ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Iceland Policy Brief

OECD Better Policies Series

SEPTEMBER 2015

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Investment

PUTTING IN PLACE A MACRO-PRUDENTIAL FRAMEWORK PROPORTIONATE TO FINANCIAL STABILITY AND INVESTMENT OBJECTIVES

- Iceland is in the process of lifting the comprehensive capital controls it imposed in 2008 as a result of a major balance of payment crisis.
- As part of the plan to gradually remove capital controls, Iceland has recently introduced several macro-prudential rules, some of which discriminate on the basis of the currency of an operation.
- While these macro-prudential rules may address liquidity risk in foreign currency, they should not create an extra impediment on investment and capital mobility and be proportionate to the financial stability risk they are targeting.
- Iceland is encouraged to continue reporting to the OECD on its plan to remove capital controls and to place its capital flow management measures with a macro-prudential intent under the transparency framework of the OECD Codes of Liberalisation.

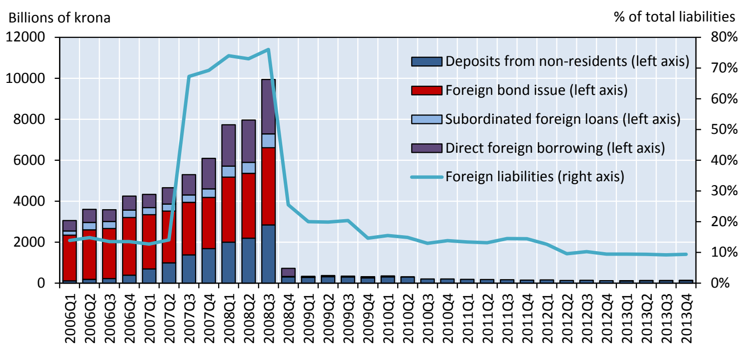
What's the issue?

As Iceland has recently made progress in unwinding seven years of capital controls, it has also introduced new macro-prudential measures to ensure financial stability during the implementation of the exit strategy. This macro-prudential framework comprises i) rules on liquidity ratio, and ii) rules on funding ratios in foreign currencies (FX).

The measures are overall in line with the liquidity standards developed by the Basel Committee on Banking Supervision, but also include elements that go beyond Basel III recommendations, such as a discrimination between currencies and in particular between FX-denominated and domestic-denominated liabilities. First, the new liquidity rule acts as the Basel III Liquidity Coverage Ratio (LCR) which requires that financial institutions hold sufficient liquid assets to meet short-term obligations. For Iceland this requirement applies to each individual currency to limit the liquidity risk in foreign currencies. Second, the new rules on funding ratios in foreign currencies are similar to the net stable funding ratios (NSFRs) under Basel, but impose a stricter requirement for foreign currencies, limiting the reliance on short-term funding, especially FX-denominated funding.

Banks' foreign liabilities collapsed at the onset of Iceland's financial crisis

Banks' foreign liabilities in billions of krona and as share of total liabilities



Note: The sample does not include Iceland's failed banks.
Source: OECD analysis based on Central Bank of Iceland (2015), Accounts of Deposit Money Banks.

While the liquidity ratio is expected to be met by different currencies with the same criterion, the funding ratio in foreign currencies imposes an asymmetric treatment between FX-denominated and domestic-denominated funds. In particular, banks will have an incentive to borrow in short-term domestic liabilities rather than in short-term foreign liabilities, since higher liquidity requirements in connection with foreign currency liabilities will increase the cost of this funding with a potential impact on cross-border banking flows and foreign currency transactions.

Why is this important for Iceland?

Iceland experienced a boom in banks' foreign liabilities in the run-up to the crisis that suddenly busted in 2008 (see Figure). From the first quarter of 2005 to the third quarter of 2008 external debt of financial institutions rose by 208%, driven mainly by increases in direct foreign borrowing and deposits from non-resident. In 2008 foreign liabilities accounted for more than 70% of the total balance sheet of the banking system, about seven times Iceland's nominal GDP. In 2008, Iceland's financial system collapsed. Banks were not able to issue bonds to international investors until 2013. Foreign deposits and direct foreign borrowing flew out causing liquidity strain for banks and financial instability.

The new macro-prudential measures aim at limiting the build-up of maturity mismatch in foreign currency, imposing requirements which tend to restrict banks' foreign liabilities and may also ultimately restrict capital mobility. As banks' foreign liabilities have decreased to around 10% of the total balance sheet of the banking system in 2013, Icelandic authorities are advised to be mindful that the new measures introduced are proportionate to financial stability objectives and do not create unnecessary impediment to capital mobility. Measures such as the funding ratio in foreign currencies may also have a bearing on the country's commitments to financial openness, including under the OECD Codes of Liberalisation.

What should policy makers do?

- Continue to make progress in the removal of capital controls.
- Report to the OECD bodies which are in charge of examining Iceland's temporary derogation from its obligations vis-a-vis Article 7 of the OECD Codes.
- Ensure that macro-prudential rules recently introduced, such as the funding ratio in foreign currencies, are proportionate to financial stability challenges and do not create unnecessary impediments to capital mobility.
- Place the new macro-prudential measures that discriminate on the basis of currency and go beyond internationally recognised standards under the framework of international co-operation and transparency provided by the OECD Codes.

Further reading

OECD (2015), *The OECD's Approach to Capital Flow Management Measures Used with a Macro-Prudential Intent*, OECD Publishing. http://www.oecd.org/daf/inv/investment-policy/G20-OECD-Code-Report-2015.pdf

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