCO Act defines most of the activities of the financial system clearly and the FME reports once a year on its activities and expenses to the MIC, who then submits the report to parliament. In addition, the FME publishes its Annual Report in the fall of each year, including a summary of its operations as well as information on amendments in the legislative framework. As to confidentiality considerations, the OSCO Act contains detailed provisions on the obligations for FME staff to observe secrecy in the conduct of its supervisory activities. Modifications in the legislative framework are based on a broad consultative process between financial institutions, financial agencies, and the relevant ministry. The FME issues consultative papers, which summarize the conclusions of the consultations with financial institutions on its homepage. For instance, draft guidelines concerning limitations on the extent to which financial obligations or shares could be held from parties that are subject to supervision, were disclosed on the website of the FME in July 2000. Legislative changes as well as modifications of rules and regulations are publicly announced in the Government Gazette and the website of the FME; changes in guidelines issued by the FME are also disclosed on the website of the FME.

166. The FME issues an Annual Report, providing a detailed assessment of how its strategic objectives are being met. Its views on future prospects for the financial system, broken down by each sector, and an overview with respect to recent legislative changes in the financial system are also included. This report is publicly disclosed on the website of the FME and presented to the public at the annual meeting. Reflecting the provisions with regard to information-sharing between financial institutions and financial agencies, the FME also publishes annual accounts of insurance companies, banks and credit institutions, pension funds, undertakings in securities markets, and UCITS. These publications also contain aggregate market indicators. The director general of the FME elaborates in the context of public speeches and press statements on the Annual Report of the FME.

167. The openness in the formulation and report of financial policies could, however, be improved further with regard to rules and regulations on the supervisory power of the FME in the area of the housing fund authority and other institutions that are subject to supervision by the FME. At present, it is not clear how the FME (i) formulates its policies with regard to the supervision of these institutions and (ii) reports about its activities in these areas.

Assessment: Observed.

Principle 7: Public Availability of Information on Financial Policies

168. The FME issues an Annual Report, which contains all major regulatory issues affecting the areas of the financial system that are subject to supervision by the FME, a summarized assessment of recent developments and trends, as well as future prospects by sector. The annual accounts for each sector of the financial system summarize the financial statements of both individual parties of a financial sector subject to supervision, as well as aggregate indicators for the sector. Both reports are publicly disclosed. In accordance with the confidentiality requirements embedded in the legislative framework of the FME,

aggregate, as well as published institution-specific data on the operations of financial institutions, are circulated on an annual basis in the reports on annual accounts for each financial sector. In addition, aggregate data on financial institutions are also published by the CBI in the quarterly Monetary Bulletin and the biannual report The Economy of Iceland.

169. However, the FME should increasingly focus on the collection of risk-based data collection and adjust its data management appropriately. The FME could also disseminate such aggregate data more frequently through their website, particular in cases where financial institutions are required to report selected aggregate financial and operational data on a monthly or quarterly basis to the financial agencies.

170. Deposit insurance and investor compensation schemes are in place for depositors in commercial and savings banks and for customers engaging in securities trading pursuant in law. Information on the nature and form of this protection scheme, operations procedures, and on the financing of the scheme is publicly disclosed. However, information on the performance of these arrangements is not yet publicly disclosed.

Assessment: Observed.

Principle 8: Accountability and Assurances of Integrity by Financial Agencies

171. The director general of the FME is readily available to explain the FME's objectives, the legislative framework for the conduct of supervision, and the performance of the FME, and to exchange views on financial policies and on the state of the financial system. There is no prespecified regular schedule of any such appearances. However, the FME is obliged to report on its activities and expenses on an annual basis to the MIC, which then passes these to the parliament. Standards for the conduct of personal financial affairs and rules to prevent exploitation of conflicts of interest are being set up. However, these rules need yet to be publicly disclosed.

Assessment: Observed.

D. Authorities' Response

172. The FME welcomes the conclusion of the IMF that the "conduct of financial policies in Iceland can be assessed as largely transparent" and "operations of financial policies carried out by financial agencies are generally open and transparent." The FME has placed emphasis on enhancing the transparency in its operations, so as to strengthen public awareness and the integrity of the market. To this effect, the FME publishes annual reports and operates a website. The FME will continue to strengthen this part of its operations.

173. The FME agrees with the need to clarify the division of duties between the FME and the CBI in relation to the responsibilities towards the payment system. The authorities have already turned their attention to this issue. The IMF notes the lack of specific rules and regulations. These regulations are due to be published in the spring.

Summary of Main Findings		
Section	Assessment	Comments
Clarity of Roles, Responsibilities, and Objectives of Financial Policies	Largely observed	Lack of transparency arises from (i) a lack of specific rules and regulations on the role and relationship of the consultative committee of parties that are subject to supervision and, therefore, on the consultative process between the FME and the financial institutions subject to supervision by the FME; and (ii) the fact that neither the existing cooperation agreement between the FME and the CBI, nor the legislative framework provides a clear delineation of responsibilities of the financial agencies as regards the supervision and oversight of the payment system. Given the complexity that is required for a well-established supervision and oversight of the different institutions involved in the payment system, clear rules and responsibilities of the FME and the CBI and all related institutions, which are part of the payment system, are essential to ensure transparency in the conduct of financial policies in this area. These provisions are not yet in place. However, on December 29, 2000, the CBI has set "Rules on Access to Settlement Accounts with the Central Bank of Iceland," which include provisions with respect to the establishment of risk control systems with financial institutions that participate in the payment system.
Open Process for Formulating and Reporting Financial Policies	Observed	At present, the legislative framework does not provide specific definitions with regard to the FME's role and conduct of supervision of the payment system, the housing bonds division of the housing fund authority, and other financial institutions subject to supervision by the FME.
Public Availability of Information on Financial Policies	Observed	An increased focus of data management and data collection on risk-based aggregate financial sector indicators would enhance transparency. The FME should also disseminate aggregate data more frequently, possibly through their website, particularly in cases where financial institutions are required to report selected aggregate financial and operational data on a monthly or quarterly basis to the financial agencies. Furthermore, information on the financial condition of client asset protection and deposit insurance schemes are not yet publicly disclosed.
Accountability and Assurances of Integrity by Financial Agencies	Observed	The rules to prevent exploitation of conflicts of interest have not yet been publicly disclosed.

E. Recommended Next Steps

174. Notwithstanding some shortcomings with respect to transparency standards in the legislative framework for financial policies, the practice of financial policies conducted by the FME can be regarded as open and transparent. However, the mission encourages the Icelandic authorities to revise the present legislative framework of the FME (OSFO Act) and, if necessary, those of the financial sectors in the near future so as to address the shortcomings and further enhance the transparency in the conduct of financial policies in Iceland.

175. The relationship between the CBI and the FME with regard to the oversight and supervision of the payment system in Iceland should be explicitly defined and formally implemented as part of the general cooperation agreement that came into effect on June 30, 2000. As to the role of the CBI, the relationship to the RB should be set out in detail and publicly disclosed. In cooperation with the financial institutions and the RB, the central bank should establish rules on information-sharing and reporting guidelines between the RB and the financial agencies in order to increase the accountability of the RB and improve the transparency of its operations in the payment system. These rules should be publicly disclosed in the Government Gazette and the central bank's website. In the event of a review of the CB Act, para. 3 of Article 3 could be usefully modified to clarify the role of the CBI in that regard. The CBI should intensify also its discussions with market participants about the draft rules on access to settlement accounts with the central bank, as these rules would provide for an establishment of risk control measures at financial institutions that are involved in the payment system. As to the role of the FME, its main task should be in the area of institution-based supervision of the payment system, i.e., to control whether the respective institutions are capable of implementing and maintaining all technical and organizational requirements that are necessary to ensure the smooth operation of the payment system. The FME should report this information on a regular basis to the CBI, which is responsible for the oversight of the payment system. In any event, Article 2.1 of the OSFO Act should explicitly include a line item on the payment system as an activity to be supervised by the FME.

176. At present, there are no specific rules defined with regard to the relationship of the FME with parties that are subject to supervision, including provisions on limitations on the extent to which financial obligations or shares may be held toward these parties. It would increase transparency in the conduct of financial policies, if the MIC set out and publicly disclosed such rules. In that regard, it would also enhance transparency of the process of policy formulation on financial policies in Iceland, if there were publicly disclosed regulations set up by the MIC, which defined the role, composition, and tasks of the consultative committee of parties subject to supervision. All these regulations are expected to be published by the MIC shortly.

177. With regard to the public availability of information on financial policies, the FME could further improve its data collection and data management practices mainly by focusing increasingly on risk-based indicators that would allow for information on the stability of the financial system by each sector. In a second step, this data should be disclosed on a more

frequent basis (e.g., as pension funds are obliged to report quarterly financial indicators to the FME, this information should be publicly available—possibly through the website of the FME—on a quarterly basis). This would enhance transparency as more comprehensive information on the recent status and degree of stability of the financial system would be available to the public.

178. Both the legislative framework of the FME and the process for formulating, conducting, and reporting financial policies currently applied by the FME should attach more attention to the so-called ‘other financial institutions’ (OSFO Act, Item 10 of Article 2.1; and Article 2.2); particularly with regard to the housing bonds division of the housing fund authority. The FME could usefully disclose information on its supervision of the activities of these institutions, including the rules and/or regulations this supervision is based on so as to enhance transparency in the conduct of financial policies in this area. Information on the supervisory activities for these institutions could also be contained in the Annual Report of the FME.