Box 1 Iceland – Financial System Stability Assessment

Now that the International Monetary Fund has made two financial system stability assessments for Iceland it is informative to look back on how much progress has been made. Although the IMF only made its first financial system stability assessment less than three years ago, the economy and financial system have been significantly transformed since then. The new Central Bank Act and setting of an inflation target have been crucial, along with the new Act on Financial Undertakings and the results achieved by strengthening and focusing the work of the Financial Supervisory Authority (FME).

The Financial System Assessment Program, a joint IMF and World Bank effort introduced in May 1999, aims to increase the effectiveness of efforts to promote the soundness of financial systems in member countries and thereby reduce the probability of shocks and financial crises. Priorities include enhanced supervision of financial sector activities among all member countries and ensuring a reliable legal and regulatory framework for them. Each assessment is concluded with a Financial System Stability Assessment (FSSA) report.

In November 2000 an IMF mission visited Iceland and spent several weeks preparing its assessment. The Central Bank and FME worked with the Fund's experts who also acquired data from the Ministry of Finance, Ministry of Commerce and a number of financial companies and their organisations. A draft report was delivered in January 2001 and in June 2001 the IMF published its FSSA report after this had been discussed by the Fund's Executive board.

In its main findings announced in January 2001, the mission expressed clear concern about Iceland's macroeconomic imbalances. It outlined the need for concerted action including measures to reduce external and internal imbalances, strengthen the financial system and boost national saving. Such measures would be more successful under a monetary framework which allowed greater exchange rate flexibility, it pointed out. Reduction of systemic risk was crucial, and the government was urged to raise the capital adequacy ratio of domestic banks and empower the FME to demand even greater capital adequacy from banks that were considered under particular risk. Potential weaknesses could also stem from flaws in the legal, regulatory and supervisory framework – especially compared with international best practice. The mission therefore recommended that the government should take the necessary legislative and regulatory measures to enhance domestic banks' credit evaluations and loss provisioning, among other things. Significant improvements were subsequently made with the Act on Financial Undertakings No. 161/2002. Regarding supervision, the main finding was that the financial market legislative framework was up-to-date and broadly in line with the Basel Core Principles for Effective Banking Supervision. The FME performed its duties well but was found to be understaffed.

As far as the Central Bank is concerned, various shortcomings were identified in legislation at that time. However, the new Central Bank Act was passed by parliament before the FSSA was published, addressing the flaws identified by the mission. The FSSA also examined compliance with IMF rules on monetary transparency and deemed the Central Bank to fulfil them in virtually all respects. It found that the Icelandic payment and settlement system did not conform to international best practice in important respects. By that time the Central Bank had already taken an initiative on reforms which have now largely been implemented, bringing the systems into line with international practice to a very large extent.

Another IMF mission visited Iceland in April 2003 to reassess the financial system. The mission was smaller than before and produced a less comprehensive update to the original FSSA. The mission delivered its draft FSSA Update at the end of June this year. After discussion by the IMF Executive Board the Update was published on August 29 and is accessible on the Fund's website (www.imf.org).

The tone of the second FSSA is much more positive, reflecting the major changes that have taken place in the meantime: "Iceland's financial sector has returned to a more balanced risk profile. The potentially destabilizing effects of the 2000-2001 króna depreciation were attenuated by the timely adoption of a credible inflation targeting framework. While meas-

ures of private sector indebtedness remain high, Iceland's modern banking sector has managed to control credit risks and maintain profitability … The Housing Financing Fund posted a small loss in 2001 but regained profitability in 2002 while the insurance industry has remained, on average, profitable and adequately capitalized." The pension industry posted negative average real returns in 2001 and 2002, the assessment noted, but since secured pension fund payments are not the norm in Iceland, the funds' operations do not entail a systemic risk.

The FSSA also reports that "the FME has received increased funding and additional supervisory powers as a result of new legislation ... these changes have enabled the FME to become even more effective. A new assessment of the Basel Core Principles for Effective Banking Supervision finds major improvements in compliance and the Central Bank of Iceland has undertaken important initiatives regarding Iceland's payment systems that are designed to address the shortcomings identified in the 2001 FSSA report and improve compliance with international best practice standards."

Alongside the FSSA, the IMF published its regular Article IV Consultation. The concluding statement notes that macroeconomic imbalances have been corrected and commends the authorities for doing so. The economy appears poised for a resumption of growth, but large planned foreign investments in aluminium smelting and construction of associated power-generating facilities will complicate macroeconomic management. After increasing rapidly in recent years, the external liabilities of the Icelandic economy are high, which makes it vulnerable to external shocks. Continued progress on strengthening the institutional policy frameworks will be crucial, especially in the fiscal area, and on market-oriented structural reforms – which refers in particular to power companies and the Housing Financing Fund.

The FSSA reports have proved useful for the Icelandic government, and especially for the FME and the Central Bank. Views from the outside are always welcome. It was interesting to receive the IMF's reassessment of financial stability following the exchange rate volatility of 2000-2001, and the cautionary note in the FSSA report has supported the FME and the Central Bank in their work in this area. Receiving the update following a readjustment in the economy was no less constructive. It confirms the results that have been achieved and points out a number of areas for closer consideration. Because of the backlog of requests for Financial System Stability Assessments, it will foreseeably be many years until the IMF makes another in-depth study of the Icelandic financial system. However, although another FSSA report is not expected in the next few years, financial stability will remain one of the regular issues examined by the IMF in its Article IV consultations.

The FSSA reports have proved useful for the Icelandic government, and especially for the FME and the Central Bank. Views from the outside are always welcome. It was interesting to receive the IMF's reassessment of financial stability following the exchange rate volatility of 2000-2001, and the cautionary note in the FSSA report has supported the FME and the Central Bank in their work in this area. Receiving the update following a readjustment in the economy was no less constructive. It confirms the results that have been achieved and points out a number of areas for closer consideration. Because of the backlog of requests for Financial System Stability Assessments, it will foreseeably be many years until the IMF makes another in-depth study of the Icelandic financial system. However, although another FSSA report is not expected in the next few years, financial stability will remain one of the regular issues examined by the IMF in its Article IV consultations.