Appendix 2 Responses to the IMF Mission's Financial System Stability Assessment

An IMF mission visited Iceland to meet government officials from March 18-27 for briefings on the Icelandic economy. At its final meeting, the leader of the mission presented an opinion and results of its discussions and studies in Iceland. Two members of the mission were assigned the task of assessing financial stability risk factors. The mission's opinion included remarks on financial stability, which are presented here together with responses to them.

IMF remark	*Item*	*Response*
Inflation remains high, posing risks to macroeconomic stability.	3	Macroeconomic stability is important for financial stability. The Central Bank's target of bringing down inflation must be firmly followed through. Results, in that respect, enhance both macroeconomic and financial stability.
Repos (with the Central Bank) are replacing to a significant extent regular sources of bank financing. Repos are distorting activity in the money markets. Repos may be creating incentives to increase risk and short-term exposures. The authorities [should] consider reforming the repo facility. Indication of an excessively low policy rate.	8	Growth in repo transactions is largely explained by inflows of krónur to the Central Bank due to intervention in the forex market, changes in the treasury position and an increase in the required reserve, partly as a result of the weakening of the króna. Owing to their high dependence on the Central Bank for liquidity, the banks must respond to changes in its policy rate. If price is not fixed, then volume would need to be. That calls for greater quality of liquidity forecasts, otherwise there is a risk that policy rates would be too volatile and the market would miss what the Central Bank was signalling through the interest rate. The advantage of that method is that a correct liquidity forecast would relay signals about the state of the market back to the Central Bank, in the form of interest rates. Liquidity mediation between credit institutions seems to be restricted by tight lending limits, which are presumably based mainly on risk assessment but could also be partly determined by competitive viewpoints. Access to securities that qualify as collateral also appears to hinder such transactions, at least for certain institutions. Part of the repo contracts are now used to finance derivative trading where the risk is very low but the possibility of other types of funding is limited, because of the immaturity of the Icelandic market and its small size. Restrictions on possibilities for repo transactions now would probably lead to a tightening of liquidity in circulation and thereby slow down the recently started reduction in interbank interest rates.
Savings banks reported less favourable results [than commercial banks] as they suffered greater loan losses and were slower in consolidating costs.	10	The crucial point for financial stability is that the systemically most important institutions are secure. Nonetheless, there are grounds for monitoring smaller institutions closely. They need to be encouraged to consolidate costs, incorporate themselves into limited liability companies, boost their own funds where appropriate and be alert to risk management. The Financial Supervisory Authority (FSA) moni-

IMF remark	*Item*	*Response*
		tors each institution closely on an individual basis. The Central Bank keeps a particular watch on their liquidity positions.
Non-performing loans increased substantially in 2001 reflecting the downturn in domestic demand on the consumer, retail and other non-exporting sectors.	10	Defaults by individuals and businesses increased substantially in 2001. The main cause was a downturn in demand, but presumably also excessive credit growth in recent years. There are grounds for analysing defaults and their causes, and classifying them better. Defaults are still much lower than they were in the first half of the last decade.
Banks increased provisions, but provisioning standards remain weak compared to international best practices.	10	FSA Rules no. 692/2001 on the Annual Accounts of Credit Institutions contain prescriptions (in Art. 57 and Appendix I) on provisions for credit losses. These rules grant credit institutions some scope in assessing their need for provisioning. Experience shows a positive correlation between provisions to accounts for loan losses and credit institutions' profits, but provisioning decisions ought to be independent of probable profitability. Requirements concerning assessments of the need for loss provisions could be clarified. Iceland follows similar rules to those applying in the other Nordic countries.
Loan portfolio credit quality is expected to deteriorate again in 2002 reflecting the decline in economic activity.	11	Portfolio quality can generally be expected to show some deterioration this year, with an increase in defaults to some extent. The impact of economic activity on the scope and timing of these factors is uncertain, while settlements of loan losses always appear in the credit institutions' accounts with some lag.
Monitoring of collateral values and associated provisions will be necessary, particularly in view of the ongoing decline in inflation-adjusted real estate prices.	11	Caution needs to be exercised in collateral valuation, especially for business premises.
Securities lending by pension funds may generate unmonitored credit risk exposures. Securities lending to related financial entities increases connectedness and could generate moral hazard conflicts that may hamper proper internal controls.	11	The FSA is examining the scope of these transactions. Insofar as the credit risk is transferred from institutions to pension funds, they improve financial stability, notwithstanding other and perhaps undesirable effects. The second point underlines the priority that must be given to establishing Chinese walls in the activities of finance companies.
The combination of inflation and declining real housing values, if sustained, may pose risks to	12	This remark is self-evident, but in order for problems to arise, a reduction in disposable income must also be assumed.

IMF remark	Item	Response
the Housing Fund Authority and pension funds in the medium term, as the servicing burden of indexed mortgages and other debt increases.		
Recommends tightening minimum standards for loan classification. Recommends tightening minimum standards for collateral valuation. Recommends more frequent on-site examinations. Recommends careful monitoring of rapidly growing securities lending.	12	These remarks echo the FSSA published in June 2001. FSA Rules no. 693/2000 on the Solvency Ratio of Credit Institutions and Undertakings Engaged in Securities Services stipulate risk categories for lending. These rules are based on EEA rules. Rules on collateral valuation could be clarified. There are grounds for examining rules in force in other countries. FSA is examining the scope of securities lending and the companies involved. This will answer conjectures about links between securities borrowers and lenders, and whether these raise the risk profile. The risk posed to financial stability both by liquidity funding and systemic shocks that could lead to a slump in securities prices needs to be examined.
Recommends careful monitoring of investment banking operations.	12	Investment bank activities are inherently riskier than those of commercial banks or savings banks.
Prompt enactment and implementation of pending financial legislation should be considered a priority, as these laws will allow: • integrated supervision of increasingly linked financial activities. • consolidated supervision of connected groups.	12	The Banking Legislation Committee is engaged in a review of banking legislation.
Prescription of additional capital requirements for banks according to their individual risk profiles.	12	The Banking Legislation Committee and a dedicated task force, addressing areas including capital adequacy, are handling the matter.