Box 3 Sound practices in foreign currency liquidity management

On the initiative of the Central Bank of Iceland and the Financial Supervisory Authority (FME), a discussion team with their representatives and others from the three largest commercial banks was established in mid-2004 to exchange views on foreign currency liquidity management. The group reached conclusions on specific aspects of sound practices in foreign currency liquidity management, which are outlined below. The FME plans to set guidelines based on the group's work and published a draft (discussion paper no. 3/2004) on its website on September 10. Financial companies have a deadline until September 30 to submit their comments on it. It is hoped that the proposals will lead to more transparent foreign currency liquidity management and enhance credibility. Better consistency should be achieved between the banks with respect to factors that need to be taken into consideration and the FME and Central Bank can receive more extensive information, in addition to which the FME should be facilitated in its task of supervising foreign currency liquidity management.

- *Management structure and responsibility.* The banks' organisational charts should clearly present the management structure and responsibility for liquidity management.
- *Strategy.* Senior management need to define a strategy for their liquidity positions and liquidity management. In particular, a strategy shall be defined for managing foreign currency liquidity.[1]
- *Senior management review*. The board, senior management and others involved, such as the Asset/Liability Committee or the like, shall regularly discuss liquidity management.
- *Limits*. Each bank shall, at a minimum, set limits for the ratio of liquid assets denominated in foreign currencies and credit lines (i.e. those available to liquidity management) against the cash flow of foreign currency liabilities at least one month ahead. Limits shall also be set for the net position of exchange rate-linked items for different residual maturities.
- *Day-to-day management*. The foreign liquidity position should be monitored on a daily basis, both within individual currencies and as a whole, and the bank's limits shall be calculated with respect to them.
- *Foreign funding*. Foreign funding requires regular evaluation of access to different sources (notes, commercial paper, loans, interbank deposits, etc.). In this regard, priority should be given to a good credit rating and a diversified investor and investor group base. Maintenance of customer relations should also be addressed.
- *Alternative sources*. Alternative sources of finance need to be addressed, i.e. the types and amounts of alternative sources. Asset liquidity should be considered as an alternative source of finance.
- *Stress testing*. The foreign liquidity position shall be regularly assessed on the basis of different scenarios. Special evaluation shall be made of debt service from borrowers of exchange rate-linked loans who do not have foreign currency revenues.
- *Exchange rate-linked lending*. The scope of exchange rate-linked assets/loans to borrowers who do not have foreign currency revenues shall be specially monitored.
- *Parent and group*. If cash management is centralised, i.e. on a group basis, the above principles, including limits, shall apply to the group and the parent.

1. Exchange rate-linked items are defined in Article 2, paragraph 1 of the Central Bank of Iceland Rules no. 387/2002, on Foreign Exchange Balance.