Appendix Internationalisation of the financial system requires ongoing adaptation of the Central Bank's tasks

Internationalisation of the Icelandic banks has led to some changes in the Central Bank of Iceland's working methods, and closer cooperation both in Iceland and abroad. More changes are required, however. The following are some of the tasks currently facing the Central Bank:

- A possible re-evaluation of prudential rules set by the Central Bank of Iceland. By law the Bank sets rules for the liquidity ratio of credit institutions and for their foreign balance, as described on p. 85. These prudential rules apply only to domestic credit institutions, i.e. the parents and not on a consolidated basis. No special limitations on inter-group trading are in effect which might affect the honouring of these prudential principles.
- A wider scope of financial stability analysis. Shocks to the financial system can now more easily originate from markets in other countries. Analysis of related risk factors needs to be stepped up. One example of an adaptation to this development is that the financial stability departments of the Nordic central banks regularly exchange information on their assessments for their home countries, because individual banks now operate in more than one Nordic country. These information exchanges are now becoming more important for the Icelandic analysis.
- Adaptation of statistics collected. As business becomes more international in character, it is increasingly more difficult to gauge statistics provided by the banks. For example, credit to foreign borrowers is not sufficiently broken down by country, sector or other classifications applying to domestic borrowers. Likewise, it is not always certain whether a transaction should be regarded as domestic or international. It has become harder to determine how much of the banks' credit expansion will impact the domestic economy.
- Greater need for soft information and contacts with counterparties. The pace of events has sped up and the necessary feel for where institutions and markets are heading is harder to come by. Ongoing dialogue with key people is a seldom-mentioned part of the functioning and preparedness of a central bank. The Central Bank also needs to strengthen its contacts with other central banks. Higher levels of foreign debt and assets associated with expansion abroad are sure to lead to more discussions with rating agencies, the IMF, the OECD, etc.
- The appropriate level of foreign exchange reserves. The Central Bank should at all times have an appropriate level of foreign reserves and thereby promote sound external liquidity of the economy. Credibility and ready access to capital markets are important factors in this respect.
- Emergency lending assistance and crisis management will become more difficult should such circumstances arise. The size and complexity of situations that might arise have grown. So has the number of parties that might have to be involved, domestically and abroad. If a bank in need of ELA is domiciled in a Nordic country and has at least one cross-border establishment in the area, the provisions of the Nordic central banks' MoU may apply.[1]
- More need for expert staff in the Central Bank. It must have access to specialists who have detailed knowledge of the type of business that international investment banks are involved with and legal complexities that can arise.

Analysis and risk measurement are important tools in efforts to maintain financial stability. What makes risk measurement difficult is how to relate the low probability of events to the magnitude of their effects on the economy, and as a bank expands in other jurisdictions, these effects become more uncertain. The important point here is how to cope

1. http://www.sedlabanki.is/uploads/files/NordiskMoUGenerellslutligENG.pdf

with the main risk factors that the bank is exposed to. Credit risk, market risk and operational risk will be well covered by the implementation of the Basel 2 capital adequacy standards, but what seems more uncertain is how to cope with the liquidity risk. Moreover, some analysts argue that it is liquidity that protects banks and financial stability from uncertain events, not capital itself.[2] The Central Bank and the Financial Supervisory Authority (FME) monitor liquidity requirements for Icelandic banks. As a bank expands rapidly abroad the Central Bank and the FME might experience difficulties in foreseeing the probability of a liquidity drain within domestic borders, caused by a foreign subsidiary bank. In this respect, these institutions might be confronted with difficulties in preventing turbulence within the domestic economy.

According to Article 104 of the Icelandic Act on Financial Undertakings, many of its prudential provisions apply for both the individual bank and the consolidated group, including the provisions of Article 83 regarding liquidity. The rules on large exposures which are based on Directive 2000/12/EC do not envisage a ceiling on exposures between parent and subsidiary as they are consolidated as a group. It is interesting to note that in Denmark there is no such exposure ceiling within a group but the subsidiary is not allowed to provide the parent with credit without the permission of the Danish FSA. In Iceland the implementation of Directive 2002/87/EC concerning supplementary supervision of financial conglomerates is being prepared, to take effect no later than the beginning of 2005. In that implementation an amendment to the Act on Financial Undertakings will be proposed which calls for further supervision of transactions between members of a group. The implementation of the Directive and accompanying regulation is expected to strengthen supervision of cross-border activities.

The interplay between the Central Bank and the FME needs to be effective and in line with the cross-border expansion of the banks. Fundamentally, this interplay is determined by the Cooperation Agreement (MoU) signed by these institutions.[3] The cross-border expansion of the Icelandic banks does not in itself call for a change in the cooperation between the Central Bank and the FME. The channels and information exchange are in place, but increased contact may be expected along with efforts to formalise cooperation with other central banks and supervisors in countries where subsidiaries and branches of Icelandic banks are domiciled.

These issues are important for the effectiveness and safety of the financial system. The Icelandic financial system has expanded its horizons and is becoming increasingly international in character, and former state banks have now been fully privatised. Households and businesses now have a more dynamic financial system than before. The Central Bank adapts its activities to these circumstances on the basis of the legislation governing it.

2. C.A.E. Goodhard (2004), “Some New Directions for Financial Stability?”, *Per Jacobsson Lecture*, pp. 10-11.

3. http://www.sedlabanki.is/uploads/files/Agreements1.pdf