

ICELAND: REPORT ON OBSERVANCE
OF STANDARDS AND CODES (ROSC)



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August 2014

This Report on Observance of Standards and Codes (ROSC) on Iceland was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in March 2014.

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REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION (BCP)

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This Summary Report was prepared in the context of an IMF stand-alone Reports on the Observance of Standards and Codes (ROSCs) mission in Iceland during March 2014, led by Fabiana Melo, IMF, and overseen by the Monetary and Capital Markets Department, IMF. Further information on ROSCs can be found at

<http://www.imf.org/external/NP/rosc/rosc.aspx>

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GLOSSARY

AC	Additional Criteria
Act 87	Act 87/1988 - Act on Official Supervision of Financial Activities
Act 161	Act 161/2002 - Act on Financial Undertakings
AML	Anti-Money Laundering
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
CAR	Capital Adequacy Ratio
CBI	Central Bank of Iceland (<i>Seðlabanki Íslands</i>)
CDD	Customer Due Diligence
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CEO	Chief Executive Officer
CESR	Committee of European Securities Regulators
CFP	Contingency Funding Plan
CFT	Combating Financing of Terrorism
COREP	Common Reporting
CP	Core Principles
CPA	Certified Public Accountant
CPI	Consumer Price Index
CRD	Capital Requirement Directive
CRO	Chief Risk Officer
CRR	Capital Requirements Regulation
CV	Curriculum Vitae
DR	Disaster Recovery
DIF	Deposit Insurance Fund
EBA	European Banking Authority
EC	European Commission
EC	Essential Criteria
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EIOPA	European Insurance and Occupational Pensions Authority
ESA	EFTA Surveillance Authority
ESMA	European Securities and Markets Authority
EU	European Union
FATF	Financial Action Task Force
FINREP	Financial Reporting
F-IRB	Foundation IRB
FIU	Financial Investigation Unit
FME	Financial Supervisory Authority in Iceland (<i>Fjármálaeftirlitið</i>)

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FX	Foreign Exchange
GDP	Gross Domestic Product
HFF	Housing Financing Fund (<i>Íbúðalánasjóður</i>)
IAS	International Accounting Standards
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
IFSA	Icelandic Financial Services Association
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Rating-based Approach
IRRBB	Interest Rate Risk in the Banking Book
IS	Information System
IS GAAP	Icelandic GAAP
ISK	Icelandic krónur
IT	Information Technology
KRI	Key Risk Indicators
LCR	Liquidity Coverage Ratio
LPAR	Loan Portfolio Analysis Reports
MoFEA	Ministry of Finance and Economic Affairs
MoU	Memorandum of Understanding
NSFR	Net Stable Funding Ratio
Rule 215	Rules No. 215/2007 –, on risk factors, risk weightings and the calculation of the risk base
RWA	Risk-Weighted Assets
SREP	Supervisory Review and Evaluation Process
TIF	The Depositors' and Investors' Guarantee Fund (<i>Tryggingarsjóður innstæðueigenda og fjárfesta</i>)
UCITS	Undertakings for Collective Investment in Transferable Securities
XBRL	eXtensible Business Reporting Language

SUMMARY AND METHODOLOGY

A. Introduction

1. This assessment of the current state of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) in Iceland has been completed as a stand-alone Report on the Observance of Standards and Codes undertaken by the International Monetary Fund (IMF) during March of 2014 at the request of the Icelandic authorities.¹ It reflects the regulatory and supervisory framework in place as of the date of the completion of the assessment. It is not intended to assess the response to the 2008 banking crisis, and it is not intended to represent an analysis of the state of the banking sector or crisis management framework.

2. This Report on the Observance of Standards and Codes (ROSC) summarizes the findings and recommendations of the assessment. An assessment of the effectiveness of banking supervision requires a review of the legal framework, and detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision. In line with the BCP methodology, the assessment focused on the FME as the main supervisor of the banking system, and did not cover the specificities of regulation and supervision of other financial intermediaries. It is important to note, however, that to the extent that FME is a unified supervisor responsible for other entities of the financial sector, the assessment of banking supervision in Iceland should provide a useful picture of current supervisory processes applicable to other financial institutions supervised by FME.

3. In 2008, Iceland faced a banking crisis of extraordinary proportions, which led to the collapse of the banking system and revealed serious deficiencies in the Icelandic banking regulation and supervision. Before the crisis, the Icelandic banking sector experienced a dramatic expansion in just a few years, funded by cheap foreign financing, which allowed it to boost its assets from 100 to almost 900 percent of GDP between 2004 and end-2007. The crisis triggered an abrupt adjustment in key asset prices and severely disrupted operations in the onshore foreign exchange market and external payment systems. As a result, the crisis brought down the three main banks within a week. Addressing the weaknesses in the supervisory framework was therefore an integral part of the country's recovery. An informal assessment of supervisory practices was conducted and published in April 2009² by Kaarlo Jännäri, retired Director General of the Finnish Financial Supervision Authority. The report was focused on liquidity management, connected lending, large exposures, cross-ownership, and the "fit and

¹ In the context of the IMF Program of Financial Support for Iceland (2008–11), some of the structural benchmarks were related to improvements in banking supervision and regulation. Two assessments were conducted by private consultants, and the authorities committed to addressing the deficiencies indicated. In the Sixth Review, in particular, the authorities committed to request to the IMF a stand-alone ROSC.

² Report on Banking Regulations and Supervision in Iceland: past, present and future. Available at: http://eng.forsaetisraduneyti.is/media/frettir/KaarloJannari_2009.pdf

proper" status of owners and managers, i.e., the obvious weaknesses of the framework exposed by the crisis.

4. Authorities took steps to improve banking regulation and supervision. Since the Jännäri report, several pieces of legislation were proposed, including some discretionary powers of the Financial Supervisory Authority (FME); the establishment of a national credit registry at the FME (that would cover significantly-sized loan exposures); tougher provisions on large exposures, connected lending; and fit and proper requirements for owners. Amendments were also made regarding the legislation of anti-money laundering and deposit insurance.

5. Issues beyond the legal and regulatory framework were also identified, and further actions were planned by the authorities to strengthen the supervision. The authorities commissioned a new assessment by a private consultant in 2011, to focus on implementation of reforms and strengthening of supervisory structures, as the authorities rightly understood that, prior to the crisis, supervision was hindered by lack of qualified persons, information systems, organization, and lack of a consistent risk-based framework. The recommendations made by the consultant were that FME should focus on improvements of internal frameworks and infrastructure, to build up necessary tools and supervisory processes along with strengthening its IT infrastructure to support the supervisory processes.

6. In response to these recommendations FME launched a comprehensive reform program in August 2011 with the aim of improving the existing corporate structure, to design and build a new and improved way of performing risk-based supervision, to document and establish a process management framework and last but not least to implement a new risk assessment system. Under the reform program five different project parts were originally launched, each one to target a specific unique area mentioned above. These project parts are known as (i) Global Risk Based Supervision Framework ; (ii) Supervision Processes and Procedures; (iii) IT/IS infrastructure; (iv) Structure and management; (v) Human Resource Management.

7. While much was achieved, the program had to be adjusted due to uncertainty of funding. Part of the IT/IS infrastructure was a new document management and information system, but a decision has been taken to postpone that project part until the beginning of 2015 due to lack of funding. In September 2013 it was decided to discontinue the Human Resource Management project part and move defined activities from that project part into the Global Risk Based Supervision Framework and the Supervision Processes and Procedures. The total timeline for the reform program was originally planned for three years and the program was intended to reach its goals by the end of year 2014 but now the timeline has been extended to end of 2016, mainly because of delays within the originally defined project and because of uncertainty regarding financing of the project.

8. Additionally, the FME has been hampered in improving the supervisory framework by its lack of authority to issue prudential regulations and legally binding guidelines. While staff has been working intensively and seeking to promote an intrusive and conclusive

supervisory process³, some of the requirements and corrective actions that finalize their work may be based on inadequate legal/regulatory basis, and as banks again grow stronger and bolder, lengthy and costly contestation will arise more frequently. Effective supervision needs to be able to move quickly and decisively. While it is understandable that the higher level legal framework needs to be approved by Parliament, FME should have been able to issue technical prudential standards that can be legally binding and substantiate its enforcement actions without costly delays.

9. This Core Principles assessment, therefore, took place while the FME is still halfway in its restructuring project - since the crisis the FME has been putting-out fires while also implementing significant reforms to its supervisory approach. The goal of FME is to put in place a risk-based supervision approach. At the time of the assessment the FME was in the process of developing regulations and rules to support the development of the new supervisory approach. Plans were also in place to develop internal methodologies for FME staff to monitor, assess and grade risks. The FME has implemented a Supervisory Review and Evaluation Process (SREP) and an Internal Capital Adequacy Assessment Process (ICAAP) requirement that jointly provide a foundation for the supervisory planning process. SREP involves a series of meetings and interactions with the banks following the submission of the ICAAP report that concludes with a final meeting to discuss the results of the process and inform the bank of its capital requirements and any other deficiencies noted in the review process.

10. The environment in which FME supervision takes place is still extraordinary. For instance, as a condition to the licensing of Arion Bank, Landsbankinn and Islandsbanki in the aftermath of the crisis and the collapse of the existing banks, the FME required the banks to improve internal risk management. The areas covered by the licensing conditions on risk management included risk appetite setting, fragmentation of risk reporting, limit setting metrics and procedure, risk return metric and target setting, Board role in risk management, management fit-and-proper requirements, analysis of impaired assets and restructuring. A follow-up review of each bank was conducted, jointly with external experts, to ensure that the three banks had met the conditions (sign-off project).⁴

11. For effective ongoing supervision under normal conditions, however, there is much yet to be done. There is a general lack of standards, guidelines and rules issued by the FME concerning the evaluation of banks' risk management that may hinder the transparency of the FME decision making process. Guidelines and rules provide reference points for banks to

³ For reference, see the IMF SPN/10/08: "The Making of Good Supervision: Learning to Say "No" (<https://www.imf.org/external/pubs/ft/./sfn1008.pdf>)

⁴ In 2009, in the process of licensing the three banks to assume the assets/liabilities of the failed banks, conditions were imposed on the banks to implement and improve risk management practices. The benchmarks/targets were developed with the assistance of external experts and the banks' compliance and achievement of the targets was monitored by FME (sign-off project).

understand the supervisor's actions and recommendations and also increase consistency within FME staff in discussing with the banks the adequacy of internal guidelines and policies.

12. In addition, this assessment shows that implementation of training and system development needs are paramount if the institution is to be recognized for its competence.

The institution is still adjusting to its rapid and much needed growth after the banking crash and the internal reorganization implemented. About half of the staff has been in the entity for 5 years or less, and only a handful of employees have had over 10 years supervisory experience. As the economy and the financial sector recover, the chances that staff is hired by the private sector increase, therefore FME needs to develop a sound strategy to retain staff: attractive salaries and career path, training and development programs, perhaps mentoring programs and partnerships with foreign supervisors. Systems need to be developed so that staff can be freed for compliance and data verification and conduct more analytical work.

B. Information and Methodology Used for Assessment

13. The Icelandic authorities requested to be assessed according to the Revised Core Principles (BCP) Methodology issued by the BCBS (Basel Committee of Banking Supervision) in September 2012.

The current assessment was thus performed according to a revised content and methodological basis as compared with the previous BCP assessment carried out in 2003. It is important to note, for completeness' sake, that the two assessments will not be directly comparable, as the revised BCP have a heightened focus on risk management and its practice by supervised institutions and its assessment by the supervisory authority, raising the bar to measure the effectiveness of a supervisory framework (see box for more information on the Revised BCP).

14. The Icelandic authorities chose to be assessed and rated against only the Essential Criteria.

To assess compliance, the BCP Methodology uses a set of essential and additional assessment criteria for each principle. The essential criteria (EC) were usually the only elements on which to gauge full compliance with a Core Principle (CP). The additional criteria (AC) are recommended best practices against which the authorities of some more complex financial systems have agreed to be assessed and rated. The assessment of compliance with each principle is made on a qualitative basis. A four-part grading system is used: compliant; largely compliant; materially noncompliant; and noncompliant. This is explained below in the detailed assessment section. The assessment of compliance with each CP is made on a qualitative basis to allow a judgment on whether the criteria are fulfilled in practice. Effective application of relevant laws and regulations is essential to provide indication that the criteria are met.

15. The assessment team reviewed the framework of laws, rules, and guidance and held extensive meetings with officials of the FME, and additional meetings with the Central Bank of Iceland, the Ministry of Finance and Economic Affairs, auditing firms, and banking sector participants. The authorities provided a self-assessment of the CPs rich in quality and

comprehensiveness, as well as detailed responses to additional questionnaires, and facilitated access to supervisory documents and files, staff and systems.

16. The team appreciated the very high quality of cooperation received from the authorities. The team extends its thanks to staff of the authorities who provided excellent cooperation, including extensive provision of documentation and access, at a time when staff was burdened by many initiatives related to the European and global regulatory changes, and still maneuvering the consequences of the 2008 banking crash.

17. The standards were evaluated in the context of the Icelandic financial system's structure and complexity. The CPs must be capable of application to a wide range of jurisdictions whose banking sectors will inevitably include a broad spectrum of banks. To accommodate this breadth of application, a proportionate approach is adopted within the CP, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the standards that supervisors impose on banks. An assessment of a country against the CPs must, therefore, recognize that its supervisory practices should be commensurate with the complexity, interconnectedness, size, and risk profile and cross-border operation of the banks being supervised. In other words, the assessment must consider the context in which the supervisory practices are applied. The concept of proportionality underpins all assessment criteria. For these reasons, an assessment of one jurisdiction will not be directly comparable to that of another.

Box 1. The 2012 Revised Core Principles

The revised BCPs reflect market and regulatory developments since the last revision, taking account of the lessons learnt from the financial crisis in 2008/2009. These have also been informed by the experiences gained from FSAP assessments as well as recommendations issued by the G-20 and FSB, and take into account the importance now attached to: (i) greater supervisory intensity and allocation of adequate resources to deal effectively with systemically important banks; (ii) application of a system-wide, macro perspective to the microprudential supervision of banks to assist in identifying, analyzing and taking pre-emptive action to address systemic risk; (iii) the increasing focus on effective crisis preparation and management, recovery and resolution measures for reducing both the probability and impact of a bank failure; and (iv) fostering robust market discipline through sound supervisory practices in the areas of corporate governance, disclosure and transparency.

The revised BCPs strengthen the requirements for supervisors, the approaches to supervision and supervisors' expectations of banks. The supervisors are now required to assess the risk profile of the banks not only in terms of the risks they run and the efficacy of their risk management, but also the risks they pose to the banking and the financial systems. In addition, supervisors need to consider how the macroeconomic environment, business trends, and the build-up and concentration of risk inside and outside the banking sector may affect the risk to which individual banks are exposed. While the BCP set out the powers that supervisors should have to address safety and soundness concerns, there is a heightened focus on the actual use of the powers, in a forward-looking approach through early intervention.

The number of principles has increased from 25 to 29. The number of essential criteria has expanded from 196 to 231. This includes the amalgamation of previous criteria (which means the contents are the same), and the introduction of 35 new essential criteria. In addition, for countries that may choose to be assessed against the additional criteria, there are 16 additional criteria.

While raising the bar for banking supervision, the Core Principles must be capable of application to a wide range of jurisdictions. The new methodology reinforces the concept of proportionality, both in terms of the expectations on supervisors and in terms of the standards that supervisors impose on banks. The proportionate approach allows assessments of banking supervision that are commensurate with the risk profile and systemic importance of a wide range of banks and banking systems.

C. Overview of the Institutional Setting and Market Structure

18. The Ministry of Finance and Economic Affairs (MoFEA), the Financial Supervisory Authority (FME), and the Central Bank of Iceland (CBI) have overall responsibility for financial markets. FME and CBI are independent agencies "under the auspices of MoFEA." FME is an integrated supervisor, responsible for supervision of all types of financial intermediaries. The legal and regulatory framework for the supervisor and operations of the financial intermediaries and the securities market are in general harmonized with the European Union's regulatory framework. Iceland, as a member of the European Economic Area (EEA), is obliged to implement in national legislation the EU regulatory framework concerning the financial sector.

19. FME supervises commercial banks, savings banks, credit undertakings (investment banks), securities companies, securities brokerages, management companies of Undertakings for Collective Investment in Transferable Securities (UCITS), stock exchanges, central securities depositories, pension funds, insurance companies, and insurance brokers licensed to operate in

Iceland. The following table shows the number of entities and total assets of the main categories of the financial intermediaries under FME's supervision at June 30 2013 :

Financial intermediaries	Number of entities	Total assets ISK billion 30.06.2013	Total assets % of GDP
Deposit Money Banks	12	3,007	170.6
<i>of which commercial banks</i>	4	2,951	167.4
<i>of which savings banks</i>	8	56	3.2
Various credit undertakings	7	1,074	60.9
<i>of which the Housing Financing Fund</i>	1	873	49.5
Pension funds	27	2,546	144.4
Insurance companies	13	167	9.5
Mutual funds	60	243	13.8
Investment funds	42	97	5.5
Institutional funds	61	264	15.0
Total	196	7,398	419.6

20. The Icelandic financial system is characterised by the dominance of three banks, Arion Bank, Íslandsbanki and Landsbankinn, all established by the national authorities as a part of emergency measures to secure continued financial services to households and domestic businesses following the banking crisis of 2008. The Treasury currently holds 99 percent equity share in Landsbankinn, 13 percent in Arion Bank, and 5 percent in Íslandsbanki. The remaining stakes in Arion Bank and Íslandsbanki are indirectly owned by the old banks' estates, Kaupthing (83 percent), and Glitnir (95 percent) respectively. Around 90 percent of the creditor's claims on the two estates are in the hands of foreign claimholders. Following a financial restructuring of the savings banks, the Treasury holds a majority stake in three of the eight savings banks. The three large banks are focused mainly on the domestic market in contrast to the three large internationally active banks, Glitnir, Kaupthing, and Landsbanki Íslands, they replaced.

21. The number of financial undertakings has decreased in recent years as many savings banks and specialised lenders have ceased their operations, which has increased concentration in the financial market and further consolidation can be expected in the years ahead. The combined market share of the three biggest banks in total deposits is at present approximately 94 percent. However, measured as a share of deposits, concentration was very high even before the 2008 financial crisis. The picture is somewhat different if concentration is measured in terms of market share in total direct lending, because of the importance of retail

lending by Housing Financing Fund (HFF)⁵ and the pension funds, which together account for some 34 percent of direct lending to households and business firms. For this reason, the market share of the three biggest banks, in total lending at the end of 2012, amounted to approximately 66 percent. Neither HFF nor the pension funds are obliged to comply fully with the same prudential rules as other financial undertakings, such as capital requirements and large exposures.

22. The three largest banks' capital and liquidity positions are well above the minimum required by FME and CBI. As regards the capital levels, all the three large banks have capital levels at 24–27 percent at end-Q3 2013 - well above the minimum capital adequacy ratio required by FME. Most of this is Tier 1 capital, or between 20–27 percent of risk-weighted assets. The leverage ratio (the total assets to equity) was 4.9–6.6 at end-Q2 2013. The commercial banks' return on equity was just over 12 percent (annualised) for the first nine months of 2013 and return on total assets was 2.2 percent. Calculated profits before tax on core operations were, however, 1.3 percent of total assets during the same period.

23. The banks' operating environment still reflects a number of legal and political uncertainties. Among these are the interpretation of the Supreme Court decisions on exchange rate-linked loans and the uncertainty concerning removal of the capital controls, which could affect loan valuation and funding. Furthermore, many borrowers remain highly leveraged and could need further debt restructuring. After a peak in late 2008, the default ratios of the banks' loan portfolios have decreased considerably. The default ratios, however, are still high which might explain why banks hold high capital adequacy ratios of the banks. In November 2013 the Icelandic government announced an action plan aimed at reducing the country's housing debt. The total scope of the action plan is estimated at around ISK 150 billion (8 percent of GDP), spread over a four-year period. Of this, the debt relief applied to inflation-indexed housing mortgages is estimated at around ISK 80 billion and the utilisation of tax exemption on private pension savings at around ISK 70 billion. The estimate of the scope of the debt relief, however, is subject to some uncertainty.

24. After the crisis, the government-owned Housing Financing Fund (HFF) has experienced great loan loss resulting in an injection of ISK 46 billion of new capital from the Treasury. The capital ratio at end-Q2 2013 is, however, only 2.5 percent and a need for more capital injection is foreseeable. The authorities have been working on finding a viable solution to the Fund's operational problems and define its future position in the Icelandic financial system. An overhaul of the HFF's operations remains a challenge in view of reducing the government's contingent liabilities.

25. According to the October 2013 Financial Stability Report issued by CBI, "the main risks facing the financial system at present relate to the settlement of banks in winding-up"

⁵ The Housing Financing Fund (HFF) is an independent government institution granting mortgage loans to individuals, municipalities, companies and organizations to finance housing purchase and construction work.

proceedings, the intended removal of the capital controls, foreign debt refinancing, and high corporate debt levels. In addition, the Housing Financing Fund's (HFF) difficult situation could prove costly for the Treasury." Furthermore, many borrowers remain highly leveraged and could need further debt restructuring, and default ratios could be underestimated.

D. Preconditions for Effective Banking Supervision

26. The Treasury Budget for 2014 provides balanced Treasury operations for the first time since 2007. Estimated Treasury performance for the years 2015–2017 according to the 2014 medium–term budget plan as a percent of GDP is 0.1, 0.0, and 0.8, respectively. The central government total liabilities at end-Q2 2013 amounted to 1,913 billion ISK or 109.1 percent of the GDP. Taking account of the public sector financial assets, the net financial assets, i.e., the financial assets less liabilities, were negative by 864 billion ISK or 47.5 percent of the GDP.

27. CBI is in charge of monetary policy implementation in Iceland and performs a wide range of functions to this end. The main objective of monetary policy is price stability. On 27 March 2001, a formal inflation target was adopted. According to the target CBI aims for an annual rate of inflation, measured as the twelve-month increase in the CPI, which in general will be as close as possible to 2½ percent. CBI implements its monetary policy by managing money market interest rates, primarily through interest rate decisions for its collateral loan agreements with credit institutions, which then affect other interest rates. Furthermore, CBI is also obliged to contribute towards the Government's main economic policy objectives insofar as it does not consider this to conflict with its own goal of price stability.

28. Economic growth reached 1.4 percent in 2012 and is projected to be 2 percent in 2013 according to Statistics Iceland. The forecast for 2014 is 2.5 percent and 2.6 percent–2.8 percent per annum for the years 2015–2018. Inflation is expected to be 3.8 percent in 2013, deteriorating from the last forecast (3.5 percent). For 2014, inflation is predicted to be 3.6 percent, 3 percent in 2015 and hit CBI's target rate of 2.5 percent in 2016. Unemployment has decreased steadily from late 2010. Further declines in unemployment are forecast as economic recovery continues, with an expected average rate of registered unemployment of 4.6 percent in 2013 and 4.4 percent in 2014.

29. Icelandic financial institutions are sheltered to some extent from volatility in international markets by the capital controls. Still the controls exacerbate foreign refinancing risk. For the longer term, they give rise to certain kinds of risk, including distorting asset prices. This risk will materialise when the controls have been lifted, with potential impact on the banks' balance sheets. In March 2011 CBI issued a report on Capital Account liberalisation strategy. The strategy is divided into two main phases, Phase I—reduction of offshore króna positions and Phase II—removal of controls on onshore króna. According to the strategy, Phase II can begin when sufficient progress has been made under Phase I. In the beginning of the year 2014, Phase I is still in process and it is uncertain when Phase II can begin.

30. A cooperation agreement is in place between FME and CBI, issued in January 2011, covering cooperation to enhance financial stability and information sharing. According to the cooperation agreement working groups on main risk factors have been established charged with analyzing and assessing the main risks in the financial system as a preparation for semi-annual meetings between the Director General of FME and Governor of CBI. The findings of such meetings are brought forward to relevant ministers of the Government. Furthermore, a Memorandum of Understanding (MoU) is in place between the Prime Minister's Office, Ministry of Finance, Ministry of Commerce and Economic Affairs, FME, and CBI, issued in April 2012, on the tasks of the Committee on Financial Stability. MoFEA has established working groups entrusted with preparing proposals for a legal framework on financial stability and macro-prudential surveillance, including a Financial Stability Board. The cooperation contract between FME and CBI is under revision, which will be concluded in the first quarter of 2014.

31. The Icelandic legal system is based on civil law. The Icelandic constitution establishes the independence of the courts. The courts deal with criminal and civil actions, including cases concerning public administration and financial sector regulation. State Aid to financial institutions is subject to scrutiny by EFTA Surveillance Authority (ESA). Iceland ranks thirteen (out of 189 economies) on the 2014 Ease of Doing Business index for starting and operating local firms.⁶ Subcategories of that index are Enforcing Contracts and Resolving Insolvency where Iceland ranked third and eleventh, respectively. The external audit function is considered compliant with international standards of auditing. Iceland has implemented International Financial Reporting Standards (IFRS) in Icelandic law. The financial statements of the commercial banks are compliant with IFRS. There is a full range of high-quality accountancy, audit, legal, and ancillary financial services available in Iceland. In 2012, based on the 2012 Corruption Perception Index Iceland was listed as the eleventh most favorable on anti-corruption.⁷ The payment systems are considered effective and reliable.⁸

32. Crisis measures taken in October 2008 and in the aftermath of the collapse of the banks to protect the stability of the banking system were largely based on the Emergency Act No. 125/2008. The Treasury was authorized, according to the provisions of the act, to disburse a considerable amount of funds to recapitalize the banking system and FME was authorized to take special measures in extreme circumstances, i.e. assume the powers of a shareholders' meeting, dismissing the board of directors in whole or in part, taking over the assets, rights and obligations of a financial undertaking in whole or in part, or disposing of such an undertaking in whole or in part, including merging it with another undertaking.

⁶ Just below Finland. A co-publication of The World Bank and the International Finance Corporation.

⁷ Just below Netherlands and Canada but ahead of Luxembourg and Germany. Published by *Transparency International*.

⁸ See following link: <http://www.cb.is/payments/payment-systems/>

33. Specific measures that were taken by the government included recapitalization and bank takeovers and a declaration on the safety of domestic deposits. As a state-aid, the various measures taken were subject to scrutiny by the ESA. As mentioned above, a cooperation agreement is in place between FME and CBI covering cooperation to enhance financial stability and information sharing. Chapter 5 of the cooperation agreement stipulates responses to systemic risk or shock, i.e., the requirement to report if suspicion of an imminent problem, cooperation on contingency planning and exercises and cooperation on measures. Furthermore, the aforementioned MoU is in place between the Prime Minister's Office, MoFEA, Ministry of Industries and Innovation, FME, and CBI on the tasks of the Committee on Financial Stability. MoFEA has established working groups charged with preparing proposals for a legal framework on financial stability, including a legal framework on the resolution and recovery of financial undertakings.

34. Iceland has a deposit-guarantee and investor-compensation scheme, the Depositors' and Investors' Guarantee Fund (TIF) established by Act No 98/1999. The TIF guarantees deposits of up to EUR 20,887 for each depositor. Iceland has not yet implemented amendments made in the year 2009 to the EU Directive 94/19/EC on Deposit Guarantee Schemes. By implementing these amendments, the covered amount for the aggregate deposits of each depositor would be EUR 100,000. The TIF is a private foundation operating pursuant to Act No. 98/1999. The Act is based on Directive 94/19/EC on deposit-guarantee schemes and Directive 97/9/EC on investor-compensation schemes. The objective of the Act is to guarantee a minimum level of protection to depositors in commercial banks and savings banks, and to customers of companies engaging in securities trading, in the event of difficulties of a given company in meeting its obligations to its customers according to the provisions of the Act.

35. According to Article 7 of Act No. 26/2001 on the Central Bank of Iceland, CBI may grant credit to credit institutions authorized to conduct deposit transactions with CBI through collateralized lending or by other means against collateral deemed acceptable by CBI. These credit transactions, the collateralized lending facility and deposit facility, are performed in domestic currency but additionally there is an allowance for the Central bank to conduct case by case transactions in foreign currency. Under exceptional circumstances, and when CBI deems it necessary in order to maintain confidence in the domestic financial system, CBI may issue guarantees to credit institutions in liquidity difficulties or grant them other loans than previously referred to and with other guarantees than previously referred to or on special terms. In October 2008 the Government of Iceland declared that deposits in domestic commercial and savings banks and their branches in Iceland would be fully covered.

36. FME has published on its website a Transparency Policy and an Information Policy. FME discloses as much information as possible about its decisions and conclusions of on-site and off-site inspections but does not, however, disclose sensitive information that has disproportionately negative impact on firms or the market as a whole. FME's annual reports and information on financial issues, decisions and various areas of FME's operation are accessible on FME's website. Issuers of securities listed in the Stock Exchange are subject to additional

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requirements regarding public disclosure, according to the Act on Securities Transactions (No. 108/2007). CBI prepares reports and forecasts on monetary issues, the balance of payments, exchange rate and foreign exchange issues, and other matters pertaining to its functions and policies and publishes quarterly reports on those issues. Furthermore, CBI carries out economic research relating to its tasks concerning monetary policy and the financial system.

MAIN FINDINGS

Responsibility, Objectives, Powers, Independence, Accountability and Cooperation (CPs 1-3)

37. The FME is the supervisor of the financial system, including insurance and securities and close collaboration channels have been established with domestic and foreign supervisors.

A collaboration agreement has been signed between the Central Bank of Iceland (CBI) and the Financial Supervisory Authority (FME) and work between the two entities includes permanent working groups reviewing macro-micro issues that feed into the supervisory process. Additionally, a MoU was signed between the Prime Minister's Office, the Ministry of Finance and Economic Affairs, FME and CBI on participation on the Committee on Financial Stability.

38. In fact, the regulatory framework is complex, due to Iceland's membership in EEA and FME's limited capacity to impose binding rules. FME depends on the Minister of Finance to put forward prudential legislation and regulation. This generates at least two problems.

- **First, implementation of many EU directives and regulations enacted since 2010 has been delayed mainly due to a constitutional interpretation,** according to which Regulations (EU) No 1093-1095/2010 (regulations establishing European Supervisory Authorities), cannot be implemented. This constitutional interpretation and its unresolved consequences have resulted in a backlog of unimplemented directives and regulations, dating back to the year 2010, which affects the whole financial market - banking, insurance and securities. While FME expects that implementation of CRD IV, for example, would fill several legal and regulatory gaps, the size of the CRD IV package, including regulations and standards, that will need to be transposed into national legislation will create a major strain on the country's limited regulatory resources (in all involved agencies).
- **Second, the fact that prudential legislation and regulation is mostly dependent on governmental action undermines the timeliness of regulatory updates, and in practice may prevent FME from responding adequately if there are conflicting interests between the government and prudential supervision.** Besides not being able to propose legislation, the regulatory powers of FME are very limited as it is only allowed to issue rules if explicitly commanded to do so by the legislation. This has seemingly led to the situation where FME relies on the issuances of guidelines not only to clarify to the banks its supervisory expectations, but to detail and interpret where law and regulation is too general. However, such guidelines are not legally binding.

39. In a society very keen in its counter-argument and contestation rights, such inadequate legal and regulatory framework unnecessarily slows supervisory action, creates regulatory uncertainty and regulatory gaps which banks sometimes exploit, and uses up scarce supervisory resources - which need to be diverted to deal with legalistic issues instead of focusing on assertive early action to prevent the accumulation of problems.

Ownership, Licensing, and Structure (CPs 4-7)

40. Licensing criteria and procedures is aligned with international standards, but implementation can be enhanced, in particular assessment of qualified holdings. It must be noted that given the extraordinary conditions in which most licenses were given (restructuring of the sector following the collapse in 2008); FME has not yet used the procedures in “normal” circumstances. The assessment of qualified holdings, which affects not only licensing, transfer of ownership and acquisitions, but also monitoring of large exposures and related parties, can be improved. Although the definition of qualified holder and control includes a qualitative assessment of “other holding which enables the exercise of a significant influence over the management of the company concerned,” in practice most processes, systems, monitoring and supervisory action are exclusively based on the quantitative thresholds. Therefore, significant connections that may even signify effective control may fall under FME’s radar.

Methods of Ongoing Supervision (CPs 8-10)

41. The FME has been building its supervisory process/methodology with the aim of achieving a system based on supervision-by-risk. The FME is working on a methodology for risk-based supervision with the aim of grading individual risks (liquidity, credit, market) within each bank and assigning an overall risk level to the bank. The methodology will enable the FME to more precisely rank the level and direction of risks

42. The FME is working on guidance to be provided to staff for performing supervisory reviews of the risks. Currently each bank is reviewed under the SREP process and additional capital requirements are imposed as warranted by the bank’s risk. Procedures (checklists) have been developed to guide staff in the review of certain risks (credit, liquidity). Additionally from information collected from the banks an automated report is produced with key risk indicators and peer-comparisons, this is combined with the ICAAP reviews in SREP. A forward looking perspective is added by the use of stress testing and reviewing the banks’ business plans during SREP.

43. When conducting targeted reviews supervisors develop questionnaires and refer to EBA/BCBS documents for requirements and guidelines to formulate the questions and assess the risk. Questionnaires are maintained in a centralized database so that other staff preparing their questionnaires for upcoming supervisory activities can draw information to build their questionnaire/checklist. Developing procedures for risk analysis and standards would facilitate the supervisory process and allow for deeper, more efficient and prompt reviews.

44. The feedback cycle with the banks does not provide timely information to banks on the FME’s assessments; additionally the feedback loop should include meetings with the Board of Directors. There can be a significant time-lag from the time a report is filed with FME or the FME concludes a supervisory review and the time that the bank receives feedback. Additionally, the process of providing feedback tends to be mainly through correspondence and does not include recurring meetings with the full Board and senior management to discuss the

condition of the bank and the FME supervisory process and the results of significant supervisory activity. A meeting with the full Board is held at the conclusion of the SREP process.

45. Risk-based supervision effectiveness is dependent on informed, qualitative judgments made by qualified and experienced staff. The lack of internal guidance/methodology and regulatory guidelines for reviewing individual risks and for making judgments on the overall condition of the institution when all risk factors are considered will affect the effectiveness of the risk-based assessment. The lack of guidance may also result in conflicting conclusions/recommendations to banks on the same issue.

Corrective and Sanctioning Powers of Supervisors (CP 11)

46. FME has a wide capacity to impose fines and to revoke licenses – both instruments have been used several times - but its early action powers are limited. In general its capacity to act before limits and laws are actually breached is mostly limited to what the authority can do under the SREP process, and the understanding that “minimum” under Art. 84 of Act 161 means supervisory minimum. FME lacks important tools regarding its capacity to suspend distribution of dividends, bar individuals from the banking sector, and has few tools to make board accountable. Banks comply with FME’s requests, but in practice the current situation is quite extraordinary – all major banks have been restructured and have to comply with additional requirements, and all boards are professional rather than appointed by more profit-maximizing shareholders. This situation may change in the future. In the past experience, banks feel emboldened and would argue to the letter of the legal text instead of its spirit and substance. FME must be granted a stronger legal basis for swift early action, including all the tools listed in the Core Principles, which can be taken according with the gravity of the situation and on a timely and expeditious way. In addition, important tools, although to be used only in emergency situations, had been granted through Interim Provision VI, which at the time of the assessment had expired.⁹ These tools should be given to FME on a permanent basis.

Consolidated and Cross-Border Banking Supervision (CPs 12- 13)

47. The legislative framework provides FME with supervisory authority to conduct consolidated supervision. The structure of banks in Iceland is holding-company oriented and there are no financial conglomerates, banking groups or cross-border establishments. The holding companies are one-bank only. The FME performs its supervision on a consolidated basis and regularly reviews compliance with the prudential standards and the other regulatory requirements established by the law and the regulations.

48. The FME does not have a cross-border home or host supervisory role due to the lack of cross-border establishments. However, laws and regulations provide the FME authority

⁹ After the mission, authorities have informed measures have been re-enacted until December 2015 by Act 29/2014, on April 4, 2014.

to share information with foreign supervisors. The FME has signed a number of MoUs and routinely participates in supervisory groups in the EU and EEA involved in developing international best practices.

Corporate Governance (CP 14)

49. The FME has not issued rules or guidance outlining for banks its expectations on sound governance practices but monitors compliance with guidelines issued by the Iceland Chamber of Commerce. The FME reviews banks' business plans and discusses risk appetite with banks but has not issued its own guidelines so that banks address primary objectives set by FME. Although the European Banking Authority (EBA) has issued Internal Governance guidelines and the FME may refer to them in discussions with banks, it is important for FME to clarify standards to be applied and enforced. There is also a need to develop a methodology for staff on assessing the adequacy of corporate governance in relation to the bank's risk profile.

Prudential Requirements, Regulatory Framework, Accounting and Disclosure (CPs 15-29)

50. The banks in Iceland are well capitalized after the crisis, and the supervisor has been actively imposing Pillar 2 requirements based on the banks ICAAP process. However, processes for application, analysis of validation, approval and constant monitoring of advanced approaches of Basel II are yet to be developed, and the authority is still developing guidelines on the ICAAP submission, risk management and internal control requirements that substantiate Pillar 2 requirements. Banks have no good guidance in what is expected of them in terms of ICAAP. This situation permeates supervision of risk management in nearly all risks.

51. There is a general lack of requirements issued to banks on risk management policies. The FME has not issued detailed guidance or standards to banks on its expectations as to what constitutes adequate operating risk management policies and procedures.

52. With the aid of an external consultancy, the FME did substantial work in 2009-2011 in correcting deficiencies in the credit practices of the three large banks. However; the requirements of the sign-off project were not transposed into regulatory requirements at the conclusion of the project. The FME monitors credit trends and spot checks bank practices as part of its supervisory process. However; there is a lack of processes and procedures for review of banks' credit risk. FME has not issued detailed rules or other requirements on what banks should address through risk management policies.

53. Since the crisis the FME has been focused on addressing problem loans in the system and ensuring that they are properly identified and accounted for. In addition, the FME has had to adjust monitoring to include the special programs put in place by the government to aid troubled borrowers. The first part of the initiative was to ensure the three restructured banks valued and recorded their collateral properly, all connected lending was identified, loan pricing improved and provisions established (sign-off project). The FME has now

issued special rules and standards through the Loan Portfolio Analysis Report (LPA) for monitoring the restructured loans, forbearance and valuation as a result of post-crisis programs.

54. While the process above has been appropriate in the immediate post-crisis period, there is a need for the FME to focus on building a problem loan supervisory framework.

The FME onsite work reviewing the banks' classification and management of problem loans has had a positive impact on the valuation and reporting of problem loans. However, going forward, there is a need for issuing rules on: risk rating of loans, clarifying what constitutes a cured loan, factors determining impairment and valuation of collateral. These would be developed in collaboration with accountants and the banks.

55. Regarding supervision of large exposures, much has been achieved in the past years, although more needs to be done regarding concentration risk and related party lending.

The regulatory and supervisory framework for large exposures has greatly improved since the collapse of the banks. FME has been given discretionary powers to connect exposures that compose the limits and controls, and has effectively been using them. Regarding more general concentration risk, more needs to be done. In practice, FME has been discussing sector and geographic concentration in more detail with the largest banks, but in fact there is no requirement or guidance on the management of concentration risk. The legal and regulatory framework for related party transactions is fragmented and incomplete. There is no single definition of related parties, the closer to international standards being the definition used in FME's 2010 guideline – which is not binding. Contrary to the existing provision regarding connected parties, the supervisor has no discretion to apply a broad definition of related party. Existing limits, risk management and policy requirements mostly regard members of the Board. The supervisor has no power to set limits, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. Authorities must review the related party framework, broadening the base definition and allowing FME's discretion, and establishing requirements as per these essential criteria in laws or regulations which are legally binding.

56. The FME and the Central Bank of Iceland (CBI) closely collaborate on market risk analysis, however; there is a need for FME to develop internal procedures for the valuation of market risk.

There is also a need to issue guidelines and standards to banks on the management of market risk and on the development of internal risk management policies and procedures. Currently, the CBI has issued rules and monitors banks' foreign exchange activities while the FME focus is on the setting of capital requirements and the ICAAP/SREP review.

57. The FME reviews interest rate risk in the banking book (IRRBB) as part of market risk analysis.

The FME reviews IRBBB through stress testing, repricing gap analysis and quarterly reports on the impact on capital of a parallel shift in the interest rate curves of 100 and 200 basis points. During the SREP process parallel shifts of 200 basis points for non-ISK, 240 basis points for indexed ISK and 400 basis points for non-indexed ISK. These reviews provide the FME with a quantitative measure of IRRBB.

58. The FME devotes significant attention to liquidity and works with the CBI in a joint technical working group addressing liquidity issues. After the collapse of the commercial banks in 2008, the CBI's liquidity rules were reviewed, and revised rules adopted incorporating new requirements for liquidity ratios in foreign currencies. Among other provisions in the new rules, liquidity requirements now extend to off-balance sheet items and apply to credit institutions at the group level. Furthermore, in their liquidity management, credit institutions are subjected to tighter requirements as regards their reliance on liquidity lines. The purpose of the new rules on foreign currency liquidity is to reduce liquidity risk in foreign currencies, which proved to be one of the most significant risks during the run-up to the 2008 collapse.

59. During onsite inspections the FME does not perform a detailed review of banks' internal controls. The FME has not developed onsite inspection procedures to assess banks' internal control systems. Additionally, enforceable guidelines or standards providing banks with the FME expectations for components of an internal control system have not been developed.

60. The FME lacks authority to require a bank to replace an external auditor it considers unqualified or doing an improper job. Additionally, the FME lacks authority to require an expansion of the audit scope when it is considered inadequate. The interactions between the FME and external auditors are infrequent. A protocol for collaboration and exchange of information should be developed.

Table 1. Summary Compliance with the Basel Core Principles - ROSC

Core Principle	Comments
1. Responsibilities, objectives and powers	<p>The institutional and regulatory framework for banking supervision is complex. It is unclear at this point if enactment of CRD IV will provide FME with some of the powers it lacks.¹⁰ Current legal framework seems to describe FME competencies with a compliance-based focus instead of the discretion needed for risk-based approach. While there is strong cooperation between CBI and FME (see CP 3), there are still gray areas regarding responsibilities. It is unclear, for instance, whether the corrective action powers of FME could be triggered by breaches in the LCR requirement, and which institution should initiate action in such cases. Whatever the institutional arrangement decided by the authorities, it is important the FME has the power to supervise liquidity risk management within its ongoing supervision and SREP process, and be able to supervise individual bank's liquidity risk compliance and management and apply adequate corrective actions early on.</p> <p>Current legal framework seems to describe FME competencies with a compliance-based focus instead of the risk-based approach it will need to adopt to be an effective supervisor.</p>

¹⁰ After the mission authorities have informed a bill of law under discussion in Parliament would grant FME some of these powers.

Core Principle	Comments
	<p>The fact that prudential legislation and regulation is mostly dependent on governmental action undermines the timeliness of regulatory update, and in practice may prevent FME to respond adequately if there are conflicting interests between the government and prudential supervision. Besides only being able to propose legislation through the MoFEA, the regulatory powers of FME are limited to the extent that it is only allowed to issue rules if explicitly commanded to do so by the legislation. This has seemingly led to the situation where FME relies on the issuance of guidelines not only to clarify to the banks its supervisory expectations, but to detail and interpret where law and regulation is too general. However, such guidelines are not legally binding. In a society very keen in its counter-argument and contestation rights, such inadequate legal and regulatory framework unnecessarily slows supervisory action, creates regulatory uncertainty and regulatory gaps which banks sometimes exploit, and uses up scarce supervisory resources.</p> <p>In addition, while FME has several tools for corrective actions, some important tools in a crisis situation are only available per Interim Provisions VI of Act 161. At the time of the mission the provisions had expired and had not been reenacted, which only occurred after this assessment.¹¹</p>
<p>2. Independence, accountability, resourcing and legal protection for supervisors</p>	<p>The legal framework imbeds the potential of political interference, as members of the Board who make major decisions are political appointees, and the Minister is responsible for submitting all FME-related legislation to Parliament, including the budget. A draft bill of law in discussion in parliament would further open the potential for political interference, as it mandates the end of earmarked resources for supervision – the fees collected by FME would be directed to the general treasury.</p> <p>Although the number of staff is likely adequate, training and system development needs are paramount if the institution is to be recognized for its competence. The institution is still adjusting to the rapid and much needed growth after the banking crash and the internal reorganization implemented in 2012/13 (after recommendation from an external consultant). About half of the staff has been in the entity for 5 years or less, and only a handful of employees have had over 10 years supervisory experience. As the economy and the financial sector recover, the chances that staff is hired by the private sector increase, therefore FME needs to develop a sound strategy to retain staff: attractive salaries and career path, training and development programs, perhaps mentoring programs and partnerships with foreign supervisors.</p> <p>The law does not state independence of the FME, nor is there a fixed minimum term for the Director General. The legal framework does not explicitly protect the supervisor against lawsuits.</p>

¹¹ After the mission, authorities have informed measures have been re-enacted until December 2015 by Act 29/2014, on April 4, 2014.

Core Principle	Comments
	<p>These deficiencies were not considered material as there is no public perception or evidence of influence of government or industry in the actions or decisions of FME, or integrity of staff. The occasion when a Minister requested the removal of the Director General has been considered an extreme crisis circumstance (as all the Board and the Minister also resigned). In addition, in practice there have been no cases of lawsuits against individual supervisors.</p> <p>However, it is important that such deficiencies are corrected in the legal framework in order to guarantee operational independence for the supervisor, and that the FME invests in staff development in order to build professional expertise – and retain it.</p>
3. Cooperation and collaboration	<p>The FME is the supervisor of the financial system, including insurance and securities and close collaboration channels have been established with domestic and foreign supervisors. A collaboration agreement has been signed between the Central Bank of Iceland (CBI) and the Financial Supervisory Authority (FME) and work between the two entities includes permanent working groups reviewing macro-micro issues that feed into the supervisory process. Additionally, a MoU was signed between the Prime Minister’s Office, the Ministry of Finance and Economic Affairs, FME and CBI on participation on the Committee on Financial Stability.</p>
4. Permissible activities	<p>The permissible activities of licensed banks are well defined and the use of the word “bank” controlled.</p>
5. Licensing criteria	<p>Assessors reviewed more recent licensing files and internal manuals and procedures. It must be noted, however, that given the extraordinary conditions in which the most licenses were given (restructuring of the sector following the collapse in 2008), FME has not yet used the procedures in “normal” circumstances regarding banks.</p>
6. Transfer of significant ownership	<p>Although the definition of qualified holder and control includes a qualitative assessment of “other holding which enables the exercise of a significant influence over the management of the company concerned,” in practice most processes, systems, monitoring and supervisory action is exclusively based on the quantitative thresholds. In a recent situation, a qualified holder’s participation in a bank was reduced below the threshold, and FME has worked under the assumption that the bank has no major shareholder. This very mechanistic interpretation of the law by FME hinders its effective monitoring in action in other aspects as well (see CP 20).</p>
7. Major acquisitions	<p>Assessors were provided access to various requests for authorization for holding ancillary activities, and the FME’s use of its capacity to qualify acquisitions as temporary. This has been in practice the best tool to prevent excessive exposure in non-banking activities.</p> <p>The authorization and notification framework is based on the concept of qualifying holding. Again, as mentioned in CP 6, the concept used in practice by the supervisors is narrower than what the law allows for, and information reports and monitoring systems are based on the quantitative thresholds. Therefore, acquisitions below qualifying holding threshold, even when they mean effective control, and even if they are on non-banking entities, or in entities abroad, may fall under the radar. Given the small number of banks and</p>

Core Principle	Comments
	the intensive work carried by FME to identify close links under Art. 18 of Act 161, brought about by the recent experience of the country with undesirable connection between companies and banks, has somewhat mitigated this deficiency in practical terms, but this needs to be corrected. In addition, the criteria used by the supervisor to approve applications needs to be clarified in rules and guidelines.
8. Supervisory approach	<p>The FME needs to map all qualitative and quantitative prudential and legal requirements under the scope of its supervision and determine if and how each condition is monitored. There is a need to complete the current reform program on the risk-based supervisory framework and improve the drawing of conclusions from its offsite financial analysis.</p> <p>Procedures to aid staff in the analysis of individual risks need to be developed to increase the depth of analysis and improve efficiency. The feedback cycle with the banks does not provide timely information to banks on the FME's assessments; additionally the feedback loop should include meetings with the Board of Directors.</p>
9. Supervisory techniques and tools	<p>The FME employs a mix of onsite inspections and offsite monitoring to supervise banks. However; the effectiveness of supervisory techniques and tools is adversely impacted by the following:</p> <ul style="list-style-type: none"> • A lack of detailed policies and procedures to aid in the performance of inspections and offsite analysis. • A lack of detailed regulations concerning requirements on corporate governance and risk management. • A need for increased communication and interaction with Boards and senior management. • Need to improve offsite analysis of financial indicators and other reports submitted by banks and produce executive summaries for FME senior management with overall assessment of bank condition, pending issues, planned supervisory activities, scheduled meeting with the Board any action required from FME management. • The follow-up and corrective process following deficiencies identified in the performance of supervisory activities is not always graduated based on the gravity of the deficiency. • Lack of FME authority to issue enforceable guidelines in all risk areas.
10. Supervisory reporting	<p>FME has full access to information and collects relevant information for its work. Analysis of the information collected is hindered by the fact that it is mostly done manually until the new automated systems and tools are fully functional. Given the small number of banks under supervision, this deficiency was not considered material. Fully developed systems will increase efficiency and allow scarce supervisory resources to be allocated in more analytical tasks (see CP 8 and 9).</p>
11. Corrective and sanctioning powers of supervisors	<p>FME has a wide capacity to impose fines and to revoke licenses – both instruments have been used several times. However, in general its early action capacity – before any law or regulation is actually breached- is limited to what the authority can do under the SREP process, and the understanding that “minimum” under Art. 84 of Act 161 means supervisory minimum. Imposing Art. 86 (convocation of a shareholder meeting, official recuperation plan, and</p>

Core Principle	Comments
	<p>revocation of license) based on this understanding of Art. 84 is not, however, completely clear under the law.</p> <p>FME lacks important tools regarding its capacity to suspend distribution of dividends, bar individuals from the banking sector, and has few tools to make board accountable.</p> <p>Banks comply with FME's requests, but in practice the current situation is quite extraordinary – all major banks have been restructured and have to comply with additional requirements, and all boards are professional rather than appointed by more profit maximizing shareholders. This situation may change in the future. In the past experience, banks feel emboldened by the tradition that all the authorities' actions need to be strictly based in law and regulations/rules, and given the culture of argument and contestation in the country, banks would argue to the letter of the legal text instead of the spirit and objective. FME must be granted a stronger legal basis for swift early action, including all the tools described in this core principle, which can be taken according with the gravity of the situation and on a timely and expeditious way. In addition, important tools, although to be used only in emergency situations, had been granted through Interim Provision VI, which at the time of the assessment had expired (see CP1). These tools should be given to FME on a permanent basis.</p>
12. Consolidated supervision	<p>The legislative framework provides FME with supervisory authority to conduct consolidated supervision. The structure of banks in Iceland is holding-company oriented and there are no financial conglomerates, banking groups or cross-border establishments. The holding companies are one-bank only. The FME performs its supervision on a consolidated basis and regularly reviews compliance with the prudential standards and the other regulatory requirements established by the law and the regulations.</p>
13. Home-host relationships	<p>The FME does not have a cross-border home or host supervisory role due to the lack of cross-border establishments. However, laws and regulations provide the FME authority to share information with foreign supervisors. The FME has signed a number of MoUs and routinely participates in supervisory groups in the EU and EEA involved in developing international best practices.</p>
14. Corporate governance	<p>There is a lack of processes and procedures for FME staff to review banks' compliance with existing laws, rules and recognized guidelines regarding corporate governance. Existing legislation on corporate governance is general and mainly provides a listing of items that should be addressed. Although the FME has issued Rule 670/2013 and under Article 19 of 161/2002 can recommend bank compliance with the Chamber of Commerce Corporate Governance Guidelines, these are general in nature. The FME has not issued standards detailing its expectations for banks' corporate governance policies. Although internally FME considers EBA corporate guidelines when assessing a bank's corporate governance regime, it has not issued a standard or rule communicating to the banks that it will follow and enforce the EBA guidelines.</p>
15. Risk management process	<p>There is a lack of FME methodology establishing processes and procedures for review and evaluation of banks' risk management process, including effective Board and senior management oversight. Current requirements from the FME are general in nature and do not provide sufficient guidance for banks. The lack</p>

Core Principle	Comments
	of issued guidance and clarity on FME methodology in conducting supervisions reduces the transparency to banks of FME expectations and processes.
16. Capital adequacy	The banks in Iceland are well capitalized after the crisis, and the supervisor has been actively imposing Pillar 2 requirements based on the banks' ICAAP process. However, the authority is still developing guidelines on the ICAAP submission, risk management and internal control requirements that substantiate Pillar 2 requirements. Banks have little guidance on what is expected of them in terms of ICAAP. The framework for the imposition of systemic risk charge is still pending CRD IV transposition into law. In addition, processes for application, analysis of validation, approval and constant monitoring of advanced approaches of Basel II are yet to be developed, although the legal framework has established the possibility of use of advanced approaches based on internal measurements
17. Credit risk	The FME monitors credit trends and spot checks bank practices as part of its supervisory process. However; there is a lack of processes and procedures for review of banks credit risk on an ongoing basis. FME has not issued detailed rules or other requirements on what banks should have on risk management policies.
18. Problem assets, provisions, and reserves	Since the crisis the FME has been focused on addressing the problem loans in the system and ensuring that they are properly identified and accounted for. In addition the FME has had to adjust monitoring to include the special programs put in place to aid troubled borrowers. The first part of the initiative was to ensure the three restructured banks valued and recorded their collateral properly, all connected lending was identified, loan pricing improved and provisions established (sign-off project). The FME has now issued special rules and standards through the LPAR for monitoring the restructured loans and valuation. While these steps have been appropriate in the immediate post-crisis period and have had a significant effect on the banks' problem asset management, there is a need for the FME to focus on building proper problem loan management requirements for non-crisis times.
19. Concentration risk and large exposure limits	The regulatory and supervisory framework for large exposures has greatly improved since the collapse of the banks. FME has been given discretionary powers to connect exposures that compose the limits and controls, and has effectively been using them. Regarding more general concentration risk, there is still much to be developed regarding risk management, monitoring, mitigation and control. In practice, FME has been discussing sector and geographic concentration in more detail with the largest banks, and including such discussion in the ICAAP process, including stress tests. Pillar 2 requirements have been imposed due to concentration risk in some banks. However, there is no requirement (laws do not mention concentration) or guidance on the management of concentration risk.
20. Transactions with related parties	The legal and regulatory framework for related party transactions is fragmented and incomplete. There is no single definition of related parties: articles 1, 55, 57 of Act 161 and the guidelines issued by FME use different concepts, the closer being the definition used in the guideline 1/2010 – which is not binding. Contrary to the existing provision regarding connected parties, as described in CP 19, the supervisor has no discretion to apply a broad definition of related

Core Principle	Comments
	party. Existing limits, risk management and policy requirements mostly regard members of the Board. The supervisor has no power to set limits, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. There are no requirements that the banks should have policies and procedures regarding identification, monitor, or control of transactions parties. There is no general requirement that transactions with related parties should not be granted on more favorable terms. Authorities must review the related party framework, broadening the base definition and allowing FME's discretion, and establishing requirements as per these essential criteria in laws or regulations which are legally binding.
21. Country and transfer risks	There are no requirements or guidance to banks regarding identification, measurement, evaluation, monitoring, reporting and control or mitigation of country risk and transfer risk. Although all risks in principle can be covered in the ICAAP and SREP process, there is no guidance for country and transfer risk to be included in the process. Since the banking crash and given the existing capital controls, country risk exposure of Icelandic banks is very limited. For one bank with more active foreign exposures, a one-site inspection was carried out and recommendations made. Although country risk is currently considered immaterial, Iceland will need a robust country risk framework when normality returns.
22. Market risk	There is a need to develop, implement and approve processes and procedures for the valuation of market risk and lay out criteria for appropriate market risk limits related to financial undertakings size and complexity. There is also a need to issue guidelines to banks on the management of market risk and on the development of internal policies and procedures. Currently the FME focus is on the setting of capital requirements and discussions surrounding the ICAAP/SREP review; a more intrusive analytical process should be implemented for ongoing supervision, including onsite reviews as appropriate.
23. Interest rate risk in the banking book	The lack of internal processes and procedures for review and evaluation of each bank's management, control, monitoring, strategy, policies, and processes relating to IRRBB and the lack of onsite work reduces the effectiveness of the analysis of IRRBB. The FME has not issued rules providing banks with guidance on the types of issues it expects to be addressed in bank policies.
24. Liquidity risk	The FME devotes significant attention to liquidity and works with the CBI in a joint technical working group addressing liquidity issues. After the collapse of the commercial banks in 2008, the CBI's liquidity rules were reviewed, and revised rules adopted incorporating new requirements for liquidity ratios in foreign currencies. Among other provisions in the new rules, liquidity requirements now extend to off-balance sheet items and apply to credit institutions at the group level. Furthermore, in their liquidity management, credit institutions are subjected to tighter requirements as regards their reliance on liquidity lines. The purpose of the new rules on foreign currency liquidity is to reduce liquidity risk in foreign currencies, which proved to be one of the most significant risks during the run-up to the 2008 collapse.
25. Operational risk	There is no specific requirement for banks to have operational risk management strategies, policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk. There are some Guidelines No. 1/2012

Core Principle	Comments
	<p>on Information Systems and outsourcing of internal audit and compliance functions. Although non-binding, they are usually complied with and can be used as basis for the supervisory review process.</p> <p>Operational risk is mainly reviewed in relation with the capital adequacy in the banks' annual ICAAP reports and during the SREP review. Assessors have seen evidence that FME has, in recent SREP processes, actively discussed operational risk management and processes and required the banks to increase capital related to operational risk, in particular legal risks. However, banks have no instructions on how to implement operational risk management structures, or what is expected of them during the ICAAP process. Most importantly, perhaps, addressing operational risk management deficiencies mostly through capital adequacy is inappropriate – operational risk monitor, control and mitigation is ultimately much more relevant for the soundness of the bank than the capital coverage for such risk.</p>
26. Internal control and audit	There is a lack of established methodology in FME for reviews and evaluation of each bank's management of internal controls. Regular, formal and informal, communication need to be improved between the FME and the internal control functions of the banks.
27. Financial reporting and external audit	The FME lacks authority to require a bank to replace an external auditor it considers unqualified or doing an improper job. Additionally, the FME lacks authority to require an expansion of the audit scope when it is considered inadequate.
28. Disclosure and transparency	Banks are required to regularly publish information that is easily accessible and reflects their financial position, as well as qualitative information on risk, governance and processes.
29. Abuse of financial services	FME has stepped up its supervision of AML/TF and general use of banking system for criminal activities following FAFT/GAFI reports. Assessors were given access to examination reports focused on the topic, which had happened for the first time since the crisis, covering two off-site surveys and three on-site visits to banks. The regulatory framework still needs further adjustments; in particular, there is no requirement that banks report suspicious activities not only to the Police but also to the FME, and the general guidance related to CDD needs to be adjusted to reflect FAFT recommendations regarding identification of ultimate beneficiaries by banks.

RECOMMENDED ACTIONS AND AUTHORITIES' COMMENTS

A. Recommended Actions

Table 2. Recommended Actions

Recommended Actions to Improve Compliance with the Basel Core Principles and the effectiveness of regulatory and supervisory frameworks	
Reference Principle	Recommended Action
Principles 1, 2, 11	<p>Ensure planned legislative amendments clarify the roles regarding banking supervision of liquidity risk, including corrective action.</p> <p>Ensure planned legislative amendments clarify FME actions in the enforcement of buffers.</p> <p>Ensure planned legislative amendments do not affect operational independence of the FME, in particular regarding budgetary allocation.</p> <p>Amend legal framework giving FME explicit capacity to increase prudential requirements based on the individual risk profile of banks and enforce risk based (instead of compliance-based) supervision.</p> <p>Amend legal framework to provide FME with corrective tools as enumerated in EC 4, which can be taken according with the gravity of the situation and on a timely and expeditious way, before the financial situation of banks is seriously deteriorated.</p> <p>Amend legal framework giving FME explicit and broader powers to issue binding rules so that prudential requirements can be timely updated and enforced.</p> <p>Amend legal framework providing FME permanently with the tools that existed under Interim Provision VI.</p> <p>Amend legal/regulatory framework defining a mandate for the head of FME.</p> <p>Develop training, and a human resource strategy including salaries and career path, among other elements, in order to develop and retain qualified staff.</p>
Principles 5, 6, 7	<p>Amend processes, systems and practices in order to use the full definition of qualified holder, beyond the mere quantitative thresholds.</p> <p>Define criteria used by supervisor to approve applications .</p>
Principles 8, 9, 14, 15, 16, 17, 18, 21, 22,23, 25, 26	<p>Develop rules and guidelines for banks on the benchmarks, standards and procedures that the FME will follow in determining the adequacy of bank's risk management and governance systems.</p> <p>Develop internal methods and guidelines for FME staff to be used in analyzing banks' practices in risk areas.</p>
Principles 9 and 10	<p>Finalize development of automated analysis (data quality verification) of reports received.</p> <p>Produce risk reports from offsite analysis summarizing the bank's overall condition and main risks, financial trends, status of any pending actions and addressing pending issues and upcoming supervisory events.</p> <p>Consider holding an annual meeting with the full Board of Directors to discuss results of FME supervision and its overall assessment of the bank's financial condition.</p>

Principle 18	<p>Develop definitions for “cured” loans</p> <p>Adopt rules detailing requirements for banks’ loan policies and internal loan review and classification systems.</p> <p>Develop guidelines for FME staff on assessing loan quality, and adequacy of repayment source to have discussions with banks on adequacy of provisioning and assessing the adequacy of banks’ loan review systems.</p> <p>Issue rules or regulations on loan classification and provisioning, views on events or factors that provide objective evidence of impairment to strengthen FME’s authority to require provisions and define default.</p>
Principle 20	<p>Establish in law or regulation or rule a definition of related parties as defined in the Core Principles, and include FME’s discretion to apply a broader definition on a case by case basis.</p> <p>Introduce limits or the requirement of limits, policies and controls for all related parties</p> <p>Introduce law/regulation/rule requiring that transactions with related parties should not be granted on more favorable terms.</p>
Principle 27	<p>Review legislative options to address the FME lack of authority to require a bank to replace an external auditor it considers unqualified or doing an improper job and to require an expansion of the audit scope when it is considered inadequate.</p>
Principle 29	<p>Introduce requirement that banks report suspicious activities not only to the FIU but also to FME.</p> <p>Amend guidelines to ensure banks use the correct definition in the identification of ultimate beneficiaries</p>

B. Authorities’ Response to the Assessment

FME welcomes the assessment of the regulation and supervision of the Icelandic banking sector and intends to draw on the recommendations stated in the report to improve the regulation and supervision of the banking sector in Iceland.

In general FME shares the views expressed in the assessment. However, FME would like to stress the following:

Principles 1, 2, 11

Due to Iceland’s membership of the European Economic Area (EEA), it must transpose into Icelandic law the substance of Directives, Regulations and Technical Standards that apply to the financial market and that have been adopted by the EU. FME is participating with the Ministry of Finance and Economic Affairs in preparing for the implementation of the CRD IV and CRR (Directive 2013/36/EU and Regulation (EU) 575/2013). A bill of law, partially implementing Directive 2013/36/EU, has already been introduced to Parliament and is expected to be acted into Icelandic law in 2014. The legislation will among other things result in higher minimum capital ratios, a higher requirement for common equity Tier 1 capital, i.e. introduction of a capital

conservation buffer. A subsequent bill of law, implementing the remainder of CRDIV/CRR is expected to be introduced to Parliament before the end of 2014. Work is in progress regarding clarification of roles on the supervision of liquidity risk.

FME takes note of the recommendation to strengthen the legal framework for the structure of FME and its independence. Regarding budgetary allocation and possible effect on FME's operational independence, FME has raised its concerns that the bill of law on abolition of earmarked taxes will, if adopted, mark the end of reserved resources for supervision.

FME takes note of the recommendations made in the assessment regarding training, and a human resource strategy including salaries and career path, among other elements, in order to develop and retain qualified staff.

FME takes note of the comment that it has relatively limited regulatory powers and that the situation may restrict its operations. FME will inform the legislator accordingly. In doing so FME will especially emphasise the recommended amendments to the legal framework regarding increased prudential requirements, corrective tools, and explicit and broader power to issue binding rules.

The Ministry of Finance and Economic Affairs has established a working group charged with preparing proposals for a legal framework on the resolution and recovery of financial undertakings. The intention is to permanently put in place a legal framework that will replace Interim Provision VI of Act No. 161/2002 and implement the new European Union Directive on Recovery and Resolution of credit institutions and investments firms.

Principles 5, 6, 7

Regarding recommended changes of processes, systems and practices in order to use the full definition of qualified holder, beyond the mere quantitative thresholds it is the opinion of FME that the legal framework of Act no. 161/2002, in particular point 3 in paragraph 1 of Article 1. a, allows for the interpretation that a shareholder will be perceived as a qualified owner even though he owns less than 10 percent shares in a bank, if it can be presumed that he exercises significant influence on the management of the company concerned. Furthermore, guidelines, processes etc. also request information on close links and other relationships, therefore FME does not only use quantitative thresholds.

Regarding definition of criteria used by the supervisor to approve applications it shall be mentioned that a criteria has been defined regarding licensing and qualified holders, as has been thoroughly explained in FME's self-assessment.

Principles 8, 9, 14, 15, 16, 17, 18, 21, 22, 23, 25, 26

FME has been developing and will further develop guidance for banks on the benchmarks, standards and procedures the authority will follow in determining the adequacy of bank's risk management and governance systems. As a main principle and where applicable FME will directly refer to EBA guidelines.

Regarding development of internal methods and guidelines for FME staff to be used in analysing banks' practices in risk areas, FME has in place a restructuring plan covering these issues to be finalised before end of the year 2016.

Principles 9 and 10

Further improvement of the automated analysis of reports received is an integrated part of the restructuring plan.

Regarding risk reports from offsite analysis, FME will follow the recommendations made in the assessment.

FME takes note of the recommendation in the assessment to hold regular annual meetings with the full Board of Directors to discuss results of FME's supervision and its overall assessment of a bank's financial condition. FME will, from now on, hold such regular meetings with systemically important banks.

Principle 18

FME has already started work to cover the recommended issues, including rules directed to banks on loan classification and provisioning and guidelines for FME staff on assessing loan quality. FME has already defined the term "cured" loans.

Principle 20

FME will bring to the attention of the legislator the mismatch between the current legislation and the definition of related parties in the BCP principle 20 as well as recommendation on wider discretion to apply a broader definition on a case by case basis. The same applies to the issue that transactions with related parties should not be granted on more favourable terms.

FME endorses the recommendation that the authorities must review the related party framework and intends to do so.

Principle 27

FME will inform the legislator of the recommended amendments regarding its lack of authority to require a bank to replace an external auditor it considers unqualified or doing an improper job and to require an expansion of the audit scope when it is considered inadequate.

Principle 29

61. FME has in June 2014 adopted new guidelines where the relevant issues regarding the definition and identification of ultimate beneficiaries has been addressed. With regard to the recommendation that banks are required to report to FME on suspicious activities related to AML issues, FME refers to board's and managing director's obligation to this respect established in Art. 52c of Act No. 161/2002.